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PERSISTENT SYSTEMS | IT Services | 19 July 2024

Worry around true underlying margin

- **Good revenue growth QoQ. Partly helped by passthrough items and delivery shift to onsite**
- **The big discussion point has been around one-offs in 1Q which helped PSYS hit the 14% EBIT margin number**
- **Company reiterated industry-leading revenue growth in FY25 and flat margins vs FY24 (14.4%)**

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Better-than-expected revenue growth: The company's revenue grew QoQ constant currency (CC) to 5.6% compared to the 5% it anticipated for 1QFY25. EBIT margin at 14% was in line with management's expectations. The street anticipated only about 3-3.5% QoQ growth until very recently.

Revenue growth supported by pass through items and delivery mix shift onsite: While there was no discussion on the call, there was a 160bps increase in passthrough (software support charges) which would have inflated the QoQ revenue growth number too. The QoQ revenue growth has also been supported, to an extent, by a shift in delivery mix towards onsite.

Healthcare and Life Sciences drive revenue growth: Revenue growth in the quarter was driven by the strong performance of the Healthcare and Life Sciences (HC & LS) vertical. In fact, HC & LS has been growing at a mid-teen rate QoQ for the last three quarters and has been essentially driving revenue growth for PSYS. PSYS indicated that the HC & LS growth was broad-based due to multiple clients and would continue. The banking, financial services & insurance (BFSI) vertical grew by 6% QoQ in USD terms. Management said that in the foreseeable future growth would be led by Healthcare and Life Sciences, followed by BFSI and High-Tech. In 1QFY25, BFSI also drove part of QoQ growth. The Hi-Tech vertical has been showing weak performance for the last three quarters.

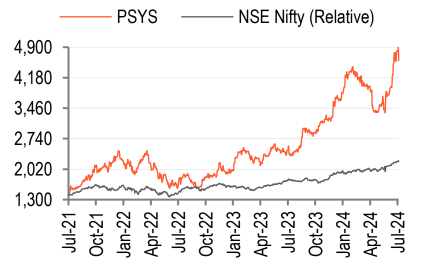
BFSI vertical springs new business: BFSI has done well for PSYS as it won new deals from existing clients and business from new clients by dislodging incumbents, including some of the larger ones. The wins are because of fresh thinking and a platform-based approach to execution.

Reiterates revenue goal for FY27: PSYS reiterated its revenue goal of hitting US$ 2bn by FY27 (including inorganic elements) with an EBIT margin which would be around 17-18% by then.

Ticker/Price	PSYS IN/Rs 4,583
Market cap	US$ 4.2bn
Free float	70%
3M ADV	US$ 32.0mn
52wk high/low	Rs 4,929/Rs 2,317
Promoter/FPI/DII	30%/26%/44%

Source: NSE | Price as of 19 Jul 2024

Stock performance



Source: NSE

- The stock price was down ~6.5% in today's market largely due to concerns around the true underlying EBIT margin excluding the one-offs. The 50bps drop QoQ was due to the collective headwind of ~340bps, partially offset by a collective tailwind of ~290bps. The headwind items included 210bps from subcontractor costs, 60bps from visa cost and 70bps from higher SGA. Tailwinds included higher utilisation (90bps), operating efficiencies (90bps), reversal of earn outs (60bps), change in depreciation policy (40bps) and net impact of employee benefit rationalisation (10bps).
- EBIT margin has been partly impacted by higher subcontractor costs which hit a historical high of 15.4% in 1QFY25 compared to 14.1% in 4QFY24 and 10.2% in 1QFY24. It has risen steeply for the last three quarters now. PSYS said that the usage of subcontractors was necessary to capture growth, and, at an appropriate time, they would be replaced by PSYS's own employees which would drive margin expansion.
- PSYS maintained its aspiration to deliver industry-leading growth in FY25, with full-year EBIT margin in line with that of FY24 (14.4%)
- The company continued to report strong order inflow with total contract value (TCV) coming in higher at ~US$ 463mn which was the third best in its history. The net new average contract value (ACV) was the highest ever at US$ 198mn. The TTM net new ACV grew by 26%.
- PSYS raised salaries starting 1 July 2024 which would put pressure on its margins by 150-200bps QoQ in 2QFY25. However, it indicated that much of this would be countered by productivity improvements and operating leverage. PSYS instituted a cost optimisation programme in 1QFY25. Some of the benefits were achieved in 1Q, but PSYS believes the larger benefits will come in subsequent quarters.
- PSYS stated that a high 4QFY25 exit margin will help bring overall FY25 margins closer to that of FY24.
- As it increases in size, PSYS has been trying to play the game of Tier-1 IT services players by bidding for large-sized 'cost take-out' contracts. These typically involve dislodging an existing larger-sized vendor and would require the commitment of saving costs for the customer. This would entail two to three quarters of transition costs which would adversely impact PSYS's margins.
- On the overall market environment, Mr Sandeep Kalra, CEO, stated that the strong growth was due to a small turn in sentiment and more because of proactive proposals from its side, which were bringing value, platform-based solutions, and more, to its customers.

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