Information Technology March 25, 2011

Persistent Systems

Bloomberg: PSYS IN EQUITY
Reuters: PERS.BO

BUY

AMBIT
Acumen at work

MANAGEMENT MEET UPDATE

Non linearity on the rise

Persistent has underperformed the Sensex by 17% since 3Q FY11 results primarily led by margin worries from the interim wage hike announcement. We spoke to Persistent's management and industry sources to assess the demand and supply situation in the outsourced product development (OPD) space. We find improved demand outlook, lower wage hike impact in FY12 (incremental hike of ~5-7%) coupled with the share price correction as compelling reasons to upgrade the stock to a BUY.

Improved demand outlook: Persistent's demand is a function of the R&D allocation and spending on new technology areas by global product firms. The trend of increased spending in these areas (R&D as % of sales up by 0.5% in CY10) suggests improved demand outlook for OPD firms such as Persistent.

Strong growth trajectory within top client: Our discussions with the management suggest that IBM (top client, 15% of revenues) is likely to grow strongly in FY12 with cloud-related services and IP-led revenues being the primary growth drivers. Incidentally, IBM itself expects US$3 bn of incremental revenues from cloud by 2015. Persistent given its strong relationship and early investment in this space is well positioned to capitalize on cloud.

Primary data sources reaffirm the improved demand trends: Our discussions with the senior management of one of the unlisted OPD players reaffirms the improved demand trend. In fact, OPD players are also witnessing increased outsourcing from sub-optimal captives. Furthermore, they believe that large OPD players should easily see 25%+ YoY growth in FY12.

IP-led revenues will help combat wage pressures: Persistent derives 8% of revenues from IP-led services where gross margins (~60%) are far higher than the company average (40% on a trailing 12 months basis). Our channel checks suggest interesting opportunities which should materialize into incremental revenue streams in 2H FY12. We expect the IP-led revenue contribution to grow from 8% currently to 13% by FY13 thereby becoming a primary shield against wage hike pressures.

Stable margins in FY12: We gather that attrition post the interim wage hike is on a decline. Lower impact of wage hikes (incremental wage hikes of ~5-7%) and sufficient margin levers will ensure stable margins in FY12.

Upgrade to BUY; revise valuation upwards to Rs470: Our DCF valuation of 470 (previously Rs440) implies a target PE multiple of 13.9x FY12 EPS. Persistent is trading on 10x FY12 earnings vs. peer average of 12x. We are revising our FY13 EPS upwards by 8% as we build in higher proportion of IP revenues (13% vs. 10% earlier). Given a 35% upside potential from the current price, we are upgrading the stock to a BUY.

Exhibit 1: Key financials

Year to March	FY09	FY10E	FY11E	FY12E	FY13E
Operating income	5,938	6,012	7,687	9,720	11,821
EBITDA	1,788	1,464	1,601	2,092	2,570
EBITDA (%)	30.1%	24.3%	20.8%	21.5%	21.7%
EPS (Rs)	18.6	32.3	34.7	33.7	40.9
RoE (%)	18.9	22.3	19.7	16.4	17.2
RoCE (%)	41.2	21.7	16.8	19.5	20.8
P/E (x)	18.6	10.7	10.0	10.3	8.5

Source: Company, Ambit Capital research

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Recommendation

CMP:	Rs346
Target Price (March 2012):	**Rs470**
Previous TP:	*Rs440*
Upside (%)	***35***
EPS (FY12):	Rs33.7
Change from previous (%)	*-0.4%*
Variance from consensus (%)	*-2%*

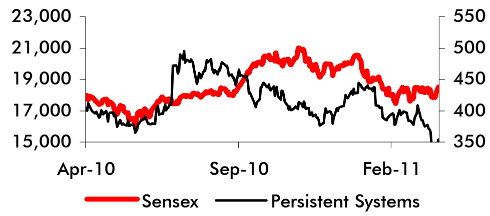
Stock Information

Mkt cap:	Rs14bn/US$309mn
52-wk H/L:	Rs505/308
3M ADV:	Rs22mn/US$0.5mn
Beta:	0.6x
BSE Sensex:	18,351
Nifty:	5,522

