

Satyam Computer Services

 BSE code: 500376
 NSE code: SATYAMCOMP

CMP: Rs 462
Target: Rs 523 ↓

BUY

| | |
|--|--|
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|--|--|

Company data

| Particulars | |
|--------------------------------|-----------|
| Market cap (Rs bn / US\$ bn) | 308.9/7.8 |
| Outstanding equity shares (mn) | 668.7 |
| 52-week high/low (Rs) | 525/401 |
| 2-month average daily volume | 614,134 |

Financial snapshot

| Particulars | FY07 | FY08E | FY09E |
|-------------------------|------|-------|-------|
| Sales (Rs bn) | 64.8 | 81.7 | 94.1 |
| Growth (%) | 35.3 | 26.0 | 15.2 |
| Adj. net profit (Rs bn) | 14.0 | 17.1 | 19.5 |
| Growth (%) | 23.0 | 21.4 | 14.6 |
| FDEPS (Rs) | 21.5 | 25.4 | 29.0 |
| Growth (%) | 20.5 | 18.6 | 14.1 |
| P/E (x) | 21.5 | 18.2 | 15.9 |
| ROE (%) | 23.0 | 22.1 | 20.5 |

Risk-return profile



Shareholding pattern

| (%) | Sep-07 | June-07 |
|--------------|--------|---------|
| Promoters | 8.8 | 8.8 |
| FII's | 46.6 | 47.9 |
| Banks & FI's | 12.9 | 12.1 |
| Public | 31.7 | 31.2 |

Stock performance

| Returns (%) | CMP | 1-mth | 3-mth | 6-mth |
|-------------|--------|-------|--------|-------|
| Satyam | 462 | 12.6 | (11.1) | (3.0) |
| Sensex | 18,493 | 11.6 | 17.5 | 32.8 |
| BSE IT | 4,580 | 6.61 | (6.6) | 7.8 |

 Company website www.satyam.com

Outperforms peers

Satyam's Q2FY08 results have been above our expectations. The growth momentum witnessed was the strongest amongst tier-1 IT services players. Revenues and net profit grew by 11% and 8.1% QoQ respectively against our estimates of 5.3% and 1.2% growth. However, the operating profit margin during the quarter was below our estimates, declining 260bps QoQ against our expectation of a flattish trend. Salary hikes, higher onsite effort and rupee appreciation had an adverse impact of 550bps on margins. The management has increased its dollar revenue and EPS guidance for FY08 by 4.8% and 4% respectively, and its rupee revenue and EPS guidance by 3.5% and 2.4% respectively.

We are increasing our revenue and EPS estimates for FY08 by 5% and 3.9% respectively on the back of better-than-expected Q2FY08 performance and the increase in guidance for FY08. We are also realigning our FY09 estimates to an average exchange rate scenario of Rs 39/US\$ which has led to a 0.6% and 2.6% decline in our revenue and EPS estimates for FY09. Consequently we decrease our target price for the stock to Rs 523 but maintain our Buy recommendation.

Actual vs estimated performance

| (Rs mn) | Actual | Estimated | % Variance |
|-------------------|----------|-----------|------------|
| Revenues | 20,317.2 | 19,275.7 | 5.4 |
| EBITDA | 4,027.0 | 4,330.0 | (7.0) |
| EBITDA margin (%) | 19.8 | 22.5 | (264bps) |
| Net profit | 4,090.9 | 3,828.8 | 6.8 |
| EPS (Rs) | 6.12 | 5.7 | 7.4 |

