ANANDRATHI

India I Equities

Technology

Company Update

Change in Estimates ☑ Target ☑ Reco☐

07 May 2020

Persistent Systems

Rating: **Buy**
Target Price: ₹630
Share Price: ₹503

Reducing dependence on top client and IP, key positives; Buy

In services Persistent's Q4 was strong ($106m, up 4.2% q/q), driven by new smaller assignments (in India) as $1m+ clients slipped by three q/q. The top client declined 12% q/q; it now brings 19% to business (24% two quarters back). Weak IP ($20.7m, down 19% y/y) brought just 16% to revenue, down from 22% a year ago. This should ease growth volatility. The EBIT margin (9.2%, up 51bps q/q, down 144bps y/y) has started reflecting trends in the services margins, as IP contribution shrinks. The cut in our estimates is 12%/7%, and we lower our target to ₹630 (from ₹670)at 13.5x FY22 EPS.

Top client, IP drags are retreating. Persistent's dependence on its top client has contracted from 28% (in FY17) to 19% now. It has started working with RedHat (an IBM subsidiary), which should help it keep revenue from its top client stable to a mite up. Weakness in top client was also reflected in IP revenues; positives here are reduced investments in IP development and no fresh acquisition of/allocation to end-of-life products. On the other hand, Services is likely to maintain growth momentum as the unit is more aligned to digital. Europe (9% of Rev) declined 18.5% q/q.

EBIT margin at 9.2%, up 51bps q/q, down 144bps y/y. Margin expansion sequentially was supported by the rupee depreciation (50bp benefit, q/q) but adjusted for that, it was resilient (absorbing the decline in IP revenues in Q4 FY20), thereby reflecting underlying services business margins. The company announced pay-cuts (short term, till the growth recovers) for senior management and believes cost-containment programs can give it a tailwind of ~100bps in FY21 to help absorb the margin impact of Covid-19 shock.

Estimates revised down; retaining a Buy on valuation. Taking into account potential weakness in contract renewals and smaller accounts, we cut our FY21e and FY22e respectively ~12% and 7%. However, we believe that current valuations factor in the risks and, on an FCF basis, the stock can generate 14% yield. We expect growth of -2% and +7% for FY21 and FY22. **Risk:** Declines in the top client.

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (₹m)	30,337	33,659	35,658	36,239	38,922
Net profit (₹m)	3,231	3,517	3,409	3,079	3,666
EPS (₹)	40.4	44.1	44.6	40.3	48.0
PE (x)	11.9	10.9	11.3	12.5	10.5
EV / EBITDA (x)	5.0	4.0	4.7	5.0	4.3
PBV (x)	1.8	1.6	1.6	1.5	1.4
RoE (%)	16.0	15.7	14.4	12.5	14.1
RoCE (%)	13.8	16.0	11.6	10.3	11.7
Dividend yield (%)	2.4	8.2	4.4	4.4	5.7
Net debt / equity (x)	-0.4	-0.4	-0.4	-0.4	-0.5

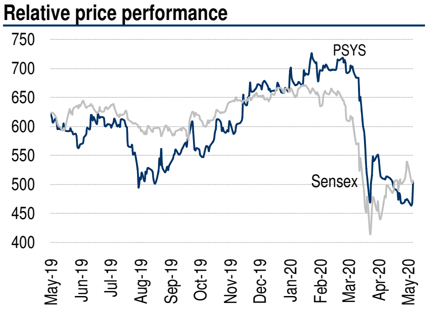
Source: Company, Anand Rathi Research

Key data	PSYS IN / PERS.BO
52-week high / low	₹740 / 420
Sensex / Nifty	31686 / 9271
3-m average volume	$0.7m
Market cap	₹39bn / $509m
Shares outstanding	76m

Shareholding pattern (%)	Mar'20	Dec'19	Sep'19
Promoters	31.4	31.9	31.9
- of which, Pledged			
Free float	68.6	68.1	68.1
- Foreign institutions	20.0	19.5	19.4
- Domestic institutions	24.8	23.5	21.7
- Public	23.8	25.1	27.0

Estimates revision (%)	FY21e	FY22e
Sales ($)	(6.1)	(4.8)
EBITDA	(12.9)	(9.1)
PAT	(12.4)	(7.4)

