

**SELL**

TP: Rs 840 | ▼ 29%

**PERSISTENT SYSTEMS**

| IT Services

| 26 October 2020

## IP revenues volatile; retain SELL

**Persistent Systems (PSYS) reported 3.9% QoQ dollar revenue growth, led by the services segment (+5.4% QoQ). IP business remained volatile due to a dip in reseller revenues. Alliance business saw continued YoY weakness. EBIT margin at 12.1% was up 170bps QoQ. We raise FY21 EPS by 7% baking in the Q2 performance and keep FY22/FY23 estimates largely unaltered. Rolling valuations over, we have an unchanged Sep'21 TP of Rs 840 with 13.5x target PE. Given IP revenue volatility and heady valuations, we retain SELL.**

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**IP revenues decline:** PSYS reported 3.9% QoQ USD growth in Q2, slightly ahead of our 3.1% estimate. IP revenue declined 3.3% while services grew 5.4%. IP revenue was volatile due to seasonality and a dip in reseller business (royalty revenue held strong). Top client concentration increased 13.8% QoQ. Europe business remained weak with a 22.6% decline. BFSI/healthcare/tech-emerging verticals grew 4.2%/1.8%/4.5% QoQ. Operating margin was up 170bps QoQ to 12.1% (11.1% est.) due to increased offshoring and reduced employee costs. PSYS plans to implement salary hikes starting Nov'20.

Ticker/Price	PSYS IN/Rs 1,189
Market cap	US\$ 1.3bn
Shares o/s	80mn
3M ADV	US\$ 4.0mn
52wk high/low	Rs 1,391/Rs 420
Promoter/FPI/DII	30%/26%/44%

Source: NSE

**Healthy deal wins:** The deal pipeline looks healthy going into FY21 with several multimillion-dollar engagements across the BFSI, healthcare, hi-tech and industrial verticals. PSYS won a KYC-supporting deal in BFSI, an application modernisation deal leveraging cloud from a US-based pharma company, and a multimillion, multiyear deal with a global media player.

## STOCK PERFORMANCE



Source: NSE

**Upbeat management outlook:** Management stated that digital projects continued their momentum in Q2, the Alliance segment pipeline has increased, and revenue from the Capiot acquisition will flow through starting Q3FY21. PSYS is also positive regarding opportunities emerging from IBM's split into two separate companies.

## KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	33,659	35,658	41,106	46,363	51,422
EBITDA (Rs mn)	5,805	4,930	6,722	7,794	8,880
Adj. net profit (Rs mn)	3,516	3,403	3,991	4,479	5,227
Adj. EPS (Rs)	43.9	42.7	50.0	56.2	65.5
Adj. EPS growth (%)	8.8	(2.9)	17.3	12.3	16.7
Adj. ROAE (%)	15.7	14.1	15.3	15.6	16.4
Adj. P/E (x)	27.1	27.9	23.8	21.2	18.2
EV/EBITDA (x)	16.1	18.9	13.9	11.9	10.2

Source: Company, BOBCAPS Research

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## Other highlights

- Sandeep Kalra has been appointed CEO at PSYS after Christopher O'Connor's resignation. He will hold office for a period of five years. Sandeep joined the company in May'19 from Harman Connected Services (a Samsung company) and has experience in outsourced product development and IT services. He has also handled key leadership roles during his tenure at HCL Tech.
- In Oct'20, PSYS' top client IBM split into two companies to focus more on its higher margin businesses such as cloud computing and artificial intelligence. A new company focusing solely on legacy IT business will be spun off in 2021. Management is positive regarding opportunities arising from this event.
- PSYS acquired US based Capiot (FY20 revenue ~US\$ 6.3mn) this month, which will help increase its salesforce ecosystem capabilities. Capiot specialises in enterprise integration with expertise in Red Hat. Management intends to continue looking for more inorganic opportunities.
- PSYS' revenue crossed the Rs 10bn milestone this quarter.
- DSO improved from 69 to 63 days due to improved collection from clients.

