Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Persistent Systems Ltd

All-round Q1; multiple growth opportunities ahead

IT & ITES	Sharekhan code: PERSISTENT

Reco/View: Buy ↔	CMP: Rs. 3,631	Price Target: Rs. 4,300 ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 20.80

Updated Jul 08, 2022

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

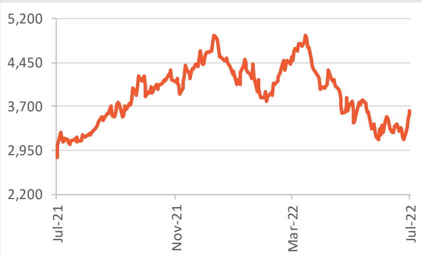
Company details

Market cap:	Rs. 27,752 cr
52-week high/low:	Rs. 4,986 / 2,815
NSE volume: (No of shares)	3.0 lakh
BSE code:	533179
NSE code:	PERSISTENT
Free float: (No of shares)	5.3 cr

Shareholding (%)

Promoters	31.3
FII	22.0
DII	26.8
Others	20.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	12.5	-10.4	-14.7	27.8
Relative to Sensex	4.9	-7.9	-8.5	22.3

Sharekhan Research, Bloomberg

Summary

- Persistent Systems Limited (PSL) beat estimates on all fronts; Q1 also saw strong deal intake, robust net headcount additions, good client mining and growth across top accounts.
- Management sees demand staying robust as it does not see delays in decisions on deals despite macro factors. In contrast, macro concerns could create huge opportunities for PSL in cost optimisation areas.
- We believe PSL is well poised to outpace industry yet again in FY2023 led by strong deal intake, strong capabilities and synergies in recent acquisitions. We forecast sustainable margins in FY23E.
- We retain a Buy on PSL with a revised PT of Rs. 4,300, given strong earnings visibility, sustained acceleration in deal TCVs, new growth avenues from recent acquisitions and strong execution.

Persistent Systems Limited (PSL) delivered yet another quarter of outstanding all-round growth, beating our estimates in revenue and operating profitability. The company's strong revenue growth remained in excess of 9% q-o-q for five consecutive quarters. USD revenue grew by 11.1% q-o-q (up 44.8% y-o-y) to $241.5 million, led by continued strong growth in IT services (including revenue contribution from acquisitions). Organic revenue growth stood at 5.6% q-o-q and 30.5% y-o-y in Q1FY2023. EBIT margin improved by 27bps q-o-q to 14.3% (exceeded our estimates), as margin headwinds (continued supply-side issues, visa costs, rising travel expenses, and higher depreciation expenses) were offset by operating leverage and currency tailwinds. Management indicated that demand continues to remain robust as it does not see any material delay in decision-making process on deals or project cancellation owing to adverse macro factors. In contrast, it believes the current macro headwinds remain favourable for the company given rising opportunities in cost-optimisation areas. Growth in the medium term would be supported by robust deal intake, revenue synergies in the acquired business, new logo additions, and rising growth and cost-optimisation opportunities.

Key positives

- Deal TCVs/deal ACVs grew by 61%/39% y-o-y, respectively; one of the strongest growth among its peers in the recent macro situation
- Revenue grew at 9%+ sequentially over the past five successive quarters
- Strong net headcount addition of 3,039 employees on a q-o-q basis, includes 1,950 freshers
- Broad-based growth across top 5/10/20 accounts

Key negatives

- Technology companies and emerging vertical's EBIT margin declined by 1100 bps q-o-q
- OCF to EBITDA declined to 20% in Q1FY2023 from 63% in Q4FY2022

Management Commentary

- Management aims to reach $1 billion annual revenue run rate over the next 3-4 quarters
- The current macro factors remain favourable for the company in terms of increasing number of opportunities in cost-optimisation areas.
- EBIT margin to come under pressure by 200-300 bps in Q2FY2023 due to higher-than usual wage revision owing to the inflationary environment.
- Excluding the addition of freshers, the trailing 12-month attrition for the quarter remained at 26.3% versus 26.6% in Q4FY2022. It expects attrition to moderate going ahead.

Revision in estimates – We have broadly maintained our earnings estimates for FY2023E/FY2024E because of strong deal intake, healthy deal pipeline, robust headcount addition, and stable margin despite supply-side challenges.

Our Call

Valuation – Growth outlook intact: We believe PSL is well poised to deliver another year of industry-leading growth in FY2023 because of strong deal intake, sharpening focus on fast-growing verticals, capabilities to participate in both growth and cost-optimisation transformation initiatives, and potential synergies from recent acquisitions. Margin headwinds are expected to be absorbed by improving utilisation, reduction in subcontracting costs, pyramid balancing, and currency tailwinds. We expect USD revenue/earnings to report a CAGR of 27%/25% over FY2022-FY2024E. At the CMP, the stock trades at a valuation of 32x/26x its FY2023E/FY2024E earnings estimates. Hence, we retain our Buy rating on the stock with a revised price target (PT) of Rs. 4,300.

