

PERSISTENT SYSTEMS LTD



NIRMAL BANG
a relationship beyond broking

Initiating Coverage

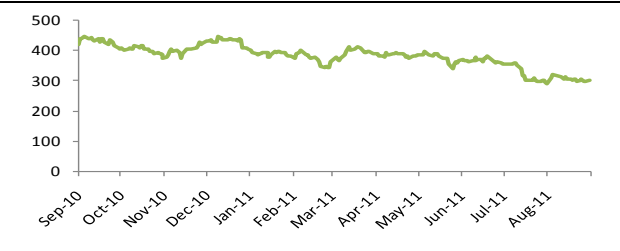
Persistent Systems Ltd.

Recommendation	Buy
CMP (27/09/2011)	Rs 313.7
Target Price	Rs 387
Sector	IT Software

Stock Details

BSE Code	533179
NSE Code	PERSISTENT
Bloomberg Code	PSYS: IN
Market Cap (Rs. cr)	1260
Free Float (%)	61.11
52- wk HI/Lo	467/281
Avg. volume BSE (Monthly)	5169
Face Value (Rs)	10.00
Dividend (FY11)	55%
Shares o/s (Cr)	4

Relative Performance	1Mth	3Mth	1Yr
PSL	1.7%	-17.8%	-28.5%
Sensex	-0.6%	-12.0%	-20.2%



Shareholding Pattern 30/06/2011

Promoters Holding	38.89%
Institutional (Incl. FII)	31.55%
Corporate Bodies	1.14%
Public & others	28.42%

Kavita Vempalli – Research Analyst (022 3926-8173)
kavita.vempalli@nirmalbang.com
 Amrita Burde – Research Associate (022 3926-8223)
amrita.burde@nirmalbang.com

Snapshot

Persistent Systems Ltd (PSL) was incorporated in 1990 and is engaged in the outsourced product development (OPD) business. It caters to the software product companies and provides assistance across the lifecycle of product development. In addition, they are one of the front-runners in hot areas of cloud computing, analytics, collaboration and telecom mobility.

Investment Rationale

Deep focus in niche area of OPD

Offshore OPD market is growing at a CAGR of 9.1% and is expected to touch \$16.1 bn in 2013 as per IDC. PSL is a pure OPD vendor having expertise across the value chain of product development and thus has a competitive advantage.

Forerunner in newer technology

PSL is one of the pioneers in giving services in new technology areas like Cloud, Analytics, Collaboration and Enterprise Mobility. All these are hot buzzing segments gaining specific priorities amongst mid-sized business houses worldwide as per IBM study. PSL derived almost 40% of its revenues from these emerging areas in FY11.

Growth in IP led revenues

PSL engages almost 4% to 6% of its employees in R&D. This has resulted in the company owning 14 IP's (Intellectual Property) currently and many are in pipeline. We expect the share of IP revenue to increase to 17% in FY13E from 8.8% in FY11. This would result in the expansion of EBITDA margins by 60 bps in FY13E.

Growing in a slow growth environment

PSL focuses on non-BFSI segment which currently is under chaos in the US and European countries. PSL's focus in the telecom, Life sciences and Infrastructure segments cushions it from the Global slowdown.

Valuation & Recommendation

PSL, over the years has built a differentiated model focusing only in the OPD business and is investing heavily in the upcoming areas of technology. The next growth for the company would start coming from the IP led revenues where it would have a shared risks and revenue model on the pay per use concept. Amidst fierce competition from the bigger players, supply-side pressures and gloomy external environment, we believe PSL would emerge as a winner led by good visionary management. At CMP, PSL is trading at 9.7x and 7.8x its FY12E and FY13E expected earnings. We assign a 12x target P/E for FY12E earnings and arrive at a target price of Rs. 387 and assign a BUY rating on the stock.

Year	Net Sales (Rs. in Crs)	Growth %	EBITDA (Rs. In Crs)	Margin %	PAT (Rs Crs)	Margin %	EPS (Rs)	PE (X)	EV/EBIDTA
FY10	601.2	1.2%	146.4	24.3%	115.0	19.1%	32.1	10.9	7.3
FY11	775.8	29.1%	158.3	20.4%	139.7	18.0%	34.9	9.0	7.3
FY12E	993.8	28.1%	207.2	20.8%	128.9	13.0%	32.2	9.7	5.6
FY13E	1188.9	19.6%	250.6	21.1%	160.4	13.5%	40.1	7.8	4.6

Initiating Coverage

Persistent Systems Ltd.

