

Satyam Computers

BUY

Rs 428

October 20, 2006

Q2 FY07 Result Update – Done well

Satyam's results were ahead of our expectations: consolidated revenue, at Rs 16bn, rose 11% qoq (of which 9.5 percentage points were due to a rise in volumes, 0.3 percentage points were due to increase in blended pricing (0.4 for onsite and 0.2 for offshore) and 1.2 percentage points were due to foreign exchange fluctuation). A 200-bp fall in the EBITDAM (to 22.6%), led to a marginal 2.1% growth in EBITDA, to Rs 3.6bn. The 200-bp fall in EBITDAM can be broken down into- -420bp due to wage hikes, +30bp due to rupee appreciation, +125bp due to lower visa cost, +30bp due to positive contribution from subsidiaries and +30bp due to operational efficiencies. All this resulted in a 9.7% qoq decline (34.7% yoy growth) in PAT, to Rs 3.2bn, ahead of our estimates of Rs.3.1bn, implying a 13.4% qoq decline.

Key Figures

Y/e March	FY05	FY06	FY07E	FY08E
Net Sales (Rs m)	35,208	47,926	65,482	81,853
PAT (Rs m)	7,114	9,821	11,148	15,598
EPS (Rs)	22.3	30.5	40.3	48.1
EPS Growth (%)	36.5	36.8	32.2	19.3
CEPS (Rs)	25.8	34.5	45.3	54.2
PER (x)	30.8	22.5	17.0	14.3
CPER (x)	26.6	19.9	15.1	12.7
EV / EBITDA (x)	22.5	16.5	10.7	8.8
EV / Sales (x)	5.6	4.0	2.5	2.0
RoE (%)	24.5	26.4	26.7	24.7
RoCE (%)	31.9	33.1	33.3	30.8

Satyam's volumes, rising 9.5% qoq, have once again in Q2 FY07 grown robustly. Client addition was good with 35 (34 in the previous quarter) new clients added during the quarter. Client traction within the top ten clients (excluding the top five) was yet again robust, registering a double-digit growth of 10.1%. Though in the past ten quarters the contribution from the top client has slid in seven quarters, it is heartening to note that the top five clients (excluding the top client) have recorded an 11.2% qoq growth.

The company is currently focussing on large deals, inferring from the fact that it currently is working on 25 of them, of which 12 are in an advanced stage of negotiation. The size of these large deals ranges from \$50m-\$100m and is spread over a period of 3-7 years. The company is also looking at acquisitions of \$10-15m size.

Over the past 12 quarters, Satyam has been successfully reducing its share of on-site revenue. In Q2FY07 its efforts led to an 11.8% qoq rise in offshore revenue (48.1% yoy), whilst its on-site revenue grew 10% qoq (and 29.3% yoy). This follows the broader trend seen with its peers, Infosys, TCS, and Wipro. We expect Satyam to be one of the beneficiaries of the prevailing outsourcing wave, as it successfully keeps altering its revenue mix in favour of offshore revenue.

(Stock price as on October 20, 2006)



Nipuna, its BPO subsidiary reported good numbers as compared to Q1FY07. With revenue of Rs 416.3m, it grew by 14.5% qoq and lower net loss of Rs 47.7m (Rs 61.5m in Q1). It added 441 employees (highest ever), taking the total to 2,446. In FY06, Nipuna's revenues were \$20m (an almost 100% leap). It is expecting revenue in FY07 to grow 80%, to \$36m. It increased its total number of customers and processes to, respectively, 29 (from 27 in the previous quarter) and 69 (from 80).

Growth across all the verticals was robust and the star vertical this time was Healthcare (which posted a strong 24.5% qoq growth). Telecom grew by 18.1%, whereas BFSI and Manufacturing grew by 6.9% and 6.3% qoq, respectively. Over the past nine quarters, BFSI, Telecom and Healthcare have had CQGRs of 8.5%, 10.3%, and 11%, respectively.

Though the company has been successfully adding a number of clients with a run rate of \$5m and \$10m, contribution from the company's top ten clients has been on a downtrend. No. of \$5m and \$10m clients have risen from 43 and 22 a year ago to 54 and 32, respectively, in Q2. In all, the company added 35 clients during the quarter. Contribution from top five grew 8.8% qoq; the next five in the top-ten category grew 10.1% qoq.

In the past 14 quarters, while the top five clients have reported a 3.9% CQGR, the next five in the top-ten category have reported a 6.4% CQGR. Were we to compute growth in contribution from the same clients (barring the top client), it was 5.3% and 5.8%, respectively, whilst the other clients (barring the top ten), have had a 10.6% CQGR. This should offer multiple client-mining opportunities ahead.

