Persistent Systems Ltd

Paving new growth paths

IT & ITES	Sharekhan code: PERSISTENT	Company Update

Summary

- We forecast PSL's USD revenue to grow by 8% q-o-q to $180 million in Q2FY2022, led by broad-based demand and a recovery in IP-led revenues. We expect deal TCVs to stay healthy in Q2.
- We expect USD revenue/earnings to clock a CAGR of 20%/30% over FY2021-FY2024E, led by broad-based demand, robust deal TCVs, healthy deal pipeline, and new logo additions.
- EBITDA margin is expected to decline by 50 bps q-o-q to 15.9% in Q2 despite wage revision, aided by strong revenue growth, improving utilisation and higher IP revenue. Attrition is also likely to inch up.
- We retain a Buy on Persistent Systems Limited (PSL) with an unchanged PT of Rs. 4,160, given strong earnings growth potential, healthy cash generation and M&A opportunities.

Persistent Systems Limited (PSL) is well-poised to capture immense growth opportunities from accelerated spends in cloud and digital transformation areas. We expect PSL would continue to deliver industry-leading revenue growth among its mid-cap peers in Q2FY2022 led by anticipated broad-based growth across verticals (especially in healthcare vertical), strong deal wins, robust deal pipelines, traction from partnerships, new logo additions, strong execution and strong presence in digital engineering space. The deal win momentum is likely to remain strong.

- **Expect strong growth momentum to continue in Q2:** Since Q1FY2021, PSL has been delivering a revenue growth of 6.2% CQGR, led by a strong 7.6% CQGR growth in services revenues (86.9% of its total revenues). Further, the company's growth was supported by strong executions, strong competencies in digital engineering space, and an effective sales incentive programme. We forecast the company's USD revenue to grow by 8 % q-o-q to $180 million in Q2FY2022, led by broad-based demand, growth recovery in IP-led revenues, and traction from partnerships.
- **Expect to stay at top quartile of industry-revenue growth:** PSL started the fiscal year with industry-leading organic growth of 9.2% q-o-q (up 27.3% y-o-y) and is well-poised to deliver another strong quarter in terms of revenue growth in Q2FY2022. Strong net headcount additions make the company well-placed to fulfil demand. Further, we expect order bookings to remain healthy in coming quarters given strong conversion of its deal pipeline. Given broad-based demand, healthy order inflow, robust deal pipeline and strong execution, we believe PSL's revenue growth would remain strong over the next few years.
- **Strong growth likely to restrict the impact of wage revisions in Q2:** The management indicated that the roll-out of wage revision (effective from July 1, 2021) is expected to affect margins by around 250-275 bps q-o-q in Q2FY2022. We believe the net impact on EBITDA margins to be restricted to ~50 bps q-o-q, aided by strong revenue growth, improving utilisation, lower visa costs and higher IP-led revenues. Attrition rate would inch up in Q2FY2022.

Our Call

Valuation – On a strong growth track: PSL's management remains confident of delivering sustainable revenue growth going ahead on the back of strong demand across verticals, demand for company's product offerings and strong digital engineering capabilities. We believe that any positive surprise in Q2FY2022 would result in an earnings upgrade. At CMP, the stock is trading at a valuation of 31x/27x its FY2023E/FY2024E earnings, justified given its strong earnings growth potential, healthy cash conversion, and M&A opportunity for strengthening its capabilities. We expect USD revenue/earnings to report a CAGR of 20%/30% over FY2021-FY2024E. Hence, we retain a Buy on the stock with an unchanged price target (PT) of Rs. 4,160.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	4,187.9	5,402.6	6,428.2	7,436.8
OPM (%)	16.3	16.6	18.5	18.7
Adjusted PAT	450.7	649.2	879.3	993.0
% YoY growth	*32.4*	*44.1*	*35.4*	*12.9*
Adjusted EPS (Rs.)	59.0	84.9	115.1	129.9
P/E (x)	59.6	41.4	30.5	27.0
P/B (x)	9.6	8.4	7.2	6.2
EV/EBITDA (x)	39.9	29.7	21.9	18.2
RoNW (%)	17.4	21.7	25.4	24.6
RoCE (%)	22.7	28.1	33.1	32.2

