

# FIRST GLOBAL

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## India Research



**Sector: Technology (Software Services)**

**Update**

**Downgrade** ↓

***Mahindra Satyam Computer Services Ltd. (SCS.IN/SATY.BO)***

**To**

***Market perform with Underperform bias***

*CMP: Rs. 91.3, Mkt. Cap: Rs.107.4 bn, \$2.4 bn (Oct. 1,'10)*

*Relevant Index: CNX Nifty: 6,143.4 (Oct. 1,'10)*

***The disappointing numbers increase probability of an adverse merger ratio vis-à-vis Tech Mahindra***

***Business outlook, salary hikes & higher attrition rate to limit significant margin recovery ahead...***

*Last report's recommendation: Buy (MP: Rs. 108.5, Dec.10' 09)*

*Relevant Index: CNX Nifty: 5,134.7 (Dec.10' 09)*

*Relative performance since last rating change (Jun 9,'09)*

*Nifty: Up 35.0% Mahindra Satyam: Up 36.7%*

**October 01, 2010**

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**IMPORTANT DISCLOSURES CAN BE FOUND AT THE END OF THIS REPORT**



# Price and Ratings History Chart

## Ratings Key

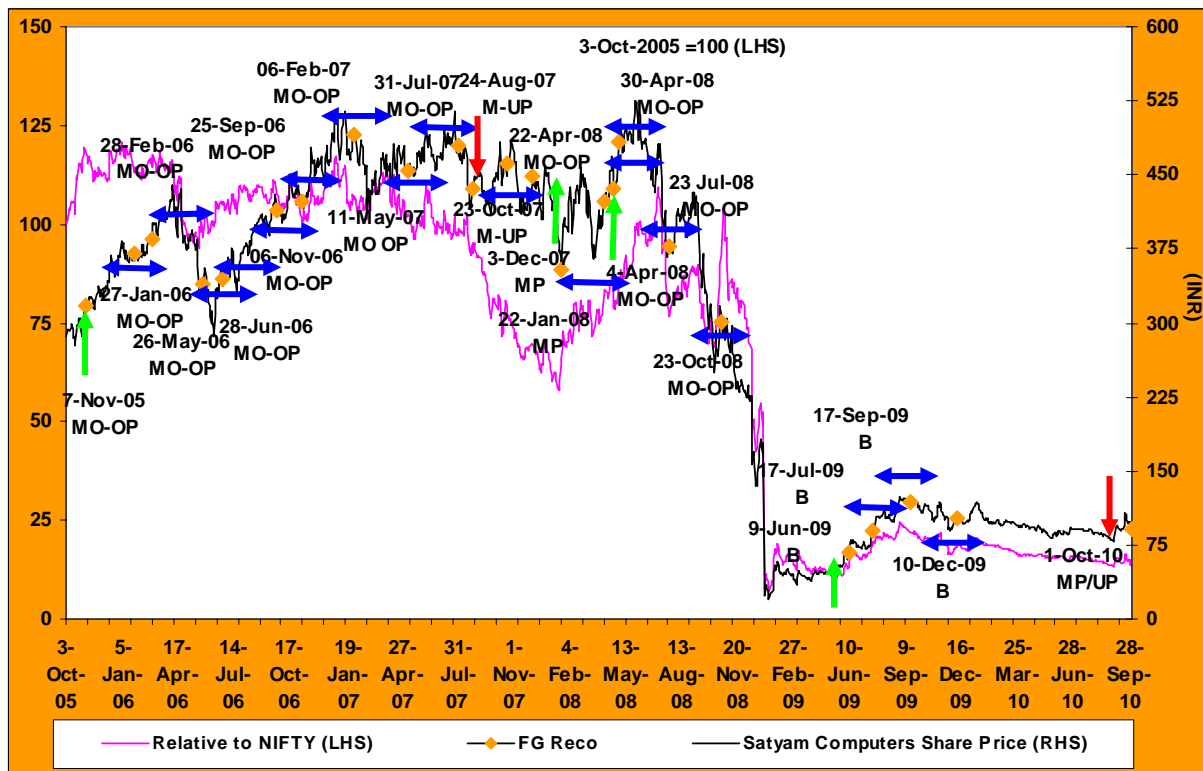
Positive Ratings	B = Buy	BD = Buy at Declines	OP = Outperform
	S-OP = Sector Outperform	M-OP = Market Outperform	MO-OP = Moderate Outperform
Neutral Ratings	H = Hold	MP = Market Perform	SP = Sector Perform
Negative Ratings	S = Sell	SS = Sell into Strength	UP = Underperform
	A = Avoid	MO-UP = Moderate Underperform	S-UP = Sector Underperform

