MARKET UPDATE

ESPIRITO SANTO Securities

India | Technology | Small & Mid Cap | 26-November-2012

Accounting & corporate governance	GREEN
Franchise Strength	GREEN
Earnings Momentum	GREEN

Persistent Systems

Tops our conviction list

We are raising our fair value on Persistent from Rs.500 to Rs.577 as we see a structural shift in its revenue and margin profile. Persistent satisfies all the three criteria of a scalable outsourced product development (OPD) company: i) anchor clients and long relationships enable it to get access to the source code, which software product companies are generally wary about sharing with third party vendors; ii) strong operations and quality work enables it to attract talent and iii) OPD when added with IP (19% of revenues) and higher revenues from emerging technologies like mobility, cloud and big data (c.50% of revenues), becomes scalable. We reiterate BUY on our top mid cap IT pick.

Success is a combination of two factors

In times when companies are struggling to record double digit YoY growth and meet NASSCOM's estimates, Persistent recorded 10% QoQ growth in Q2 FY13. While this was largely driven by two large IP led deals won earlier this year, the question is whether there is a structural shift in the gross margin profile of the company and whether this also reduces the revenue volatility that was always argued against Persistent Systems. We think so.

- **IP has added c.200bps to margins since FY10**: Persistent's revenue from Intellectual Property (IP) has increased from 7.1% in FY10 to 16.5% in H1 FY13, adding c.200bps to gross margin over the period. With Persistent targeting taking it to 25% over the next 3 years there is an incremental buffer of an additional 200bps to margin purely from IP.
- **Presence in emerging technologies helps billing rates**: At a time when the IT services industry is struggling to maintain pricing, Persistent has seen its billing rates increase by 6% from FY10 to H1 FY13. This can be attributed to early presence in emerging technologies where demand is stronger than supply and hence pricing can be improved. Thus, Persistent's success is a combination of two factors: IPs and presence in emerging technologies. OPD being prone to discretionary spending could remain volatile in short run, however, our channel checks suggest that Persistent has positioned itself well by clubbing IP, cloud, analytics and mobility (c.50% of revenue) with its pure play OPD business and hence is able to record good growth and demand price increases.
- **Strong cash generation and high FCF yield**: Persistent's OCF as percentage of EBITDA for last 7 years stands at 88% which is even better than Tier-I IT companies. FCF generation also stands on a par with Tier-I IT, indicating sound cash management practices. Cash and marketable investments at 22% of market cap (Rs96.5 per share) and a free cash flow yield of 9% make us believe that the risk-reward balance is favourable.

Valuation

We raise our earnings estimates by 4% and 7% for FY13 and FY14. Attrition rates have started to decline which gives one more lever to manage margins. A strong anchor client base is also helping it. Nine out of Persistent's top ten clients are either pure tech companies or companies in cloud computing which gives us comfort. We reiterate BUY and highlight this as our top mid cap IT pick.

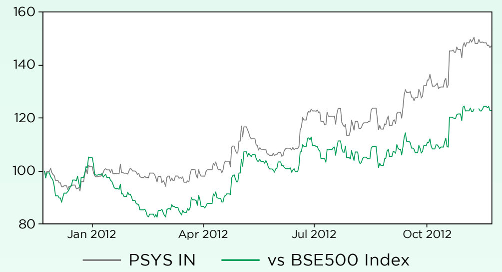
BUY 21% upside

Fair Value	Rs577.00
Bloomberg ticker	**PSYS IN**
Share Price	Rs476.00
Market Capitalisation	Rs18,944.00m
Free Float	61%

INR m Y/E 31-Mar	2011A	2012A	2013E	2014E
Revenue	7758	10003	12970	14272
EBITDA	1583	2293	3528	3542
EBIT	1159	1682	2729	2623
Pre Tax Profit	1330	1983	2666	2946
Net Income	1210	1432	1886	2121
EPS	34.6	35.4	47.1	53
Free Cash Flow	619	(73)	783	2111

Y/E 31-Mar	2011A	2012A	2013E	2014E
P/E	13.7	13.5	10.1	9.0
EV / Sales	2.3	1.8	1.3	1.0
EV / EBITDA	11.3	7.8	4.8	4.1
EV / EBIT	15.4	10.7	6.2	5.5
FCF Yield	2%	-2%	4%	9%

