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Stock Update

Persistent Systems Limited

Strong show in Q2, momentum to gain pace

IT & ITES	Sharekhan code: PERSISTENT	Result Update

Summary

- We retain our Buy rating on Persistent Systems Limited (PSL) with a revised PT of Rs. 1,450, as we expect strong earnings growth over FY2021-23E.
- Q2 numbers beat estimates on all fronts; deal signings remained strong for all verticals; we believe appointment of Mr. Sandeep Kalra as CEO is a positive given his proven track record.
- Management remains optimistic that Alliance business would return to growth trajectory on the back of cross-selling opportunities; targets annual revenue of over $1 billion over next 4 years.
- Cash & cash equivalents account for 19% of its current market-cap; expect USD revenue/earnings to clock a CAGR of 13%/20% over FY2021-FY23E, led by strong deal wins, cross-selling opportunities & margin expansion.

Persistent Systems Limited (PSL) reported better-than-expected performance across all financial parameters, as revenue, margin and net profit, all three beat estimates. US Dollar revenues grew by 3.9% q-o-q and 8.4% y-o-y to $136.1 million, slightly above our estimates, led by strong 5.3% q-o-q growth in IT services. However, IP-led business revenue declined 3% q-o-q owing to absence of revenue from the re-seller business. The Technology Services Unit (TSU) and Alliance business reported a revenue growth of 4.1% q-o-q and 3.0% q-o-q, respectively. EBITDA margin improved 168 bps q-o-q to 16.4%, exceeding our expectations, led by higher revenue, better royalty income and improved utilisation. Net profit was 4% ahead of our estimates led by higher profitability. We believe that the appointment of Mr. Sandeep Kalra as CEO is positive for the company as he would focus on replicating the success story of the TSU segment in the Alliance business (22.7% of total revenue). The management remains optimistic that the Alliance business would return to the growth trajectory on the back of benefits from its certain investments in the Red Hat area and cross-selling opportunities. Further, the recent decision by IBM's management to split the company into two entities by the end of December 2021 would positively impact PSL. Further, the TSU segment (that contributes 77.3% of total revenue) is expected continue its growth momentum (3.9% CQGR over the last 5 quarters) on the back of strong deal wins, robust deal pipeline, new account opening and higher adoption of new-age technologies. PSL's management guided that annual revenue could touch $1 billion over next four years, translating into a 15-16% CAGR. Margins are expected to sustain at current levels in Q3FY2021 despite investment in building capabilities and wage hike, driven by (1) higher IP-led revenue, (2) improvement in margin profile of a large deal won in Q1FY2021, and (3) reduction of discount of pricing provided to certain customers. We believe that the absence of COVID-19 related expenses (credit provisions/PM Cares), higher offshoring and lower amortisation expenses would drive PSL's margin trajectory in FY2022E.

Key positives

- EBIT margin at 12.1%, exceeding our estimates
- Broad-based growth in top accounts; revenue from top/top-20 grew14%/7% q-o-q respectively
- Added one clients in $5 million+ client category on q-o-q basis

Key negatives

- European business' revenue declined 22.6% q-o-q

Our Call

Valuation – Growth momentum to continue, retain Buy: We have raised our earnings estimates upward for FY2021E/FY2022E/FY2023E on account of strong Q2FY2021, large deal wins across verticals, higher demand for digital technologies and anticipation of growth in Alliance business. We expect PSL would be one of mid-tier IT companies to report industry-leading revenue growth in FY2021 given strong revenue growth in H1FY2021. EBITDA margin is expected to improve in FY2022E on the back of absence of COVID-19 related expenses/provisions and lower amortisation expenses. Further, the company focuses on strategies to drive growth and profitability of Alliance business. We model PSL's USD revenue/earnings to clock a CAGR of 13%/20% over FY2021-FY23E. At CMP, the stock is trading at a reasonable valuation of 18x/16x its FY2022E/FY2023E earnings. Further, cash & cash equivalents account for 19% of its current market capitalisation. Hence, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 1,450.

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.