ST: Short Term

MT: Medium Term

LT: Long Term

### Mahindra Satyam Computer Services Ltd. (SCS.IN/SATY.BO)



Represents an Upgrade



Represents a Downgrade



Represents Reiteration of Existing Rating

Details of First Global's Rating System given at the end of the report



## Financial Snapshot

### Key Financials

YE March (Rs. mn)	FY08	FY09	FY10	FY11E	FY12E
<b>Total Revenues</b>	<b>84,735</b>	<b>88,126</b>	<b>54,810</b>	<b>59,360</b>	<b>65,092</b>
<i>Revenue Growth (Y-o-Y)</i>	30.7%	4.0%	(37.8%)	8.3%	9.7%
<b>EBIDTA</b>	<b>18,348</b>	<b>3,017</b>	<b>4,569</b>	<b>7,746</b>	<b>9,248</b>
<i>EBIDTA Growth (Y-o-Y)</i>	19.3%	NA	51.4%	69.5%	19.4%
<b>Net Profit</b>	<b>16,879</b>	<b>(81,768)</b>	<b>(1,246)</b>	<b>5,913</b>	<b>7,157</b>
<i>Net Profit Growth (Y-o-Y)</i>	20.2%	NA	NA	NA	21.0%
<b>Net Profit Excl. extra-ordinaries</b>	<b>16,879</b>	<b>(1,848)</b>	<b>2,923</b>	<b>5,913</b>	<b>7,157</b>
<i>Net Profit Growth Excl. extra-ordinaries (Y-o-Y)</i>	20.2%	NA	NA	102.3%	21.0%
<b>Shareholders Equity</b>	<b>72,392</b>	<b>(8,800)</b>	<b>18,809</b>	<b>25,294</b>	<b>34,147</b>
<b>Adjusted number of Diluted shares (mn)</b>	<b>683</b>	<b>674</b>	<b>1,176</b>	<b>1,176</b>	<b>1,176</b>

NA – Not Applicable

### Key Operating Ratios

YE March	FY08	FY09	FY10	FY11E	FY12E
<b>Diluted EPS (Rs.)</b>	<b>24.71</b>	<b>(121.33)</b>	<b>(1.06)</b>	<b>5.03</b>	<b>6.08</b>
<i>Diluted EPS Growth (Y-o-Y)</i>	17.8%	NA	NA	NA	21.0%
<b>Diluted EPS Excl. extra-ordinaries (Rs.)</b>	<b>24.71</b>	<b>(2.74)</b>	<b>2.48</b>	<b>5.03</b>	<b>6.08</b>
<i>Diluted EPS Excl. extra-ordinaries Growth (Y-o-Y)</i>	17.8%	NA	NA	102.3%	21.0%
CEPS Excl. extra-ordinaries (Rs.)	27.1	2.1	4.3	6.9	8.1
<b>EBIDTA (%)</b>	<b>21.7%</b>	<b>3.4%</b>	<b>8.3%</b>	<b>13.0%</b>	<b>14.2%</b>
<b>NPM (%) Excl. extra-ordinaries</b>	<b>19.9%</b>	<b>NA</b>	<b>5.3%</b>	<b>10.0%</b>	<b>11.0%</b>
Tax/PBT (%)	12.0%	NA	NA	12.0%	12.0%
<b>RoE (%) Excl. extra-ordinaries</b>	<b>25.5%</b>	<b>NA</b>	<b>58.4%</b>	<b>26.8%</b>	<b>24.1%</b>
<b>RoCE (%) Excl. extra-ordinaries</b>	<b>25.3%</b>	<b>NA</b>	<b>15.3%</b>	<b>17.7%</b>	<b>17.4%</b>
Book Value Per share (Rs.)	106.0	NA	16.0	21.5	29.0
Debt/Equity (x)	0.03x	NA	0.02x	0.02x	0.01x
Dividend Payout Ratio (%)	13.9%	0.0%	0.0%	0.0%	0.0%

