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Institutional Equities

Persistent Systems

12 February 2019

Reuters: PERS.BO; Bloomberg: PSYS IN

Event Update

New CEO – Focus On Strengths. Enterprise Pivot May Suffer

Persistent Systems (PSL) yesterday appointed Christopher (Chris) O'Connor as CEO. Chris will be based in the US and join on February 25, 2019. According to the press statement "Chris led the Internet of Things (IoT) business unit at IBM including roles as its General Manager, Head of Sales and Head of all software R&D. He has been the founding strategist, leader and industry wide innovator of IBM IoT. His prior roles in IBM have centered around building new businesses for IBM such as Systems Management, IBM Commerce and Financial Software, and founding the IBM Smart Cities software and services business. He also has led network hardware R&D in the startup community both exiting and returning to IBM in that tenure". In hiring Chris, PSL seems to be going back to its core strength of software product engineering. We also think this is a defensive move to protect its large relationship with IBM – at ~25% of revenues – which has been a bit rocky lately with PSL not being able to extract any material value from the CE-CLM product that it partnered IBM on. Chris being a senior from the IBM ranks on the technology side may be able to understand IBM and its needs and be able to navigate PSL better in that relationship. In a way this may be a futuristic bet that PSL is laying on IoT and also on Cloud technologies. They are large opportunities, both on product engineering side as well as on the enterprise services side. For PSL what would be relevant currently would the former. With IBM trying to make a mark in Cloud software through purchase of Red Hat for USD34bn in cash (deal to be closed mid 2019) and its IBM Watson software family, Chris could potentially help not only protect turf but also try to bring in revenue in new areas that IBM will focus on. While this may optically look good for growth, client concentration risk only gets reinforced. Chris could also be critical to a likely corporate event that may happen in the next 12 months. Despite PSL's insistence that CE-CLM is among the priority set of IPs of IBM, we believe otherwise. Especially considering that it does not fit into the current priority of IBM – cloud software. At some point in the next 12 months, we believe IBM will ask PSL to take over the IP along with the sales team (the engineering team moved three years back). Having Chris on PSL's side in our view would help it negotiate this deal better. However this hiring in our view might mean that PSL has weakened its pivot to enterprise services. This pivot, which has been on for the past four to five years, has been difficult with problems in both sales and delivery. We had highlighted its structural weakness in our note (Not The Ideal 'Digital' Play). In digital, the company has not been able to scale up project sizes and we still believe that it has not built out an annuity component that would ensure smooth growth. Post this recruitment we continue with our 'Sell' rating on PSL and hold on to our estimates that we put out in our 3QFY19 results note (Pivot To Enterprise Proving Tough To Execute, CE-CLM A Headache). Our target price on PSL is Rs481 (8.3x September 2020E EPS, 50% discount to the target P/E multiple of TCS). The 50% discount is for the weak business model and lack of revenue predictability, even compared to some of its mid-cap peers. While PSL has been an early trend identifier in digital, execution has not been robust. In what clearly is one of the strongest demand environments in the past 10 years, PSL's weak performance reveals serious internal problems. Valuation looks cheap. Unless backed by better execution, it may remain so. We are also concerned about the 'IBM' risk - that IBM has been an underperforming technology company which seems financially leveraged with the Red Hat purchase especially in an emerging demand environment where enterprise spending on technology will likely see softness.

Will the new CEO make a difference?: We had been expecting an candidate - someone senior from any of the Tier-1 IT services companies, possibly with a BFSI or a healthcare vertical background – which would help with PSL's pivot to the enterprise side of the business. But PSL has chosen to focus on software product engineering side. Needs to be seen if the new CEO can make a material difference. There have been a few instances of significant change in fortunes of companies under new CEOs (LTI and NIIT Technologies come to mind in recent days). However, it remains to be seen how much independence the new CEO would be given as Anand Deshpande will continue to the executive Chairman of the company for some more time. Also, we believe the new CEO would be facing some adverse industry headwinds in the days ahead – we predict no industry growth in FY21. Chris however seems to be fairly familiar to PSL as he has apparently been working with it for about 10 years from the IBM side.