Valuations Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	3,365.9	3,565.8	4,132.6	4,626.4	5,125.2
OPM (%)	17.2	13.8	15.8	16.3	16.5
Adjusted PAT	351.7	340.3	421.1	517.6	583.9
% YoY growth	*8.8*	*-3.2*	*23.7*	*22.9*	*12.8*
Adjusted EPS (Rs.)	44.0	44.4	55.1	67.7	76.4
P/E (x)	27.0	26.8	21.6	17.5	15.5
P/B (x)	4.0	3.8	3.5	3.2	2.9
EV/EBITDA (x)	15.5	17.8	13.1	10.7	9.2
RoNW (%)	15.7	14.4	16.8	18.8	19.4
RoCE (%)	21.4	18.8	22.2	24.9	25.7

Source: Company; Sharekhan estimates

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 1,187**	
Price Target: **Rs. 1,450**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

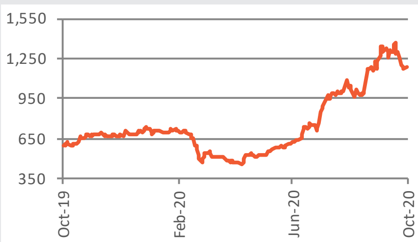
Company details

Market cap:	Rs. 9074 cr
52-week high/low:	Rs. 1,389 / 420
NSE volume: (No of shares)	2.1 lakh
BSE code:	533179
NSE code:	PERSISTENT
Free float: (No of shares)	5.2 cr

Shareholding (%)

Promoters	31.3
FII	20.4
DII	29.4
Others	18.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-6.9	38.8	152.9	97.9
Relative to Sensex	-12.6	33.0	126.4	95.6

Sharekhan Research, Bloomberg

Strong quarter

PSL reported better-than-expected performance across all financial parameters, with a beat in revenue, margin and net profit. USD revenue grew 3.9% q-o-q and 8.4% y-o-y to $136.1 million, slightly above our estimates, led by strong 5.3% q-o-q growth in IT services. However, IP-led business revenue declined 3% q-o-q during the quarter. The Technology Services Unit (TSU) and Alliance business reported revenue growth of 4.1% q-o-q and 3.0% q-o-q respectively. EBITDA margin improved 168 bps q-o-q to 16.4%, ahead of our expectations, led by higher revenue, better royalty income and improved utilisation. Net profit was up by 13.3% q-o-q to Rs. 102 crore and was 4% ahead of our estimates led by higher profitability, partially offset by lower other income (down 25.6% q-o-q).

Focus on driving growth in Alliance unit; target to achieve $1 billion revenue over next 4 years

We believe that the appointment of Mr. Sandeep Kalra as CEO is positive for the company as he would focus on replicating the success story of TSU segment in the Alliance business. Under his leadership, TSU segment (77.3% of the total revenue) has been consistently growing at a CQGR of 3.9% over last five quarters. We believe that TSU segment would continue its growth momentum on the back of strong deal wins, a robust deal pipeline, new account opening and higher adoption of new-age technologies. The company also sees strong traction for its offerings in the area of infrastructure, cloud and cloud-related offerings. Management remains optimistic that Alliance business would return to growth trajectory on the back of benefits from its certain investments in the Red Hat area and cross-sell opportunities. Further, the recent decision by IBM management to split the company into two entities by the end of December 2021 would have a positive impact on PSL. Management indicated that IP-led revenue could revenue could remain strong in Q3FY2021 on the back of strong seasonality. Management guided that it plans to achieve $1 billion annual revenue over the next years, implying around a 15-16% CAGR over FY2021-25E.

Expect margin sustainability going ahead

EBIT margin improved 170bps q-o-q to 12.1% (in-line with management's earlier guidance), led by higher revenue, improved utilisation and better royalty income. The management expects margin can be sustainable at this level in coming quarters, despite investments in building digital capabilities, wage hike, addition of employees and return of higher spends post normalcy. Margin levers for Q3FY2021 are – (1) higher IP-led revenue (seasonally strong quarters), (2) improvement in margin profile of a large deal won in Q1FY2021 (shifting of resources from onsite to offshore), and (3) reduction of discount of pricing. Further, the company would focus on optimising delivery headcount in the IP portfolio across various products, which would also aid the company's margins. We believe that the absence of COVID-19 related expenses, higher offshoring and lower amortisation expenses would improve the company's margin profile in FY2022E.

