Prabhudas Lilladher

Company Report
Industry: Technology

Persistent Systems

Persistence Personified

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Contents

![Prabhudas Lilladher]

Company Report
June 21, 2010

Persistent Systems

Rating	**BUY**
Price	Rs396
Target Price	Rs525
Implied Upside	32.6%
Sensex	17,571

(Prices as on June 18, 2010)

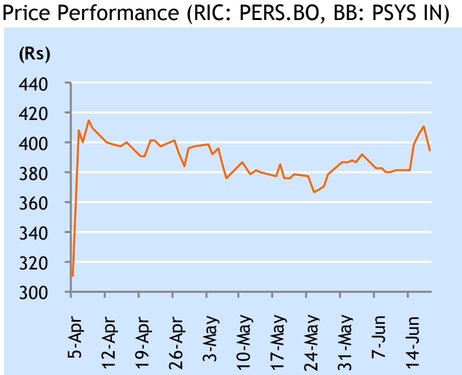
Trading Data	
Market Cap. (Rs bn)	14.1
Shares o/s (m)	35.7
Free Float	61.15%
3M Avg. Daily Vol ('000)	NA
3M Avg. Daily Value (Rs m)	NA

Major Shareholders	
Promoters	38.85%
Foreign	4.90%
Domestic Inst.	25.23%
Public & Others	31.02%

Stock Performance

(%)	1M	6M	12M
Absolute	2.4	NA	NA
Relative	(1.7)	NA	NA

Price Performance (RIC: PERS.BO, BB: PSYS IN)



Source: Bloomberg

We believe that a shorter product life cycle and cost pressure would drive the growth of Outsourced Product Development (OPD). We anticipate that the delivery model of Persistent Systems (PSYS) will become a de-facto standard in the OPD market and the stock price does not reflect the growth potential. We initiate the coverage on PSYS with a **'BUY'** rating at a target price of **Rs525**.

- **OPD - Offshoring to grow PSYS market share even faster:** According to IDC (International Data Corporation), software product development market (~US$350-400bn) is expected to grow at CAGR of ~5% from 2009-13. Indian OPD market grew at CAGR of 16% between FY06-10 and is expected to grow at a CAGR ~17% over the next three years. We expect PSYS revenue to grow at CAGR 23% over the next three years.
- **Niche industry leadership to bring EPS growth of 15% CAGR over the next 3 years:** An expanding OPD revenue stream and significant non-linear revenue indicates that revenue growth should continue at a CAGR of ~23% by FY13E. We believe that subdued corporate spending in the OPD market in CY09 would see a rebound in CY10 with a fast pace product development cycle.
- **Non-linear initiative can help offset near-term margin tailwinds:** Currency fluctuation would have a higher margin impact (90bps per percent point change in USD/INR) than peers due to high offshoring (87%) component. However, we believe that migration towards IP-based (~8%) revenue and increased contribution from FPP (~17%) would help mitigate some currency risk.
- **Valuation and Recommendation - 'BUY' with a target price of Rs525:** PSYS' FY12E P/E (14x) is high, but we think it deserves to be so, given its 15% EPS growth which would indicate lowest PEG at 1.0. Valuation also needs to reflect industry, leading growth potential. PSYS is currently trading at 9.9x FY12E, implying a potential upside of 33% We are confident of ~23% revenue growth in FY11, with net income margin of 18%.

Key financials (Y/e March)	FY09	FY10	FY11E	FY12E	FY13E
Revenues (Rs m)	5,938	6,012	6,864	8,209	10,148
Growth (%)	*39.8*	*1.2*	*14.2*	*19.6*	*23.6*
EBITDA (Rs m)	914	1,464	1,563	1,781	2,198
PAT (Rs m)	676	1,150	1,315	1,365	1,725
EPS (Rs)	31.2	32.2	36.8	38.2	48.3
Growth (%)	*(23.8)*	*3.0*	*14.3*	*3.8*	*26.3*
Net DPS (Rs)	1.7	0.8	1.5	1.7	2.0

Source: Company Data; PL Research

Profitability & valuation	FY09	FY10	FY11E	FY12E	FY13E
EBITDA margin (%)	*15.4*	*24.3*	*22.8*	*21.7*	*21.7*
RoE (%)	*16.7*	*17.9*	*17.1*	*15.2*	*16.2*
RoCE (%)	*15.6*	*17.5*	*15.4*	*15.0*	*16.1*
EV / sales (x)	2.3	2.3	1.9	1.6	1.3
EV / EBITDA (x)	15.0	9.3	8.5	7.5	6.2
PE (x)	12.4	12.3	10.8	10.4	8.2
P / BV (x)	2.1	2.2	1.8	1.6	1.3
Net dividend yield (%)	*0.4*	*0.2*	*0.4*	*0.4*	*0.5*

Source: Company Data; PL Research

Investment Argument

We anticipate that a rebound in PES/OPD (Product Engineering Services/Outsourced Product Development) spend in FY11 won't be a one-hit wonder, but rather the beginning of another cycle of sustained growth in technology spending that will lead to a new wave of technology that will drive company purchases, make existing technology more flexible or incorporate "awareness". According to us, PSYS would be a bigger beneficiary due to increased spending on account of a strong focus in the outsourced product development space. We initiate coverage with '**BUY**' rating at a target price of **Rs525**.

Outsource Product Development - Offshoring to grow faster

OPD companies take responsibility of building products for their customers. The software product development industry is ~US$350-400bn, led by US and followed by Japan.

OPD market is slowly maturing and has got increased acceptability across varied software product companies and independent software vendors.

- **Why OPD?:** OPD allows product companies to benefit from the access to larger resource pool of developers at a lower cost. Also, it helps to reduce time-to-market, reduce management bandwidth to manage the product and reduces risk of failure by going to someone who has the expertise.