Source: Company, Religare Research

Quarterly results

| (Rs mn) | Q2FY08 | Q1FY08 | % Chg QoQ | Q2FY07 | % Chg YoY |
|---------------------|----------------|----------------|--------------|----------------|-------------|
| Revenue | 20,317.2 | 18,301.9 | 11.0 | 16,018.8 | 26.8 |
| Cost of revenues | 13,034.3 | 11,064.3 | 17.8 | 9830.6 | 32.6 |
| Gross profit | 7,282.9 | 7,237.6 | 3.0 | 6,188.2 | 17.7 |
| SG&A expenses | 3255.9 | 3134.7 | 3.9 | 2563.3 | 27.0 |
| EBITDA | 4,027.0 | 4,102.9 | (1.8) | 3,624.9 | 11.1 |
| Depreciation | 390.6 | 386.9 | 1.0 | 375.1 | 4.1 |
| EBIT | 3,636.4 | 3,716.0 | (2.1) | 3,249.8 | 11.9 |
| Other income | 1,104.5 | 632.0 | 74.8 | 282.3 | 291.3 |
| Interest expenses | 41.0 | 33.2 | 23.5 | 27.2 | 50.7 |
| PBT | 4,699.9 | 4,314.8 | 8.9 | 3,504.9 | 34.1 |
| Provision for taxes | 609.0 | 531.6 | 14.6 | 306.8 | 98.5 |
| Net profit | 4,090.9 | 3,783.2 | 8.1 | 3,198.1 | 27.9 |
| EPS (Rs) | 6.1 | 5.7 | 7.9 | 4.9 | 24.9 |

Source: Company, Religare Research

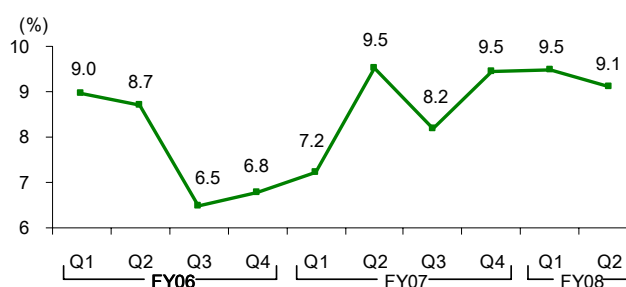
Result highlights

Volumes rose 9.1% QoQ, driving revenue growth of 11% QoQ and 26.8% YoY

Strong volume growth and better pricing drive revenues...

The company continued to witness better-than-peer volume growth in the IT services business. Volumes rose 9.1% QoQ and this together with pricing improvement resulted in overall revenue growth of 11% QoQ and 26.8% YoY. Blended billing rates improved by 1.6% QoQ, supported by a 2.2% and 1.3% QoQ improvement in onsite and offshore billing rates respectively.

Volume growth



Source: Religare Research

Billing rate improvement

| (%) | Q2FY07 | Q3FY07 | Q4FY07 | Q1FY08 | Q2FY08 |
|----------|--------|--------|--------|--------|--------|
| Onsite | 0.5 | 0.4 | 0.6 | 1.3 | 2.2 |
| Offshore | 0.2 | 0.1 | 0.7 | 1.5 | 1.3 |

Source: Company, Religare Research

Negative surprise on the EBITDA margin with a sharp 260bps decline QoQ

...but margins decline more than expected

We had anticipated a flattish margin trend during the quarter despite the salary hikes as the magnitude of rupee appreciation was lower as compared to Q1FY08. Contrary to our expectations, however, the EBITDA margin for the quarter declined by 260bps QoQ to 19.8% due to the following: a) higher-than-industry average salary hikes of 16% and 5% for offshore and onsite employees respectively, b) 1.3% rupee appreciation in the quarter, and c) higher onsite effort due to a ramp-up in new accounts.

The utilisation rate in the quarter too has been lower than our expectations. The utilisation rate for offshore employees including trainees was flat at 76.4% as compared to 76.5% in Q1FY08.