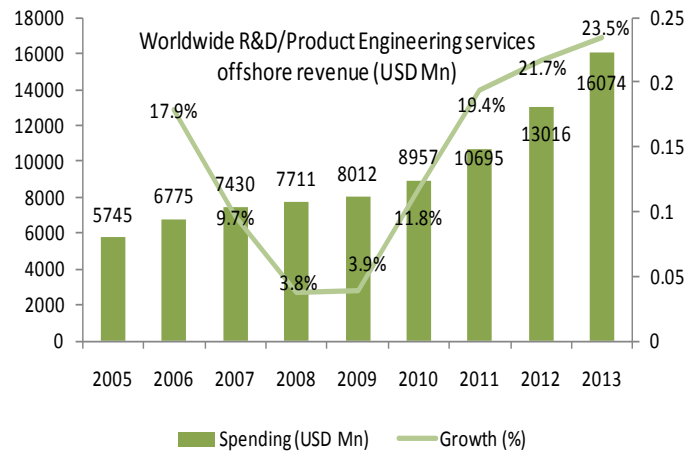
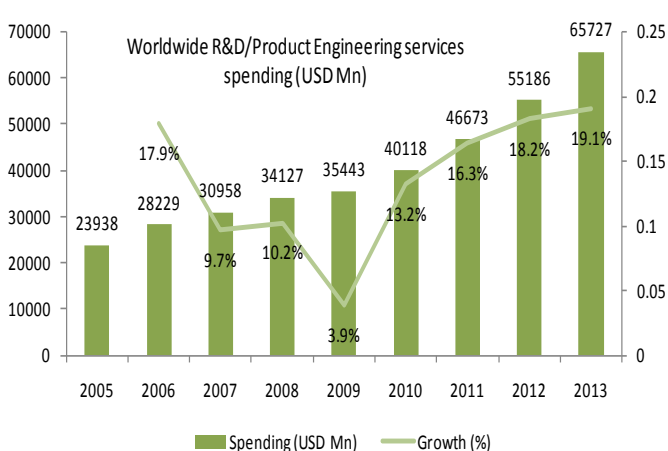
INDUSTRY ANALYSIS

OPD	
What is OPD?	Offshore Product Development involves contracting out an IT function – one that was previously performed in-house - to an external provider to save costs and reduce time to market.
Why OPD?	<ul style="list-style-type: none"> ❖ Helps to stay competitive. ❖ Helps cut costs. ❖ Get operational expertise. ❖ Improves quality.
Worldwide Opportunity	Worldwide R&D/product engineering services market opportunity was at US\$35.4bn in 2009 and now is growing at a CAGR of 16.7% to US\$65.7bn in 2013.
Offshore Opportunity	Offshore OPD market was at US\$8.0bn in 2009 and is growing at a CAGR of 19.1% to US\$16.1bn by 2013.
Services Offered by PSL	<ul style="list-style-type: none"> ❖ Designs ❖ Develops ❖ Maintains software systems and solutions. ❖ Create new applications ❖ Enhances the functionality of their customers' existing software products.

Source: Company, Nirmal Bang Research

Path Ahead

International Data Corporation (IDC) expects R&D / Product Engineering (PE) services to grow at a 5 yr (CY09-13) CAGR of 14% to reach USD 65.7bn. Over the same period, outsourced R&D spending (off-shore revenue) is expected to grow at 19.1% CAGR to USD 16.1 bn. Only 5% of the total R&D spend is outsourced to third party OPD players. With fuelling costs and uncertainty more and more ISVs are expected to outsource at least noncore part of their business to OPD companies. With this, in the near future, OPD companies would have huge potential in several untapped areas.



Source: Company

In earlier times, Outsourced OPD work included non-core work with no value addition and no innovation. However, currently these trends have changed and OPD players are adding more value to the products, helping clients to reach markets quickly.

Initiating Coverage

Persistent Systems Ltd.

