Sharekhan
by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

| 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. 1,894** | |
| Price Target: **Rs. 2,200** | ↑ |

↑ Upgrade ↔ Maintain ↓ Downgrade

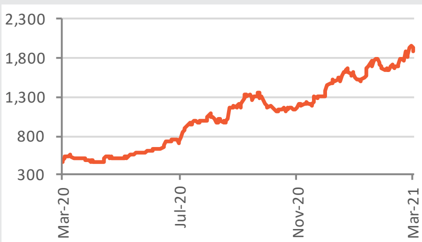
**Company details**

| | |
|---|---|
| Market cap: | Rs. 14,478 cr |
| 52-week high/low: | Rs. 1,990 / 420 |
| NSE volume: (No of shares) | 1.8 lakh |
| BSE code: | 533179 |
| NSE code: | PERSISTENT |
| Free float: (No of shares) | 5.2 cr |

**Shareholding (%)**

| | |
|---|---|
| Promoters | 31.3 |
| FII | 20.4 |
| DII | 30.1 |
| Others | 18.2 |

**Price chart**




**Price performance**

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 14.5 | 30.1 | 60.5 | 301.9 |
| Relative to Sensex | 15.0 | 23.6 | 29.3 | 211.4 |

*Sharekhan Research, Bloomberg*

# Persistent Systems Limited

## Staying ahead of the pack

IT & ITES | Sharekhan code: PERSISTENT | Company Update

Stock Update


## Summary

- We retain our Buy rating on Persistent Systems Limited (PSL) with a revised PT of Rs. 2,200, given strong revenue growth potential and scope of margin improvement.
- Though revenue from IP-led business would decline on a sequential basis in Q4FY2021, we believe PSL would report growth in Q4 because of strong revival in the BFSI vertical and continued growth in the technology vertical.
- Management remains optimistic about Alliance business returning to its growth trajectory from Q1FY2022. This coupled with continued strong growth in TSU segment would help it to deliver industry-leading growth in FY2022.
- Strong balance sheet and potential strong earnings growth (23% CAGR over FY2021-23E) provide comfort on the stock despite the recent run up. Cash accounts for 13% of its current market capitalisation.


**We interacted with Persistent Systems Limited's (PSL) management to understand the growth prospects in both Technology Services Unit (TSU) and Alliance business, deal momentum, Cloudification opportunity, and margin outlook. Mid-tier IT companies have been outperforming large-cap companies over the past three quarters. Among mid-tier Indian IT services companies, PSL remained the only Indian IT company to report sequential growth in Q1FY2021 and Q2FY2021 and reported strongest growth among leading Indian IT companies in Q3FY2021, aided by reinvigorated sales, negligible exposure to troubled verticals, and focus on high-growth verticals. Though revenue from IP-led business would decline on a sequential basis in Q4FY2021, we believe PSL would continue to report q-o-q growth in Q4FY2021 because of strong revival in the BFSI vertical (absence of cost control by its large customers owing to furloughs) and continued growth in the healthcare and technology verticals. PSL reported its order book of $302 million (book to bill of ~2x) for the first time in Q3FY2021, of which $175 million is net new. We believe the TSU segment would continue its growth momentum in the coming quarters, led by robust deal wins, healthy deal pipeline, new logo wins, and strong demand environment. Further, growth was supported by sharpening focus on the signing of the large long-term/annuity deal over the past few quarters. Management remains optimistic that Alliance business would return to its growth trajectory from Q1FY2022, led by benefits from the Red Hat area, expansion of relationship with IBM, contribution of revenue from large deals won earlier, and cross-selling opportunities. Hence, management is confident that its revenue growth would remain in the top quartile of industry growth in FY2022E. Notably, net hiring stood at 1,618 employees during Q3FY2021, of which 70% are lateral hires. This indicates the company plans to deploy them immediately in certain large projects that it has won recently and avoid the risk of talent supply shortage in digital transformation projects. Management aspires to achieve $1 billion revenue over the next 3-4 years with an improving margin profile. Management expects growth would be driven by expansion in European region, improving opportunities around digital transformation programme, and cross collaboration between TSU and Alliance business.**

## Our Call

**Valuation: Growth to accelerate:** PSL's EBIT margin has been improving (up 340 bps over the past three quarters), aided by revenue growth, higher offshoring, higher digital revenue mix, and cost-efficiency measures. Further, management aspires to maintain its current margin levels despite returning of some of the costs post normalcy, led by higher offshoring or near-shoring revenue, reduced travel expenses even after normalcy, lower amortisation expense, absence of COVID-19 related expenses/provisions, and cost efficiency measures. We believe PSL is well positioned to capture growth opportunities in the industry, given its strong capabilities in the product engineering space, strong relationship with large enterprises, and focus on large long-term engagements. We expect PSL to be one of the mid-tier IT companies to report industry-leading revenue growth in FY2022, given strong growth potential in the TSU business and anticipated growth revival in Alliance business. We model PSL's USD revenue/earnings to report a CAGR of 15%/23% over FY2021-FY2023E. At the CMP, the stock is trading at a valuation of 26x/22x its FY2022E/FY2023E earnings. Further, cash and cash equivalents account for 13% 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. 2,200.