Profit margin movement

| (%) | Q2FY07 | Q3FY07 | Q4FY07 | Q1FY08 | Q2FY08 |
|---------------------|--------|--------|--------|--------|--------|
| Gross profit margin | 38.6 | 41.7 | 39.5 | 39.8 | 35.8 |
| EBITDA margin | 22.6 | 24.7 | 23.1 | 22.4 | 19.8 |
| Net profit margin | 20.0 | 20.3 | 22.1 | 20.7 | 20.1 |

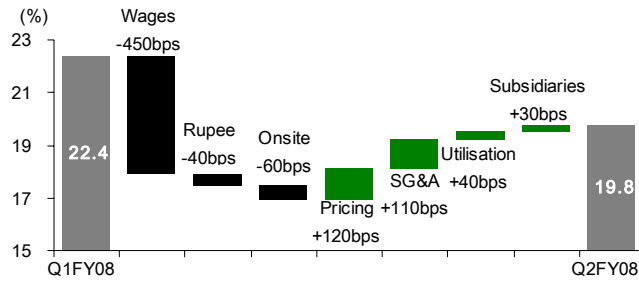
Source: Company, Religare Research

Improved pricing and lower SG&A expenses cushion margins

Salary hikes and rupee appreciation had a negative impact of 550bps on margins. However, margin levers in the form of pricing improvement, lower SG&A expenses and improved subsidiary performance restricted the fall in the EBITDA margin to 260bps QoQ.

Constituents of EBITDA margin performance QoQ

Improved pricing, lower SG&A expenses and better subsidiary performance shored up margins



Source: Religare Research

Key performance highlights

| Parameters | Comments |
|----------------------------|---|
| Volume growth | The company witnessed strong volume growth across all verticals including BFSI. Volumes grew by 9.1% QoQ on the back of growth seen from the Asia-Pacific and European geographies. |
| Pricing | Satyam has been able to renegotiate its existing deals at higher rates with offshore and onsite billing rates rising 1.3% and 2.2% respectively during the quarter. |
| Onsite-Offshore mix | The share of onsite revenues increased to 49.6% during the quarter as compared to 48% in Q1FY08. The shift towards more onsite work has had a 60bps negative impact on margins. Offshore revenue contribution during the quarter has decreased to 50.4% compared to 52% in Q1FY08. |
| Employee addition | The company has added 3,037 employees in Q2FY08 as against our estimate of 2,626 employees. About 1,889 trainees were recruited during the quarter taking the total number of employees to 41,423. The company is increasing its fresher mix in order to maintain the cost of delivery. |
| Attrition rate | Attrition rates have declined consistently over the past few quarters from 18.3% in Q2FY07 to 13.9% in Q2FY08. Higher-than-industry salary hikes has been the key motivating factor behind the reduced attrition. |
| Clients & deals | During the quarter, Satyam signed a deal with Fujitsu involving standard application maintenance and development, infrastructure management services and network operation centre related services. It also signed an agreement to acquire UK-based Nitor Global Solutions for up to £2.76mn in an all-cash deal. |
| Utilisation levels | Onsite and offshore net utilisation (excluding trainees) increased by 90bps and 160bps QoQ respectively. |
| Client growth | The company has added eight more clients in Q2FY08, and the number of customers with a run-rate of US\$ 1mn has increased to 213 from 190. |
| Salary hikes | Satyam gave a salary hike of 16% and 5% to offshore and onsite employees respectively. These increments had a negative impact of ~450bps on margins. |
| Services metrics | Satyam's enterprise solutions segment remained buoyant, clocking 14% growth QoQ. Besides enterprise solutions, the ADM segment has shown sequential growth of 12.4%. |
| Vertical metrics | BFSI has grown 12.1% QoQ, higher than the overall company growth rate despite the US sub-prime concerns. Retail & transportation and the TIMES verticals also posted strong growth of 21.3% and 19.9% QoQ respectively. |
| Geographical mix | The contribution from the US has decreased to 58.4% in Q2FY08 as against 61.6% in Q1FY08. The decline was primarily due to higher growth witnessed in Europe and RoW. The contribution from these geographies has increased to 21% and 20.6% as against 20.1% and 18.2% in Q1FY08 respectively. |

Future outlook

FY08 dollar and rupee revenue guidance upped 4.8% and 3.5% respectively

FY08 guidance revised upwards

Satyam has raised its dollar and rupee revenue guidance by 4.8% and 3.5% respectively for FY08. EPS for the year is guided to grow at 36% in dollar terms and 17% in rupee terms. The rupee guidance is at Rs 39.5/US\$ as against Rs 40.5/US\$ in Q1FY08.

