



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. 1,499	
Price Target: Rs. 1,720	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

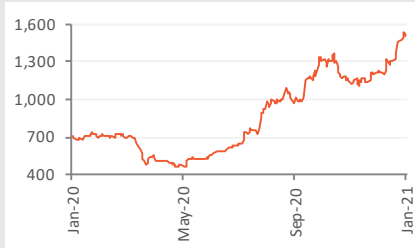
Company details

Market cap:	Rs. 11,454 cr
52-week high/low:	Rs. 1,542/420
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	23.6	12.9	133.1	110.0
Relative to Sensex	16.3	(9.9)	99.5	95.0

Sharekhan Research, Bloomberg

Summary

- We retain our Buy rating on Persistent Systems Limited (PSL) with a revised PT of Rs. 1,720, given anticipated strong revenue growth in FY2022E and FY2023E.
- We expect USD revenue to grow by 5% q-o-q to \$142.9 million (excluding revenue from re-seller deal) in Q3FY2021, led by healthy growth in TSU business and strong seasonality in Alliance business.
- EBIT margin is expected to improve by 10 bps q-o-q in Q3FY2021 despite two-month impact of wage hike and increased hiring. Headwinds would be offset by higher Alliance revenue and rising offshoring revenue.
- Cash and cash equivalents account for 15% of its current market capitalisation; strong balance sheet and potential strong earnings growth (22% CAGR over FY2021-FY2023E) provide us comfort on the stock despite the recent run up.

We expect mid-tier companies would deliver strong growth on a sequential basis in Q3FY2021 despite weak seasonality, led by higher spends on digital technologies by enterprises, ramp-up of deals, and anticipated lower impact furloughs. Among mid-tier Indian IT services companies, Persistent Systems Limited (PSL) has been delivering its strongest revenue performance over the past two consecutive quarters because of its high concentration to less impacted verticals (such as BFSI and healthcare) and strong execution in Technology Services Unit (TSU) business. We believe PSL would continue to maintain its strong growth momentum in Q3FY2021 due to strong seasonality in its Alliance business. We expect USD revenue to grow by 5% q-o-q to \$142.9 million in Q3FY2021 with stable EBIT margin. Revenue growth in Q3FY2021 would be driven by continued strong growth momentum in TSU business and robust growth in Alliance business. Note that there is an immediate revenue potential of \$2.5 million (1.7% of our estimated Q3FY2021 revenue) from a re-seller deal. Management indicated that revenue recognition from the above deal is uncertain in this quarter; however, if the same revenue is recognised during this quarter, it would outpace our current revenue growth estimate of 5% q-o-q. We expect a stable EBIT margin performance (up 10 bps q-o-q) in Q3FY2021 despite two-month impact of wage hike and increased hiring. We believe margin headwinds would be offset by (1) higher Alliance revenue, (2) improvement in margin profile of a large deal won earlier (shifting of resources from onsite to offshore), and (3) reversal of certain discount to clients. PSL's management aspires to achieve \$1 billion revenue within four years, which implies a ~19% CAGR. However, we are currently assuming revenue growth CAGR of 13% over FY2020-FY2023E.

Our Call

Valuation: Growth to accelerate: PSL's stock price has run up around 24% in the past one month due to anticipation of revenue estimate upgrade post the expected strong quarterly performance in Q3FY2021. We expect PSL would be one of the mid-tier IT companies to report industry-leading revenue growth in FY2021, given strong revenue growth in H1FY2021 and anticipated strong revenue growth in Q3 and Q4 of FY2021E. Even if the company does not recognise the revenue from re-seller deal (\$2.5 million) in Q3FY2021, this revenue would spill over to Q4FY2021, which would aid to its overall growth in FY2021. We model PSL's USD revenue/earnings to report a CAGR of 13%/22% over FY2021-FY2023E. At the CMP, the stock is trading at a valuation of 21x/18x its FY2022E/FY2023E earnings. Further, cash and cash equivalents (as of September 30, 2020) account for 15% of its current market capitalisation. Given strong revenue growth with a scope for margin improvement, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 1,720.

Key risk

Any delay in product launches/stronger rupee and/or adverse cross-currency movements could affect earnings.