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	FY22	FY23E	FY24E	FY25E
Revenue	5,710.7	8,216.0	9,821.6	11,505.0
OPM (%)	16.8	16.9	17.3	17.4
Adjusted PAT	690.4	875.8	1,085.2	1,274.5
% YoY growth	*53.2*	*26.9*	*23.9*	*17.4*
Adjusted EPS (Rs.)	90.3	114.6	142.0	166.8
P/E (x)	40.2	31.7	25.6	21.8
P/B (x)	8.2	7.1	6.1	5.2
EV/EBITDA (x)	30.0	20.1	16.0	13.0
RoNW (%)	22.4	24.1	25.6	25.7
RoCE (%)	26.0	26.5	29.0	29.8

Source: Company; Sharekhan estimates

An excellent start to the year

PSL delivered yet another quarter of outstanding all-round growth, beating our estimates in revenue and operating profitability. The company has been reporting strong 9%+ q-o-q growth for the past five successive quarters. USD revenue grew by 11.1% q-o-q (up 44.8% y-o-y) to $241.5 million, led by continued strong 13.5% q-o-q (up 55% y-o-y) growth in IT services (contributes 93% to total revenue). Strong revenue growth was led by broad-based growth across verticals and $12 million revenue contribution from the acquisitions of Data Glove (one-month impact) and MediaAgility (nearly two-month impact). The company's organic revenue growth stood at 5.6% q-o-q and 30.5% y-o-y in Q1FY2023. EBITDA margin improved by 58bps q-o-q to 17.7% despite supply-side challenges, lower IP-led revenue, costs related to acquisition, visa costs, and rising travel expenses, exceeding our expectation. The above margin headwinds were absorbed by operating leverage from strong revenue growth and currency tailwinds (+90bps). Depreciation and amortisation expenses were higher due to recent acquisitions (full quarter impact of Data Glove acquisition and two-month impact of MediaAgility acquisition), resulting in 3.4% of total revenue in Q1FY2023 compared to 3.1% in Q4FY2022. Hence, EBIT margin improved by 27 bps q-o-q to 14.3%, ahead of our estimates. EBIT grew by 16.8% q-o-q and 61.4% y-o-y to Rs. 268.8 crore. Net profit was up 5.3% q-o-q and 40% y-o-y to Rs. 212 crore and was in-line with our estimates as the strong beat in operating profitability was almost offset by lower other income (down 65% q-o-q, owing to Rs. 400 crore cash outflows to fund the recent acquisitions).

Expect strong revenue growth in the medium term

Management cited that demand environment continues to remain robust as it does not see any deferment of programmes or material delay in decision-making process on deals or project cancellation owing to the ongoing macro events. Further, the company indicated that customers will continue with their business-transformation programme that they started 1 to 2 years ago as these initiatives will make them relevant to customers. The current macro factors also remain favourable for the company in terms of increasing number of opportunities in cost-optimisation areas. Notably, the company has won a few large cost-optimisation deals in the past few quarters to prepare its customers from any potential downturn in the future. During Q1FY2023, the company's total deal TCVs grew by 61% y-o-y to $394 billion, which provides strong growth visibility in the medium term. Notably, the company secured a seven-year deal in the excess of $50 million from a leading European software company despite adverse macro environment in the region. This indicates its differentiated capabilities in the product engineering space. Management remains confident of achieving its goal of $1 billion revenue run-rate in the next 3-4 quarters. Growth would be supported by broad-based demand across verticals, robust deal intake, synergies in the acquired business, and new logo additions. Further, strong net headcount additions over the past four quarters indicate robust underlying demand going ahead. We believe the company is well poised to capture a fair share of strength in demand, given its strong capabilities in digital engineering capability and inorganic investment in new-age technology areas.

Expect sustainable margin in FY2023E; Expect margin levers to offset impact of wage revision in Q2

EBIT margin to come under pressure by 200-300 bps in Q2FY2023 due to higher-than-usual wage revision owing to the inflationary environment. Management believes impact of wage revision in Q2FY2023 and other margin headwinds would be offset by improving utilisation, absence of visa expenses ($1.1 million), and cost related to acquisition and pyramid rationalisation. Further, attrition rate moderated by 180 bps q-o-q to 24.8% in Q1FY2023. Excluding the addition of freshers, the trailing 12-month attrition for the quarter remained at 26.3% versus 26.6% in Q4FY2022. Management expects attrition would continue to moderate in the coming quarters, given strong fresher hiring across the industry and retention measures (financial interventions, career planning, and higher bonuses). Further, margin is expected to improve in 2HFY2023, aided by increased utilisation rate, decreased subcontracting costs, pyramid balancing, lower ESOP expenses, and currency tailwinds. Further, the company has been focusing on better realisation in new engagements and higher pricing in some renewals including COLA clause in new contracts.

