

Company Flash

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Patni Computer Systems (PTNI.BO)

3Q06: Good Cost Takeouts; Headcount Declines

- Topline in line and good cost controls** — Revenues grew 6.7% to Rs700m broadly in line with our expectations. Utilization improvement and good cost control resulted in gross margins improving ~280bp to 37.7%. Flat SG&A qoq resulted in EBIT margins improving ~420bp from a historical low of 15.2% in Q2. Net profit for the quarter was Rs1.02bn.
- Headcount declines; attrition at 24.5%** — Headcount declined by 180 qoq. In the past four quarters headcount increased 1,172, which is 10.4% off the base a year ago (vs. 40% for Satyam). Attrition at 24.5% is among the highest in the industry and could cap further utilization improvements.
- Revenue from the top five clients grew 2.7% qoq** — Revenue from the company's top five clients' grew 2.7% qoq (in US\$ terms), in line with our belief that mature clients could result in slower growth for Patni. However, non-top 10 accounts did well with 11.5% sequential growth (in US\$ terms).
- Q4 guidance muted – More seasonality?** — Patni's Q4 guidance is for US\$152m in revenue and net profit of US\$20.4-20.6m, which is flat at the topline and -8% on net profit. While 4Q has had lower billing days, the guidance is lower than peers'.
- Reiterating rating** – Patni stock has done well in the recent past after the good performance last quarter and due to the belief that it is one of the prime acquisition targets in Indian IT. Our key concerns remain on top line growth, headcount additions, decline in Europe revenue and sluggish top 5 client growth.

Sell/Medium Risk	3M
Price (26 Oct 06)	Rs453.00
Target price	Rs405.00
Expected share price return	-10.6%
Expected dividend yield	0.6%
Expected total return	-10.0%
Market Cap	Rs63,208M US\$1,396M

Figure 1. Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2004A	2,366	19.07	2.7	23.8	4.3	22.9	0.4
2005A	2,678	21.03	10.3	21.5	2.8	16.1	0.6
2006E	2,364	16.64	-20.9	27.2	2.9	11.3	0.6
2007E	3,730	26.09	56.8	17.4	2.5	16.2	0.7
2008E	4,305	30.11	15.4	15.0	2.2	16.3	1.1

Source: Company Reports and Citigroup Investment Research estimates

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See page 5 for Analyst Certification and important disclosures.

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3Q06 Result Analysis

Figure 2. Key Financials

	3Q05	2Q06	3Q06	QoQ	YoY
Revenue (US\$ m)	118	143	152	6.1%	28.3%
Revenue	5,197	6,561	6,999	6.7%	34.7%
Cost of revenue	3,285	4,273	4,360	2.0%	32.7%
Gross profit	1,913	2,288	2,639	15.4%	38.0%
Gross margin	36.8%	34.9%	37.7%	283bp	91bp
Operating expenses	954	1,293	1,279	-1.1%	34.1%
EBITDA	959	995	1,360	36.7%	41.9%
EBITDA margin	18.5%	15.2%	19.4%	427bp	98bp
Depreciation and amortization	176	205	202	-1.4%	14.8%
EBIT	783	790	1,158	46.7%	47.9%
EBIT margin	15.1%	12.0%	16.5%	451bp	148bp
Other income	69	178	134	-24.7%	94.8%
Profit before tax	851	967	1,292	33.6%	51.7%
Income tax expense	138	202	268	32.6%	94.1%
Net income - recurring	714	765	1,024	33.8%	43.5%
EO income/(loss)	0	-913	0	n.a.	n.a.
Net profit	714	-147	1,024	-795.2%	43.5%
EPS - basic (recurring)	5.71	5.55	7.43	33.8%	30.2%
EPS - fully diluted (recurring)	5.64	5.55	7.38	32.8%	30.7%

Source: Company Reports

Figure 3. Key HR and Execution Metrics

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06
Total staff	10,426	10,877	11,256	11,802	12,148	12,608	12,428
- Offshore	8,006	8,350	8,750	9,221	9,594	9,908	9,648
- Onsite	2,420	2,527	2,506	2,581	2,554	2,700	2,780
- Delivery	9,337	9,778	10,140	10,667	10,951	11,343	11,150
- Sales and Support	1,089	1,099	1,116	1,135	1,197	1,265	1,278
Effort by location of delivery							
Offshore	62.9%	63.8%	65.0%	64.6%	66.3%	66.3%	66.1%
Onsite	37.1%	36.2%	35.0%	35.4%	33.7%	33.7%	33.9%
Other Key metrics							
Utilization (inc. trainees)	64.7%	67.5%	67.7%	68.6%	67.8%	70.2%	72.3%
Attrition (Qtrly, annualized)	19.6%	19.2%	18.6%	20.1%	20.3%	21.0%	24.5%

