Sharekhan
by BNP PARIBAS

# Persistent Systems Limited

## Steady quarter, reasonable valuation

**Sector: IT & ITES**
**Results update**

| | Change |
|---|---|
| Reco: **Buy** | ↔ |
| CMP: **Rs. 505** | |
| Price Target: **Rs. 650** | ↓ |

↑ Upgrade ↔ No change ↓ Downgrade

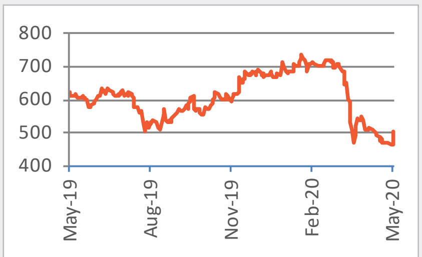
### Company details

| | |
|---|---|
| Market cap: | Rs. 3,856 cr |
| 52-week high/low: | Rs. 739/420 |
| NSE volume: (No of shares) | 1.1 lakh |
| BSE code: | 533179 |
| NSE code: | PERSISTENT |
| Sharekhan code: | PERSISTENT |
| Free float: (No of shares) | 5.2 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | 31.9 |
| FII | 21.8 |
| DII | 25.3 |
| Others | 21.0 |

### Price chart




### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | -0.7 | -29.3 | -15.4 | -18.8 |
| Relative to Sensex | -6.1 | -6.3 | 5.9 | -1.6 |

*Sharekhan Research, Bloomberg*

**Persistent Systems Limited (PSL) delivered a steady performance in a tough environment, with better-than-expected performance in both revenue and operating profitability. USD revenue came at $127.1 million (ahead of our modest expectations), down by 1.8% q-o-q, attributed to significant 24.3% q-o-q decline in IP-led revenue due to weak seasonality and lower revenue re-seller business because of COVID-19 outbreak. However, the sharp decline in IP revenue was partially offset by 3.8% q-o-q growth in Technology Services Unit (TSU, 73.7% of total revenue), driven by strong 7% q-o-q growth in digital revenue. EBITDA margin improved by 41 bps q-o-q to 13.8% despite lower IP revenue and bad provisions in the wake of COVID-19, led by lower sales and marketing expenses, decline in purchase/royalty expenses, and rupee benefits (50 bps). The provision for impairment value of deposits in a troubled NBFC remained at Rs. 4.8 crore. Management remains cautiously optimistic on the demand environment, given some of its smaller clients are asking for discounts and slower demand environment in the wake of COVID-19. However, the company's TSU segment has been growing for the past four quarters at a CQGR of 4.5% under the new leadership. Management expects the growth momentum in this unit to continue on account of strong deal wins, new logo addition, and a healthy deal pipeline. Further, management continues to see significant opportunity from the salesforce business (grew by 13% q-o-q in Q4FY2020), given its presence in the healthcare and patient-care segment. Management expects margin to improve in FY2021E on account of lower sales and marketing expenses and completion of rebranding activities. We assume FY2021E is going to be a weak year, given anticipated material deterioration in the demand environment. However, growth is likely to recover in FY2022E once the situation normalises.**

### Key positives

- Strong 3.8% q-o-q/14.7% y-o-y growth in TSU revenue, led growth in BFSI, software, and hi-tech vertical
- EBITDA margin at 13.8%, ahead of our estimates
- Strong account mining in TSU – 3.9% and 4% q-o-q revenue growth in top and top 5 accounts (specific to TSU)

### Key negatives

- IBM Alliance business revenue declined by 18.4% q-o-q

### Our Call

**Valuation – Reasonable valuation, retain Buy:** We have fine-tuned our earnings estimates for FY2021E/FY2022E on account of better-than-expected performance in Q4FY2020 and decent commentary around TSU business, while headwinds in alliance business are expected to continue. We assume FY2021E is going to be a weak year, given anticipated material deterioration in the demand environment, and growth is likely to recover in FY2022E once the ongoing situation normalises. However, EBITDA margin is expected to improve in FY2021E on account of lower sales and marketing expenses and completion of re-branding exercise. At the current market price, the stock is trading at a reasonable valuation of 11x/9x its FY2021E/FY2022E earnings. Further, cash and cash equivalents account for 38% of its current market capitalisation. Hence, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 650.