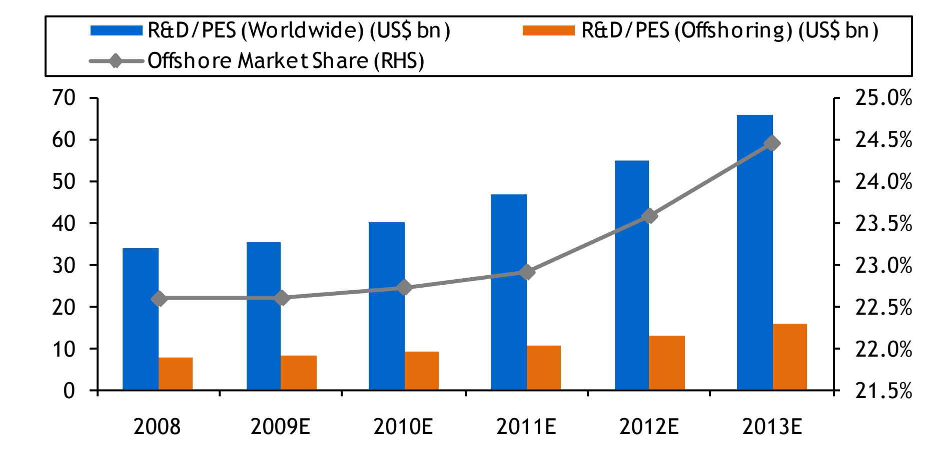
- **Why not captive?:** Captive centers setup by product companies partially meet offshore development requirements for product companies. Companies prefer to focus on what is core to their business and outsource context.

- **Why India?:** India, with its large pool of qualified technical resources and low-cost of living, is the leading destination for all outsourced software development activities.

IDC forecasts a five-year CAGR of 14% for R&D/PE services, reaching an estimated US$65.7bn by 2013. IDC defines R&D/PE Services as the taking over of research and development of a product company's value chain by a third-party services organization.

Shorter product life cycle and cost pressure will influence clients to relocate R&D/PES centres to India, China, and Russia. According to IDC, R&D/PES (offshoring) is expected to grow at a CAGR of 16% to US$16.1bn by 2013.

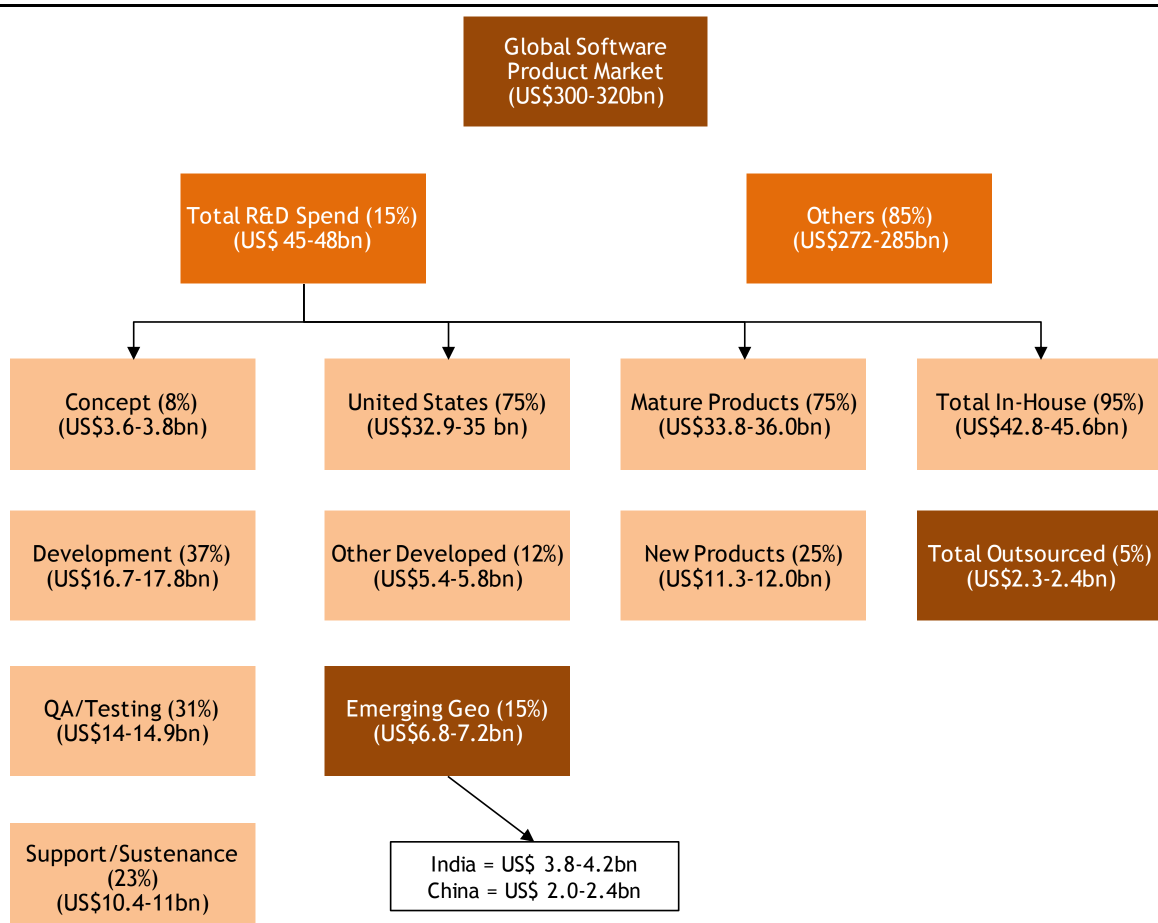
R&D/PES offshoring to gain ground - Expected to grow faster than R&D/PES



Source: IDC, PL Research

Contrary to common perception that companies are aggressively leveraging global delivery model, there are still untapped opportunities in the market.

