

Satyam Computer Services Ltd

INR: 368

Outperformance likely to diminish

BUY



We have analyzed the results of Satyam post Q1FY09 results & our key findings are:

Q1FY09 Results – Key highlights

- **Missing Q1FY09 USD revenue (US GAAP) guidance-** While rupee revenue was above guidance, the company has missed its USD guidance(US GAAP) after adjusting for rupee benefits
- **Retail/Transportation and TIMES verticals continue to grow-** Since last 8 quarters Retail/Transportation sector has been growing at ~15% q-o-q
- **Operating margins increased by 133 bps -** EBITDA increased 14.8% q-o-q to Rs 623.3 crore in Q1FY09. Visa costs impacted EBITDA margins negatively by 80bps
- **Decline in volumes growth points towards deceleration –** In comparison to the previous 2 quarter volume growth of 8.8% and 9.4%, Q1FY09 volumes grew by merely 3.01%

Q2 FY09 Guidance

Particulars	Q2FY09	Initial FY09	Revised FY09
Revenue (US\$ mn)	648.8	2,672.5	2,672.5
Revision (%)			-
Revenue (Rs cr)	2,756.0	10,585.0	11,272.0
Revision (%)			6.5
Rs /US\$ rate	42.9	40.0	42.8
Revision (%)			7.0
EPS (Rs)	7.75	29.79	32.09
Revision (%)			7.7

Source: Company data, KRC Research

Financial Performance

Particulars	Q1 FY09	Q4 FY08	q-o-q (%)	Q1 FY08	y-o-y (%)
Net Sales	2,620.8	2,416.0	8.5%	1,830.2	43.2
EBITDA	632.3	550.6	14.8%	410.3	54.1
Net Profit	547.7	466.8	17.3%	378.3	44.8
EPS	8.14	6.97	16.8%	5.67	43.8
OPM (%)	24.1	22.8	133 bps	22.4	171 bps
NPM (%)	20.9	19.3	158 bps	20.7	23 bps

Source: Company data, KRC Research

Valuations

At the CMP of Rs 368, Satyam is trading at 13.3x its TTM earnings of Rs 27.7 and 11.3x FY09E EPS of Rs 32.56. We maintain a BUY on the stock with a target price of Rs 456 based on a 30% P/E discount to Infosys. At the target price, the stock would be valued at 14.0x FY09E EPS of Rs 32.56, implying an upside potential of 23%.

Price Outlook (INR): 456

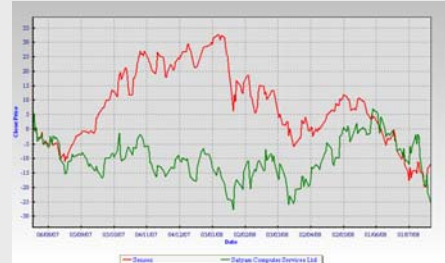
Market Data July, 22 2008

Shares outs (Cr)	286
Equity Cap	134
Mkt Cap (Rs. Cr)	24,748
52 Wk H/L (Rs)	544/305
Avg Vol (1yr avg)	6,30,916
Face Value (Rs)	2
Bloomberg Code	SCS IN

Market Info:

SENSEX - 14,104
NIFTY - 4,240

Price Performance



Share Holding pattern (%) as on June 30, 2008

Promoter	8.63
Institutions	14.39
FII	47.65
Other Corp Holding	0.52
Public	9.4
GDR	19.42
Total	100.00

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Rising inflation and energy costs fuel growth of retail and transportation segments

Over the last 8 quarters, Retail, Transportation and Logistics segments have grown at a compounded quarterly growth rate of 15.9%

Detailed Analysis:

Missing Q1FY09 USD revenue (US GAAP) guidance

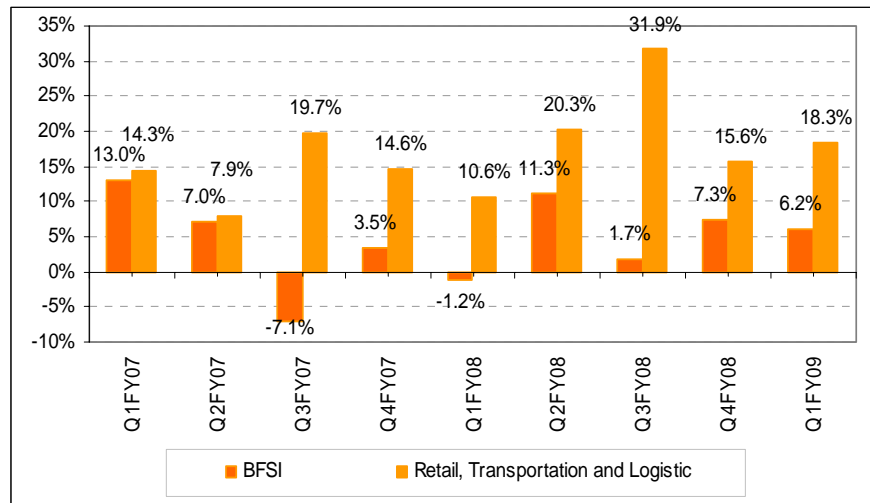
Satyam missed its Q1FY09 USD revenue (US GAAP) guidance, while meeting the Rupee guidance on the back of rupee depreciation of 6.7%. While the USD revenues (US GAAP) appear ahead of guidance, this is mainly due to US GAAP standards that have inflated the revenues by including currency fluctuations benefits.

