

Mahindra Satyam

ADD

Downgrade from BUY

Rs76

Limited upside

Reason for report: Q3FY12 result review and recommendation change

We had upgraded Mahindra Satyam (Satyam) to Buy in our report *The liability adjustment* (14-Dec'11). Our upgrade was underpinned by a favourable risk-reward that adequately embedded concerns around the impact of contingent liabilities in a merger valuation and a higher exposure to the discretionary spends in our opinion. Given that the stock has since run up 17% and that Q3FY12 was below our expectations on operational parameters, we downgrade the stock back to ADD with a target price of Rs80.

► **Q3FY12 revenues below expectation.** Satyam reported revenues of US\$325mn in Q3FY12, representing a 1.7% QoQ decline due to a 1.3% decline in volumes and cross-currency impact of 1.4%. Efficiency gains of 1% were the primary offset to the above. Revenues declined 0.3% in constant currency terms. Typical December seasonality and some decision-making delays on the discretionary side were cited as primary reasons for the tepid volume performance. Revenues in INR terms were Rs17.18bn (vs Rs15.78bn in Q2FY12), driven by ~10% depreciation in the INR vs the USD during Q3FY12.

► **Margins in line with our expectation though should have been better.** EBITDA margin came in at 16.2% vs our expectation of 16.4%. INR depreciation offset the impact of wage inflation (230bps) with the expansion in margin driven by efficiency gains through higher offshoring (100bps shift), higher fixed-price mix (300bps improvement) and higher utilisation (~100bps increase to 75%). However, given the fact that there was no provision for bad debts during Q3FY12, unlike Q2FY12 when bad debt provision posed a >200bps drag, we would have expected the EBITDA margin to be better. The key reason for the lower-than-expected margin was the increase in subcontractor costs by Rs180mn (increase of ~1% of revenues).

► **PAT significantly higher on higher forex income.** Despite revenues being lower than expected and margins being just in-line, Satyam reported PAT of Rs3.08bn vs our estimate of Rs2.27bn. The upside relative to our expectation was driven by higher forex income of Rs663mn (translation gain of ~Rs840mn and the rest being hedge losses) and higher treasury income.

► **Lower estimates marginally; downgrade to ADD.** Given a lower revenue base as a result of the miss (to our estimates) in Q3FY12 and an assumption of higher subcontracting costs, we reduce our FY13 revenue estimate by 2% and EBITDA by 8%. Our EPS estimate now stands at Rs7.8 vs Rs8.1 earlier. Given that the stock has seen a sharp run-up in quick time, post our upgrade on 14-Dec'11, we see limited upside to our target price of Rs80. As such, we downgrade the stock to **ADD**. Our target price embeds a haircut to the valuation on account of contingent liabilities that may be considered in case of a merger.

Market Cap	Rs89.5bn/US\$1.8bn	Year to March	2010	2011	2012E	2013E
Reuters/Bloomberg	SATY.NS/SCS.IN	Revenue (Rs mn)	54,810	51,450	64,175	70,710
Shares Outstanding (bn)	1,177	Rec Net Inc (Rs mn)	2,923	4,946	9,854	9,259
52-week Range (Rs)	94/54	Recurring EPS (Rs)	2.5	4.2	8.4	7.8
Free Float (%)	57.3	% Chg YoY		69.2	98.9	(6.3)
FII (%)	17.1	P/E (x)	30.6	18.1	9.1	9.7
Daily Volume (US\$'000)	7,023	CEPS (Rs)	4.3	5.8	9.7	9.2
Absolute Return 3m (%)	2.7	EV/E (x)	13.5	12.7	5.9	4.6
Absolute Return 12m (%)	26.4	Dividend Yield (%)	0.0	0.0	0.0	0.0
Sensex Return 3m (%)	(0.9)	RoCE (%)	34.8	27.4	47.5	32.1
Sensex Return 12m (%)	(4.4)	RoE (%)	58.4	27.4	47.7	32.1

