

Company

28 July 2010 | 8 pages

Patni Computer Systems (PTNI.BO)

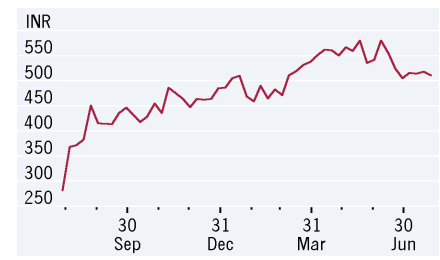
Equity

Quarter Below Expectations

- Weak quarter** — Revenue at \$168m was down ~3% qoq (CIRA exp: \$175m) with EBIT margin at ~16%, down ~200bps qoq. Buoyed by forex gains and higher other income, profits at Rs1.5b were down only ~2% qoq, ahead of our estimates of Rs1.4b.
- Decent top-line guidance for Q3** — Guidance for next quarter is for revenue growth of ~5-6% qoq – but should be seen in conjunction with the weak Q2, where revenues have declined ~3% qoq. Net profit guidance at \$22.5-23m for Q3 looks weak – Q2 profit was ~\$32m.
- Other key points** — (a) US revenues declined ~1% qoq while Europe revenues were down ~13% qoq (\$-terms). (b) ADM and package implementation both declined ~4-6% qoq while BPO witnessed a strong 30%+ growth on a low base. (c) Manufacturing and Telecom witnessed a sequential decline of 6-7% qoq. (d) Headcount addition of ~900 employees was the highest in the last many quarters. (e) Staff attrition increased ~380bp qoq to 21.5% (LTM basis).
- M&A the only likely trigger, but difficult to predict** — Patni's stock has historically traded at a meaningful discount to larger peers due to (a) Lower exposure to growth segments and (b) Higher supply-side challenges in a buoyant demand environment – we don't see that changing. M&A is the only likely positive trigger – where hopes have come off post recent announcement of NTT Data buying Intelligroup. Without M&A, we don't see any catalysts in the near term.
- Key points to discuss in the earnings call** — (a) Sustainability of ~5%+ qoq growth rate in the current demand environment. (b) Likelihood of recovery in operating margins post the sharp fall in this quarter. (c) Details of \$19m of inorganic and operating asset purchases – expected revenue contribution of the same going forward. (d) Headcount addition plans over coming quarters.

Sell/Medium Risk	3M
Price (28 Jul 10)	Rs499.90
Target price	Rs545.00
Expected share price return	9.0%
Expected dividend yield	0.8%
Expected total return	9.8%
Market Cap	Rs65,019M
	US\$1,394M

Price Performance (RIC: PTNI.BO, BB: PATNI IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Dec	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	4,433	34.49	4.2	14.5	2.3	16.2	0.6
2009A	5,434	40.94	18.7	12.2	1.9	17.4	0.6
2010E	5,501	41.30	0.9	12.1	1.6	14.7	0.8
2011E	5,511	41.38	0.2	12.1	1.4	13.0	1.0
2012E	5,941	44.60	7.8	11.2	1.3	12.6	1.2

Source: Powered by dataCentral

Surendra Goyal, CFA

+91-22-6631-9870
surendra.goyal@citi.com

Vishal Agarwal

vishal1.agarwal@citi.com

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Result Tables

Figure 1. Key Financials

Rs m	2Q09	1Q10	2Q10	QoQ	YoY
Revenue (\$ m)	162	172	168	-2.8%	3.5%
Revenue	7,729	7,745	7,776	0.4%	0.6%
Cost of revenue	4,850	4,594	4,855	5.7%	0.1%
Gross profit	2,879	3,151	2,922	-7.3%	1.5%
Gross margin	37.2%	40.7%	37.6%	-311bp	33bp
Operating expenses	1,232	1,461	1,354	-7.3%	9.9%
EBITDA	1,647	1,690	1,568	-7.2%	-4.8%
EBITDA margin	21.3%	21.8%	20.2%	-166bp	-115bp
Dep & amortization	296	279	304	9.1%	2.7%
EBIT	1,351	1,411	1,264	-10.5%	-6.5%
EBIT margin	17.5%	18.2%	16.3%	-197bp	-123bp
Other income	339	414	520	25.7%	53.3%
Profit before tax	1,690	1,825	1,783	-2.3%	5.5%
Income tax expense	325	328	310	-5.4%	-4.4%
Net profit	1,365	1,497	1,473	-1.6%	7.9%
EPS - Basic	10.66	11.58	11.37	-1.8%	6.7%
EPS - Fully Diluted	10.61	11.24	11.01	-2.1%	3.7%

Source: Company Reports

Figure 2. Q3 Guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (\$ m)	176	177	5.0%	5.6%
Net profit (\$ m)	22.5	23.0	-29.7%	-28.2%

Source: Company Reports

Figure 3. Key Client Metrics

	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10
Client concentration						
Top Client - GE	12.3%	12.3%	11.9%	11.1%	11.7%	11.2%
Top 5 Clients	33.7%	37.2%	38.3%	37.0%	36.4%	35.5%
Top 10 Clients	46.8%	50.1%	51.4%	50.9%	48.7%	48.6%
Client relationship						
Total Active Clients	320	294	283	272	260	280
New Clients added	22	7	7	20	9	11
US\$1+m Clients	94	90	92	92	92	92