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	-9.9	-17.7	0.0	-19.1
Rel. to Sensex	-13.9	-9.1	0.0	-8.5

Performance (%)

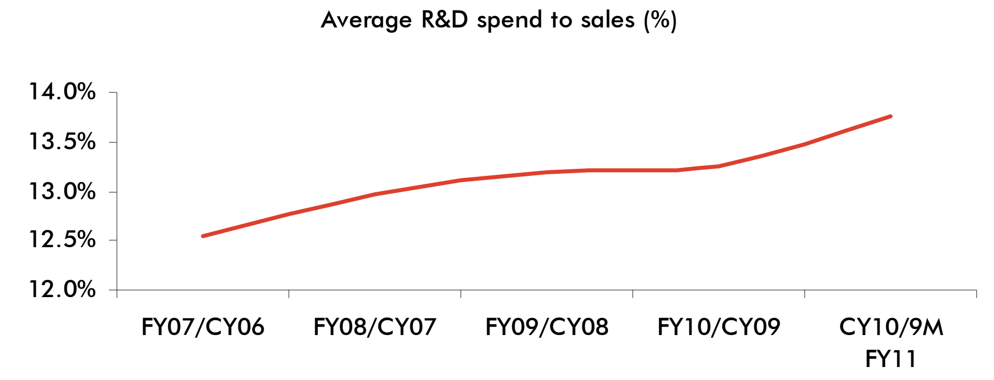


Source: Bloomberg, Ambit Capital research

Key takeaways from management meeting

Improved demand outlook: While structural growth drivers for the OPD space remain intact, firms in this space are benefiting from: (a) increased R&D spending and (b) higher spending on newer technology areas from global product companies (such as IBM, Oracle, SAP etc). Persistent's management noted that its growth outlook looks buoyant with an improved order pipeline and deal conversions in the last six months. We expect Persistent's revenue to grow at a 23% CAGR over FY11-13 (FY07-10 CAGR was 24%).

Exhibit 2: R&D spend by global product companies is on the rise



Source: Ambit Capital research, Company

Strong growth outlook within top client: Persistent's revenues from its top client, IBM (15% of revenues on a trailing 12 months basis) has grown at a 40% CAGR over the last four years. IBM is a classic client in so far as it showcases Persistent's client mining skills. Persistent initially worked with only IBM's Tivoli software product (Tivoli is widely used for monitoring and management of infrastructure remotely). Given that remote infrastructure services is a fast growing service line (potential addressable market of ~US$90 bn), we see strong growth prospects for Persistent as well. Additionally, Persistent has been able to penetrate other areas within IBM's software division (Rational, Lotus, content management, business analytics and WebShpere) and also ramp up its newer service offerings (cloud related services: 30% of revenue, professional services: 25%, IP-related: 30%). Interestingly, most of the business is self initiated (and not driven by request for proposals) which positions it differently as a thought leader vs. other vendors. Our discussions with the management suggest that IBM is likely to grow strongly with cloud-related services and IP-led business being the primary growth drivers. Incidentally, IBM itself expects incremental cloud revenue growth to be US$3 bn by 2015. Persistent given its strong relationship and early investments in new technology areas is well positioned to capitalize it.

Primary data checks reaffirm the improved demand outlook: Our discussions with the senior management of one of the large unlisted OPD players reaffirms the improved demand trajectory in the OPD space. Most large players have also been witnessing increased outsourcing from sub-optimal captives (~200-500 headcount). The unlisted OPD player also noted that there is no shortage of opportunities and large OPD players should easily see a 25%+ YoY revenue growth in FY12. Interestingly, this OPD player encounters Persistent in most deals and perceives it as an able competitor.