## Key Risks

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

**Valuation** Rs cr

| Particulars | FY19 | FY20 | FY21E | FY22E | FY23E |
|---|---|---|---|---|---|
| Revenue | 3,365.9 | 3,565.8 | 4,181.7 | 4,844.7 | 5,491.9 |
| OPM (%) | 17.2 | 13.8 | 16.3 | 17.0 | 17.2 |
| Adjusted PAT | 351.7 | 340.3 | 435.0 | 558.1 | 655.6 |
| *% YoY growth* | *8.8* | *-3.2* | *27.8* | *28.3* | *17.5* |
| Adjusted EPS (Rs.) | 44.0 | 44.4 | 56.9 | 73.0 | 85.8 |
| P/E (x) | 43.1 | 42.7 | 33.3 | 25.9 | 22.1 |
| P/B (x) | 6.4 | 6.1 | 5.5 | 5.0 | 4.5 |
| EV/EBITDA (x) | 25.2 | 29.3 | 20.9 | 16.6 | 14.1 |
| RoNW (%) | 15.7 | 14.4 | 17.3 | 20.2 | 21.4 |
| RoCE (%) | 21.4 | 18.8 | 23.0 | 26.6 | 28.4 |

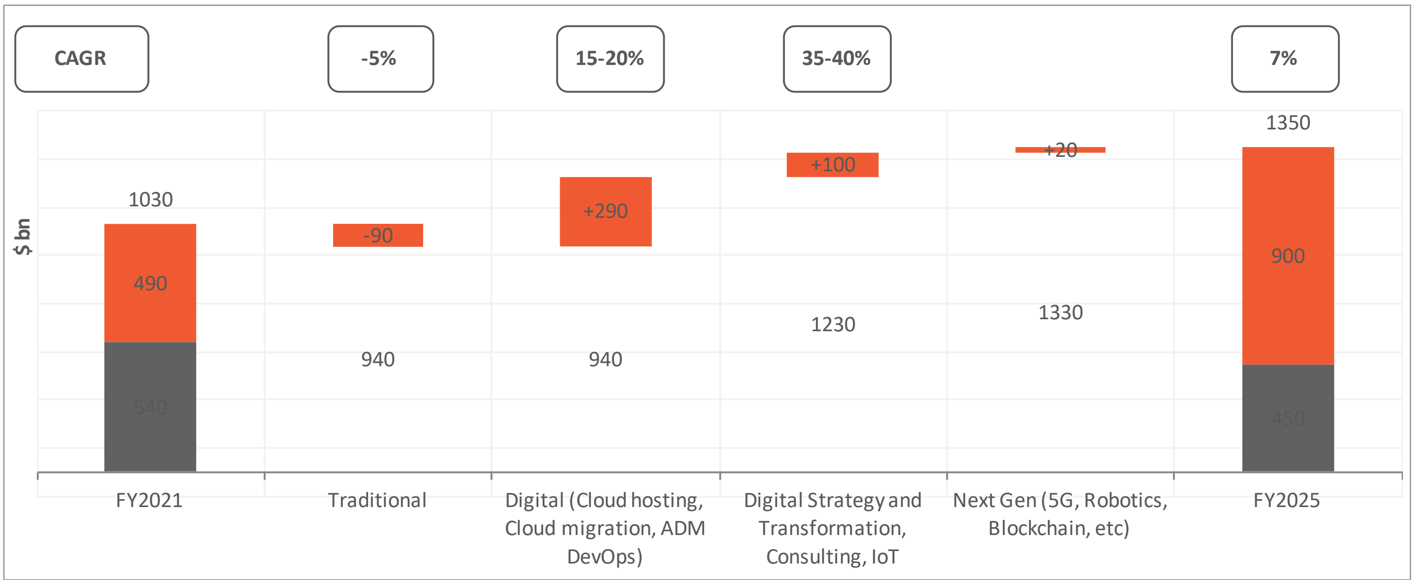
*Source: Company; Sharekhan estimates*

### Strong demand for product engineering services likely to drive growth

The pandemic 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 think this is the first phase of a multi-year technology transformation phase, where enterprises are focusing on building a digital foundation by investing Cloud-based technologies. Subsequently, customers would start investing on new-age technologies such as artificial intelligence (AI), augmented reality, robotics, data analytics, and Internet of Things (IOT). During the last phase, it is expected that companies would invest on creating a new business model and leverage technologies to stay relevant to their customers.

