

Company Flash

23 October 2007 | 9 pages

Satyam Computers Services (SATY.BO)

Buy: Strong 2Q FY08 Results; Another Beat and Raise Quarter

- Revenue +12.7% qoq (US\$ terms), a five-year high** — Satyam reported a strong 2Q FY08: top-line growth was 12.7% qoq (est 9.4%). Volume growth at ~9% qoq was in line with the last few quarters; pricing (~3% qoq improvement in blended pricing) contributed to the strong top-line performance.
- EBITDA margin decline 260bps qoq** — Satyam reported EBITDA margin of 19.8% (our est: 20.1%). The margin decline was due to wage hikes in the quarter, the rupee's appreciation and higher onsite proportion of revenues partly offset by better pricing, lower SG&A and higher utilization.
- Raises FY08 guidance again** — Satyam raised FY08 revenue guidance to Rs81.9-82.2bn (~26-27% growth yoy), up ~4% in INR terms. EPS guidance has been raised by ~3% to Rs25.0-25.1.
- Non-US geographies growing faster** — Non-US revenue continues to grow at a fast pace: Europe grew ~17% qoq while the rest of world grew ~27% qoq. North American revenue grew ~6% qoq and now contributes ~58% to revenue.
- Top 5 companies post strong quarter** — The top 5 companies – Infosys, TCS, Wipro, Satyam and HCL Tech – have reported a strong 2Q with ~8-12% qoq growth, good pricing increases and BFSI double-digit QoQ growth.
- Satyam trades at 15x FY09E EPS**— Satyam's guidance implies ~17% yoy growth in EPS in a difficult year (~12% INR appreciation).

Buy/Medium Risk	1M
Price (22 Oct 07)	Rs448.45
Target price	Rs570.00
Expected share price return	27.1%
Expected dividend yield	1.8%
Expected total return	28.9%
Market Cap	Rs299,909M
	US\$7,589M

Price Performance (RIC: SATY.BO, BB: SCS IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	9,979	15.09	36.9	29.7	6.7	26.2	0.8
2007A	14,047	20.81	38.0	21.5	5.1	27.9	0.8
2008E	17,069	24.93	19.8	18.0	4.3	27.0	1.8
2009E	20,733	30.28	21.5	14.8	3.6	27.5	2.2
2010E	22,718	33.18	9.6	13.5	3.1	25.6	2.7

Source: Powered by dataCentral

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Other Highlights

- Satyam hired over 3000 associates including ~1900 campus recruits (~8% increase qoq).
- Offshore pricing was up ~1.3% qoq while onsite pricing was up ~2.2% qoq.
- Margins declined ~260bp qoq primarily on account of wage hikes (-450bp qoq), higher onsite (-70bp qoq) and INR appreciation (-40bp qoq). This was partially offset by pricing, SG&A leverage and higher utilization resulting in a margin decline of ~260bp qoq.
- Satyam's subsidiaries reported growth of ~19% qoq (US\$ terms). EBITDA margin for the quarter was 1.3% (as against a negative margin of 3.4% in the previous quarter). Growth was led by Nipuna, which grew ~27% qoq.
- Satyam added 37 customers including 8 Fortune 500 customers. Prominent customer additions included world's leading retailer, leading oil & natural gas E&P Company and a world's leading commercial and investment bank. Satyam also signed a multi-year deal with Fujitsu Services.
- Satyam has entered into a definitive agreement to acquire UK-based Nitor Global Solutions, for a consideration up to GBP 2.76m in an all-cash deal. Nitor is in the area of infrastructure management services.
- Satyam had a forex cover of \$783m at the end of Q2. Forex gains in the quarter were Rs.430m.
- Satyam expects margins to decline ~175bp yoy in FY08. This is against the earlier guidance of a 125-150bp yoy margin decline and on account of further rupee appreciation.
- Satyam management expects ~52,000 employees by year end.

Figure 1. Key Financials

Rs m	2Q07	1Q08	2Q08	QoQ	YoY
Revenue (US\$ m)	352	452	510	12.7%	44.8%
Revenue	16,019	18,302	20,317	11.0%	26.8%
Cost of revenue	9,831	11,064	13,034	17.8%	32.6%
Gross profit	6,188	7,238	7,283	0.6%	17.7%
Gross margin	38.6%	39.5%	35.8%	-370bp	-278bp
Operating expenses	2,563	3,135	3,256	3.9%	27.0%
EBITDA	3,625	4,103	4,027	-1.8%	11.1%
EBITDA margin	22.6%	22.4%	19.8%	-260bp	-281bp
Depreciation and amortization	375	387	391	1.0%	4.1%
EBIT	3,250	3,716	3,636	-2.1%	11.9%
EBIT margin	20.3%	20.3%	17.9%	-241bp	-239bp
Other income	282	632	1,105	74.8%	291.3%
Profit before tax	3,505	4,315	4,700	8.9%	34.1%
Income tax expense	307	532	609	14.6%	98.5%
Income from operations	3,198	3,783	4,091	8.1%	27.9%
EPS - basic	4.89	5.67	6.12	8.0%	25.2%
EPS - fully diluted	4.74	5.53	5.97	8.1%	26.0%