NA – Not Applicable

### Free Cash Flow Analysis

YE March (Rs. mn)	FY08	FY09	FY10	FY11E	FY12E
Operating Cash Flows	9,205	15,105	5,762	5,665	7,870
Capex	6,207	2,857	-379	1,000	1,000
Total Free Cash Flows	3,864	NA	1680	4,990	7,271

### Valuation Ratios

YE March	FY08	FY09	FY10	FY11E	FY12E
<b>P/E (x)</b>				<b>18.2x</b>	<b>15.0x</b>
P/BV (x)				4.2x	3.1x
P/CEPS (x)				13.1x	11.2x
<b>EV/EBIDTA (x)</b>				<b>10.2x</b>	<b>7.5x</b>
Market Cap./ Sales (x)				1.8x	1.6x

Source: FG Estimates, Company Reports



**Market Cap. and Enterprise Value Data as on Oct 01,2010**

Current Market Price (Rs.)	91	
No. of Basic Shares (mn)	1,176	
	<b>Rs mn</b>	<b>US\$ mn</b>
<b>Market Cap</b>	<b>107,402</b>	<b>2,391</b>
Total Debt*	422	9
Cash & Cash Equivalents*	28,036	624
<b>Enterprise Value</b>	<b>79,788</b>	<b>1,776</b>

\* Debt & Cash & Cash Equivalents as of FY 10, INR Exchange Rate 44.92

<b>DuPont Model</b>					
<b>YE March</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11E</b>	<b>FY12E</b>
EBIDTA/Sales (%)	21.7%	3.4%	8.3%	13.0%	14.2%
Sales/Operating Assets (x)	3.1x	4.3x	8.2x	12.6x	16.3x
<b>EBIDTA/Operating Assets (%)</b>	<b>67.7%</b>	<b>14.8%</b>	<b>68.5%</b>	<b>165.0%</b>	<b>231.0%</b>
Operating Assets/ Net Assets(x)	0.4x	0.5x	0.3x	0.1x	0.1x
Net Earnings/ EBIDTA (%)	92.0%	NA	64.0%	76.3%	77.4%
Net Assets/ Equity (x)	1.0x	1.3x	4.3x	1.6x	1.4x
<b>Return on Equity (%)</b>	<b>25.5%</b>	<b>NA</b>	<b>58.4%</b>	<b>26.8%</b>	<b>24.1%</b>

NA – Not Applicable

<b>Common Sized Profit &amp; Loss Account</b>					
<b>YE March</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11E</b>	<b>FY12E</b>
<b>Total Revenues</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
Less:					
Cost of Revenues	62.1%	68.9%	72.6%	69.0%	67.8%
Operating and Administration Expenses	16.2%	27.7%	19.0%	18.0%	18.0%
<b>EBIDTA</b>	<b>21.7%</b>	<b>3.4%</b>	<b>8.3%</b>	<b>13.0%</b>	<b>14.2%</b>
Depreciation	1.9%	3.7%	3.9%	3.8%	3.7%
Interest Paid	0.2%	0.7%	0.6%	0.5%	0.4%
Non-Operating Income	3.2%	0.7%	1.9%	2.6%	2.4%
Extraordinary Expense	0.0%	90.7%	7.6%	0.0%	0.0%
<b>Profit Before Tax</b>	<b>22.6%</b>	<b>NA</b>	<b>NA</b>	<b>11.3%</b>	<b>12.5%</b>
Tax	2.7%	1.8%	0.4%	1.4%	1.5%
<b>Net Profit</b>	<b>19.9%</b>	<b>NA</b>	<b>NA</b>	<b>10.0%</b>	<b>11.0%</b>
<b>Net Profit Excl. extra-ordinaries</b>	<b>19.9%</b>	<b>NA</b>	<b>5.3%</b>	<b>10.0%</b>	<b>11.0%</b>

