



Patni Computer Systems

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,652	PATNI IN
	REUTERS CODE
S&P CNX: 4,223	PTNI. BO

8 February 2007

Neutral

Previous Recommendation: Neutral

Rs437

	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
Equity Shares (m)	138.2										
52-Week Range	511/251										
1,6,12 Rel. Perf. (%)	2/-12/-57										
M.Cap. (Rs b)	60.3										
M.Cap. (US\$ b)	1.4										
	12/06E	26,112	3,572	25.8	18.8	16.9	2.7	16.8	21.2	1.8	9.6
	12/07E	31,008	4,270	30.9	19.6	14.1	2.3	17.5	22.0	1.5	7.5
	12/08E	39,359	5,101	36.9	19.4	11.8	2.0	17.9	22.4	1.1	5.7

* Reflects adjusted PAT

- Sales growth continues to remain low, margin improvement and other income boost profits:** Patni Computer reported revenue of Rs6.8b, a decline of 2.4% QoQ. Operating margins (adjusted for depreciation) improved by 130bp during the quarter due to better utilization rates, higher offshore composition and lower SG&A. Net profit was up 10.9% to Rs1.13b driven by margin expansion, higher other income and lower tax rate during the quarter.
- Absence of full year guidance indicates low revenue visibility:** Unlike last year, wherein Patni issued full year guidance, this time Patni has issued guidance only for 1QCY07. Patni has guided for revenue of US\$155m (almost flat QoQ) and net profit (excluding forex gain/loss) decline to US\$22.5-US\$23m (decline of 10.5%-12.5% QoQ). Given the bullishness witnessed in the sector recently in terms of demand outlook and volume growth, we are disappointed by this muted growth expectation in CY07.
- Attrition rises further to 27.4%, expect significant wage pressures ahead:** Attrition increased to 27.4% from 24.5% in 3QCY06. While Infosys expecting offshore wage hike of 13-15% for FY08, Patni's management expects higher wage hikes in CY07 (15-20% offshore and 4-5% onsite). Patni likely to under perform peers in CY07 as well.
- Valuation and view:** We remain unconvinced on Patni's organic growth prospects over the near term. With consistent out performance in the EBITDA margins, we have revised our CY07 and CY08 EPS upward by 1% each to Rs30.9 and Rs36.9 respectively. Though current valuation at 14.1x CY07E and 11.8x CY08E are not expensive, we do not foresee any major visibility in organic revenues in the near term to warrant any significant re-rating. We continue to remain **Neutral**. We believe that near term trigger could be inorganic growth opportunity which management is actively considering to diversify in new geographies, new verticals, and new services lines.

Y/E DECEMBER	QUARTERLY PERFORMANCE									
	CY05				CY06				CY05	CY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Revenues	4,337	4,730	5,197	5,569	5,776	6,561	6,971	6,805	20,242	26,112
Q-o-Q Change (%)	8.1	9.1	9.9	7.2	3.7	13.6	6.3	-2.4	38.9	29.0
Direct Expenses	2,516	3,007	3,285	3,441	3,593	4,273	4,344	4,215	12,499	16,424
Sales, General & Admin. Expenses	846	908	977	1,023	1,160	1,298	1,215	1,123	3,818	4,796
Operating Profit	976	816	935	1,106	1,022	990	1,413	1,467	3,925	4,893
Margins (%)	22.5	17.2	18.0	19.9	17.7	15.1	20.3	21.6	19.4	18.7
Other Income	40	68	92	-78	11	187	77	172	115	446
Depreciation	145	160	176	189	193	205	202	239	684	839
Provisions									0	1
PBT bef. Extra-ordinary	872	723	851	840	840	972	1,288	1,400	3,356	4,501
Provision for Tax	189	102	138	179	197	201	264	265	620	928
Rate (%)	21.7	14.1	16.2	21.3	23.5	20.7	20.5	18.9	18.5	20.6
Net Income bef. Extra-ordinary	682	621	714	661	642	770	1,024	1,135	2,736	3,573
Q-o-Q Change (%)	-5.8	-9.0	15.0	-7.4	-2.8	19.9	32.9	10.9	4.7	30.6
Extra-ordinary items	0	0	0	0	0	917	0	0	0	917
Net Income aft. Extra-ordinary	682	621	714	661	642	-147	1,024	1,135	2,736	2,655
Q-o-Q Change (%)	-5.3	-9.0	15.0	-7.4	-2.8	-122.9	596.6	10.9	4.6	-2.9