Global Software Product Market - strong outsourcing opportunities

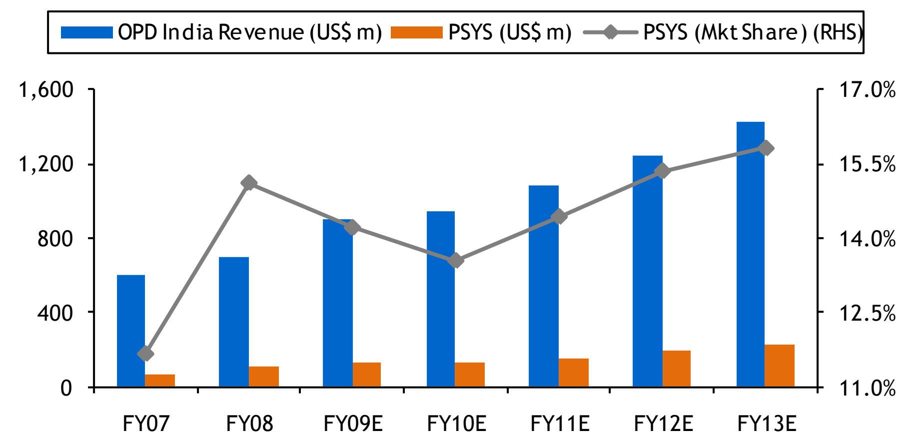


Source: Zannov, PL Research

Persistent: Growing market share in OPD offshoring

According to our estimate, PSYS has around 13-14% market share of the OPD market in India. According to IDC estimates, this market is expected to grow at a CAGR of 18% to FY13, nearly three times the growth it has penned for the overall software market. There are two key drivers: 1) access to larger resource pool of developers at a lower cost. 2) helps to reduce time-to-market, reduce management bandwidth to manage the product and reduce risks of failure by going to someone who has the expertise. Using the services of players like PSYS is one of the best solutions. We expect the company to grow faster than OPD (offshoring-India) revenue and hence, increase market share to ~17% by FY13.

PSYS – Demonstrating strength in OPD space in India



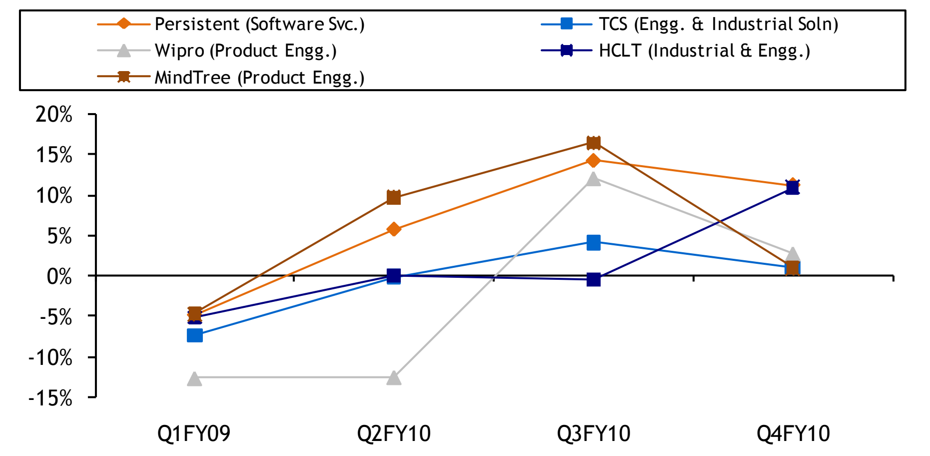
Source: IDC, PL Research

PSYS' approach is differentiated – its technology focus offshore team gives its delivery a perfect platform a relevance and scalability advantage. PSYS has got other advantages of strong management (including board members), who all are well regarded not only in Silicon Valley (US), but also globally. The strong management helps them win deals from "Independent Software Vendors".

A unique case of pure play OPD

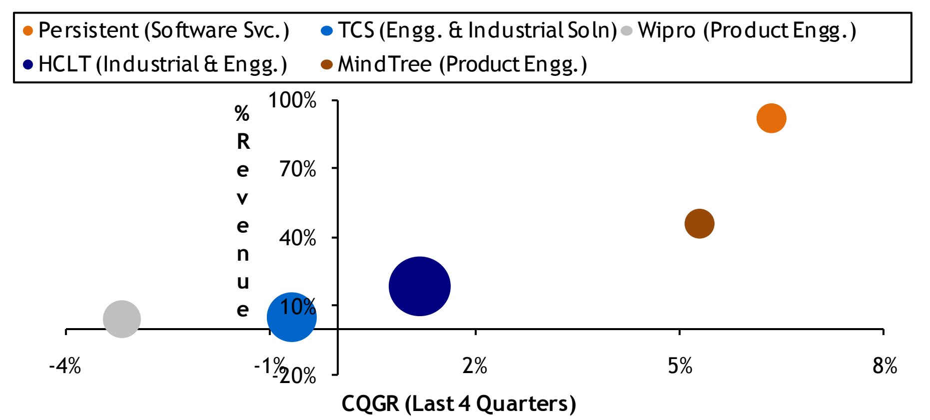
PSYS reported strongest growth in FY10. On like-to-like comparison, PSYS grew at a CQGR (Compound Quarterly Growth Rate) of 6%, ahead of TCS (Engg & Ind soln), Wipro (Prod Engg), HCLT (Ind &Engg) and MindTree (Prod Engg) which grew at a CQGR of -0.7%, -3.2%, 1.2% and 5.3%, respectively. We believe that stronger focus on outsourced product engineering space has helped PSYS deliver stronger than its peer growth. We expect OPD/PES to deliver one of the strongest growths for the respective company.

PSYS - growing fastest among peer (respective segment)



Source: Company Data, PL Research

PSYS - Exhibiting strong growth by virtue of being in growth area



Source: Company Data, PL Research

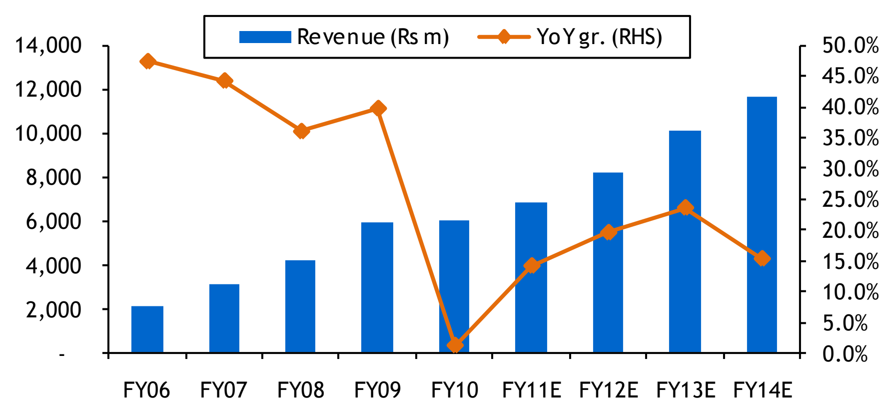
Superior financial and operational performance

PSYS' financial model is based on three growth drivers – new product development, maintenance of developed product and royalty revenue from Tech companies that embed PSYS' products (IP Sales). There are very little Services in the revenue mix; hence, operating margin during cyclical upturn is going to be high.