Key conference call highlights

- **CEO appointment:** Mr. Sandeep Kalra was appointed as CEO effective October 23, 2020, after the resignation of Christopher O'Connor. He had joined Persistent systems in May 2019. He was the Executive Director and President of PSL, responsible for setting the strategic direction and managing the sales, delivery functions for the Technology Services Unit. Under his leadership, TSU has delivered strong CQGR of 4% over last six quarters. We believe the appointment of Mr. Kalra as the CEO is positive for the company as he could start focusing on Alliance business to drive growth like in the TSU business.
- **Revenue growth outlook:** The management expects sequential revenue growth would be in the range of 2-4% over Q3/Q4 of FY2021. It indicated that the Alliance business would turnaround and become a growth business over next 2-3 quarters. Management also remains optimistic about cross-selling opportunities between TSU and Alliance business unit. Red Hat opportunities can be taken to enterprise customers, which would drive its overall growth going ahead. The management also indicated that the margin profile of Alliance business can be improved on back of cost optimisation initiatives.
- **Margin walkthrough:** Higher linear revenue, better royalty income and improved utilisation are tailwinds for the margin improvement during the quarter despite rupee appreciation. Gross margin improved 170bps q-o-q to 34.7% in Q2FY2021. Currency headwind has an adverse impact of 70 bps on margin during the quarter.

- **IT services revenue delivered strong growth:** IT services revenue grew by 5.3% q-o-q and 17.2% y-o-y despite COVID-19 related challenges, pricing discount and ramp-down of projects. Onsite linear revenue grew by 1.8% q-o-q, driven by a 2% q-o-q growth in volume, while billing rates declined 0.3% q-o-q. Offshore linear revenue declined by 7.7% q-o-q, led by 7.8% q-o-q growth in volume, while billing rate declined by 0.1% q-o-q during the quarter. IP-led business declined 3% q-o-q owing to seasonality weakness in reseller business (higher reseller deals in Q1FY2021). Higher royalty income in IP-led business during the quarter helped company to drive overall margin profile.
- **TSU space continued to grow strongly:** The TSU's revenue growth accelerated to 4.1% q-o-q to $105.2 million, led by strong growth in BFSI (up 4.2% q-o-q/21.8% y-o-y) and technology companies and emerging vertical (4.5% q-o-q, but down 0.5% y-o-y). Healthcare and life sciences vertical grew by 1.8% q-o-q/13.7% y-o-y. Company won number of large deals in TSU across existing customers and new customers. Growth in the TSU business was driven by cross-selling and gaining wallet share in existing customer accounts. The management sees strong traction around cloud-related offerings. The company has a strong pipeline in cloud and infrastructure business.
- **Decent growth in Alliance business:** Alliance business' revenue increased by 3% q-o-q to $30.9 million in Q2FY2021 compared to $30 million in Q1FY2021. PSL has secured royalty contracts with growth products and enhanced level of service contracts with new and existing re-sell customers. Company also partners with IBM for financial services clients. Company sees growth in the large deals' pipeline in Alliance business and number of multi-million and multi-year deals across services include Red Hat and Cloud businesses. The management highlighted that the partnership with Red Hat provides opportunities across worldwide. Company also enhanced partnership with Red Hat to advanced level and expanded its partnership in go-to-market with opportunity in Europe and APAC.
- **Expect positive impact from IBM spinoff:** IBM is PSL's largest client. The management highlighted that the recent decision by IBM management to split the company into two companies by the end of December 2021 would not have any material impact on PSL. It expects this event would be positive for PSL in medium-to-long term perspective. Majority of PSL's revenue from IBM relationship comes from core IBM side.
- **Vertical performance:** Revenue of the emerging vertical grew by 4.5% q-o-q (versus 1% q-o-q in Q1FY2021), followed by 4.2% q-o-q/21.8% y-o-y (versus 4.8% q-o-q/25.7% y-o-y growth in Q1FY2021) growth in BFSI vertical. The share of revenue from the BFSI vertical increased to 31.9% in Q2FY2021 from 31.8% in Q1FY2021. The healthcare and life-sciences vertical reported revenue growth of 1.8% q-o-q/13.7% y-o-y during the quarter versus 5.8% q-o-q/14.2% y-o-y in Q1FY2021.
- **Service-line performance:** PSL continued to see strong traction for its product engineering, cloud and infrastructure services.
- **US continues growth momentum, while Europe declined:** North America and India business reported revenue growth of 7.1% q-o-q and 6.5% q-o-q during the quarter, while Europe and RoW business reported revenue decline of 22.6% q-o-q and 3.1% q-o-q. Europe business witnessed a sharp decline due to (1) absence of reseller business on a sequential basis during Q2FY2021, and (2) weakness in both services and IP-led business.
- **IP-led revenue declined:** IP-led revenue declined 3% q-o-q after a strong growth of 9.8% q-o-q in Q1FY2021.
- **Lower travel expenses:** Travel expenses declined by 56.8% q-o-q (44.9% q-o-q in Q1FY2021) during the quarter due to restriction in travel in the wake of COVID-19 outbreak.
- **Top clients' reported broad-based growth:** Revenue from the top client grew by 13.8% q-o-q after three consecutive quarters of a sequential decline. Revenue from the top-5 and top-10 clients increased by 5.9% and 7.0% q-o-q, respectively. Revenue from top 2-5 and top 2-10 clients increased by 3.9% and 3.2% q-o-q, respectively. Further, management highlighted that revenue top-20 customers grew 7% q-o-q during the quarter. Revenue share of top customer increased to 19.4% in Q2FY2021 from 17.7% in Q1FY2021.
- **Client metrics remained strong:** The number of clients under the $5 million+ category increased by one on sequential basis to 16. Further, the number of clients under $1 million+ bucket remained flat on a q-o-q basis at 63.
- **Utilisation improved, attrition rate lowered:** Utilisation during the quarter improved to 81.2% versus 78.5% in Q1FY2021. Attrition rate reduced to 10.6% compared to 12.7% in Q1FY2021. Headcount remained flat on a sequential basis. Management indicated that it would hire around 300-400 people per quarter in Q3 and Q4 of FY2021 to meet the incremental demand.