IP-led revenues will help combat wage pressures: Persistent has been early in pursuing a IP-led strategy (royalty, licensing based revenues) by consistently allocating 5% of its technical workforce towards R&D efforts which has enabled the creation of tools, connectors, frameworks, accelerators etc. Persistent currently derives 8% of revenues from IP-led revenues where gross margins (~60%) are far higher than the company average (40% LTM). Management mentioned that it has recently closed a strategic deal with a life sciences client during the quarter. Our channel checks also suggest interesting opportunities which they are pursuing with some of the leading clients which should materialize into incremental revenues streams in 2H FY12. We estimate IP-led revenue contribution to grow from 8% currently to 13% by FY13 and expect this to be a primary shield against the wage hike pressures.

Stable margins in FY12: Persistent announced an interim wage hike of 10% in January 2011 (effective 4Q FY11) to rein in the attrition levels which had peaked in 3Q FY11 (22%). We gather that attrition levels post the wage hikes have started to decline with resignations down 30-40% in the current quarter-to-date. Whilst the wage hikes would impact 4Q FY11 EBITDA margins (higher impact of ~300 bps given the high offshore mix), management believes that wage hikes for FY12 would only be incremental at ~5-7%. Additionally levers such as: (a) increase in IP-led revenues, (b) broadening of the employee pyramid should help offset these incremental pressures. We expect EBITDA margins to remain stable at 21% in FY12 (FY10: 24.3%, FY11: 20.9%).

Upgrade to BUY; revise valuation upwards to Rs470: Our DCF model values the company at Rs470 (previously Rs440) and implies a target PE multiple of 13.9x FY12 EPS. Persistent is trading on 10x FY12 earnings vs. peer average of 12x. We are revising our FY13 EPS upward by 8% as we build in higher proportion of IP-led revenues (13% vs. 10% earlier). Given a 35% upside potential from the current price, we are upgrading the stock to a BUY.

Exhibit 3: Change to estimates

	New estimates		Old estimates		Change		Comments
	FY12	FY13	FY12	FY13	FY12	FY13	
US$ revenue (mn)	216	263	216	258	0.2%	2.0%	Improved demand outlook and higher contribution from IP-led business in FY13
YoY %	28%	22%	27%	20%			
IP led revenue contribution (%)	10.0%	13.0%	10.0%	10.5%	0.0%	2.5%	
Revenues (Rs mn)	9,720	11,821	9,729	11,631	-0.1%	1.6%	
EBITDA (Rs mn)	2,092	2,570	2,119	2,373	-1.3%	8.3%	
EBITDA margin (%)	21.5%	21.7%	21.8%	20.4%	-0.3%	1.3%	Increase in FY13 margins attributable to higher revenue contribution from IP-led revenues in FY13 (13% vs. 10% earlier)
PAT(Rs mn)	1,344	1,628	1,337	1,512	0.5%	7.7%	
EPS (Rs)	33.7	40.9	33.6	38.0	0.4%	7.6%	

Source: Company, Ambit Capital research

Valuation

We have valued Persistent's business using a three stage DCF model. Our FCFE model has three distinct phases:

- **FY10-FY13**: We model each year and broadly assume that revenues will grow at 25% CAGR and EBITDA margins to decline to 22% by FY13 vs. 24% in FY10.
- **FY14-18**: We fade the revenue growth gradually so that by FY18 the revenue growth is 14%. We assume EBITDA margins to fall to 20%.
- **From FY18-23:** We fade the revenue growth further so that by FY23 the revenue growth is 5%. We assume decline in EBITDA margins to 12% by 2023.
- Post FY23 we assume perpetuity growth of 4%.

Based on the assumptions shown above and assuming and WACC at 14.4%, our FCFE model values Persistent's business at Rs470 per share (implied PE multiple of 13.9x on FY12 EPS) implying 35% upside.

