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Persistent Systems Ltd

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Creating niche by digital transformation…

Incorporated in 1990, Persistent Systems (Persistent) provides product engineering services, platform based solutions and IP-based software products to its customers. It operates in two key segments viz; Services (~79% of overall revenue in FY16) and IP Led (~21%). The services business is further bifurcated into ISVs (52%) and Enterprise (~26%).

Investment Rationale

- **Digital transformation provides compelling opportunity:** According to NASSCOM (National Association of Software and Services Companies) SMAC (social, mobility, analytics and cloud) revenue is estimated to account for c.20% of total revenue of Indian IT companies in 2020, from current levels of ~5%. Further, Internet of Things (IoT) connected devices are expected to increase to 6.4 bn and 20.8 bn by 2016 and 2020 respectively. We believe Persistent is best placed to capture the growth opportunity in the digital and IoT space given its strong tech capability and early adoption of digital technologies.

- **Improving product mix to drive growth ahead:** Given the company's ISV business is undergoing structural challenges due to cloud-led disruption and shrinking spending by vendors, the company has shifted focus to enterprise and digital business. In this direction, Persistent has significantly enhanced its offering in enterprise digital transformation space by forging an alliance with the IBM Watson IoT business. This alliance combines IBM Watson IoT Platform with Persistent's expertise around continuous engineering, analytics and enterprise digital transformation. It will further enhance its capability in IoT space. Thus, we expect services business revenue to grow at a CAGR of 11% over FY16-19E.

- **IP business - another feather in its cap:** Persistent's IP business displays its superior technological capability and provides a strong competitive edge over peers in an uncertain environment. The company rebranded its IP business as 'Accelerite'. Accelerite not only compliments the leadership of Persistent in product development services by leveraging upon its R&D capability, but also helps in bolstering its offerings and boost customer base/addressable market. The company has made a strong portfolio in the IP business through acquisitions and in-house software development. The revenue from this business has grown at a staggering >50% CAGR over FY12-16 powered by acquisitions. We expect the business to sustain its growth momentum going forward led by its inorganic growth strategy. We expect IP Led revenue to grow at 32% CAGR over FY16-19E.

Valuation: Persistent's improving business mix with focus on enterprise digital transformation and IoT coupled with its strong engineering capability and early adoption of SMAC technology lends confidence on sustainability of growth trajectory going forward. Further, its enhanced focus on IP business will not only drive earnings but also provide a strong competitive edge over peers. Hence, we expect revenue/PAT to grow at a CAGR of 16%/11% over FY16-19E. We initiate Persistent with a BUY rating with a TP of Rs709 at 14x FY19E EPS.

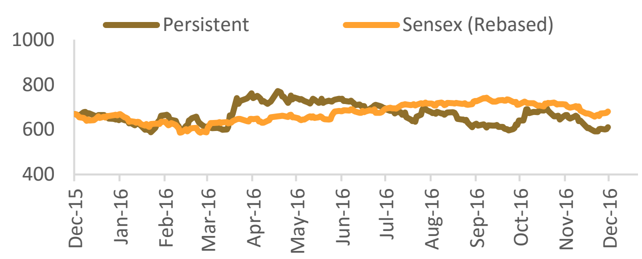
Market Data

Rating	**BUY**
CMP (Rs.)	603
Target (Rs.)	709
Potential Upside (%)	18
Duration	Long Term
Face Value (Rs.)	1.0
52 week H/L (Rs.)	798/575
Adj. all time High (Rs.)	798
Decline from 52WH (%)	24.4
Rise from 52WL (%)	4.9
Beta	0.3
Mkt. Cap (Rs.Cr)	4,827

Fiscal Year Ended

Y/E	FY16	FY17E	FY18E	FY19E
Revenue (Rs.Cr)	2,312	2,880	3,257	3,647
Adj. Profit (Rs.Cr)	297	296	352	405
EPS (Rs.)	37.2	37.0	44.0	50.7
P/E (x)	16.2	16.3	13.7	11.9
P/BV (x)	2.9	2.6	2.3	2.0
ROE (%)	19.5	17.0	17.7	17.7