Revised FY08 guidance

| Parameters | New | | Old | |
|-----------------------|---------------|-------------|---------------|-------------|
| | Value | Growth (%) | Value | Growth (%) |
| In US\$ terms | | | | |
| Revenue (US\$ mn) | 2,068 – 2,076 | 41.5 - 42.0 | 1,958 – 1,980 | 34.0 - 35.5 |
| EPS (US\$) | 1.24 | 36.0 | 1.17-1.19 | 28.3 - 29.7 |
| In rupee terms | | | | |
| Exchange rate | Rs 39.5/US\$ | | Rs 40.5/US\$ | |
| Revenue (Rs bn) | 81.9 – 82.2 | 26.3 - 26.7 | 78.5 – 79.4 | 21.1 - 22.5 |
| EPS (Rs) | 25.0 - 25.1 | 16.5 - 17.0 | 24.1 - 24.5 | 12.5 - 14.0 |

Source: Company, Religare Research

We too revise our estimates

We are increasing our revenue and EPS estimates for FY08 by 5% and 3.9% respectively on the back of better-than-expected Q2FY08 performance and the increase in guidance for FY08. We are also realigning our FY09 estimates to an average exchange rate scenario of Rs 39/US\$ (from Rs 40.5/US\$ earlier) which has led to a 0.6% and 2.6% decline in our revenue and EPS estimates for FY09 respectively.

Revised estimates

| (Rs bn) | FY08 | | | FY09 | | |
|------------|---------|---------|-------|---------|---------|-------|
| | Earlier | Revised | % Chg | Earlier | Revised | % Chg |
| Revenues | 77.8 | 81.7 | 5.0 | 94.6 | 94.1 | (0.6) |
| Net profit | 16.4 | 17.1 | 4.0 | 20.1 | 19.5 | (2.7) |
| EPS (Rs) | 24.5 | 25.4 | 3.9 | 29.8 | 29.0 | (2.6) |

Source: Religare Research

EBITDA margin to dip in FY08 and FY09

We expect the company's EBITDA margin to decline by 140bps in FY08 and 20bps in FY09 due to rupee appreciation, higher-than-industry salary hikes given in FY07 and FY08, and RSU charges. A part of the negative impact would be offset by increased utilisation rates and an improvement in blended billing rates in FY08 (by ~4% and ~2% for offshore and onsite effort respectively).

We decrease our target price but maintain Buy

Consequent to the reduction in revenue and profit estimates for FY09 we are decreasing our target price for Satyam. We are also lowering our target P/E multiple for the stock from 19x to 18x, which is at an 18% discount to our target multiple of 22x for Infosys. The discount between Satyam's valuations and other tier-1 IT peers has narrowed in the past few months due to the company's improved performance.

At the current price of Rs 462, the stock is trading at 18.2x and 15.9x its expected FY08 and FY09 earnings of Rs 25.4 and Rs 29 respectively. Our one-year target price for the stock has been revised to Rs 523 from Rs 561. We maintain our Buy recommendation on the stock.