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. 3,515**	
Price Target: **Rs. 4,160**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

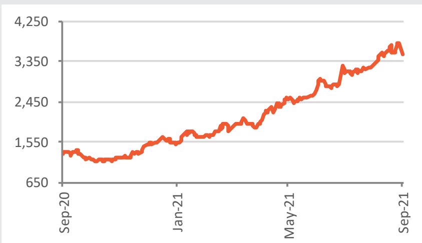
Company details

Market cap:	Rs. 26,860 cr
52-week high/low:	Rs. 3,838 / 1,075
NSE volume: (No of shares)	2.3 lakh
BSE code:	533179
NSE code:	PERSISTENT
Free float: (No of shares)	5.3 cr

Shareholding (%)

Promoters	31.3
FII	21.0
DII	29.8
Others	18.0

Price chart



Price performance

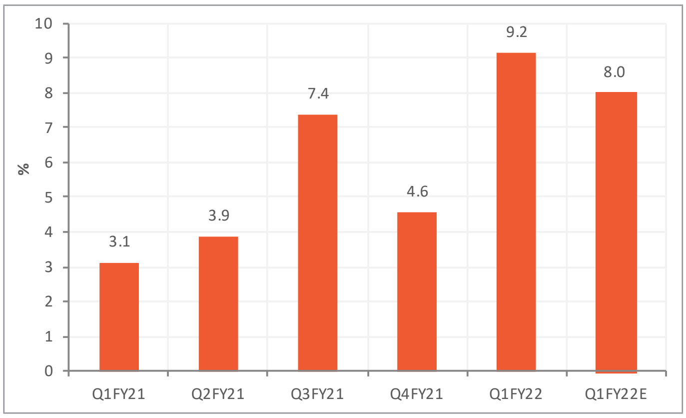
(%)	1m	3m	6m	12m
Absolute	6.1	24.9	83.1	175.5
Relative to Sensex	1.2	11.4	64.1	118.4

Sharekhan Research, Bloomberg

Expect strong growth momentum to continue in Q2; Deal wins likely to stay strong

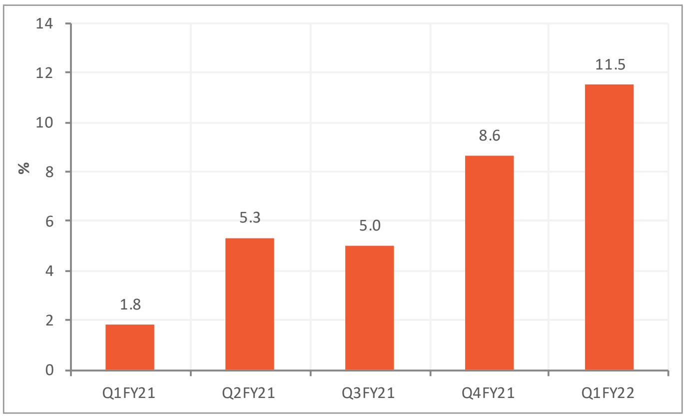
PSL is well placed to deliver strong revenue growth over the next 2-3 years on the back of broad-based demand across its verticals and service lines, strong deal wins and a healthy deal pipeline. We note that PSL has a strong positioning in digital product engineering space, with an estimated revenue contribution of around 60%. Since Q1FY2021, the company has been reporting industry-leading revenue growth performance among its mid-tier peers, registering a CQGR of 6.2%. This growth has been driven by 7.6% CQGR growth in its services revenues (86.9% of its total revenues). PSL reported strong revenue growth in Q1FY2022 despite a high base, led by strong 11.5% q-o-q growth in services revenue. We expect PSL would continue to report strong revenue growth in Q2FY2022 because of expected broad-based growth across verticals (especially in healthcare and lifescience vertical), strong deal wins ($793 million TCVs over last three quarters), robust deal pipeline, traction from the partnership ecosystem and new logo additions. In Q1FY2022, it added 13 clients y-o-y (10 q-o-q) under the $1 million+ bucket, while in the $5 million+ bucket the count increased by six clients y-o-y (four q-o-q). Further, PSL reported a total TCVs of $245 million (book-to-bill of ~1.5x) in Q1FY2022, of which $189 million is total ACVs. We believe total deal TCVs would improve in Q2FY2022 given a strong deal pipeline in the transformation area. The net headcount addition has been strong for last three quarters and we expect net headcount additions could moderate in Q2FY2022. Hence, we forecast the company's USD revenue to grow by 8.2% q-o-q to $180.5 million in Q2FY2022.