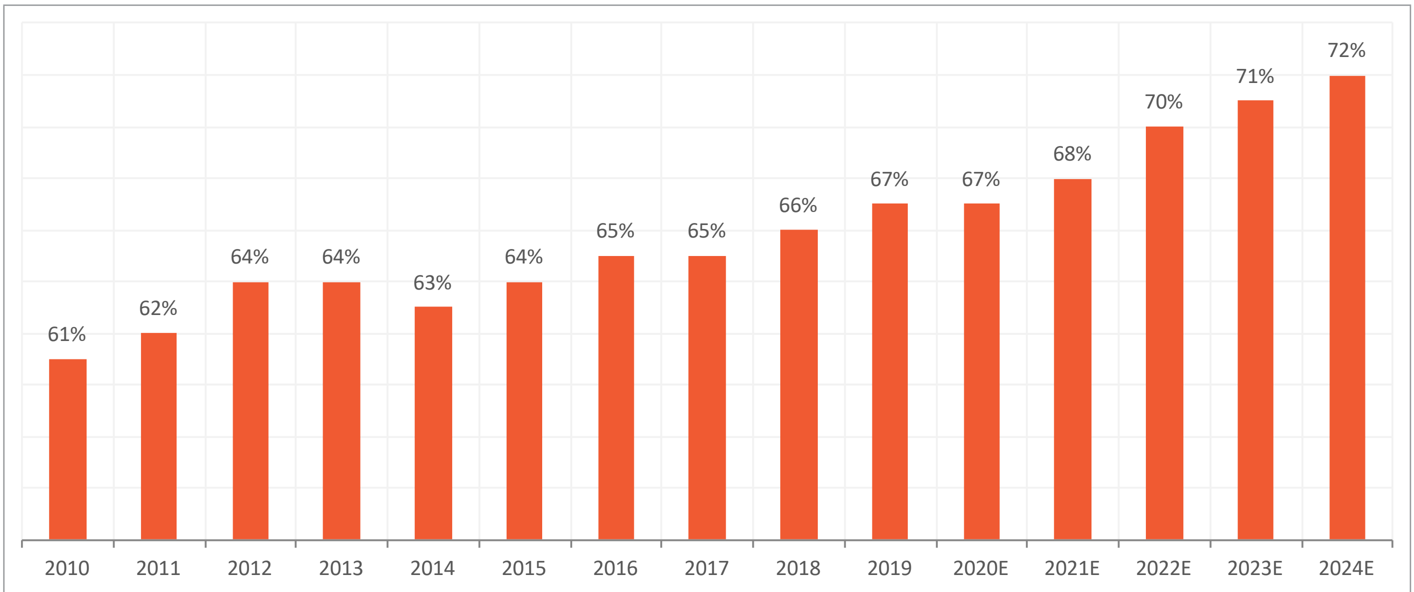
As per Gartner, worldwide IT spending is likely to report a 7% CAGR over FY2021-FY2025, led by a 16% CAGR in overall digital technology. Digital technologies (cloud hosting, cloud migration, ADM DevOps, consulting, IoT, etc.) would report a 15%-20% CAGR under incremental revenue over FY2021-FY2025, while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

**Digital and next-gen technologies will drive incremental growth**




*Source: Gartner; Sharekhan Research*

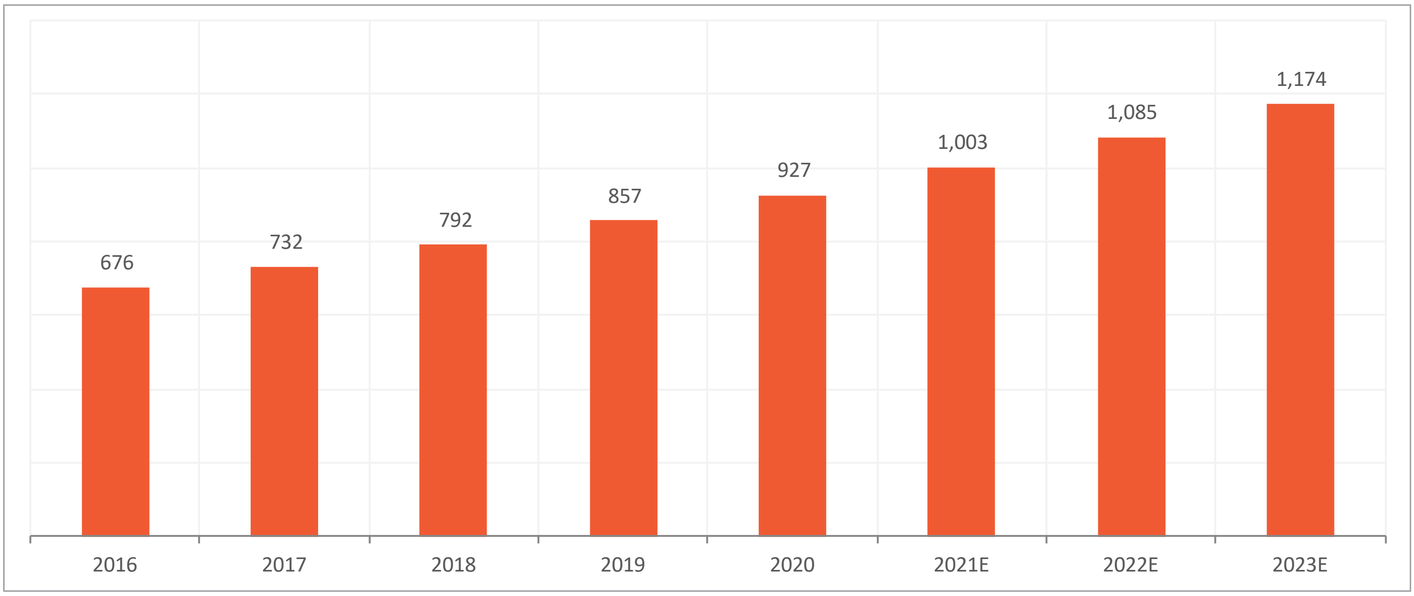
**IT outsourcing penetration would improve**




