

## Satyam Computer

STOCK INFO.	BLOOMBERG
BSE Sensex: 11,919	SCS IN
	REUTERS CODE
S&P CNX: 3,471	SATY.BO

Equity Shares (m)	326.3
52-Week Range	890/515
1,6,12 Rel. Perf. (%)	-1/-11/2
M.Cap. (Rs b)	260.2
M.Cap. (US\$ b)	5.6

8 September 2006

Buy

Previous Recommendation: Buy

Rs797

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
3/06A	47,926	9,820	30.3	35.9	26.3	6.0	25.8	29.5	4.7	19.2
3/07E	64,904	13,221	40.3	33.3	19.8	4.8	27.1	30.3	3.3	14.3
3/08E	83,758	15,935	48.1	19.2	16.6	3.9	26.0	29.4	2.5	11.1

\* PAT figures reflect adjusted PAT

We attended Satyam Computer's Analyst Meet at Mumbai, recently. We present below our key takeaways.

### Enterprise solutions, engineering services to spur revenue growth

Satyam concedes that the contribution of package implementation to its overall revenues is high at 40%. However, it believes that despite concerns of a slowdown in the global economy, there would be no slowdown in discretionary IT spending. Currently, SAP, Oracle and Microsoft together control 36.4% of the total enterprise application market while the rest of the market is highly fragmented. Impending consolidation should lead to higher market share for leaders like SAP and Oracle, resulting in higher growth in package implementation revenues for vendors like Satyam. The company's enterprise solutions business grew 49.4% in FY06. It expects enterprise solutions to lead growth in the coming years as well, outpacing overall company averages.

Besides package implementation, Satyam expects good growth in engineering services, which is one of the fastest growing domains in the industry. Engineering services formed 6.6% of Satyam's overall revenues in FY06 and grew 30% during the year. Given its strong focus on the manufacturing vertical (contributing 28% of revenues), we believe that Satyam's engineering services business could outperform. At the same time, considering the expectation of strong demand for offshoring in engineering services, we believe that competition from peers would be intense.

### Any significant slowdown in US economy would impact Satyam the most

Satyam's management has stated that there has been no slowdown in discretionary IT spending despite concerns of a slowdown in the global economy. However, if there is indeed a significant slowdown in the US economy, it would directly impact discretionary IT spending. This, in turn, would adversely impact package implementation revenues of Indian IT services companies. Satyam derives about 40% of its revenues from package implementation against TCS' 25%, Infosys' 17% and Wipro's 11%. Besides, it has a relatively lower exposure to other growing geographies like Europe. Therefore, Satyam is most vulnerable to a possible slowdown in the US economy.

#### CONTRIBUTION OF PACKAGE IMPLEMENTATION TO REVENUES (%)

	FY05	FY06	1QFY07
Satyam	34.9	38.9	40.3
Infosys	15.2	16.2	16.5
Wipro	11.2	10.9	10.7
TCS	21.8	22.5	25.3

Source: Company/ Motilal Oswal Securities

### Aggressive pitch for large deals could increase volume growth...

The company has set up a strategic deals group to pursue deals over US\$100m. However, of the deals that are up for renewal, 46% are in ADM and 38% are in IMS. As Satyam has a relatively lower presence than its peers in these areas, we believe that it would have to bid aggressively to win such deals. The management believes that large deals would not help in increasing average billing rates. Also, given

its already high utilization rates and higher contribution from fixed price contracts than peers, we do not expect such large deals to favorably impact Satyam's margins.

#### COMPOSITION OF RENEWAL CONTRACTS TILL MAY 2008

SERVICE	% COMPOSITION
ADMS	46
IMS	38
BPO	13
Other	3

Source: Company/ Motilal Oswal Securities

### ...but margins would be under pressure

Despite offering higher than industry average salary hikes (18% offshore, 5-6% onsite) in FY07, Satyam believes that it has still not matched industry standards. Given that it has a higher attrition rate than peers (attrition in 1QFY07: 19.6% Satyam, 11.9% Infosys, 17% Wipro, 10.6% TCS), Satyam would have to offer higher salary hikes than the industry in FY08, as well. The salary hike for FY07 (effective July 2006) would impact Satyam's EBITDA margins by 400bp.