Key conference call highlights

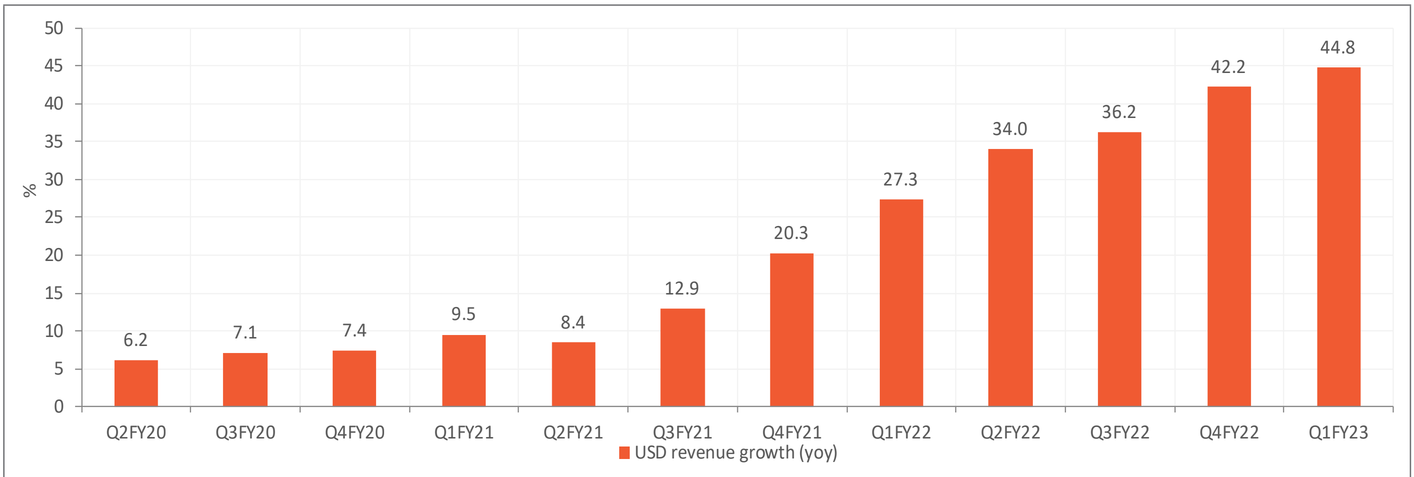
- **Strong order intake provides growth visibility:** The company has won deals across its verticals and total order booking stood at $394 million for Q1FY2023, up 9% q-o-q. This translates into book-to-bill of 1.6x. New business deal TCVs grew by 18% q-o-q to $230.3 million. Total deal ACV remained flat sequentially at $263 million. New business deal ACV grew slightly by 6.7% q-o-q to $139.8 million. The company's deal TCVs to deal ACVs improved to 1.5x in Q1FY2023 from 1.3x in Q1FY2022. During Q1FY2023, the company won a large deal of $50mn+ in Europe for a tenure of seven years.
- **Strong momentum in IT services continued:** IT services revenue growth accelerated to 55% y-o-y in Q1FY2023 from 52.3% y-o-y in Q4FY2022. Offshore linear revenue increased by 11.1% q-o-q, led by 9.3% q-o-q growth in volume and 1.6% q-o-q growth in billing rates. Onsite linear revenue grew by 17.5% q-o-q, led by 17.2% q-o-q growth in volume and 0.2% q-o-q growth in billing rates.
- **Robust growth across verticals:** The BFSI vertical grew strongly by 15.6% q-o-q and 58.4% y-o-y, given its strong execution. The software, hi-tech, and emerging industries vertical grew by 10% q-o-q and 37.9% y-o-y, led by incremental revenue contribution from MediaAgility's acquisition. Revenue of the healthcare and life sciences vertical grew 6.8% q-o-q and 40.5% y-o-y.
- **Broad-based growth across geographies:** All key geographies performed well in Q1FY2023. Growth of Europe business accelerated to 12.5% q-o-q in Q1FY2023 compared to 10.5% in Q4FY2022, while business growth in North America was 10.9% q-o-q. India business reported strong revenue growth of 14.2% q-o-q. Rest of world (RoW) business reported flat revenue growth on a q-o-q basis and 44.8% y-o-y in Q1FY2023.
- **Softness in top account due to lower royalty income:** Revenue from the top client fell 7.1% q-o-q, owing to lower royalty income. Revenue from the top-5 clients grew by 5.3% q-o-q, while revenue from the top-10 clients grew by 7.4% q-o-q. Revenue from the top 2-5 clients accelerated to 11.1% q-o-q. Revenue from the top-20 clients grew by 9.2% q-o-q, while revenue from the non-top-20 clients grew by 13.2% q-o-q.
- **Strong client addition continued:** The number of clients under $30 million+ bucket increased by 1 on q-o-q basis, while it added one client sequentially under its $10 million+ revenue bucket.
- **Lower utilisation, offshoring revenue, and stable attrition rate:** Utilisation during the quarter declined by 110 bps q-o-q to 79.5% in Q1FY2023. Offshoring revenue mix stayed flat sequentially at 56.5% in Q1FY2023. Attrition rate reduced to 24.8% in Q1FY2023 compared to 26.6% in Q4FY2022 despite continued strong demand and shortage of digital skills. Management believes attrition rate will moderate in the second half of FY2023 due to increased strong hiring of freshers across the industry in the past few quarters. The company added 1,950 fresh graduates who will become billable in the next 3-6 months.
- **Decline in sub-contract costs to revenue:** Subcontractor expenses declined to 13.9% of revenue versus 13.1% in Q4FY2022. Management believes subcontractor expenses would further reduce once travel restrictions ease out.
- **Strong net headcount addition, including employees from MediaAgility:** Headcount increased by 3,039 employees q-o-q versus net addition of 1,610/1,224 employees in Q4FY2022/Q1FY2022. This includes 545 employees from MediaAgility's acquisition. Net employee addition is 16.3% of total headcount in Q4FY2022, which indicates a strong underlying demand environment. Out of total net headcount additions, the company added 1,950 freshers during Q1FY2023, in-line with its strategy, who are expected to become billable in the next 3-4 months. The company plans to 1,350 freshers in Q2FY2023.
- **Capex:** Capex increased this quarter to Rs. 1,163 million because the company acquired a facility in Gurgaon.
- **Weak cash generation; DSO increased:** The company had cash and cash equivalents of Rs. 1,479 crore as of June 30, 2022, versus Rs. 1,737 crore as of March 31, 2022. DSO days increased by one day to 60 days as certain collections spilled over to the first week of July. OCF to EBITDA ratio declined to 20% due to spill-over of collection. Unbilled receivable days increased due to MediaAgility's acquisition.