Source: Company Reports

Figure 2. Performance Against Guidance

	Guidance		Actual	Vs. guidance	
	Lower	Upper		Lower	Upper
Revenue (Rs m)	19,170	19,260	20,317	6.0%	5.5%
Revenue (\$ m)	477	479	510	6.8%	6.3%
EPS (Rs)	5.36	5.41	6.12	14.2%	13.2%

Source: Company Reports

Figure 3. FY08 Guidance Revision

	Guidance – Original		Guidance - post 1Q08		Revision		Guidance - post 2Q08		Revision	
	Lower	Upper	Lower	Upper	Lower	Upper	Lower	Upper	Lower	Upper
Revenue (Rs m)	77,930	79,160	78,530	79,420	0.8%	0.3%	81,890	82,200	4.3%	3.5%
Revenue (\$ m)	1,870	1,900	1,958	1,980	4.7%	4.2%	2,068	2,076	5.6%	4.8%
EPS (Rs)	25.32	25.73	24.14	24.46	-4.7%	-4.9%	25.00	25.10	3.6%	2.6%
INR/USD assumption		42.30		40.50		-4.3%		39.50		-2.5%

Source: Company Reports

Figure 4. Key HR and Execution Metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Total employee base	29,639	34,105	37,230	38,586	41,380	44,723
BPO services (Nipuna)	2,005	2,446	2,825	2,916	2,994	3,300
IT Services - parent only	27,634	31,659	34,405	35,670	38,386	41,423
Support	1,781	1,829	1,811	1,858	2,030	2,270
Delivery employees - total	25,853	29,830	32,594	33,812	36,356	39,153
- Onsite	5,967	6,428	6,551	7,073	7,635	8,949
- Offshore	18,831	21,835	25,007	25,269	27,600	29,222
- Domestic	1,055	1,567	1,036	1,470	1,121	982
Avg. realization (US\$ per hour)						
Onsite	56.07	56.32	56.52	56.87	57.62	58.89
- change	0.30%	0.45%	0.36%	0.62%	1.31%	2.21%
Offshore	23.00	23.05	23.08	23.24	23.58	23.90
- change	0.18%	0.21%	0.12%	0.72%	1.46%	1.34%
Utilization						
Onsite	97.03%	96.99%	96.76%	96.63%	96.19%	97.13%
Offshore	79.56%	78.75%	77.60%	78.42%	79.92%	81.54%
Offshore with trainees	71.24%	71.11%	68.49%	71.34%	76.54%	76.41%
Attrition % (IT services)	19.62%	18.27%	17.62%	15.70%	14.90%	13.89%

Source: Company Reports

Figure 5. Revenue Mix

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Geography wise						
North America	65.9%	65.9%	64.3%	62.6%	61.7%	58.4%
Europe	17.6%	18.0%	19.0%	19.9%	20.1%	21.0%
RoW	16.5%	16.1%	16.7%	17.6%	18.2%	20.6%
Service line wise						
Development & Maintenance	48.5%	48.0%	47.3%	46.4%	43.7%	43.9%
Package implementation	40.3%	40.4%	42.0%	42.6%	44.2%	45.0%
Engineering services	6.0%	6.4%	6.8%	7.0%	7.2%	6.5%
IMS	5.2%	5.2%	3.9%	4.0%	4.9%	4.5%
Vertical wise						
BFSI	29.7%	28.6%	25.6%	24.7%	23.8%	23.8%
Manufacturing	27.8%	26.7%	27.1%	27.2%	25.9%	23.7%
TIMES	19.1%	20.4%	20.7%	21.8%	22.0%	23.5%
Healthcare	6.5%	7.3%	7.6%	8.0%	8.0%	7.9%
Retail & Transportation	5.4%	5.2%	6.0%	6.4%	6.9%	7.5%
Others	11.5%	11.8%	13.0%	11.9%	13.5%	13.5%

Source: Company Reports

Figure 6. Client Metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Client relationship						
Total active clients	489	504	523	538	551	577
New clients added	34	35	34	35	29	37
1+ mn USD Clients	142	154	164	180	190	213
5+ mn USD Clients	51	54	54	57	65	75
10+ mn USD Clients	33	32	32	35	36	40
Client concentration						
Top client	7.1%	6.7%	6.3%	6.1%	5.7%	5.8%
Top 5 clients	22.7%	22.3%	21.6%	22.2%	21.1%	20.8%
Top 10 clients	34.4%	33.9%	34.2%	36.3%	34.4%	33.9%
Revenue from existing business	87.7%	86.1%	85.7%	88.7%	89.5%	93.1%

Source: Company Reports

Satyam Computers Services

Company description

Satyam is the fourth-largest IT solutions provider from India and is one of the pioneers of offshore IT services delivery. The company has more than 500 clients across the globe and employs over 38,500 professionals across IT and BPO services. Satyam was an early entrant into IT consulting/package implantation work. As of 4Q FY07, ~42% of its revenue came from this service line. It has domain competencies in verticals such as Manufacturing, Banking & Financial Service and Insurance, among others.