Exhibit 4: Valuation sensitivity to key assumptions

	High Case	Base Case	Low Case
Revenue	2% points higher than base case until FY13; 1.5% higher than base case from FY14-18 and 1% point higher from FY19-23 driven by higher revenues from IP led business and newer technology services.	Revenue CAGR of 25% over FY10-13, 17% over FY13-18, 8% over FY18-23.	2% points lower than base case till FY13; 1% point lower than base case from FY14-18 and 0.5% higher from FY19-23 driven by lower order wins
Gross margin	Same as base case	Gross margin gradually declines to 31% in FY23 from 44% in FY10	50 bps lower than base case
Other expenses as % of sales	Lower by 0.5% v/s base case	Decrease to 15% by FY18 but again gradual increase to 17% by FY23	Lower by 0.5% v/s base case
Capex	Same as base case	Capex as % of sales to decline from 6% in FY13 to 5% by FY23	Capex as % of sales higher by 50 bps as compared to base case
Fair value- (Rs)	**Rs555**	**Rs470**	**Rs432**
Upside	Upside of 61%	Upside of 35%	Upside of 25%

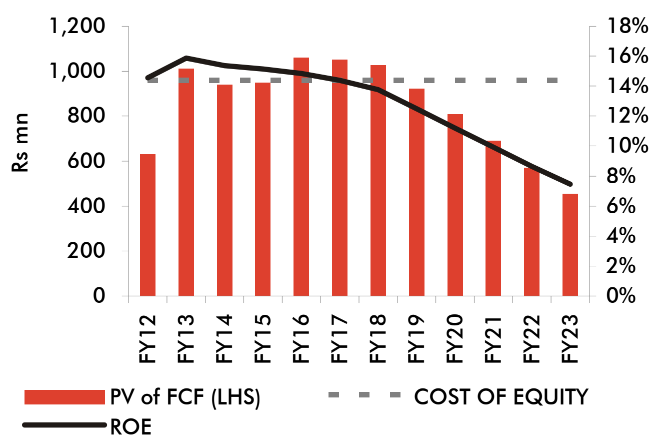
Source: Ambit Capital research

Exhibit 5: Comparison with consensus

	Ambit	Consensus	% difference
Revenue (Rs mn)			
FY11	7,687	7,633	1%
FY12	9,720	9,510	2%
FY13	11,821	11,468	3%
EBITDA (Rs mn)			
FY11	1,635	1,622	1%
FY12	2,060	2,104	-2%
FY13	2,420	2,371	2%
EPS (Rs)			
FY11	34.7	34.8	0%
FY12	33.7	34.4	-2%
FY13	40.9	40.3	2%

Source: Bloomberg, Ambit Capital research

Exhibit 6: FCF cash flow profile (US$ mn)

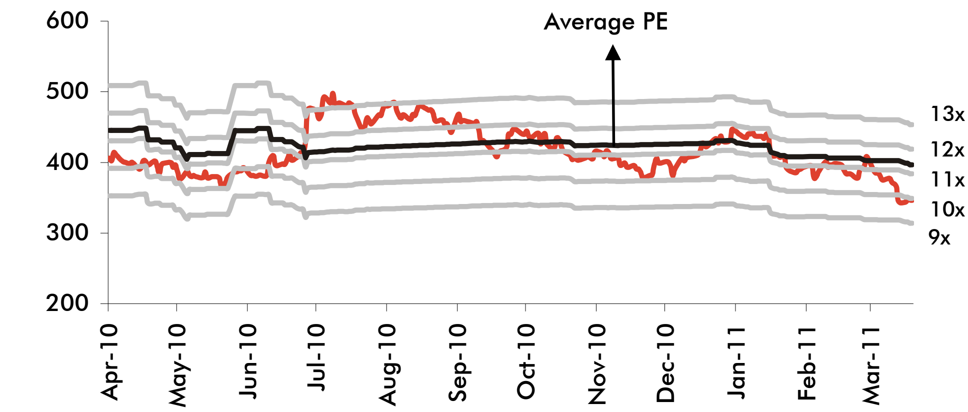


Source: Bloomberg, Ambit Capital research

Ambit versus Consensus

We are lower than consensus estimates in FY12 as we factor in higher wage hikes while we are higher than the consensus for FY13 as we expect higher revenue contribution from the IP-led business.

