

Persistent Systems

Event Update

18 March 2011

Sell

Target Price: Rs366

CMP: Rs365*

Upside: 0%

*as on 17 March 2011

Target price breached; contra call justified

Persistent Systems achieved our target price of Rs366/share justifying our Sell call on the scrip. We are the only brokerage among 30 covering this stock with a Sell rating. The consensus target price on the stock is Rs490. Smaller addressable universe, lack of pricing power, competition with captive ISV units/diversified IT services players and worsening supply side issues are the rationale for our negative view on the company (Refer our initiation report "Positioning Trap" dated 25th Oct 2010). We value the stock at 11x FY13E FDEPS for a target price of Rs366. Higher than expected wage increases and lower volume growth presents further downside risks to our valuation while better realization gain due to stronger than expected growth in IP-led revenue could be the upside risk from current levels.

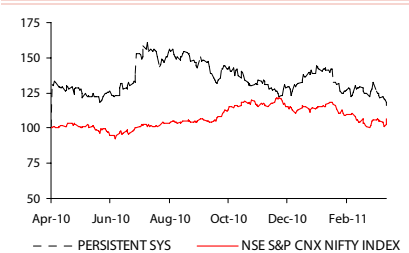
- **Stock's underperformance justifies our contra call:** Persistent Systems has underperformed the BSE-IT index by 16% since our initiation. This clearly vindicates our negative stance on the company.
- **Our Rationale:** A very high end and niche outsourced product development (OPD) not only restricts the addressable market of the company, it also makes it prone to an exodus of talent and high wage pressure. Also, the company's inability to translate the high end work into premium pricing works against it. On top of this, the entry of diversified players into OPD is likely to erode the market share of Persistent as larger diversified players will benefit from vendor consolidation and better cross selling opportunities.
- **Sharp decline in FY12 EPS will be followed by a bounce back in FY13.** We have factored in a sharp decline in FY12E EPS due to margin contraction owing to wage pressure and high tax rate. This will be followed by a bounce back in earnings in FY13E driven by topline growth of 18% and margin expansion as the company utilizes its operating levers to cushion margin pressures. Our FY12E and FY13E EPS estimates are 25% and 21% below consensus expectations respectively.
- **Valuation:** We value the company at 11x FY13e FDEPS of Rs33.4 arriving at a target price of Rs366. We believe most of the negatives that we factored in our model are now reflected in the price.
- **Risks to our call:** Higher than expected wage increases in FY13 and lower volume growth due to market share loss to diversified players (due to vendor consolidation) presents further downside risk to our valuation. Higher pricing yield due to stronger than expected growth in IP-led revenue could be the upside risk from current levels.

Key Data

Bloomberg Code	PSYS IN
Reuters Code	PERS.BO
Current Shares O/S (mn)	40.0
Diluted Shares O/S(mn)	40.0
Mkt Cap (Rsbn/USDmn)	14.6/323.8
52 Wk H / L (Rs)	505/308
Daily Vol. (3M NSE Avg.)	36,112
Face Value (Rs)	10

1 USD = Rs45.1

One Year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
Persistent	(8.4)	(14.9)	-
NIFTY	(1.0)	(8.2)	3.0

Source: Bloomberg, Centrum Research
*as on 17 March 2011

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Y/E Mar (Rsmn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY %	Fully DEPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY09	5,938	39.8	914	15.4	661	(22.1)	16.5	18.7	17.0	22.2	15.0
FY10	6,012	1.2	1,464	24.3	1150	70.2	28.7	22.3	21.7	12.7	8.1
FY011E	7,743	28.8	1,643	21.2	1435	24.6	35.8	20.8	17.7	10.2	7.8
FY12E	9,700	25.3	1,675	17.3	1043	(27.2)	26.0	13.3	14.6	14.0	7.4
FY13E	11,432	17.9	2,130	18.6	1341	28.5	33.4	15.1	16.9	10.9	5.6

Source: Centrum Research

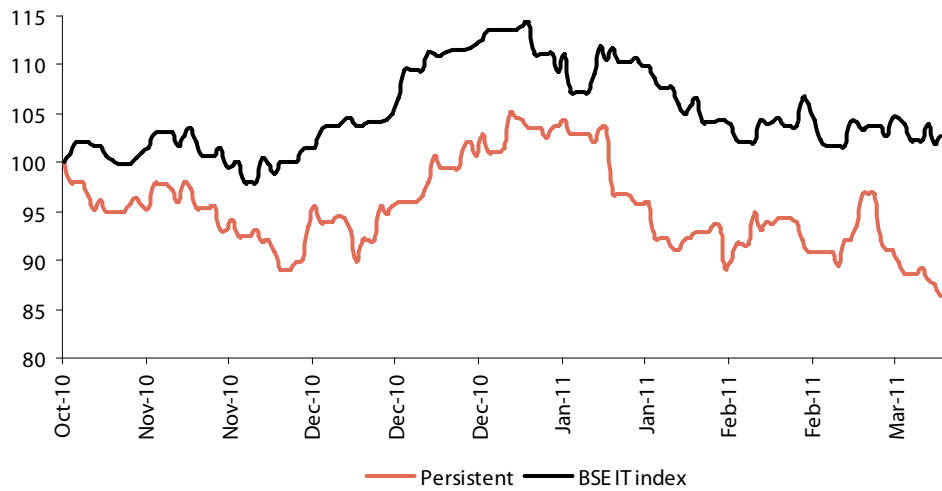
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Centrum Equity Research is available on Bloomberg, Thomson Reuters and FactSet