Share Price Performance



Source: Espirito Santo Investment Bank Research, Company Data, Bloomberg

Analysts

Soumitra Chatterjee
+91 22 4315 6829
soumitra.chatterjee@espiritosantoib.co.in
Execution Noble Ltd

Nitin Padmanabhan
+91 (0) 22 4315 6830
nitin.padmanabhan@espiritosantoib.co.in
Execution Noble Ltd

Decoding the twin factors of success

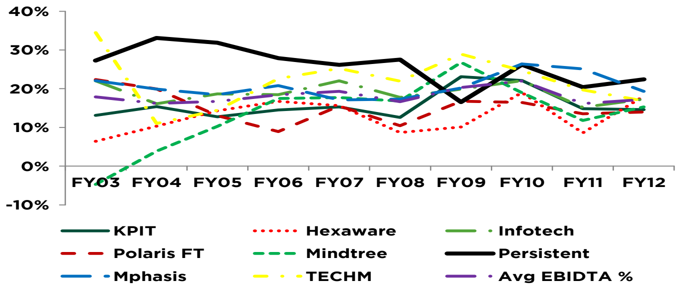
Persistent's presence in emerging technologies and its bouquet of IPs has helped recoup the majority of margin decline caused by wage hikes (figure 1). Additionally the last 10 years history of EBITDA margins shows it has the lowest margin volatility of its peer group and during this period the average currency rate was Rs.45 to the USD (figure 2).

Figure 1 IPs and pricing have helped counter wage pressure

	FY10	FY12	Change	YTD	Change
Gross margins	**38.7%**	**35.9%**	**-2.8%**	**41.9%**	**6.0%**
Wage increases	3.2%	3.2%	-6.4%	4.2%	-4.2%
Currency	47.2	48.3	1.3%	54.6	7.1%
IP Led revenues	7.1%	8.5%	0.3%	16.5%	1.6%
Pricing	1.2%	3.2%	2.0%	2.3%	1.4%
Total			**-2.8%**		**6.0%**

Source: Espirito Santo Investment Bank Research, Company Data

Figure 2 EBITDA margin profile in last 10 years

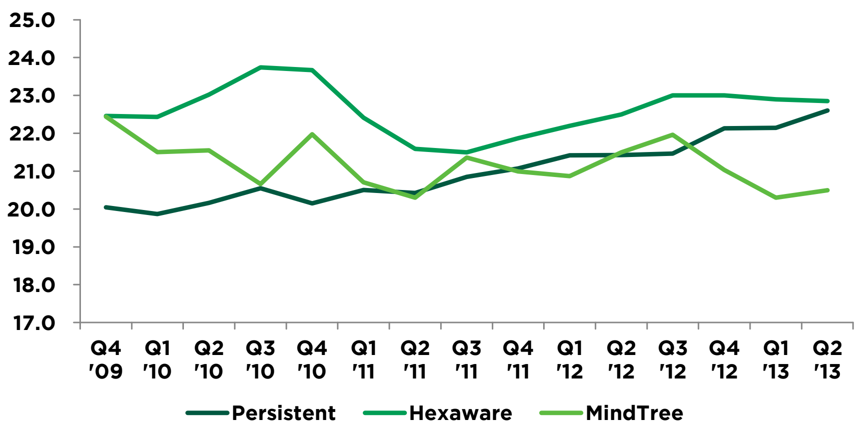


Source: Espirito Santo Investment Bank Research, Company Data

Pricing improvement due to presence in emerging technologies

Persistent has seen its billing rates going up by 13% from Q4FY09 to Q2FY13. When compared with other Tier-II IT companies which disclose billing rates, namely Hexaware and MindTree, Persistent has seen the highest jump in billing rates. It was listed in Q4 FY09 and at that time its offshore billing rate was 11% lower than Hexaware's and MindTree's. In the last 15 quarters it has seen a 13% increase in its billing rates and is now on a par with Hexaware and 10% above MindTree. This improvement can be attributed to an early presence in emerging technologies which now contribute to c.50% of total revenue. Persistent spotted this early and hence is able to command and improve billing rates. While we don't build any pricing improvement into our model (to be conservative), we wouldn't be surprised by any improvement in billing rates as there is strong demand for these technologies and not enough supply. Management is also of the view that most product companies have just started to explore the OPD model and pricing is not a constraint when seen in the context of timely execution.