### Key Risks

Any slowdown in non-Internet of Things (IoT) revenue/delay in product launches/stronger rupee and/or adverse cross-currency movements could affect earnings.

**Valuation** Rs cr

| Particulars | FY18 | FY19 | FY20 | FY21E | FY22E |
|---|---|---|---|---|---|
| Revenue | 3,033.7 | 3,365.9 | 3,565.8 | 3,626.3 | 3,995.0 |
| OPM (%) | 15.5 | 17.2 | 13.8 | 14.5 | 15.6 |
| Adjusted PAT | 323.1 | 351.7 | 340.3 | 356.1 | 414.5 |
| % YoY growth | 3.3 | 8.8 | -3.2 | 4.6 | 16.4 |
| Adjusted EPS (Rs.) | 40.4 | 44.0 | 44.4 | 46.6 | 54.3 |
| P/E (x) | 12.5 | 11.5 | 11.4 | 10.8 | 9.3 |
| P/B (x) | 1.9 | 1.7 | 1.6 | 1.5 | 1.4 |
| EV/EBITDA (x) | 7.1 | 6.1 | 6.8 | 6.1 | 4.5 |
| RoNW (%) | 16.0 | 15.7 | 14.4 | 14.4 | 15.6 |
| RoCE (%) | 20.9 | 21.4 | 18.8 | 18.7 | 20.3 |

*Source: Company; Sharekhan estimates*

**Steady quarter:** PSL reported better-than-expected revenue and margin performance despite COVID-19 induced business disruption. USD revenue declined by 1.8% q-o-q to $127.1 million, owing to sharp drop in IP-led revenue (down by 24.3% q-o-q) due to weak seasonality. However, the sharp decline in IP revenue was partially offset by 3.8% q-o-q growth in TSU (73.7% of the total revenue). Growth in TSU business during the quarter was driven by strong 7% q-o-q growth in digital revenue. Management highlighted that BFSI and software and hi-tech industry segments reported strong growth during the quarter. IP-led revenue during the quarter was impacted due to lower revenue in re-seller business due to COVID-19 outbreak in developed markets. EBITDA margin improved by 41 bps q-o-q to 13.8% despite lower IP revenue and bad provisions in the wake of COVID-19, led by lower sales and marketing expenses, decline in purchase/royalty expenses, and rupee benefits (50 bps). The provision for impairment value of deposits in a troubled NBFC remained at Rs. 4.8 crore. Net profit of Rs. 83.8 crore was 4.1% ahead of our estimates owing to higher profitability, partially offset by lower forex gain and higher tax provision.

**Remains cautiously optimist on the demand environment, focus on margin improvement:** Management remains cautiously optimistic on the demand environment as some of its smaller clients are asking for discounts and some accommodations, slower demand environment in the view of COVID-19 and continued headwinds in IBM Alliance business. However, the company's TSU segment (73.7% of the total revenue) has been growing for the past four quarters at a CQGR of 4.5% despite a tough environment, under the new leadership team. The company continues to focus on BFSI and healthcare and life science verticals and expects growth momentum in these verticals to continue in the medium term on account of strong deal wins, new logo addition, and a healthy deal pipeline. Further, management highlighted that execution in the salesforce business has not impacted been yet and it continues to see significant opportunity from the salesforce business (grew by 13% q-o-q), given its presence in the healthcare and patient care segments. Management expects U-share recovery in the demand environment post COVID-19. Additionally, management expects revenue recovery in its alliance business in the coming quarters because of anticipated higher opportunities from Red Hat business of IBM and higher access to IBM's clients. Note the company has won a deal relating to the Red Hat business. Management focuses on margin improvement in FY2021E on account of lower sales and marketing expenses and completion of rebranding activities.