Valuations

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	3,365.9	3,565.8	4,135.0	4,762.9	5,429.2
OPM (%)	17.2	13.8	16.0	17.0	17.2
Adjusted PAT	351.7	340.3	432.1	554.6	641.9
% YoY growth	8.8	-3.2	27.0	28.3	15.7
Adjusted EPS (Rs.)	44.0	44.4	56.5	72.5	84.0
P/E (x)	34.1	33.8	26.5	20.7	17.8
P/B (x)	5.1	4.8	4.4	4.0	3.6
EV/EBITDA (x)	19.8	22.9	16.7	13.0	10.9
RoNW (%)	15.7	14.4	17.2	20.1	21.0
RoCE (%)	21.4	18.8	22.7	26.5	27.8

Source: Company; Sharekhan estimates

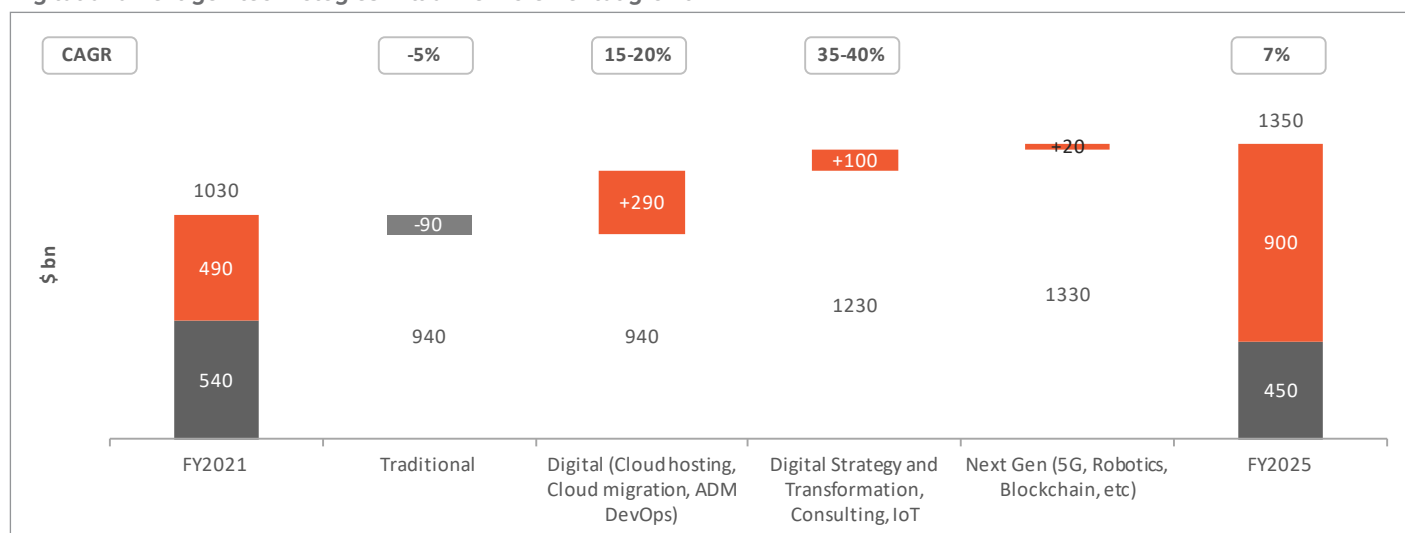
Digital is becoming mainstream; Digital technologies to be key growth engines going ahead

The outbreak of COVID-19 has accelerated the adoption of digital technologies among enterprises across the globe. Hence, most managements of Indian IT companies believe that the technology sector has entered into a multi-year growth cycle. We expect strong recovery in revenue growth for many Indian IT companies in the coming couple of years.

As per Gartner, worldwide IT spending is likely to report a 7% CAGR over FY2021-FY2025, led by a 16% CAGR in overall digital technology. Digital technologies (cloud hosting, cloud migration, ADM DevOps, consulting, IoT, etc.) would report a 15%-20% CAGR under incremental revenue over FY2021-FY2025, while next-generation technologies (5G, robotics, and blockchain) are expected to report a CAGR of 35%-45% over the same period.

IT services vendors are placed well considering the size of opportunities from long-term contracts to operate IT infrastructure on the cloud. Indian IT service providers generate revenue by helping enterprises migrate to the cloud roadmap, including services such as data management, processes and applications transformation, digital transformation, creating multi-cloud environment, and offering products and platforms.