E: MOSSt Estimates

Sales growth continues to remain low, margin improvement and other income boost profits

Patni Computer reported revenue of Rs6.8b, lower than our estimate of Rs6.9b. In dollar terms, revenue was up 1.7% to US\$154.3m, marginally higher than our estimate of US\$153.3m. Underlying volume growth was muted at around 2% QoQ, the lowest in our coverage universe due to slowdown in top clients during the quarter.

However on the EBITDA front, Patni has registered higher than expected margin at 21.6% (adjusted for Depreciation, versus expectation of 19.5%, reported EBIT margins were 18.1% v/s estimate of 16.1% and 17.4% in 3QCY06). Higher margins were on account of higher than expected utilisation rate improvement (improved by 140bp QoQ v/s estimate of 50bp) and offshore revenue growth. During 3QCY06, Patni has reduced its employee strength by 180 employees. All these factors have lead to savings of 40bp in gross margins despite 100bp impact of rupee appreciation.

While S&M expenses held steady, G&A reduced 80bp during the quarter. Consequently, operating margins (adjusted for depreciation) improved by 120bp during the quarter. Other income at Rs172m was higher than our estimate of Rs85m despite lower than expected forex loss of Rs26m. There was also write back of certain costs to the tune of US\$1.7m during the quarter. Effective tax rate at 18.9% was lower due to higher offshore revenue (v/s 20.5% in 3QCY06). Net profit (before extraordinary) was up 10.9% to Rs1.13b (v/s our estimate of Rs95b) driven by margin expansion, higher other income and lower tax rate during the quarter.

Business metrics continue to be lackluster (in rupee terms)

Top clients (excluding top 2-5) declined during the quarter due to budgeting cycle and vendor consolidation with one of the top client. Revenue from this client would decline in 1QCY07 as well due to transition of work to another vendor, which would impact revenue growth during the quarter (management is claiming that they will continue work with the client, however volume will decline significantly).

TOP CLIENTS PERFORMANCE - RUPEE TERMS (RS M)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Top Client	986	953	951	983	919
QoQ Growth (%)	-19.3	-3.3	-0.2	3.3	-6.5
Top 2-5 Clients	1,202	1,346	1,548	1,589	1,667
QoQ Growth (%)	10.6	11.9	15.1	2.7	4.9
Top 6-10 Clients	769	895	1,043	1,025	966
QoQ Growth (%)	30.1	16.4	16.5	-1.8	-5.7

Source: Company/Motilal Oswal Securities

Except Telecom, all major verticals declined during the quarter, with Financial Services declining by a sharp 10.5%. The management expects BFSI to revive post 1QFY07. Management has also sited that typically for Patni growth in 1Q and 4Q are lower, however underperformance is much higher than the peers, which is disappointing.

REVENUE BY VERTICAL - RUPEE TERMS (RS M)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Insurance	1,415	1,392	1,522	1,617	1,531
QoQ Growth (%)	-1.0	-1.6	9.4	6.3	-5.3
Manufacturing	1,164	1,172	1,404	1,568	1,511
QoQ Growth (%)	1.3	0.7	19.7	11.7	-3.7
Financial Services	869	913	1,017	1,087	973
QoQ Growth (%)	-5.6	5.0	11.4	6.9	-10.5
Telecom	969	1,092	1,312	1,192	1,320
QoQ Growth (%)	25.1	12.6	20.2	-9.2	10.7
Product Engineering	540	578	636	739	694
QoQ Growth (%)	46.4	6.9	10.2	16.1	-6.1

Source: Company/Motilal Oswal Securities

Absence of full year guidance indicates low revenue visibility, negative in a favorable demand scenario with peers having improved visibility