Results (Consolidated) — Rs cr

Particulars	Q1FY23	Q1FY22	Q4FY22	Y-o-Y %	Q-o-Q %
Revenue ($ mn)	**241.5**	**166.8**	**217.3**	**44.8**	**11.1**
Net sales	**1,878.1**	**1,229.9**	**1,637.9**	**52.7**	**14.7**
Direct costs	1,243.3	817.3	1,085.9	52.1	14.5
SG&A	301.5	211.1	270.7	42.8	11.4
EBITDA	**333.3**	**201.5**	**281.2**	**65.4**	**18.5**
Depreciation and amortisation	64.5	35.0	51.1	84.3	26.2
EBIT	**268.8**	**166.5**	**230.0**	**61.4**	**16.8**
Forex gain/(loss)	4.2	10.9	12.0	-61.7	-65.2
Other income	8.9	25.6	25.1	-65.2	-64.5
PBT	**281.9**	**203.1**	**267.2**	**38.8**	**5.5**
Tax provision	70.3	51.8	66.2	35.6	6.1
Net profit	**211.6**	**151.2**	**201.0**	**39.9**	**5.3**
EPS (Rs.)	27.7	19.8	26.3	39.9	5.3
Margin (%)				**BPS**	**BPS**
EBITDA	17.7	16.4	17.2	136	58
EBIT	14.3	13.5	14.0	77	27
NPM	11.3	12.3	12.3	-103	-100
Tax rate	24.9	25.5	24.8	-59	15

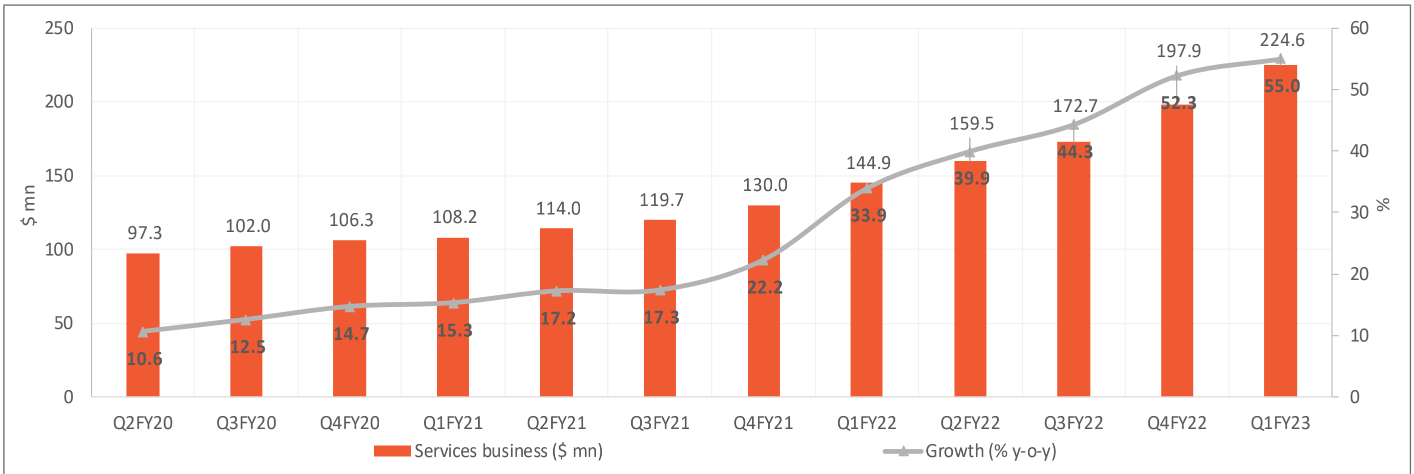
Source: Company; Sharekhan Research

USD revenue growth trend (y-o-y)