Figure 3 Offshore billing rates for the last 15 quarters



Source: Espirito Santo Investment Bank Research, Company Data

Improvement in pricing could also be attributed to the fact that Persistent is contributing to a client's revenue opportunity rather than reducing costs.

IPs will help maintain gross margins over next two years

The recent jump in IP led revenues was due to the IBM and Open wave deals signed earlier this year. There is reasonable certainty that these types of deals will continue to accrue in the future as the execution in the IBM project has been ahead of schedule. Our core thesis is that IP led revenues will increase from 8% in FY12 to 22% in FY15E and the contribution of this to gross profit would increase from 13% in FY12 to 33% in FY15E, which will enable Persistent to maintain its gross margins, which is a rarity for mid cap IT companies.

Figure 4 Gross margin expected to remain stable

	FY12A	FY13E	FY14E	FY15E
Revenues ($ mn)	207	238	275	316
IP led revenue ($ mn)	18	35	52	69
Other revenue ($ mn)	189	203	223	247
Share of IP led revenues	9%	15%	19%	22%
Gross Margin from IP led business	**60.0%**	**60.0%**	**60.0%**	**60.0%**
Share of IP led revenues to gross profit	**13%**	**22%**	**28%**	**33%**
Gross profit from IP Led business ($ mn)	11	21	31	41
Total gross profit ($ mn)	85	97	111	127
Total gross margin	**40.8%**	**40.8%**	**40.5%**	**40.1%**
Gross profit from OPD business ($ mn)	74	76	80	85
Gross margins in OPD business	**39.0%**	**37.5%**	**36.0%**	**34.5%**

Source: Espirito Santo Investment Bank Research, Company Data

Channel checks suggest OPD business itself could grow 16-18%

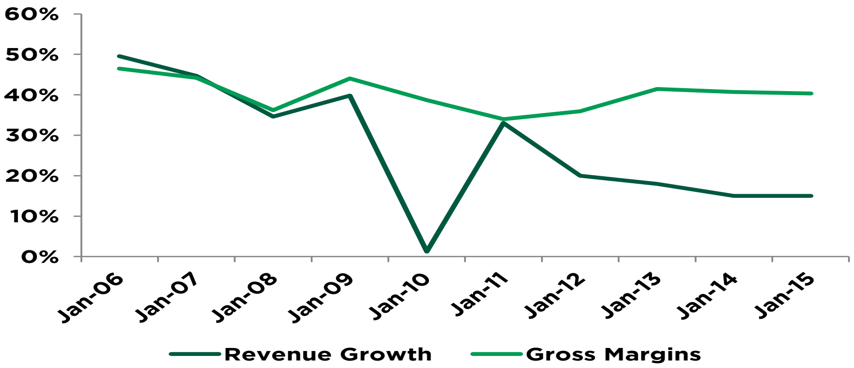
Outsourced product development (OPD) has been a volatile business on a quarterly basis. However, on a yearly comparison the OPD segment in India has grown 17% CAGR over the last five years and Persistent' s market share during this period has grown from 12% to 16%. We met a couple of unlisted OPD companies to get a sense of growth expectations in the next 2-3 years and we came away confident that the core business (ex-IP) could grow in the mid-teens (15%) over the next three years. Key takeaways were:

- On a secular basis there are concerns on growth as budgets will remain flat and OPD being discretionary in nature could suffer
- However, Persistent identified the key growth areas in advance and has developed capabilities around it which is helping it grow faster
- What are also helping it are its large anchor clients like IBM and Intuit, where Persistent is an integral part of the client's product development. This is rare as no product company would usually make a third party vendor an integral part of its product development process.
- Although deal sizes for the industry are coming down, Persistent is doing high-end work for clients in cloud computing and the cloud is very disruptive technology with an attractive growth rate.

Conclude that a structural shift could happen in earnings profile

In our view there is a structural shift in the gross margin profile of the company and despite generic industry headwinds. Persistent should be able to manage its gross margins over the next three years. The drop in EBITDA margins in our model is due to higher S,G&A, which we raise from 6% at present to 8% as Persistent is spending more on sales in an attempt to create higher visibility of the firm's capabilities.