Cloud Computing

What is Cloud?	Cloud computing is the delivery of computing as a service rather than a product, whereby shared resources, software and information are provided to computers and other devices as a utility over a network (typically the Internet).
Why Cloud?	<ul style="list-style-type: none"> ❖ Cost cutting. ❖ Efficiency. ❖ Less investment in hardware.
Worldwide Oppr	Worldwide cloud services is expected to reach \$150.1 bn in 2013 from \$56.3 bn in 2009 as per Gartner
Services Offered by PSL	<ul style="list-style-type: none"> ❖ Builds tools and accelerators. ❖ Facilitates customers in faster migration to cloud infra. ❖ Helps in thorough analysis of applications providing their readiness and feasibility to move on to the cloud.

Analytics

What is Analytics?	Analytics refers to computer-based techniques used in identifying, extracting and analyzing business data and to solve problems in business and industry
Why Analytics?	Helps in efficient analysis and management of large volume of data.
Services Offered by PSL	<ul style="list-style-type: none"> ❖ Building and managing smart BI systems for large enterprises. ❖ Works with Enterprise Software vendors to enhance their analytical offerings.

Enterprise Collaboration (EC)

What is Enterprise Collaboration?	EC is a type of information system that helps to provide each user with the tools for managing communications, documents and other information that individuals need to manage their own tasks efficiently in their departments.
Why EC?	<ul style="list-style-type: none"> ❖ Incremental productivity. ❖ Ease in communication.
Worldwide Oppr	Gartner research predicts that enterprise social software market would grow by 15.7% to reach \$769 mn in 2011 and will touch \$1 bn through 2012.
Services Offered by PSL	<ul style="list-style-type: none"> ❖ End-to-end solutions for leveraging collaboration technologies. ❖ Consulting & Implementation. ❖ Develops connectors for search engines like Google. ❖ Currently working as partners for CISCO & Microsoft.

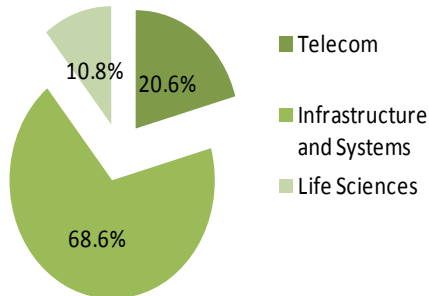
Enterprise Mobility (EM)

What is Enterprise Mobility?	Enterprise Mobility involves capturing and delivering information at very point of activity in an enterprise using mobile & wireless technologies.
Why EM?	<ul style="list-style-type: none"> ❖ Allows streamlined communication. ❖ Saves time.
Services Offered by PSL	Persistent provides OPD services to Telecom OEMs /ISVs that build applications for the mobile platforms for clients like HTC, Motorola, Sony, Google and Nokia.

Initiating Coverage

Persistent Systems Ltd.

Industry Segments



COMPANY BACKGROUND

Persistent Systems Limited (PSL) is one of the market leaders in outsourced software product development services. The company designs, develops, maintains software systems, creates new applications and enhances the functionality of customer's existing software products. IBM is the top client with 15% contribution to revenues. Other Top 5 clients include Wells Fargo Bank, Openwave, Agilent and Yahoo. The new areas of technology contributed 40% of PSL's revenues in FY11. PSL has delivery centers in Pune, Nagpur, Goa and Hyderabad.

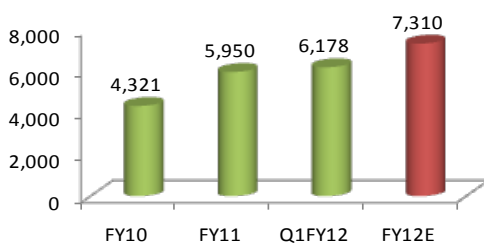
Key Events

1990	Incorporated as a Pvt. Limited Company.
1998-1999	Started operations at owned premises at Panini, Pune.
2001-2002	Set up wholly owned subsidiary namely, Persistent Systems, Inc & started operations at Bhageerath, Pune.
2003-2004	Set up a branch office at Edinburgh, Scotland, UK.
2005-2006	Acquired Goa based Control Net (India) Pvt Ltd and started operations at Pingala-Aryabhata, Pune.
2008-09	Formed a wholly owned subsidiary, Persistent Systems and Solutions Limited in Pune.
2010	IPO at a price band of Rs.290-310/share.
Feb, 2011	Acquired OPD business of Infospectrum.
April, 2011	Formed JV with Sprint Nextel (world's 3rd largest wireless provider).
May, 2011	Acquired Software business from Agilent Technologies.

