

Company Flash

20 April 2007 | 8 pages

Satyam Computers Services (SATY.BO)

Buy: In-Line Quarter; Strong Guidance

- In-line results; good guidance** — Satyam delivered in-line Q4 results – topline was up 9.5% qoq to \$406m (est. \$402m) while EBITDA at Rs. 4.1b was flat qoq and lower than our expectation of Rs.4.3b. Satyam guided to a strong FY08 with topline growth of 28-30% and EPS growth of 27-29% (\$ terms).
- Q4FY07 results - key points** — Gross margins were down 220bp qoq but lower SG&A resulted in EBITDA margin decline of ~160bp qoq. Lower depreciation, higher other income and lower tax rate (despite higher other income) resulted in net income of Rs.3.9b (against our expectation of Rs.3.6b).
- Pricing in line with sector trend** — Satyam witnessed an improvement in blended pricing of ~70bp qoq and guided to a 2-3% increase in realizations in FY08. This is in line with sector trends where we have witnessed pricing improvement for all the leading companies in the sector.
- Attrition moving down** — Attrition moved down again in the quarter; Attrition for last twelve months fell to 15.7% as against 17.3% at the end of Q3.
- Ambitious guidance of flat margins in FY08** — Satyam has talked about flat margins for FY08. With full impact of RSU, rupee appreciation and wage hikes, it is an ambitious target in our view. Levers like pricing, employee pyramid, offshorization, improvement in profitability of subsidiaries would all need to fall in place to achieve that.
- Maintain Buy** — The stock trades at 18x FY08E earnings – maintain Buy/Medium Risk (1M) recommendation on the stock.

Buy/Medium Risk	1M
Price (19 Apr 07)	Rs447.85
Target price	Rs582.00
Expected share price return	30.0%
Expected dividend yield	1.3%
Expected total return	31.3%
Market Cap	Rs298,804M US\$7,129M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	7,116	11.02	36.1	40.6	8.7	23.9	0.6
2006A	9,979	15.09	36.9	29.7	6.7	26.2	0.8
2007E	13,761	20.39	35.2	22.0	5.5	28.4	1.3
2008E	16,981	25.18	23.5	17.8	4.5	28.7	1.8
2009E	20,382	30.22	20.0	14.8	3.8	28.6	2.2

Source: Powered by dataCentral

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Other key points

- Subsidiary performance improved marginally – operating margins improved to 4.3% (from 1.6% qoq). For the next year, management expects margin to improve further.
- For Nipuna, management guided to a 60% growth for FY08 leading to a revenue of \$61m.
- Other income high at Rs. 7b – primarily on account of a Rs. 40m forex gain as against Rs. 350m forex loss in Q3.
- In terms of hedging, Satyam continues to hedge 50% of its expected dollar inflow over the next twelve months. The hedge position at the end of Q4 was \$470m.
- Management reiterated that demand remains strong – interaction with customers does not indicate any slowdown in activity.
- For FY08, Satyam guided to a 28-30% growth in revenues and 27-29% growth in EPS (\$ terms). In Re terms, it translates to a growth of 20-22% revenue growth and 18-20% EPS growth.
- The guidance factors in wage hikes of 5% onsite and 16% offshore.
- The EPS guidance also factors in a 2.25% ESOP related equity dilution.

Figure 1. Key Financials

	3Q06	2Q07	3Q07	QoQ	YoY
Revenue (US\$ m)	301	376	411	9.5%	36.8%
Revenue	13,136	16,611	17,792	7.1%	35.4%
Cost of revenue	7,509	9,681	10,768	11.2%	43.4%
Gross profit	5,627	6,930	7,024	1.4%	24.8%
Gross margin	42.8%	41.7%	39.5%	-224bp	-336bp
Operating expenses	2,282	2,830	2,922	3.2%	28.0%
EBITDA	3,345	4,100	4,102	0.1%	22.6%
EBITDA margin	25.5%	24.7%	23.1%	-162bp	-241bp
Depreciation and amortization	372	394	354	-10.1%	-4.8%
EBIT	2,973	3,706	3,748	1.1%	26.1%
EBIT margin	22.6%	22.3%	21.1%	-124bp	-157bp
Other income	289	102	704	592.2%	143.7%
Profit before tax	3,246	3,776	4,378	16.0%	34.9%
Income tax expense	397	403	442	9.7%	11.3%
Income from operations	2,848	3,372	3,936	16.7%	38.2%
Affiliates/Minority	-2	0	0	n.a.	n.a.
Net income - recurring	2,847	3,372	3,936	16.7%	38.3%
EO gain/(loss)	0	0	0	n.a.	n.a.
Net income for shareholders	2,847	3,372	3,936	16.7%	38.3%
EPS - basic	4.18	5.15	5.98	16.2%	43.1%
EPS - fully diluted	4.03	5.00	5.83	16.6%	44.7%