Investment strategy

We rate Satyam as Buy/Medium Risk (1M). We believe offshore IT outsourcing is now a mainstream option and Satyam, which has achieved meaningful scale with its top-five position in India, appears well positioned to benefit from

growing business volumes. Over the past several quarters, volume growth has trended at over 5% qoq. With revenue of over US\$1bn, Satyam becomes a strong contender for winning large deals. It has won at least three large deals over the past four quarters. We expect a gradual margin decline (rather than steep), as wage inflation should be partly offset by positive leverage from a better onsite-offshore mix, hiring strategies and improved utilization. Overall, we forecast 24.4% revenue CAGR and 16% EPS CAGR over FY07-10E.

Valuation

Our 12-month target is Rs570, based on 19x FY09E earnings. We value Satyam on a P/E basis relative to its medium-term growth potential and also on its valuation relative to peer Infosys, which is the industry benchmark. Given that we expect Satyam's earnings to grow at 16% CAGR over the next three years, we believe the stock should trade toward the upper end of its historical three-year trading range of 12-21x 12-month forward earnings. Satyam has traded at a 10-40% discount to Infosys in the past two years due to its lower growth rates. Our forward P/E is based on a ~25% discount to our target multiple of 25x for Infosys.

Risks

Although our quantitative risk-rating system suggests Low Risk for Satyam, we rate Satyam as Medium Risk given the similar risk ratings for other mid-sized IT peer-group companies in our coverage universe. The key downside risks that could impede the shares from reaching our target price include: (1) A slowdown in enterprise software license revenues; (2) The supply side situation becoming more difficult; (3) Risks to earnings from a sharp US slowdown; (4) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (5) A sharp slowdown in the US economy; (6) A slowdown in the banking, financial services and insurance (BFSI) sector; and (7) Limited H1B visa quotas.

Infosys Technologies (INFY.BO - Rs1,903.15; 1L)

Valuation: Our target price of Rs2,440 is based on 25x FY09E EPS. This is close to the midpoint of the last one-year trading band of 20-28x 1-year forward earnings and factors in some deceleration in growth. We are forecasting 19% earnings growth (on a high base of FY07) with some upside potential from pricing improvement and/or rupee depreciation. This is also supported by comparing it with global peers and the broader Indian market. The 25x multiple was also derived from a P/E band analysis of Infosys' trading pattern. During slowdowns in tech and offshore IT services, Infosys has traded at an average one-year rolling P/E of 25.1x with a low of 13x. Our estimates continue to assume a certain P/E premium to the market; this is justified, in our view, given the strong FCF, ROIC and growth rates for Infosys vs. the overall market. We believe P/E remains the most appropriate valuation measure given Infosys' profitable record and high earnings visibility.

Risks: We rate Infosys shares as Low Risk, which is consistent with our quantitative risk-rating system that tracks historical share price volatility. The key downside risks to the shares reaching our target price include: (1) any significant appreciation of the rupee against the US dollar/euro/pound; (2) pressure on billing rates (as Infosys continues to enjoy a 10-15% premium in its billing rates); (3) a sharp slowdown in the US economy; and (4) limited H1B visa quotas.

Appendix A-1

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Infosys Technologies (INFY.BO) Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal, CFA (covered since October 5 2006)



#	Date	Rating	Target Price	Closing Price
1:	13 Jan 05	1M	*1,200.00	982.70
2:	29 Jun 05	1M	*1,400.00	1,162.05
3:	12 Jul 05	1M	*1,350.00	1,109.97
4:	11 Oct 05	1M	*1,570.00	1,341.95
5:	12 Mar 06	*1L	*1,635.00	1,466.70
6:	16 Apr 06	1L	*1,737.50	1,615.15
7:	4 Oct 06	1L	*2,165.00	1,803.20
8:	11 Oct 06	1L	*2,340.00	1,981.35
9:	11 Jan 07	1L	*2,660.00	2,183.00
10:	23 Apr 07	1L	*2,580.00	2,067.55
11:	10 Jun 07	1L	*2,440.00	1,980.10

*Indicates change.

Satyam Computers Services (SATY.BO) Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal, CFA (covered since October 5 2006)



#	Date	Rating	Target Price	Closing Price
1:	24 Jan 05	1M	*230.00	186.80
2:	29 Jun 05	1M	*300.00	244.48
3:	20 Oct 05	1M	*350.00	293.75
4:	22 Jan 06	1M	*450.00	363.13
5:	23 Apr 06	*1L	*465.00	386.73
6:	4 Oct 06	*2M	*475.00	401.42
7:	8 Nov 06	*1M	*510.00	415.20
8:	6 Feb 07	1M	*582.00	490.65
9:	23 Apr 07	1M	*590.00	480.65
10:	13 Jun 07	1M	*570.00	486.35

*Indicates change.

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Satyam Computers Services (SATY.BO)

23 October 2007

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