Growth around 30%: PSYS has been growing at a CAGR of 30-35% for the last five years and for FY11, we estimate the organic growth to be slow at 22%, with growth returning back for OPD market after a sluggish FY10. We are factoring 17% CAGR for the next three financial years to FY13E.

OPD revenues to rise sharply: After subdued spending in software development for almost 18 months, we expect the companies to ramp-up their development process. PSYS is poised to benefit from their software development spend. While the volatility in these spends are higher, we anticipate that rebound in Engineering/R&D (including PES/OPD) spend in FY11 won't be a one-hit wonder. However, the beginning of another cycle of sustained growth in technology spending will lead to the new wave of technology that will drive company purchases, make existing technology more flexible or incorporate "awareness".

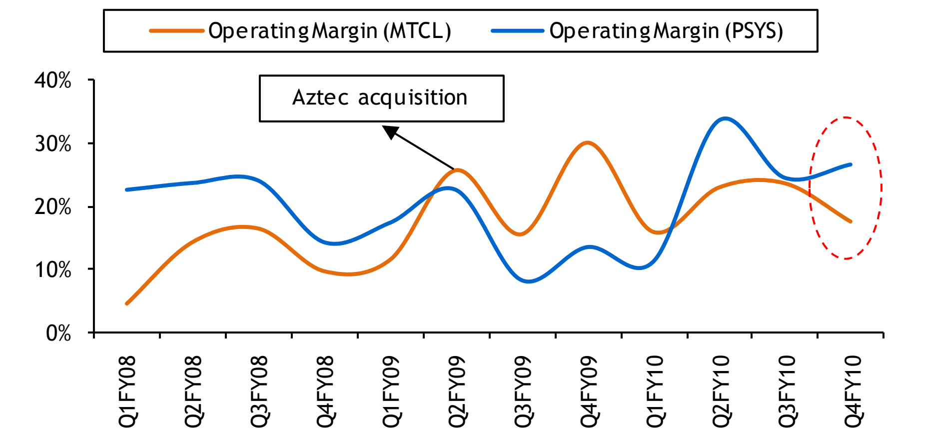
We expect PSYS to grow at CAGR of 23% to US$236m by FY13E



Source: Company Data, PL Research

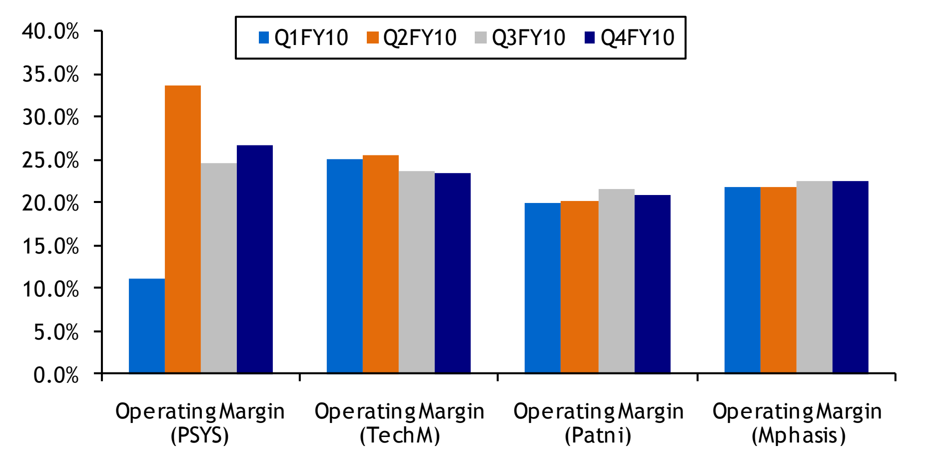
Margins to show steady improvement: PSYS has reported operating margin of 26.7% for Q4FY10 and 24.3% for FY10 and we expect the margins to steadily improve to 25%. When compared to its peers, PSYS delivered stronger operating margin performance than some of the closest competitors. Over the last three years, average operating margin of PSYS is 20.2% as compared to 19.6% of MindTree.

PSYS operating margin strengthening compared to the closest competitor



Source: Company Data, PL Research

PSYS - Strongest operating margin when compared to mid-tier companies



Source: Company Data, PL Research

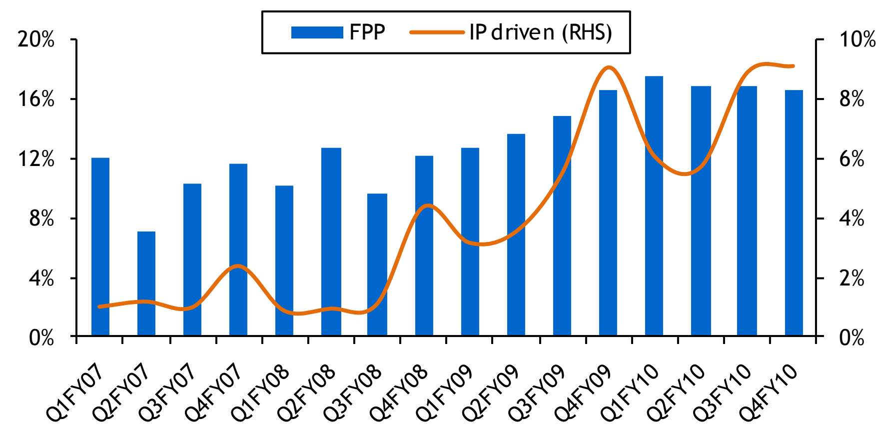
Focus on efficiency and non-linearity

PSYS slowly improved their delivery model and used mature model to increase its revenue from both IP and FPP. The company has innovated and customised software processes that allow them to monitor and plan the progress of software projects. The maturity of the delivery model helps them to reduce time-to-market and the risk of engineering failures. FPP project contribution to total revenue has increased by ~500bps, whereas IP revenue share changed magnitude by ~400bps. We expect the company to continue their non-linear initiative and increase the contribution by FPP, using efficiency to provide tail-winds to operating margin. We believe that the growth in FPP and IP driven revenue would give further tailwinds to operating margin.