**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
<b>Revenue (US\$ mn)</b>	<b>136.1</b>	<b>125.5</b>	<b>8.4</b>	<b>131.0</b>	<b>3.9</b>
<b>Revenue (Rs mn)</b>	<b>10,077</b>	<b>8,846</b>	<b>13.9</b>	<b>9,914</b>	<b>1.7</b>
Operating Expenditure	8,420	7,630	10.4	8,449	(0.4)
Cost of revenues	6,577	5,773	13.9	6,646	(1.0)
as % of sales	65.3	65.3	-	67.0	-
SG&A expenses	1,843	1,856	(0.7)	1,803	2.2
as % of sales	18.3	21.0	-	18.2	-
EBITDA	1,658	1,216	36.3	1,464	13.2
Depreciation	440	425	3.5	436	1.0
<b>EBIT</b>	<b>1,218</b>	<b>792</b>	<b>53.9</b>	<b>1,029</b>	<b>18.4</b>
Other Income	157	364	-	192	-
PBT	1,375	1,156	19.0	1,220	12.7
Total Tax	355	295	20.5	320	10.9
<b>Adjusted PAT</b>	<b>1,020</b>	<b>861</b>	<b>18.5</b>	<b>900</b>	<b>13.3</b>
(Profit)/loss from JV's/Ass/MI	-	-	-	-	-
APAT after MI	1,020	861	18.5	900	13.3
Extra ordinary items	0	0	-	0	-
Reported PAT	1,020	861	18.5	900	13.3
Reported EPS	12.7	10.8	18.5	11.3	13.3

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
<b>Margins (%)</b>			<b>(bps)</b>		<b>(bps)</b>
EBITDA	16.4	13.8	270	14.8	168
EBIT	12.1	8.9	314	10.4	171
EBT	13.6	13.1	58	12.3	134
PAT	10.1	9.7	39	9.1	104
Effective Tax rate	25.8	25.5	31	26.2	(42)

Source: BOBCAPS Research

## FIG 2 – OPERATING METRICS

(in US\$ terms)	Q2FY21 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
<b>Revenue by Geography</b>			
North America	82.9	7.1	10.4
Europe	7.6	(22.6)	(16.8)
India, APAC	9.3	3.9	15.9
<b>Client Concentration</b>			
Top Client	19.4	13.8	(18.1)
Top 5 Clients	41.6	5.9	(6.1)
Top 10 Clients	50.5	7.0	(5.4)
Non-Top 10 Clients	49.5	1.9	6.2

	Q2FY21	Q1FY21	Q2FY20
<b>Onsite- Offshore mix (%)</b>			
Onsite	33.1	33.7	31.0
Offshore	50.7	48.9	46.5
IP-led	16.2	17.4	22.5
<b>Headcount</b>	<b>10,820</b>	<b>10,829</b>	<b>10,543</b>

Source: BOBCAPS Research

### Valuation methodology

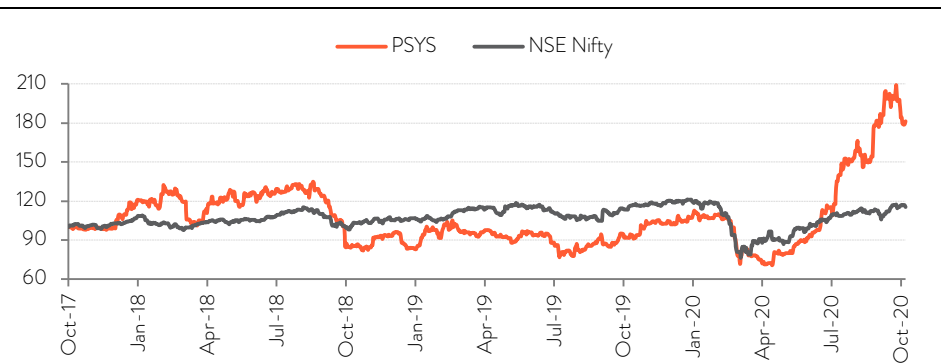
We raise our FY21 EPS estimate by 7% based on a resilient operating performance in Q2FY21 while keeping FY22/FY23 estimates largely unaltered. Rolling valuations forward, we have an unchanged Sep'21 target price of Rs 840 set at one year forward PE of 13.5x. Overall, we stay wary of (1) volatility in the IP segment, (2) the project-based nature of revenues and lack of annuity, and (3) a delayed pivot to 'enterprise', leading to weak domain expertise compared to other mid-tier peers. The stock is trading at 23.1x/19.7x FY21E/FY22E EPS, which looks rich in our view. Reiterate SELL.

