Sharekhan
by BNP PARIBAS

Persistent Systems

Initial signs of recovery, upgrade to Buy

Sector: IT & ITES

Results Update

	Change
Reco: **Buy**	↑
CMP: **Rs. 601**	
Price Target: **Rs. 680**	↑

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 4,601 cr
52-week high/low:	Rs. 693/472
NSE volume: (No of shares)	1.0 lakh
BSE code:	533179
NSE code:	PERSISTENT
Sharekhan code:	PERSISTENT
Free float: (No of shares)	5.2 cr

Shareholding (%)

Promoters	31.9
FII	21.8
DII	24.7
Others	21.7

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	7.5	16.4	-3.0	8.2
Relative to Sensex	0.5	5.9	-7.0	-7.2

Sharekhan Research, Bloomberg

Persistent Systems Limited (PSL) delivered strong revenue growth (including revenue from inorganic initiatives) led by growth across segments, while EBIT margin disappointed us. Strong revenue performance was aided by a 9.7% q-o-q growth in IP-led revenues and a 7.7% q-o-q growth in the enterprise segment. Digital revenue regained growth momentum, rising by 3.5% q-o-q, which included additional revenue from inorganic initiatives. EBIT margin contracted by 86 bps q-o-q to 8.9%, owing to rebranding expenses, acquisition costs and wage revision. The management expects sustainable growth momentum in the coming quarters on the back of recent deal wins in the BFSI and healthcare verticals, opportunity in the IBM Alliance business, addition of new logos in the industrial domain and yields from structural changes in the sales team. Margins are expected to remain under pressure owing to higher spends on rebranding activities, net staff additions and investments in building capabilities, though the management believes that better utilisation rates and higher IP revenue are key levers for margin improvement.

Key positives

- Alliance business registered strong growth of 6.1% q-o-q; IP-led business grew 9.7% q-o-q after four consecutive weak quarters
- Revenue from top client and top 5 clients grew 5.4% q-o-q and 4.2% q-o-q, respectively.
- Net hiring remained strong - added 376 employees in Q2FY2020.

Key negatives

- ISV business revenue remained soft.
- EBIT margin further declined to 8.9% versus 9.8% and 12.4% in Q1FY2020 and Q2FY2019 respectively.

Our Call

Upgrade to Buy as valuations reasonable: We have fine-tuned our earnings estimates for FY2020E/FY2021E as operating numbers marginally missed estimates and owing to the management commentary on upcoming opportunity from IBM Alliance business. We expect growth trajectory in FY2020E to be better than FY2019 on account of recent deal wins, a healthy deal pipeline and robust hiring in the past four quarters. We see some initial signs of recovery and benefits from structural changes in the sales team. At current market price, the stock is trading at a reasonable valuation of 11x its FY2021E earnings, factoring in the anticipated soft performance in FY2020E. Further, high cash & cash equivalents (27% of market capitalisation) is expected to provide downside support to the stock price. Hence, we upgrade our rating from Hold to Buy on the stock with a revised PT of Rs. 680.

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 — **Rs cr**

Particulars	FY17	FY18	FY19	FY20E	FY21E
Revenue	2,878.4	3,033.7	3,365.9	3,582.5	3,852.7
OPM (%)	16.2	15.5	17.2	15.2	16.9
Adjusted PAT	312.9	323.1	351.7	372.8	417.5
% YoY growth	*5.2*	*3.3*	*8.8*	*6.0*	*12.0*
Adjusted EPS (Rs.)	39.1	40.4	44.0	48.6	54.6
P/E (x)	15.4	14.9	13.7	12.4	11.0
P/B (x)	2.5	2.3	2.0	1.9	1.7
EV/EBITDA (x)	9.1	8.7	7.4	7.1	5.6
RoNW (%)	17.6	16.0	15.7	15.3	15.8
RoCE (%)	22.9	20.9	21.4	20.2	21.0

Source: Company; Sharekhan Research

Strong revenue growth, margins meet our modest expectation

PSL reported slightly better-than-expected USD revenue in Q2FY2020 that grew strongly by 4.9% q-o-q (including revenue from the inorganic initiatives). This was due to broad-based growth across segments. The IBM Alliance and technology services verticals grew 6.1% q-o-q and 3.5% q-o-q respectively, while digital business revenue growth recovered to 3.5% q-o-q. IP-led revenue grew robustly by 9.7% q-o-q after muted performance n the last four consecutive quarters. IT services revenue grew by 3.6% q-o-q, led by a strong 7.7% q-o-q growth in the enterprise business, while ISV revenue growth remained flat (down 0.2% q-o-q). EBITDA margin contracted by 69 bps q-o-q to 13.8% in Q2FY2020, in line with our estimates, owing to wage revision, higher sales & marketing expenses and provision for impairment value of deposits in a troubled NBFC (Rs. 5 crore) that partially offset by growth in IP revenue, reduction in visa costs and margin rupee tailwinds. Net profit stood at Rs. 86.1 crore, 9% ahead of our estimates, aided by higher-than-expected forex gain.