1) **IP driven revenue -** Greater the number of IPs, higher is the royalty revenue likely to be. The company not only managed to build IPs for clients but also strengthened their IP portfolio; hence, increasing revenue contribution to 9.1% in Q4FY10 (one of the highest among peers). PSYS owns IP in telecom (majority of IPs), IMS and Life Sciences.

2) **Productivity in FPP -** The other key variable for margin tailwind is efficiency built in delivering FPP assignments. Each FPP essentially pays an upfront fee and then a milestone-based payment. As PSYS developed more and more mature delivery model, we expect productivity and efficiency to improve further.

Increased focus on FPP and IP

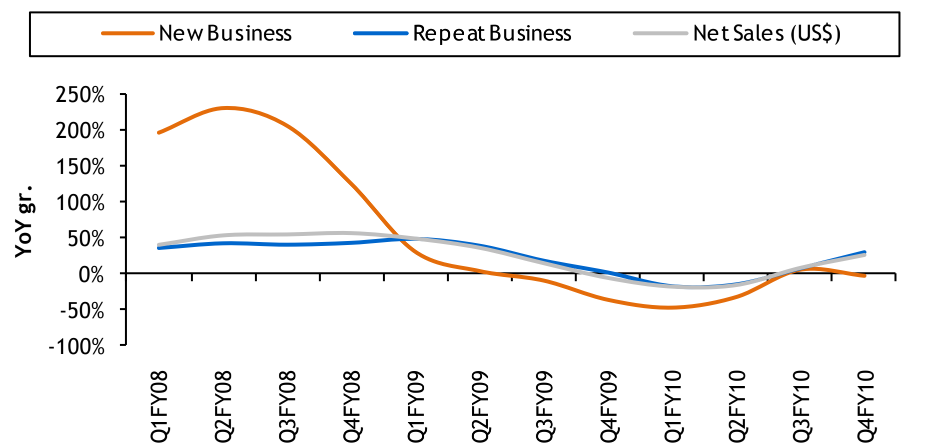


Source: Company Data, PL Research

Fostering strong relationship with the existing client

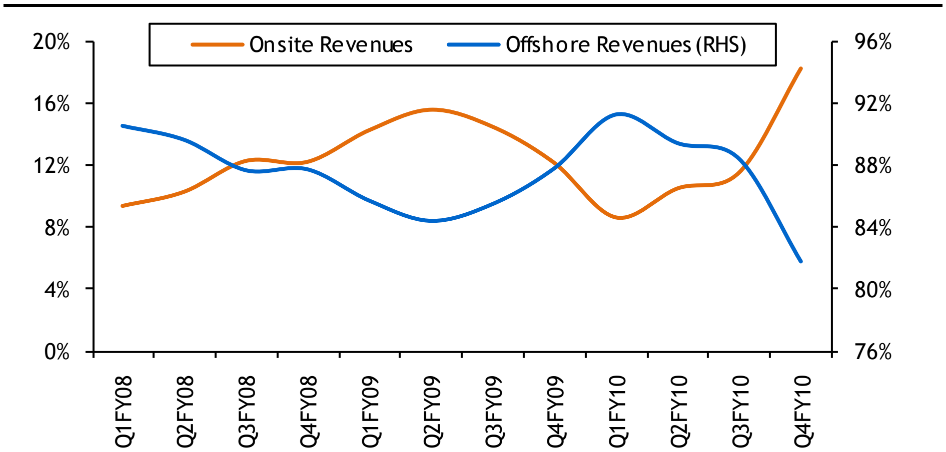
We are convinced about the long-term opportunity at PSYS. We see the continuous deal win as one of the major risks. PSYS manages expectations sensibly and has a strong reputation in the OPD market. We believe that the company has a strong relationship with existing clients and ability to win new business. New business grew at a CAGR of 26%, whereas repeat business grew at a CAGR of 22% between FY07-10. We expect the company to continue this growth momentum for both, new and repeat business. We believe that an increased IT spend and smaller product life cycle (due to onset of cloud computing) would push the software companies as well as independent software vendors to deliver newer version quickly; hence, utilizing services of vendors like PSYS.

New business subdued due to macro, Repeat business picking-up



Source: Company Data, PL Research

Uptick in onsite revenue – leading indicator of new projects ramp up

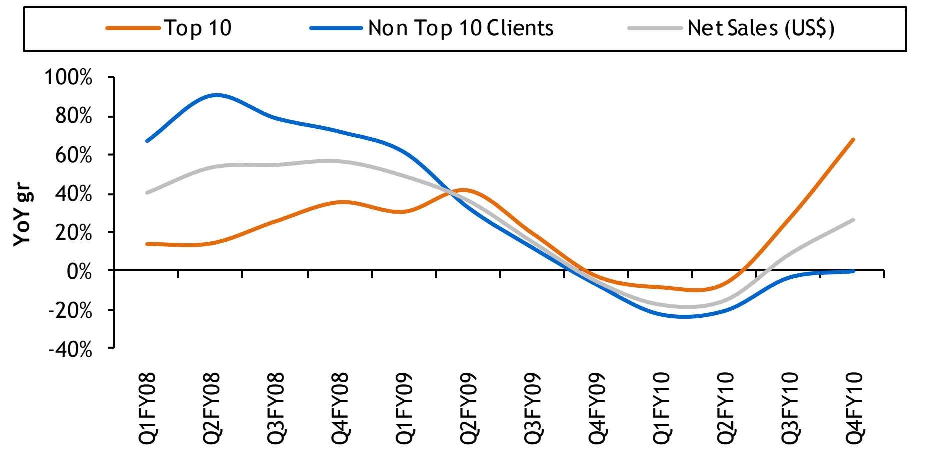


Source: Company Data, PL Research

PSYS has built sustainable business relationships with their existing customers to generate increasing revenues. The company plans to continue to expand the scope and range of services provided to their existing customers by continuing to build our expertise in major industries and extending capabilities into new and emerging technologies.

Top Client, Top 2-5 and Top 6-10 clients grew at a CAGR of 33%, 22% and 10% between FY07-10, respectively, indicating a strong relationship with the existing clients. We believe that the company will stand to benefit due to increased spending from the existing clients.