Technology

Target price Rs80

Earnings revision

(%)	FY12E	FY13E
Sales	↓ 1.6	↓ 2.1
EBITDA	↓ 4.3	↓ 8.1
EPS	↑ 7.2	↓ 3.2

Target price revision

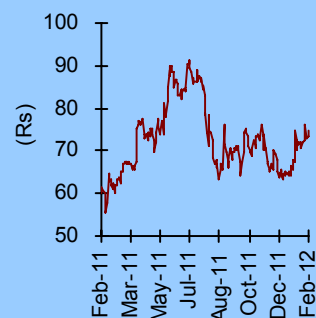
Rs80 from Rs78

Shareholding pattern

	Jun '11	Sep '11	Dec '11
Promoters	42.7	42.7	42.7
Institutional investors	16.3	18.5	20.9
MFs and UTI	0.0	0.0	0.0
Insurance Cos.	3.3	3.3	3.8
FII	13.0	15.2	17.1
Others	41.0	38.8	36.4

Source: www.nseindia.com

Price chart



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Table 1: Q3FY12 result review (consolidated)

(Rs mn, year ending March 31)

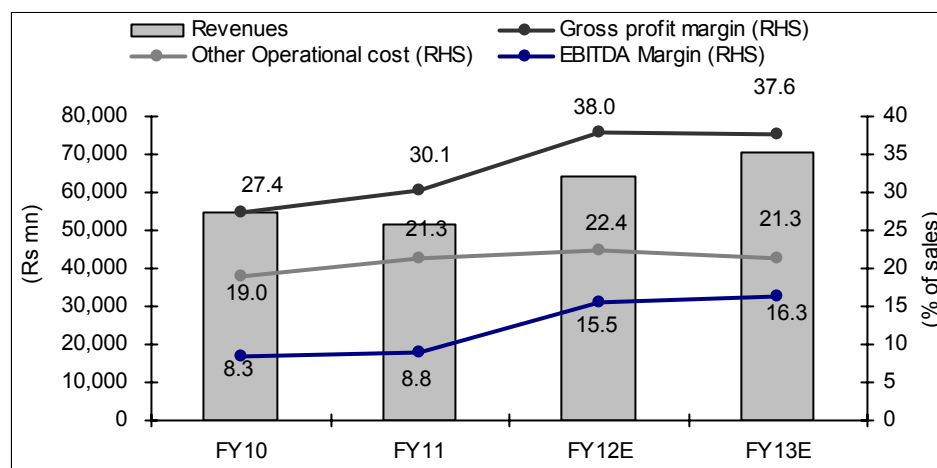
	Q3FY12	Q2FY12	Q3FY11	% chg (QoQ)	% chg (YoY)	I-Sec estimates	% Variance
Revenues	17,181	15,777	12,793	8.9	34.3	17,535	(2.0)
Employee cost	10,463	9,620	9,089	8.8	15.1	11,103	(5.8)
Other operating expenditure	3,937	3,740	2,885	5.3	36.5	3,550	10.9
Total operating expenses	14,400	13,360	11,974	7.8	20.3	14,653	(1.7)
EBIDTA	2,781	2,417	819	15.1	239.5	2,882	(3.5)
Depreciation	385	396	381	(2.8)	1.1	473	(18.6)
EBIT	2,396	2,021	438	18.5	447.0	2,409	(0.5)
Interest	27	20	23	32.4	17.4	20	32.4
Other income	1,513	967	873	56.4	73.3	385	292.7
PBT	3,881	2,968	1,288	30.8	201.4	2,774	39.9
Less: tax provision	790	578	159	36.6	396.9	499	58.3
Net income	3,091	2,390	1,129	29.4	173.8	2,274	35.9
Less: minority interest	7	7	7	(1.4)	-	3	180.0
Net profit after minority interest	3,084	2,382	1,122	29.5	174.9	2,272	35.8
Extraordinary income/(exp.)	-	-	(533)	-	-	-	-
Reported net profit	3,084	2,382	589	29.5	423.7	2,272	35.8
Ratios (%)							
EBITDA margin	16.2	15.3	6.4			16.4	
Recurring net margin	18.0	15.1	8.8			13.0	

Source: Company data, I-Sec research

Table 2: Segment results

	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Information technology services	13,476	14,074	15,479	16,847
BPO	325	316	363	409
Total	13,801	14,390	15,842	17,256
Less: Inter segment revenue	48	50	65	75
Net sales / Income from operations	13,753	14,339	15,777	17,181
Segment profit/loss before tax & interest				
Information technology services	1,551	1,707	1,974	2,317
BPO	42	12.2	47	112
Total	1,593	1,720	2,021	2,428
Less:				
Interest and financing charges	24	45.3	20.4	27.0
other unallocated expenditure/income	4,944	(1,009)	(967)	(1,480)
Total profit/loss before tax	(3,375)	2,683	2,968	3,881