Large deals to boost revenue growth, margin to remain under pressure

The management highlighted that strong growth in Q2FY2020 was primarily on account of strong implementation of projects and yields from the structural changes in sales & marketing. It also cited that use of success stories from existing clients and ongoing rebranding activities of Persistent Systems would help the company sell its services better. In addition, the company is sharply focusing on new large deals, developing the pipeline and converting it for sustainable growth momentum going ahead. The company has witnessed growth in the sizes of deal during the quarter. Net staff additions remained strong for last five quarters that implies possibilities of growth in coming quarters. Margins are expected to remain under pressure in coming quarters owing to rebranding activities and higher investment in building competencies, partially offset by improvement in operational efficiencies and higher IP revenue.

Key conference call highlights

- **Inorganic contribution in technology services:** Technology services revenue increased 3.5% q-o-q to $56.7 million, of which organic was 1.9% and inorganic (acquired Youperience) was 1.6%.
- **Segmental performance:** The BFSI vertical delivered strong growth of 7.6/22.1% q-o-q/y-o-y. The healthcare and lifesciences verticals saw revenue growth recover to 2.1% q-o-q (versus a decline of 2.5% in Q1FY2020). The company has won a three-year double-digit million dollar deal in the financial space during the quarter. In the healthcare and lifesciences space, the company won a multi-million dollar multi-year deal with a US based non-profit healthcare delivery system of providers.
- **Alliance business:** The Alliance business grew 6.1% q-o-q. The company had a 93% renewal rate on existing contracts in this business. The company has acquired 10 new logos in the industrial market during the quarter. The recent acquisition of Red Hat by IBM provides a growth opportunity.
- **Digital business:** Digital business revenue growth bounced back to 3.5% q-o-q after declining by 5.9% q-o-q in Q1FY2020. Revenue was driven by additional revenue from acquisition of Youperience during last quarter.
- **Exposure to a troubled NBFC:** Persistent has provided an additional amount of Rs. 5 crore during Q2FY2020, taking the total provision to Rs. 33.3 crore (77% of the total exposure) towards its investments in bonds of a troubled NBFC.
- **Top clients performance:** Revenue from the top client increased by 5.4% q-o-q. Revenue from top-5 and top-10 clients grew by 4.2% and 6.5% q-o-q respectively, respectively. Beyond the top-10 clients, revenue increased by 3.2% q-o-q.
- **Client metrics:** The number of clients under the $3 million+ category declined by 2% q-o-q to 20, while the number of clients under $1 million+ bucket remained flat during the quarter.

Results					Rs cr
Particulars	**Q2FY20**	**Q2FY19**	**Q1FY20**	**Y-o-Y (%)**	**Q-o-Q (%)**
Revenue ($ mn)	**125.5**	**118.2**	**119.6**	**6.2**	**4.9**
Net sales	884.6	835.6	832.1	5.9	6.3
Direct costs	577.3	541.0	543.4	6.7	6.2
SG&A	185.6	151.0	168.5	23.0	10.2
EBITDA	**121.6**	**143.6**	**120.2**	**-15.3**	**1.2**
Depreciation & amortisation	42.5	39.9	38.6	6.6	10.0
EBIT	**79.2**	**103.8**	**81.6**	**-23.7**	**-3.0**
Forex gain/(loss)	13.8	3.6	8.0	286.7	72.8
Other income	22.6	19.5	20.2	15.7	11.9
PBT	115.6	126.9	109.8	-8.9	5.3
Tax provision	29.5	38.7	27.3	-23.9	8.1
Net profit	**86.1**	**88.1**	**82.5**	**-2.3**	**4.4**
EPS (Rs)	11.3	11.0	10.7	2.2	5.7
Margin (%)				**BPS**	**BPS**
EBITDA	13.8	17.2	14.4	-344	-69
EBIT	8.9	12.4	9.8	-347	-86
NPM	9.7	10.5	9.9	-82	-18