Industry Segments

PSL focuses mainly on Telecom, Infrastructure and Life Sciences industries, Infrastructure being the largest contributor.

Employee Base



Geographical Mix

PSL earns almost 85.6% of its business from US, 6% from Europe and the remaining from Asia-Pacific. Concentration is high in the US and this remains a concern.

Employee Base

The total employee count of the company was at 6620 in Q1FY12, out of which 93% were technical employees. Company plans to add 1500 employees for FY12E out of which 1000 would be freshers.

Promoter Background

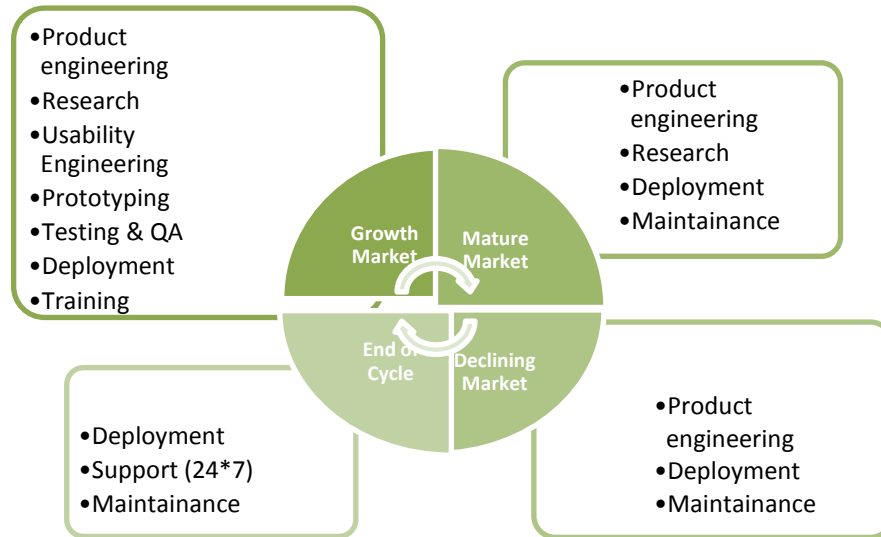
Dr. Anand Deshpande is a B.Tech (1984) in Comp Sc from IIT Kharagpur and Masters (1986) and a Ph.D. (1989) in Comp Sc from Indiana University (USA). He has worked with HP and was President of the Software Exporter's Association and NASSCOM.

Investment Rationale

Deep Focus in OPD Business

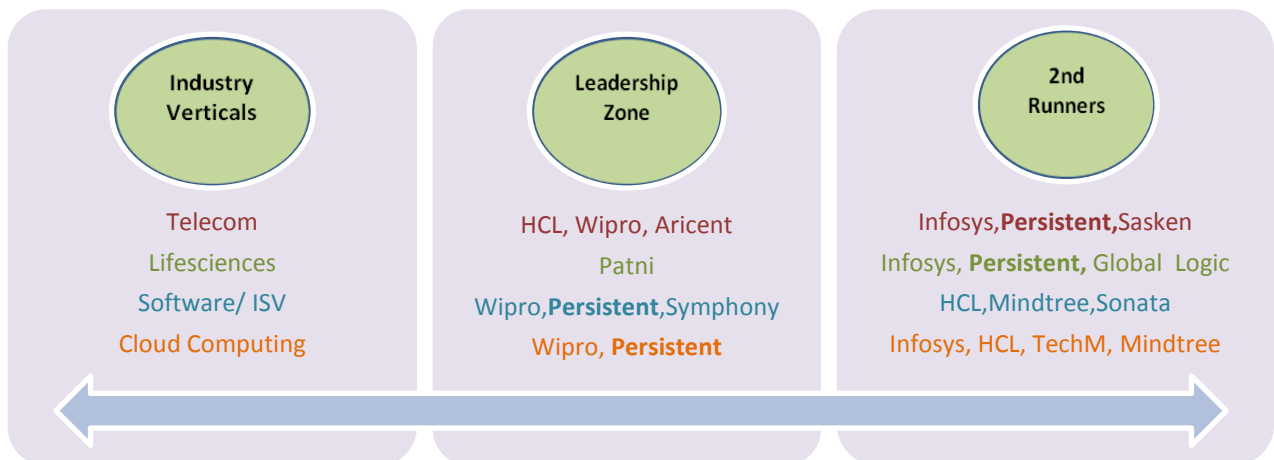
PSL is a pure OPD vendor having expertise across the value chain of product development. In this respect, the company is involved right from product engineering to deployment and maintenance services. Symphony Systems, Mindtree and Global Logic are some of its competitors.