Table 1 Revenue growth and gross margin profile



Source: Espirito Santo Investment Bank Research, Company Data

Change in estimates

We have raised our revenues estimates by 4% and 2% for FY13 and FY14 to factor in the Doyenz acquisition and generic strength in the IP business. We have increased our EBITDA estimates by 16% for FY13 and by 8% for FY14 as higher IP revenues (60% gross margin) and higher pricing (up 2.3% in H1FY13 over FY12) are sustainable over the rest of FY13. Due to an increase in EBITDA estimates, our PAT estimates have gone by up by 4% and 7% for FY13 and FY14. The change in PAT is lower than the change in EBITDA for FY13E due to higher forex loss recorded in Q2 FY13.

Figure 5 Old versus New estimates

(Rs m)	Old	New	Change %
Sales			
FY13	12,429	12,970	4%
FY14	13,949	14,272	2%
EBIDTA			
FY13	3,028	3,528	16%
FY14	3,275	3,542	8%
PAT			
FY13	1,815	1,886	4%
FY14	1,983	2,121	7%

Source: Espirito Santo Investment Bank Research, Company Data

ESIB versus consensus

We are largely in line with consensus on revenues, but 9% higher than consensus on EBITDA for FY13 due to a higher margin assumption. However, this has got offset against forex loss and we are in line with consensus on PAT. For FY14, we are 3% ahead on EBITDA and 2% on PAT.

Figure 6 US versus consensus

(Rs m)	US	Cons	Difference
Sales			
FY13	12,970	12,728	2%
FY14	14,272	14,235	0%
EBITDA			
FY13	3,528	3,247	9%
FY14	3,542	3,442	3%
PAT			
FY13	1,886	1,866	1%
FY14	2,121	2,074	2%

Source: Espirito Santo Investment Bank Research estimates, Bloomberg estimates for consensus

Valuation Methodology

Led by strong outperformance in Q2 FY13 the 10-15% discount that Persistent used to historically trade at has changed to a 10% premium. We think it is sustainable as:

- Competitive positioning in the OPD segment: not many pure play OPDs and the ones that are there are unlisted.
- Persistent is contributing to a client's revenue opportunity rather than reducing costs and hence has pricing power which others don't have.
- Reasonable barriers to entry: OPD requires specialized skills and not many IT Services have those skills except MindTree (PES segment), HCL Tech (strong on embedded systems) and Wipro.
- IP gives cushion to protect margins: IP, currently 14% of revenues and expected to reach to 20% by Q4 FY14, has a gross margin of c.60%
- High level of governance: Persistent is the only company in the Tier-II IT space where we have a green rating on corporate governance.

Figure 7 DCF Summary

Category	Previous	Current	Change
COE	15%	15%	0%
Terminal Growth Rate	3%	3%	0%
PV of growth phase	3,619	3,715	3%
PV of consolidation	5,252	6,398	22%
PV of maturation	5,933	6,831	15%
PV of terminal value	5,173	6,120	18%
DCF of equity value	19,977	23,065	15%
Net Cash			
Total Equity Value	**19,977**	**23,065**	**15%**

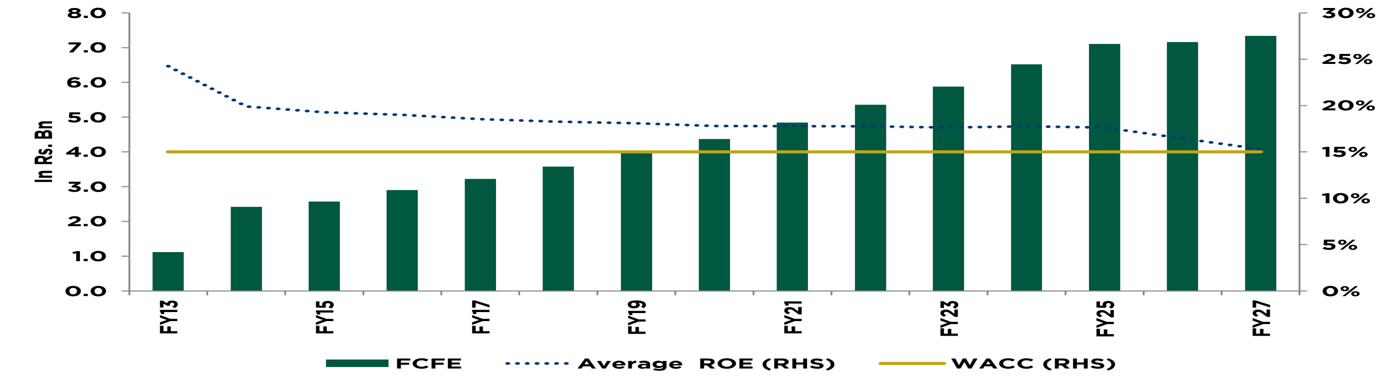
Source: Espirito Santo Investment Bank Research, Company Data