Source: Company; Sharekhan Research

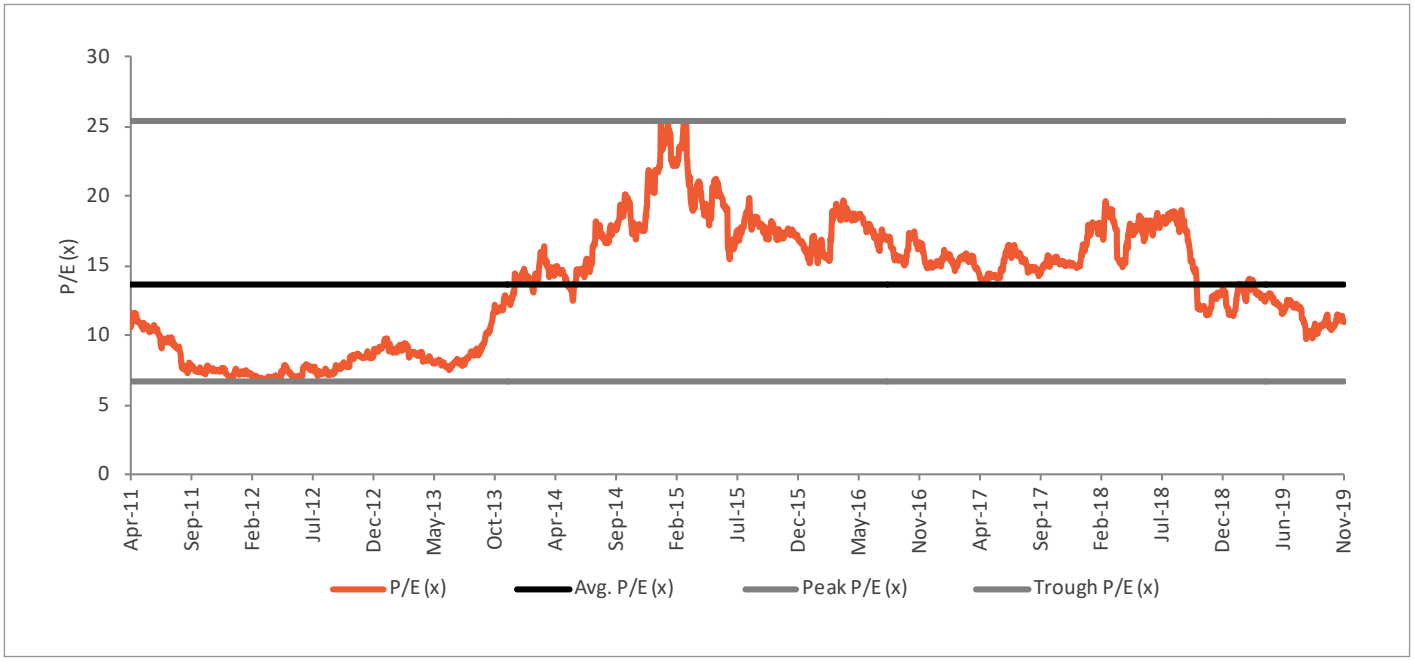
Outlook

Social, mobility, cloud, analytics and IoT are estimated to account for more than 20% of the IT sector's revenue in 2020. Further, NASSCOM estimates the Indian digital industry to be worth $225 billion in FY2020. 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. Though large exposure to its major clients (IBM) is a risk, the newly-appointed CEO highlighted that the company would de-risk the IBM relationship by balancing the large client portfolio with industrial sector focus. Further, the company's leadership in outsourced product development (OPD), elongated client relationships and being an end-to-end service provider and partner in the clients' journey would help the company to make most of the opportunity.

Valuation

Valuation – Upgrade to Buy as valuations reasonable: We have fine-tuned our earnings estimates for FY2020E/FY2021E as operating numbers marginally missed estimates and owing to the management commentary on upcoming opportunity from IBM Alliance business. We expect growth trajectory in FY2020E to be better than FY2019 on account of recent deal wins, a healthy deal pipeline and robust hiring in the past four quarters. We see some initial signs of recovery and benefits from structural changes in the sales team. At current market price, the stock is trading at a reasonable valuation of 11x its FY2021E earnings, factoring in the anticipated soft performance in FY2020E. Further, high cash & cash equivalents (27% of market capitalisation) is expected to provide downside support to the stock price. Hence, we upgrade our rating from Hold to Buy on the stock with a revised PT of Rs. 680.

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 (%)	
				FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
LTI	1,640	17	28,459	19.1	16.6	13.5	11.5	4.8	4.1	27.8	28.0
LTTS	1,459	10	15,177	19.5	16.9	12.6	10.1	4.9	3.9	28.2	26.1
Mastek	328	2	786	7.5	6.4	4.5	3.4	1.0	0.9	14.6	15.2
PSL	601	8	4,601	12.4	11.0	7.1	5.6	1.9	1.7	15.3	15.8

Source: Company, Sharekhan Research

About company

Incorporated in 1990, Persistent Systems Ltd (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 is focusing on developing Internet of Things (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 initiative and IT spends are moving from ISV to enterprise model. PSL has restructured its business and aligned its sales resources to capitalise the benefits from the clients' digital transformation journey. The alliance with IBM and investments in new-age technologies (IoT, Blockchain, artificial learning and machine learning) are expected to help the company capture opportunities from these spends.

Key Risks

1) Any slowdown in non-IoT revenue; 2) hostile regulatory development against current VISA regime; 3) delay in product launches and traction from clients in Accelerite; 4) stronger Indian rupee and/or adverse cross-currency movements; 5) margin dilution from M&A activity; and 6) high client concentration (around 23%+ revenue comes from IBM) could affect revenue growth.

Additional Data

Key management personnel

Dr. Anand Deshpande	Founder, Chairman and MD
Christopher O'Connor	Chief Executive Officer (CEO)
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	Anand Deshpande	29.90
2	HDFC Asset Management Company Limited	4.91
3	Nitin Kulkarni	4.48
4	L&T Mutual Fund Trustee Limited	4.45
5	Government Pension Fund (Global)	3.29
6	Norges Bank Investment Management	3.08
7	PSPL ESOP management trust	2.86
8	UPADHYE NARASINHA	2.82
9	Saif India V FII Holding Limited	2.68
10	PPFAS Asset Management	2.25

Source: Bloomberg

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