Expect strong growth momentum to continue



Source: Company, Sharekhan Research; # Organic

Services revenue growth remained strong



Source: Company, Sharekhan Research

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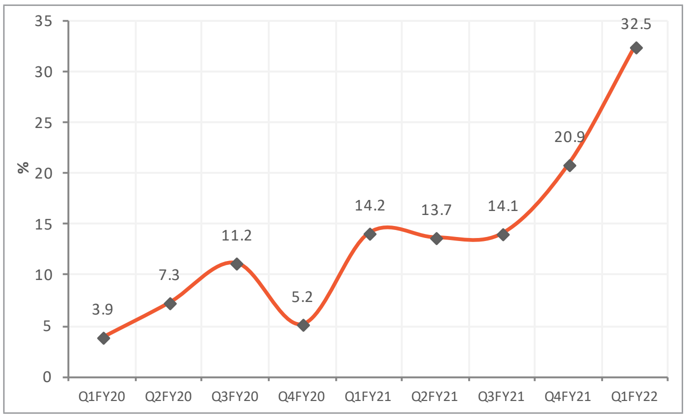
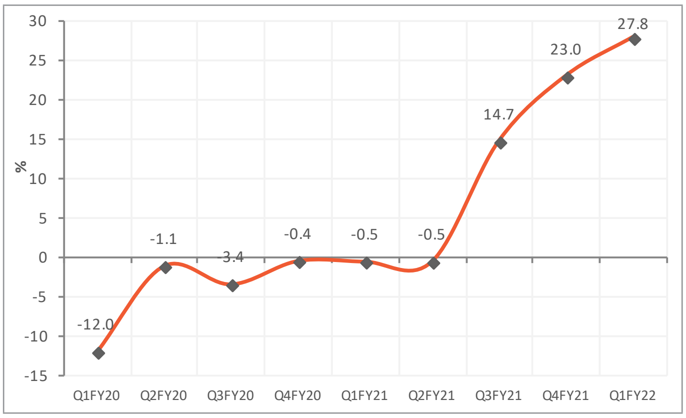
Software & hi-tech revenue growth trend (y-o-y)



Source: Company, Sharekhan Research

Healthcare & life sciences revenue growth trend (y-o-y)



Source: Company, Sharekhan Research

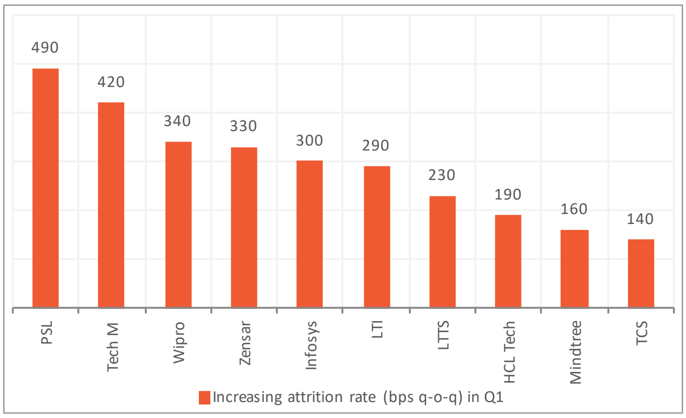
Expect to stay at top quartile of industry-revenue growth; scouting for M&A to enhance capabilities