An unexpected fall in revenues in the BPO animation business also impacted revenues. The decline in revenues was mainly because the client did not extend the contract in Q1FY09, but going forward, Satyam expects the services to resume in Q2FY09. BPO revenues in Q1FY09 therefore fell by about 30% q-o-q to Rs.49 crore.

Retail/Transportation and TIMES verticals continue to grow

While the BFSI vertical saw flattish USD revenue growth, the retail / transportation segments continued to grow. The TIMES vertical also grew 18.3% q-o-q on new client additions in these verticals and support from recently acquired businesses. In Q1FY09, TIMES, Bridge Strategy Group, and Nitor Global Solutions helped Satyam to add 3 new clients. With the surge in energy costs in the US, and inflation, there is an increased focus on improving operating margins in the transportation industry (airlines in particular), which has supported transformational service growth for Satyam. The management had indicated in Q4FY08 that these segments were facing challenges, and this outlook remains broadly unchanged. We expect this scenario to support future growth from retail and transportation business.

Exhibit 1: Growth in BFSI and Retail, Transportation and Logistics



Source: Company data, KRC Research

EBITDA margins increase by 133 bps q-o-q but are expected to decline in Q2FY09

Volume growth declined by 577 bps to 3.0% q-o-q

Outperformance in the next 3 quarters now seems unlikely

Operating margins increase by 133 bps

Despite the increase in revenues, the EBITDA remained flat at Rs.632 crore in Q1FY09. Higher visa costs coupled with lower utilization rates negatively impacted EBITDA margin by 133 bps. The decline in utilization rates is coupled with a decline in additions, which could point to a slowdown in demand. Going forward in Q2FY09, company has guided to a decline in EBITDA margins q-o-q, but an increase in FY09 EBITDA margins by 50 bps y-o-y. We expect the single largest factor to be rupee depreciation coupled with an increase in utilization rates.

EBITDA margin reconciliation	
EBITDA margin in Q4FY08	22.79%
Rupee depreciation (a)	268 bps
Visa costs	(80) bps
Decrease in utilization	(55) bps
Negative impact (b)	(135) bps
Total impact (a) - (b)	133 bps
EBITDA margin in Q1FY09	24.12%

Source: Company data, KRC Research

Volume growth decline points towards declaration of growth

Satyam reported a subdued volume growth during the quarter at 3% (higher than Infosys and TCS which reported sequential volume growth of 0.5% and 1.3% respectively, but appears extremely low when compared with 8-9% growth rates during the past few quarters). Besides the employee addition was muted (Core IT service additions were 115). Although growth rates were expected to decline, the extent of sluggish volume growth, and muted employee additions was above our expectations and we expect this to hamper the company's relative performance.

Lack of backended growth and volume slowdown limits chances of outperformance

While most of Satyam's peers have guided towards back ended growth (in H2FY09) Satyam has guided towards a stable revenue growth. In Q1FY09, the company also witnessed some client ramp downs across the board, including its BPO services. We therefore expect the outperformance (as seen in the past few quarters) to be diminished in the next 3 quarters, as its peers benefit from volume growth and project rampups.

Increase in revenue guidance purely reflects benefits from rupee depreciation

Utilization calculation method revised to meet industry standards

Extended Engineering Solutions grew 5.3% q-o-q

Despite uncertainties in economic environment, pricing is expected to remain stable

Revised rupee guidance, dollar guidance remain unchanged

Guidance for Q2FY09 is largely subdued and FY09 guidance implies a growth of 4.9% q-o-q, which according to us, is muted given the company's growth over the last year. We attribute this mainly to the challenging business environment and macro economic weakness across key verticals

Exhibit 3: Guidance for Q2FY09 and FY09

Particulars	Q2FY09	Initial FY09 guidance	Revised FY09 guidance
Revenue (US\$ mn)	1,220	5,010	5,010
Revision (%)			-
Revenue (Rs cr)	5,251	20,054	21,450
Revision (%)			7.0
Rs /US\$ rate	43.04	40.02	43.04
Revision (%)			7.6
EPS (Rs)	23.74	93.12	100.20
Revision (%)			7.6