## Key conference call highlights

- **IT services revenue delivered growth:** IT services revenue grew by 4.2% q-o-q, led by 5% q-o-q growth in ISV and 3.6% q-o-q growth in the enterprise business. Offshore linear revenue grew by 5.1% q-o-q, driven by 4.9% q-o-q growth in volume and 0.2% q-o-q growth in billing rate. Onsite linear revenue growth was driven by 3.1% q-o-q growth in billing, while volume growth was down by 0.2% q-o-q.
- **Strong growth in TSU:** Technology services revenue increased by 3.8% q-o-q to $93.6 million, led by strong growth in BFSI (up 0.7% q-o-q/24.5% y-o-y) and followed by software and hi-tech business. Revenue growth in the healthcare and life science business remained flat. On service line perspective, salesforce services continued the growth momentum and delivered 13% q-o-q growth. Management sees strong traction around cloud-related offerings. The company has a strong pipeline in could and infrastructure business. In the TSU business, revenue from the top customer grew by 3.9% q-o-q, while revenue from the top 5, top 10 and top 20 customers grew by 4%, 2.3% and 3.8%, respectively, on sequential basis. This indicates secular growth in the top accounts in the TSU business. Growth in the TSU business was driven by cross-selling and gaining wallet share in existing customer accounts.
- **Segmental performance:** The BFSI vertical continued to deliver 0.7 q-o-q/24.5% y-o-y growth during Q4FY2020. The share of revenue from BFSI customers increased to 31.3% in Q4FY2020 from 30.5% in Q3FY2020 to 27.0% in Q4FY2019.The healthcare and lifesciences vertical's revenue growth remained flat on a sequential basis, while revenue grew by 5.2% y-o-y during the quarter. Revenue of the emerging vertical's declined by 4% q-o-q.
- **Alliance business:** Alliance business's revenue declined by 18.4% q-o-q in Q4FY2020 against a decline of 2% q-o-q in Q3FY2020. The recent acquisition of Red Hat by IBM provides a strong growth opportunity.
- **Decline in IP revenue:** IP-led revenue declined by 24.3% q-o-q, owing to seasonally weak quarter and lower growth in the re-seller business due to COVID-19 outbreak. Management highlighted that the re-seller business was impacted in March due to rapid spread of COVID-19 in developed markets. Note that a large portion of new license deal happens in March every year. With the outbreak of COVID-19, there is a setback in securing new license deal in its re-seller business.

- **Exposure to a troubled NBFC:** PSL provided an additional amount of Rs. 4.85 crore during Q4FY2020, taking the total provision to Rs. 43 crore (100% of the total exposure) towards its investments in bonds of a troubled NBFC.
- **Lower marketing expenses:** Marketing expenses declined by 1% q-o-q during the quarter due to few exits of employees at the end of the last quarter and adjustment in the cost structure.
- **Top clients' performance:** Revenue from the top client declined by 12.3% q-o-q. Revenue from the top-5 and top-10 clients declined by 3.7% and 4.1% q-o-q, respectively. Revenue from top 2-5 and top 2-10 increased by 5.2% and 1.8% q-o-q, respectively. The share of top customer reduced from 19.2% in Q4FY2020 from 21.5% in Q3FY2020 and 20.2% in Q4FY2019.
- **Client metrics:** The number of clients under the $3 million+ category dropped by a couple to 20, while the number of clients under $1 million+ bucket dropped by one on a q-o-q basis to 52.
- **Cash balance:** The company had cash and cash equivalents of Rs. 1,479.6 crore as of March 31, 2020, versus Rs. 1,377.9 crore as of December 31, 2019.