The company had a headcount addition of 4,025 (the highest ever in its history), taking the total to 31,659. Of its present strength 94.2% are technical. Due to the aggressive measures taken by the company on compensation front, its TTM attrition has come down to 18.3% from 19.6% in the previous quarter (annualised attrition is 15.9%). Company plans to add about 13,000+ gross employees in FY07. We believe incubating such experienced skills-sets would enable the company to understand the business dynamics in-depth, and to drive efficiency.

The company has raised its "guidance" for FY07—by 4.2-2.9% on the top line and 6.6-5.4% on the bottom line, compared to its earlier "guidance". It has now "guided" to growth of 34.6-35.1% in the top line and 35.9-36.4% in the bottom line.

For Q3FY07, the "guidance" is for 4-4.5% growth on the top line and a 4.1-4.5% growth in the bottom line. Although margins are to be impacted by RSUs (-120bp) and rupee appreciation (-70bp), we expect the company would still be able to increase its margins due to operational efficiencies, positive contribution from subsidiaries and higher offshore revenue mix.

We have raised our estimates—by 0.4% in the top line for FY07 and by 1.1 % for FY08, and by 3.8% and 2.6% on the bottom line for FY07 and FY08 respectively. We now expect revenue to grow 37.1% and 28%, respectively, and net profit to grow 39% and 20.7%. Based on our estimates and the CMP, the stock trades at 20.5x FY07E earnings and 17x those of FY08; and 15.1x and 11.3x FY07 and 08 estimated EV/EBITDA, respectively. We re-iterate our **BUY** rating on it, with a target price of Rs 505 (24.2x FY07 and 20x FY08 estimates, implying 18% upward potential).



Q2 FY07 Result Overview

(Rs m)

Y/e March	Q1 FY07	Q4 FY06	qoq gr. (%)	Q1 FY06	yoy gr. (%)	FY06	FY07E	yoy gr. (%)
Net Sales	14,429	13,136	9.8	10,587	36.3	47,926	65,482	36.6
Total Expenses	10,879	9,791	11.1	8,193	32.8	36,264	49,992	37.9
Software Development	8,316	7,500	10.9	6,391	30.1	28,047	38,962	38.9
Others	2,563	2,291	11.9	1,802	42.2	8,217	11,030	34.2
Operating Profits / EBITDA	3,550	3,345	6.1	2,394	48.3	11,662	15,490	32.8
Depreciation	362	372	(2.7)	330	9.6	1,373	1,700	23.8
EBIT	3,188	2,973	7.2	2,064	54.5	10,289	13,790	34.0
Interest	26	17	54.5	5	442.6	55	110	98.6
EBT before Other Income	3,163	2,957	7.0	2,060	53.6	10,234	13,680	33.7
Other Income	745	289	157.8	234	217.9	1,168	1,400	19.8
PBT	3,908	3,246	20.4	2,294	70.4	11,402	15,080	32.3
Tax	368	397	(7.5)	392	(6.2)	1,509	2,000	32.6
<i>Tax Rate (%)</i>	<i>9.4</i>	<i>12.2</i>		<i>17.1</i>		<i>13.2</i>	<i>13.3</i>	
PAT before Extraordinaries	3,540	2,848	24.3	1,902	86.1	9,893	13,080	32.2
Extraordinaries	(1.2)	1.8		29.6		72.6	72.6	
PAT after Extraordinaries	3,541	2,847	24.4	1,872	89.1	9,821	13,008	32.5
Key Ratios								
<i>GPM (%)</i>	<i>42.4</i>	<i>42.9</i>	<i>(0.5)</i>	<i>39.6</i>	<i>2.7</i>	<i>41.5</i>	<i>40.5</i>	<i>(1.0)</i>
<i>OPM (%)</i>	<i>24.6</i>	<i>25.5</i>	<i>(0.9)</i>	<i>22.6</i>	<i>2.0</i>	<i>24.3</i>	<i>23.7</i>	<i>(0.7)</i>
<i>NPM (%)</i>	<i>24.5</i>	<i>21.7</i>	<i>2.9</i>	<i>17.7</i>	<i>6.9</i>	<i>20.5</i>	<i>19.9</i>	<i>(0.6)</i>
Adjusted EPS before Extras (Rs)	10.8	8.7	24.3	5.8	86.1	30.3	40.1	32.2

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