



Satyam Computer

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,415	SCS IN
	REUTERS CODE
S&P CNX: 3,577	SATY.BO

5 March 2007

Buy

Previous Recommendation: Neutral

Rs414

Equity Shares (m)	657.1
52-Week Range	525/271
1,6,12 Rel. Perf. (%)	-1/-3/-12
M.Cap. (Rs b)	271.8
M.Cap. (US\$ b)	6.1

YEAR	NET SALES	PAT*	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/07E	64,635	13,745	21.0	38.5	19.7	4.9	27.9	30.4	3.6	15.1
3/08E	86,714	16,944	25.5	21.9	16.2	3.9	27.0	30.6	2.6	11.7
3/09E	108,270	20,112	30.0	17.5	13.8	3.2	25.6	29.9	2.0	9.3

Valuations are attractive: Over the past few months, Satyam has underperformed, following concerns of continued wage pressures, high attrition and higher exposure to discretionary spending. The stock has corrected 21% from its 52 week high and has underperformed the BSE-IT Index by 22% over the last 12 months. While we expect wage inflation and RSU charges to continue to put pressure on margins, we believe that current valuations at 16.2x and 13.8x EPS for FY08E and FY09E are attractive. The recent fall in stock price, should be utilized as an opportunity to invest in the stock. We upgrade the stock to **Buy**.

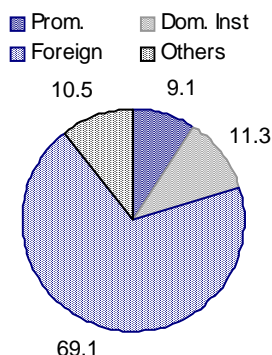
Engineering design and infrastructure outsourcing to reduce dependence on PI: Revenue contribution from engineering services and infrastructure management (IMS) is currently low at 6.8% and 3.9% respectively. However, the company has recently stepped up activity in this space to bag big deals. We expect further developments in these domains to reduce dependence on discretionary expenditure and reduce risk perception for Satyam.

Greater contribution from Europe to help diversify revenue base, reduce risk: Satyam derives lower revenue contribution from Europe, with 64.3% of its revenue from the US at present. Revenue growth from Europe has been picking up over the past quarters, outpacing growth from the US. We expect this to increase further as the company actively seeks to mitigate risk due to heavy dependence on the US.

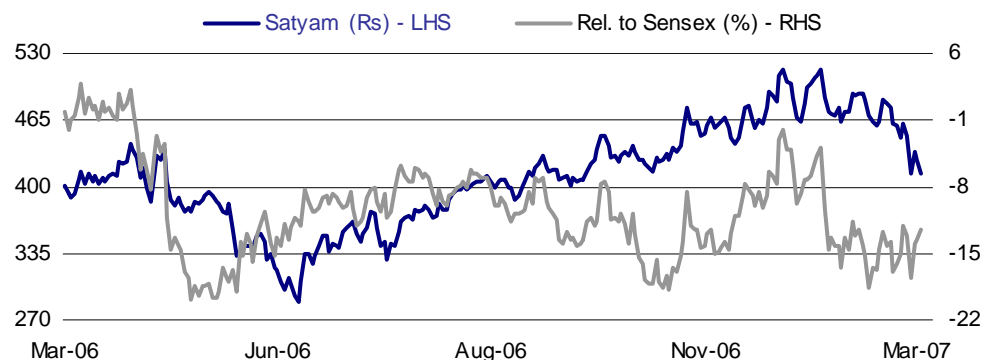
Wage pressures to continue, but already factored in estimates and valuations: Satyam's high exposure to package implementation, lower salaries in certain sections of the employee base etc could also result in higher wage increase in FY08 as well. However, we believe that these concerns have already been built into estimates.

Valuation and view: The stock trades at a P/E of 16.2x and 13.8x for FY08E and FY09E respectively. Considering sharp correction and under performance in the last 12 months, valuations are now attractive. Given the strong demand outlook and resulting volume growth over FY07-FY09E, we believe that the stock offers limited downside from current valuations. We upgrade the stock to **Buy** with a target price of Rs.540, an upside of 30.4%.