Source: Company data, I-Sec research

Chart 1: Margins to improve in FY13E

Source: Company data, I-Sec research

Table 3: Operating metrics

Satyam added 35 new clients in Q3FY12. The QoQ client attrition in the >US\$10mn band is a bit concerning

The US market declined for Satyam (as it was for its other large-cap peers) and Europe grew a healthy 4.2% QoQ

	Q4FY11	Q1FY12	Q2FY12	Q3FY12
No. of clients				
>US\$1mn	144	130	124	125
>US\$5mn	48	47	47	46
> US\$10mn	33	36	35	30
> US\$20mn	12	14	16	16
> US\$50mn	3	3	3	3
Total active clients	230	220	228	217
Utilisation (including trainees - %)	73.5	74	74	75
Geography growth (%) - QoQ				
Americas	3.8	3.1	7.2	(4.8)
Europe	(11.1)	0.9	3.0	4.2
RoW	45.4	13.9	(0.1)	(2.0)
Vertical growth (%) - QoQ				
Manufacturing		5.0	4.3	(2.0)
TME (Telecom, Media and Entertainment)		10.5	7.4	(9.6)
BFSI (Banking, Financial Services & Insurance)		(0.8)	16.1	8.8
Retail		14.5	(4.4)	(2.0)
Healthcare		(8.1)	4.3	(16.0)
Others		5.0	(8.9)	2.9
Total		5.0	4.3	(2.0)
Revenue-mix (%)				
Onsite	57	56	52	51
Offshore	43	44	48	49

Source: Company data

Table 4: Valuation methodology

Particulars	Amount
Rs.7.8 FY13E EPS with currency @Rs47.5/US\$ - 11x multiple (A)	87
Market cap at Rs87/share (Rs mn)	102,466
~20% haircut on Rs42,500 mn contingent liabilities (Rs mn)	8,500
Market cap post the haircut (Rs mn)	93,966
Per share Impact of the haircut (Rs) – B	7
Target price for Satyam (Rs) (A-B)	80

Source: Company data, I-Sec research

Financial Summary

Table 5: Profit and Loss statement
(Rs mn, year ending March 31)

	FY10	FY11	FY12E	FY13E
Operating Revenues (Sales)	54,810	51,450	64,175	70,710
Operating Expenses	50,241	46,899	54,224	59,155
EBITDA	4,569	4,551	9,951	11,555
% margins	8.3	8.8	15.5	16.3
Depreciation & Amortisation	2,144	1,847	1,540	1,585
Gross Interest	329	97	120	108
Other Income	1,056	2,942	3,913	2,497
Recurring PBT	3,152	5,549	12,204	12,359
Less: Taxes	222	578	2,328	3,090
Less: Minority Interest	7	25	22	10
Add: Extraordinaries	(4,169)	(6,411)	(2,950)	0
Net Income (Reported)	(1,246)	(1,465)	6,904	9,259
Recurring Net Income	2,923	4,946	9,854	9,259

Note: Extraordinary item in FY11 reflects US class action lawsuit settlement and in FY12 reflects Upaid settlement

Source: Company data, I-Sec research

Table 6: Balance sheet
(Rs mn, year ending March 31)

	FY10	FY11	FY12E	FY13E
Assets				
Total Current Assets	39,693	47,286	50,239	57,769
of which cash and deposits with FI	21,768	27,538	26,666	32,432
Total Current Liabilities & Provisions	24,116	31,044	28,558	28,638
Net Current Assets	15,577	16,242	21,681	29,131
Investments	6,268	4,348	4,348	4,348
Net Fixed Assets	9,865	9,499	10,859	12,974
Deferred Tax Asset	65	81	65	65
Total Assets	31,775	30,170	36,953	46,517
of which cash and equivalents	28,036	31,886	31,014	36,780
Liabilities				
Borrowings	422	315	315	315
Deferred Tax Liability	39	68	39	39
Minority Interest	201	234	256	266
Equity Share Capital	2,352	2,353	2,360	2,366
Face Value per share (Rs)	2	2	2	2
Preference Share Capital	0	0	0	0
Reserves & Surplus	16,457	14,896	21,679	31,227
Net Worth	18,809	17,249	24,039	33,593
Investigation Suspense Account	12,304	12,304	12,304	12,304
Total Liabilities	31,775	30,170	36,953	46,517

