



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

Reco/View	Change
Reco: Buy	↔
CMP: Rs. 3,586	
Price Target: Rs. 4,160	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

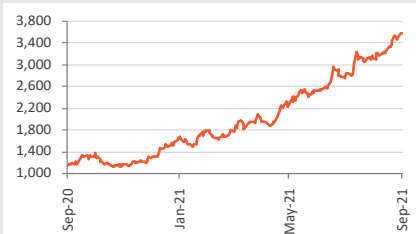
Company details

Market cap:	Rs. 27,409 cr
52-week high/low:	Rs. 3,649/1017
NSE volume: (No of shares)	2.2 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	15.3	41.5	102.8	210.7
Relative to Sensex	10.6	31.1	87.2	160.4

Sharekhan Research, Bloomberg

Summary

- We retain a Buy on Persistent Systems with a revised PT of Rs. 4,160, on expectations of industry-leading organic revenue growth, healthy cash generation, and M&A activity to enhance capabilities.
- With ~60% of revenues arising from digital engineering, PSL is well-poised to capture opportunities from rising spends on digital engineering, the market for which is likely to clock a 16% CAGR over 2020-2025.
- We expect USD revenue/earnings to clock report a CAGR of 20%/30% over FY2021-FY2024E, led by broad-based demand, robust deal TCVs, healthy deal pipeline and steady addition of new logos.
- Wage revisions would affect margins by 250-275 bps q-o-q in Q2FY2022, but the net effect is likely to be restricted to 75-100 bps, given operating leverage and lower visa costs.

Our interaction with the management of Persistent Systems Limited (PSL) indicate that the company would sustain its sequential revenue growth momentum (5.6% CQGR over the past six quarters) in the coming quarters because of broad-based demand, robust deal TCVs, healthy deal pipeline and new logo additions. With around 60% revenue contribution from digital engineering and lower legacy drags, we believe PSL is well poised to capture opportunities from the accelerated spend in the digital engineering area.

- Well poised to outgrow its peers in FY2022:** Management aspires to achieve annual revenue run-rate of \$1 billion+ over next three years from current annual revenue run-rate of \$667 million, implies a CAGR of around 22%. The company's book-to-bill stood at 1.7x in Q1FY2022. The company's net headcount addition over the past nine months is at 38% of its September 2020 headcount, which implies strong underlying demand environment. Management cited that it is at the final stage of closure of its acquisition in the BFSI/healthcare vertical. We expect PSL to report industry-leading revenue growth of 28% y-o-y in FY2022E, followed by a 15% CAGR revenue growth over FY2022-FY2024E.
- Focus on long tenure deals & market expansion in Europe:** PSL's total ACV to total TCY ratio remains at 0.8x, which indicates about the short tenure of its projects. Management indicated that it focuses on winning longer tenure deals of 3-5 years, which would improve its growth visibility. The company has recently won a few long tenure deals of 3-5 years and has been the beneficiary of vendor consolidation, given its strong capabilities and solid execution. It expects revenue contribution from Europe to reach around 15% in next 3-4 years from 9.5% currently.
- Margins to remain under pressure in Q2FY2022:** PSL's attrition rate increased by 490 bps q-o-q in Q1FY2022, which is the highest among its peers. The roll-out of wage revision (effective from July 1, 2021) is expected to impact margins by around 250-275 bps q-o-q. However, management expects the net impact on margin to be restricted to around 75-100 bps q-o-q on account of strong revenue growth, improving utilisation, lower visa costs, and flattening pyramid. Management expects EBITDA margin to be sustainable at 17% in FY2022.

Our Call

Valuation – Sustainable growth momentum: PSL is well positioned to capture opportunities in the market place, given its strong capabilities in the product engineering space, strong executions, hiring of senior-level talents, and an effective sales incentive programme. At the CMP, the stock is trading at a valuation of 31x/28x its FY2023E/FY2024E earnings, justified given its strong earnings growth potential, healthy cash conversion, and M&A opportunity for strengthening its capability. We expect USD revenue/earnings to report a CAGR of 20%/30% over FY2021-FY2024E. Hence, we retain our Buy rating on the stock with a revised 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)

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)	60.8	42.2	31.2	27.6
P/B (x)	9.8	8.6	7.4	6.3
EV/EBITDA (x)	40.7	30.3	22.4	18.6
RoNW (%)	17.4	21.7	25.4	24.6
RoCE (%)	22.7	28.1	33.1	32.2

Source: Company; Sharekhan estimates

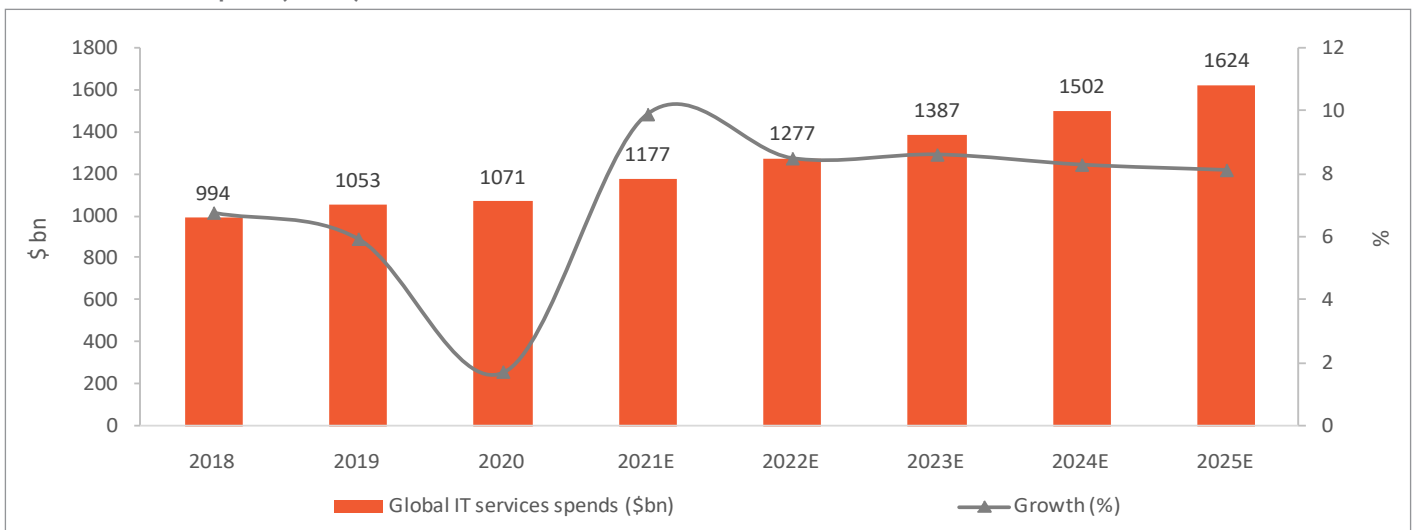
India IT is well placed to capture opportunities from strong demand and higher outsourcing

The pandemic has accelerated the pace of adoption for digital and cloud technologies as these technologies helped enterprises to re-imagine the operating model, increase business resilience and agility, optimise cost structure, catching up with digitally mature and cloud-native competitors, and personalising experiences for customers and employees.

Industry demand is being driven by two big trends – (1) investment in both front-end and back-end transformation to enhance experience in digital transactions and (2) higher tech spending around cloud migration, application modernisation, and data modernisation for greater resilience and agility within enterprises. In addition, most of the large enterprises have been making a strategic shift towards outsourcing models for saving costs or sharpening focus on core areas. Hence, it has resulted in terminating or postponing their plans to set up/expand their global capabilities centres (GCC) in India. Given new outsourcing opportunities and rising spend on digital and cloud-related technologies, we believe technology spends would remain strong in the next 2-3 years.