Digital and next-gen technologies will drive incremental growth

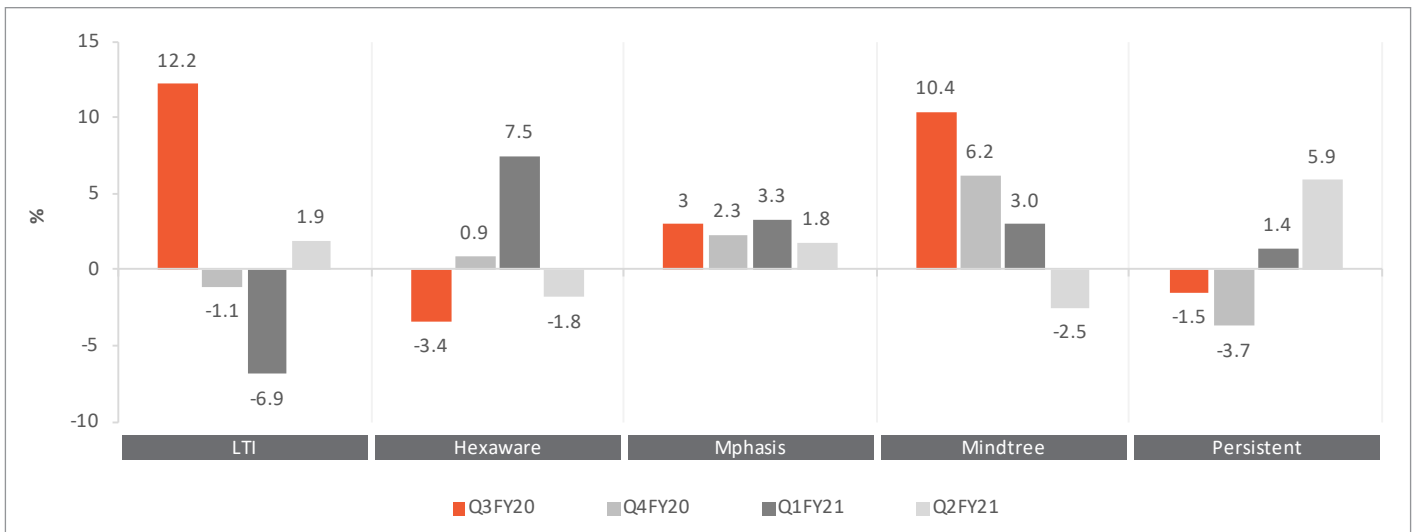


Source: Gartner; Sharekhan Research

Expect mid-tier companies to continue to report strong growth

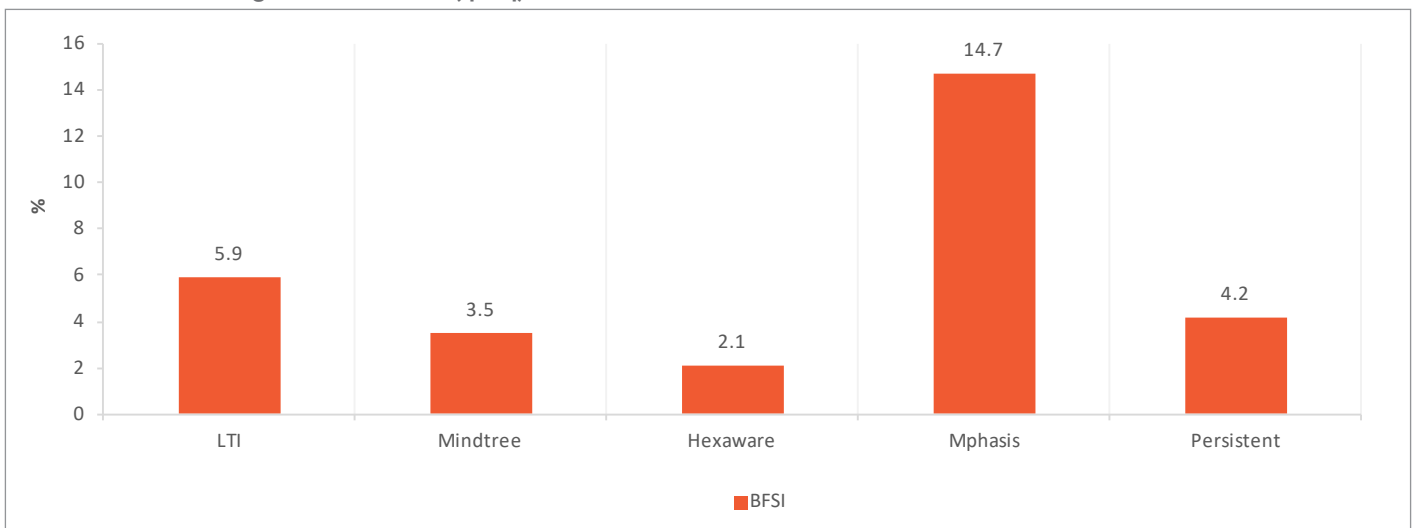
Contrary to traditional observations, high client concentration (particularly to financial services and/or hi-tech companies) helped mid-tier companies to protect their revenue from COVID-19-led disruptions. Although most of the mid-tier IT companies (excluding Persistent Systems) reported revenue decline (in USD terms) on a y-o-y basis in Q1FY2021 owing to outbreak of the pandemic, growth of many mid-tier IT services firms returned to positive trajectory in Q2FY2021. We