*Source: Gartner; Sharekhan Research*

The product engineering services market is expected to post an 8.2% CAGR, reaching $1,174 billion by 2023. Growth in engineering services would be driven by higher connected devices and convergence of technologies, rising use of electronic components, enhancing customer experience, and development of new products and services. Product engineering services are expected to see meaningful transformation, aided by rapidly expanding digital technologies. Global IoT cloud platform market size is expected to report a 16.5% CAGR over 2020-2025, reaching $1,009.8 billion by 2025.

**Product engineering market to grow at a CAGR of 8.2% over 2020-2025**

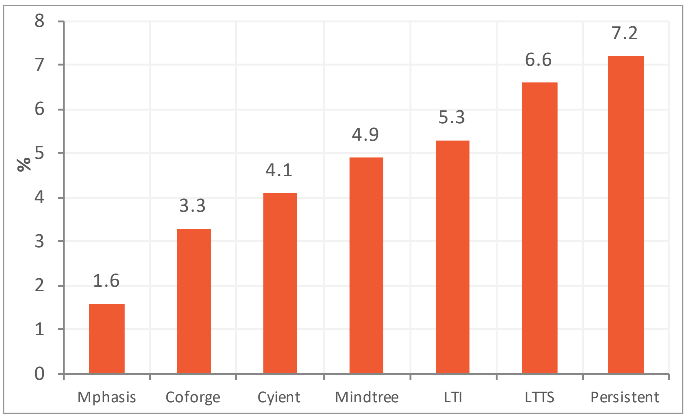



*Source: Sharekhan Research*

## Strong growth in mid-cap IT companies to continue

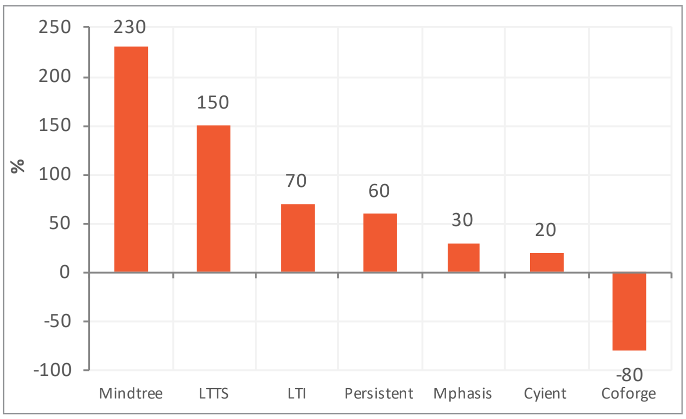
Mid-tier IT companies have been outperforming large-cap companies for the past three consecutive quarters. We expect this trend to continue in Q4FY2021. Managements of most mid-cap companies have indicated double-digit growth in FY2022, aided by higher spending relating to Cloud-related technologies, faster-than-expected conversion of deal pipeline, and ramp-up of deals won earlier. Large retailers in the US and Europe are expected to strengthen their omni-channel capabilities to enhance their customer experience post COVID-19 and would invest to leverage data better through analytics and AI. Net new deal TCVs continue to remain strong for most Indian mid-cap companies in Q3FY2021, while PSL disclosed its order book for the first time at $302 million (book to bill of ~2x). As large enterprises have allocated budgets towards digital transformation, we believe quality Indian IT companies would deliver strong double-digit growth in the next 3-5 years. EBIT margin of Indian mid-tier companies' profitability would be sustainable in the medium term because of higher offshoring, WFH efficiencies, strong revenue growth, and increasing digital mix.