PSL provides services across different phases of product life cycle:



Source: Company

The company also has leadership position in some of its verticals and in cloud computing in comparison to the other industry players. As per Zinnov consultants, Persistent is in the leadership zone in the software/ISV and Cloud Computing and 2nd runner in the life sciences and telecom industries. With huge opportunities emerging in the OPD space, Persistent is well set to get a good share of this pie.



Source: Zinnov

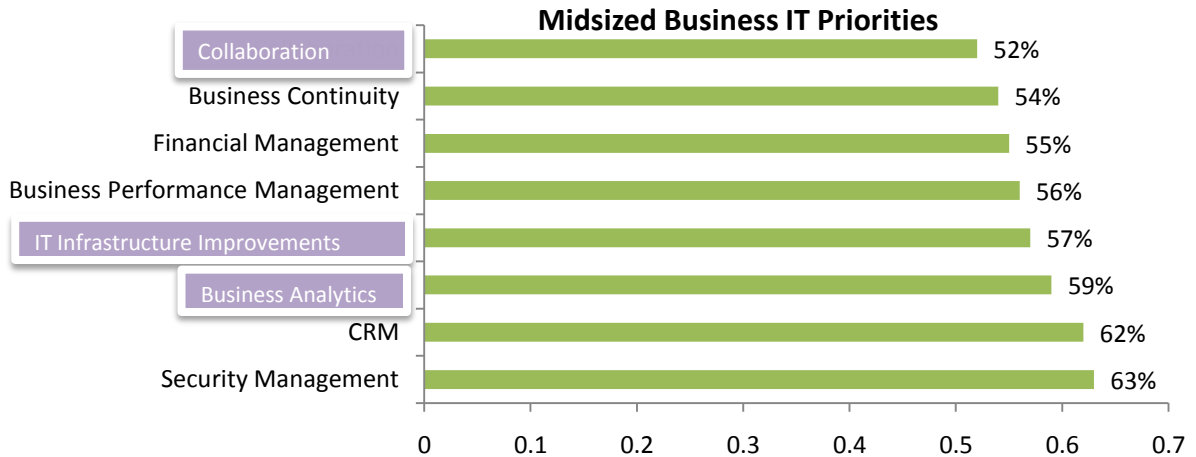
Initiating Coverage

Persistent Systems Ltd.

Forerunner in New Technology areas

PSL engages almost 5% of its revenues and 4-6% of its engineers into building capabilities into new technology. In this space, PSL's thrust is on Cloud computing, Analytics, Collaboration and Enterprise Mobility which contributed 40% of revenues in FY11. **Persistent shares a leadership position along with Wipro in Cloud computing as per Zinnov report (Refer earlier graph).**

As per latest IBM study, mid-sized enterprises are focusing on the following services wherein PSL already has good foothold.

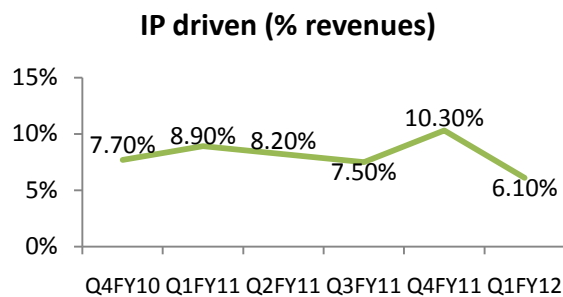


Source: IBM study

Almost 59% of Mid-sized businesses want to focus on Business Analytics as an IT priority, while 52% and 57% wants to give priority to Collaboration and Infrastructure improvements (Cloud) respectively. These are the new buzzing areas in the sector where PSL has a competitive advantage.