expect mid-tier companies to continue to deliver strong growth despite weak seasonality, led by higher spends on digital technologies by enterprises, ramp-up of deals, and lower-than-expected furloughs. Further, tech spending of top US and European BFS firms has remained stable in the quarter ending in September 2020. New investments in new-age technologies and cost takeouts initiative would drive growth of Indian IT services companies.

Mid-tier: Top 5 clients revenue growth in Q2FY21 (q-o-q)



Source: Gartner; Sharekhan Research

Mid-tier: BFSI revenue growth in Q2FY21 (q-o-q)



Source: Company; Sharekhan Research

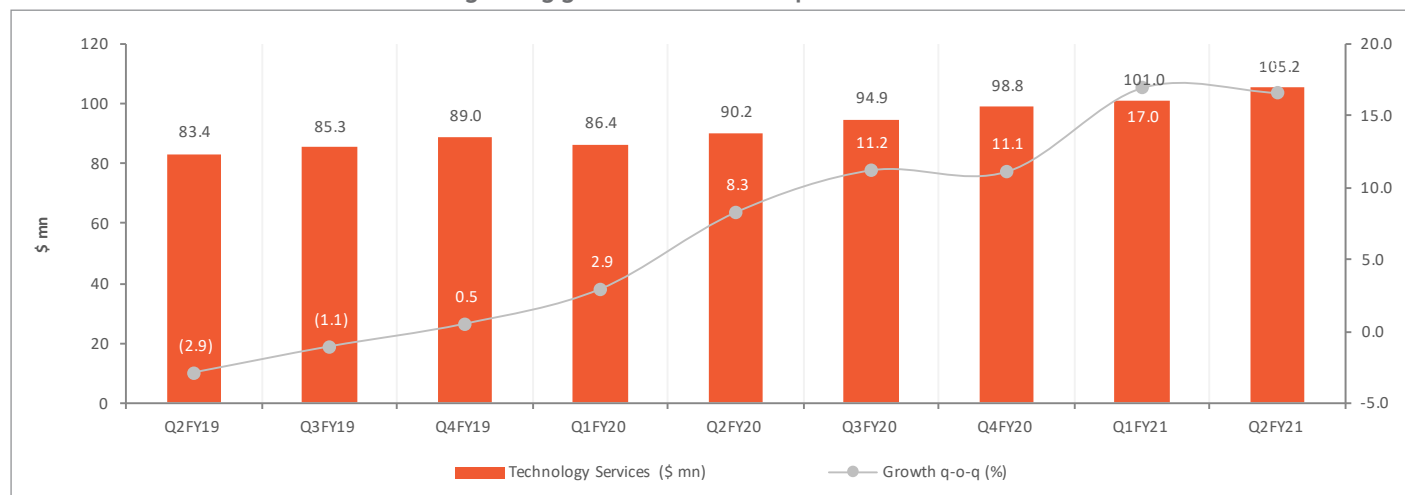
Expect strong revenue growth on a q-o-q basis in Q3FY2021