Source: Company data, KRC Research

Other highlights

- Net employee addition for the quarter is 653, attrition rate of declined to 12.6% from 14.9% in Q1FY08
- Addition of 34 clients in the quarter compared to 29 clients in Q1FY08, Active clients stand at 631.
- Satyam has changed its method of calculating utilization by increasing number of available hours in a year from 1,884 hours to 2,120 hours. Using the old base, offshore utilization is 84.4%, a decline of 120 bps
- Top client contributed to 4.45% of revenue, wherein top 5 customer contribution increased by 12 bps to 19.11%
- Won 3 large deals in the quarter
- Growth in Extended Engineering Solutions services was 5.3%, better than overall growth of the company

Management Outlook

- Company maintains optimistic outlook on growth of its portfolio and increased off-shoring
- As the credit market is yet to show any significant signs of improving, the outlook for the quarter remains unchanged and is expected to continue to be fluid.
- Pricing is expected to be stable with no unexpected billing rate re-negotiations.
- Effective tax rate to remain around 12% for FY09.

Diluted EPS grew to Rs 8.14 in Q1FY09

Satyam is trading at discount compared to its peers

We recommend a BUY on Satyam with revised target of Rs 456

Financial Snapshot

Particulars	Q1FY09	Q4FY08	q-o-q (%)	Q1FY08	y-o-y (%)
Net sales	2,620.8	2,416.0	8.5	1,830.2	43.2
Expenses	1,988.6	1,865.4	6.6	1,419.9	40.0
EBITDA	632.3	550.6	14.8	410.3	54.1
Depreciation	46.7	43.5	7.3	38.7	20.7
Other Income	33.1	23.0	44.2	63.2	-47.6
PBT	626.5	546.1	14.7	407.0	53.9
Tax	65.3	58.7	11.2	53.2	22.7
Adjusted PAT	547.7	466.8	17.3	378.3	44.8
Diluted EPS	8.14	6.97	16.8	5.67	43.8

Source: Company data, KRC Research

Relative Valuations

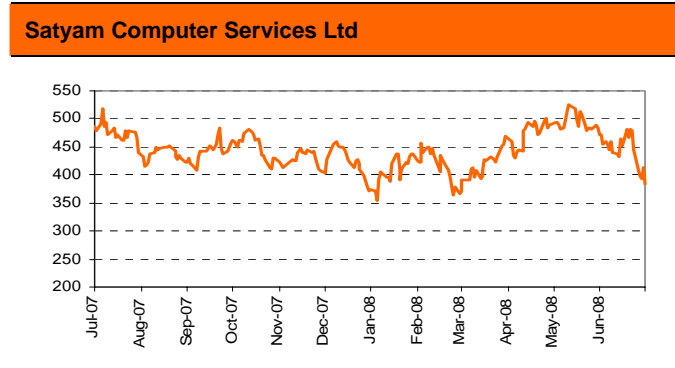
Company	Infosys	TCS	Wipro	Satyam
CMP (Rs)	1,578	834	394	444
OPM (%)	32.5%	26.0%	25.6%	27.9%
NPM (%)	27.9%	22.1%	21.6%	23.3%
P/E (x)	18.4	15.9	19.2	13.3
P/BV (x)	7.1	7.2	5.2	4.1
EV/Sales (x)	5.7	4.2	3.5	3.1
EV/EBIDTA (x)	15.8	14.2	14.9	12.2
M.Cap/Sales (x)	6.1	4.2	3.4	3.7

Source: Company data, KRC Research,

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At the CMP of Rs 368, Satyam is trading at 13.3x its TTM earnings and 11.2x FY09E EPS of Rs 32.56. We maintain a BUY on the stock with a target price of Rs 456 based on a 30% P/E discount to Infosys. Historically Satyam has traded at 20% P/E discount to Infosys; however, we have lowered our target P/E to reflect the anticipated deceleration in our performance. At the target price the stock would be valued at 14.0x FY09E EPS of Rs32.56, implying an upside potential of 23%.

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Rating	Expected performance in next 12 months
Buy	Appreciate over 15%
Accumulate/Hold	Appreciate upto 15%
Reduce	Depreciate upto 10%
Sell	Depreciate over 10%

Other Stocks in the sector under our active coverage: IT

Date	Company	Type of Report	Recommendation	Price	Target Price
17 July 2008	TCS	Result Update	Hold	782	898
12 July 2008	Infosys	Result Update	Buy	1676	2070

Disclaimer:

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