Source: Company Reports

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Figure 2. Annual Guidance

FY08 guidance	Guidance		Implied growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	77,930	79,160	20.2%	22.1%
Revenue (\$ m)	1,870	1,900	28.0%	30.0%
EPS (Rs)	25.32	25.73	18.0%	20.0%
INR/USD assumption		42.30		-6.1%

Source: Company Reports

Figure 3. Quarterly Guidance

1Q08	Guidance		Implied growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	18,010	18,100	1.2%	1.7%
Revenue (\$ m)	432	434	5.0%	5.5%
EPS (Rs)	5.93	5.98	-0.8%	0.0%

Source: Company Reports

Figure 4. Key HR and execution metrics

	1Q07	2Q07	3Q07	4Q07
Total employee base	29,639	34,105	37,230	38,586
BPO services (Nipuna)	2,005	2,446	2,825	2,916
IT Services - parent only	27,634	31,659	34,405	35,670
Support	1,781	1,829	1,811	1,858
Delivery employees - total	25,853	29,830	32,594	33,812
- Onsite	5,967	6,428	6,551	7,073
- Offshore	18,831	21,835	25,007	25,269
- Domestic	1,055	1,567	1,036	1,470
Avg. realization (US\$ per hour)				
Onsite	56.07	56.32	56.52	56.87
- change	0.30%	0.45%	0.36%	0.62%
Offshore	23.00	23.05	23.08	23.24
- change	0.18%	0.21%	0.12%	0.72%
Domestic	13.74	14.02	14.09	14.18
- change	-1.58%	2.04%	0.50%	0.64%
Utilization				
Onsite	97.03%	96.99%	96.76%	96.63%
Offshore	79.56%	78.75%	77.60%	78.42%
Offshore with trainees	71.24%	71.11%	68.49%	71.34%
Attrition % (IT services)	19.62%	18.27%	17.62%	15.70%

Source: Company Reports

Figure 5. Revenue Mix

	1Q07	2Q07	3Q07	4Q07
Geography wise				
North America	65.9%	65.9%	64.3%	62.6%
Japan	1.1%	1.7%	1.7%	1.5%
Europe	17.6%	18.0%	19.0%	19.9%
RoW	15.4%	14.5%	15.1%	16.1%
Service line wise				
Development & Maintenance	48.5%	48.0%	47.3%	46.4%
Package implementation	40.3%	40.4%	42.0%	42.6%
Engineering services	6.0%	6.4%	6.8%	7.0%
IMS	5.2%	5.2%	3.9%	4.0%
Vertical wise				
BFSI	29.7%	28.6%	25.6%	24.7%
Manufacturing	27.8%	26.7%	27.1%	27.2%
TIMES	19.1%	20.4%	20.7%	21.8%
Healthcare	6.5%	7.3%	7.6%	8.0%
Retail & Transportation	5.4%	5.2%	6.0%	6.4%
Others	11.5%	11.8%	13.0%	11.9%

Source: Company Reports

Figure 6. Key client metrics

	1Q07	2Q07	3Q07	4Q07
Client relationship				
Total active clients	489	504	523	538
New clients added	34	35	34	35
1+ mn USD Clients	142	154	164	180
5+ mn USD Clients	51	54	54	57
10+ mn USD Clients	33	32	32	35
Client concentration				
Top client	7.1%	6.7%	6.3%	6.1%
Top 5 clients	22.7%	22.3%	21.6%	22.2%
Top 10 clients	34.4%	33.9%	34.2%	36.3%
Revenue from existing business	87.7%	86.1%	85.7%	88.7%

Source: Company Reports

Satyam Computers Services

Company description

Satyam is the fourth-largest IT solutions provider from India and is one of the pioneers of offshore IT services delivery. The company has over 500 clients across the globe and employs over 37,000 professionals across IT and BPO services. Satyam was an early entrant into IT consulting/package implantation work. As of 3Q07, ~40% of its revenue comes from this service line. It has domain competencies in verticals such as Manufacturing, Banking & Financial Service and Insurance among others.