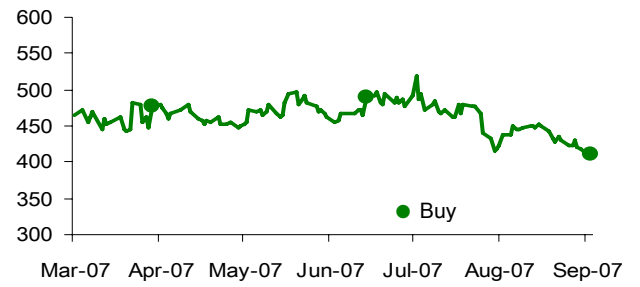
Target reduced to build in revised estimates and a de-rating of target P/E multiples across the sector

Recommendation history

| Date | Event | Reco price | Tgt price | Reco |
|-----------|----------------|------------|-----------|------|
| 23-Apr-07 | Results Update | 476 | 598 | Buy |
| 9-Jul-07 | Sector Update | 489 | 561 | Buy |
| 24-Oct-07 | Results Update | 462 | 523 | Buy |

Source: Religare Research

Stock performance



Source: Religare Research

Consolidated financials

Profit and Loss statement

| (Rs bn) | FY06 | FY07 | FY08E | FY09E |
|------------------------|-------|-------|-------|-------|
| Revenues | 47.9 | 64.8 | 81.7 | 94.1 |
| Growth (%) | 36.1 | 35.3 | 26.0 | 15.2 |
| EBITDA | 11.7 | 15.6 | 18.5 | 20.9 |
| Growth (%) | 34.3 | 33.5 | 18.8 | 13.2 |
| Depreciation | 1.4 | 1.5 | 1.7 | 2.0 |
| EBIT | 10.3 | 14.0 | 16.8 | 18.9 |
| Growth (%) | 36.3 | 36.4 | 19.4 | 13.1 |
| Interest | 0.1 | 0.2 | 0.1 | 0.1 |
| Other income | 3.3 | 1.2 | 1.7 | 3.1 |
| EBT | 13.6 | 15.1 | 18.9 | 21.9 |
| Growth (%) | 61.8 | 11.0 | 25.8 | 15.7 |
| Tax | 2.1 | 1.4 | 2.1 | 2.4 |
| Effective tax rate (%) | 15.3 | 9.2 | 11.0 | 10.8 |
| Net income (adjusted) | 11.4 | 14.0 | 17.1 | 19.5 |
| Growth (%) | 60.4 | 23.0 | 21.4 | 14.6 |
| Shares outstanding(mn) | 641.2 | 657.9 | 670.2 | 673.2 |
| FDEPS (Rs) | 17.8 | 21.5 | 25.4 | 29.0 |
| DPS (Rs) | 5.0 | 3.5 | 4.0 | 5.0 |
| CEPS(Rs) | 19.9 | 23.7 | 28.0 | 32.0 |

Source: Company, Religare Research

Cash flow statement

| (Rs bn) | FY06 | FY07 | FY08E | FY09E |
|---------------------------|-------|--------|-------|-------|
| Net income | 11.4 | 14.0 | 17.1 | 19.5 |
| Depreciation | 1.4 | 1.5 | 1.7 | 2.0 |
| Other adjustments | 0.0 | 0.0 | - | - |
| Changes in WC | (3.2) | (3.3) | (2.3) | (2.5) |
| Operating cash flow | 7.5 | 10.0 | 16.5 | 19.0 |
| Capital expenditure | (2.5) | (3.9) | (3.6) | (4.0) |
| Investments | 0.4 | (15.9) | 0.2 | - |
| Other investing inc/(exp) | 1.5 | 2.8 | - | - |
| Investing cash flow | (0.5) | (17.0) | (3.4) | (4.0) |
| Free cash flow | 7.0 | (7.0) | 13.1 | 15.0 |
| Issue of equity | 1.4 | 3.0 | 1.0 | 1.4 |
| Issue/repay debt | 0.8 | 0.5 | - | - |
| Dividends paid | (1.8) | (2.6) | (2.7) | (3.4) |
| Others | (0.1) | (0.2) | - | - |
| Financing cash flow | 0.3 | 0.7 | (1.6) | (1.9) |
| Beg. cash & cash eq | 5.5 | 12.8 | 6.7 | 18.2 |
| Chg in cash & cash eq | 7.3 | (6.3) | 11.5 | 13.1 |
| Closing cash & cash eq | 12.8 | 6.7 | 18.2 | 31.3 |