Growth in IP led revenues

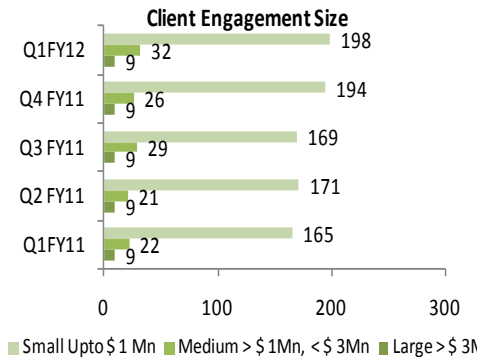
Company's IP led business had been growing at a good pace and is adding to non-linearity in the business. The IPs that PSL develops are in line with the new strategic focus areas viz, Cloud computing, BI & Analytics, Mobility and Collaboration. With almost 4-6% of employees engaged in R&D, the company owns 14 IP's (Intellectual Property) currently with many in pipeline. It has been investing in IP's and selling them on a revenue sharing basis to its clients.



PSL earns almost 60% on gross margins through IP. The revenue contribution from IP licensing has increased from 7.2% in FY2010 to 8.8% in FY11. There is seasonality in IP revenues with the fourth quarter being the strongest. We expect this share to reach 17% by FY13 for PSL, thus resulting in expansion of EBIDTA margins by 70 basis points in FY13E from FY11.

Initiating Coverage

Persistent Systems Ltd.



Stickyness of Customers

PSL derives almost 92% - 94% of its business from its existing customers. Its customer base includes over 40 customers having annual revenues of over \$ 1 bn with R&D spend of over 10-20% of revenues. Another 300 plus clients are small fragmented ones with revenues less than USD 1 mn revenues.

Company's revenue model going forward might transform into shared revenues and shared risks model on the back of focus in the new technology areas where outcome based pricing component (pay per use) as part of traditional contracts have seen a rise. Top Client IBM contributes ~15% of PSL's revenues and the other 4 Top clients contribute ~ 23 % to revenues. This leaves a lot of room for PSL to penetrate the other 4 Top clients further.

Growing in a Slow Growth Environment

Indian IT industry revenues comprise 41% coming from Banking & Financial industry (BFSI) segment. In the current Global meltdown, BFSI segment is the most affected. However, experts believe Healthcare, Telecom, Utilities and Retail are the current focused segments. PSL derives 21% of its revenues from Telecom segment, 11% from Life sciences and the rest from the Infrastructure and Systems segment. The vertical segments of PSL's business are not much likely to get affected in the current slowdown of the industry.

PEER COMPARISON

PSL is a one of the market leaders in outsourced software product development services. There are no listed players strictly comparable, however, Mindtree, KPIT, Infotech Ent, Wipro have some portion of similar business.

Rs. In Crores (FY11)	Sales	Mcap	EBITDA Margin	PAT Margin	PE	ROE
Mindtree	1509.0	1402.0	11.8%	6.7%	13.4	14.0%
KPIT Cummins	1023.0	1320.2	14.9%	9.2%	12.7	14.3%
Infotech Enterprises	1188.0	1375.8	15.2%	11.8%	9.83	13.8%
Persistent	775.8	1255.0	20.4%	18.0%	9.03	20.2%
Wipro	31054.2	83435.0	18.6%	17.2%	15.2	25.8%

Source: Company data, Nirmal Bang Research

PSL with its niche concentration in OPD scores higher than its mid-sized peers on margin front and are close to some of its bigger peers like Wipro. This can be attributed to its onsite revenues where it's billing rates are in par with the large IT companies. Its Return on Equity for FY11 was at 20.3% which we believe would decline in FY12E to 16.1% due to high effect of taxes on earnings. However, ROE would improve to 17.5% In FY13E. On Price/ Earnings basis, PSL enjoys premium valuations due to niche focus in OPD, higher EBIDTA margins and ROE.