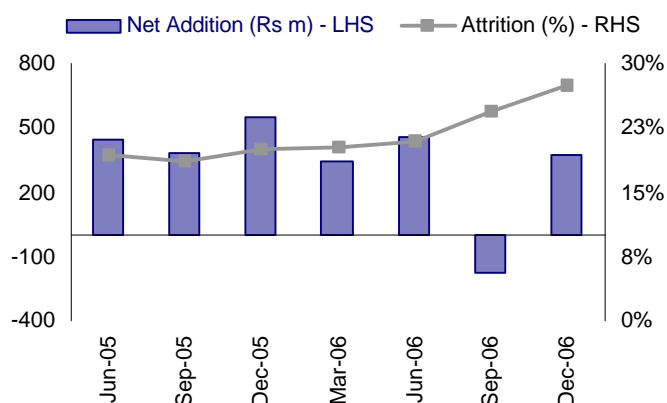
Unlike last year, wherein Patni issued full year guidance, the company has issued guidance only for 1QCY07. Patni has guided for revenue of US\$155m and net profit (excluding forex gain/loss) of US\$22.5-US\$23m, which assumes flat revenue growth and 10.5%-12.5% decline in net profit (excluding forex gain/loss) in dollar terms for 1QCY07. Margins (EBIT) are expected to decline by 120-130bp in 1QCY07 due to investments in Sales & Marketing (50-60bp), increased depreciation (20bp), lower utilization and other factors (50-60bp). The management expects vendor consolidation in a top client and budgeting cycle in another

top client to result in muted growth in 1QCY07, but anticipates better growth rates post 1QCY07 with pick up in 2HCY07. However, given the bullishness witnessed in the sector recently in terms of demand outlook and volume growth expectations for FY08, we are disappointed by this guidance.

Attrition rises further to 27.4%, expect significant wage pressures ahead

Attrition continues to an increasing phenomenon; LTM attrition increased to 27.4% from 24.5% in the previous quarter (though management claims that absolute attrition have declined marginally). While the leaders like Infosys is currently anticipating wage hike similar to FY07 (offshore hike of 13%-15%), Patni's management expects higher wage hikes in CY07. The company is looking at wage hikes of 15%-20% offshore and 4%-5% onsite (CY06 salary hikes of 8% onsite and 17% offshore were higher than industry average of 3%-5% onsite and 13%-15% offshore). Wage inflation will continue to put pressure on margins despite management's efforts to increase the employee productivity and G&A cost.

INCREASING ATTRITION TO TRANSLATE INTO GREATER WAGE PRESSURE



Source: Company/Motilal Oswal Securities

Patni likely to under perform peers in CY07 as well

In terms of business metrics, we still believe that Patni lags its peers due to high client concentration and client mining (number of clients with more than \$5-10m revenues is lesser than peers). While Europe revenues have grown at 52% QoQ to 15% contribution (9.7% in 3QCY06), it still lags peers, which have over 20% of revenue coming from this high growth area. Management believes that the growth drivers will be Product Engineering and ISV. These verticals together contribute 14.4% to overall revenues and are not likely to make a big impact on overall organic revenue growth in the near term.

Margins have increased steadily over the last three quarters due to improvement in internal efficiencies. However, volume growth and ramp up in employee base remains unappealing compared to the rest of the sector. Post the December quarter, industry leaders have clearly indicated that volume growth in FY08 is likely to be strong due to greater offshoring. In such a scenario, we believe that Patni is clearly far behind in terms of volume growth. While industry peers are witnessing 2%-5% price hikes in renewals and between 3%-10% in new contracts, Patni maintains that it is witnessing only marginal increases in pricing. This is due to high client concentration and presence of high GE revenue, where billing rates are lower.

Valuation and view

We remain unconvinced on Patni's organic growth prospects over the near term. With consistent out performance in the EBIDTA margins, we have revised our CY07 and CY08 EPS upward by 1% each to Rs30.9 and Rs36.9 respectively. Though current valuation at 14.1x CY07E and 11.8x CY08E are not expensive, we do not foresee any major visibility in organic revenues in the near term to warrant any significant re-rating. We continue to remain **Neutral**. We believe that near term trigger could be inorganic growth opportunity which management is actively considering to diversify in new geographies, new verticals, and new services lines.