Figure 8 Sensitivity to terminal growth and cost of capital

		Weighted Average Cost of Capital				
		13.0%	14.0%	15.0%	16.0%	17.0%
Terminal Growth	0.5%	695	618	553	498	451
	1.5%	715	633	564	506	457
	2.5%	738	650	**577**	516	464
	3.5%	766	670	592	527	473
	4.5%	801	695	609	540	483

Source: Espirito Santo Investment Bank Research, Company Data

Figure 9 Persistent' s estimated FCFE profile



Source: Espirito Santo Investment Bank Research, Company Data

Figure 10 Comparative valuation table

Company	Market cap Mn	Net Debt Mn	EV Mn	Sales CAGR FY12-14	EBITDA CAGR FY12-14	EPS CAGR FY12-14	P/Sales 2012 A	P/Sales 2013E	P/Sales 2014E	EV/EBITDA (x) 2012 A	EV/EBITDA (x) 2013E	EV/EBITDA (x) 2014E	P/E 2012 A	P/E 2013E	P/E 2014E
Infosys Ltd.	1,364,077	(205,910)	1,158,167	13%	12%	11%	3.6	2.9	2.5	11.2	9.4	7.8	17.0	15.1	13.2
Tata Consultancy Services Ltd.	2,501,524	(88,275)	2,413,249	17%	17%	15%	4.8	3.8	3.5	16.2	12.6	11.7	22.9	18.4	17.5
Wipro Ltd.	912,415	(60,665)	851,750	12%	8%	11%	2.4	2.0	1.8	12.5	10.2	8.8	17.5	14.7	13.1
HCL Technologies Ltd.	435,157	(3,085)	432,073	14%	16%	18%	2.1	1.7	1.6	10.9	8.3	8.1	17.7	12.9	12.7
Average				**14%**	**13%**	**14%**	**3.2x**	**2.6x**	**2.3x**	**12.7x**	**10.1x**	**9.1x**	**18.8x**	**15.3x**	**14.1x**
Other Indian IT Companies															
Tech Mahindra + Satyam	116,211	7,243	123,454	15%	26%	10%	1.0	0.8	0.7	6.4	4.1	4.0	11.7	10.1	9.6
Hexaware Technologies Ltd.	30,182	(4,377)	25,805	25%	32%	16%	2.1	1.5	1.3	9.8	5.8	5.6	11.1	8.3	8.3
Polaris Financial Technology Ltd	11,499	14,600	26,099	18%	13%	13%	0.6	0.5	0.4	9.0	7.9	7.0	5.2	4.3	4.1
Persistent Systems Ltd.	19,002	(3,283)	15,719	19%	24%	22%	1.9	1.5	1.3	6.9	4.5	4.4	13.4	10.1	9.0
MphasiS Ltd.	83,086	(17,598)	65,488	6%	9%	2%	1.6	1.5	1.4	6.7	6.1	5.6	10.1	10.4	9.7
MindTree Ltd.	26,984	(3,103)	23,881	20%	27%	28%	1.4	1.1	1.0	8.2	5.5	5.0	12.8	8.5	7.8
KPIT Cummins Infosystems Ltd.	21,924	459	22,383	29%	36%	32%	1.5	1.0	0.9	10.3	6.4	5.6	15.5	10.4	8.8
Average				**19%**	**24%**	**18%**	**1.4**	**1.1**	**1.0**	**8.1**	**5.8**	**5.3**	**11.4**	**8.9**	**8.2**

Source: Espirito Santo Investment Bank Research, Company Data

Risks to Fair Value

The risks to our fair value of Rs577 are:

1. **Sharp appreciation in currency**: Persistent Systems has the highest sensitivity to currency as most of the work (c.80%) is delivered from offshore locations. Any sharp appreciation in currency puts our margin expectations and fair value at risk.
2. **Rise in attrition rate**: The attrition rate currently stands at 19%. In FY11, Persistent gave two wage hikes as the attrition rate spiraled. While the attrition rate is expected to remain constant in the near term as hiring remains subdued, any spike could put pressure on margins and our fair value.