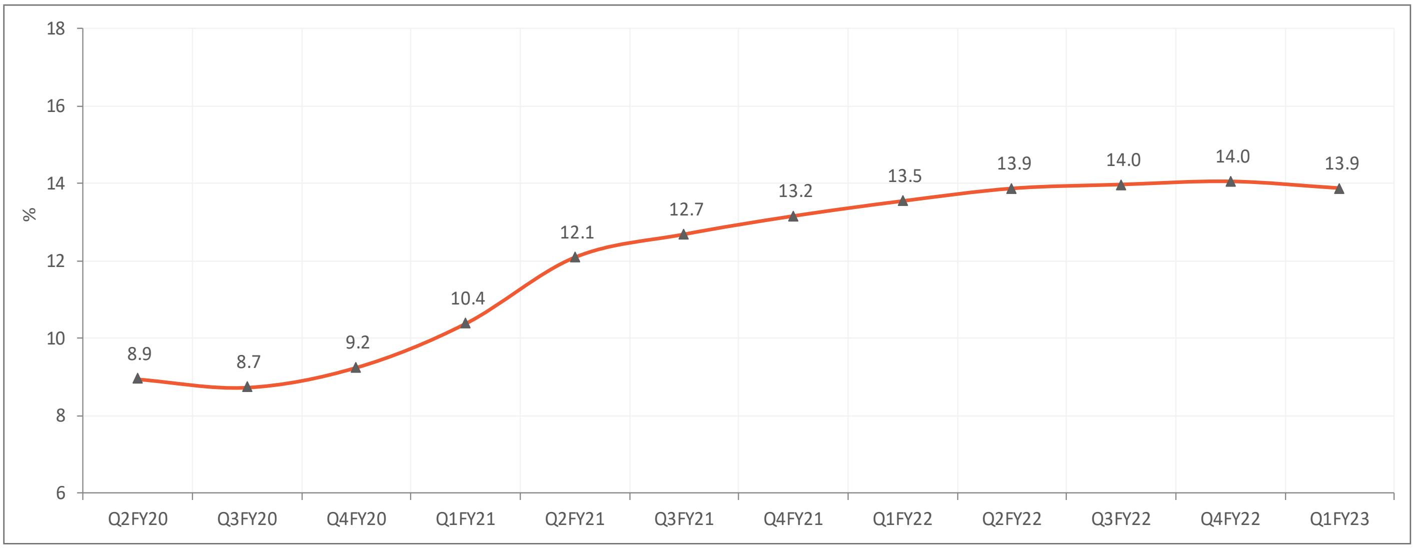
Source: Company, Sharekhan Research

Service business growth momentum remains strong (y-o-y)



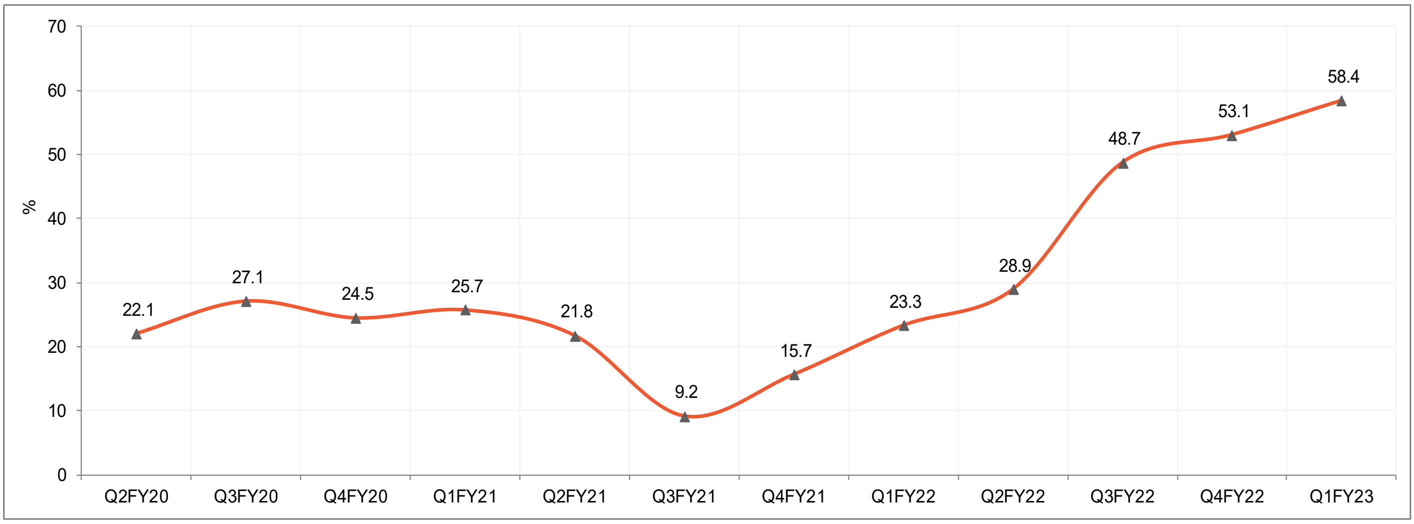
Source: Company, Sharekhan Research

EBIT margin trend (%)