Persistent has underperformed the IT index since our initiation

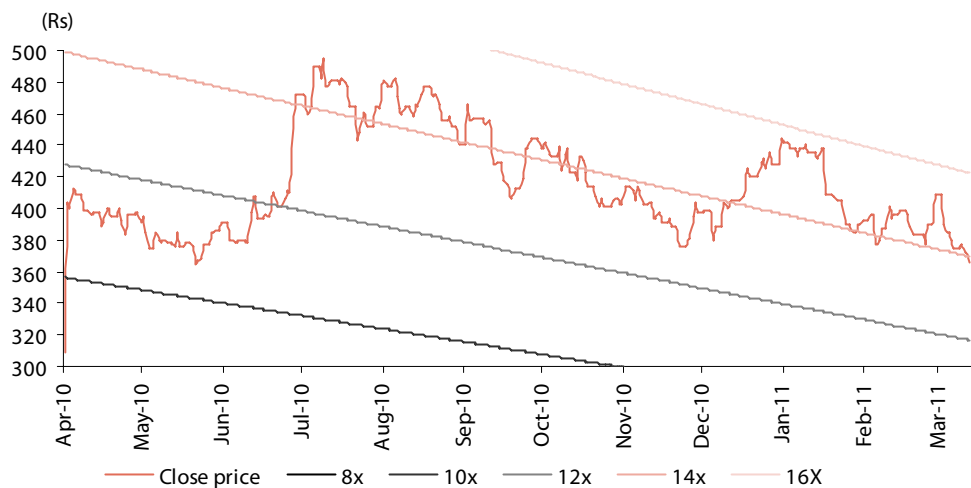
Persistent has underperformed the BSE-IT index by 16% since our initiation (Oct 25th 2010). Persistent Systems has returned -13.6% during this interval while BSE IT index has given a return of +2.8%.

Exhibit 1: Persistent’s underperformance has vindicated our negative stance



Source: Bloomberg, Centrum Research

Exhibit 2: PE multiple has started coming down to our target multiple of 11x



Source: Bloomberg, Centrum Research

Exhibit 3: We are significantly lower than consensus in our numbers

(Rs bn)	Consensus			Persistent			Difference (%)		
	FY11E	FY12E	FY13E	Centrum			FY11E	FY12E	FY13E
				FY11E	FY12E	FY13E			
Revenue	7.7	9.6	11.7	7.7	9.7	11.4	0.7	0.8	(2.5)
EBITDA	1.6	2.1	2.5	1.6	1.7	2.1	0.9	(18.7)	(15.5)
PAT Adj	1.4	1.4	1.7	1.4	1.0	1.3	0.5	(25.2)	(20.8)
EPS Adj (in Rs)	36.6	34.8	42.1	35.8	26.0	33.4	(2.3)	(25.3)	(20.7)
EBITDA Margin (%)	21.2	21.4	21.5	21.2	17.3	18.6	0bps	(410)bps	(290)bps

Source: Bloomberg, Centrum Research

Financials

Exhibit 4: Income Statement

Y/E March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Net Sales	5,938	6,012	7,743	9,700	11,432
-Growth (%)	39.8	1.2	28.8	25.3	17.9
Personal Expense	3,324	3,687	5,090	6,824	7,928
% of sales	56.0	61.3	65.7	70.4	69.3
Operating expenses	1,701	860	1,010	1,201	1,374
% of sales	28.6	14.3	13.0	12.4	12.0
EBIDTA	914	1,464	1,643	1,675	2,130
-EBIDTA margin (%)	15.4	24.3	21.2	17.3	18.6
Depreciation	297	335	420	529	624
EBIT	617	1,128	1,223	1,146	1,507
Interest exp	-	-	-	-	-
PBT from operations	617	1,128	1,223	1,146	1,507
Other income	69	112	335	344	355
PBT	685	1,241	1,558	1,491	1,862
-PBT margin (%)	11.5	20.6	20.1	15.4	16.3
Provision for tax	10	91	125	447	521
Effective tax rate (%)	1.4	7.3	8.0	30.0	28.0
Net profit	676	1,150	1,433	1,043	1,341
Minority interest & Exceptional Items	(14.7)	-	1.7	-	-
Net profit	661	1,150	1,435	1,043	1,341
-Growth (%)	(22.1)	70.2	24.6	(27.2)	28.5
-Net profit margin (%)	11.1	19.1	18.5	10.8	11.7