**Mid-tier reported strong revenue growth (q-o-q) in Q3**




*Source: Company, Sharekhan Research*

**Mid-tier: healthy margin expansion**

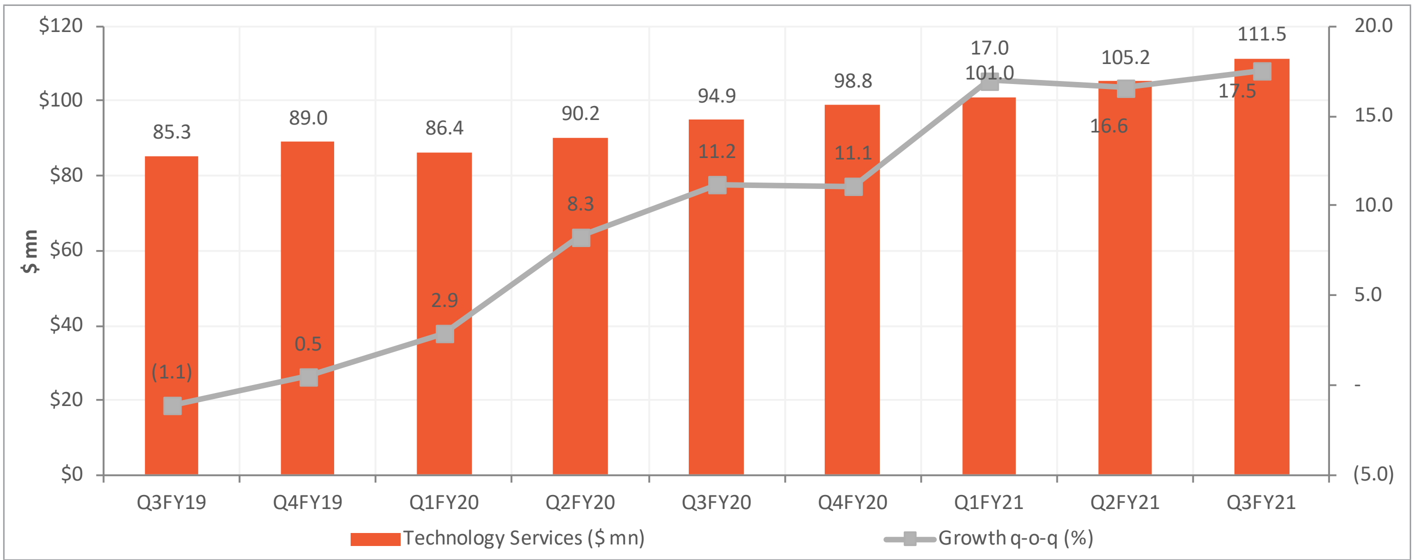



*Source: Company, Sharekhan Research*

**Expect growth momentum to continue in Q4; Deal wins likely to remain strong**

PSL has been delivering its strongest revenue performance among its mid-tier peers over the past three consecutive quarters, aided by reinvigorated sales, negligible exposure to troubled verticals, and focus on high-growth verticals. PSL reported strong revenue growth in Q3FY2021 because of strong growth in IP-led business (seasonally strong quarter and uptick in re-seller revenue) and continued growth in the Technology Services Unit (TSU) segment. Though revenue from IP-led business would decline on a sequential basis in Q4FY2021, we believe PSL would continue to report growth in Q4FY2021 because of strong revival in the BFSI vertical (absence of cost control by its large customers owing to furloughs) and continued growth in technology companies and emerging verticals. The BFSI vertical has witnessed a CQGR of 4.5% over the past seven quarters, while healthcare and life sciences and technology companies and emerging verticals have posted at CQGR of 3.6% and 2.7%, respectively. With emergence of a new business model and higher adoption of digital channels, the company is engaged with global hi-tech companies in advanced technology areas, including DevOps, agile, and other digital technologies for better product development. Further, growth would be aided by incremental revenue of around $2 million from the acquisition of Capiot. PSL reported its order book of $302 million (book to bill of ~2x) for the first time in Q3FY2021, of which $175 million is net new. We believe strong deal win momentum would continue in Q4FY2021 given its healthy deal pipeline in the Cloud and digital transformation space. Hence, we expect USD revenue to grow by 2.4% q-o-q to $149.6 million in Q4FY2021, led by continued growth momentum in the technology services segment.