One year Price Chart



Shareholding Pattern	Sep-16	Jun-16	Change
Promoters (%)	37.9	38.2	(0.3)
FII (%)	22.2	22.5	(0.3)
DII (%)	35.2	34.7	0.5
Others (%)	4.7	4.6	0.1

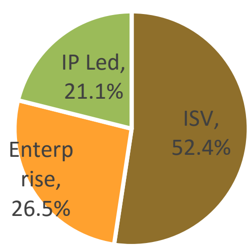
Persistent provides product engineering services, platform based solutions and IP-based software products.

Persistent Systems: Business overview

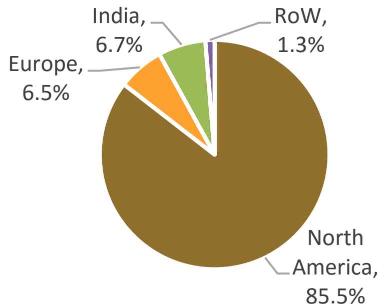
Incorporated in 1990, Persistent provides product engineering services, platform based solutions and IP-based software products to its customers. It caters to different industries ranging from infrastructure & systems, telecom & wireless, life science & healthcare, & financial services customers. Persistent's revenue mix comprises of two main segments – Services (~79% of overall revenue in FY16) and IP Led (~21%). The services business is further bifurcated into ISVs (52%) and Enterprise (~26%).

Persistent started as a boutique company focused on database internals. Since then the company has transformed itself to become one of the leading players in the full-lifecycle product development i.e.; Out sourced Product Development (OPD). Further, the company has acknowledged digital technology as the next phase of growth and started focusing on digital transformation and Internet of Things (IoT). Moreover, the company has reorganized itself into four business units effective from April 1, 2016 namely – Services, Digital, IBM alliance and Accelerite businesses.

Business Offerings - Revenue mix



Geography wise revenue mix



Source: Company, In-house research

Well poised to exploit the growth opportunity

According to NASSCOM, SMAC revenue is estimated to account for c.20% of the total revenue of Indian IT companies in 2020, from current levels of ~5%. Further, IoT connected devices are expected to increase to 6.4 bn and 20.8 bn by 2016 and 2020 respectively. Further, NASSCOM estimates proportion of investment in digital technology to rise from 10% in 2014 to 35% in 2020 and 60% in 2025.

Persistent has already sensed this opportunity and has restructured its business to focus on digital transformation and IoT in order to meet the requirements of its customers. As a step forward, the company has significantly enhanced its offering in enterprise digital transformation space by forging an alliance with the IBM Watson IoT business in February 2016. This alliance combines IBM Watson IoT Platform with Persistent' expertise around continuous engineering, analytics and enterprise digital transformation. It will help customers in developing solutions on the Watson IoT Platform using the IoT Continuous Engineering solution. The contribution from digital business currently stood at ~15% of the overall revenue.

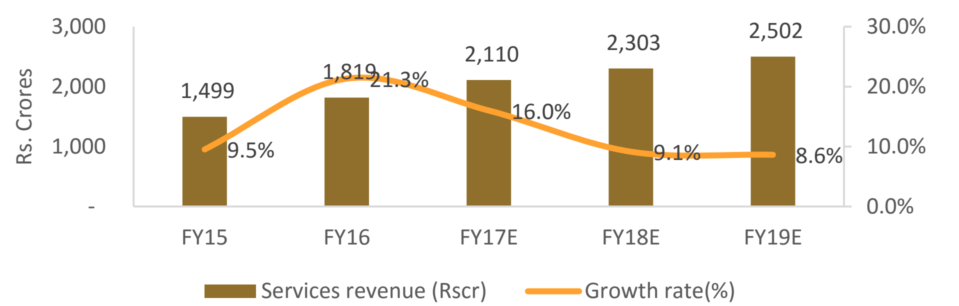
Software product development remains the DNA