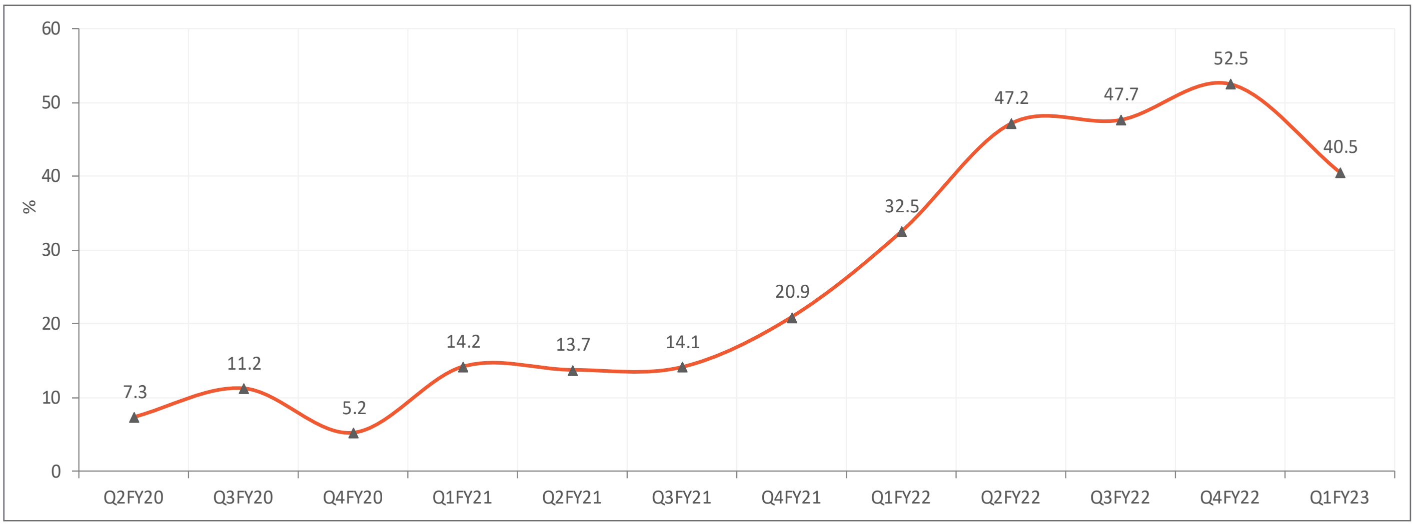
Source: Company, Sharekhan Research

BFSI revenue growth trend (y-o-y)