Exhibit 7: Persistent's 1 year forward PE band



Source: Bloomberg, Ambit Capital research

Relative Valuation

Exhibit 8: Comparison with peers

	Mkt Cap	Sales CAGR	EBITDA CAGR	EV/EBITDA		NOPAT CAGR	EV/NOPAT		EPS CAGR	P/E		ROE	
	(Rsmn)	(CY10-12)	(CY10-12)	CY11	CY12	(CY10-12)	CY11	CY12	(CY10-12)	CY11	CY12	CY11	CY12
Indian peers (Tier 1 IT services)													
Hcl Technologies	315,709	24%	28%	10.6	8.6	27%	16.9	13.6	29%	16.9	13.3	23%	24%
Infosys Technologies	1,723,997	22%	21%	14.7	12.2	21%	21.2	17.6	21%	24.1	19.8	28%	28%
TCS	2,140,026	23%	22%	15.9	13.3	18%	21.9	18.6	19%	23.4	19.8	36%	34%
Wipro	1,079,034	18%	17%	14.8	12.6	14%	20.4	17.8	14%	20.3	17.6	24%	23%
Median		**22%**	**21%**	**14.7**	**12.4**	**20%**	**20.8**	**17.7**	**20%**	**21.8**	**18.7**	**26%**	**26%**
Mean		**22%**	**22%**	**14.0**	**11.7**	**20%**	**20.1**	**16.9**	**21%**	**21.2**	**17.6**	**27%**	**27%**
Indian peers (mid-sized services)													
Tech Mahindra	92,635	10%	5%	8.4	7.7	5%	11.4	10.4	7%	12.5	11.2	21%	19%
Patni Computer	62,013	13%	1%	6.6	5.9	-4%	9.7	8.8	-6%	11.6	11.1	15%	14%
Mphasis Ltd	82,154	11%	3%	5.7	5.0	-5%	8.1	7.6	-5%	15.8	14.8	24%	21%
Polaris Software	18,019	17%	15%	5.1	4.4	11%	7.4	6.5	10%	8.6	7.5	19%	19%
Mindtree	14,559	18%	24%	5.6	4.5	30%	9.5	7.6	19%	13.8	11.0	19%	20%
Hexaware	17,582	21%	16%	10.8	8.9	14%	13.7	12.2	23%	12.3	10.7	13%	14%
KPIT	13,365	25%	21%	7.0	5.6	14%	11.5	9.4	22%	12.1	9.9	22%	23%
Persistent Systems	13,862	24%	22%	6.9	5.8	11%	11.1	9.7	6%	9.9	8.7	17%	17%
Median		**17%**	**16%**	**6.7**	**5.6**	**11%**	**10.4**	**9.0**	**9%**	**12.1**	**10.8**	**19%**	**19%**
Mean		**18%**	**14%**	**7.0**	**5.9**	**9%**	**10.3**	**9.0**	**10%**	**12.0**	**10.6**	**19%**	**18%**

Source: Company, Bloomberg, Ambit Capital research

Our relative valuation table above shows that Persistent trades at an 18% discount on CY11E EPS to the mid-sized IT services firms. We believe that a PE re rating from hereon is warranted given a stronger revenue growth (24% CAGR over CY10-12) and EBITDA growth (22% CAGR over CY 10-12) over the reference set.

Financials

Exhibit 9: Profit and loss statement

Y/E March	FY09	FY10	FY11E	FY12E	FY13E
Net sales	**5,938**	**6,012**	**7,687**	**9,720**	**11,821**
Growth (%)	39.8	1.2	27.9	26.5	21.6
EBITDA	**1,788**	**1,464**	**1,601**	**2,092**	**2,570**
EBITDA margin (%)	***30.1***	***24.3***	***20.8***	***21.5***	***21.7***
Growth (%)	95.8	-18.1	9.4	30.7	22.9
Other non-operational income	-805	112	336	314	283
Depreciation & amortisation	297	335	418	486	591
EBIT	**685**	**1,241**	**1,518**	**1,919**	**2,261**
Pre tax profit	685	1,241	1,518	1,919	2,261
Taxes	10	91	136	576	633
Extraordinary (income)/expense (net)	15	0	0	0	0
Restatements	7	0	0	0	0
Adjusted net profit	**668**	**1,150**	**1,382**	**1,344**	**1,628**
Margin (%)	11.2	19.1	18.0	13.8	13.8
Diluted Share capital (mn)	36	36	40	40	40
EPS (Rs)	**18.6**	**32.3**	**34.7**	**33.7**	**40.9**
Growth (%)	-20.0	73.3	7.6	-2.8	21.2
Dividend per share	1.2	3.2	4.1	4.7	4.8