SHAREHOLDING PATTERN (%) - DEC.06



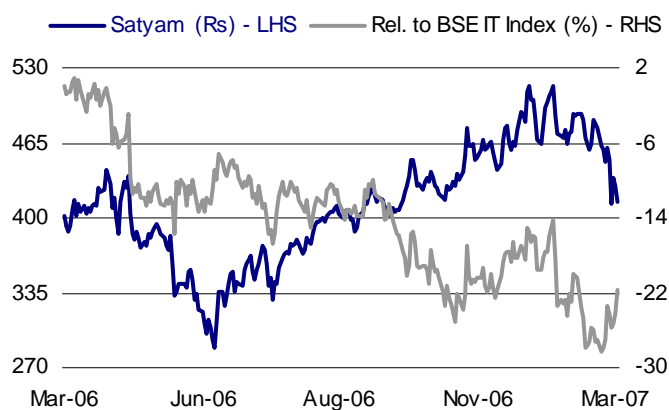
STOCK PERFORMANCE (1 YEAR)



Valuations are attractive

Over the past few months, Satyam has underperformed, following concerns of continued wage pressures, high attrition and higher exposure to discretionary spending. The stock has corrected 21% from its 52 week high and has underperformed the BSE-IT Index by 22% over the last 12 months. While we expect wage inflation and RSU charges to continue to put pressure on margins, we believe that current valuations at 16.2x and 13.8x EPS for FY08E and FY09E are attractive. The recent fall in stock price, should be utilized as an opportunity to invest in the stock. We upgrade the stock to **Buy** with a target price of Rs540.

STOCK UNDER PERFORMANCE RELATIVE TO SECTOR (1 YEAR)



Source: Company/ Motilal Oswal Securities

Engineering design and infrastructure outsourcing to reduce dependence on PI

Currently, close to 42% of Satyam's revenue comes from its enterprise business, which is more dependent on discretionary spending (Infosys – 18%, TCS – 11.8%, Wipro – 11.3%, HCL Tech – 12.7%). Satyam has been a laggard in new services such as engineering services and infrastructure outsourcing. Revenue contribution from engineering services and infrastructure management (IMS) is currently low at 6.8% and 3.9% respectively.

However, the company has recently stepped up activity in this space to bag big deals (~10% of revenue to come from big deals). The company is witnessing increasing number of deal wins in this space – the recent deal with Northrop Grumman being a case in point. As per the deal, both companies will jointly bid and provide high-end engineering

services to global players in aerospace and defense. The alliance provides Satyam with an opportunity to become a significant presence in the aerospace domain, which is expected to be one of the primary verticals for engineering design outsourcing. Engineering design is expected to be one of the key growth drivers for the Indian IT services industry. Global spending on engineering services expected to increase from US\$750b at present to US\$1.1trillion by 2020 (Booz Allen Hamilton Study 2006). Of this, the potential market for India is expected to touch US\$12-16b by 2010 and US\$34-42b by 2020 from current market of revenue base of US\$1.2-1.8b.

IMS on a fast track

According to Forrester, most of IT service providers are ramping up their low-cost, remote infrastructure delivery capabilities. Providers are moving toward a more distributed, process-centric, global delivery model that relies on near shore and offshore facilities to remotely service clients. This has led to demand for remote Infrastructure services from Indian offshore vendors also due to availability of talent pool and offshore execution capabilities. Therefore, after IT application outsourcing and BPO, Infrastructure outsourcing is expected to be the next big opportunity for Indian IT vendors.

According to the Nasscom-McKinsey study 2005, total addressable market for IT infrastructure offshoring, inclusive of support, network administration and help desk is around US\$70-85b and expected to increase significantly going forward. According to Gartner, around 32% of a CIO's IT budget was going into internal resources to service infrastructure operations and management. Since this segment represents significant chunk, it is most important area for CIO to reduce the cost. Offshore market for Infrastructure management services is expected to grow at a CAGR of 55% to US\$9b from CY05-CY10E, indicating a strong demand for Infrastructure outsourcing. Satyam is stepping up efforts to grow its IMS business and is actively scouting for deals in this space. We expect further developments in both engineering design and infrastructure outsourcing to reduce dependence on discretionary expenditure and reduce risk perception for Satyam.

Greater contribution from Europe to help diversify revenue base, reduce risk

Satyam derives lower revenue contribution from Europe, as compared to 33.6%, 26.8% and 22.1% for Wipro, Infosys and TCS respectively. Satyam derives 64.3% of its revenue from the US at present (Infosys – 63%, TCS-52%, Wipro -61%). Our interaction with most of the IT companies, indicate that growth in outsourcing and offshoring is likely to be higher in Europe than US for coming years. In terms of margins, Europe currently has higher margins than US.