Persistent is a leader in outsourced software product development services catering to independent software vendors (ISVs). Given its core competence and marquee clientele, it has created a niche in this space. Further, the company's association with each stage of the product development lifecycle starting from conceptulisation-to-design-to-development-to-implementation and finally maintenance provides it a competitive edge as it uniquely positions the company to serve customers in both business of software (ISV) as well as enterprises. However, the ISV business has remained under pressure for the last few quarters due to cloud led disruption and shrinking spending by vendors. Thus, the company has reduced its dependence on ISV business as the share of ISV business has plummeted from ~59% in FY15 to 44.4% in Q2FY17 while shifting focus to enterprise & digital businesses. However, in order to arrest the slowdown in ISV business, the company is targeting Silicon Valley start-ups and born-digital companies (remain focus on innovation). Besides, this move would also lead to the improved demand for ISV portfolio. Further, recovery in investments in cloud offerings by ISVs is expected to drive growth for the company in the longer term.

Shifting focus to enterprise & IP Led businesses lends confidence on growth trajectory

Enterprise business is the second largest revenue contributor to the company (~26% of revenue in FY16). The company is improving its business mix towards enterprise business (rose to ~26% in FY16 from ~22% in FY15) by focusing on enterprise digital transformation. This will help enterprises in adopting disruptive technologies and transforming their business model. Further, the company's partnership with IBM-Watson is a reflective of the company's strategy to strengthen its presence in the space. This partnership will not only strengthen relationship with IBM, the company's largest customer but also significantly enhance its offerings especially in the IoT space. Given the company's core expertise in software product development and its early investments in SMAC and enterprise digital technology, we believe it is best placed to benefit from the disruption play.

Services business to grow at a CAGR of 11% over FY16-19E

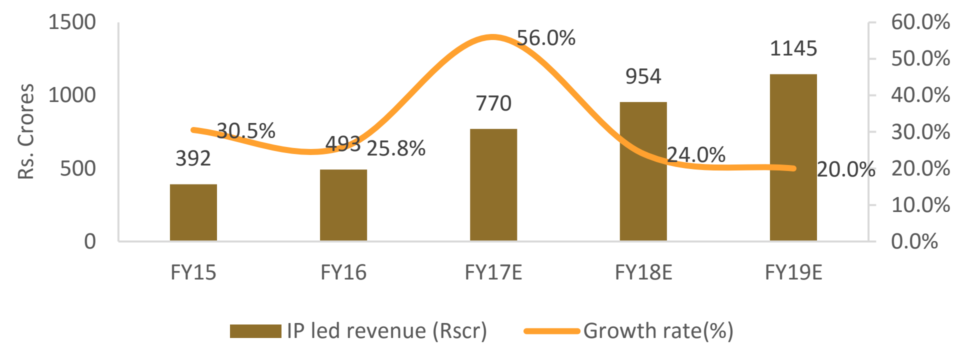


Source: Company, In-house research

…. IP business – A compelling proposition

Over the years, Persistent has built a strong portfolio in the IP business through acquisitions and in-house software development that contributes ~21% to overall revenue. Persistent's IP business displays its superior technological capability and provides a strong competitive edge over peers in an uncertain environment. The company's IP business primarily focuses on acquiring under-leveraged products of software product development companies and reinvigorating them. The company generates revenue mainly from licence renewal. The company rebranded its IP business as 'Accelerite'. Accelerite not only compliments the leadership of Persistent in product development services by leveraging upon its R&D capability, but also helps in bolstering its offerings and boost customer base/addressable market. In FY16, the company has acquired five IPs and the key product acquisition includes Aepona IoT platform from Intel and CloudPlatform assets from Citrix. The revenue from this business has grown at a staggering >50% CAGR over FY12-16 powered by acquisitions. We expect the business to sustain its growth momentum going forward led by its inorganic growth strategy. Thus, we expect IP Led revenue to grow at 32% CAGR over FY16-19E.