The management is guiding a 100bp decline, as it expects higher utilization rates, higher fixed price contribution, higher SG&A leverage and increasing fresher composition would help to cushion the impact on margins due to salary hikes. However, the fixed price contribution for Satyam is already high at 37.9% (Wipro at 21.9%, Infosys at 26.9%, TCS at 43.6%) and increasing it further would be challenging. Similarly, its offshore utilization rate is also high at 73.8% (with trainees). Given that 40-50% of its employees have experience of below three years and that the composition of freshers is increasing, improving utilization rates on a sustainable basis would also be challenging.

COMPANY	FY06	
	* UTILISATION RATES (%)	EMPLOYEES LESS THAN 3 YEARS EXPERIENCE (%)
Satyam	73.8	45
Infosys	71.5	59
Wipro	71.0	40-42
TCS	75.8	49-50

\* For Satyam it reflects offshore with trainees, for rest it reflects blended with trainees

Source: Company/ Motilal Oswal Securities

The management is also counting on SG&A leverage as a margin lever. Satyam has reported SG&A expenses at 17.7% of sales for 1QFY07. However, its expense classification is different from peers and readjustment in line with peers shows that the upside is not significant enough. We also believe that the headroom to improve the offshore revenue contribution is also limited, considering the relatively higher proportion of low offshorable package implementation services and lower proportion of high offshorable ADM services.

COMPANY	1QFY07 REVENUE CONTRIBUTION (%)		
	OFFSHORE	PACKAGE IMPLEM.	ADM
Satyam	47.2	40.3	48.5
Infosys	50.5	16.5	53.8
Wipro	46.6	10.7	59.6
TCS	38.1	25.3	68.9

Source: Company/ Motilal Oswal Securities

We expect margin pressures for Satyam to continue beyond FY07, as well.

Currently, employees with less than three years' experience constitute 45% of Satyam's total workforce. It has headroom to expand its fresher composition, which the company intends to do. In line with the increase in fresher recruitment, Satyam also plans to double its training capacity from 2,500 employees at any point of time to around 4,000. We believe that increasing fresher component will be the biggest margin lever for Satyam. However, this would put pressure on utilization rates, as well as fixed price contribution. Satyam also expects improvement in subsidiary performance to reduce margin pressures in FY08. However, this margin lever is also available with other peers.

### MSA renegotiations could result in billing rate upsides – a blessing in disguise

Currently, a significant portion of Satyam's projects run under several master service agreements (MSAs), where the billing rates are comparatively lower as various services are charged at a single rate. This has resulted in Satyam having lower than industry average billing rates. In FY06, Satyam introduced a competency-based pricing scheme that is aimed at substituting MSA based pricing. In a competency-

based pricing model, the customer would be billed according to the kind of service rendered. This would result in higher billing rates for value-added and more technology intensive services.

Satyam is now insisting that customers opt for competency-based pricing for newer service lines outside the MSA. While the actual conversion to the new pricing model would be a slow process, any renegotiation of rates would provide the much-needed cushion to counter margin pressure. The management is expecting pricing uptick in FY08, based on MSA renegotiations and addition of new clients at higher rates. However, Satyam's peers are also renegotiating their MSAs with clients. Hence, they too could see a price uptick in FY08.

#### **ESOP charges – per share impact higher than peers**

SFAS 123 (revised) under US GAAP requires measurement and recognition of compensation expense for all stock based payments awarded to employees under employee stock options based on estimated fair value from FY07 onwards. Prior to this revision, the companies were allowed to show this as proforma disclosure to their notes to accounts under US GAAP as impact on EPS by following fair value method. In our opinion, the Indian market follows Indian GAAP while tracking Infosys and Satyam and US GAAP while tracking TCS, Wipro, Patni Computers and HCL Tech. Therefore, EPS estimates for FY07 onwards for TCS, Wipro, Patni and HCL Tech will be after considering ESOP charges; however the EPS estimates for Infosys and Satyam would be before considering the same.