PSL delivered strongest revenue growth of 12.9% y-o-y among mid-tier peers in a year hit by a pandemic. Further, the company started the fiscal with industry-leading organic growth of 9.2% q-o-q (up 27.3% y-o-y) and is well-poised to deliver another strong quarter in terms of revenue growth in Q2FY2022. Further, management believes that demand environment would remain strong in the next 2-4 years as enterprises commit spending on cloud and digital transformation initiatives. PSL reported healthy deal TCVs ($0.8 billion, implying 1.7x book-to-bill) over last three quarters. Strong net headcount additions (over 4,000 employees in the last three quarters, translating 38% of Q2FY2021 headcount) positions the company well to fulfil demand. PSL also aims to increase its share of revenues from Europe to 15% over next 3-5 years from 9.5% currently, including inorganic route. Further, the company is actively scouting for M&A opportunities to increase its capability in the healthcare/BFSI verticals or expand its presence in Europe. Given broad-based demand, healthy order inflow, robust deal pipeline and strong execution, we assume PSL would yet again report market-leading revenue growth of 28% y-o-y in FY2022E and 17%/14% y-o-y growth in FY2023E/FY2024E.

Strong growth likely to partially mitigate wage hike concerns in Q2

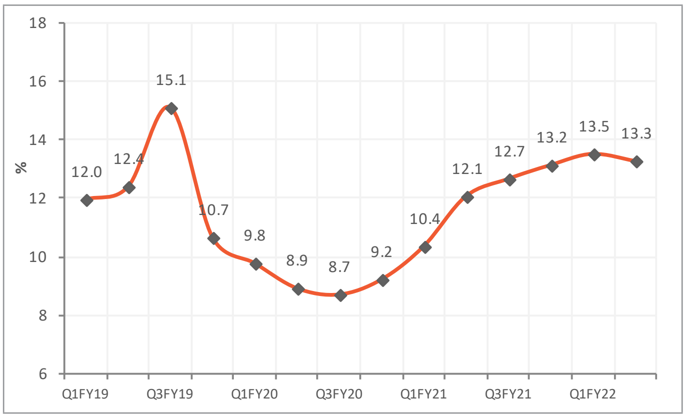
We expect PSL to clock strong revenue growth in Q2FY2022 and it should largely offset any concerns on wage hike given by the company effective July 1, 2021. The roll out of wage revision is expected to impact margin by around 250-275 bps q-o-q. However, margin levers such as strong revenue growth, improving utilisation, lower visa costs, higher IP-led revenue and flattening pyramid would mitigate the impact of a wage hike to a large extent. Hence, we believe that net impact on margins to be restricted to ~50 bps q-o-q. However, we believe that the attrition rate would increase further in Q2FY2022 given its higher presence in cutting-edge technology compared to its peers and a shortage of digital talent across industries. We note that the company works with some of its potential customers where it sees flexibility in increasing pricing, given supply-side challenges in niche areas. Further, management works with its customers to bring Cost of Living Adjustments to the right levels during renewals. The subcontracting cost is also expected to remain elevated in Q2FY2022 owing to a strong demand environment, increasing attrition and supply-side challenges. However, we expect EBIT margin would decline by 20 bps q-o-q to 13.3% in Q2FY2022, aided by benefit from lower amortisation expenses.

PSL: sharp increase in attrition rates during Q1FY22



Source: Company, Sharekhan Research

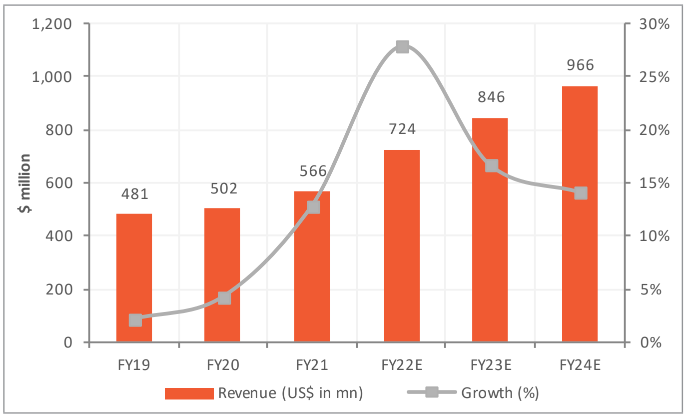
Margin to remain under pressure in Q2FY22