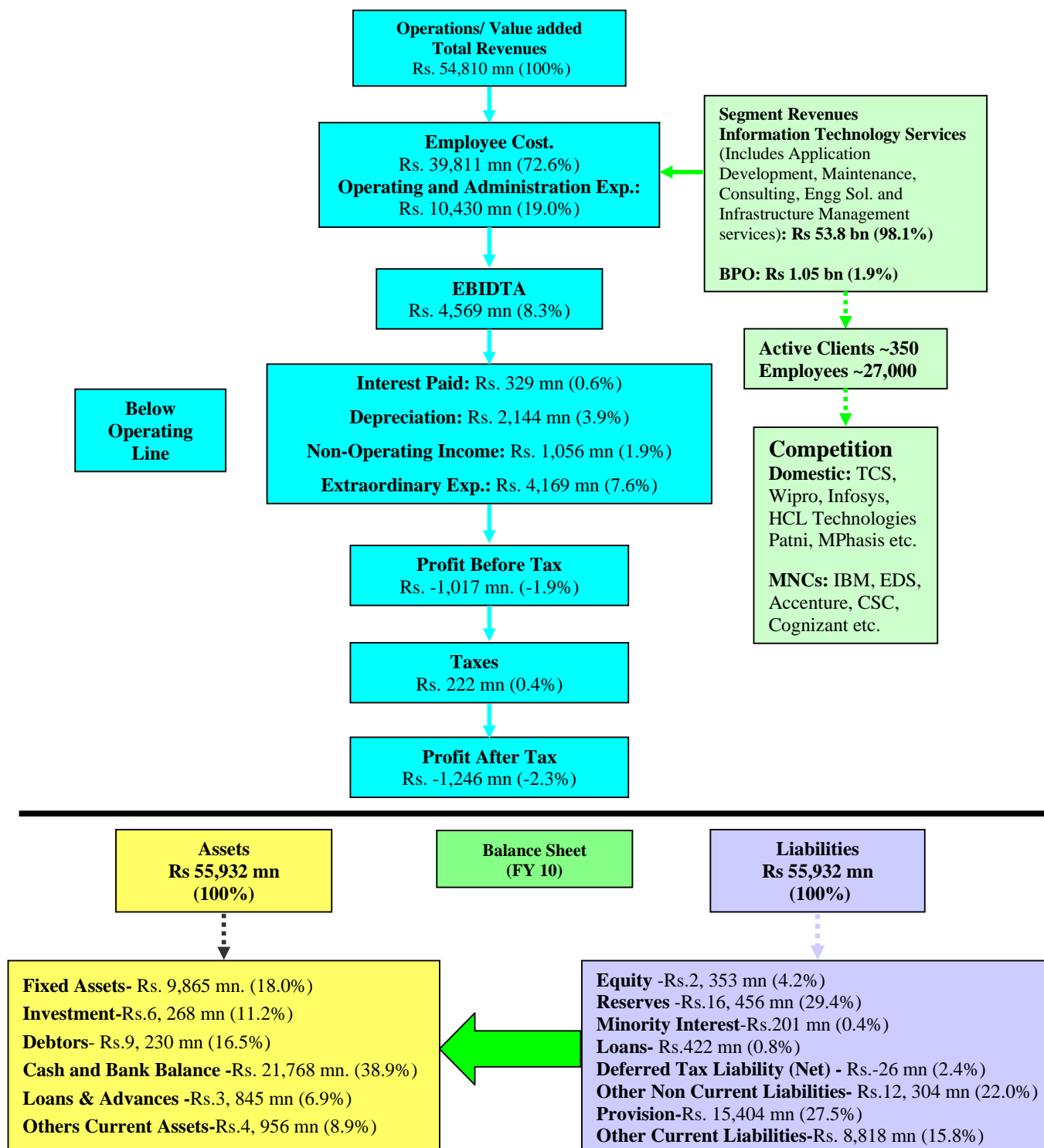
NA – Not Applicable

Source: FG Estimates, Company Reports



# Mahindra Satyam's Business in Pictures (FY10)

(All figures are in Rs. Mn except where stated otherwise) All percentages are percent of revenues, unless Otherwise stated)