PSL has been delivering its strongest revenue performance among its mid-tier peers over the past two consecutive quarters due to its high concentration to less impacted verticals such as BFSI and healthcare. We believe PSL would continue to report strong growth in Q3FY2021 due to strong seasonality in its Alliance business. During Q2FY2021 conference call, management indicated that revenue of the Alliance business could remain strong in Q3FY2021 because of strong demand environment. Hence, we expect USD revenue to grow by 5% q-o-q to \$142.9 million in Q3FY2021, led by strong growth momentum in the technology services segment and anticipated strong revenue growth in Alliance business. There is an immediate revenue potential of \$2.5 million (1.7% of our estimated Q3FY2021 revenue) from the re-seller deal. As per management, revenue recognition from the above deal is uncertain in this quarter; however, if the same revenue is recognised during this quarter, it would outpace our current revenue growth estimate of 5% q-o-q.

Expect strong growth in FY2022E; Targets to achieve \$1 billion revenue over the next 4 years

We believe 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 the past five quarters. We believe the TSU segment would continue its growth momentum due to strong deal wins, a robust deal pipeline, new account opening, and higher adoption of new-age technologies. Further, EBIT margin has improved by ~310 bps to 12.1% in Q2FY2021 over the past five quarters, aided by higher offshoring, improving margins in Alliance business, and cost optimisation. PSL's management aspires to achieve \$1 billion revenue within four years (~19% CAGR including inorganic revenue) with an improving margin profile. However, we are currently assuming revenue CAGR of 13% over FY2020-FY2023E.

Tech services business has been delivering strong growth in the recent quarters

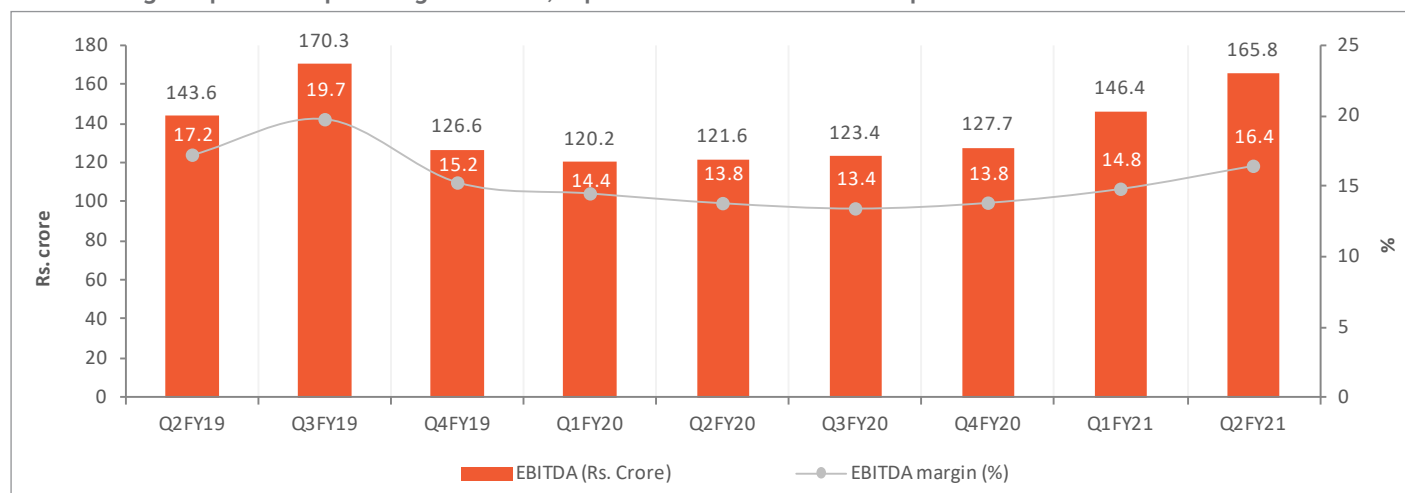


Source: Company, Sharekhan Research

Expect sustainable margin performance going ahead

Management indicated that margin can be sustained at Q2FY2021 level (12.1% EBIT margin) in Q3FY2021, despite investments in building digital capabilities, wage hike (two-month impact) and increased hiring. These margin headwinds would be offset by (1) higher Alliance 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) reversal of discount to clients. Further, the company would focus on optimising delivery headcount in the IP portfolio across various products, which would also aid the company's margins.