SELL

Sector: Information Technology

CMP: Rs638

Target Price: Rs481

Downside: 25%

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Key Data

Current Shares O/S (mn)	80.0
Mkt Cap (Rsbn/US$mn)	51.0/717.2
52 Wk H / L (Rs)	915/532
Daily Vol. (3M NSE Avg.)	285,719

Price Performance (%)

	1 M	6 M	1 Yr
Persistent Systems	(30.4)	(23.0)	(15.3)
Nifty Index	(8.1)	(3.0)	1.0

Source Bloomberg

Exhibit 1: Key financials

Y/E March (Rsmn)	FY17	FY18	FY19E	FY20E	FY21E
Revenues (Rsmn)	28,784	30,337	34,026	39,268	39,613
YoY Growth (%)	*24.5*	*5.4*	*12.2*	*15.4*	*0.9*
EBIT (Rsmn)	3,049	3,102	4,202	5,050	4,977
% of sales	*10.6*	*10.2*	*12.3*	*12.9*	*12.6*
Adj. PAT (Rsmn)	3,015	3,231	3,505	4,406	4,567
YoY Growth (%)	*1.4*	*7.2*	*8.5*	*25.7*	*3.6*
FDEPS (Rs)	37.7	40.4	44.2	57.2	59.3
RoE (%)	*17.2*	*15.4*	*19.7*	*21.9*	*19.0*
RoCE (%)	*17.1*	*15.3*	*19.5*	*21.6*	*18.7*
RoIC (%)	*31.1*	*29.7*	*41.4*	*49.9*	*53.5*
P/E (x)	15.0	14.0	12.8	9.9	9.6
P/BV (x)	2.4	2.1	2.0	1.8	1.6

Source: Company, Nirmal Bang Institutional Equities Research

View on Indian IT services sector: We downgraded the Indian IT sector (see our report: Street Is Not Factoring Even A Soft Landing; We Downgrade) on 27 December 2018 based on: (1) Consensus not factoring in significantly softer growth in FY21 as the best demand environment since 2008-09 is largely behind us with corporate capex in both the US and Europe likely to have peaked in 2018. (2) The US BFSI space could witness pressure on margins from a flattened/inverted yield curve and probably a more hostile regulatory environment through a split Congress in the US. (3) Pressure on cost structure because of tariffs levied on imports from China impacting US manufacturers. (4) Front-office capabilities in digital still elusive for Indian IT services players, leading to inability to tap into the marketing budgets of customers in a material way. The focus has been on the technology-intensive back-end of digital where we believe the field is relatively more crowded. (5) 'Automation at scale' in legacy services eating into growth coming in from new services. This is driven by explosive growth in both intelligent and robotic process automation software industry. (6) Factoring in lower INR depreciation benefits than estimated earlier (Refer: Incorporating New INR Estimate). (7) Capital return to shareholders not being as potent a stock driver as it was earlier as the cash hoard is shrinking after two to three rounds of buyback over the past three years. (8) Talent pressure in the US in new-age services because of a tighter H1-B visa regime. We were planning the downgrade a quarter or two down the road, but the global macro set-up has turned weaker far more quickly than we anticipated, hastening this move. While some of the 'relative' factors - investor positioning, valuation, earnings revision momentum - partly the reasons for turning 'tactically positive in March 2018 - still exist, we believe they are unlikely to carry as much importance with investors as deteriorating fundamentals would over FY19-FY21. While many of our competitors are expecting a better FY20 versus FY19, we believe that is unlikely. We probably had the best macro environment that the industry has seen in the past 10 years in 2018 and incrementally we only see a deterioration which should crimp spending by customers. More importantly, we reiterate our no-industry-growth-in-FY21 call initiated in March 2018. We base this scenario on an explicit expectation of a soft landing in the US (0%-1.5% real GDP growth) in 2020. We believe consensus is expecting mid-high single-digit revenue growth in FY21 for the industry, implicitly assuming continued robust growth in the US (2%-2.5%). It is our belief that the street will converge with our no-growth expectations over time. Until the market prices in this scenario, we believe technical factors are not likely to hold the sector up. A hard landing (recession) - not our current base case - could lead to single-digit negative growth for the sector. Just as outperformance of the sector in 2018 was driven largely by P/E multiple expansion in the belief that growth is going to accelerate, we believe the downside in 2019 will be driven by P/E multiple deflation as investors begin to re-calibrate growth expectations lower over FY19-FY21. We prefer large-caps over mid-caps. The faster growth shown by select mid-caps is a case of 'rising tide lifting all boats', a smaller base and lower exposure to legacy services. But as digital demand shifts from the front to back, we believe that traditional large Indian companies will be in a better position to capture the market. We would advise investors to focus on sustainability and not overpay for a riskier business model - some companies have seen client concentration rising over the past two years.