Strong relationship with top 10 clients

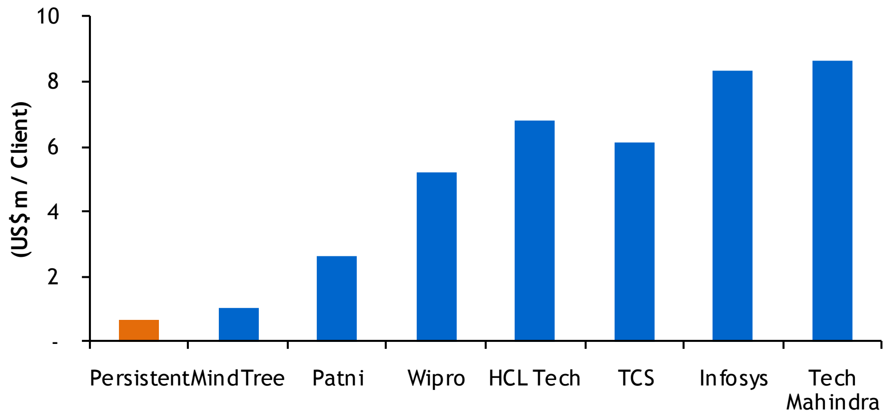


Source: Company Data, PL Research

Client concentration and revenue per client low

Diversified client portfolio: PSYS has got the most diversified portfolio of earning when compared to its peers. It has 195 clients contributing about an annual run-rate of US$127m, making it the most diversified in terms of revenue per client. We believe that a small dependence on each client diversifies the risk of earnings for the company. Also, it provides opportunities to mine some of the existing relationships with the client. We believe that there is scope of improving business from these existing clients.

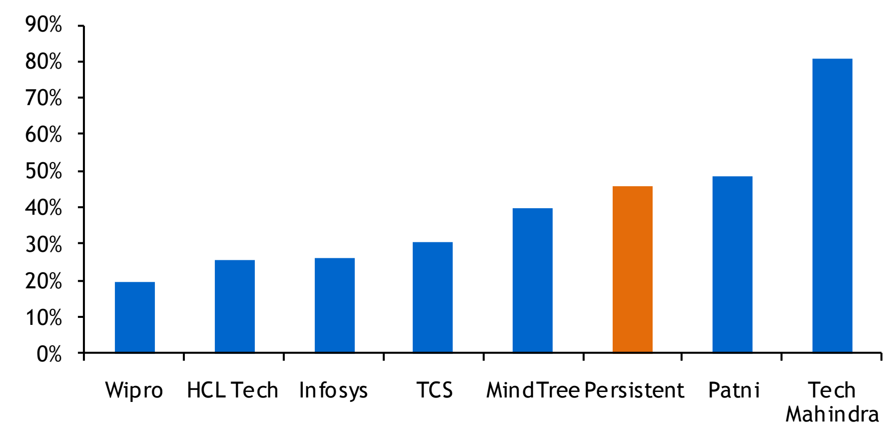
Lowest per client revenue - opportunity for ramp up



Source: Company Data, PL Research

Top 10 client contribution in line with larger peers: PSYS has got one of the lowest exposures to the top 10 clients when compared to other mid-tier Indian IT companies. Tier-1 Indian IT services companies drive ~30% of revenue from their top 10 clients, whereas Tier-2 companies drives more than 50% of revenue from top 10 clients, when compared to PSYS, which drives only ~45% of revenue from them. We anticipate that the continued focus on the existing clients would help the company to register stronger growth as management strengthens its ties with the existing company. As the company gears itself for delivering services in growth areas like cloud computing, the company's revenue from top 10 clients could grow at mid-single digit.

Top 10 client contribution not alarming

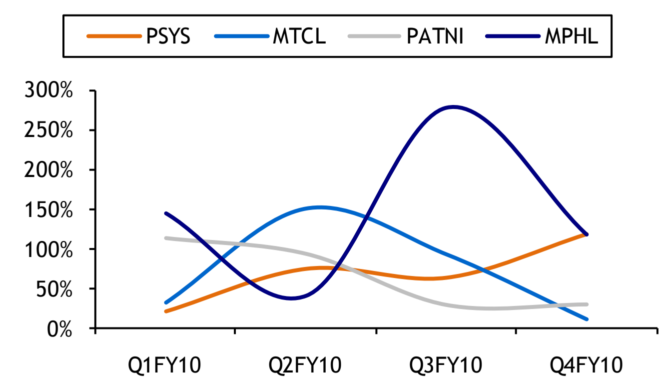


Source: Company Data, PL Research

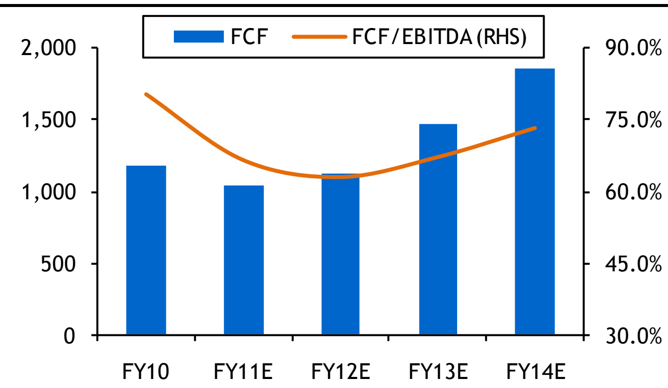
Improved cash generation- Indicates superior performance

PSYS has steadily improved FCF/EBITDA conversion when compared to its peers. We believe that PSYS has high earnings quality with FCF conversion (80% of EBITDA in FY10), which is expected to go down in FY11E and FY12E to 62% and 65%, respectively due to capex plan. However, going forward, we expect to see a steady FCF growth. We expect strong cash conversion by the company.

Strong cash generation in FY10



Expected to see a dip in FY11 due to capex plan



Source: Company Data, PL Research

Financial Guidance

Forex hedging – Withstand currency appreciation: PSYS has been proactive in taking the currency hedges during FY10 that would help the company to withstand currency appreciation. It has got US$79m hedges mostly in long-term options. We believe that the company is adequately hedged, but a sudden appreciation in currency could impact the margin.