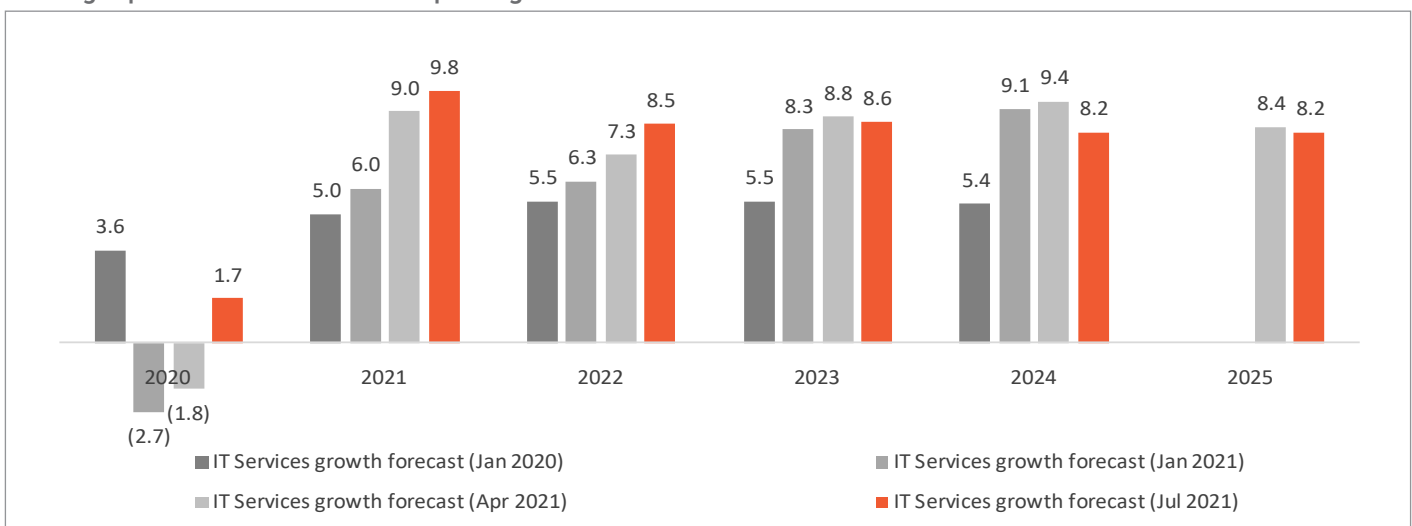
According to the latest forecast, Gartner expects worldwide IT spending to rise by 8.6% y-o-y to \$4.2 trillion in 2021. Of this, Gartner forecasts IT services spend would grow by 9.8% in FY2021. Further, IT services spending is likely to report an 8.7% CAGR over FY2021-FY2025, led by strong growth in digital technology. Digital technologies (such as cloud hosting, cloud migration, ADM DevOps, consulting, IoT, etc.) would report a 15-20% CAGR over FY2021-FY2025, while next-generation technologies (5G, robotics, and Blockchain) are expected to report a CAGR of 35-45% over the same period.

Global IT services spend (Rs. bn)



Source: Gartner, Sharekhan Research

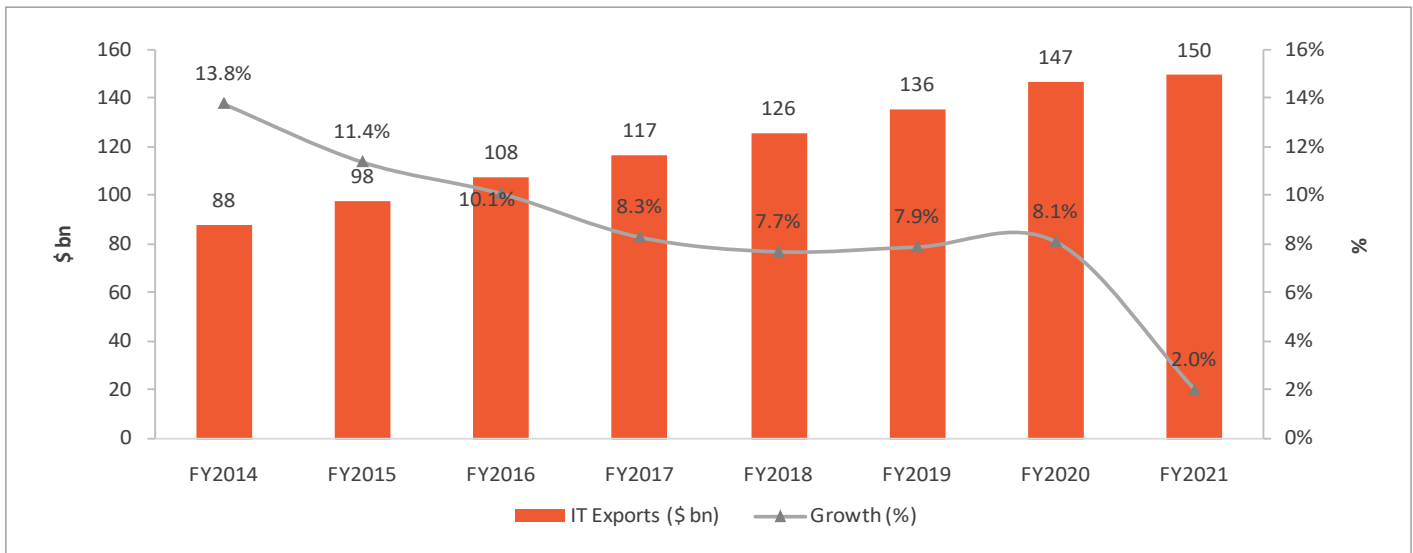
Industry experts revised in IT services spending



Source: Nasscom, Sharekhan Research

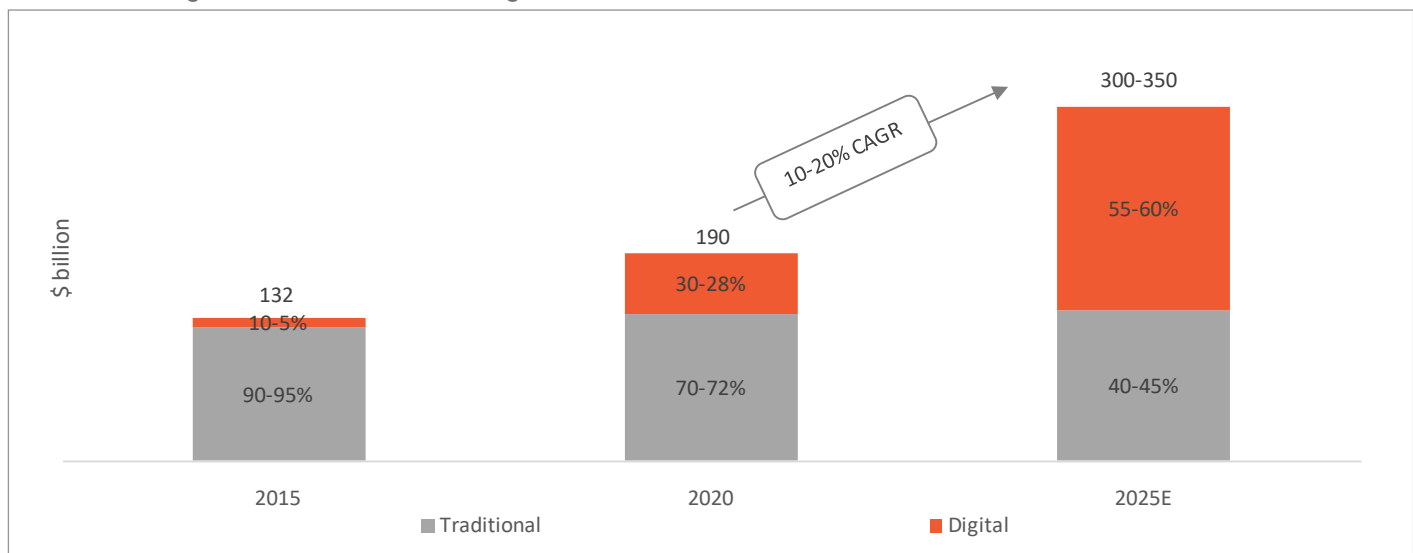
According to NASSCOM, the Indian IT industry reached a size of \$194 billion in FY2021, rise of 2.3% y-o-y. Exports from the Indian IT industry grew by 2.0% y-o-y to reach \$150 billion in FY2021 and domestic revenue of the IT industry grew by 3.4% y-o-y to ~\$45 billion. Growth is driven by increased demand for digital transformation and infrastructure modernisation. Digital revenue accounted for 28-30% of total industry revenue in FY2021, growing at a rapid pace. The Indian IT services industry is expected to touch \$300 billion-350 billion in annual revenue in the next five years, led by higher demand in emerging technology areas such as cloud, artificial intelligence (AI), and cyber security.