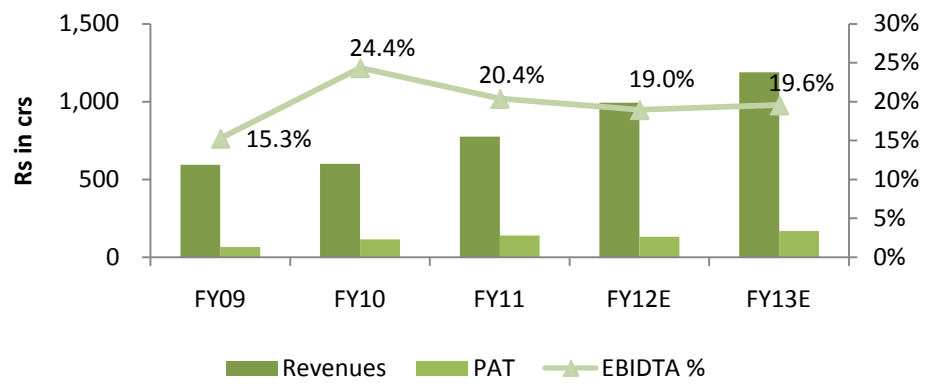
RISKS TO RECOMMENDATION

- **Supply side pressure:** To combat pressure on attrition, company has given hike twice to its employees in the recent past. This problem persists across the industry.
- **Scaling up existing customers:** Battling price pressure and competition while penetrating more into existing customers would remain a challenge for the company.
- **IP business:** Non-take off of IP led business poses risk for PSL.

FINANCIAL PERFORMANCE

Revenues of PSL have grown at a CAGR of 14.3% during the FY09-11 with good traction in Infrastructure and Life science segments, while PAT has moved up by a CAGR of 46% during the same period. EBIDTA margins have expanded by 510 basis points during FY09 and FY11 on the back of lower operational expenses. Due to pressure from supply side, PSL has controlled attrition by giving price hikes twice in this year. We believe PSL would still be able to safeguard its EBIDTA margins on the back of operational excellence and adding up of freshers. And the earnings would be lower due to occurrence of higher tax rates. However, the PAT margin would improve in FY13E to 13.5%.

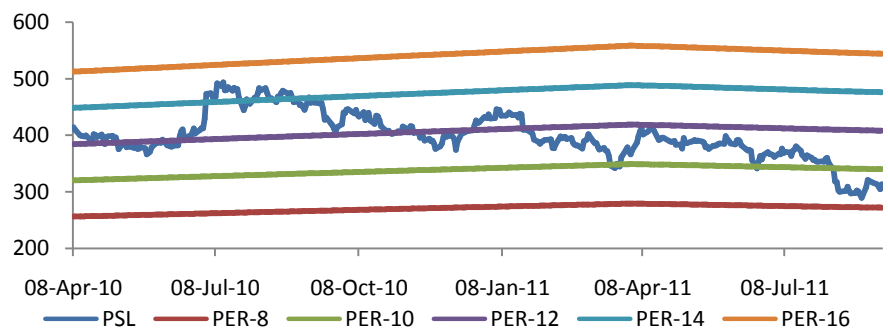
We expect Revenues of PSL to grow at a CAGR of 24% during FY11 and FY13. During the same period; earnings would grow at a CAGR of 7.1%.



VALUATION & RECOMMENDATION

PSL is a niche player with deep focus in the OPD space. Though competition is rising, PSL's leadership in its verticals would entail topline growth for the company. Over the years, PSL has built a differentiated model focusing only in the OPD business and is investing heavily in the upcoming areas of technology. We believe that the next growth for the company would start coming from the IP led revenues. Amidst competition from the bigger players, supply-side pressures and gloomy external environment, we believe PSL would still emerge as a winner led by good visionary management.

P/E forward



We are assigning a price to multiple valuations for the company and based on the forward P/E chart, we believe PSL can be assigned a target P/E of 12x and thus arrive at a Target Price of Rs 387 on FY12E earnings. At CMP, PSL is trading at 9.7x and 7.8x its FY12E and FY13E expected earnings and recommend a BUY rating on the stock.

Initiating Coverage
Persistent Systems Ltd.