Source: Company data, I-Sec research

Table 8: Quarterly trend
(Rs mn, year ending March 31)

	Mar-11	Jun-11	Sep-11	Dec-11
Net sales	13,753	14,339	15,777	17,181
% growth (YoY)		14.9	27.0	34.3
Recurring EBITDA	1,783	2,100	2,417	2,781
Margin (%)	13.0	14.6	15.3	16.2
Other income	1,024	1,009	967	1,513
Extraord. Inc / (Loss)	(5,715)	0	0	0
Recurring Net Income	2,453	2,252	2,382	3,084

Source: Company data, I-Sec research

Table 7: Cashflow statement
(Rs mn, year ending March 31)

	FY10	FY11	FY12E	FY13E
Operating Cashflow before Working Capital changes	4,338	4,002	7,594	8,465
Working Capital Inflow / (Outflow)	618	(587)	(623)	(1,394)
Capex	(1,788)	(1,505)	(2,882)	(3,700)
Free Cashflow	3,168	1,910	4,089	3,372
Cashflow from other Investment Activities (ex-Capex)	(5,212)	4,862	3,913	2,497
Proceeds from Issue of Share Capital	28,855	(85)	(114)	6
Inc/(Dec) in Borrowings	(7,720)	(107)	0	0
Divided paid	0	0	0	0
Interest Paid	(329)	(97)	(120)	(108)
Extraordinaries	(2,002)	(721)	(8,640)	0
Others	(1)	8	0	0
Increase/(Decrease) in Cash	16,759	5,770	(872)	5,766

Source: Company data, I-Sec research

Table 8: Key ratios
(Year ending March 31)

	FY10	FY11	FY12E	FY13E
Per Share Data (Rs)				
Recurring EPS	2.5	4.2	8.4	7.8
Recurring CEPS	4.3	5.8	9.7	9.2
Dividend per share (DPS)	0.0	0.0	0.0	0.0
Book Value per share (BV)	16.0	14.7	20.4	28.4
Growth Ratios (%)				
Operating Income (Sales)	(37.8)	(6.1)	24.7	10.2
EBITDA	51.4	(0.4)	118.7	16.1
Recurring Net Income		69.2	99.2	(6.0)
Recurring EPS		69.2	98.9	(6.3)
Cash EPS	105.2	34.0	67.5	(5.1)
Valuation Ratios (x)				
P/E	30.6	18.1	9.1	9.7
P/CEPS	17.6	13.2	7.9	8.3
P/BV (x)	4.8	5.2	3.7	2.7
EV/EBITDA	13.5	12.7	5.9	4.6
EV / Sales	1.1	1.1	0.9	0.8
EV/FCF	19.5	30.3	14.4	15.7
Operating Ratio				
Employee Cost/Sales (%)	72.6	69.9	62.0	62.4
Other Op. Expenditure/Sales (%)	19.0	21.3	22.4	21.3
Other Income / PBT (%)	33.5	53.0	32.1	20.2
Effective Tax Rate (%)	7.0	10.4	19.1	25.0
NWC / Total Assets (%)	27.9	26.5	33.1	38.8
Fixed Asset Turnover (x) on average	4.9	5.3	6.3	5.9
Receivables (days)	61	82	80	80
D/E Ratio (x)	2.2	1.8	1.3	0.9
Return/Profitability Ratio (%)				
Recurring Net Income Margins	5.3	9.6	15.4	13.1
RoCE (Based on Avg)	34.8	27.4	47.5	32.1
RoNW (Based on Avg)	58.4	27.4	47.7	32.1
Dividend Payout Ratio	0.0	0.0	0.0	0.0
Dividend Yield	0.0	0.0	0.0	0.0
EBITDA Margins	8.3	8.8	15.5	16.3

NM = Not Meaningful

Source: Company data, I-Sec research

New I-Sec investment ratings (all ratings based on absolute return)

BUY: >15% return; ADD: 5% to 15% return; REDUCE: Negative 5% to positive 5% return; SELL: < negative 5% return

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