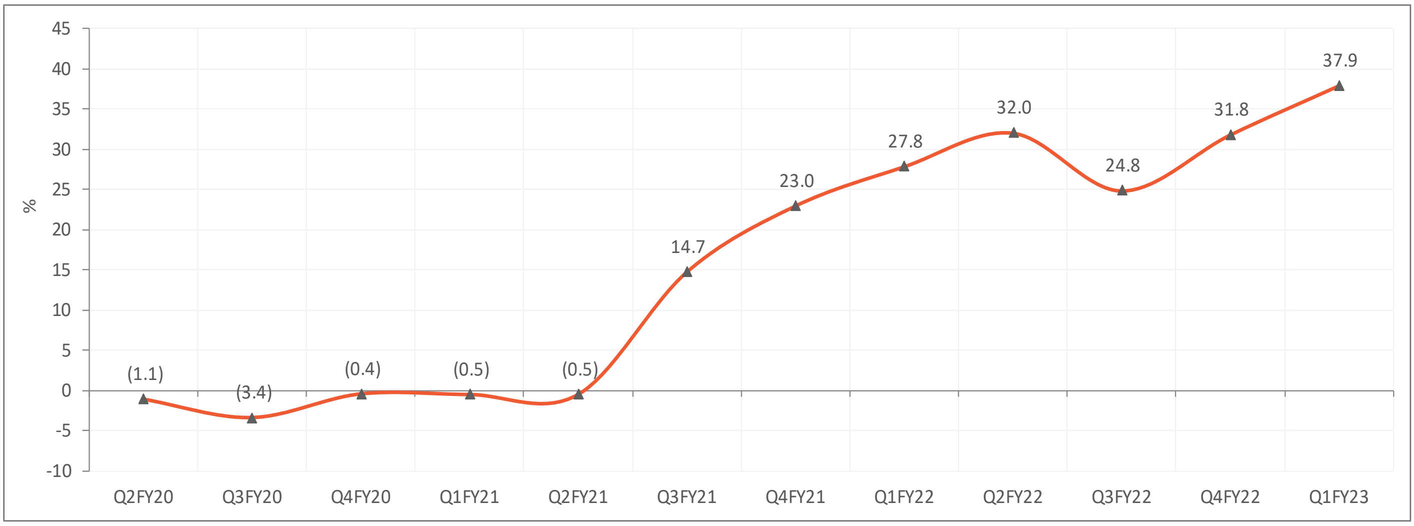
Source: Company, Sharekhan Research

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



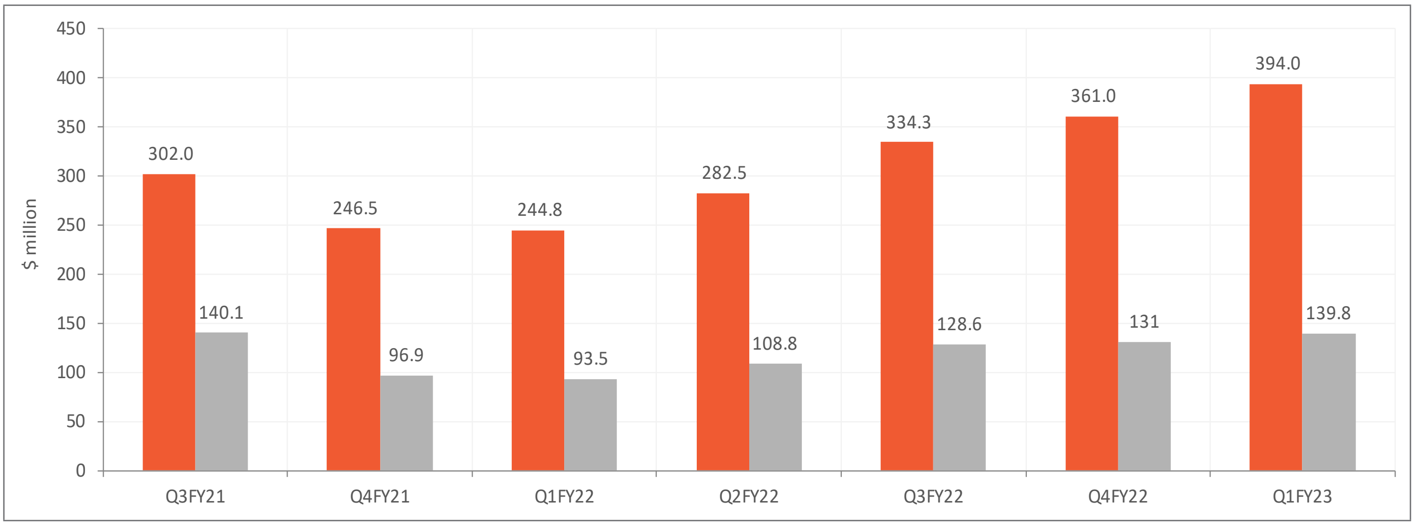
Source: Company, Sharekhan Research

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



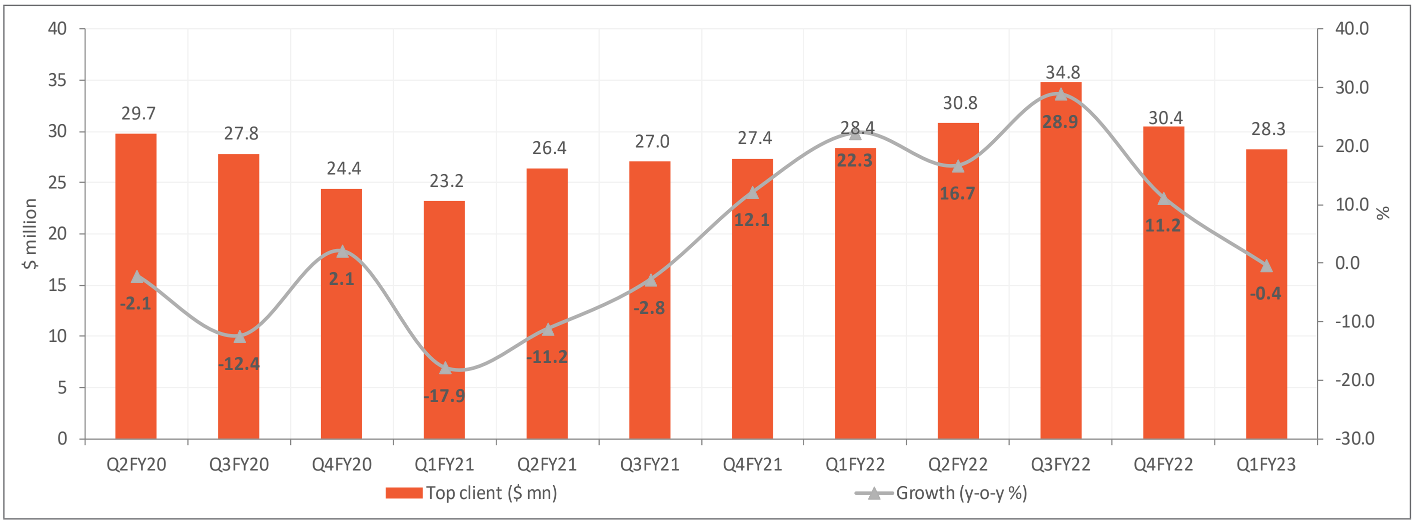
Source: Company, Sharekhan Research

Total deal TCV and new business ACV trend



Source: Company, Sharekhan Research

Top client ($ mn) and growth (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Expect acceleration in technology spending going forward