Relative price performance



Source: Bloomberg

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Revenues ($ m)	**470.6**	**481.0**	**501.6**	**493.7**	**530.3**
Growth (%)	***10***	***2***	***4***	***-2***	***7***
Net revenues (₹ m)	30,337	33,659	35,658	36,239	38,922
Employee & direct costs	18,748	19,874	21,934	23,330	24,546
Gross profit	11,589	13,785	13,724	12,909	14,376
Gross margins (%)	*38.2*	*41.0*	*38.5*	*35.6*	*36.9*
SG&A	6,901	7,980	8,795	8,238	8,914
EBITDA	**4,687**	**5,805**	**4,930**	**4,671**	**5,463**
EBITDA margins (%)	***15.5***	***17.2***	***13.8***	***12.9***	***14.0***
- Depreciation	1,585	1,573	1,660	1,548	1,624
Other income	1,190	631	1,259	948	1,039
Interest expenses					
PBT	4,293	4,863	4,529	4,070	4,878
Effective tax rate (%)	*25*	*28*	*25*	*24*	*25*
+ Associates / (Minorities)					
Net income	**3,231**	**3,517**	**3,409**	**3,079**	**3,666**
WANS	80	80	76	76	76
FDEPS (₹/ sh)	**40.4**	**44.1**	**44.6**	**40.3**	**48.0**

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Share capital	800	791	764	764	764
Net worth	21,272	23,447	23,858	25,243	26,709
Debt	17	12	46	46	46
Minority interest					
DTL/(Assets)	-642	-405	-960	-960	-960
Capital employed	**20,647**	**23,054**	**22,944**	**24,329**	**25,796**
Net tangible assets	2,581	2,331	2,791	2,817	2,861
Net intangible assets	2,464	1,595	1,434	695	-56
Goodwill	77	81	90	90	90
CWIP (tang. &intang.)	52	316	303	303	303
Investments (strategic)	2,881	4,346	4,621	4,621	4,621
Investments (financial)	5,916	3,296	5,165	6,714	8,728
Current assets (ex cash)	9,561	9,462	10,985	11,620	12,474
Cash	2,414	6,724	4,572	4,551	4,444
Current liabilities	5,300	5,098	7,018	7,082	7,670
Working capital	4,261	4,365	3,967	4,539	4,804
Capital deployed	**20,647**	**23,054**	**22,944**	**24,329**	**25,796**
Contingent liabilities	52	-	-	-	-

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
PBT	4,293	4,863	4,529	4,070	4,878
+ Non-cash items	1,077	1,155	1,396	778	763
Oper. prof. before WC	5,370	6,018	5,925	4,849	5,641
- Incr./(Decr.) in WC	-56	290	1,369	571	265
Others incl. taxes	-1,214	-1,405	-1,328	-991	-1,212
Operating cash-flow	**4,212**	**4,323**	**3,228**	**3,286**	**4,163**
- Capex (tang. +intang.)	651	374	746	834	918
Free cash-flow	**3,560**	**3,949**	**2,482**	**2,452**	**3,245**
Acquisitions	-	148	435	-	-
- Div.(incl. buyback & taxes)	950	1,588	2,978	1,694	2,200
+ Equity raised	-	-	-	-	-
+ Debt raised	-6	-5	38	-	-
- Fin investments	3,095	2,245	-515	1,549	2,014
- Misc. (CFI + CFF)	-1,396	-4,350	1,710	-770	-861
Net cash-flow	906	4,610	-2,088	-22	-107

Source: Company, AnandRathi Research

Fig 4 – Ratio analysis

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
P/E (x)	***11.9***	***10.9***	***11.3***	***12.5***	***10.5***
EV / EBITDA (x)	***5.0***	***4.0***	***4.7***	***5.0***	***4.3***
EV / Sales (x)	1.0	0.8	0.8	0.8	0.7
P/B (x)	1.8	1.6	1.6	1.5	1.4
RoE (%)	**16.0**	**15.7**	**14.4**	**12.5**	**14.1**
RoCE (%) - after tax	13.8	16.0	11.6	10.3	11.7
RoIC (%) - after tax	22.7	30.8	25.3	23.6	29.7
DPS (₹ / sh) *	11.9	41.4	22.3	22.2	28.8
Dividend yield (%)	2.4	8.2	4.4	4.4	5.7
Dividend payout (%) - incl. DDT	29.4	93.9	50.0	55.0	60.0
Net debt / equity (x)	-0.4	-0.4	-0.4	-0.4	-0.5
Receivables (days)	79	73	84	86	86
Inventory (days)					
Payables (days)	24	20	22	21	20
CFO : PAT%	130.4	122.9	94.7	106.7	113.6