Company Background

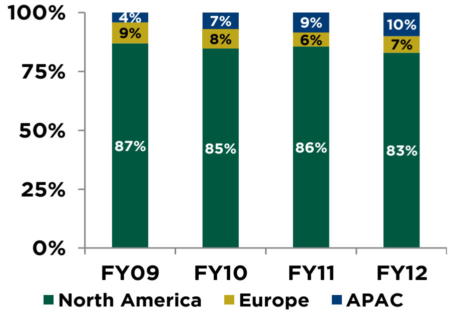
Started in 1990, Persistent focuses exclusively on the Offshore Product Development (OPD) segment and operates largely out of Pune. Of the seven product development centres, four are in Pune and one each in Goa, Nagpur (Maharashtra) and Hyderabad (Andhra Pradesh).

Persistent differs from a typical IT Services company due to its focus on OPD and its customers are predominantly product companies. Thus, Persistent's focus is on CTOs instead of CIOs where most IT Services companies focus on. However, in its new focus areas like Cloud Computing and Mobility, Persistent's focus is shifting to CIOs. These new services currently generate 40% of revenue and around 2,000 people work exclusively in these service lines.

OPD is outsourcing of specific activities or all activities related to the development and maintenance of a product. While outsourcing product development may seem conceptually similar to the outsourcing of software applications development, there are significant differences in terms of skill-sets, standards and execution expertise required for product development.

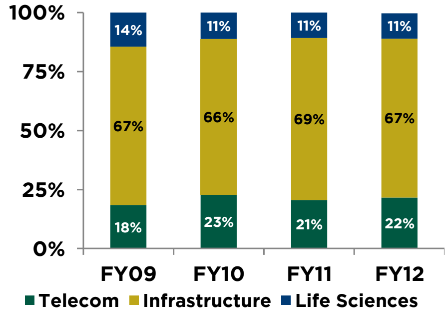
Persistent derives 25% of its revenues from technology Start-ups and another 35% from SMEs Persistent is well connected with Private Equity and Venture Capital Funds and the start-up companies. Small businesses often get acquired by larger companies which give Persistent the opportunity to add marquee clients to its kitty. Over last five years (FY06-10) Persistent has grown revenues and earnings by 29% and 26% CAGR respectively.

Figure 11 Geography wise revenues breakup



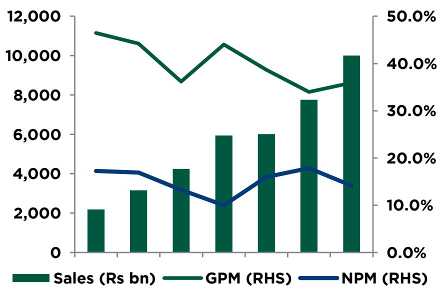
Source: Espirito Santo Investment Bank Research, Company Data

Figure 12 Geography wise revenues breakup



Source: Espirito Santo Investment Bank Research, Company Data

Figure 13 Revenue, Gross and Net margins



Source: Espirito Santo Investment Bank Research, Company Data

Persistent Systems

Recommendation:	**BUY**
Fair Value:	**INR 577**
Share Price:	INR 476
Upside / Downside	21%
3 Month ADV ($m)	1
Free Float	60.0%
52 Week High / Low	INR 427 - 290
Bloomberg:	PSYS IN
Model Published On:	26 November 2012

Shares In Issue (mm)	40
Market Cap ($mn)	**420**
Net Debt ($mn)	-63
Enterprise Value ($mn)	**356**