IP Led business to grow at a CAGR of 32% over FY16-19E



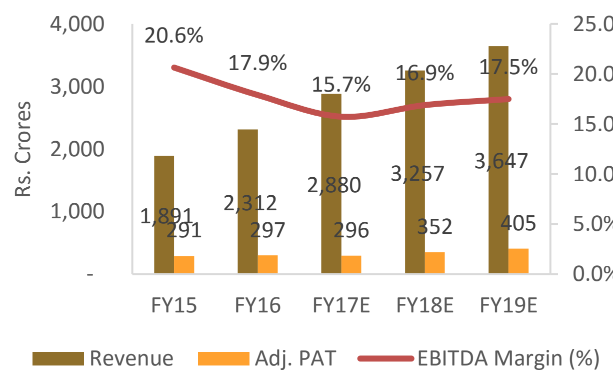
Source: Company, In-house research

Revenue to grow at CAGR of 16% over FY16-19E

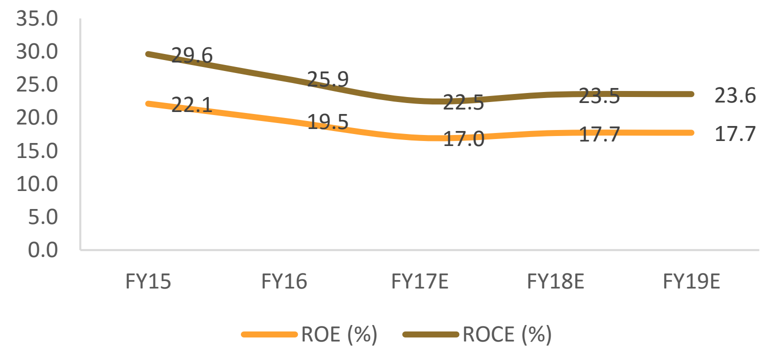
We expect top-line of the company to grow at a CAGR of 16% over FY16-19E.

Persistent's improving business mix with focus on enterprise digital transformation and IoT coupled with its strong engineering capability and early adoption of SMAC technology lends confidence on the sustainability of growth trajectory going forward. Further, its enhanced focus on IP business will not only drive earnings but also provide a strong competitive edge over peers. Thus, we expect revenue to grow at a CAGR of 16% over FY16-19E. Though, EBITDA margin is expected to remain under pressure in FY17E owing to higher investments towards IoT and induction of talent in the senior and managerial level, the same is likely to improve to 17.6% in FY19E as investments will start to produce results. In line with this, PAT margin is expected to reduce to 10.4% in FY17E and will improve to 11.2% in FY19E. Similarly, ROE and ROCE is projected to increase from 17.1% and 22.7% in FY17E to 17.8% and 23.6% in FY19E respectively.

Revenue to grow at a CAGR of 16% over FY16-19E



Return ratios trend



Source: Company, In-house research

Key Risks:

1. Appreciation of INR against USD could negatively impact earnings.
2. Slowdown in global IT spend on digital technologies.
3. Significant exposure to North America and restricted industry presence leading to high vulnerability.

Profit & Loss Account (Consolidated)

Y/E (Rs.Cr)	FY16	FY17E	FY18E	FY19E
Total operating Income	**2,312**	**2,880**	**3,257**	**3,647**
Raw Material cost	159	198	195	219
Employee Cost	1,383	1,783	2,007	2,225
Other operating expenses	357	447	505	566
EBITDA	**414**	**453**	**550**	**638**
Depreciation	97	143	162	179
EBIT	**317**	**310**	**388**	**459**
Interest cost	0	0	0	0
Other income	78	85	80	80
Profit before tax	**396**	**394**	**468**	**539**
Tax	98	98	116	134
Profit after tax	**297**	**296**	**352**	**405**
Minority Interests	-	-	-	-
P/L from Associates	-	-	-	-
Adjusted PAT	**297**	**296**	**352**	**405**
E/oincome/ (Expense)	-	-	-	-
Reported Profit	**297**	**296**	**352**	**405**