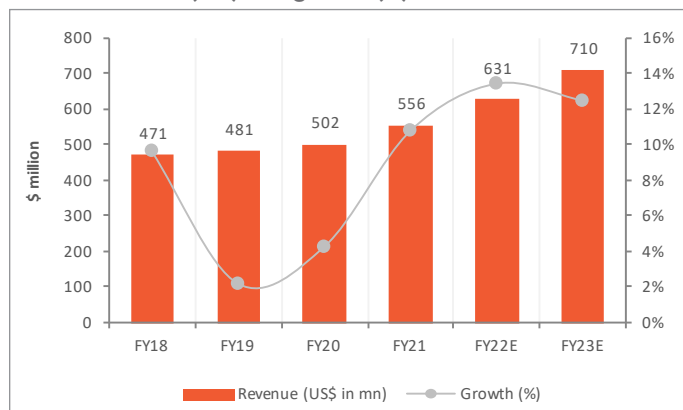
EBITDA margin improved sequentially in Q2FY21; expect to remain stable on a sequential basis



Source: Company, Sharekhan Research

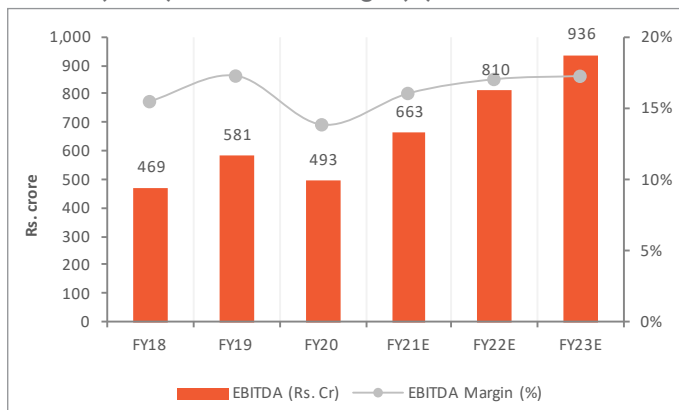
Financials in charts

Revenue in US\$ (mn) and growth (%)



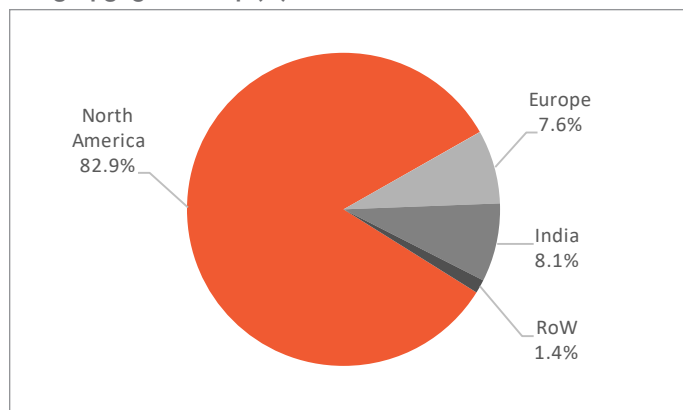
Source: Company, Sharekhan Research

EBITDA (Rs. cr) and EBITDA margin (%)



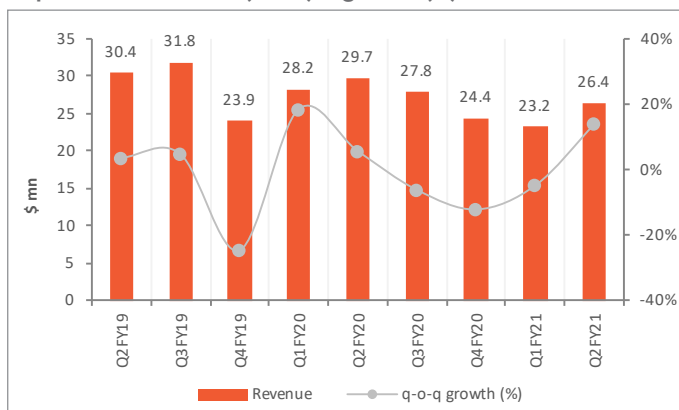
Source: Company, Sharekhan Research

Geography break-up (%)