Profitability (Rs. In Cr)					Financial Health (Rs. In Cr)				
	FY10A	FY11A	FY12E	FY13E		FY10A	FY11A	FY12E	FY13E
Revenues	601.2	775.8	993.8	1188.9	Share Capital	40.0	40.0	40.0	40.0
% change	1.2%	29.1%	28.1%	19.6%	Reserves & Surplus	595.8	703.6	821.9	933.2
EBITDA	146.4	158.3	207.2	250.6	Net Worth	635.8	743.6	861.9	973.2
% change in EBITDA	24.3%	20.4%	20.8%	21.1%	Stock Option o/s	3.2	3.5	3.5	3.5
Depn & Amort	33.52	42.39	47.15	54.00	Deferred Tax Liabilities	4.5	3.0	3.0	3.0
Operating income	112.8	115.9	160.0	196.6	Total Liabilities	643.5	750.1	868.4	979.7
Interest	0.0	0.0	0.0	0.0	Net Fixed Ass (Incl WIP)	231.8	286.6	339.4	382.3
Other Income	11.23	34.44	27.13	31.31	Investments	156.2	250.0	288.0	316.8
PBT	124.1	150.4	187.2	227.9	Defered Tax Assets	0.7	6.0	6.0	6.0
Tax	9.1	10.8	58.3	67.6	Sundry Debtors	136.3	158.2	202.5	241.0
PAT	115.0	139.7	128.9	160.4	Cash & Bank	191.8	100.0	88.3	96.1
CEPS	35.7	45.5	44.0	53.6	Loans & Advances	72.3	86.9	95.0	104.9
EPS	32.06	34.93	32.21	40.09	Other CA	34.0	22.6	24.7	29.0
Quarterly (Rs. In Cr)	Sep.10	Dec.10	Mar.11	Jun.11	C A L&A	434.4	367.7	410.5	471.0
Revenue	187.0	194.9	212.8	223.8	CL & P	179.6	160.2	175.5	196.4
EBITDA	42.4	42.1	37.4	38.2	Total Assets	643.5	750.1	868.4	979.7
Dep	10.1	10.6	11.9	12.6	Cash Flow (Rs. In Cr)	FY10A	FY11A	FY12E	FY13E
Op Income	32.3	31.5	25.5	25.6	Operating				
Interest	0.0	0.0	0.0	0.0	OP before WC	146.4	158.3	207.2	250.6
Other Inc.	5.9	7.3	8.7	13.8	Change in WC	13.72	(63.78)	(40.37)	(35.13)
PBT	38.3	38.8	34.2	39.4	(-) Tax	9.05	10.79	58.31	67.59
Tax	3.1	3.2	1.7	12.5	CF from Operation	169.13	105.32	225.13	283.09
PAT	35.2	35.6	32.5	26.9	Investment				
EPS (Rs.)	8.80	8.90	8.11	6.72	Capex	(44.97)	(94.77)	(93.86)	(75.21)
Performance Ratio	FY10A	FY11A	FY12E	FY13E	Other Investment	(68.16)	(93.87)	(38.01)	(28.70)
PAT growth (%)	71.7%	21.5%	-7.8%	24.4%	Total Investment	(113.13)	(101.90)	(154.21)	(104.74)
EBITDA margin (%)	24.3%	20.4%	20.8%	21.1%	Financing				
PAT margin (%)	19.1%	18.0%	13.0%	13.5%	Dividend Paid	(9.79)	(22.00)	(20.00)	(26.00)
ROE (%)	22.4%	20.3%	16.1%	17.5%	Others	117.79	(20.89)	(112.08)	(176.70)
Valuation Ratio	FY10A	FY11A	FY12E	FY13E	Total Financing	108.0	(42.89)	(132.08)	(202.70)
Price Earnings (x)	10.91	8.98	9.74	7.82	Net Chg. in Cash	175.23	(91.78)	(11.69)	7.80
Price / Book Value (x)	1.97	1.69	1.46	1.29	Cash at beginning	16.5	191.8	100.0	88.3
EV / Sales	1.77	1.49	1.17	0.97	Cash at end	191.8	100.0	88.3	96.1
EV / EBITDA	7.26	7.29	5.63	4.62	Per Share Data	FY10A	FY11A	FY12E	FY13E
					BV per share	158.9	185.9	215.5	243.3
					Dividend per share	2.4	5.5	5.0	6.5

Source: Company data, Nirmal Bang Research

Initiating Coverage

Persistent Systems Ltd.

NOTE

Disclaimer

This Document has been prepared by Nirmal Bang Research (Nirmal Bang Securities PVT LTD). The information, analysis and estimates contained herein are based on Nirmal Bang Research assessment and have been obtained from sources believed to be reliable. *This document is meant for the use of the intended recipient only. This document, at best, represents Nirmal Bang Research opinion and is meant for general information only. Nirmal Bang Research, its directors, officers or employees shall not in anyway be responsible for the contents stated herein. Nirmal Bang Research expressly disclaims any and all liabilities that may arise from information, errors or omissions in this connection. This document is not to be considered as an offer to sell or a solicitation to buy any securities. Nirmal Bang Research, its affiliates and their employees may from time to time hold positions in securities referred to herein. Nirmal Bang Research or its affiliates may from time to time solicit from or perform investment banking or other services for any company mentioned in this document.*