Balance Sheet (Consolidated)

Y/E (Rs.Cr)	FY16	FY17E	FY18E	FY19E
Paid up capital	80	80	80	80
Reserves and Surplus	1,559	1,774	2,044	2,367
Net worth	**1,639**	**1,854**	**2,124**	**2,447**
Minority Interest	-	-	-	-
Total Debt	3	3	3	3
Other non-current liabilities	13	13	13	13
Total Liabilities	**1,655**	**1,869**	**2,139**	**2,463**
Net fixed assets	419	502	510	511
CWIP	27	30	20	20
Goodwill	17	17	17	17
Investments	618	618	618	618
Net Current assets	379	507	779	1,101
Deferred tax assets	23	23	23	23
Other non-current assets	172	172	172	172
Total Assets	**1,655**	**1,869**	**2,139**	**2,463**

Cash Flow Statement (Consolidated)

Y/E (Rs.Cr)	FY16	FY17E	FY18E	FY19E
Pretax profit	396	394	468	539
Depreciation	97	143	162	179
Chg in Working Capital	2	(44)	(44)	(43)
Others	(139)	(85)	(80)	(80)
Tax paid	(101)	(98)	(116)	(134)
Cash flow from operating activities	**254**	**311**	**390**	**461**
Capital expenditure	(166)	(230)	(160)	(180)
Chg in investments	79	-	-	-
Other investing cashflow	(29)	85	80	80
Cash flow from investing activities	**(116)**	**(145)**	**(80)**	**(100)**
Equity raised/(repaid)	-	-	-	-
Debt raised/(repaid)	(1)	-	-	-
Dividend paid	(104)	(82)	(82)	(82)
Other financing activities	(21)	(0)	(0)	(0)
Cash flow from financing activities	**(127)**	**(82)**	**(82)**	**(82)**
Net chg in cash	11	84	228	279

Key Ratios (Consolidated)

Y/E	FY16	FY17E	FY18E	FY19E
Valuation (x)				
P/E	16.2	16.3	13.7	11.9
EV/EBITDA	11.3	10.2	8.0	6.4
EV/Net Sales	2.0	1.6	1.3	1.1
P/B	2.9	2.6	2.3	2.0
Per share data (Rs.)				
EPS	37.2	37.0	44.0	50.7
DPS	8.0	8.5	8.5	8.5
BVPS	204.9	231.7	265.4	305.9
Growth (%)				
Net Sales	22.3	24.5	13.1	12.0
EBITDA	6.0	9.5	21.5	15.9
Net Profit	2.3	-0.4	18.7	15.2
Operating Ratios (%)				
EBITDA Margin	17.9	15.7	16.9	17.5
EBIT Margin	13.7	10.7	11.9	12.6
PAT Margin	12.9	10.3	10.8	11.1
Return Ratios (%)				
RoE	19.5	17.0	17.7	17.7
RoCE	25.9	22.5	23.5	23.6
Turnover Ratios (x)				
Sales/Total Assets	1.2	1.3	1.3	1.2
Sales/Working Capital	12.0	11.2	10.8	10.6
Liquidity&Solvency Ratios (x)				
Current Ratio	1.8	1.9	2.3	2.7
Debt/Equity	0.0	0.0	0.0	0.0

Rating Criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%	**Buy**	More than equal to 15%
Hold	Upside or downside is less than 10%	**Accumulate***	Upside between 10% & 15%
Reduce	Less than equal to -10%	**Hold**	Between 0% & 10%
		Reduce/sell	Less than 0%

* To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

* Persistent Systems is a mid-cap company

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