

**SELL**

TP: Rs 740 | ▼ 14%

**PERSISTENT SYSTEMS**

| IT Services

| 28 July 2020

## Good quarter but valuations rich; downgrade to SELL

**Persistent Systems (PSYS) reported a surprisingly strong set of numbers, with Q1 dollar revenue growth at 3.1% QoQ. Both the IP-led and services businesses grew QoQ. Operating margin at 10.4% was up 164bps QoQ. We increase FY21/FY22 EPS by 23%/7% and raise our target P/E to 12.5x (vs. 11.3x) to bake in a better revenue and margin outlook. Rolling valuations over, we have a revised Jun'21 TP of Rs 740 (vs. Rs 590). Given IP revenue volatility and heady valuations post a 37% rally in the last one month, we downgrade the stock from REDUCE to SELL.**

Ruchi Burde | Seema Nayak

research@bobcaps.in

**Strong traction in IP business:** Despite Covid-19 challenges, PSYS' Q1FY21 revenue grew 3.1% QoQ vs. an expected decline of 4.8%. Outperformance was driven by recovery in both services/IP-led revenues which grew 1.8%/9.8% QoQ. Alliance business increased 6.6% as well. Improved traction in the reseller business (due to partnership with IBM 'Cloud Pak') aided a strong IP showing, while royalty revenues were steady sequentially. Management indicated success in bundling services along with most reseller deals. EBIT margin stood at 10.4% vs. 8.3% estimated, with a 180bps decline in SGA as a percentage of revenue.

**Healthy deal wins:** The deal pipeline looks healthy going into FY21 with several multimillion-dollar engagements across the BFSI, healthcare and technology verticals. PSYS won a vendor consolidation deal in BFSI, a multimillion-dollar contract from a US-based healthcare provider, and a US\$ 50mn data virtualization deal with a software company.

**Promising Q2 outlook:** Digital and cloud-related projects gained momentum in Q1FY21. IP business is looking up due to improved engagement with IBM. Management maintains a cautiously positive growth and margin outlook and expects margin recovery from here on led by declining pricing discounts and lower subcontracting costs.

Ticker/Price	PSYS IN/Rs 856
Market cap	US\$ 915.3mn
Shares o/s	80mn
3M ADV	US\$ 1.5mn
52wk high/low	Rs 919/Rs 420
Promoter/FPI/DII	30%/26%/44%

Source: NSE

## STOCK PERFORMANCE



Source: NSE

## KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	33,659	35,658	41,190	46,708	51,767
EBITDA (Rs mn)	5,805	4,930	6,513	7,809	8,901
Adj. net profit (Rs mn)	3,516	3,403	3,715	4,486	5,237
Adj. EPS (Rs)	43.9	42.7	46.6	56.2	65.7
Adj. EPS growth (%)	8.8	(2.9)	9.2	20.8	16.7
Adj. ROAE (%)	15.7	14.1	14.3	15.7	16.5
Adj. P/E (x)	19.5	20.1	18.4	15.2	13.0
EV/EBITDA (x)	11.5	13.5	10.3	8.5	7.2

Source: Company, BOBCAPS Research

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## Other highlights

- Increased marketing efforts with top client IBM led to a renewed pipeline. Under a collaborative model, PSYS has started a new IBM Cloud Pak deployment practice to help organizations migrate and modernize IBM workloads across all cloud environments, including IBM public cloud and IBM cloud services. The reseller business saw renewed traction while royalty revenues were steady QoQ. PSYS is also working towards upgrading IBM's products with Red Hat technology included in its core.
- Operating margin stood at 11.1% excluding Covid-19 donations and at 10.4% (+164bps QoQ) post-donation. PSYS has committed Rs 250mn as donations for Covid-19 relief, with 33% of it expended in Q1. Headwinds from pricing discounts, deal ramp-downs and higher subcontractor costs were offset by 110bps of tailwinds from currency depreciation. Margins are expected to improve as pricing discounts and subcontractor costs normalise.
- PSYS has taken a US\$ 0.65mn provision for bad debts on account of stressed customers affected by Covid-19.
- DSOs increased to 69 from 65 in Q4FY20 due to spillover of collection from a large client into Q2 and the Covid-related impact. DSOs are expected to revert to ~65-day levels within a few quarters.

### FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)	FY20	FY19	YoY (%)
<b>Revenue (US\$ mn)</b>	<b>131.0</b>	<b>119.6</b>	<b>9.5</b>	<b>127.1</b>	<b>3.1</b>	<b>506</b>	<b>481</b>	<b>5.1</b>
<b>Revenue (Rs mn)</b>	<b>9,914</b>	<b>8,321</b>	<b>19.1</b>	<b>9,264</b>	<b>7.0</b>	<b>36,308</b>	<b>33,659</b>	<b>7.9</b>
Operating Expenditure	8,449	7,119	18.7	7,987	5.8	31,191	27,854	12.0
Cost of revenues	6,646	5,434	22.3	6,130	8.4	24,011	21,378	12.3
as % of sales	67.0	65.3	-	66.2	-	66.1	63.5	-
SG&A expenses	1,803	1,685	7.0	1,857	(2.9)	7,180	6,476	10.9
as % of sales	18.2	20.3	-	20.0	-	19.8	19.2	-
<b>EBITDA</b>	<b>1,464</b>	<b>1,202</b>	<b>21.8</b>	<b>1,277</b>	<b>14.7</b>	<b>5,117</b>	<b>5,805</b>	<b>(11.8)</b>
Depreciation	436	386	12.8	420	3.7	1,675	1,573	6.5
<b>EBIT</b>	<b>1,029</b>	<b>816</b>	<b>26.1</b>	<b>857</b>	<b>20.1</b>	<b>3,442</b>	<b>4,232</b>	<b>(18.7)</b>
Other Income	192	282	-	274	-	1,171	631	-
<b>PBT</b>	<b>1,220</b>	<b>1,098</b>	<b>11.2</b>	<b>1,130</b>	<b>8.0</b>	<b>4,613</b>	<b>4,863</b>	<b>(5.1)</b>
Total Tax	320	273	17.4	292	9.6	1,149	1,347	(14.7)
<b>Adjusted PAT</b>	<b>900</b>	<b>825</b>	<b>9.1</b>	<b>838</b>	<b>7.4</b>	<b>3,465</b>	<b>3,516</b>	<b>(1.5)</b>
(Profit)/loss from JV's/Ass/MI	-	-	-	0	-	-	-	-
APAT after MI	900	825	9.1	838	7.4	3,465	3,516	(1.5)
Extra ordinary items	0	0	-	0	-	-	-	-
<b>Reported PAT</b>	<b>900</b>	<b>825</b>	<b>9.1</b>	<b>838</b>	<b>7.4</b>	<b>3,465</b>	<b>3,516</b>	<b>(1.5)</b>
Reported EPS	11.3	10.3	9.1	10.5	7.4	43.3	44.0	(1.5)
<b>Margins (%)</b>			<b>(bps)</b>		<b>(bps)</b>			
EBITDA	14.8	15.2	(44)	13.4	139	14.1	17.2	(315)

(Rs mn)	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)	FY20	FY19	YoY (%)
EBIT	10.4	10.7	(31)	8.7	164	9.5	12.6	(309)
EBT	12.3	13.4	(107)	12.4	(4)	12.7	14.4	(174)
PAT	9.1	10.2	(108)	9.5	(45)	9.5	10.4	(90)
Effective Tax rate	26.2	24.1	214	22.9	339	24.9	27.7	(279)

Source: BOBCAPS Research

**FIG 2 – OPERATING METRICS**

	Q1FY21 (% Contr. to Revenue)	QoQ (%)	YoY (%)
<b>Revenue breakup by Geography</b>			
North America	80.4	3.4	6.7
Europe	10.2	19.5	31.4
India, APAC	9.3	3.1	13.2
<b>Client concentration</b>			
Top Client	17.7	(4.9)	(25.0)
Top 5 Clients	40.8	1.4	(8.5)
Top 10 Clients	49.0	1.3	(6.8)
Non-Top 10 Clients	51.0	5.0	7.6

	Q1FY21	Q4FY20	Q1FY20
<b>Onsite- Offshore mix (%)</b>			
Onsite	33.7	33	30.5
Offshore	48.9	50.7	48
IP-led	17.4	16.3	21.5
Headcount	10,829	10,632	10,167

Source: BOBCAPS Research

### Valuation methodology

We increase FY21/FY22 EPS estimates by 23%/7% and raise our target P/E to 12.5x (vs. 11.3x), unwinding the 10% discount we had built in for the Covid-19 hit as PSYS has delivered a more resilient operating performance than expected in Q1FY21. Rolling valuations forward, we have a revised Jun'21 target price of Rs 740 (from Rs 590)