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




*Source: Sharekhan Research*

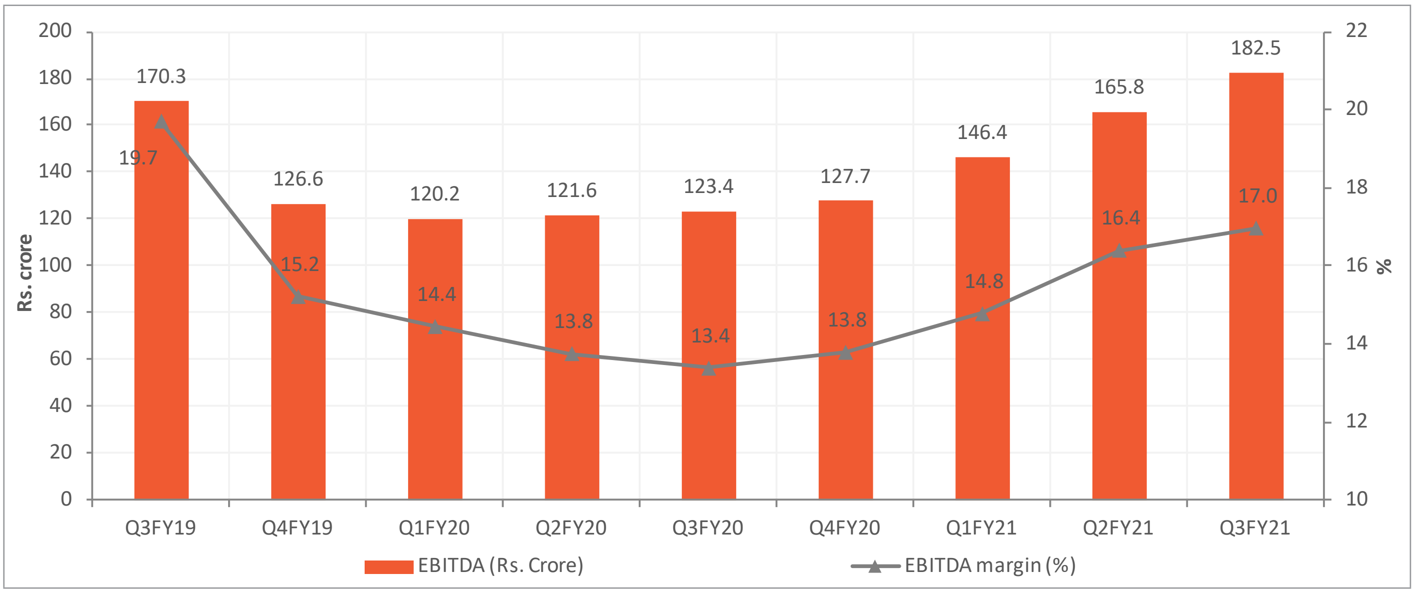
**Expect to remain at the top quartile of industry-revenue growth; Aims $1 bn revenue over the next four years**

Mr. Sandeep Kalra, CEO, PSL, has been focusing on replicating the TSU segment's success story in the Alliance business. Under his leadership, the TSU segment (76.3% of the total revenue) has been consistently posting a CQGR of 4.4% over the past six quarters. We believe the TSU segment would continue its growth momentum due to robust deal wins, healthy deal pipeline, new logo wins, and strong demand environment. Further, growth was supported by sharpening focus on signing of the large long-term/annuity deal under his leadership. Though Alliance business would decline in Q4FY2021, management remains optimistic that Alliance business would return to its growth trajectory from Q1FY2022, led by benefits from the Red Hat area, expansion of relationship with IBM, contribution of revenue from large deals won earlier, and cross-selling opportunities. Further, PSL is engaged with IBM in its strategy for cloud packs around data, integration, and multi-cloud management. Hence, management remains confident that its revenue growth would remain in the top quartile of industry-growth over the next 12 months. Notably, net hiring stood at 1,618 employees during Q3FY2021, of which 70% are lateral hires. This indicates the company plans to deploy them immediately for the execution of certain large projects, and avoid risk of talent supply shortage in digital transformation projects. Management stated that hiring would continue in the coming quarters, considering robust growth opportunities in the coming years. PSL's management aspires to achieve $1 billion revenue within four years with an improving margin profile. Management expects growth would be driven by expansion in European region, opportunities around digital transformation programme, and cross collaboration between TSU and Alliance business. Management also aims to achieve 17% EBITDA margin levels despite return of some expenses post normalisation.

**Expect sustainable margin performance going ahead**

Management indicated that margin can be sustained at Q3FY2021 level (12.7% EBIT margin) in Q4FY2021, despite increased hiring and rupee headwinds. These margin headwinds would be offset by (1) higher offshoring or near-shoring strategies, (2) lower travel expenses, (3) lower amortisation in IBM business, and (4) cost-efficiency measures. Further, the company would focus on optimising delivery headcount in the IP portfolio across various products, which would also aid the company's margins.