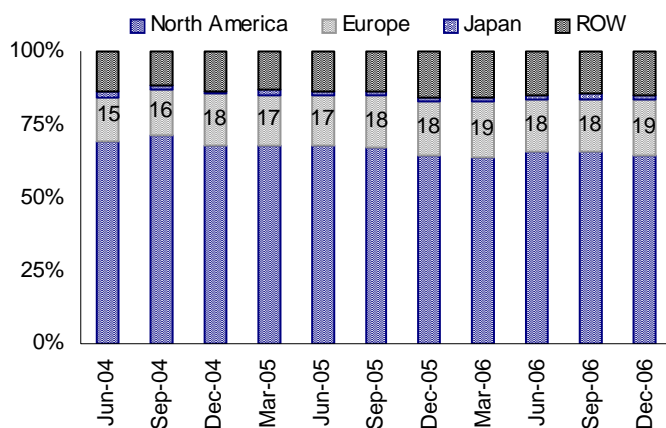
Therefore we believe that diversification towards Europe should be a key strategy for most of the large cap IT companies. We believe that Satyam has started getting deeper penetration in Europe as revenue growth from Europe has been picking up over the past quarters, outpacing growth from the US. We expect this to increase further as the company actively seeks to mitigate risk due to heavy dependence on the US (Europe contribution has steadily increased from 15% in June 2004 to 19% in December 2006).

REVENUE GROWTH - QOQ (%)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
North America	5.5	2.2	13.5	10.8	1.2
Europe	10.3	3.9	3.9	13.5	9.5

Source: Company/ Motilal Oswal Securities

SATYAM'S EUROPE CONTRIBUTION IS ON THE RISE



Source: Company/ Motilal Oswal Securities

Wage pressures to continue, but already factored in estimates and valuations

Satyam's high exposure to package implementation, wherein the supply of manpower continues to be a constraint, would continue to result in wage inflation for the company. In addition, the company's salaries are not fully aligned with the industry, which could also result in higher wage increases in FY08 as well. However, we believe that these concerns have already been built into estimates and we do not foresee any downsides from these levels.

Margin levers exist to ease pressure of wage inflation:

Employee Pyramid: Satyam's employee pyramid is more skewed towards laterals. Employees with less than 3 years experience being 45% against peers like Infosys at 59% and TCS at 52%. Therefore, considering Satyam's effort to increase the fresher employees, we believe Satyam has larger head room here than peers.

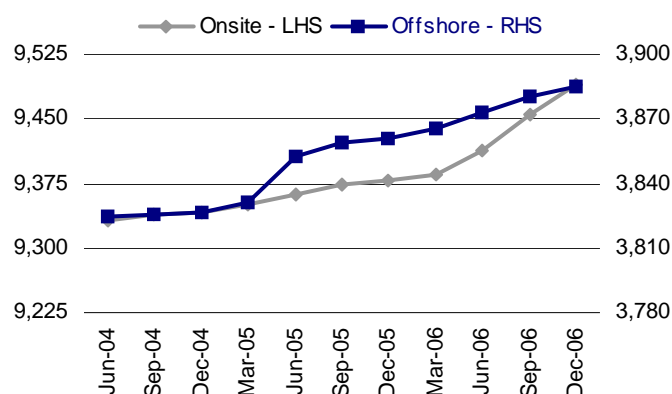
Pricing: Satyam is witnessing 3%-5% increases in billing rates in renewals, which is expected to keep price realizations on a steady upward trend. We believe that pricing would be one of the primary levers for margin improvement going forward. We also believe high proportion of new business relative to peers with higher increase in new contracts would result into faster increase in realized rates than peers going forward. We expect improvement in realizations to act as a key margin positive over the next few quarters.

NEW BUSINESS (%)

	3QFY07	3QFY06
Satyam	14.3	7.9
HCL Tech	11.8	5.0
Infosys	5.3	6.8
TCS	3.9	5.2
Wipro	3.9	6.0

Source: Company/ Motilal Oswal Securities

BILLING RATE (US\$ PER MAN MONTH) MOVEMENT FOR SATYAM



Source: Company/ Motilal Oswal Securities

Improvement in profitability of subsidiaries: Satyam has improved the profitability of its subsidiaries significantly in recent past. EBIDTA losses of subsidiaries have reduce from Rs100m in 3QFY06 to Rs6m in 1QFY07 (savings of 70bp to consolidated revenues) and Satyam expects subsidiaries to be EBIDTA positive for FY07. Key subsidiary

Nipuna (BPO) has already become EBIDTA positive in 2QFY07.