Financials

Exhibit 2: Income statement

Y/E March (Rsmn)	FY17	FY18	FY19E	FY20E	FY21E
Average INR/USD	**67.1**	**64.5**	**69.9**	**72.0**	**74.5**
Net Sales (USD mn)	**429**	**471**	**487**	**545**	**532**
YoY Growth (%)	***22.0***	***9.7***	***3.4***	***12.0***	***(2.4)***
Net Sales	28,784	30,337	34,026	39,268	39,613
YoY Growth (%)	*24.5*	*5.4*	*12.2*	*15.4*	*0.9*
Cost of Sales & Services	18,518	19,704	21,759	24,957	25,189
% of sales	*64.3*	*65.0*	*63.9*	*63.6*	*63.6*
Gross Margin	10,266	10,633	12,266	14,311	14,424
% of sales	*35.7*	*35.0*	*36.1*	*36.4*	*36.4*
SG& A	5,727	5,946	6,470	7,350	7,459
% of sales	*19.9*	*19.6*	*19.0*	*18.7*	*18.8*
EBITDA	**4,539**	**4,687**	**5,797**	**6,961**	**6,965**
% of sales	*15.8*	*15.4*	*17.0*	*17.7*	*17.6*
Depreciation	1,490	1,585	1,595	1,911	1,989
EBIT	**3,049**	**3,102**	**4,202**	**5,050**	**4,977**
% of sales	***10.6***	***10.2***	***12.3***	***12.9***	***12.6***
Other income (net)	*958*	*1,190*	*725*	*1,173*	*1,472*
PBT	4,007	4,292	4,927	6,222	6,449
-PBT margin (%)	*13.9*	*14.1*	*14.5*	*15.8*	*16.3*
Provision for tax	992	1,062	1,422	1,816	1,882
Effective tax rate (%)	24.8	24.7	28.9	29.2	29.2
Net profit	**3,015**	**3,231**	**3,505**	**4,406**	**4,567**
-Growth (%)	*1.4*	*7.2*	*8.5*	*25.7*	*3.6*
-Net profit margin (%)	*10.5*	*10.6*	*10.3*	*11.2*	*11.5*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: Balance sheet

Y/E March (Rsmn)	FY17	FY18	FY19E	FY20E	FY21E
Equity capital	800	800	770	770	770
Reserves & surplus	18,193	20,472	20,709	23,810	27,118
Net worth	18,993	21,272	21,479	24,580	27,888
Deferred tax liability	111	-	316	316	316
Other liabilities	166	160	168	168	168
Total loans	22	17	13	13	13
Total liabilities	**19,291**	**21,448**	**21,977**	**25,078**	**28,386**
Goodwill	76	77	82	82	82
Net block (incl CWIP)	5,573	5,097	4,357	3,266	2,131
Investments	6,839	8,797	11,252	11,252	11,252
Deferred tax asset	306	372	720	720	720
Other non-current assets	994	129	277	277	277
Other current assets	3,411	4,585	5,381	6,360	6,016
Debtors	4,754	4,847	5,211	6,191	5,846
Cash & bank balance	1,510	2,414	342	3,636	8,395
Total current assets	9,675	11,846	10,934	16,187	20,257
Total current liabilities	4,173	4,870	5,645	6,707	6,333
Net current assets	5,502	6,976	5,288	9,480	13,923
Total assets	**19,291**	**21,448**	**21,977**	**25,078**	**28,386**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Cash flow

Y/E March (Rsmn)	FY17	FY18	FY19E	FY20E	FY21E
EBIT	3,049	3,102	4,202	5,050	4,977
(Inc.)/dec. in working capital	(1,762)	(570)	(384)	(898)	316
Cash flow from operations	1,287	2,532	3,818	4,152	5,293
Other income	958	1,190	725	1,173	1,472
Depreciation & amortisation	1,490	1,585	1,595	1,911	1,989
Tax paid	(992)	(1,062)	(1,422)	(1,816)	(1,882)
Dividends paid	(761)	(800)	(949)	(1,305)	(1,259)
Net cash from operations	**1,982**	**3,445**	**3,767**	**4,114**	**5,612**
Capital expenditure	1,650	1,027	854	820	854
Net cash after capex	332	2,419	2,913	3,294	4,759
Inc./(dec.) in debt	127	(136)	313	-	-
(Inc.)/dec. in investments	135	(1,145)	(2,943)	-	-
Equity issue/(buyback)	-	-	(2,250)	-	-
Cash from financial activities	261	(1,280)	(4,880)	-	-
Others	(515)	(234)	(104)		-
Opening cash	1,432	1,510	2,414	342	3,636
Closing cash	1,510	2,414	342	3,636	8,395
Change in cash	77	904	(2,072)	3,294	4,759