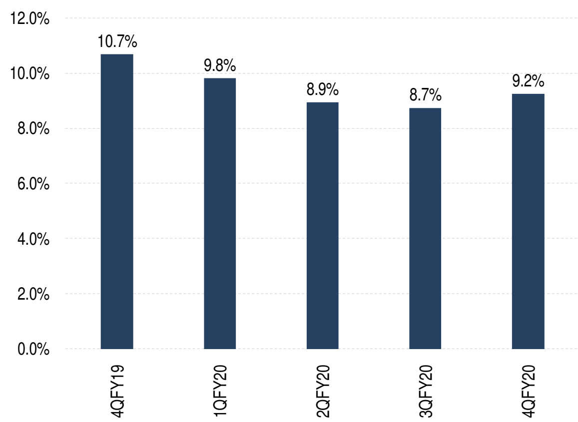
Source: Company, AnandRathi Research

**Includes buyback for calculation purposes*

Fig 5 – Price movement

Source: Bloomberg

Fig 6 – EBIT margins



Source: Company

Result Highlights

Q4FY20Results at a Glance

Fig 7 – Segment-wise results

	Q4FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q/Q %	Y/Y%
Revenues ($m)	**118**	**120**	**126**	**129**	**127**	***-1.8***	***7.4***
Growth Y/Y %	***1.2***	***-3.2***	***6.2***	***7.1***	***7.4***	***29 bps***	***624 bps***
Volume growth %	***5.4***	***6.6***	***7.6***	***11.3***	***14.1***	***274 bps***	***869 bps***
Revenues (₹ m)	8,319	8,321	8,846	9,227	9,264	*0.4*	*11.4*
Eff. exchange rate	70.3	69.6	70.5	71.3	72.9	*2.3*	*3.7*
Employees (EoP)	9,185	9,363	9,726	9,729	9,835	*1.1*	*7.1*
Revenue productivity ($'000/employee)	12.9	12.8	12.9	13.3	12.9	*-2.9*	*0.3*
Gross utilisation (IT services)	79.7	77.9	77.6	79.8	78.7	*-110 bps*	*-100 bps*
Attrition	16.7	17.1	15.7	14.9	14.3	*-60 bps*	*-240 bps*
CoR (excl. D&A)	(5,255)	(5,434)	(5,773)	(6,157)	(6,130)	*-0.5*	*16.7*
As % of revenue	*-63*	*-65*	*-65*	*-67*	*-66*	*56 bps*	*-300 bps*
SG&A	(1,798)	(1,685)	(1,856)	(1,836)	(1,857)	*1.2*	*3.3*
As % of revenue	*-22*	*-20*	*-21*	*-20*	*-20*	*-16 bps*	*157 bps*
EBITDA	1,266	1,202	1,216	1,234	1,277	*3.4*	*0.9*
EBITDA margins %	*15.2*	*14.4*	*13.8*	*13.4*	*13.8*	*41 bps*	*-143 bps*
EBIT	**889**	**816**	**792**	**806**	**857**	***6.3***	***-3.6***
EBIT margins %	***10.7***	***9.8***	***8.9***	***8.7***	***9.2***	***51 bps***	***-144 bps***
Other income	283	202	226	232	229	*-1.0*	*-18.9*
Forex gain/loss	(59)	80	138	102	45	*-26*	*-142*
PBT	1,113	1,098	1,156	1,140	1,130	*-0.8*	*1.6*
PBT margins %	*13.4*	*13.2*	*13.1*	*12.4*	*12.2*	*-15 bps*	*-118 bps*
Taxes	(268)	(273)	(295)	(260)	(292)	*12.2*	*8.9*
ETR %	*-24*	*-25*	*-26*	*-23*	*-26*	*-300 bps*	*-174 bps*
PAT	**845**	**825**	**861**	**879**	**838**	***-4.7***	***-0.8***
PAT margins %	***10.2***	***9.9***	***9.7***	***9.5***	***9.0***	***-48 bps***	***-111 bps***

