

Company

30 July 2009 | 8 pages

Patni Computer Systems (PTNI.BO)

Equity

Sell: 2QCY09 Results – Huge Margin Surprise

- Revenues grow ~3.5% qoq** — Revenues increased ~3.5% sequentially and were better than our/street expectations. Volumes increased ~2% qoq while realizations improved meaningfully as well.
- Margins surprise positively** — Cost of revenues, S&M and G&A costs declined ~6%, ~14% and ~20% respectively qoq – resulting in a margin expansion of ~450bp qoq. We did not expect such a huge reduction in all costs – the key, in our view, is sustainability. *If these margins are indeed sustainable, it could lead to meaningful upgrades in our/Street estimates without any significant change in revenue forecasts.*
- Delivery headcount down ~10% yoy** — Patni continues to rationalize its employee base – delivery headcount declined by another ~700 employees sequentially and is down ~10% yoy. The headcount data does not indicate any first signs of recovery.
- 3Q guidance – no surprises** — 3Q guidance implies revenue growth of ~1-2% sequentially while net profit (ex forex) guidance implies sequential decline of ~27-30%, which is difficult to explain.
- Key issues to focus on in the earnings call** — Patni will host an earnings call at 1800 hrs IST. The key issues to focus on are: (1) How sustainable are the sharp cost reductions effected in the quarter, (2) Views on demand recovery, (3) Hiring outlook given that headcount is down 10% yoy, and (4) Inorganic initiatives, which management has been talking about for some time now.

Sell/High Risk	3H
Price (30 Jul 09)	Rs301.90
Target price	Rs240.00
Expected share price return	-20.5%
Expected dividend yield	0.8%
Expected total return	-19.7%
Market Cap	Rs38,675M US\$801M

Price Performance (RIC: PTNI.BO, BB: PATNI IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Dec	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	4,658	33.11	73.8	9.1	1.6	18.9	1.0
2008A	4,433	34.49	4.2	8.8	1.4	16.2	1.0
2009E	3,300	25.73	-25.4	11.7	1.2	11.2	0.8
2010E	3,541	27.61	7.3	10.9	1.1	10.8	0.8
2011E	4,109	32.04	16.0	9.4	1.0	11.4	1.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Result Tables

Figure 1. Key Financials

Rs m	2Q08	1Q09	2Q09	QoQ	YoY
Revenue (\$ m)	183	156	162	3.5%	-11.3%
Revenue	7,673	7,955	7,729	-2.8%	0.7%
Cost of revenue	5,157	5,143	4,850	-5.7%	-6.0%
Gross profit	2,516	2,812	2,879	2.4%	14.4%
Gross margin	32.8%	35.3%	37.2%	5.4%	446bp
Operating expenses	1,345	1,477	1,241	-16.0%	-7.7%
EBITDA	1,171	1,335	1,637	22.7%	39.9%
EBITDA margin	15.3%	16.8%	21.2%	440bp	593bp
Dep & amortization	265	288	286	-0.7%	8.2%
EBIT	906	1,047	1,351	29.1%	49.1%
EBIT margin	11.8%	13.2%	17.5%	432bp	567bp
Other income	277	-202	339	-267.5%	22.2%
Profit before tax	1,183	844	1,690	100.2%	42.8%
Income tax expense	168	180	325	80.2%	93.1%
Net profit	1,015	664	1,365	105.6%	34.5%
EPS - Basic	7.30	5.18	10.66	105.6%	46.0%
EPS - Fully Diluted	7.29	5.18	10.61	104.9%	45.5%

Source: Company Reports

Figure 2. 3QCY09 Guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (\$ m)	163	165	0.7%	1.9%
Net profit (\$ m)	22.5	23.5	-20.1%	-16.5%

Source: Company Reports; *excluding forex gain/loss; Company guidance at USD/INR of 48.50.

Figure 3. Key Client Metrics

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09
Client concentration						
Top Client - GE	11.1%	10.4%	10.5%	11.0%	12.3%	12.3%
Top 5 Clients	32.2%	31.5%	32.9%	34.6%	33.7%	37.2%
Top 10 Clients	44.8%	44.5%	45.3%	48.7%	46.8%	50.1%
Client relationship						
Total Active Clients	331	336	332	331	320	294
New Clients added	34	21	27	18	22	7
US\$1+m Clients	86	87	91	92	94	90

Source: Company Reports

Figure 4. Revenue Mix

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09
Geography - wise						
North America	76.6%	76.1%	76.7%	78.6%	78.9%	80.0%
Europe	17.6%	18.7%	17.5%	15.6%	15.1%	14.2%
RoW	5.8%	5.1%	5.8%	5.9%	6.0%	5.8%
Service - wise						
ADM	64.6%	61.9%	64.2%	64.6%	65.1%	64.9%
PI	13.1%	16.1%	15.0%	13.5%	13.7%	13.8%
PE	11.5%	11.4%	10.8%	11.3%	11.4%	11.3%
IMS	5.1%	4.8%	4.7%	5.0%	3.5%	4.7%
BPO	5.7%	5.8%	5.2%	5.6%	6.3%	5.3%
SBU - wise						
Insurance	23.2%	23.3%	25.1%	27.1%	27.3%	29.7%
Manufacturing	24.6%	24.9%	25.5%	25.4%	29.2%	27.7%
Financial Services	12.9%	12.8%	12.5%	12.9%	13.7%	13.8%
Telecommunications	13.4%	14.2%	12.5%	10.1%	14.4%	13.7%
Product Engineering Practice	16.4%	15.6%	15.2%	15.6%	15.3%	15.1%