Indian IT Industry export growth trajectory



Source: Nasscom, Sharekhan Research

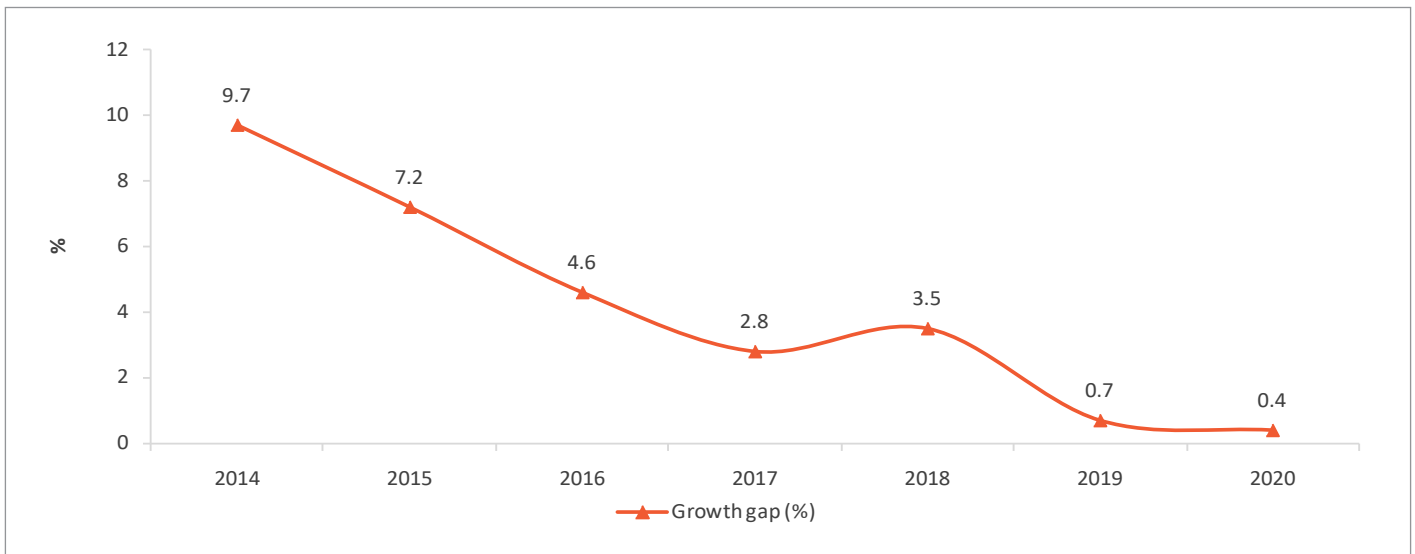
Indian IT industry can reach \$300bn-350bn by 2025



Source: Nasscom, Sharekhan Research

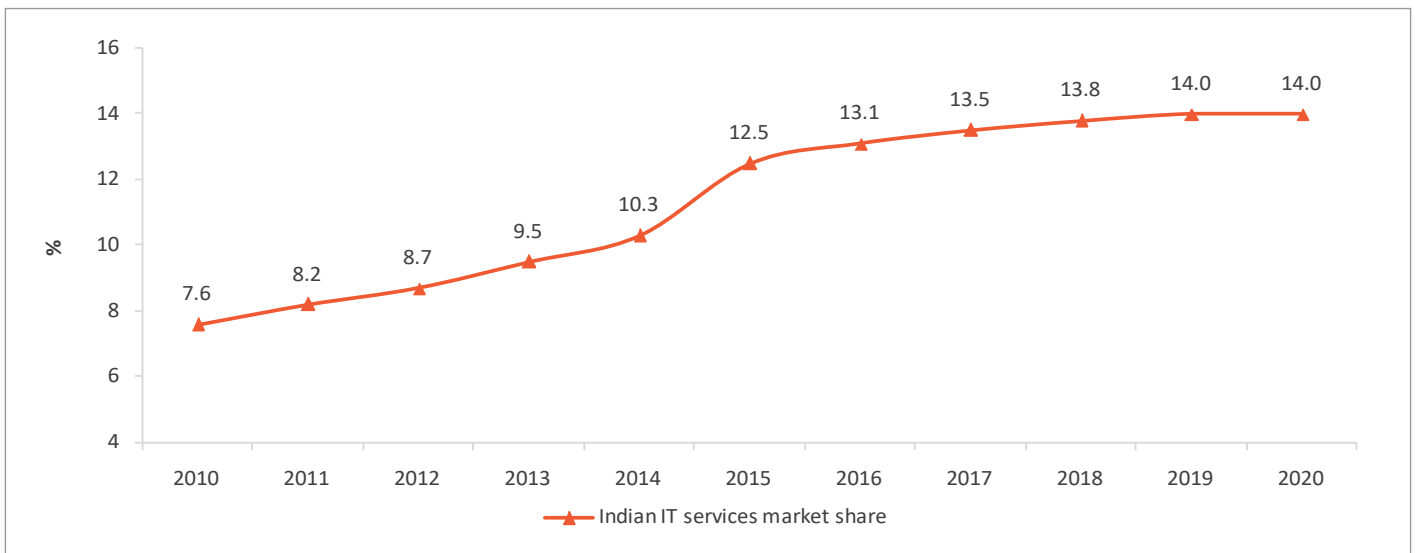
The global IT services market posted a CAGR of 3.2% over the past 10 years, while Indian IT exports have grown at a higher pace of 9.7% CAGR over the same period. This has resulted in gain in the market share by Indian IT services companies to 14% in 2020 from 7.6% in 2010. Growth of Indian IT services companies in the most recent quarters has been strong. However, the growth gap has been reduced significantly between the global outsourced IT services spending growth and Indian IT services export growth. As projected, growth rates of global IT services spending for 2021-2025E are higher than in previous years. We believe the offshoring growth differential would pick up in CY2021 and beyond.

Growth gap between global IT spend & Indian IT exports



Source: Nasscom, Gartner, Sharekhan Research

Indian IT services market share trend



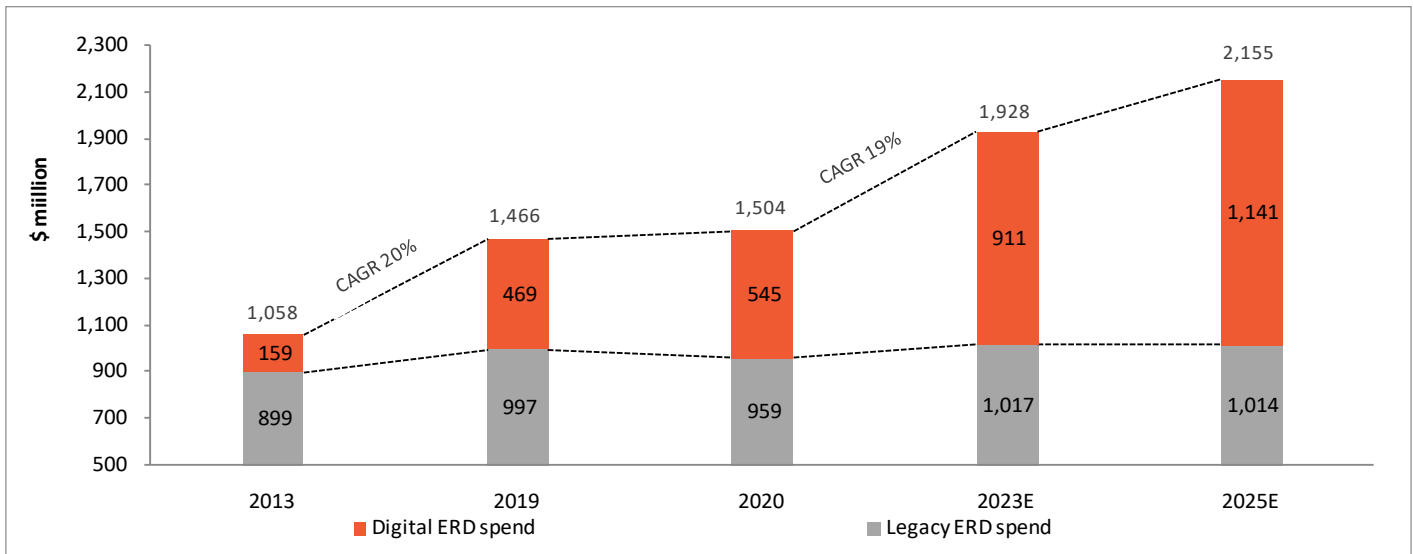
Source: Nasscom, Sharekhan Research

Well-poised to benefit from the acceleration in digital engineering spend

The Engineering and R&D Services (ERS) segment will pick up and is expected to grow at the fastest rate within the Indian technology space for the next 3-5 years. Digital technologies such as mobility, IoTs, artificial intelligence (AI), ML, and cloud-based applications are being integrated into consumer contexts, services, and products.