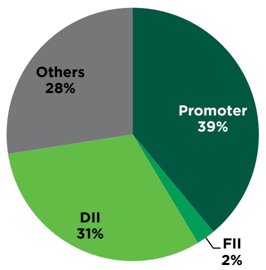
Forthcoming Catalysts

Third quarter results	Mid January

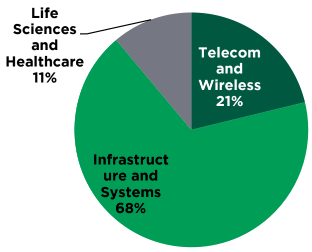
Espirito Santo Securities Analyst
Soumitra Chatterjee
(91) 22 4315 6829
soumitra.chatterjee@execution-noble.com

Nitin Padmanabhan
(91) 22 4315 6830
nitin.padmanabhan@execution-noble.com

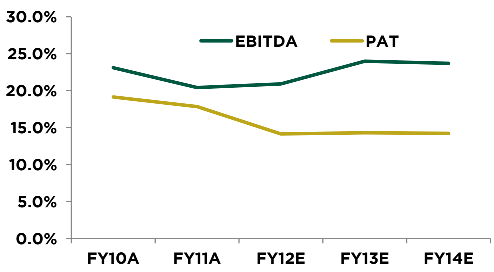
Shareholding Pattern



Revenue Breakdown



Margin Trends



Valuation Metrics	**2009A**	**2010A**	**2011A**	**2012A**	**2013E**	**2014E**
P/E	23.0	13.3	13.7	13.5	10.1	9.0
Reported P/E	23.0	13.3	13.7	13.5	10.1	9.0
EV / Sales	3.4	3.0	2.3	1.8	1.3	1.0
EV / EBITDA	11.4	12.2	11.3	7.8	4.8	4.1
EV / EBIT	13.7	15.9	15.4	10.7	6.2	5.5
FCF Yield	0.6%	5.4%	2.3%	-1.9%	4.3%	9.1%
Dividend yield	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%

Key ratios	**2009A**	**2010A**	**2011A**	**2012A**	**2013E**	**2014E**
EBITDA margin	30.1%	24.3%	20.4%	22.9%	27.2%	24.8%
EBIT margin	25.1%	18.8%	14.9%	16.8%	21.0%	18.4%
Capex / Revenue	8.3%	7.9%	12.5%	15.1%	8.9%	4.6%
Capex / Depreciation	1.65	1.42	2.29	2.47	1.45	0.71
Net Debt / EBITDA	-0.6	-2.4	-2.2	-1.5	-1.3	-2.0
EBITDA / Net Interest	NA	NA	NA	NA	NA	NA
ROE	39%	18%	16%	17%	18%	17%

P&L Summary	**2009A**	**2010A**	**2011A**	**2012A**	**2013E**	**2014E**
Revenue	**5,938**	**6,012**	**7,758**	**10,003**	**12,970**	**14,272**
% change	39.8%	1.2%	29.1%	28.9%	29.7%	10.0%
EBITDA	**1,788**	**1,463**	**1,583**	**2,293**	**3,528**	**3,542**
% change	95.8%	-18.1%	8.2%	44.8%	53.8%	0.4%
% margin	30.1%	24.3%	20.4%	22.9%	27.2%	24.8%
Depreciation & Amortisation	-297	-335	-424	-611	-798	-919
EBIT	**1,491**	**1,128**	**1,159**	**1,682**	**2,729**	**2,623**
% change	135.5%	-24.3%	2.8%	45.1%	62.3%	-3.9%
% margin	25.1%	18.8%	14.9%	16.8%	21.0%	18.4%
Associates	0	0	0	0	0	0
Operating Profit	**1,491**	**1,128**	**1,159**	**1,682**	**2,729**	**2,623**
Interest Expenses	0	0	0	0	0	0
Other Income	69	81	170	301	-64	322
Pre Tax Profit	**1,559**	**1,209**	**1,330**	**1,983**	**2,666**	**2,946**
Income Tax Expense	-10	-91	-119	-551	-780	-825
Minority Interests	0	0	0	0	0	0
Net Income	**1,550**	**1,119**	**1,210**	**1,432**	**1,886**	**2,121**
Execution Net Income	1,550	1,119	1,210	1,432	1,886	2,121
Reported EPS	20.69	35.74	34.63	35.39	47.14	53.02
EPS	**20.69**	**35.74**	**34.63**	**35.39**	**47.14**	**53.02**
DPS	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**
Payout Ratio	4.8%	2.8%	2.9%	2.8%	2.1%	1.9%
Shares In Issue (Less Treasury)	36	40	40	40	40	40