Source: Company, Anand Rathi Research

Fig 8 – Quarterly result

Year-end: Mar(₹m)	Q4FY20	Q/Q %	Y/Y%	FY20	FY21	Y/Y%
Sales ($ m)	127	*(1.8)*	*7.4*	502	494	*(1.6)*
Sales	9,264	*0.4*	*11.4*	35,658	36,239	*1.6*
EBITDA	1,277	*3.4*	*0.9*	4,930	4,671	*(5.3)*
EBITDA margins (%)	*13.8*	*41 bps*	*-143 bps*	*13.8*	*12.9*	*-94 bps*
EBIT	857	*6.3*	*(3.6)*	3,270	3,123	*(4.5)*
EBIT margins (%)	*9.2*	*51 bps*	*-144 bps*	*9.2*	*8.6*	*-55 bps*
PBT	1,130	*(0.8)*	*1.6*	4,523	4,070	*(10.0)*
Tax	(292)	*12.2*	*8.9*	(1,121)	(991)	*(11.6)*
Tax rate (%)	*(25.9)*	*-300 bps*	*-174 bps*	*(24.8)*	*(24.4)*	*42 bps*
Net income	838	*(4.7)*	*(0.8)*	3,403	3,079	*(9.5)*

Source: Company

Conference call Highlights

- During the Covid shutdown the company was able to move people to work from home before the lockdown was announced in India. Clearly, it did not face much supply-side challenges.
- IP / licence deals dried up in March due to lockdowns.
- Healthcare and BFSI verticals are growing strong. The company has little presence in high turbulence sectors like retail, outdoor etc.
- 65% of the revenues from TSU is of annuity nature while the other 35% can be classified as project based.
- The company has started working with RedHat (an IBM subsidiary). That will help the top client revenues.
- The company invests 2% of revenues in new technologies. This impacts margins in the short run as these expenses are completely charged to P&L and not capitalized.
- In the quarter, S&M expenses were lower due to the attrition in the previous quarter, when the sales headcount declined by 19.
- IL&FS provision is now fully made and ₹30m were provided in the quarter on account of receivables from smaller customers.
- Senior management is taking pay-cuts till the time growth recovers for the company. The prudent measure will help margins.

Outlook

- No quantifiable outlook was provided, citing Covid uncertainties.

Q3 FY20 concall takeaways

- In terms of linear revenue, volumes were up 5.7%, while the billing rate declined 0.8%. IP revenue was lower on the back of lower-than-expected royalty revenue, which resulted in a drop in the gross margin by 140 basis points. The reseller business grew 20% in the quarter.
- The drop in the largest customer's revenue impacted profits but the company's endeavour is to get it back to normal.
- Expenditure on events such as attending conferences like Dreamforce, and AWS led to lower profits during the quarter.
- In Alliance Unit, Mark Simpson (President of the Alliance Unit) exited and Johnnie Zhang replaced him. He is an MBA from UCLA and a Bachelor of Science from the University of California in Electrical Engineering and Computer Science
- In the quarter, the company added 53 accounts and clocked some large deals like with a leading bank in the US, with a leading private bank in Asia Pacific and with the largest aircraft manufacturer in the world.
- Cash generation during the quarter was impacted as a couple of customers have increased payment terms from 60 days to 90, impacting the DSO by about three days.
- The Board approved an interim dividend of₹9 a share.
- ETR was lower on account of R&D tax credits and overseas locations.

Outlook

- Overall, the pipeline and demand environment is healthy for Q4.
- The BFSI pipeline is healthy across existing and new customers.
- On the gross margin side, the endeavour is to get back to the trajectory of 35%+. The company is done with most of the additions to the sales team. The endeavour is to get the EBITDA margin back to 15%.
- ETR is expected at 24% to 25%.

Q2 FY20 concall takeaways

- The sales force now contributes ~$55m to revenues on a TTM basis (growing 13% q/q in Q2), including revenues from Youperience.
- In the quarter, the company won large multi-million dollar deals, including a three-year deal from a US-based bank, a many-year healthcare deal and one in the “emerging” vertical. Besides, it secured a renewal from one of its largest healthcare clients.
- Margins were hit by wage hikes, counter-balanced by a 25bp currency benefit and by a reduction in carried-forward leave from 75 days to 60, leading to a benefit at the gross margin level.
- Sales and marketing expenses were higher on a onetime cost (for a brand-refresh exercise) and legal costs pertaining to the acquisition of Youperience.Q1 had a reversal of S&M expense for incentives not paid in FY19. Without such a reversal, higher S&M was seen in Q2.
- 13 people were added to the sales department in the US.
- The bifurcation of revenues of the TSU into Legacy and Digital is not proper, according to management, as some digital works are categorised as legacy services. Therefore, the digital decline doesn’t give the proper picture.
- H1 FY19 cash flow was higher on account of a large $7m deal being booked in the Alliance segment. Also, vendor payments were released earlier in Q2 FY20, as Persistent went in for an ERP upgrade. This led to ~₹500m less cash.