Source: Company, Ambit Capital research

Exhibit 10: Cash Flow statement

Y/E March	FY09	FY10	FY11E	FY12E	FY13E
Net Profit Before Tax & Exceptional Items	685	1,241	1,518	1,919	2,261
Depreciation/amortisation	297	335	418	486	591
(Inc)/dec in working capital	-401	498	157	-279	-155
Others	118	-464	-471	-889	-916
Net cash from operations (a)	**699**	**1,611**	**1,623**	**1,237**	**1,781**
(Inc)/dec in investments (net)	-164	-710	-1,284	0	0
Capex	-490	-476	-850	-800	-802
Others	60	45	336	314	283
Cash flow from inv. (b)	**-594**	**-1,142**	**-1,799**	**-486**	**-519**
Inc/(dec) in capital	0	41	0	0	2
Dividends paid + dividend tax	-36	-27	-103	-166	-189
Others	87	-1,278	207	331	374
Financial cash flow (c)	**-51**	**1,264**	**-103**	**-166**	**-187**
Net inc/dec in cash (a+b+c)	55	1,733	-279	585	1,075
Opening cash balance	109	163	1,918	1,638	2,223
Closing cash balance	**164**	**1,896**	**1,638**	**2,223**	**3,299**

Source: Company, Ambit Capital research

Exhibit 11: Balance Sheet

Y/E March	FY09	FY10	FY11E	FY12E	FY13E
Share capital	359	400	400	400	401
Stock options outstanding	21	32	32	32	33
Reserves & surplus	3,569	5,958	7,178	8,333	9,771
Networth	3,948	6,390	7,610	8,765	10,205
Deferred tax liability	0	45	45	45	45
Sources of funds	**3,948**	**6,435**	**7,656**	**8,810**	**10,250**
Fixed assets	3,372	3,715	4,465	5,165	5,866
Less: Depreciation/amortisation	1,573	1,881	2,299	2,785	3,376
Net block	1,800	1,834	2,166	2,380	2,490
CWIP	377	485	585	685	786
Deferred tax assets	20	7	7	7	7
Current assets	2,664	5,820	6,690	7,866	9,450
Sundry debtors	1,034	1,363	1,306	1,598	1,943
Cash & bank balance	165	1,918	1,637	2,223	3,298
Other current assets	1,010	1,901	3,001	3,042	3,085
Loans & advances	454	638	746	1,004	1,124
Current liabilities & provisions	914	1,710	1,792	2,127	2,482
Net current assets	1,750	4,110	4,898	5,739	6,968
Others (net)	0	0	0	0	0
Application of funds	**3,948**	**6,435**	**7,656**	**8,810**	**10,250**

Source: Company, Ambit Capital research

Exhibit 12: Key ratios

	FY09	FY10	FY11E	FY12E	FY13E
ROCE (%)	41.2	21.7	16.8	19.5	20.8
ROE (%)	18.9	22.3	19.7	16.4	17.2
Valuation ratios (x)					
PER	18.6	10.7	10.0	10.3	8.5
PBV	2.8	2.2	1.7	1.5	1.3
EV/EBITDA	6.3	6.0	4.9	3.5	2.4
EV/Sales	1.9	1.5	1.0	0.7	0.5
Turnover ratios (no.)					
Debtor days	64	62	62	60	60
Inventory days	0	0	0	0	0
Creditor days	12	14	16	14	14

Source: Company, Ambit Capital research

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>15%
Hold	5% to 15%
Sell	<5%

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