Source: Company, Sharekhan Research

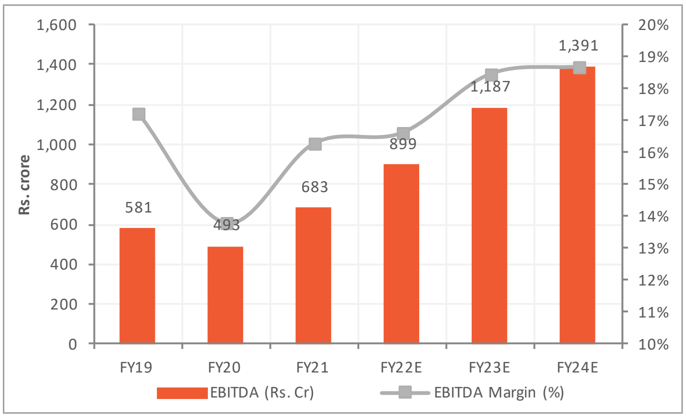
Financials in charts

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



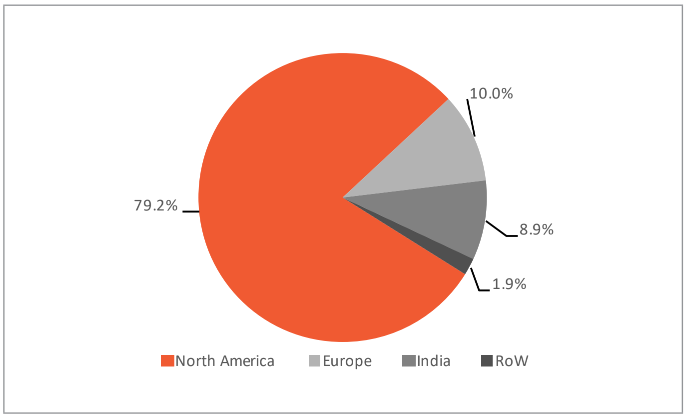
Source: Company, Sharekhan Research

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



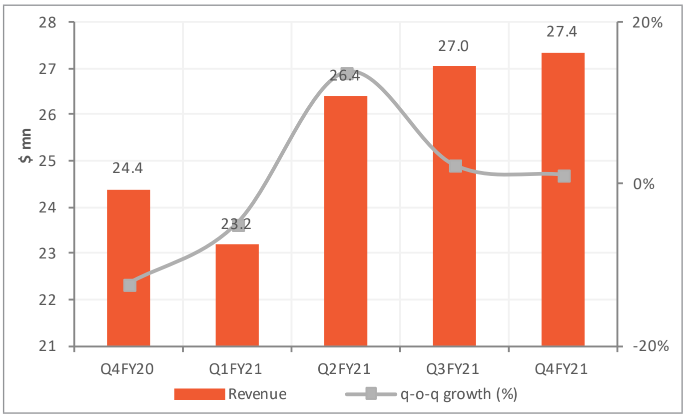
Source: Company, Sharekhan Research

Geography break-up (%)



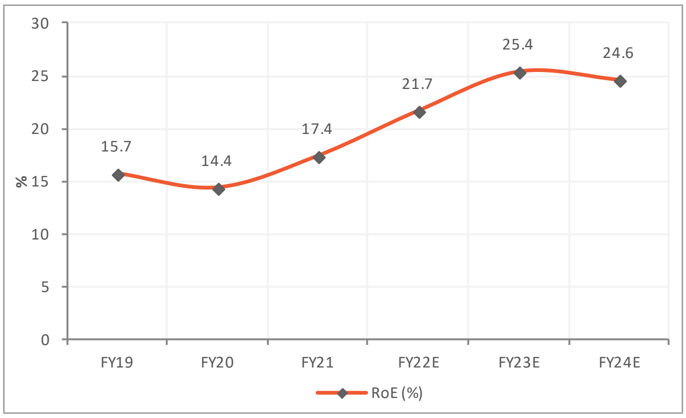
Source: Company, Sharekhan Research

Top account revenue ($ mn) and growth (%)