Patni Computers Systems: an investment profile

Company description

Patni is the sixth largest Indian IT services company employing more than 12,800 people. It services close to 250 clients and is one of the largest vendors for GE with annual business of close to US\$100m from it. Its other key clients include SBC, Guardian, MetLife, Gillette, Coca Cola, Oracle and State Farm Insurance.

Key investment arguments

- One of the beneficiaries of the current preference for offshore vendors by global clients.
- Significant presence in the BFSI and Manufacturing segments.

Key investment risks

- High client concentration with GE accounts for around 14% of revenues.
- Limited diversification in services and domain would necessitate acquisitions, which could be margin dilutive.
- Cost pressures due to high attrition could lead to higher pressure on margins and impact profitability.

COMPARATIVE VALUATIONS

		PATNI	HCL TECH.	SATYAM
P/E (x)	FY07E	16.9	19.8	23.2
	FY08E	14.1	16.7	18.9
P/BV (x)	FY07E	2.5	4.8	5.8
	FY08E	2.2	4.4	4.6
EV/Sales (x)	FY07E	1.8	3.2	4.3
	FY08E	1.4	2.4	3.1
EV/EBITDA (x)	FY07E	9.5	14.3	18.2
	FY08E	7.1	10.9	14.1

SHAREHOLDING PATTERN (%)

	DEC-06	SEP-06	DEC-05
Promoter	44.1	44.2	44.7
Domestic Inst	3.4	4.6	1.8
Foreign	50.3	49.0	51.7
Others	2.2	2.2	1.8

Recent developments

- Ranked as the global leader in engineering services in a research study conducted by Global Services and neoIT.
- Was recognized as one of 'The Giant 100' companies at the CIO Symposium and Award ceremony.

Valuation and view

- Revenue CAGR of 23% and net profit CAGR of 20% over CY06-08.
- Though valuations at 14.1x CY07E and 11.8x CY08E are not expensive, lowest visibility in earnings do not warrant any rerating.
- Maintain **Neutral**.

Sector view

- Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- Indian offshore vendors gaining market share in competition with MNCs.
- Prefer large companies as bulk of volumes going to them while niche players benefit due to lack of offshore competition.

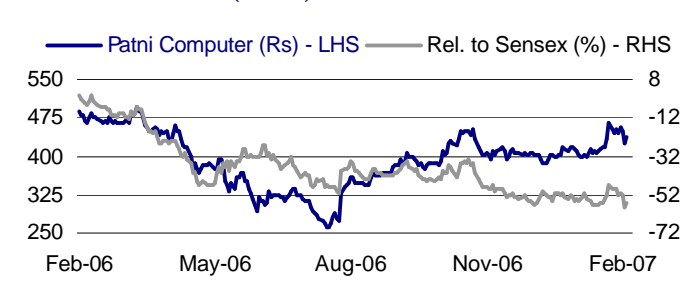
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
CY07	30.9	30.1	2.5
CY08	36.9	-	-

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
437	-	-	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E DECEMBER	2004	2005	2006	2007E	2008E	
Sales	14,574	20,242	26,112	31,008	39,359	
Change (%)	25.6	38.9	29.0	18.7	26.9	
Cost of Goods Sold	8,395	12,499	16,424	20,086	26,215	
Gross Profit	6,179	7,743	9,688	10,922	13,144	
SG&A Expenses	2,688	3,818	4,796	4,893	5,897	
EBITDA	3,491	3,925	4,893	6,030	7,247	
% of Net Sales	24.0	19.4	18.7	19.4	18.4	
Depreciation	505	684	839	1,147	1,461	
Other Income	48	115	446	480	590	
Interest expense	0	0	0	0	0	
PBT	3,034	3,356	4,500	5,362	6,376	
Tax	423	620	928	1,092	1,275	
Rate (%)	13.9	18.5	20.6	20.4	20.0	
PAT	2,612	2,736	3,572	4,270	5,101	
Change (%)	33.9	4.7	30.6	19.6	19.4	
Extr-ord Items	44.3	0.0	917.4	0.0	0.0	
Net Income	2,567	2,736	2,654	4,270	5,101	
Change (%)	31.6	6.5	-3.0	60.9	19.4	