## ***Reasons for Downgrade...***

- *Mahindra Satyam announced its numbers for FY09 and FY10, but did not provide any quarterly numbers and operating metrics (apart from number of employees & active clients). This does not provide much clarity regarding the company's performance and makes it very difficult to gauge the pace of recovery, going forward. A number of important questions still remain unanswered and the focus has now once again shifted to November 15, 2010*
- *The company posted a net profit and EPS (excluding extraordinaries) of Rs.2.92 bn and Rs.2.48 for FY10, which was much lower than our estimates of Rs.6.56 bn and Rs.5.6 respectively. This was in spite of its broadly meeting our revenue expectations.*
- *The EBITDA margin for FY09 and FY10 came in at 3.4% and 8.3% respectively, which were well below our as well as the Street's expectations*
- *The recent salary hikes undertaken by the company in order to curb rising attrition prevalent across the IT industry will limit any significant margin recovery ahead, despite the benefits of higher utilization and reduction in other overhead costs*
- *In spite of a significant recovery in the overall demand environment for IT services witnessed in the last couple of quarters, Mahindra Satyam may face an uphill task in driving a recovery in its revenue and profitability*
- *Most important, the adverse picture for Mahindra Satyam increases the risk of an adverse merger ratio vis-à-vis Tech Mahindra*



## *The Story...*

Mahindra Satyam Computer Services Ltd. (SCS.IN/SATY.BO) submitted its restated numbers for FY09 and FY10, without disclosing its quarterly numbers, and has indicated that the numbers for Q1 FY11 and Q2 FY11 will be out on November 15, 2010, which will provide clarity over the company's pace of recovery and future earnings growth. The company reported revenue of \$1.16 bn for FY10, which was in line with our as well as the Street's expectations. Total revenue for FY10 stood at Rs.54.8 bn, down 37.8 % Y-o-Y, and at Rs.88.13 for FY09. The EBITDA for FY10 came in at Rs.4.57 bn, up 51.4% Y-o-Y, and at Rs.3.02 for FY09. The EBITDA margin for FY09 and FY10 stood at 3.4% and 8.3% respectively, which were below our estimates, though there was a significant expansion of 490 bps in the EBIDTA margin for FY10 and we expect it to recover to the above 10% level in FY11E. For FY10, the company posted a loss of Rs.1.24 bn, while the profit, excluding extraordinaries, came in at Rs.2.92 bn. The diluted EPS for FY10 stood at Rs.-1.06, while the diluted EPS, excluding extraordinaries, came in at Rs.2.48. Mahindra Satyam incurred an extraordinary expense of Rs.79.9 bn and Rs.4.16 bn in FY09 and FY10, which were related to the fees paid for forensic investigations and litigation, restructuring expenses, erosion in the value of subsidiaries and prior period adjustments related to the scam. The company had cash & cash equivalents amounting to Rs.21.8 bn at the end of FY10. The company's total loans outstanding stood at Rs.422 mn in FY10. Management has indicated that the company had an active client base of around 350 clients in FY10 (as against less than 500 in FY09) and have added 44 new clients in FY10. Management has disclosed that the company had 45,000 employees at the end of FY09, which was reduced to 27,000 in FY10, and it planned to add 3,000 employees in FY11E.

*The EBITDA margin for FY09 and FY10 stood at 3.4% and 8.3% respectively, which were below our estimates, though there was a significant expansion of 490 bps in the EBIDTA margin for FY10 and we expect it to recover to the above 10% level in FY11E*

Mahindra Satyam's latest announcement appears encouraging and we believe that the company has done a credible job in terms of account restatement and cost control in FY10, thus placing itself firmly on the path to recovery. The disclosure of its financials now places Mahindra Satyam in a better position to bid for larger deals. However, the lack of disclosure on the operating metrics front

*Mahindra Satyam's latest announcement appears encouraging and we believe that the company has done a credible job in terms of account restatement and cost control in FY10, thus placing itself firmly on the path to recovery...*

*...we believe that the worst for Mahindra Satyam is now over and the company is all set to achieve a turnaround. However, in spite of a significant recovery in the overall demand environment for IT services witnessed in the last couple of quarters, we believe that Mahindra Satyam faces an uphill task in driving a recovery in its revenue and profitability*