FY11 guidance – ahead of its peers: The management has guided for 22% revenue growth and sounded confident of maintaining PAT margin of 18%. The company has given a wage hike (10-14%) in line with the industry average that could affect margin by 150bps in Q1FY11. However, using the multiple margin levers, the management should be able to maintain margins in line with their guidance. The company is planning to hire 1200 software professionals, including 400 in Q1FY11.

Inorganic growth on cards

PSYS has been acquisitive in nature. They have pursued and may continue to pursue strategic acquisition opportunities to enhance their capabilities and address gaps in industry expertise, technical expertise and geographic coverage.

In October 2005, PSYS acquired 100% shares of **ControlNet**, which was integrated from April 1, 2006. In July 2007, the company completed the acquisition of the assets of **Metrikus** (India) and in October 2009, they completed the asset acquisition of **PaxPro**, an enterprise brand and packaging management software from Paxonix, Inc.

PSYS acquisition strengthened its offering in three different business domains - (i) ControlNet was an embedded systems player, (ii) the purchase of Metrikus extended their offering in business process monitoring and (iii) the acquisition of Paxonix, Inc. expanded their services in enterprise brand and packaging management.

The company is open to make acquisitions to strengthen their service offerings. According to the management, the acquisition will be made in areas where they feel that acquisition would broaden their capabilities at lower cost than developing those organically (including the opportunity cost). The company has cash of ~Rs3.5bn.

Key Risks to Recommendation

Company Specific

Slower recovery in Europe and US: PSYS is a derivative play on demand of software product, hence, exposed to discretionary spend of its clients. A slow recovery or another dip could negatively impact the growth prospect of the company. Any increase in the uncertainty could lead to a delay in the investment in the business by clients which could lead to slower-than-anticipated growth.

Volatility in margin during slowdown: PSYS margins were volatile in the past due to an economic slowdown. We believe that due to high exposure to new development work, which gets shelved during downturn, the margins of the company could be volatile in case of increased uncertainty. Also, OPD business is more cyclical in nature, like change in the business model post dot-com, availability of PE/VC fund for new ventures, when compared to traditional IT Services business exposing PSYS to the risk of volatility.

Sector specific

Backlash against offshore outsourcing: There could be regulatory or visa restrictions and customers might defer decisions, leading to lengthening sales cycles. The possibility of such a backlash in the medium term looks low, in our view.

Rupee appreciation - could eat growth and margins: A sudden appreciation in rupee could erode operational growth delivered by the company. The margin erosion for each percentage point appreciation in rupee would be 90bp much higher than larger peers due to high contribution by offshoring.

Valuations – growth not in price

Our DCF points to a base-case fair value of Rs525/share. This assumes an average Weighted Average Cost of Capital (WACC) of 13.4% and operating margin of 17% for the near term and 14.75 for the long term.

DCF Valuation Summary of Persistent Systems - Target Price Rs525

PV of Cash Flow	7,893	55%
Terminal Value	6,423	45%
Firm Value	14,316	
Tax asset		
Less Net Debt/(Cash)	(4,447)	
Equity Value	18,763	
Number of Shares O/s	35.7	
Per Share	**525**	

Source: Company Data, PL Research

DCF sensitivity (Beta v/s Terminal growth)

		Beta Sensitivity						
		0.60	**1.00**	**1.10**	**1.20**	**1.30**	**1.40**	**1.5**
Terminal Growth Rate	**2.75%**	661	552	531	512	495	480	465
	3.00%	671	557	536	516	499	483	468
	3.25%	682	562	540	521	503	486	471
	3.50%	694	568	546	525	506	490	474
	3.75%	706	575	551	530	511	493	477
	4.00%	719	581	557	535	515	497	481
	4.25%	734	588	563	540	519	501	484

Source: Company Data, PL Research

Key long-term model assumption

Operating assumptions: We forecast a strong revenue growth in the near term, driven by robust demand in OPD space, with margins of 17.2% in the near term, decreasing to 12.5% for terminal. PSYS's strong position in OPD brings sustainable strong returns.

We do not forecast acquisitions: Our forecasts do not assume acquisitions. However, we note that the management follows a strong acquisition policy (three acquisitions in the last three years). Also, the management spoke about inorganic growth to strengthen service offerings.

Capital intensity remains consistent: We assume that capex is likely to remain stable between 7.5-6.0% of sales in the near term due to the beginning of new capex cycle and strong growth in demand and 4.4% for long term.

Cost of capital: We use a WACC of 13.4% based on the cost of equity of 13.6% and cost of debt of 11.0%, with debt-to-capital ratio stable at 10%.

Terminal assumption: For the terminal value, we assume 3.5% growth in revenue at 12.5% operating margin.

Forecast Summary

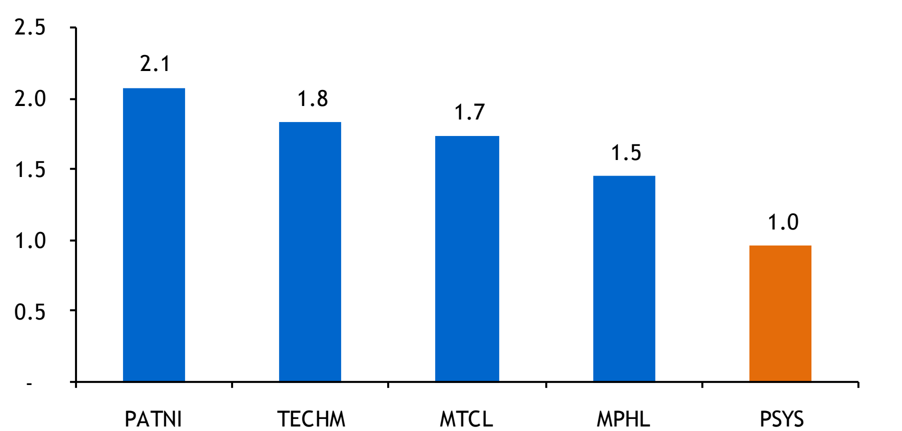
Y/e March	'05-'10	'10-'14e	'15e-'20e	'10-'20e
Sales CAGR	32.6%	18.1%	9.5%	13.3%
EBITDA CAGR	28.4%	15.3%	6.9%	10.0%
Average Operating Margin	15.7%	17.2%	14.7%	15.4%
ROIC	21.6%	15.2%	11.5%	13.2%
Return on Equity	22.5%	16.5%	16.2%	16.4%
Sales To Average WC	4.6	6.1	7.2	6.7
Average Capex to Depn	2.6	1.3	1.0	1.1
Operating Asset Turnover	1.0	0.8	0.8	0.8
WACC	11.7%	13.4%	13.4%	13.4%
FCF Growth	NA	10.1%	6.7%	8.6%

Source: Company Data, PL Research

PSYS PEG lowest among mid-cap peers

PSYS is one of the fastest OPD companies in India. According to PLe, the revenue for PSYS is growing at CAGR of 23% in US$ terms over the next three years, whereas EPS will grow at a CAGR of 15% over the same period. Our target price of Rs525 gives PSYS one of the lowest PEG among our coverage mid-cap IT Services universe.