Q4 FY19 concall takeaways

- In FY19, the Linear segment’s volumes grew ~1.7% and the billing rate improved 0.6%. The onsite Linear business grew 2.7% (volumes declined 1.2% and billing improved 4%) and Offsite Linear was up 2% (volumes grew 2.2% and billing declined 0.1%). The company expects to deliver sequential growth in this segment, driven by the new sales team. It also expects stabilisation in its top account.
- R&D tax credit on development expenses has led to reduced ETR ~24% (29% in the previous quarter). Overall, tax rates are likely to be maintained on an annual basis.
- Growth in IP-led revenues to accelerate as the company intends to purchase new IPs in H1 FY20.
- We expect acquisitions to enhance its operations in European markets.
- Management expects FY20 margins to be steady and would purely be a function of sales growth.
- Offshore revenues are likely to see an upswing, but margin benefits are likely to be offset by higher S&M expenses, leaving margins unchanged.

Factsheet

Fig 9 – Revenue split

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Effort-led	78.4	78.5	77.5	78.8	83.7
IP-led	21.6	21.5	22.5	21.2	16.3

Source: Company

Fig 10 – Revenue-split, by region

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
North America	80.9	82.5	81.4	80.1	80.2
Europe	7.9	8.5	9.9	10.6	8.8
Asia-Pacific	11.2	9.0	8.7	9.3	11.0

Source: Company

Fig 11 – Revenue-split, by segment

($ m)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Services	52.8	54.8	56.7	60.2	61.5
Digital	28.9	27.2	28.1	30.0	32.1
Alliance	29.3	33.3	35.3	34.6	28.2
Accelerite	7.3	4.4	5.4	4.7	5.2

Source: Company

Fig 12 – Client concentration

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Top-1	20.2	23.6	23.7	21.5	19.2
Top-5	40.0	44.6	44.3	42.3	41.5
Top-10	50.2	52.6	53.4	51.1	49.9

Source: Company

Fig 13 – Workforce

	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Employee movement					
Technical(EOP)	**9,185**	**9,363**	**9,726**	**9,729**	**9,835**
Net additions (qtr)	424	178	363	3	106
Net additions (LTM)	856	1,167	1,160	968	650
Utilisation (%)	*79.7*	*77.9*	*77.6*	*79.8*	*78.7*
Attrition (%)	*16.7*	*17.1*	*15.7*	*14.9*	*14.3*
Sales(EOP)	**273**	**272**	**285**	**266**	**263**
Net additions (qtr)	7	(1)	13	(19)	(3)
Net additions (LTM)	62	35	38	-	(10)

Source: Company

Fig 14 – Revenue-split, by delivery type and billing rates

	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Delivery type(%)					
On-site	31.4	30.5	31.0	31.5	33.0
Offshore	47.0	48.0	46.5	47.3	50.7
Reported billing rates ($/hr)					
On-site	90.1	89.5	91.7	89.6	92.4
Offshore	23.4	23.7	23.7	23.6	23.7

Source: Company

Fig 15 – Key areasand horizontals growth (%)

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Horizontals growth (q/q)					
Services	4.2	3.8	3.5	6.1	2.2
Digital	4.3	(5.9)	(1.5)	6.8	7.0
Alliance	(17.4)	13.3	6.1	(2.0)	(18.4)
Accelerite	4.6	(39.7)	21.9	(13.7)	11.8
Key area-wise growth (y/y)					
North America	1.2	0.2	4.6	2.5	6.5
Europe	(2.5)	(31.4)	40.1	49.4	19.6
Asia-Pacific	3.9	4.9	(6.7)	14.5	5.5

Source: Company

Fig 16 – Segment-wisegrowth (y/y)

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Effort-led	2.1	4.5	10.6	12.6	14.6
IP-led	(2.0)	(23.8)	(6.7)	(9.2)	(18.9)

Source: Company

Valuations

At the ruling market price (₹503), the stock trades at P/E of 10.5x and EV/EBITDA of 4.3x FY22e. While FY19 revenue declined 2.2%,FY20 grew 4%. Revenues are likely to touch $530m by FY22, at a ~3% CAGR. The EBIT margin declined from 12.6% in FY19 to 9.2% in FY20 and is now largely expected to decline to 8.6% in FY21 and then revert to 9.9% in FY22.

IP sales declined 15% in FY20 and we expect them to remain soft. The company's reliance on its top client has come down to 19% (from 22% in Q3)and the incremental RedHat partnership would help stabilize revenues from the top client.