According to Zinnov, the digital engineering market is expected to see a 19%/16% CAGR from \$545 billion in 2020 to \$911 billion/\$1,141 billion by 2023/2025. Digital engineering spends are accelerating across industries, and this is expected to contribute to 47%/53% of the total ERD spending by 2023/2025 as compared to 36% in 2020. The product engineering services market is expected to post an 8.2% CAGR, reaching \$1,174 billion by 2023.

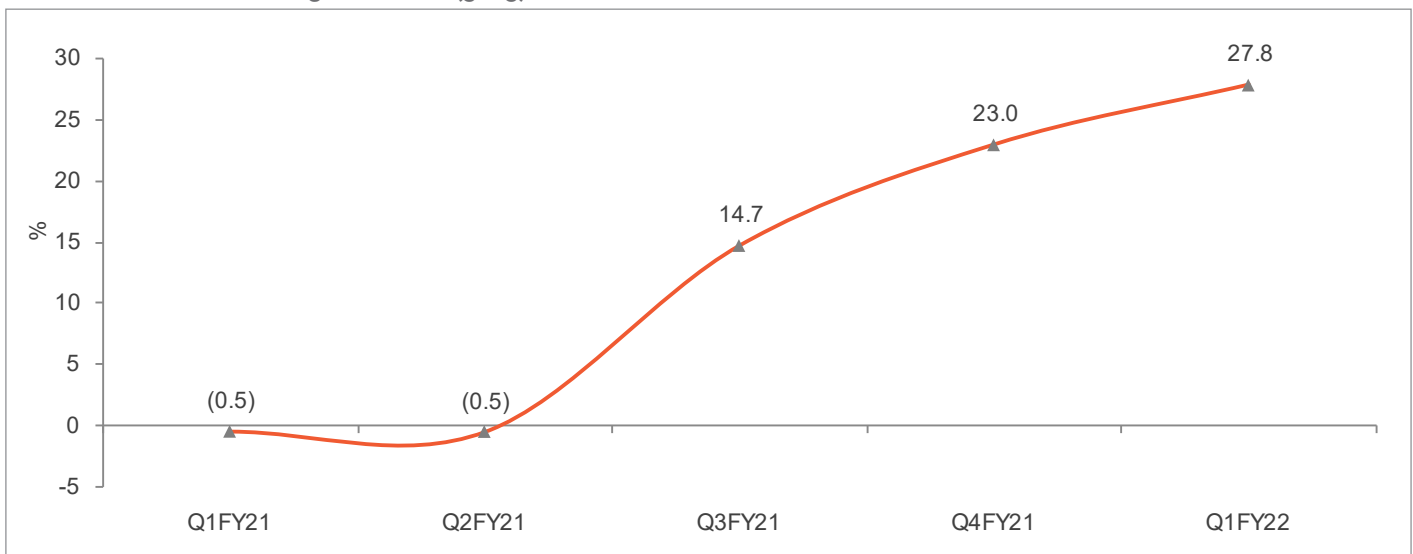
Digital engineering spend to post a 19% CAGR over 2019-2023E



Source: Zinnov, Sharekhan Research

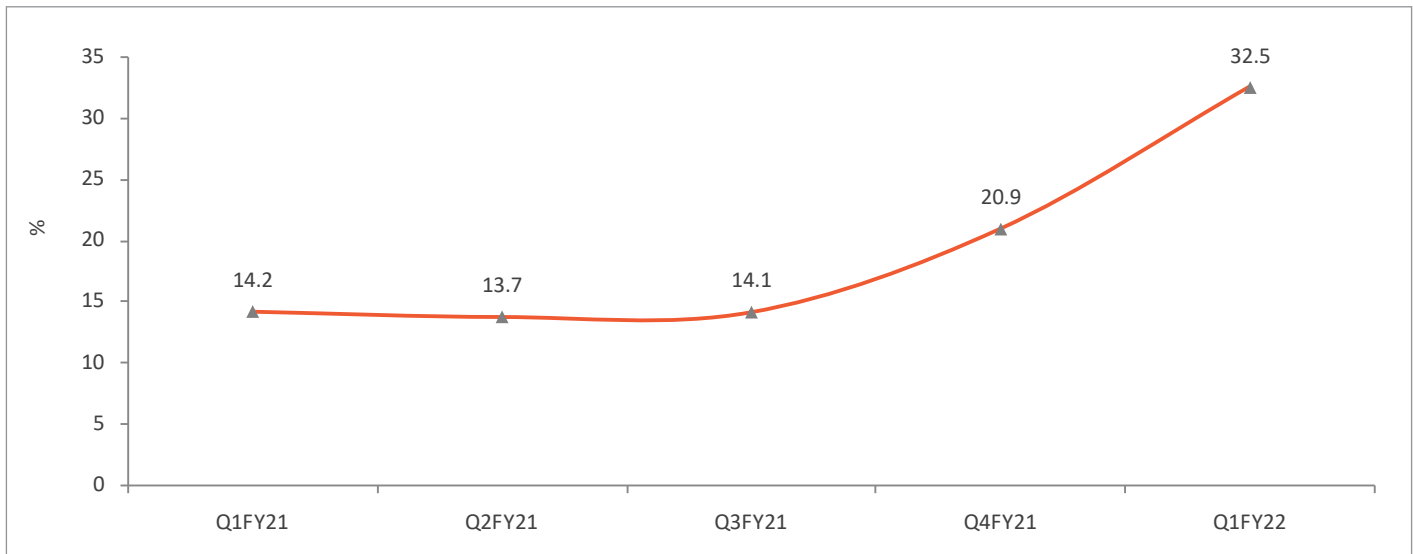
PSL is engaged in helping its customers build next-gen products using digital product engineering. Further, the company works with software clients across every stage of the software product lifecycle to improve engineering velocity, expand ecosystems, accelerate product roadmaps, and speed to market. PSL plans to open Center of Excellence (CoE) in near-shore locations in Mexico and Canada to improve its capabilities in delivering quality services to its customers. With 60% revenue contribution from digital engineering and negligible presence in legacy space, we believe PSL would continue its strong growth momentum in the next 2-3 years due to strong spend on digital product engineering and software products.

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



Source: Company, Sharekhan Research

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

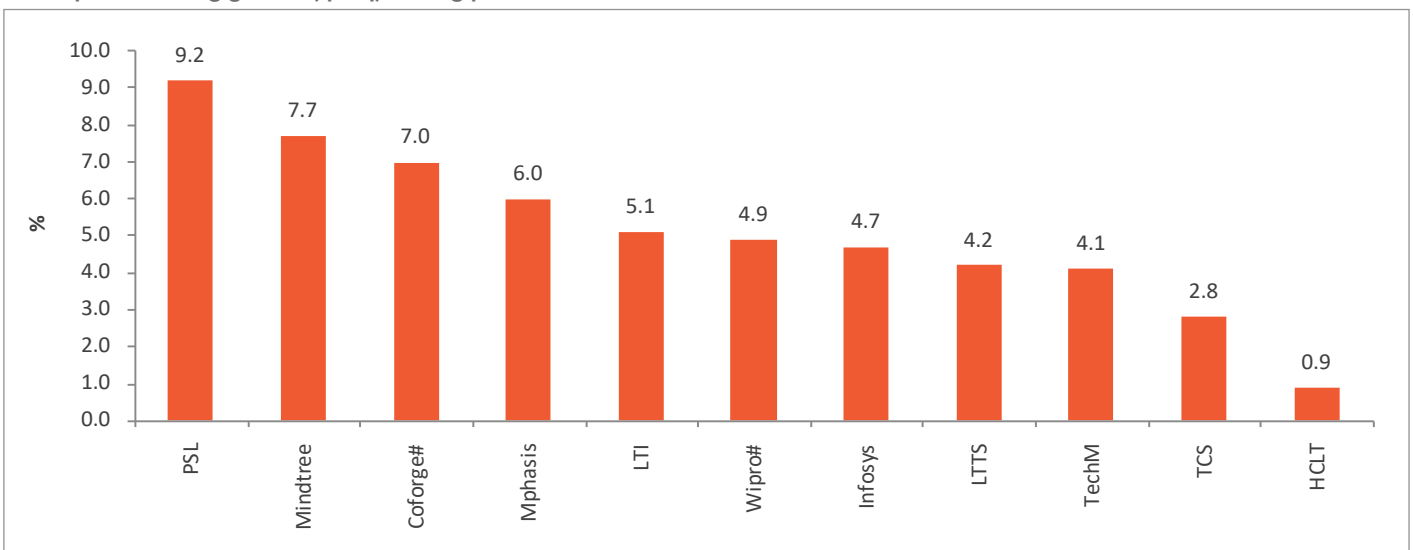


Source: Company, Sharekhan Research

Mid-tier IT companies continue to outgrow tier-I players; PSL aims to achieve growth leadership