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Key ratios

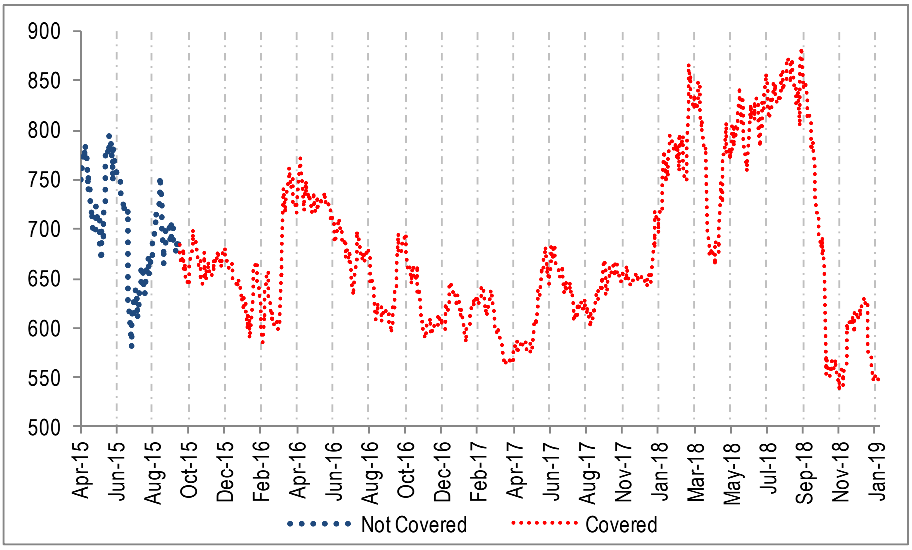
Y/E March	FY17	FY18	FY19E	FY20E	FY21E
Per Share (Rs)					
EPS	37.7	40.4	44.2	57.2	59.3
FDEPS	37.7	40.4	44.2	57.2	59.3
Dividend Per Share	9.0	10.0	10.2	14.1	13.6
Book Value	237	266	279	319	362
Dividend Payout Ratio (%)	25	25	27	30	28
Return ratios (%)					
RoE	17.2	15.4	19.7	21.9	19.0
RoCE	17.1	15.3	19.5	21.6	18.7
ROIC	31.1	29.7	41.4	49.9	53.5
Turnover Ratios					
Asset Turnover Ratio	1.5	1.4	1.6	1.6	1.4
Debtor Days (incl. unbilled Rev)	60	58	56	58	54
Working Capital Cycle Days	39	51	51	50	52
Valuation ratios (x)					
P/E	15.0	14.0	12.8	9.9	9.6
P/BV	2.4	2.1	2.0	1.8	1.6
EV/EBITDA	9.7	9.2	7.5	5.7	5.1
EV/Sales	1.5	1.4	1.3	1.0	0.9
M-cap/Sales	1.6	1.5	1.3	1.1	1.1
Dividend Yield	1.4	1.6	1.6	2.2	2.1

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
21 September 2015	Sell	685	562
27 October 2015	Sell	669	553
7 December 2015	Sell	663	544
8 January 2016	Under Review	630	-
27 January 2016	Under Review	609	-
14 March 2016	Sell	599	522
22 March 2016	Sell	741	555
26 April 2016	Sell	719	558
22 June 2016	Sell	697	558
26 July 2016	Sell	665	562
26 October 2016	Sell	660	573
19 December 2016	Sell	613	573
10 January 2017	Sell	636	557
24 January 2017	Sell	612	548
14 February 2017	Sell	624	574
27 April 2017	Sell	568	534
21 June 2017	Sell	681	516
24 July 2017	Sell	659	526
28 September 2017	Sell	651	540
17 October 2017	Sell	663	566
04 December 2017	Sell	654	566
26 December 2017	Under Review	650	-
30 January 2018	Under Review	788	-
17 March 2018	Sell	816	698
25 April 2018	Accumulate	726	717
3 July 2018	Accumulate	811	847
31 July 2018	Accumulate	828	867
5 October 2018	Buy	718	909
23 October 2018	Accumulate	560	622
12 December 2018	Accumulate	611	622
27 December 2018	Sell	630	504
7 January 2019	Sell	577	455
29 January 2019	Sell	567	481
12 February 2019	Sell	638	481

Rating track graph



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Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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