We believe the need for business continuity, operational resilience, and the switch to digital transactions have led to strong demand for IT services post the pandemic. Industry analysts such as Gartner estimate that IT services spending would grow by 8-8.5% in the next four years as compared to the average of 4.3% achieved over 2016-2020. Forecasts indicate higher demand for cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

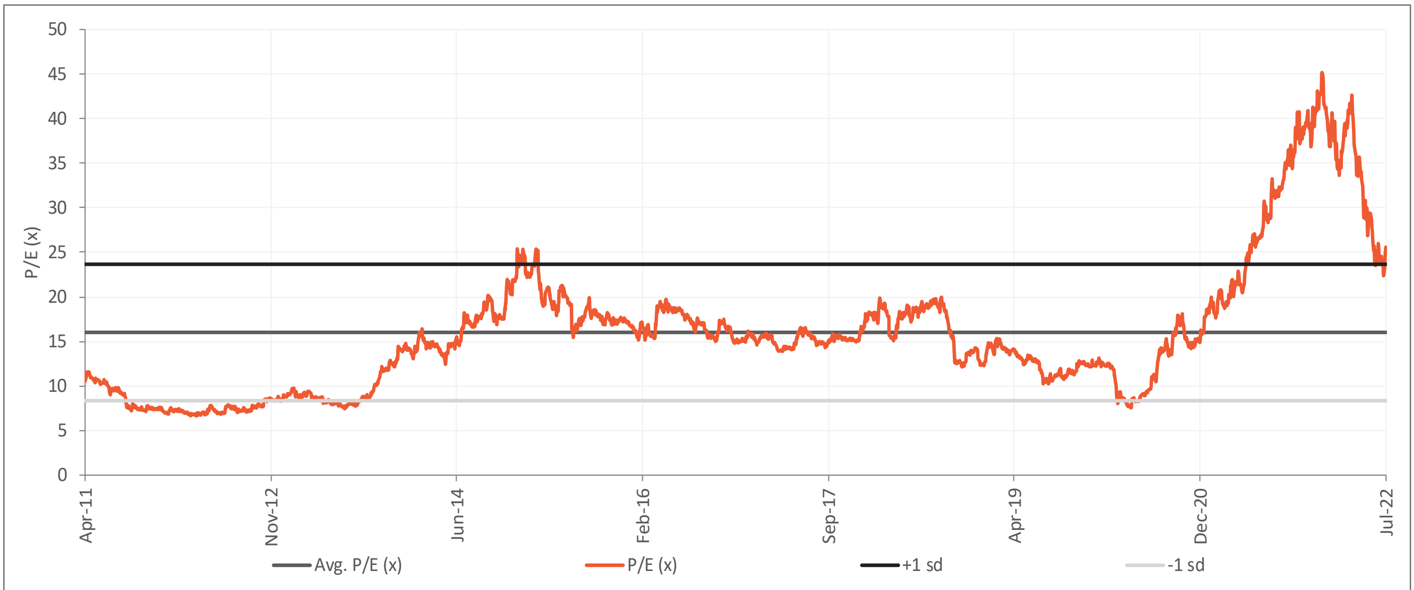
■ Company outlook – Well positioned to capture immense growth opportunity

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 industry-leading revenue growth in FY2023 on account of broad-based demand across verticals, robust deal intake, new logo additions, and incremental revenue from the acquired entities. 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 – Growth outlook intact

We believe PSL is well poised to deliver another year of industry-leading growth in FY2023 because of strong deal intake, sharpening focus on fast-growing verticals, capabilities to participate in both growth and cost-optimisation transformation initiatives, and potential synergies from recent acquisitions. Margin headwinds are expected to be absorbed by improving utilisation, reduction in subcontracting costs, pyramid balancing, and currency tailwinds. We expect USD revenue/earnings to report a CAGR of 27%/25% over FY2022-FY2024E. At the CMP, the stock trades at a valuation of 32x/26x its FY2023E/FY2024E earnings estimates. Hence, we retain our Buy rating on the stock with a revised PT of Rs. 4,300.

One-year forward P/E (x) band



Source: Company, Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
Coforge	3,732	6	22,734	28.3	22.9	16.0	13.3	6.8	5.8	26.4	27.3
L&T Infotech	4,505	18	78,976	28.9	25.6	20.0	18.3	9.0	7.1	31.1	35.1
Persistent Systems	3,631	8	27,752	31.7	25.6	20.1	16.0	7.1	6.1	24.1	25.6

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 RoW.

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 the 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	Kotak Mahindra Asset Management Company Limited	5.07
2	Kotak Mahindra Trustee	5.01
3	HDFC Asset Management Company Limited	3.89
4	PSPL ESOP Management Trust	3.14
5	Axis Asset Management Company Limited	2.83
6	Vanguard Group Inc	2.41
7	FundRock Management Co SA	1.81
8	L&T Mutual Fund Trustee Ltd	1.62
9	Nippon Life India Asset Management	1.62
10	Dimensional Fund Advisors	1.49

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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