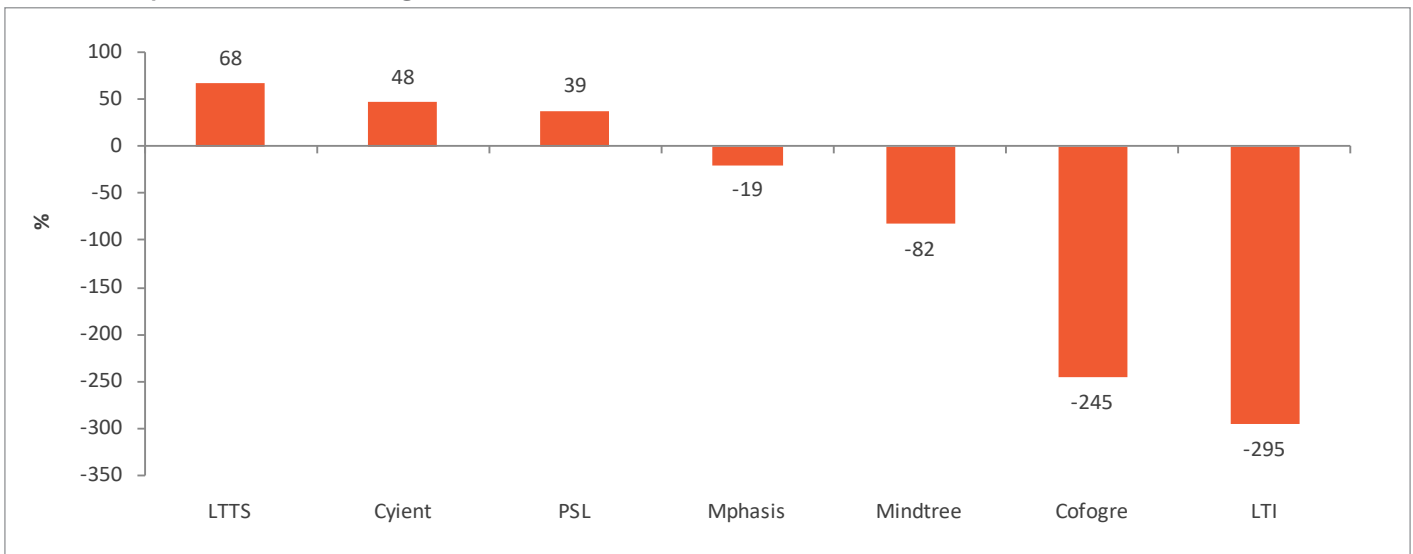
Mid-cap IT companies continued to outperform large-cap companies on the growth front in Q1FY2022. We believe resilient mid-tier IT companies will deliver better revenue growth compared to their large peers in subsequent quarters, given strong competencies in digital technologies and good strategies around partnership ecosystem to participate in customers’ transformation journey, lesser exposure to legacy business, and attracting external talents at senior levels from large organisations. Net new deal TCVs continue to remain strong for most Indian mid-cap companies in Q1FY2022, while digital revenue contribution to total revenue exceeded 50% for most of mid-tier companies. Mid-tier companies have impressed with strong net addition of employees during Q1FY2022, which indicates underlying strength of the demand environment.

PSL reported strong growth (q-o-q) among peers



Source: Company, Sharekhan Research; # Organic

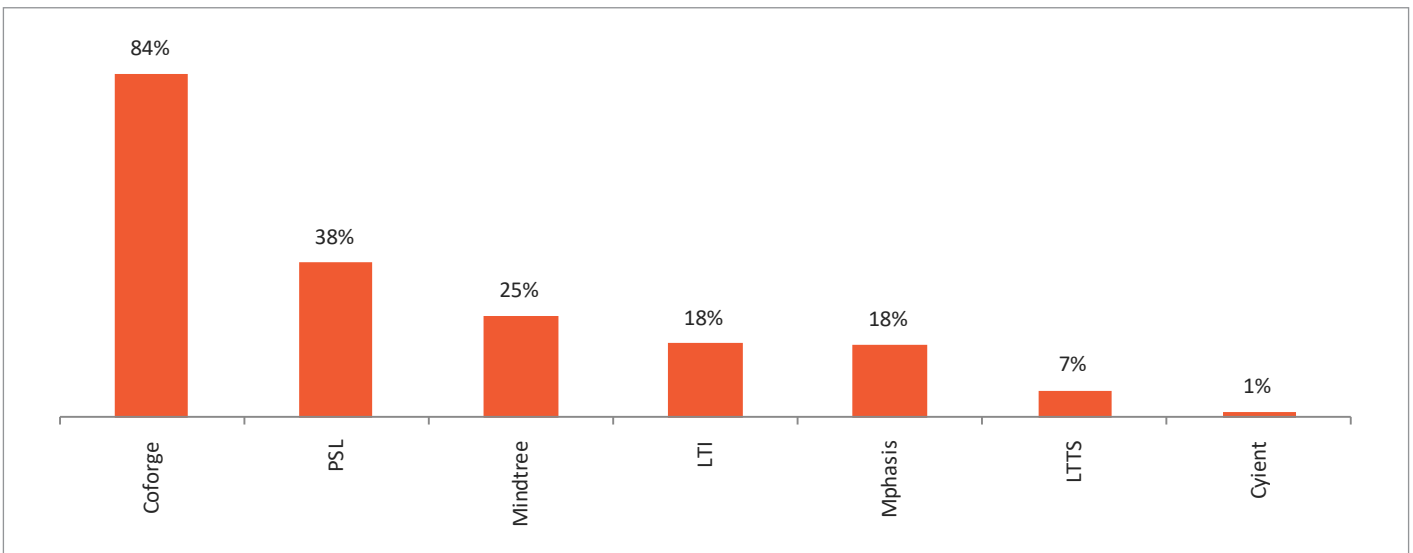
Consistent improvement in EBIT margin for PSL



Source: Company, Sharekhan Research

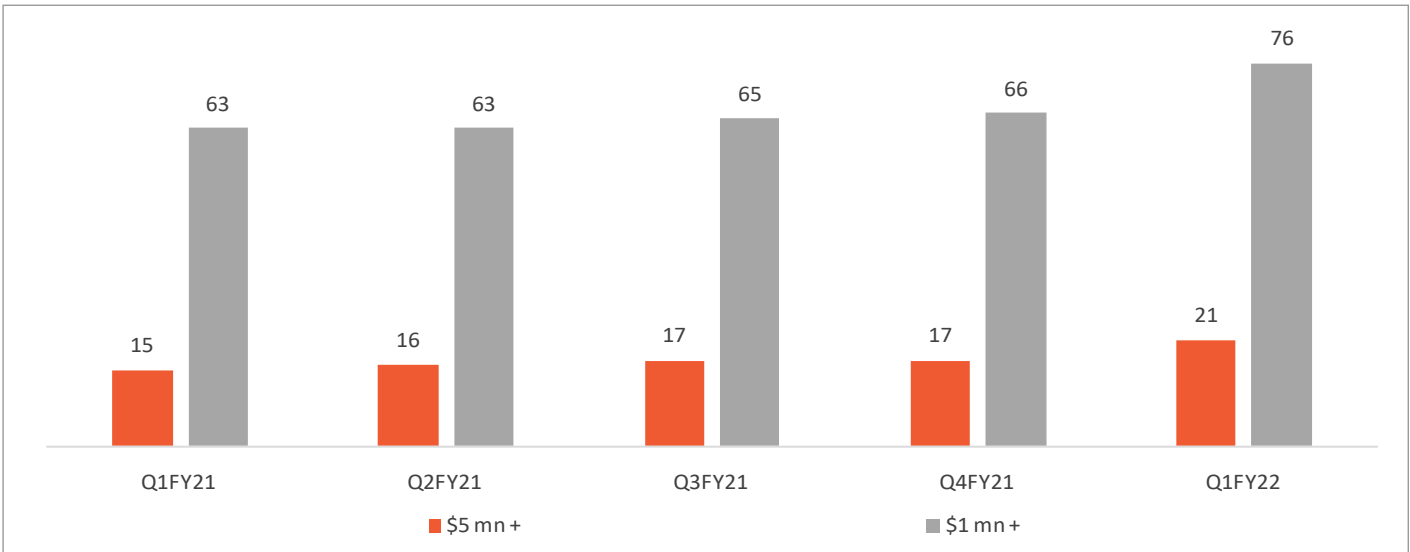
PSL’s management expects demand to remain strong for the next 2-4 years. The company aims to achieve industry-leading growth in the coming quarters because of broad-based demand, robust deal TCVs, healthy deal pipeline, and new logo additions. The company’s book-to-bill ratio of 1.5x-2.1x during the last three quarters provides strong growth visibility. Further, the number of clients under the \$1 million+/\$5 million+ category increased by 13 y-o-y (10 on q-o-q) and six y-o-y (four on q-o-q), respectively. Management expects the new logo addition momentum to continue at a steady rate in the coming quarters. PSL’s net headcount addition stood at 4,084 during the past three quarters, of which 73% are lateral hires. Strong addition of employees indicates the anticipation of strong deal wins in the coming quarters and healthy demand environment as well.