In the following table we have shown the per share impact for Infosys and Satyam based on FY06 charge under fair value method:

PARTICULARS	FY06		
	INFOSYS	SATYAM	* WIPRO
ESOP Charge under Fair Val. Meth. (US\$m)	10	22	26.9
ESOP Charge under Fair Val. Meth. (Rs m)	443	982	1191
Per share Impact (Rs)	0.8	3.0	0.8
% to FY06 EPS	1.8	9.9	5.9

\* For Wipro, as we follow US GAAP, out of Rs1191 mn charge, Rs619m was already debited to US GAAP P&L a/c therefore the additional impact for FY06 EPS was Rs0.4, around 2.2% of FY06 EPS.

Source: Company/ Motilal Oswal Securities

The above table shows that the impact for Satyam is as high as 10% of FY06 Indian GAAP consolidated EPS. The management believes that the charge of US\$22m is likely to come down to US\$14.8m in FY07 and US\$6.4m in FY08, the impact of which on our Indian GAAP consolidated EPS for FY07 and FY08 will be as follows:

PARTICULARS	FY07E	FY08E
Indian GAAP Consolidated EPS	40.3	48.1
Less: ESOP Charge (Per share)	2.1	0.9
% to EPS before charge	5.1	1.8
Indian GAAP Consolidated EPS after ESOP	38.3	47.2
P/E after ESOP	20.8	16.9

Source: Company/ Motilal Oswal Securities

#### **Valuation and view**

Considering lower earnings visibility with less flexibility in business matrix for Satyam, we believe that there is a greater likelihood of positive earnings surprises and expansion of premium of Wipro / TCS over Satyam. Though we have a BUY recommendation on Satyam, we prefer Wipro / TCS over Satyam. Infosys remains our top pick in the IT sector. The stock is trading at 19.8x FY07E and 16.6x FY08E earnings. We have downgraded our target price to Rs865 from Rs910, earlier.

INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
<b>Sales</b>	<b>25,605</b>	<b>35,208</b>	<b>47,926</b>	<b>64,904</b>	<b>83,758</b>
Change (%)	26.5	37.5	36.1	35.4	29.0
Cost of Goods Sold	16,499	23,821	32,738	45,110	59,423
SG&A	2,333	2,705	3,526	4,743	5,695
<b>EBITDA</b>	<b>6,773</b>	<b>8,682</b>	<b>11,662</b>	<b>15,050</b>	<b>18,640</b>
% of Net Sales	26.5	24.7	24.3	23.2	22.3
Depreciation	1,50	1,133	1,373	1,725	2,178
Interest	10	9	55	76	84
Other Income	713	847	1,168	1,919	2,001
<b>PBT</b>	<b>6,326</b>	<b>8,387</b>	<b>11,402</b>	<b>15,169</b>	<b>18,379</b>
Tax	1,063	1,176	1,508	1,983	2,529
Rate (%)	16.8	14.0	13.2	13.1	13.8
<b>PAT</b>	<b>5,134</b>	<b>7,116</b>	<b>9,820</b>	<b>13,221</b>	<b>15,935</b>
Change (%)	11.6	37.0	38.0	34.6	20.5
Extra Ordinary Items	0	0	1,598	0	0
<b>Net Income</b>	<b>5,134</b>	<b>7,116</b>	<b>11,418</b>	<b>13,221</b>	<b>15,935</b>