**Results** Rs cr

| Particulars | Q4Y20 | Q4FY19 | Q3FY20 | Y-o-Y (%) | Q-o-Q (%) |
|---|---|---|---|---|---|
| **Revenue ($ mn)** | **127.1** | **118.3** | **129.4** | **7.4** | **-1.8** |
| **Net sales** | **926.4** | **831.9** | **922.7** | **11.4** | **0.4** |
| Direct costs | 613.0 | 525.5 | 615.7 | 16.7 | -0.5 |
| SG&A | 185.7 | 179.8 | 183.6 | 3.3 | 1.2 |
| **EBITDA** | **127.7** | **126.6** | **123.4** | **0.9** | **3.4** |
| Depreciation & amortisation | 42.0 | 37.7 | 42.8 | 11.5 | -1.9 |
| **EBIT** | **85.7** | **88.9** | **80.6** | **-3.6** | **6.3** |
| Forex gain/(loss) | 4.5 | -5.9 | 10.2 | -176.1 | -56.4 |
| Other income | 22.9 | 28.3 | 23.2 | -18.9 | -1.0 |
| **PBT** | **113.0** | **111.3** | **114.0** | **1.6** | **-0.8** |
| Tax provision | 29.2 | 26.8 | 26.0 | 8.9 | 12.2 |
| **Net profit** | **83.8** | **84.5** | **87.9** | **-0.8** | **-4.7** |
| EPS (Rs.) | 11.0 | 10.6 | 11.5 | 3.6 | -4.6 |
| **Margin (%)** | | | | **BPS** | **BPS** |
| EBITDA | 13.8 | 15.2 | 13.4 | -143 | 41 |
| EBIT | 9.2 | 10.7 | 8.7 | -144 | 51 |
| NPM | 9.0 | 10.2 | 9.5 | -111 | -48 |