Source: Company, Religare Research

Balance sheet

| (Rs bn) | FY06 | FY07 | FY08E | FY09E |
|-----------------------|------|------|-------|-------|
| Cash and cash eq | 13.0 | 6.7 | 18.2 | 31.3 |
| Accounts receivable | 11.6 | 17.7 | 20.6 | 23.7 |
| Inventories | 2.7 | 2.4 | 4.4 | 4.9 |
| Others current assets | 27.3 | 26.8 | 43.3 | 61.6 |
| Current assets | 18.1 | 34.0 | 33.8 | 33.8 |
| LT investments | 6.3 | 8.9 | 11.5 | 12.4 |
| Net fixed assets | - | - | - | - |
| CWIP | 0.8 | 1.7 | 1.7 | 1.7 |
| Total assets | 52.4 | 71.5 | 90.3 | 109.6 |
| Payables | 1.1 | 1.6 | 2.6 | 2.9 |
| Others | 5.1 | 7.1 | 8.8 | 9.5 |
| Current liabilities | 6.2 | 8.7 | 11.3 | 12.4 |
| LT debt | 0.8 | 1.3 | 1.3 | 1.3 |
| Other liabilities | 0.4 | 0.5 | 0.5 | 0.5 |
| Equity capital | 1.3 | 1.3 | 1.3 | 1.3 |
| Reserves | 43.8 | 59.6 | 75.7 | 94.0 |
| Net worth | 45.1 | 61.0 | 77.1 | 95.3 |
| Total liabilities | 52.4 | 71.5 | 90.3 | 109.6 |
| BVPS (Rs) | 70.3 | 92.7 | 115.0 | 141.6 |

Source: Company, Religare Research

Financial ratios

| | FY06 | FY07 | FY08E | FY09E |
|-----------------------|-------|------|-------|-------|
| EBITDA margin (%) | 24.3 | 24.0 | 22.6 | 22.2 |
| EBIT margin (%) | 21.5 | 21.6 | 20.5 | 20.1 |
| Net profit margin (%) | 23.8 | 21.7 | 20.9 | 20.8 |
| FDEPS growth (%) | 50.8 | 20.5 | 18.6 | 14.1 |
| Receivables (days) | 74.4 | 99.8 | 92.2 | 92.0 |
| Inventory (days) | - | - | - | - |
| Payables (days) | 44.8 | 45.0 | 45.0 | 45.0 |
| Current ratio (x) | 4.4 | 3.1 | 3.8 | 5.0 |
| Interest coverage (x) | 206.9 | 88.5 | 139.7 | 207.8 |
| Debt/equity ratio (x) | 0.0 | 0.0 | 0.0 | 0.0 |
| ROE (%) | 25.3 | 23.0 | 22.1 | 20.5 |
| ROCE (%) | 22.2 | 22.3 | 21.2 | 19.5 |
| ROAE (%) | 19.6 | 19.6 | 18.6 | 17.3 |
| EV/Sales (x) | 6.3 | 4.7 | 3.7 | 3.2 |
| EV/EBITDA (x) | 26.0 | 19.5 | 16.4 | 14.5 |
| P/E (x) | 26.0 | 21.5 | 18.2 | 15.9 |
| P/BV (x) | 6.6 | 5.0 | 4.0 | 3.3 |
| P/CEPS (x) | 23.2 | 19.5 | 16.5 | 14.4 |

Source: Company, Religare Research

RELIGARE RESEARCH
Fundamental Research

| | | | |
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Recommendation parameters

| | | | | |
|-------------|-------|--------|---------|----------|
| Large-caps* | > 10% | < - 5% | Returns | Absolute |
| | BUY | SELL | | |
| Mid-caps** | > 25% | < 10% | | |

*Market cap over US\$ 1bn **Market cap less than US\$ 1bn

Religare Securities

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