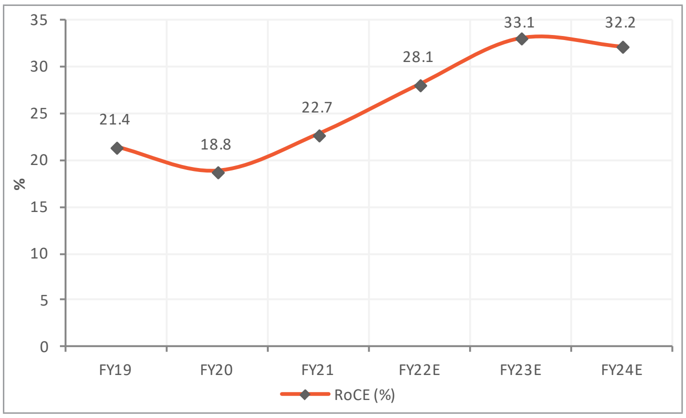
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view – Expect acceleration in technology spending going forward

The pandemic is estimated to drag world GDP by 3.3% in CY2020, with 4.7% contraction in advanced economies. As a result, global technology spend is estimated to decline by 3.2% to $1.4 trillion in 2020. Of that, IT services spending declined by 3.9%, while business process management spends fell by 2.4%. After initial dislocations led to contractions, the need for business continuity, operational resilience and the switch to digital transactions have led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved in CY2010-CY2020. 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.

■ Company outlook – Well positioned to capture opportunities

As PSL is an early identifier of digital trends and has strong product development capabilities, we believe it is well-placed to capture a significant chunk of spends in digital technologies by clients going ahead. The management remains optimistic to sustain strong revenue growth momentum on a q-o-q basis, with quarterly TCV of $200-300 million. We believe 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 the most of the opportunity.

■ Valuation – On a strong growth track

PSL's management remains confident of delivering sustainable revenue growth going ahead on the back of strong demand across verticals, demand for company's product offerings and strong digital engineering capabilities. We believe that any positive surprise in Q2FY2022 would result in an earnings upgrade. At CMP, the stock is trading at a valuation of 31x/27x its FY2023E/FY2024E earnings, justified given its strong earnings growth potential, healthy cash conversion, and M&A opportunity for strengthening its capabilities. We expect USD revenue/earnings to report a CAGR of 20%/30% over FY2021-FY2024E. Hence, we retain a Buy on the stock with an unchanged price target (PT) of Rs. 4,160.

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 (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Infosys	1,688	424	7,15,815	32.0	27.2	22.0	19.1	4.8	4.4	27.6	30.2
L&T Infotech	5,772	18	1,01,109	44.7	37.5	33.4	28.7	10.6	8.3	28.1	30.6
Persistent Systems	3,515	8	26,860	41.4	30.5	29.7	21.9	8.4	7.2	21.7	25.4

Source: Company, Sharekhan estimates

About company

Incorporated in 1990, PSL is a global software company specialising in product and technology services. 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. PSL has been focusing on product development, establishing processes to build distributed agile teams and partnering with the world's leading product companies to build software, contributing across the entire product lifecycle. The company derives revenue from North America, Europe, and Rest of the World.

Investment theme

Large corporates have been allocating higher budgets towards 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 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; 4) stronger Indian rupee and/or adverse cross-currency movements; 5) margin dilution from M&A activity; and 6) high client concentration 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	6.20
2	Kotak Mahindra Asset Management Company Limited	4.38
3	Parag ParikhFlexi	3.07
4	PPFAS Asset Management	2.53
5	L&T Mutual Fund Trustee Limited	2.27
6	Norges Bank Investment Management	2.24
7	Vanguard Group	2.09
8	Government Pension Fund (Global)	1.88
9	ICICI Prudential Asset Management	1.67
10	Axis Asset Management Company Limited	1.47

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

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