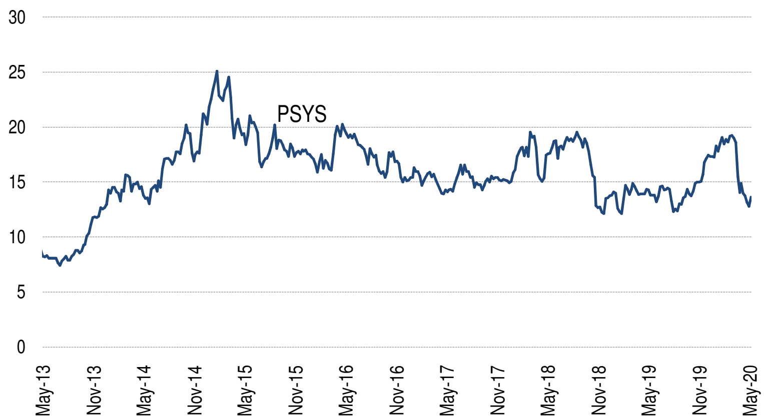
We value the stock based on a target PE of 13.5x FY22e EPS. Considering the risks of slow growth and lower margins already factored into the price, we maintain our Buy recommendation, with a revised target of ₹630(₹670 earlier).

Fig 17 –Change in estimates

	FY21			FY22		
(₹m)	New	Old	Chg %	New	Old	Chg %
Revenues ($m)	494	526	*(6.1)*	530	557	*(4.8)*
Revenues	36,239	37,986	*(4.6)*	38,922	40,274	*(3.4)*
EBITDA	4,671	5,361	*(12.9)*	5,463	6,011	*(9.1)*
EBITDA margins (%)	*12.9%*	*14.1%*	*-123 bps*	*14.0%*	*14.9%*	*-89 bps*
EBIT	3,123	3,609	*(13.5)*	3,839	4,279	*(10.3)*
EBIT margins (%)	*8.6%*	*9.5%*	*-89 bps*	*9.9%*	*10.6%*	*-76 bps*
PBT	4,070	4,601	*(11.5)*	4,878	5,235	*(6.8)*
PAT	3,079	3,515	*(12.4)*	3,666	3,960	*(7.4)*

Source: Anand Rathi Research

Fig 18 – PE band



Source: Bloomberg, Anand Rathi Research

Risk

- Declines in the top client.

Appendix

Analyst Certification

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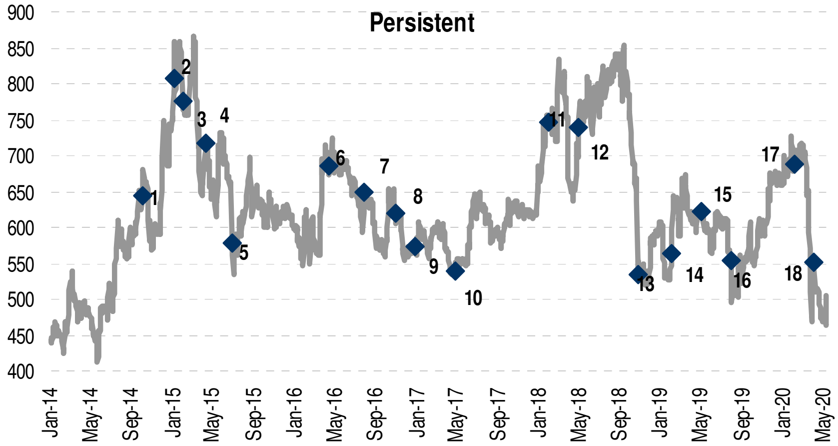
Rating and Target Price History (as of 7 May 2020)



	Date	Rating	TP (₹)	Share Price (₹)
1	30-Sep-14	Buy	975	693
2	05-Jan-15	Buy	1,000	932
3	28-Jan-15	Hold	975	902
4	09-Apr-15	Buy	930	780
5	24-Jun-15	Buy	860	647
6	08-Apr-16	Buy	950	727
7	26-Jul-16	Buy	900	664
8	25-Oct-16	Buy	875	662
9	21-Dec-16	Buy	840	609
10	25-Apr-17	Buy	800	568
11	29-Jan-18	Buy	940	789
12	25-Apr-18	Buy	960	726
13	23-Oct-18	Buy	820	560
14	29-Jan-19	Buy	760	565
15	30-Apr-19	Hold	700	565
16	26-Jul-19	Hold	630	552
17	31-Jan-20	Sell	690	704
18	31-Mar-20	Buy	670	551

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Ratings Guide (12 months)

	Buy	Hold	Sell
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