Cash Flow Summary	**2009A**	**2010A**	**2011A**	**2012A**	**2013E**	**2014E**
EBITDA	1,788	1,463	1,583	2,293	3,528	3,542
Taxes Paid	-10	-91	-119	-551	-780	-825
Interest Paid / Received	69	81	170	301	-64	322
Change in Working Capital	-401	498	48	-604	-781	51
Associate & Minority Dividends	0	0	0	0	0	0
Other Operating Cash Flow	-761	-342	-91	-5	39	-322
Operating cash flow	**684**	**1,610**	**1,591**	**1,434**	**1,943**	**2,768**
Capital Expenditure	-490	-476	-972	-1,507	-1,160	-657
Free Cash Flow	**194**	**1,134**	**619**	**-73**	**783**	**2,111**
Acquisitions & Disposals	0	0	0	0	0	0
Dividends Paid To Shareholders	-32	-22	-240	-200	-80	-80
Equity Raised / Bought Back	0	0	0	0	0	0
Other Financing Cash Flow	-107	620	-2,029	474	-133	402
Net Cash Flow	**54**	**1,733**	**-1,650**	**201**	**570**	**2,434**

Balance Sheet Summary	**2009A**	**2010A**	**2011A**	**2012A**	**2013E**	**2014E**
Cash & Equivalents	1,046	3,479	3,500	3,413	4,524	6,958
Tangible Fixed Assets	2,177	2,318	2,866	3,710	4,144	3,882
Goodwill & Intangibles	0	0	0	0	0	0
Investment in Equity Investee	0	0	0	0	0	0
Other Assets	1,639	2,348	2,737	2,997	3,727	3,864
Total Assets	**4,862**	**8,145**	**9,103**	**10,120**	**12,395**	**14,704**
Interest Bearing Debt	0	0	0	0	0	0
Other Liabilities	914	1,755	1,632	1,715	1,624	1,812
Total Liabilities	**914**	**1,755**	**1,632**	**1,715**	**1,624**	**1,812**
Shareholders' Equity	3,948	6,390	7,471	8,405	10,671	12,792
Minority Interests	0	0	0	0	0	0
Total Equity	**3,948**	**6,390**	**7,471**	**8,405**	**10,671**	**12,792**
Net Debt	-1,046	-3,479	-3,500	-3,413	-4,524	-6,958

Source: Company data and Espirito Santo Investment Bank Research estimates

Persistent Systems *PSYS IN*

Report date		Recommendation	Fair value	Share price
2012	September 20	Buy	Rs498.95	Rs413.35
2011	March 17	Buy	Rs449.00	Rs370.00

Source: Bloomberg, Espirito Santo Investment Bank Research

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Neutral	170	35.6%	11	31.4%	2.3%
Sell	81	16.9%	2	5.7%	0.4%
Restricted	0	0.0%	0	0.0%	0.0%
Under Review	0	0.0%	0	0.0%	0.0%
Trading Rating:					
Trading Buy	0	0.0%	0	0.0%	0.0%
Trading Sell	0	0.0%	0	0.0%	0.0%
Total recommendations	478	100%	35	100%	7.3%

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Contact Information

Garreth Hodgson	Senior Managing Director /Head of Sales	(212) 351-6054	ghodgson@espiritosantoib.com
Eva Gendell	Vice President	(212) 351-6058	egendell@espiritosantoib.com
James Kaloudis	Executive Director	(212) 351-6065	jkaloudis@espiritosantoib.com
Joy Bejasa	Vice President	(212) 351-6055	jbejasa@espiritosantoib.com
Lisa Gottardo	Executive Director	(212) 351-6060	lgottardo@espiritosantoib.com
Mike Williams	Vice President	(212) 351-6052	mwilliams@espiritosantoib.com
Pedro Marques	Vice President	(212) 351-6051	pmarques@espiritosantoib.com
Poorva Upadhyaya	Assistant Vice President	(212) 351-6056	pupadhyaya@espiritosantoib.com

E.S. Financial Services, Inc.
New York Branch
340 Madison Avenue, 12th Floor
New York, N.Y. 10173

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