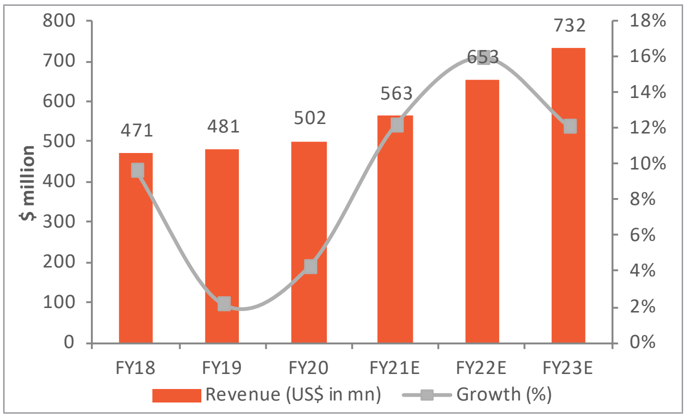
**EBITDA margin improved sequentially in Q3FY2021**




*Source: Sharekhan Research*

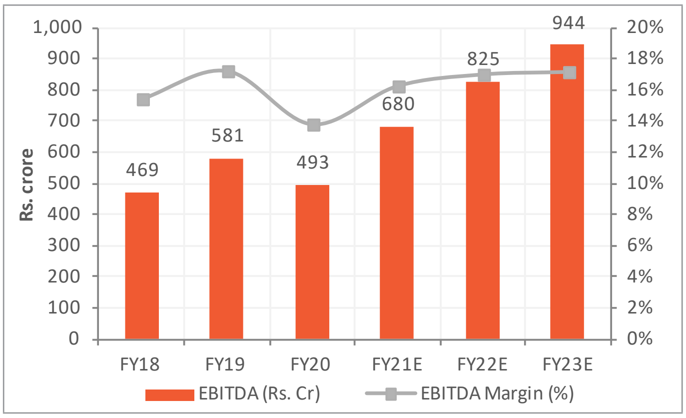
## Financials in charts

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



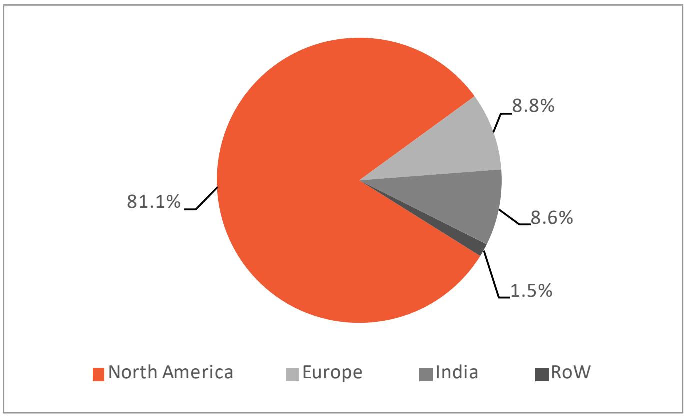

*Source: Company, Sharekhan Research*

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



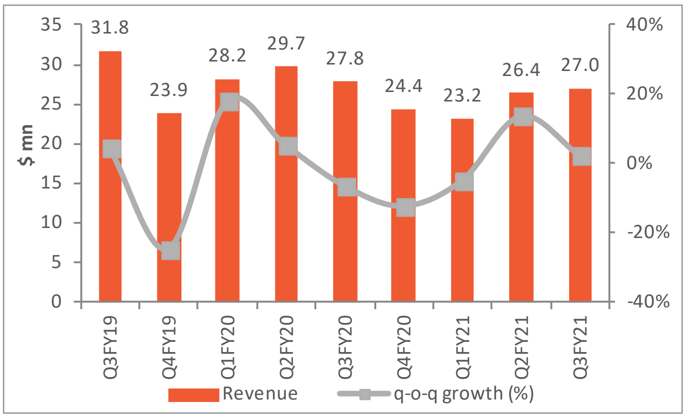

*Source: Company, Sharekhan Research*

**Geography break-up (%)**



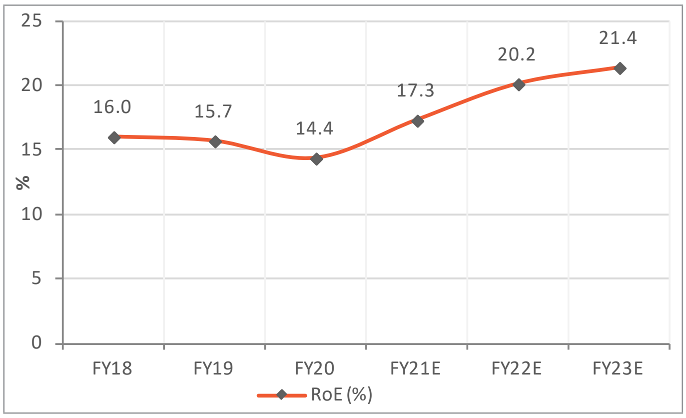

*Source: Company, Sharekhan Research*

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



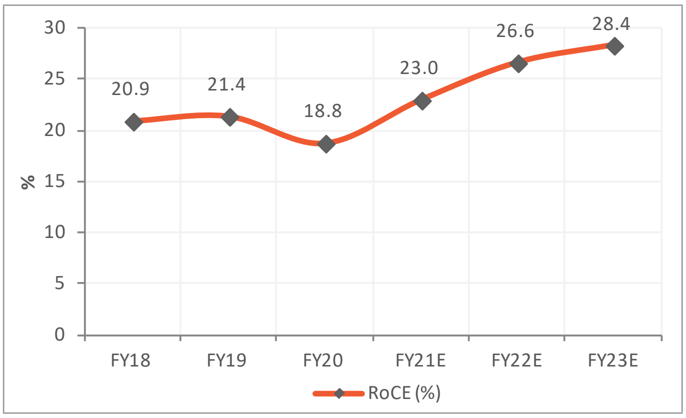

*Source: Company, Sharekhan Research*

**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 price reduction in the long term.

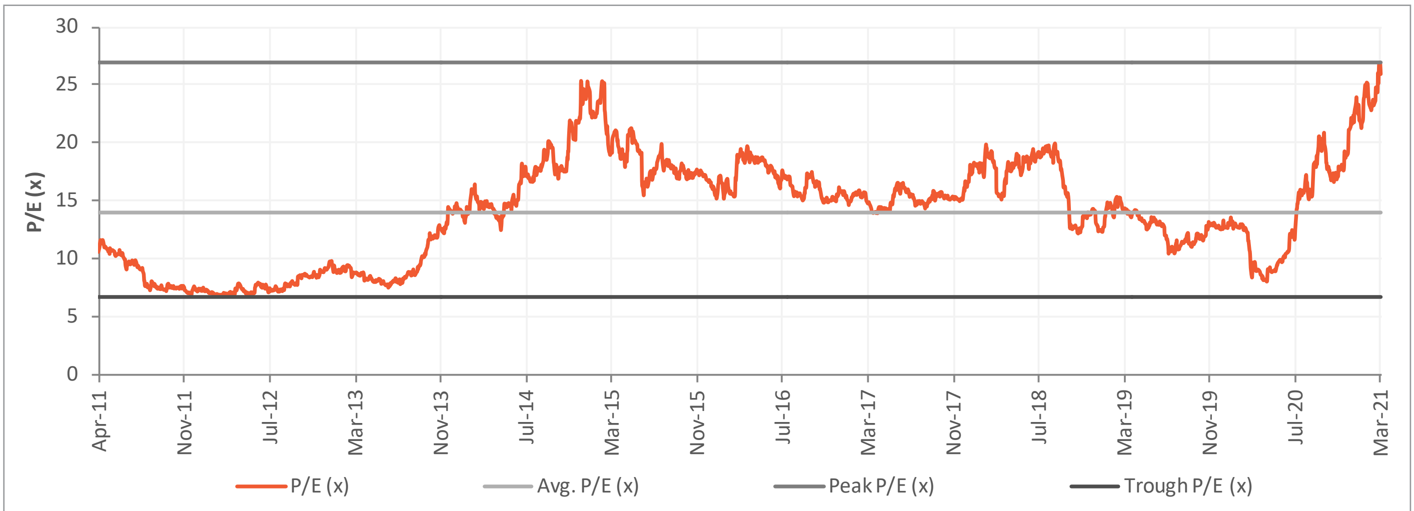
### ■ Company outlook - Well positioned to capture opportunities

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 its 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 EBIT margin has been improving (up 340bps over the past three quarters) aided by revenue growth, higher offshoring, higher digital revenue mix, and cost-efficiency measures. Further, management aspires to maintain current margin levels despite returning of some of the costs post normalcy, led by higher offshoring or near-shoring revenue, reduced travel expenses even after normalcy, lower amortisation expense, absence of COVID-19 related expenses/provisions, and cost-efficiency measures. We believe