Impact of FBT on ESOPs - clarity awaited

We are awaiting for further clarity on treatment of FBT w.r.t ESOP proposed in the Union Budget 2007. In the worst case scenario, we believe impact on EPS of Satyam could be around 2%-4% p.a. over next 3-4 years. However, the impact could be lower than our estimates, if options are not fully exercised or taxable component is less than 100% of ESOP benefit. We are also awaiting for clarification of ESOP awarded to employees outside India, if these employees are out of tax purview, the charge will lower than our estimates. The companies are also looking at option of passing FBT charge to employees, in which case the impact on income statement would be lower. We believe that current valuations even after FBT charge (based on our estimates) are attractive.

IMPACT OF FBT ON ESOPs - CLARITY AWAITED (RS M)

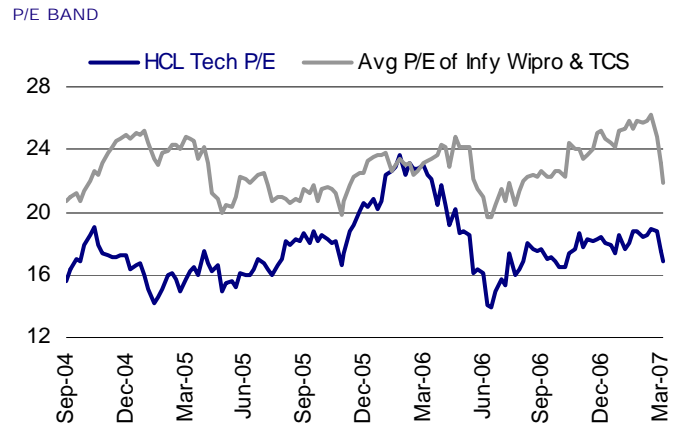
	TOTAL FBT	ANNUAL CHGE. FBT	COMMENTS
FBT on RSU granted in 4QFY07	331	110	Based on management's initial estimates, FBT charge will be US\$2.5m p.a. for 3 years
FBT on ESOP outstanding - Indian shares	2,042	510	30.25m ESOPs outstanding, management's initial estimate of average exercise price is Rs200, to be exercised over a period of 4 years
FBT on ESOP outstanding - ADS	206	51	1.71mn ADS outstanding (1 ADS = 2 Equity Shares), management's initial estimate of average exercise price is little over Rs200. We have assumed exercise price of Rs225 to be exercised over a period of 4 years
Total	2,578	672	
EPS impact over a period 3-4 years (p.a.)		1.0	
EPS impact over a period 3-4 years (p.a.) (%)		2-4	
EPS - FY08E after FBT Charge		24.5	
P/E		16.9	
EPS - FY09E after FBT Charge		29.0	
P/E		14.3	

Assumptions:

- 1) We have assumed the fair market value for all ESOPs at Rs425 for calculating FBT
- 2) We have also assumed 100% of ESOP outstanding will be exercised
- 3) We have assumed FBT to be amortised based on SLM method over average remaining life

Valuation and view

The stock trades at a P/E of 16.2x and 13.8x for FY08E and FY09E respectively. Considering sharp correction and under performance in the last 12 months, valuations are now attractive. Given the strong demand outlook and resulting volume growth over FY07-FY09E, we believe that the stock offers limited downside from current valuations. We upgrade the stock to **Buy** with a target price of Rs.540, an upside of 30.4%.