**FIG 3 – REVISED ESTIMATES**

(Rs mn)	FY21E			FY22E			FY23E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	539.9	545.8	1.1	598.8	594.4	(0.7)	663.7	659.3	(0.7)
YoY growth (%)	7.6	8.8	-	10.9	8.9	-	10.8	10.9	-
Revenues	41,190	41,106	(0.2)	46,708	46,363	(0.7)	51,767	51,422	(0.7)
EBITDA	6,513	6,722	3.2	7,809	7,794	(0.2)	8,901	8,880	(0.2)
EBITDA margins (%)	15.8	16.4	-	16.7	16.8	-	17.2	17.3	-
Net profits	3,715	3,991	7.4	4,486	4,479	(0.1)	5,237	5,227	(0.2)
EPS (Rs)	46.6	50.0	7.4	56.2	56.2	(0.1)	65.7	65.5	(0.2)

Source: BOBCAPS Research

**FIG 4 – RELATIVE STOCK PERFORMANCE**



Source: NSE

### Key risks

Upside risks to our estimates include:

- above-expected operating margin improvement, and
- increased consistency in IP-led business.

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Total revenue</b>	<b>33,659</b>	<b>35,658</b>	<b>41,106</b>	<b>46,363</b>	<b>51,422</b>
EBITDA	5,805	4,930	6,722	7,794	8,880
Depreciation	1,573	1,660	1,798	1,991	2,192
EBIT	4,232	3,270	4,924	5,803	6,688
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	631	1,254	548	418	572
Exceptional items	0	0	0	0	0
EBT	4,863	4,523	5,471	6,222	7,260
Income taxes	1,347	1,121	1,481	1,742	2,033
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>3,516</b>	<b>3,403</b>	<b>3,991</b>	<b>4,479</b>	<b>5,227</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>3,516</b>	<b>3,403</b>	<b>3,991</b>	<b>4,479</b>	<b>5,227</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	0	0	0	0	0
Other current liabilities	3,158	3,810	4,392	4,954	5,494
Provisions	1,939	1,954	2,252	2,540	2,818
Debt funds	12	12	12	12	12
Other liabilities	0	0	0	0	0
Equity capital	791	791	791	791	791
Reserves & surplus	22,656	24,002	26,552	29,414	32,754
Shareholders' fund	23,447	24,793	27,343	30,205	33,545
<b>Total liabilities and equities</b>	<b>28,556</b>	<b>30,569</b>	<b>33,999</b>	<b>37,711</b>	<b>41,869</b>
Cash and cash eq.	1,739	1,461	3,373	5,770	8,875
Accounts receivables	4,923	5,862	6,757	7,621	8,453
Inventories	0	0	0	0	0
Other current assets	3,861	5,373	6,194	6,986	7,749
Investments	13,304	13,304	13,304	13,304	13,304
Net fixed assets	4,242	4,083	3,885	3,544	3,002
CWIP	316	316	316	316	316
Intangible assets	81	81	81	81	81
Deferred tax assets, net	405	405	405	405	405
Other assets	0	0	0	0	0
<b>Total assets</b>	<b>28,556</b>	<b>30,569</b>	<b>33,999</b>	<b>37,711</b>	<b>41,869</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	5,031	5,063	5,788	6,470	7,419
Interest expenses	(285)	(1,254)	(548)	(418)	(572)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(290)	(1,784)	(836)	(807)	(776)
Other operating cash flows	(135)	0	0	0	0
<b>Cash flow from operations</b>	<b>4,321</b>	<b>2,025</b>	<b>4,405</b>	<b>5,245</b>	<b>6,071</b>
Capital expenditures	(374)	(1,500)	(1,600)	(1,650)	(1,650)
Change in investments	1,472	0	0	0	0
Other investing cash flows	(3,428)	1,254	548	418	572
<b>Cash flow from investing</b>	<b>(2,330)</b>	<b>(247)</b>	<b>(1,052)</b>	<b>(1,232)</b>	<b>(1,078)</b>
Equities issued/Others	0	(828)	0	0	0
Debt raised/repaid	(5)	0	0	0	0
Interest expenses	(713)	0	0	0	0
Dividends paid	(879)	(1,229)	(1,441)	(1,617)	(1,887)
Other financing cash flows	0	0	0	0	0
<b>Cash flow from financing</b>	<b>(1,596)</b>	<b>(2,057)</b>	<b>(1,441)</b>	<b>(1,617)</b>	<b>(1,887)</b>
<b>Changes in cash and cash eq.</b>	<b>394</b>	<b>(278)</b>	<b>1,912</b>	<b>2,396</b>	<b>3,106</b>
<b>Closing cash and cash eq.</b>	<b>1,740</b>	<b>1,461</b>	<b>3,373</b>	<b>5,770</b>	<b>8,875</b>