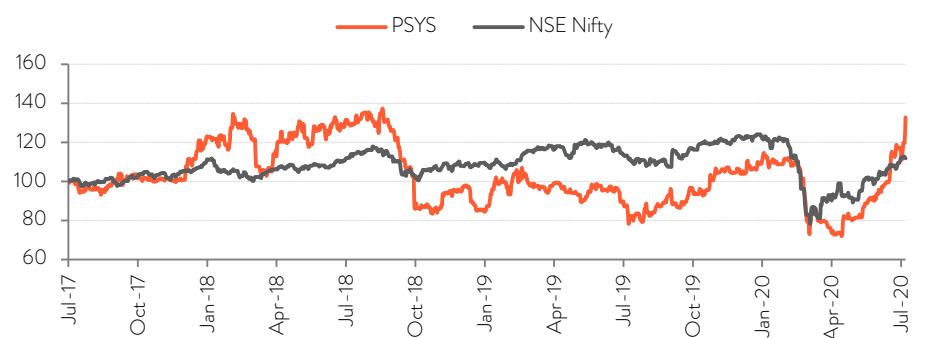
Overall, we stay wary of (1) volatility in the IP segment, (2) the project-based nature of revenues and lack of annuity, and (3) a delayed pivot to 'enterprise', leading to weak domain expertise compared to other mid-tier peers. Following the ~37% rally in the past month, the stock is trading at 18.4x/ 15.2x FY21E/FY22E EPS, which looks full in our view. Downgrade to SELL (vs. REDUCE earlier).

**FIG 3 – REVISED ESTIMATES**

(Rs mn)	FY21E			FY22E			FY23E
	Old	New	Change (%)	Old	New	Change (%)	New
Revenues (US\$ mn)	495.7	539.9	8.9	556.7	598.8	7.6	663.7
YoY growth (%)	(1.2)	7.6	-	12.3	10.9	-	10.8
Revenues	37,924	41,190	8.6	43,419	46,708	7.6	51,767
EBITDA	5,776	6,513	12.8	7,253	7,809	7.7	8,901
EBITDA margins (%)	15.2	15.8	-	16.7	16.7	-	17.2
Net profits	3,010	3,715	23.4	4,209	4,486	6.6	5,237
EPS (Rs)	37.7	46.6	23.4	52.8	56.2	6.6	65.7

Source: BOBCAPS Research

**FIG 4 – RELATIVE STOCK PERFORMANCE**



Source: NSE

### Key risks

Upside risks to our estimates include:

- a sharp recovery in the ISV business, and
- above-expected operating margin improvement.

## 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>41,190</b>	<b>46,708</b>	<b>51,767</b>
EBITDA	5,805	4,930	6,513	7,809	8,901
Depreciation	1,573	1,660	1,803	1,991	2,192
EBIT	4,232	3,270	4,710	5,818	6,709
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	631	1,254	420	413	565
Exceptional items	0	0	0	0	0
EBT	4,863	4,523	5,130	6,231	7,274
Income taxes	1,347	1,121	1,415	1,745	2,037
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>3,715</b>	<b>4,486</b>	<b>5,237</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>3,516</b>	<b>3,403</b>	<b>3,715</b>	<b>4,486</b>	<b>5,237</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	4,401	4,991	5,531
Provisions	1,939	1,954	2,257	2,559	2,837
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	26,375	29,242	32,588
Shareholders' fund	23,447	24,793	27,167	30,033	33,379
<b>Total liabilities and equities</b>	<b>28,556</b>	<b>30,569</b>	<b>33,837</b>	<b>37,595</b>	<b>41,759</b>
Cash and cash eq.	1,739	1,461	3,189	5,550	8,662
Accounts receivables	4,923	5,862	6,771	7,678	8,510
Inventories	0	0	0	0	0
Other current assets	3,861	5,373	6,207	7,038	7,800
Investments	13,304	13,304	13,304	13,304	13,304
Net fixed assets	4,242	4,083	3,880	3,539	2,997
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>33,837</b>	<b>37,595</b>	<b>41,759</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	5,518	6,477	7,429
Interest expenses	(285)	(1,254)	(420)	(413)	(565)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(290)	(1,784)	(849)	(847)	(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>4,249</b>	<b>5,218</b>	<b>6,088</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	420	413	565
<b>Cash flow from investing</b>	<b>(2,330)</b>	<b>(247)</b>	<b>(1,180)</b>	<b>(1,237)</b>	<b>(1,085)</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)	(1,341)	(1,620)	(1,891)
Other financing cash flows	0	0	0	0	0
<b>Cash flow from financing</b>	<b>(1,596)</b>	<b>(2,057)</b>	<b>(1,341)</b>	<b>(1,620)</b>	<b>(1,891)</b>
<b>Changes in cash and cash eq.</b>	<b>394</b>	<b>(278)</b>	<b>1,728</b>	<b>2,361</b>	<b>3,112</b>
<b>Closing cash and cash eq.</b>	<b>1,740</b>	<b>1,461</b>	<b>3,189</b>	<b>5,550</b>	<b>8,662</b>