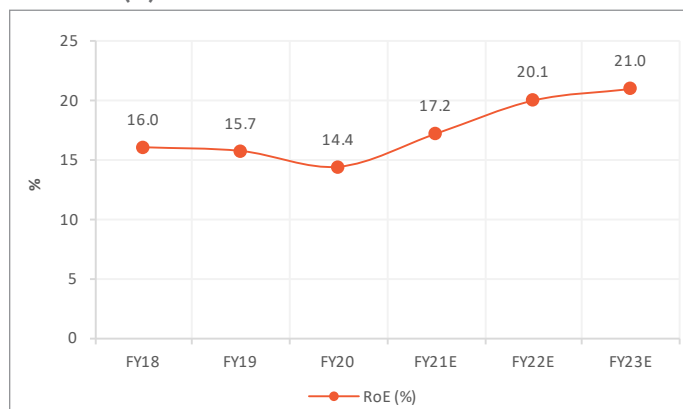
Source: Company, Sharekhan Research

Top account revenue (\$ mn) & growth (%)



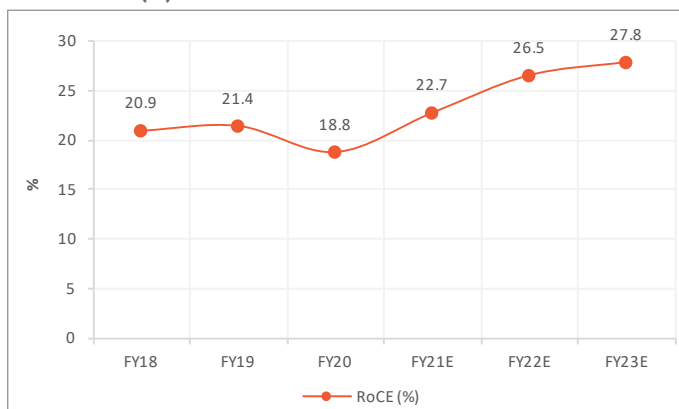
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



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-CY2024E as compared to average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Implications from the COVID-19 outbreak have accelerated digital activities among large global enterprises, leading to increased 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 the medium term. We believe it will be passed on to clients through pricing reduction in the 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 being an end-to-end service provider would help PSL to make most of the opportunity.

■ Valuation – Growth momentum to accelerate, maintain Buy

PSL's stock price has run up around 24% in the past one month due to anticipation of revenue estimate upgrade post the expected strong quarterly performance in Q3FY2021. We expect PSL would be one of the mid-tier IT companies to report industry-leading revenue growth in FY2021, given strong revenue growth in H1FY2021 and anticipated strong revenue growth in Q3 and Q4 of FY2021E. Even if the company does not recognise the revenue from re-seller deal (\$2.5 million) in Q3FY2021, this revenue would spill over to Q4FY2021, which would aid to its overall growth in FY2021. We model PSL's USD revenue/earnings to report a CAGR of 13%/22% over FY2021-FY2023E. At the CMP, the stock is trading at a valuation of 21x/18x its FY2022E/FY2023E earnings. Further, cash and cash equivalents (as of September 30, 2020) account for 15% of its current market capitalisation. Given strong revenue growth with a scope for margin improvement, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 1,720.

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	978	97	94,570	20.9	18.1	13.2	11.2	3.5	3.2	17.9	18.6
L&T Infotech	3,699	17	64,606	36.3	30.4	24.3	21.4	9.1	7.0	29.8	29.1
Persistent	1,499	6	8,762	26.5	20.7	16.7	13.0	4.4	4.0	17.2	20.1

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 the 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	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	7.57
2	PPFAS Asset Management	3.87
3	Kotak Mahindra Asset Management	3.76
4	L&T Mutual Fund Trustee Limited	3.60
5	Norges Bank Investment Management	3.55
6	PSPL ESOP management trust	3.22
7	Government Pension Fund (Global)	2.72
8	ICICI Prudential Asset Management	2.39
9	Vanguard Group Inc/The	1.69
10	FundRock Management Co SA	1.25

Source: Bloomberg

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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 deteriorating 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

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