INCOME STATEMENT						RATIOS					
(Rs Million)											
Y/E MARCH	2005	2006	2007E	2008E	2009E	Y/E MARCH	2005	2006	2007E	2008E	2009E
Sales	35,208	47,926	64,635	86,714	108,270	Basic (Rs)					
Change (%)	37.5	36.1	34.9	34.2	24.9	EPS	11.1	15.1	21.0	25.5	30.0
Cost of Goods Sold	23,821	32,738	44,991	61,697	78,599	Cash EPS*	12.9	17.2	23.4	28.9	34.2
SG&A	2,705	3,526	4,274	5,788	6,794	Book Value	516	66.5	84.6	105.8	129.9
EBITDA	8,682	11,662	15,370	19,229	22,877	DPS	2.5	3.5	4.4	5.4	6.3
% of Net Sales	24.7	24.3	23.8	22.2	21.1	Payout %(Incl.Div.Taxes)	22.4	23.3	21.0	21.0	21.0
Depreciation	1,133	1,373	1,570	2,255	2,815	Valuation (x)					
Interest	9	55	120	173	54	P/E		27.3	19.7	16.2	13.8
Other Income	847	1,168	1,591	2,454	3,109	Cash P/E		24.0	17.7	14.3	12.1
PBT	8,387	11,402	15,271	19,255	23,117	EV/EBITDA		20.7	15.1	11.7	9.3
Tax	1,176	1,508	1,527	2,311	3,005	EV/Sales		5.0	3.6	2.6	2.0
Rate (%)	14.0	13.2	10.0	12.0	13.0	Price/Book Value		6.2	4.9	3.9	3.2
PAT	7,116	9,820	13,745	16,944	20,112	Dividend Yield (%)		0.9	1.1	1.3	1.5
Change (%)	37.0	38.0	40.0	23.3	18.7	Profitability Ratios (%)					
Extra Ordinary Items	0	1,598	0	0	0	RoE	23.9	25.8	27.9	27.0	25.6
Net Income	7,116	11,418	13,745	16,944	20,112	RoCE	28.1	29.5	30.4	30.6	29.9
BALANCE SHEET	(Rs Million)					Turnover Ratios					
Y/E MARCH	2005	2006	2007E	2008E	2009E	Debtors (Days)	81	75	72	72	72
Share Capital	639	649	1,311	1,326	1,340	Asset Turnover (x)	3.5	3.6	3.9	4.1	4.2
Preference share capital	910	910	910	910	910	Leverage Ratio					
Share Premium	8,917	10,292	11,573	13,462	15,112	Debt/Equity Ratio (x)	0.0	0.0	0.0	0.0	0.0
Other Reserves	22,515	31,322	41,696	54,464	69,629	CASH FLOW STATEMENT	(Rs Million)				
Net Worth	32,981	43,173	55,491	70,162	86,991	Y/E MARCH	2005	2006	2007E	2008E	2009E
Minority Interest	0	42	0	0	0	Cash Flow from Operations	7,350	10,128	13,453	15,754	18,647
Loans	189	1,027	1,280	1,000	750	Cash for Working Capital	-1,336	-2,605	-1,312	-4,598	-2,407
Deferred Tax	-107	-46	-436	-1,600	-2,826	Net Operating CF	6,015	7,523	12,141	11,156	16,240
Capital Employed	33,063	44,195	56,335	69,562	84,915	Net Purchase of FA	-1,854	-3,034	-2,798	-4,650	-5,000
Gross Block	10,142	13,172	16,422	20,922	25,922	Net Purchase of Invest.	1,797	2,584	1,591	2,454	3,109
Less : Depreciation	7,057	8,402	9,972	12,227	15,042	Net Cash from Invest.	-57	-451	-1,206	-2,196	-1,891
Net Block	3,086	4,770	6,450	8,696	10,881	Equity and related items	1,122	1,399	1,945	1,905	1,664
CWIP	693	803	350	500	500	Proceeds from LTB/STB	107	838	253	-280	-250
Investments	763	0	0	0	0	Dividend Payments	-1,732	-1,893	-3,171	-3,826	-4,490
Curr. Assets	32,900	45,752	59,309	73,049	89,330	Net CF from Finan.	-502	343	-972	-2,201	-3,076
Debtors	7,805	11,684	15,232	20,404	24,091	Free Cash Flow	4,161	4,489	9,344	6,506	11,240
Cash & Bank Balance	23,701	31,117	41,080	47,838	59,111	Net Cash Flow	5,455	7,416	9,963	6,758	11,273
Loans & Advances	1,148	1,843	2,035	3,168	3,978	Opening Cash Bal.	18,246	23,701	31,117	41,080	47,838
Other Current Assets	247	1,108	962	1,639	2,150	Add: Net Cash	5,455	7,416	9,963	6,758	11,273
Current Liab. & Prov	4,379	7,130	9,774	12,682	15,795	Closing Cash Bal.	23,701	31,117	41,080	47,838	59,111
Creditors	1,720	3,323	3,406	5,147	4,939						
Other Liabilities	763	1,047	2,055	1,587	2,203						
Provisions	1,896	2,760	4,313	5,949	8,654						
Net Current Assets	28,522	38,622	49,535	60,366	73,534						
Application of Funds	33,063	44,195	56,335	69,562	84,915						

E: Most Estimates

NOTES



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Disclosure of Interest Statement

Satyam Computer

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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