Source: Company, Centrum Research Estimate

Exhibit 5: Balance Sheet

Y/E March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Share capital	359	400	400	400	400
Stock Options outstanding	21	32	36	36	36
Reserves & surplus	3,569	5,958	6,944	7,865	9,049
Total shareholder's fund	3,948	6,390	7,380	8,301	9,485
Loan fund	-	-	-	-	-
Deferred liability	-	45	36	36	36
Total capital employed	3,948	6,435	7,416	8,337	9,521
Gross block	3,372	3,715	4,247	4,859	5,653
Accumulated depreciation	1,800	1,834	1,966	2,048	2,219
Net Block	1,573	1,881	2,282	2,811	3,434
Capital WIP	377	485	528	639	752
Net fixed assets	1,950	2,366	2,810	3,450	4,186
Investment	880	1,562	2,513	2,513	2,513
Cash and bank	165	1,918	1,051	1,401	1,984
Debtors	1,034	1,363	1,661	2,010	2,365
Loans and advances	454	638	872	1,076	1,272
Other current assets	130	340	319	353	407
Total current assets	1,784	4,258	3,902	4,840	6,026
Current liabilities and provisions	914	1,710	1,507	1,717	2,003
Net current assets	870	2,548	2,395	3,123	4,023
Deferred tax assets	20	7	14	14	14
Total assets	3,948	6,435	7,416	8,337	9,521

Source: Company, Centrum Research Estimate

Exhibit 6: Cash Flow

Y/E March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Cash flow from operating					
Profit before tax	685	1,241	1,558	1,491	1,862
Depreciation	297	335	420	529	624
Other non cash charges	-	-	-	-	-
Operating profit before WC change	982	1,576	1,978	2,020	2,486
Working capital adjustments	(197)	119	(723)	(378)	(318)
Tax Paid	(30)	(77)	(132)	(447)	(521)
Net cash from operating	755	1,619	1,123	1,195	1,647
Cashflow from investing					
Net Capex	(501)	(476)	(595)	(723)	(907)
Investments	(188)	(682)	(952)	-	-
Dividend/Interest Income					
Net cash from investing	(689)	(1,158)	(1,547)	(723)	(907)
CF from financing					
Proceeds from Share Cap. and premium	21	53	4	-	-
Borrowings	-	-	-	-	-
Addition to reserves	22.5	1,353.6	(281.2)	(0.0)	(0.0)
Interest paid					
Dividend paid	(42)	(115)	(168)	(122)	(157)
Net cashflow from financing	1	1,292	(445)	(122)	(157)
Exceptional Item	(15)	-	2	-	-
Net cash increase/(decrease)	52	1,752	(867)	350	583

Source: Company, Centrum Research Estimate

Exhibit 7: Key Ratios

Y/E March	FY09	FY10	FY11E	FY12E	FY13E
Profitability ratios (%)					
EBIDTA margin	15.4	24.3	21.2	17.3	18.6
EBIT margin	10.4	18.8	15.8	11.8	13.2
PBT margin	11.5	20.6	20.1	15.4	16.3
PAT margin	11.0	18.8	17.8	10.4	11.4
Return ratios (%)					
ROCE	17.0	21.7	17.7	14.6	16.9
ROIC	22.9	38.5	35.9	27.7	31.9
ROE	18.7	22.3	20.8	13.3	15.1
Turnover Ratios					
Asset turnover ratio (x)	1.2	0.7	0.9	1.0	1.0
Working capital FYcle (days)	37.3	40.5	46.5	57.7	60.1
Average collection period (days)	54.7	72.8	71.3	69.1	69.8
Per share (Rs)					
Basic EPS	17.4	30.4	37.9	27.5	35.4
Fully diluted EPS	16.5	28.7	35.8	26.0	33.4
Book value	104.2	168.6	194.7	219.1	250.3
SolvenFY Ratio (%)					
Debt-equity	-	-	-	-	-
Interest coverage ratio	-	-	-	-	-
Valuation (x)					
P/E	22.2	12.7	10.2	14.0	10.9
P/BV	3.5	2.2	1.9	1.7	1.5
EV/EBIDTA	15.0	8.1	7.8	7.4	5.6
EV/Sales	2.3	2.0	1.7	1.3	1.0
M-cap/Sales	2.3	2.3	1.8	1.4	1.2

Source: Company, Centrum Research Estimate

Appendix A

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