Investment thesis

We rate Satyam Buy / Medium Risk (1M) with a target price of Rs582. We believe offshore IT outsourcing is now a mainstream option and Satyam - which has achieved meaningful scale with its top-five position in India - appears well positioned to benefit from growing business volumes. Over the last several quarters, volume growth has trended at over 5% QoQ. With revenue over US\$1

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billion, Satyam becomes a strong contender for winning large deals looking at leveraging offshore. It has won at least three large deals over the past four quarters. We expect gradual margin decline (rather than steep), as wage inflation should be partially offset by positive leverage from better onsite-offshore mix, fresher hiring and improved utilization. Overall, we forecast 30.7% revenue CAGR and 26.1% EPS CAGR over FY06-09E.

Valuation

Our 12-month target is Rs582, based on 21x average FY08E-09E earnings. We value Satyam on a P/E basis relative to its medium-term growth potential and also on its valuation relative to peer Infosys, which is the industry benchmark. Given that we expect Satyam's earnings to grow at a 26.1% CAGR over the next three years - with upside risk to estimates given strong industry growth - we believe the stock could trade toward the upper end of its historical three-year trading range of 12-21x 12-month forward earnings. Satyam has traded at a 10%-40% discount to Infosys in the past two years due to its lower growth rates. Our forward P/E is based on a ~25% discount to our target multiple for Infosys. Our Rs582 target price equates to an average FY08E-09E Price/Sales of 4x, which is within the historical trading range of 2-5x.

Risks

Although our quantitative risk-rating system suggests Low Risk for Satyam, we rate Satyam as Medium Risk given the similar risk ratings for other mid-sized IT peer-group companies in our coverage universe. The key downside risks that could impede the shares from reaching our target price include: (1) A slowdown in enterprise software license revenues; (2) The supply side situation becoming more difficult; (3) Risks to earnings from a sharp US slowdown; (4) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (5) A sharp slowdown in the US economy; (6) A slowdown in the banking, financial services and insurance (BFSI) sector; and (7) limited H1B visa quotas.

Appendix A-1

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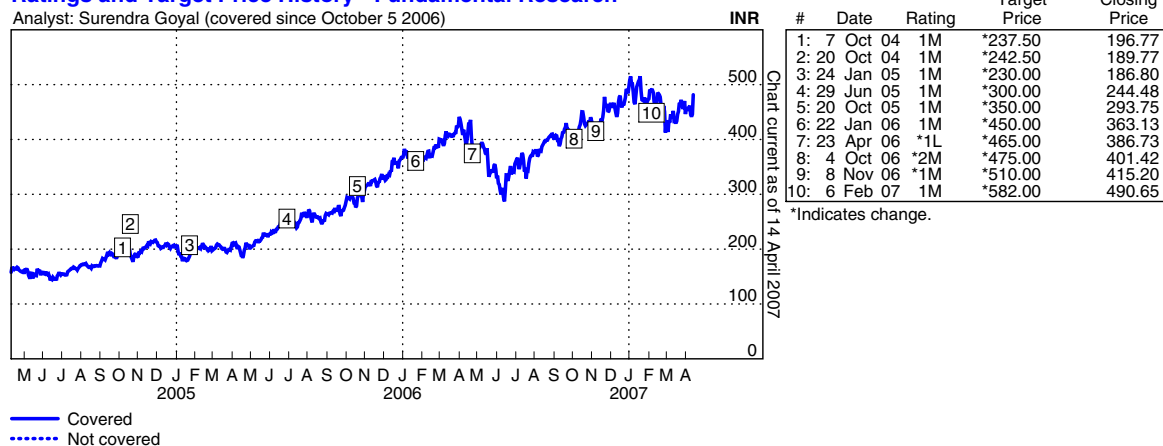
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Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)



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