*Source: Company; Sharekhan Research*

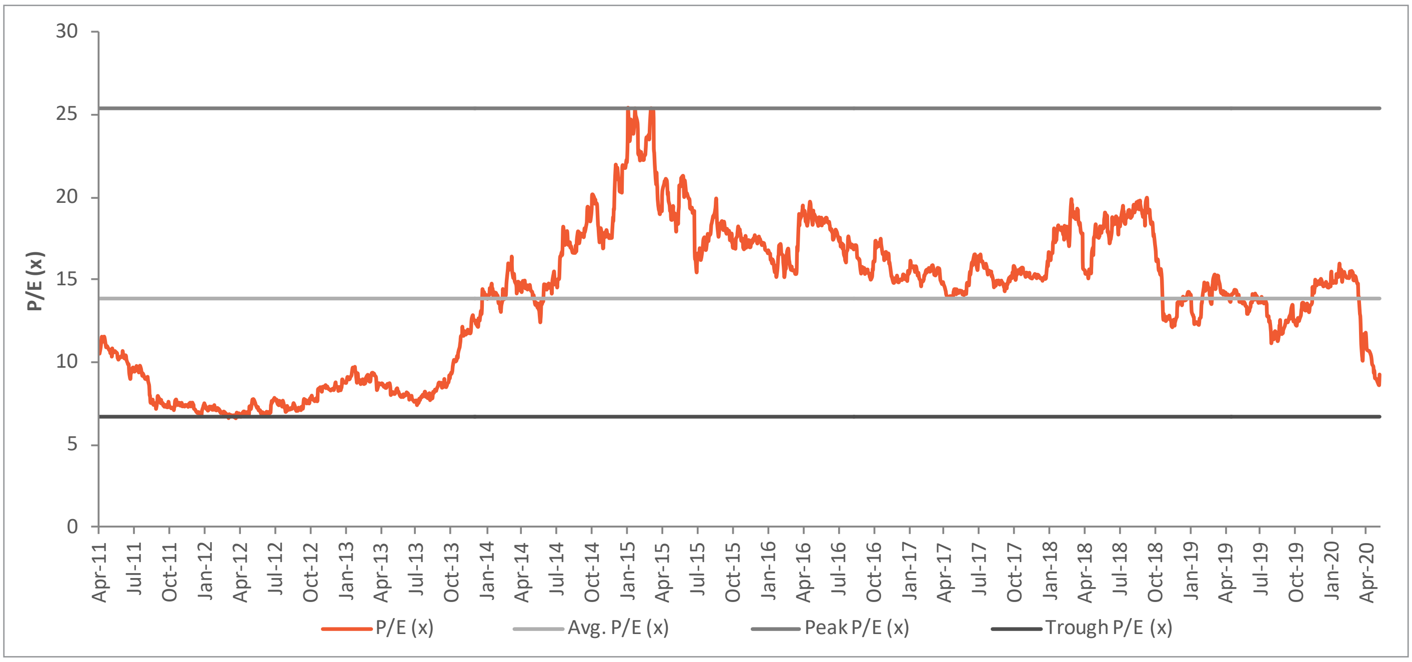
## Outlook

Social, mobility, cloud, analytics and IoT are estimated to account for more than 20% of the IT sector's revenue in 2020. As PSL is an early identifier of digital trends and has strong product development capabilities, we believe the company is well placed to capture a significant chunk of spends in digital technologies by clients going ahead. Though large exposure to its major clients (IBM) is a risk, the newly appointed CEO highlighted that the company would de-risk the IBM relationship by balancing the large client portfolio with focus on the industrial sector. Further, the company's leadership position in outsourced product development (OPD), elongated client relationships, and being an end-to-end service provider and partner in the clients' journey would help PSL to make most of the opportunity.

## Valuation

We have fine-tuned our earnings estimates for FY2021E/FY2022E on account of better-than-expected performance in Q4FY2020 and decent commentary around the TSU business, while headwinds in the alliance business are expected to continue. We assume FY2021E is going to be a weak year, given anticipated material deterioration in the demand environment and growth likely to recover in FY2022E once the ongoing situation normalises. However, EBITDA margin is expected to improve in FY2021E on account of lower sales and marketing expenses and completion of re-branding exercise. At the current market price, the stock is trading at a reasonable valuation of 11x/9x its FY2021E/FY2022E earnings. Further, cash and cash equivalents account for 38% of its current market capitalisation. Hence, we retain our Buy rating on the stock with a revised PT of Rs. 650.

**One-year forward P/E (x) band**




*Source: Sharekhan Research*

## About company

Incorporated in 1990, PSL is a global software company specialising in product and technology services. The company has organised itself into four business units - Services, Digital, Alliance and Accelerite. The company has proven expertise, strong presence in newer technologies and strength to improve its IP base. PSL focuses on developing IoT products and platforms, as it sees significant traction from industrial machinery, SmartCity, healthcare, and smart agriculture verticals. The company derives revenue from North America, Europe and Rest of the World.

## Investment theme

Large corporates have been allocating higher budgets toward digital transformation initiatives and IT spends are moving from ISV to enterprise model. PSL has restructured its business and aligned its sales resources to capitalise the benefits from the clients' digital transformation journey. The alliance with IBM and investments in new-age technologies (IoT, Blockchain, artificial learning and machine learning) are expected to help the company capture opportunities from these spends.

## Key Risks

1) Any slowdown in non-IoT revenue; 2) hostile regulatory development against current VISA regime; 3) delay in product launches and traction from clients in Accelerite; 4) stronger Indian rupee and/or adverse cross-currency movements; 5) margin dilution from M&A activity; and 6) high client concentration (around 23%+ revenue comes from IBM) could affect revenue growth.

## Additional Data

**Key management personnel**

| | |
|---|---|
| Dr. Anand Deshpande | Founder, Chairman and MD |
| Christopher O'Connor | Chief Executive Officer (CEO) |
| Sandeep Kalra | President: Technology Services |
| Sunil Sapre | Chief Financial Officer (CFO) |
| Mark Simpson | President, IBM Alliance |

*Source: Company Website*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | HDFC Asset Management Company Limited | 8.54 |
| 2 | L&T Mutual Fund Trustee Limited | 4.87 |
| 3 | Norges Bank Investment Management | 3.55 |
| 4 | Government Pension Fund (Global) | 3.51 |
| 5 | PSPL ESOP management trust | 3.22 |
| 6 | UPADHYE NARASINHA | 2.82 |
| 7 | PPFAS Asset Management | 2.70 |
| 8 | Saif India V FII Holding Limited | 2.68 |
| 9 | Kotak Mahindra Asset Management Co | 2.58 |
| 10 | ICICI Prudential Asset Management | 2.17 |

*Source: Bloomberg*

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