Source: Company Reports

Figure 5. Key HR and Execution Metrics

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09
Total staff	15,152	15,044	14,701	14,894	14,540	13,780
- Offshore	12,216	11,992	11,662	11,928	11,693	11,022
- Onsite	2,936	3,052	3,039	2,966	2,847	2,758
- Delivery	13,636	13,548	13,190	13,331	12,990	12,285
- Sales and Support	1,516	1,496	1,511	1,563	1,550	1,495
Effort by location of delivery						
Offshore	70.8%	70.8%	71.8%	71.3%	71.7%	72.4%
Onsite	29.2%	29.2%	28.2%	28.7%	28.3%	27.6%
Other Key metrics						
Utilization (inc. trainees)	70.0%	72.0%	75.0%	73.1%	70.3%	74.4%
Attrition Rate (Quarterly, annualized)	18.7%	17.8%	22.6%	15.3%	6.3%	8.6%
Attrition Rate (TTM)	23.0%	21.2%	20.2%	18.6%	15.5%	13.2%

Source: Company Reports

Patni Computer Systems

Company description

Patni is a mid-tier Indian IT solutions provider and a pioneer of offshore IT services delivery. Founded in 1978, it operated both software and hardware businesses until 1999, when the hardware business was de-merged. It continues to operate as a global consulting and IT services provider. Patni employs ~14,000 professionals, who service ~320 global corporations. It has a sizeable presence in insurance, financial services, manufacturing and telecoms verticals. GE is Patni's largest customer, contributing ~12% of revenues.

Investment strategy

Our Sell / High Risk (3H) rating is based on a challenging outlook for Tier-II IT companies and Patni's poor performance over many quarters. Valuations are in line with other mid-tier companies; however, growth remains a challenge. With poor growth prospects, we see little room for upside. We expect flatish revenues over CY08-11E, slower than those of peers.

Valuation

Our target price of Rs240 is based on 9x the average of CY09-10E EPS. This is towards the mid-point of the 4x-17x band that the stock has traded over the last three years. We believe that this is justified given that revenue visibility is still unclear. We believe P/E is the most appropriate valuation measure given Patni's profitable track record.

Risks

We rate Patni shares High Risk consistent with our quantitative risk rating system that tracks historical share price volatility. Key upside risks that could cause the shares to continue to exceed our target price include: 1) uptick in growth rates; 2) any significant depreciation of the rupee against the USD/EUR/GBP; 3) sharp recovery in the US economy; and 4) any value generating acquisition.

Appendix A-1

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Analyst: Surendra Goyal, CFA

Covered since October 5 2006

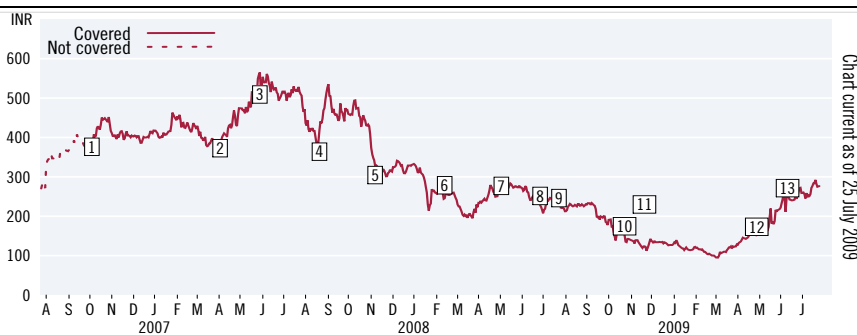


Chart current as of 25 July 2009

	Date	Rating	Target Price	Closing Price
1	4-Oct-06	*3M	*405.00	381.95
2	3-Apr-07	*1M	*463.00	377.70
3	29-May-07	*3M	*565.00	565.10
4	21-Aug-07	*1M	*525.00	418.95
5	7-Nov-07	*1H	*475.00	328.40

	Date	Rating	Target Price	Closing Price
6	13-Feb-08	1H	*390.00	245.70
7	2-May-08	1H	*365.00	270.90
8	26-Jun-08	1H	*340.00	228.05
9	23-Jul-08	*3H	*260.00	235.80
10	23-Oct-08	3H	*140.00	152.25

	Date	Rating	Target Price	Closing Price
11	20-Nov-08	3H	*125.00	123.60
12	28-Apr-09	3H	*150.00	150.40
13	10-Jun-09	3H	*240.00	259.90

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2009

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