**Per Share**

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	43.9	42.7	46.6	56.2	65.7
Adjusted EPS	43.9	42.7	46.6	56.2	65.7
Dividend per share	13.2	12.8	14.0	16.9	19.7
Book value per share	293.0	310.8	340.6	376.5	418.5

**Valuations Ratios**

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	2.0	1.9	1.6	1.4	1.2
EV/EBITDA	11.5	13.5	10.3	8.5	7.2
Adjusted P/E	19.5	20.1	18.4	15.2	13.0
P/BV	2.9	2.8	2.5	2.3	2.0

**DuPont Analysis**

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	72.3	75.2	72.4	72.0	72.0
Interest burden (PBT/EBIT)	114.9	138.3	108.9	107.1	108.4
EBIT margin (EBIT/Revenue)	12.6	9.2	11.4	12.5	13.0
Asset turnover (Revenue/Avg TA)	122.1	120.6	127.9	130.8	130.5
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.3
Adjusted ROAE	15.7	14.1	14.3	15.7	16.5

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	15.5	13.4	10.8
EBITDA	23.8	(15.1)	32.1	19.9	14.0
Adjusted EPS	8.8	(2.9)	9.2	20.8	16.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	17.2	13.8	15.8	16.7	17.2
EBIT margin	12.6	9.2	11.4	12.5	13.0
Adjusted profit margin	10.4	9.5	9.0	9.6	10.1
Adjusted ROAE	15.7	14.1	14.3	15.7	16.5
ROCE	15.0	10.9	14.4	17.3	19.6
<b>Working capital days (days)</b>					
Receivables	53	55	56	56	57
Inventory	0	0	0	0	0
Payables	42	41	43	44	45
<b>Ratios (x)</b>					
Gross asset turnover	7.2	8.6	10.3	12.6	15.8
Current ratio	2.1	2.2	2.4	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%

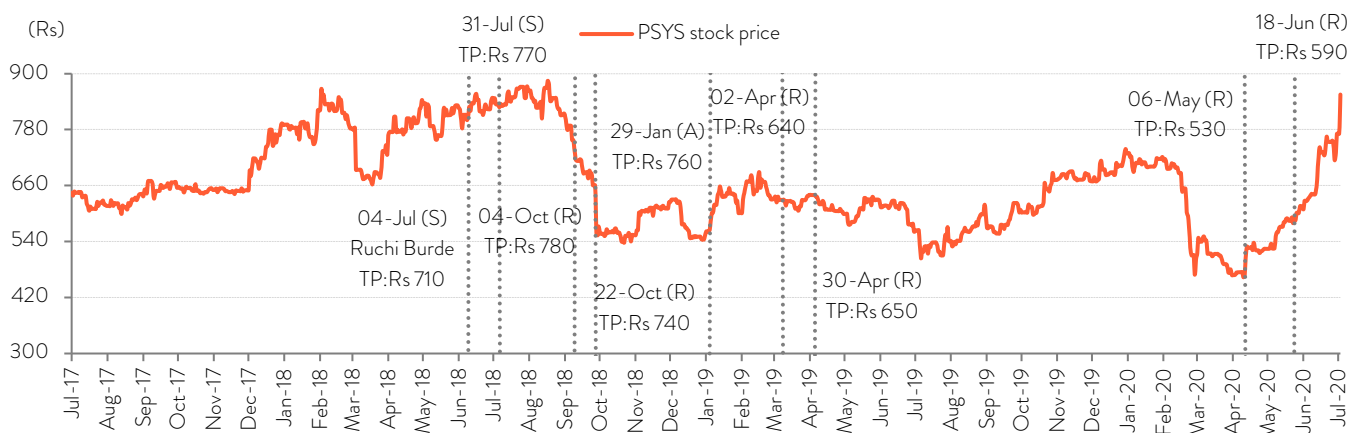
**ADD** – Expected return from >+5% to +15%

**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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