BALANCE SHEET		(Rs Million)				
Y/E DECEMBER	2004	2005	2006E	2007E	2008E	
Share Capital	240	269	276	276	276	
Share Premium	7,828	13,206	13,356	13,356	13,356	
Other Reserves	4,413	6,572	8,801	12,599	17,087	
Net Worth	12,480	20,047	22,434	26,232	30,720	
Loans	28	31	17	25	25	
Capital Employed	12,509	20,078	22,451	26,257	30,745	
Gross Block	4,096	6,342	8,668	11,868	15,368	
Less : Depreciation	1,713	2,281	3,120	4,268	5,729	
Net Block	2,383	4,061	5,547	7,600	9,638	
Other assets	1,846	1,946	2,826	2,103	2,631	
Investments	3,705	6,256	7,000	8,000	9,000	
Curr. Assets	7,570	11,425	12,353	14,697	19,283	
Debtors	3,116	3,284	5,157	5,037	7,903	
Cash & Bank Balance	3,338	6,568	6,158	7,287	9,817	
Loans & Advances	0	0	0	0	0	
Other Current Assets	1,117	1,573	1,038	2,373	1,563	
Current Liab. & Prov	3,232	4,067	5,524	6,184	9,611	
Creditors	159	242	359	151	496	
Other liabilities	2,843	3,612	4,097	3,973	5,908	
Provisions	230	213	1,068	2,060	3,208	
Net Current Assets	4,339	7,358	6,830	8,514	9,671	
Deferred Tax	236	456	248	40	-195	
Application of Funds	12,509	20,077	22,451	26,257	30,745	

E: M0St Estimates

RATIOS						
Y/E DECEMBER	2004	2005	2006E	2007E	2008E	
Basic (Rs)						
EPS	20.6	21.8	25.8	30.9	36.9	
Cash EPS	34.4	39.9	48.4	61.8	78.4	
Book Value	99.3	159.5	162.4	189.8	222.3	
Valuation (x)						
P/E		20.1	16.9	14.1	11.8	
Cash P/E		10.9	9.0	7.1	5.6	
EV/EBITDA		10.7	9.6	7.5	5.7	
EV/Sales		2.1	1.8	1.5	1.1	
Price/Book Value		2.7	2.7	2.3	2.0	
Profitability Ratios (%)						
RoE	25.8	16.8	16.8	17.5	17.9	
RoCE	29.9	20.6	21.2	22.0	22.4	
Turnover Ratios						
Debtors (Days)	78	59	72	59	73	
Asset Turnover (x)	3.6	3.2	3.0	2.6	2.6	
Leverage Ratio						
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	

CASH FLOW STATEMENT		(Rs Million)				
	2004	2005	2006E	2007E	2008E	
CF from Operations	2,680	3,102	3,891	5,037	5,843	
Cash for Working Capital	574	-214	1,016	-769	-1,725	
Net Operating CF	2,106	3,317	2,875	5,805	7,568	
Net Purchase of FA	-2,354	-2,499	-2,326	-3,200	-3,500	
Net Purchase of Invest.	-1,256	-2,526	-744	-1,000	-1,000	
Net Cash from Invest.	-3,610	-5,025	-3,070	-4,200	-4,500	
Proceeds from Equity Rais	2,803	5,240	158	0	0	
Proceeds from LTB/STB	-13	-15	-14	8	0	
Dividend Payments	-132	-288	-358	-484	-539	
Cash Flow from Fin.	2,658	4,937	-214	-476	-539	
Free Cash Flow	-248	818	549	2,605	4,068	
Net Cash Flow	1,154	3,229	-409	1,129	2,529	
Opening Cash Balance	2,184	3,338	6,568	6,158	7,287	
Add: Net Cash	1,154	3,229	-409	1,129	2,529	
Closing Cash Balance	3,338	6,567	6,159	7,287	9,817	



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Patni Computer Systems

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|---|----|
| 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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