(apart from the number of employees & active clients) and the absence of a clear view on the current business outlook, as well as pace of recovery, have come as a disappointment. Management has further indicated that the company is adding new clients and the client losses in the past were not very significant. In fact, Mahindra Satyam has added new client across all the predominant geographies and verticals (including wins from financial services customers in the US & Germany and a financial regulator in the Asia Pacific & UID project in India), which indicates that the company's core business strength remains intact and it is well poised for growth, going forward. We believe that the worst for Mahindra Satyam is now over and the company is all set to achieve a turnaround. However, in spite of a significant recovery in the overall demand environment for IT services witnessed in the last couple of quarters, we believe that Mahindra Satyam faces an uphill task in driving a recovery in its revenue and profitability. Moreover, the improvement in the industry's growth



prospects has led to an increase in employee attrition across the industry (evident from the sharp rise in attrition in recent quarters witnessed by all IT majors), which forced Mahindra Satyam to hike salaries by 25-30% in January 2010, thereby impacting its margins for FY10. We expect the salary hikes and higher attrition rate to limit any significant margin recovery ahead, despite the benefits of increased utilization and reduction in other overhead costs. Hence, we are making a downward revision to our revenue and EPS estimates. For FY11, we now estimate net revenue of Rs.59.4 bn and an EPS of Rs.5.03, as against our previous estimated EPS of Rs.8.6 on revenue of Rs.75.8 bn. We expect the company's net revenue to increase 9.7% to Rs.65.1 bn and the EPS to come in at Rs.6.08 for FY12E. The stock currently trades at a P/E and EV/EBITDA multiple of 18.2x and 10.2x FY11E earnings respectively. In view of the higher than expected margin pressure in FY10 and lower future visibility due to non-disclosure of the company's quarterly numbers and operating metrics plus the risk of an adverse merger ratio vis-à-vis Tech Mahindra, we now downgrade Mahindra Satyam from Buy to Market Perform with Underperform bias.

*We expect the salary hikes and higher attrition rate to limit any significant margin recovery ahead, despite the benefits of increased utilization and reduction in other overhead costs...*

*...in view of the higher than expected margin pressure in FY10 and lower future visibility due to non-disclosure of the company's quarterly numbers and operating metrics plus the risk of an adverse merger ratio vis-à-vis Tech Mahindra,, we now downgrade Mahindra Satyam from Buy to Market Perform with Underperform bias*

### Comparative Valuation

Company	YE	EPS (RS)		P/E		P/S		P/BV		EV/Sales		EV/EBITDA		EBITDA (%)	RoE (%)	RoCE (%)	Annual EPS Growth	Annual Sales Growth
		FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY11E	FY11E	(12/11)	(12/11)
<b>MAHINDRA SATYAM</b>	Mar	5.0	6.1	18.2	15.0	1.8	1.6	4.2	3.1	1.3	1.0	10.2	7.5	13.0%	26.8%	17.7%	21.0%	9.7%
TCS	Mar	40.3	46.1	23.9	20.9	5.3	4.5	7.2	5.9	5.3	4.5	18.0	15.4	29.4%	31.7%	30.3%	14.4%	17.0%
INFOSYS	Mar	124.4	146.6	24.9	21.2	6.4	5.4	6.3	5.2	5.9	4.8	17.3	14.2	34.0%	26.7%	26.7%	17.8%	18.6%
WIPRO	Mar	22.9	25.9	20.2	17.8	3.6	3.0	4.7	3.7	3.4	2.8	14.7	12.1	23.5%	25.5%	20.5%	13.0%	18.6%
HCLTECH	Jun	23.5	28.5	18.3	15.1	2.0	1.7	3.8	3.4	2.0	1.6	10.0	8.4	19.5%	20.7%	14.5%	21.1%	15.5%