Net staff addition in last 9M as % of Q2FY21 headcount



Source: Company, Sharekhan Research

Steady improvement in client metrics to continue

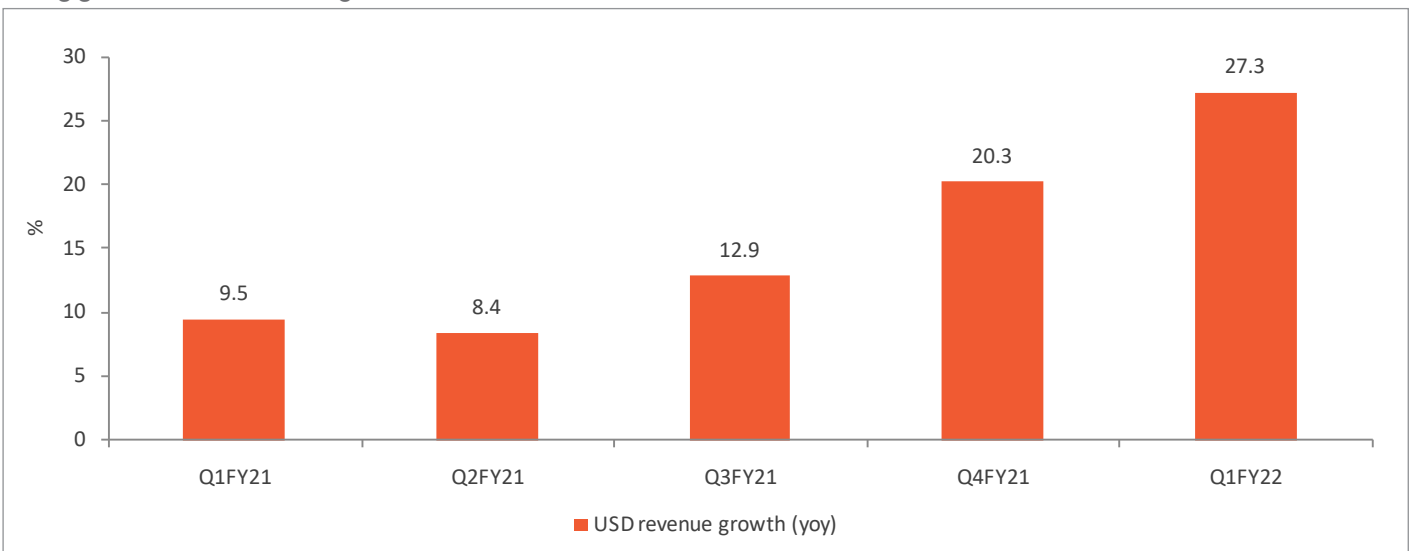


Source: Company, Sharekhan Research

Expect strong revenue growth momentum to continue; Eyeing M&A opportunities

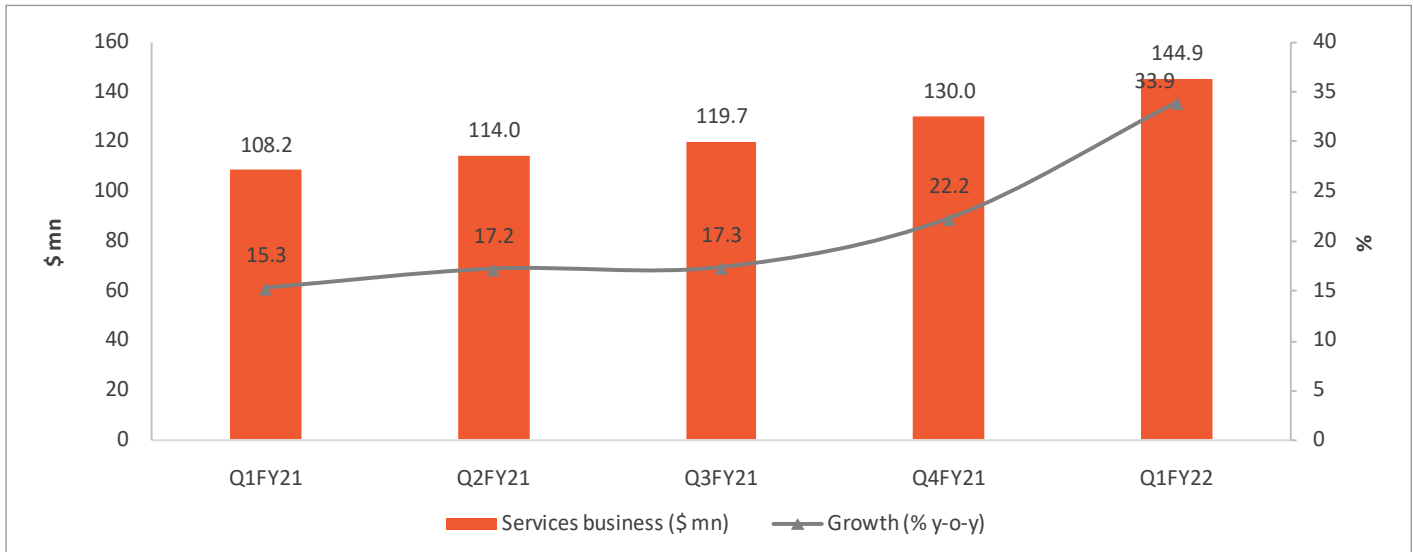
PSL delivered strongest revenue growth of 12.9% y-o-y in FY2021, among mid-tier peers in a year hit by a pandemic, aided by reinvigorated sales, minimal exposure to legacy business, and focus on high-growth verticals. Further, the company started the fiscal year with industry-leading organic growth of 9.2% q-o-q (up 27.3% y-o-y), led by broad-based growth across verticals. Management remains confident on delivering strong revenue growth in FY2022 even after delivering strong growth in FY2021, led by strong deal wins, a robust deal pipeline, and traction for its service offerings (such as cloud, data, analytics, and digital engineering). The company’s total order book remained at \$646 million in the past three quarters, including new ACV of \$331 million. Further, the company’s total order book TCVs stood at \$793.3 million over the past three quarters, implying total ACV to total TCV ratio of 0.8x, which indicates the short duration of its projects. Management indicated that it focuses on winning a longer tenure deals of 3-5 years, which would improve its growth visibility. Further, the company has been collaborating with potential customers to improve pricing in some of its projects, given rise in attrition rates. Management indicated that the company is close to the final stage of closure of acquisition. We believe the company would make acquisitions to enhance its capabilities in the BFSI and healthcare verticals. We expect PSL to report industry-leading revenue growth of 28% y-o-y in FY2022E and 15% CAGR over FY2022-FY2024E.