**Per Share**

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	43.9	42.7	50.0	56.2	65.5
Adjusted EPS	43.9	42.7	50.0	56.2	65.5
Dividend per share	13.2	12.8	15.0	16.8	19.7
Book value per share	293.0	310.8	342.8	378.7	420.5

**Valuations Ratios**

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	2.8	2.6	2.3	2.0	1.8
EV/EBITDA	16.1	18.9	13.9	11.9	10.2
Adjusted P/E	27.1	27.9	23.8	21.2	18.2
P/BV	4.1	3.8	3.5	3.1	2.8

**DuPont Analysis**

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	72.3	75.2	72.9	72.0	72.0
Interest burden (PBT/EBIT)	114.9	138.3	111.1	107.2	108.6
EBIT margin (EBIT/Revenue)	12.6	9.2	12.0	12.5	13.0
Asset turnover (Revenue/Avg TA)	122.1	120.6	127.3	129.3	129.2
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.2
Adjusted ROAE	15.7	14.1	15.3	15.6	16.4

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**Ratio Analysis**

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
<b>YoY growth (%)</b>					
Revenue	10.9	5.9	15.3	12.8	10.9
EBITDA	23.8	(15.1)	36.4	16.0	13.9
Adjusted EPS	8.8	(2.9)	17.3	12.3	16.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	17.2	13.8	16.4	16.8	17.3
EBIT margin	12.6	9.2	12.0	12.5	13.0
Adjusted profit margin	10.4	9.5	9.7	9.7	10.2
Adjusted ROAE	15.7	14.1	15.3	15.6	16.4
ROCE	15.0	10.9	15.2	17.3	19.6
<b>Working capital days (days)</b>					
Receivables	53	55	56	57	57
Inventory	0	0	0	0	0
Payables	42	41	44	44	45
<b>Ratios (x)</b>					
Gross asset turnover	7.2	8.6	10.3	12.5	15.7
Current ratio	2.1	2.2	2.5	2.7	3.0
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.1)	(0.1)	(0.1)	(0.2)	(0.3)

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

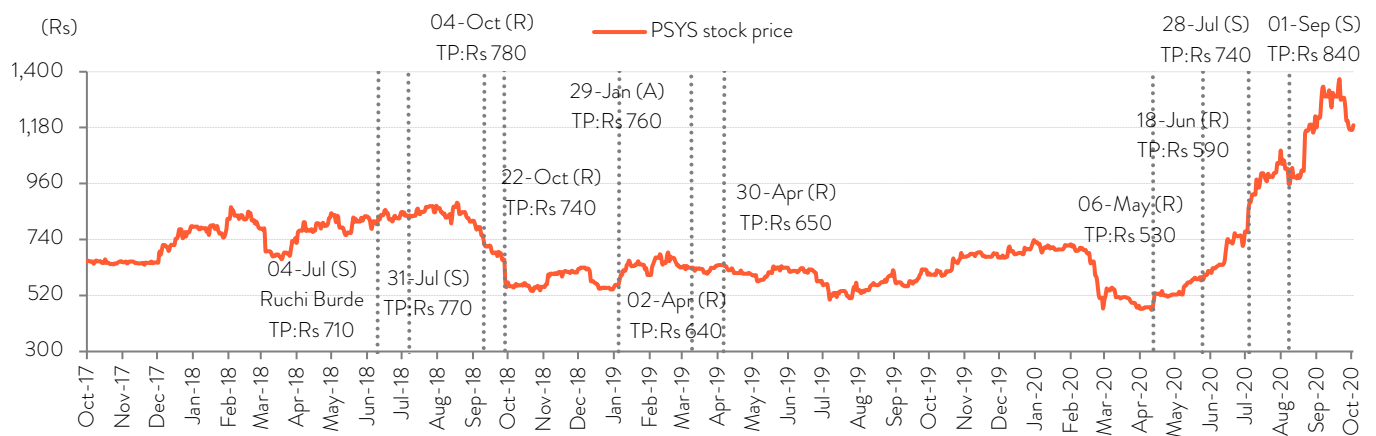
**ADD** – Expected return from >+5% to +15%

**REDUCE** – Expected return from -5% to +5%

**SELL** – Expected return <-5%

**Note:** Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

### RATINGS AND TARGET PRICE (3-YEAR HISTORY): PERSISTENT SYSTEMS (PSYS IN)



B – Buy, A – Add, R – Reduce, S – Sell

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