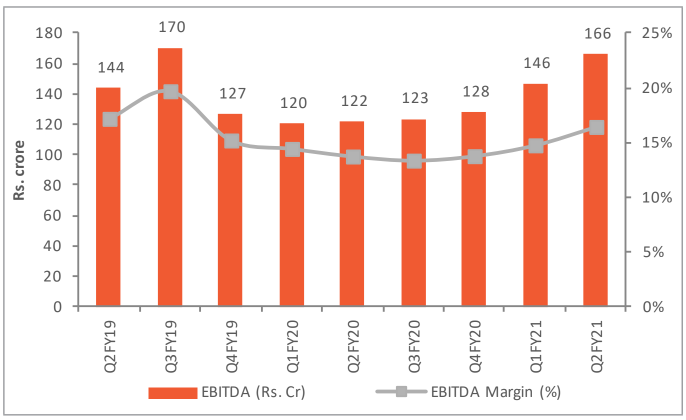
- **Wage hike:** Management highlighted that it would roll-out annual wage hike effective from November 1, 2020.
- **Strong cash balance:** Company had cash & cash equivalent of Rs. 1,693.3 crore as of September 30, 2020, versus Rs. 1,493.9 crore as of June 30, 2020.
- **Acquired CAPIOT to strengthen digital capabilities:** Persistent System has entered into the stock purchase agreement to acquire Capiot Software Inc., USA along with its subsidiaries in India, Singapore and Australia. The acquisition is expected to be completed within 2-4 weeks. Capiot Software Inc. generated revenue of $6.28 million in FY2020. CAPIOT has strong track record in enterprise integration with expertise in MuleSoft, Red Hat and TIBCO. Further, Capiot delivers enterprise modernization with advanced proficiency in key partner platforms, frameworks and industry data models. Management indicated that this acquisition would contribute to revenues in Q3FY2021. This acquisition would strengthen PSL's digital capabilities especially in the area of go-to-market (GTM) strategy with its partner Salesforce. Going ahead, company would continue to evaluate acquisition opportunities and accelerate inorganic growth opportunities going ahead.

Results Rs cr

Particulars	Q2FY21	Q2FY20	Q1FY21	Y-o-Y (%)	Q-o-Q (%)
Revenue ($ mn)	**136.1**	**125.5**	**131.0**	**8.4**	**3.9**
Net sales	**1,007.7**	**884.6**	**991.4**	**13.9**	**1.7**
Direct costs	657.7	577.3	664.6	13.9	-1.0
SG&A	184.3	185.6	180.3	-0.7	2.2
EBITDA	**165.8**	**121.6**	**146.4**	**36.3**	**13.2**
Depreciation & amortisation	44.0	42.5	43.6	3.5	1.0
EBIT	**121.8**	**79.2**	**102.9**	**53.9**	**18.4**
Forex gain/(loss)	-5.1	13.8	-8.8	-136.7	-42.3
Other income	20.8	22.6	27.9	-8.1	-25.6
PBT	**137.5**	**115.6**	**122.0**	**19.0**	**12.7**
Tax provision	35.5	29.5	32.0	20.5	10.9
Net profit	**102.0**	**86.1**	**90.0**	**18.5**	**13.3**
EPS (Rs.)	13.3	11.3	11.8	18.5	13.2
Margin (%)				**BPS**	**BPS**
EBITDA	16.4	13.8	14.8	270	168
EBIT	12.1	8.9	10.4	314	171
NPM	10.1	9.7	9.1	39	104