PSL is well positioned to capture the growth opportunity in the industry, given its strong capabilities in the product engineering space, strong relationship with large enterprises, and focus on large long-term engagements. We expect PSL would be one of the mid-tier IT companies to report industry-leading revenue growth in FY2022, given strong growth potential in the TSU business and anticipated growth revival in Alliance business. We model PSL's USD revenue/earnings to report a CAGR of 15%/23% over FY2021-FY2023E. At the CMP, the stock is trading at a valuation of 26x/22x its FY2022E/FY2023E earnings. Further, cash and cash equivalents account for 13% 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 PT of Rs. 2,200.

**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 | 995 | 97 | 96,313 | 19.2 | 16.7 | 12.8 | 10.8 | 3.5 | 3.1 | 19.7 | 20.2 |
| L&T Infotech | 3,971 | 17 | 69,380 | 37.5 | 31.7 | 25.3 | 22.2 | 9.6 | 7.4 | 30.9 | 29.7 |
| Persistent | 1,894 | 8 | 14,478 | 33.3 | 25.9 | 20.9 | 16.6 | 5.5 | 5.0 | 17.3 | 20.2 |

*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 the 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 | 7.67 |
| 2 | L&T Mutual Fund Trustee Limited | 4.26 |
| 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 | UPADHYE NARASINHA | 2.82 |
| 8 | Saif India V FII Holding Limited | 2.68 |
| 9 | ICICI Prudential Asset Management | 2.52 |
| 10 | FMR LLC | 1.81 |

*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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