Source: Company Reports

Figure 4. Revenue Mix

	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10
Geography - wise						
North America	78.9%	80.0%	80.8%	80.5%	79.7%	81.0%
Europe	15.1%	14.2%	13.5%	14.0%	13.4%	12.0%
RoW	6.0%	5.8%	5.7%	5.5%	6.8%	7.0%
Service - wise						
ADM	65.1%	64.9%	65.0%	65.8%	64.6%	62.5%
PI	13.7%	13.8%	12.9%	12.8%	13.4%	13.2%
PE	11.4%	11.3%	11.1%	11.2%	12.1%	12.2%
IMS	3.5%	4.7%	6.0%	5.3%	5.0%	5.4%
BPO	6.3%	5.3%	5.0%	4.8%	4.9%	6.7%
SBU - wise						
Insurance	27.3%	29.7%	31.2%	30.5%	29.0%	30.1%
Manufacturing	29.2%	27.7%	28.4%	30.3%	30.8%	29.9%
Financial Services	13.7%	13.8%	12.3%	12.0%	11.7%	11.9%
Telecommunications	14.4%	13.7%	13.5%	12.3%	12.2%	11.7%
Product Engineering Practice	15.3%	15.1%	14.6%	14.8%	16.3%	16.4%

Source: Company Reports

Figure 5. Key Execution Metrics

	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10
Total staff	14,540	13,780	13,607	13,995	13,959	14,893
- Offshore	11,693	11,022	10,843	11,264	11,118	11,774
- Onsite	2,847	2,758	2,764	2,731	2,841	3,119
- Delivery	12,990	12,285	12,087	12,511	12,544	13,409
- Sales and Support	1,550	1,495	1,520	1,484	1,415	1,484
Effort by location of delivery						
Offshore	71.7%	72.4%	73.2%	73.1%	74.8%	72.6%
Onsite	28.3%	27.6%	26.8%	26.9%	25.2%	27.4%
Other Key metrics						
Utilization (inc. trainees)	70.3%	74.4%	77.0%	77.4%	79.9%	75.0%
Attrition (Qtrly, annualized)	6.3%	8.6%	15.0%	24.9%	22.3%	23.8%
Attrition Rate (TTM)	15.5%	13.2%	11.3%	13.7%	17.7%	21.5%

Source: Company Reports

Patni Computer Systems

Company description

Patni is a mid-tier Indian IT solutions provider and a pioneer of offshore IT services delivery. Founded in 1978, it operated both software and hardware businesses until 1999, when the hardware business was de-merged. It continues to operate as a global consulting and IT services provider. Patni employs about 14,000 professionals, who service about 260 global corporations. It has a sizeable presence in insurance, financial services, manufacturing and telecoms verticals. GE is Patni's largest customer, contributing 11.7% of revenues.

Investment strategy

Our Sell / Medium Risk (3M) rating is based on a challenging outlook for tier-II IT companies and Patni's poor performance over many quarters. Its valuations are in line with other mid-tier companies; however, growth remains a

challenge. With poor growth prospects, the stock has little room for upside. We expect ~11% revenue CAGR over CY09-12E, slower than those of peers.

Valuation

Our target price of Rs545 is based on 13x Sep'11E EPS. This is closer to the higher end of the 3-17x band that the stock has traded in over the past 3-years. We believe that this is justified given that revenue visibility is improving (across the sector) and Patni has made some good effort in cost cutting. We believe P/E is the most appropriate valuation measure to value the stock given Patni's track record in profitability.

Risks

Although our quantitative risk-rating system suggests High Risk, we rate Patni shares Medium Risk, in line with other mid-cap stocks. Key upside risks that could cause the shares to exceed our target price include: (1) uptick in growth rates; (2) any significant depreciation of the rupee against the USD/EUR/GBP; (3) sharp recovery in the US economy; and (4) any value generating acquisition.

Appendix A-1

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Patni Computer Systems (PTNI.BO)

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Fundamental Research

Analyst: Surendra Goyal, CFA

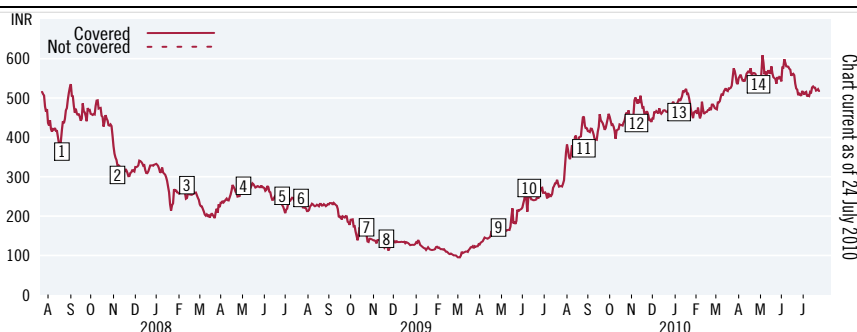


Chart current as of 24 July 2010

	Date	Rating	Target Price	Closing Price
1	21-Aug-07	*1M	*525.00	418.95
2	7-Nov-07	*1H	*475.00	328.40
3	13-Feb-08	1H	*390.00	245.70
4	2-May-08	1H	*365.00	270.90
5	26-Jun-08	1H	*340.00	228.05

	Date	Rating	Target Price	Closing Price
6	23-Jul-08	*3H	*260.00	235.80
7	23-Oct-08	3H	*140.00	152.25
8	20-Nov-08	3H	*125.00	123.60
9	28-Apr-09	3H	*150.00	150.40
10	10-Jun-09	3H	*240.00	259.90

	Date	Rating	Target Price	Closing Price
11	26-Aug-09	*3M	*440.00	452.95
12	9-Nov-09	3M	*470.00	494.55
13	7-Jan-10	3M	*525.00	498.20
14	29-Apr-10	3M	*545.00	534.80

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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