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	633	639	649	656	663
Preference share capital	910	910	910	910	910
Share Premium	8,251	8,917	10,292	11,944	13,705
Other Reserves	16,016	22,515	31,322	41,024	52,721
<b>Net Worth</b>	<b>25,810</b>	<b>32,981</b>	<b>43,173</b>	<b>54,534</b>	<b>67,999</b>
Minority Interest	0	0	42	50	60
Loans	73	189	1,027	1,186	1,000
<b>Capital Employed</b>	<b>25,882</b>	<b>33,170</b>	<b>44,241</b>	<b>55,770</b>	<b>69,059</b>
Gross Block	8,472	10,142	13,172	16,672	21,672
Less : Depreciation	5,978	7,057	8,402	10,127	12,304
<b>Net Block</b>	<b>2,494</b>	<b>3,086</b>	<b>4,770</b>	<b>6,545</b>	<b>9,368</b>
CWIP	222	693	803	500	500
Investments	748	763	0	0	0
<b>Curr. Assets</b>	<b>25,955</b>	<b>33,007</b>	<b>45,799</b>	<b>58,480</b>	<b>73,159</b>
Debtors	5,928	7,805	11,684	14,989	19,433
Cash & Bank Balance	18,154	23,701	31,117	40,632	49,198
Loans & Advances	906	1,148	1,843	2,051	2,974
Other Current Assets	915	247	1,108	841	1,672
<b>Current Liab. &amp; Prov</b>	<b>3,536</b>	<b>4,379</b>	<b>7,130</b>	<b>9,755</b>	<b>13,968</b>
Creditors	1,508	1,720	3,323	2,900	5,131
Other Liabilities	437	763	1,047	1,030	1,650
Provisions	1,591	1,896	2,760	5,825	7,186
<b>Net Current Assets</b>	<b>22,419</b>	<b>28,629</b>	<b>38,669</b>	<b>48,725</b>	<b>59,191</b>
<b>Application of Funds</b>	<b>25,882</b>	<b>33,170</b>	<b>44,241</b>	<b>55,770</b>	<b>69,059</b>

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>16.3</b>	<b>22.3</b>	<b>30.3</b>	<b>40.3</b>	<b>48.1</b>
Cash EPS*	19.9	25.6	34.5	45.6	54.7
Book Value	81.7	101.2	133.1	166.4	205.2
DPS	4.0	5.2	7.1	9.4	11.2
Payout %(Incl.Div.Taxes)	24.7	23.3	23.3	23.3	23.3
<b>Valuation (x)</b>					
P/E		35.8	26.3	19.8	16.6
Cash P/E		31.1	23.1	17.5	14.6
EV/EBITDA		26.5	19.2	14.3	11.1
EV/Sales		6.5	4.7	3.3	2.5
Price/Book Value		7.9	6.0	4.8	3.9
Dividend Yield (%)		0.6	0.9	1.2	1.4
<b>Profitability Ratios (%)</b>					
RoE	21.8	24.2	25.8	27.1	26.0
RoCE	26.7	28.4	29.5	30.3	29.4
<b>Turnover Ratios</b>					
Debtors (Days)	85	81	75	72	72
Asset Turnover (x)	3.0	3.5	3.6	3.9	3.9
<b>Leverage Ratio</b>					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Cash Flow from Operations	6,413	8,344	11,266	14,911	18,028
Cash for Working Capital	1,727	-169	2,695	487	828
<b>Net Operating CF</b>	<b>4,687</b>	<b>8,512</b>	<b>8,571</b>	<b>14,424</b>	<b>17,200</b>
Net Purchase of FA	-665	-2,142	-3,140	-3,198	-5,000
Net Purchase of Invest.	-171	-15	2,361	0	0
<b>Net Cash from Invest.</b>	<b>-836</b>	<b>-2,157</b>	<b>-779</b>	<b>-3,198</b>	<b>-5,000</b>
Proceeds from Pvt. Place.	375	672	1,384	1,659	1,768
Proceeds from LTB/STB	-111	116	838	159	-1,186
Dividend Payments	-1,381	-1,596	-2,608	-3,512	-4,233
<b>Net CF from Finan.</b>	<b>-1,116</b>	<b>-808</b>	<b>-386</b>	<b>-1,693</b>	<b>-3,651</b>
Free Cash Flow	4,308	5,299	4,807	10,964	10,204
<b>Net Cash Flow</b>	<b>2,735</b>	<b>5,547</b>	<b>7,407</b>	<b>9,533</b>	<b>8,549</b>
<b>Opening Cash Bal.</b>	<b>15,418</b>	<b>18,154</b>	<b>23,701</b>	<b>31,117</b>	<b>40,632</b>
Add: Net Cash	2,735	5,547	7,407	9,533	8,549
<b>Closing Cash Bal.</b>	<b>18,153</b>	<b>23,701</b>	<b>31,108</b>	<b>40,650</b>	<b>49,180</b>

**N O T E S**



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**Satyam Computer**

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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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