Source: FG Estimates





## *Restated FY09- FY10 (Consolidated)*

### *P&L Numbers*

YE March (Rs. mn)	FY09	FY10	Y-o-Y change %
<b>Total Revenue</b>	<b>88,126</b>	<b>54,810</b>	<b>(37.8%)</b>
<b>Less:</b>			
Cost of Revenues	60,737	39,811	(34.5%)
Operating and Administration Expenses	24,372	10,430	(57.2%)
<b>Total Cost</b>	<b>85,109</b>	<b>50,241</b>	<b>(41.0%)</b>
<b>EBIDTA</b>	<b>3,017</b>	<b>4,569</b>	<b>51.4%</b>
Interest Paid	621	329	(47.0%)
Less: Depreciation	3,263	2,144	(34.3%)
Non-operating Income	631	1,056	67.4%
Extraordinary Expense	79,920	4,169	(94.8%)
<b>Profit Before Tax</b>	<b>(80,156)</b>	<b>(1,017)</b>	<b>NA</b>
<b>Profit Before Tax Excl. extra-ordinaries</b>	<b>(236)</b>	<b>3,152</b>	<b>NA</b>
Tax	1,590	222	(86.0%)
<b>Profit After Tax before Minority Interest</b>	<b>(81,746)</b>	<b>(1,239)</b>	<b>NA</b>
Minority Interest	(22)	(7)	NA
<b>Profit After Tax</b>	<b>(81,768)</b>	<b>(1,246)</b>	<b>NA</b>
<b>Profit After Tax Excl. extra-ordinaries</b>	<b>(1,848)</b>	<b>2,923</b>	<b>NA</b>
Diluted EPS (Rs.)	-121.33	-1.06	NA
Diluted EPS Excl. extraordinary (Rs.)	-2.74	2.48	NA
Diluted No of Share (mn)	674	1,176	74.6%
<b>Margins %</b>			Change in bps
EBIDTA Margin (%)	3.4%	8.3%	491
PBT Margin (%)	-91.0%	-1.9%	NA
NPM (%)	-92.8%	-2.3%	NA
NPM Excl. extra-ordinaries (%)	-2.1%	5.3%	NA
Effective Tax Rate (%)	-2.0%	-21.8%	NA

Source: Company Reports

NA – Not Applicable

### *Exceptional Item Break-up for FY09 and FY10*

	FY09	FY10
Expenses related to restructuring/right sizing	0	934
Expenses related to forensic investigation & litigation support	832	1,068
Provision for Doubtful Debts Advances	4,191	0
Impairment of Assets Erosion in value of Assets in subsidiaries	7,719	2,167
Provision for contingencies	4,750	0
Prior Period Items	62,428	0
<b>Total</b>	<b>79,920</b>	<b>4,169</b>

Source: Company Reports



## **IMPORTANT DISCLOSURES**

### ***Price Target***

Price targets (if any) are derived from a subjective and/or quantitative analysis of financial and non financial data of the concerned company using a combination of P/E, P/Sales, earnings growth, discounted cash flow (DCF) and its stock price history.

*The risks that may impede achievement of the price target/investment thesis are -*

- **Change in the economic climate/legislation in favour of Indian offshore development in the countries where the company provides its services**
- **Higher than expected ease in billing rate pressure from clients**
- **Fluctuation on US\$-Rupee exchange rate**
- **No Salary and wage inflation & lower employee attrition**
- **Availability of tax holidays and incentives from Government of India**
- **Favourable decision in legal cases (Caterpillar Inc., Bridge strategy group, S&V Management consultant, Venture Global, U.S. Class action Law Suit.)**



## ***First Global's Rating system***

Our rating system consists of three categories of ratings: Positive, Neutral and Negative. Within each of these categories, the rating may be absolute or relative. When assigning an absolute rating, the price target, if any, and the time period for the achievement of this price target, are given in the report. Similarly when assigning a relative rating, it will be with respect to certain market/sector index and for a certain period of time, both of which are specified in the report.

**Rating in this report is relative to: CNX Nifty Index**

### **Positive Ratings**

**(i) Buy (B)** – This rating means that we expect the stock price to move up and achieve our specified price target, if any, over the specified time period.

**(ii) Buy at Declines (BD)** – This rating means that we expect the stock to provide a better (lower) entry price and then move up and achieve our specified price target, if any, over the specified time period.

**(iii) Outperform (OP)** – This is a relative rating, which means that we expect the stock price to outperform the specified market/sector index over the specified time period.

### **Neutral Ratings**

**(i) Hold (H)** – This rating means that we expect no substantial move in the stock price over the specified time period.

**(ii) Marketperform (MP)** – This is a relative rating, which means that we expect the stock price to perform in line with the performance of the specified market/sector index over the specified time period.

### **Negative Ratings**

**(i) Sell (S)** – This rating means that we expect the stock price to go down and achieve our specified price target, if any, over the specified time period.

**(ii) Sell into Strength (SS)** – This rating means that we expect the stock to provide a better (higher) exit price in the short term, by going up. Thereafter, we expect it to move down and achieve our specified price target, if any, over the specified time period.

**(iii) Underperform (UP)** – This is a relative rating, which means that we expect the stock price to underperform the specified market/sector index over the specified time period.

**(iv) Avoid (A)** – This rating means that the valuation concerns and/or the risks and uncertainties related to the stock are such that we do not recommend considering the stock for investment



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