Strong growth momentum likely to continue



Source: Company, Sharekhan Research

Service business growth momentum remains strong



Source: Company, Sharekhan Research

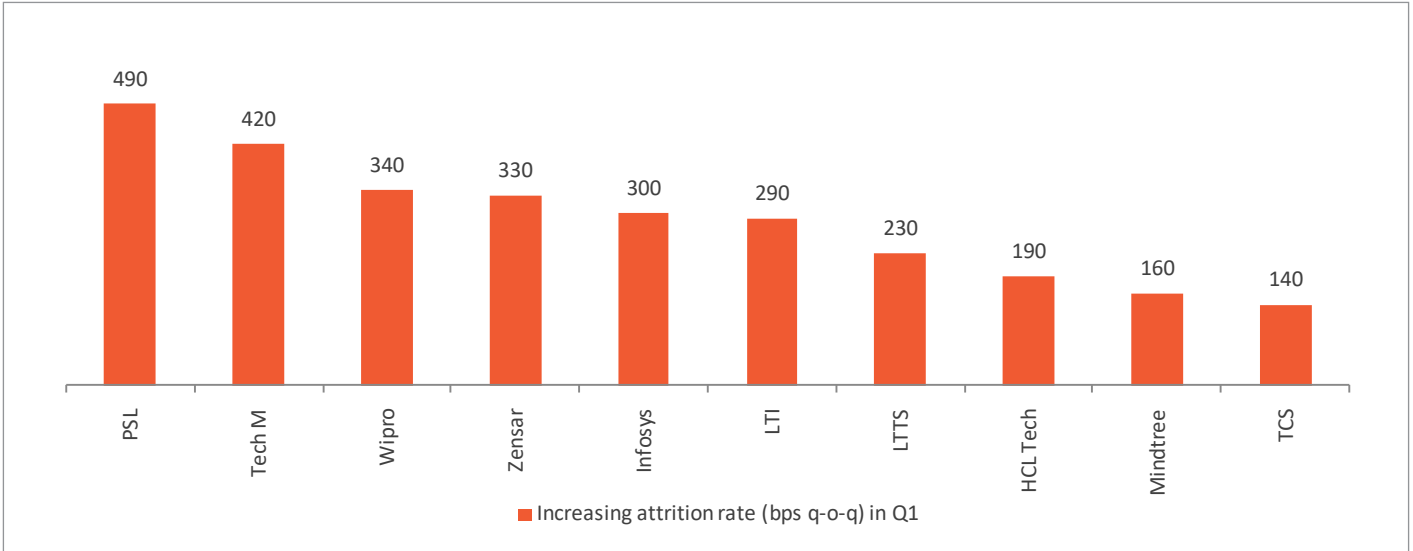
Focus on strengthening partnership ecosystem

The company would continue to invest in deepening its collaboration with IBM, sales force, hyperscalers, and others to participate in the digital transformation journey of customers. The company’s sales force practice annual revenue run rate is at \$120 million-\$130 million and is progressing well for the company.

Expect margin to remain under pressure in Q2FY2022

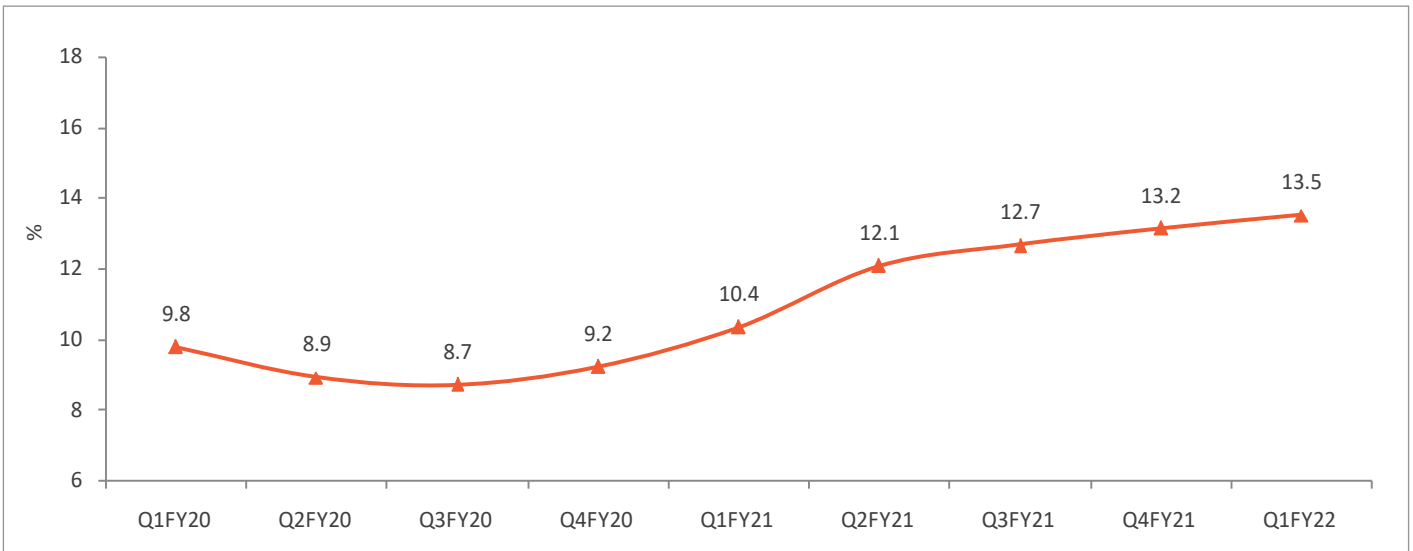
Margin pressure across Indian IT companies during Q1FY2022 was due to increased discretionary costs, a shortage of digital talent, higher attrition, higher costs to backfill attrition, and increased subcontracting costs. During Q1FY2022, PSL’s attrition rate increased by 490 bps q-o-q, which is the highest among its peers. The sharp increase in attrition rate was due to its higher presence in cutting-edge technology compared to its peers, which the demand remains robust across the geographies. Though the company is taking proactive measures such as flexible working hours, higher fresher intake, and upskilling of employees to meet the supply challenge, management believes that the attrition rate would remain elevated in the next 2-3 quarters. Hence, 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 (COLA) at the right levels during renewals. In case of new projects, the company tries for correct pricing given current market dynamics. The company has rolled out its wage revision from July 1, 2021, which 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, and flattening pyramid would mitigate the impact of a wage hike to a large extent. Hence, management expects net impact on margin to be restricted to around 75-100 bps q-o-q. Management expects EBITDA margin would be sustainable at 17% in FY2022 despite investments in building digital capabilities, hiring at senior levels, and higher discretionary spends. The company is likely to benefit from lower amortisation expenses, which would help it to expand its EBIT margin in FY2022.

PSL: sharp increase in attrition rates



Source: Company, Sharekhan Research

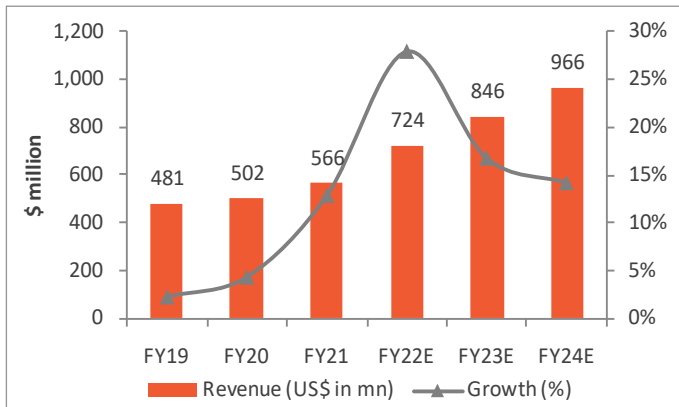
Margin to remain under pressure in Q2FY22