Source: Company Reports

Revenue Mix by Geography

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06
North America	85.5%	85.3%	84.3%	84.3%	83.0%	81.0%	82.1%
Europe	9.2%	9.3%	9.2%	8.8%	10.2%	11.2%	9.7%
Japan	3.9%	4.2%	4.5%	4.6%	4.5%	3.9%	3.8%
Rest of the world	1.4%	1.3%	2.0%	2.3%	2.3%	3.9%	4.4%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Company Reports

Revenue Mix by Business Unit

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06
Insurance	30.5%	28.2%	27.5%	25.4%	24.1%	23.2%	23.2%
Manufacturing	22.2%	22.6%	22.1%	20.9%	20.3%	21.4%	22.5%
Financial Services	15.5%	15.3%	17.7%	15.6%	15.8%	15.5%	15.6%
Telecommunications	13.6%	14.9%	14.9%	17.4%	18.9%	20.0%	17.1%
Other	6.8%	6.4%	6.1%	6.6%	6.8%	6.0%	6.9%
ISV Practice	5.3%	5.7%	4.7%	4.5%	4.1%	4.2%	4.0%
Product Engineering Practice	6.2%	6.9%	7.1%	9.6%	10.0%	9.7%	10.6%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Company Reports

Key Client Metrics

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06
Client concentration							
Top Client - GE	24.9%	23.0%	23.5%	17.7%	16.5%	14.5%	14.1%
Top 5 Clients	50.5%	48.0%	48.8%	42.1%	39.8%	38.1%	36.9%
Top 10 Clients	62.5%	60.0%	61.3%	59.3%	55.3%	54.0%	51.6%
Client relationship							
Total Active Clients	181	191	191	199	206	220	235
New Clients added	18	19	18	19	20	23	27
1+ mn USD Clients	46	50	58	61	61	64	71

Source: Company Reports

Patni Computer Systems**Company Description**

Patni is the sixth-largest IT solutions provider from India and is a pioneer of offshore IT services delivery. Founded in 1978, the company operated in both software and hardware businesses until 1999, when the hardware business was de-merged and Patni continued to operate as a global consulting and IT services provider. Patni employs 12,000 professionals, who service more than 200 global corporations. It has a sizeable presence in insurance, financial services, manufacturing and telecoms verticals. GE is Patni's largest customer, contributing close to 15% of 2Q06 revenues.

Investment Thesis

We rate Patni as Sell/Medium Risk. Patni has historically offered lower pricing to clients by employing low-cost resources. However, with strong demand for IT professionals, Patni is facing increased wage pressure and therefore margins have eroded significantly despite improvements in several operating factors. Over the past five quarters, EBITDA margin has declined by 760bps in spite of increased blended realization, higher offshore effort share and lower GE dependence. We believe Patni's below-average margin could be improved with better operating efficiency; however, we do not expect the improvement to be significant due to greater sales efforts and likely Cymbal-type acquisitions that tend to be margin dilutive at the early stages. The stock has had a good run after the last quarter results, and we believe investor expectations are running far too high.

Valuation

Our target price is Rs405. We value Patni against closest peer Satyam. We expect Patni's recurring earnings to grow by a 13.6% CAGR for the next two years (much lower than its peers). Patni has traded at a 10-30% discount to Satyam over the past year, mainly due to its slower growth and RoIC/RoE. We believe the stock will continue to trade at the high end of the discount range until Patni's operations show a sustained turnaround. Our 2007E target P/E is based on 15x earnings, a 30% discount to our target P/E of 21x for Satyam. We believe P/E is a good valuation measure given Patni's profitability and strong earnings visibility. Our target price is also supported by a P/Sales of 1.8x, which is within the stock's one-year historical range of 1.2x to 2.7x.

Risks

We rate Patni as Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility.

The key upside risks that could take the stock above our target price include the following:

- Any significant depreciation of the rupee against the USD/Euro/GBP;
- A sharp pick-up in discretionary spend;
- Patni being an acquisition target by a global IT services vendor; and
- Patni acquiring a small-to-mid-sized company at attractive valuations.

The key downside risks to our target price include:

- Significant QoQ volatility in growth rates;
- Any significant appreciation of the rupee against the USD/Euro/GBP;
- A sharp slowdown in the US economy;
- A slowdown in the banking, financial services and insurance (BFSI) sector;
- H1B visa quotas; and
- Acquisition-related risks.

Analyst Certification Appendix A-1

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Patni Computer Systems Ltd (PTNI.BO) Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)



#	Date	Rating	Target Price	Closing Price
1:	23 Sep 05	1M	510.00	416.05
2:	1 Feb 06	1M	*560.00	464.60
3:	26 Apr 06	1M	*500.00	416.70
4:	4 Oct 06	*3M	*405.00	381.95

*Indicates change.

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