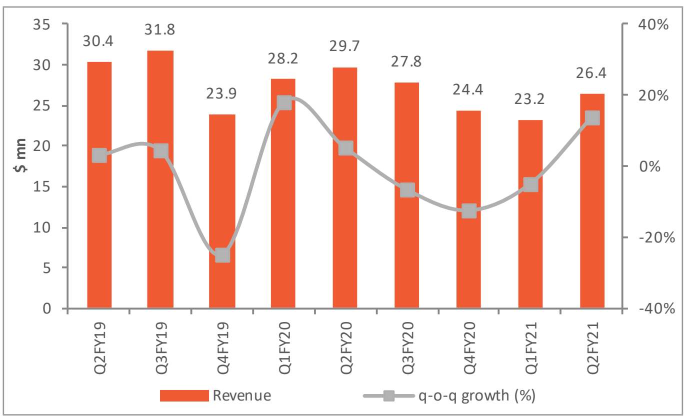
Source: Company; Sharekhan Research

Margin beats our expectations; expect margin to sustain going ahead



Source: Company, Sharekhan Research

Top account recovery remained strong



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view – Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate that IT services spending would grow by 5-8% over CY2021-24E as compared to average of 4.2% achieved in CY2010-19. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients and increase in online adoption across verticals. The implications from the COVID-19 outbreak have accelerated the digital activities among large global enterprises, leading to increase in spending on workplace transformation and collaboration tools, cyber-security and higher cloud migration. WFH efficiencies, lower travel costs and higher offshoring would drive margins in medium term, we believe that it will be passed on to clients through pricing reduction in long term.

■ Company outlook - Well positioned to capture opportunities

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. Management 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 its status as an end-to-end service provider would help it make most of the opportunities.

■ Valuation - Growth momentum to continue, maintain Buy

We have raised our earnings estimates upward for FY2021E/FY2022E/FY2023E on account of strong Q2FY2021, large deal wins across verticals, higher demand for digital technologies and anticipation of growth in Alliance business. We expect PSL would be one of mid-tier IT companies to report industry-leading revenue growth in FY2021 given strong revenue growth in H1FY2021. EBITDA margin is expected to improve in FY2022E on the back of absence of COVID-19 related expenses/provisions and lower amortisation expenses. Further, the company focuses on strategies to drive growth and profitability of Alliance business. We model PSL's USD revenue/earnings to clock a CAGR of 13%/20% over FY2021-FY23E. At CMP, the stock is trading at a reasonable valuation of 18x/16x its FY2022E/FY2023E earnings. Further, cash & cash equivalents account for 19% of its current market capitalisation. Hence, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 1,450.

One-year forward P/E (x) band

Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Tech M	819	97	79,226	17.5	15.2	10.9	9.1	2.9	2.6	17.9	18.6
L&T Infotech	2,999	17	52,351	29.5	24.7	19.6	17.3	7.4	5.7	29.8	29.1
Persistent	1,187	8	9,074	21.6	17.5	13.1	10.7	3.5	3.2	16.8	18.8

Source: Company, Sharekhan estimates

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
Sandeep Kalra	Chief Executive Officer (CEO)
Sameer Bendre	Chief People Officer
Sunil Sapre	Chief Financial Officer (CFO)
Bipin Sahni	Chief Strategy Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Company Limited	7.58
2	L&T Mutual Fund Trustee Limited	4.49
3	PPFAS Asset Management	3.87
4	Norges Bank Investment Management	3.55
5	Government Pension Fund (Global)	3.51
6	PSPL ESOP management trust	3.22
7	ICICI Prudential Asset Management	2.23
8	FMR LLC	1.81
9	Vanguard Group Inc	1.60
10	Shukla Shridhar Bhal	1.60

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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