Source: Company, Sharekhan Research

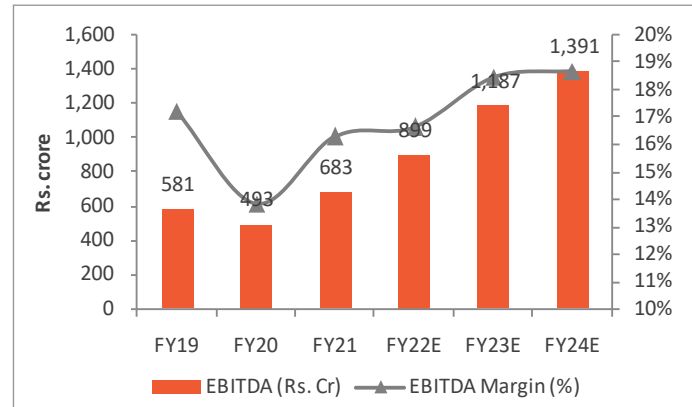
Financials in charts

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



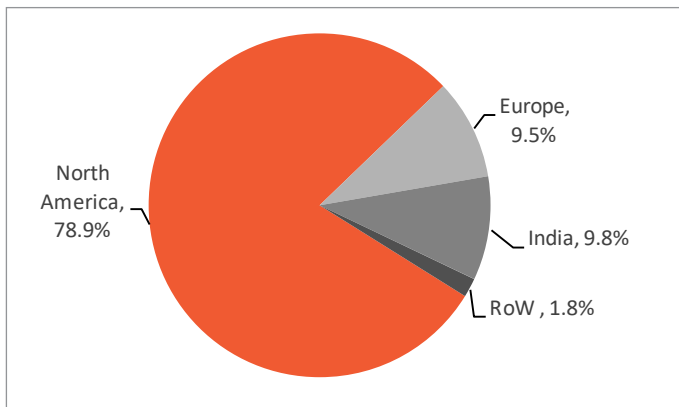
Source: Company, Sharekhan Research

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



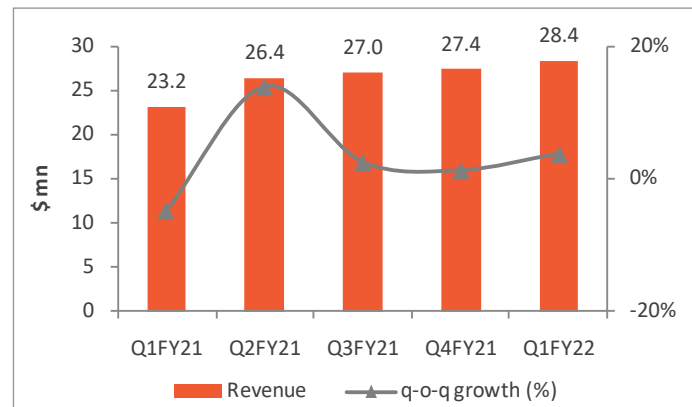
Source: Company, Sharekhan Research

Geography break-up (%)



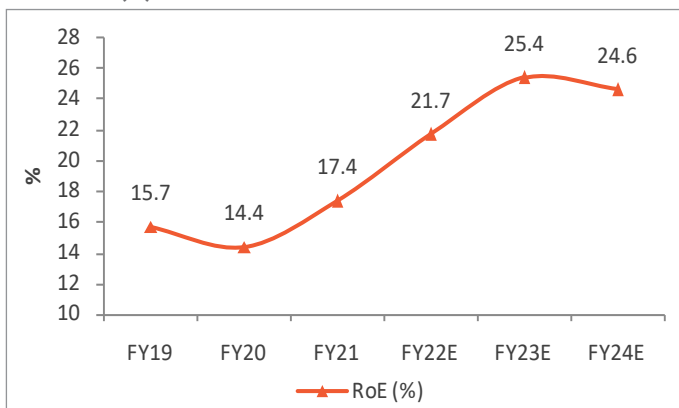
Source: Company, Sharekhan Research

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



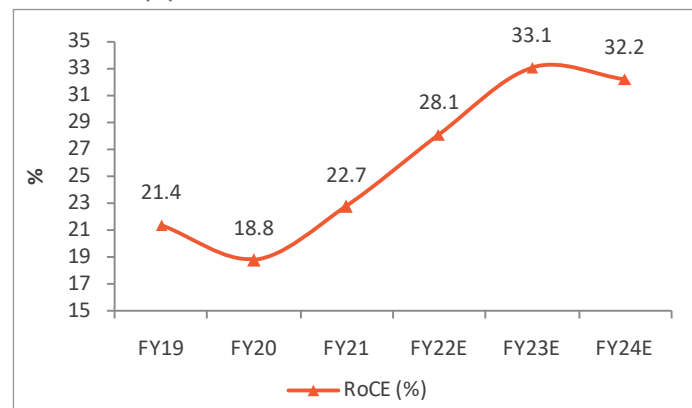
Source: Company, Sharekhan Research

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 the world output 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. Within that, IT services spending declined by 3.9%, while business process management spends fell by 2.4%. After the 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. WFH efficiencies, efficiency measures, and higher offshoring would help in sustaining margins in the medium term.

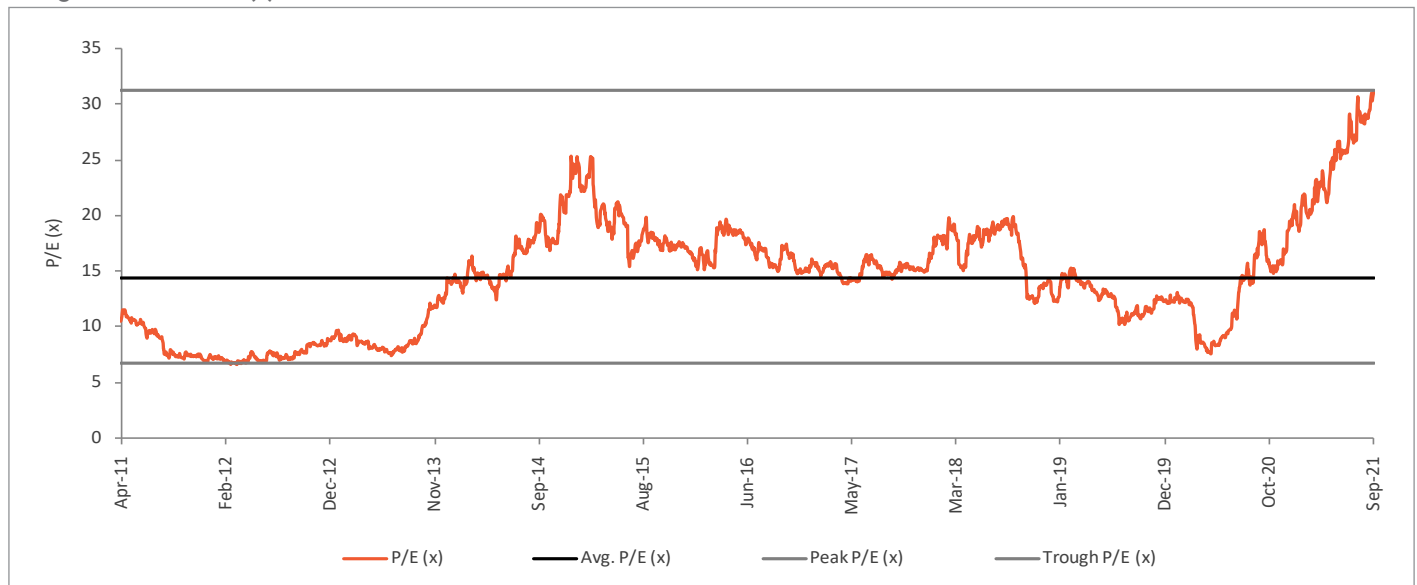
■ Company outlook - Well positioned to capture opportunities

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 remains optimistic to deliver strong revenue growth on a q-o-q basis, with quarterly TCV of \$200 million-250 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 - Sustainable growth momentum

PSL is well positioned to capture opportunities in the market place, given its strong capabilities in the product engineering space, strong executions, hiring of senior-level talents, and an effective sales incentive programme. At the CMP, the stock is trading at a valuation of 31x/28x its FY2023E/FY2024E earnings, justified given its strong earnings growth potential, healthy cash conversion, and M&A opportunity for strengthening its capability. We expect USD revenue/earnings to report a CAGR of 20%/30% over FY2021-FY2024E. Hence, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 4,160.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Company	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Infosys	1,686	424	7,15,136	32.0	27.1	22.0	19.1	4.8	4.4	27.6	30.2
L&T Infotech	5,578	18	97,719	43.2	36.2	32.3	27.8	10.3	8.0	28.1	30.6
Persistent Systems	3,587	8	27,409	42.2	31.2	30.3	22.4	8.6	7.4	21.7	25.4

Source: Company, Sharekhan Research

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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Company Limited	6.20
2	Kotak Mahindra Asset Management Co Limited	4.38
3	Parag Parikh Flexi	3.07
4	PPFAS Asset Management	2.53
5	L&T Mutual Fund Trustee Limited	2.27
6	Government Pension Fund (Global)	2.24
7	Vanguard Group	2.06
8	Government Pension Fund - Global	1.88
9	ICICI Prudential Asset Management	1.67
10	Axis Asset Management Company Limited	1.47

Source: Bloomberg

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a position in the companies mentioned in the article.

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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