Strongest growth among peers yielding lowest PEG (EPS CAGR FY10-13E)



Source: Company Data, PL Reserach

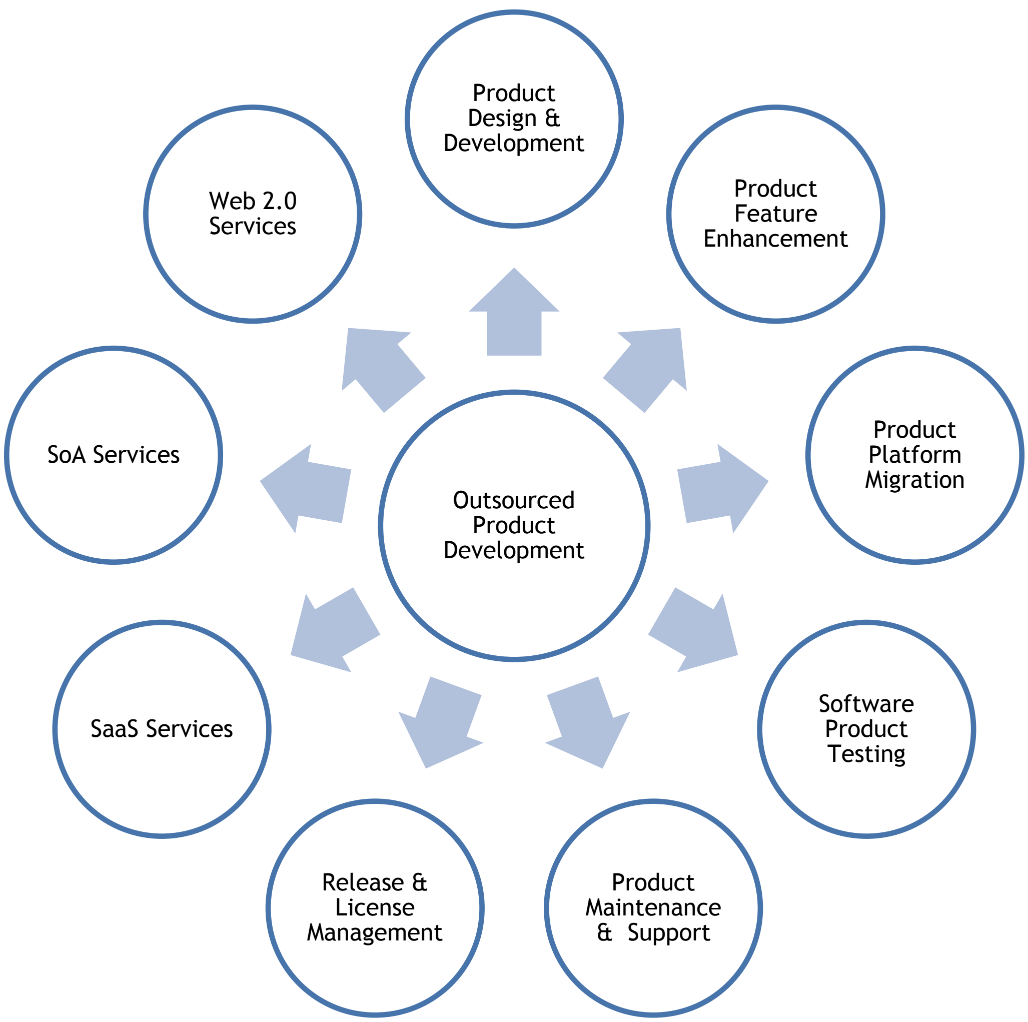
Annexure

Outsource Product Development

PSYS, a leader in OPD, caters to the ISV and software product companies, including start-ups and aids in freeing their valuable resources from development and concentrating on their core activities.

PSYS offers shorter development and testing life cycles which directly affects time-to-market, reducing software development and support costs & enhances product functionality in order to generate greater value to their clients. Due to the volatile nature of technology and software, availability of skills is at risk to which OPD player like PSYS becomes a mitigating factor.

PSYS offerings cover entire product development lifecycle, including…



Source: PL Research

PSYS services across product engineering lifecycle

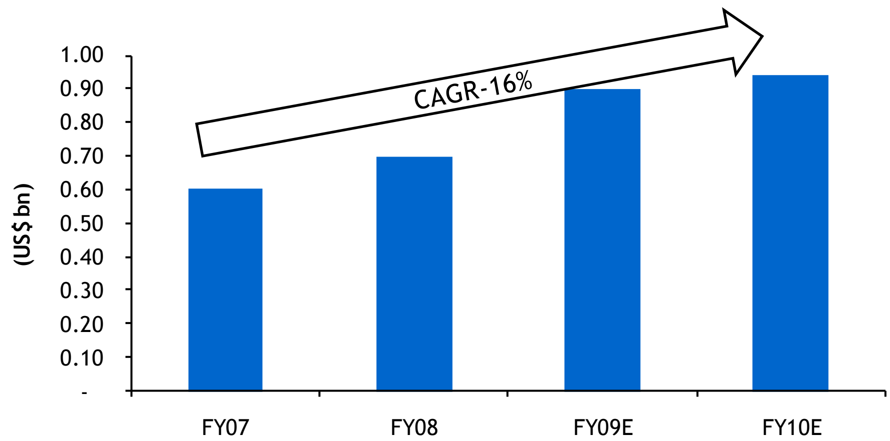
Source: Persistent, PL Research

Market leans towards maturity

OPD grew by 4% to reach US$0.94bn in FY10. The global recession has impacted the hi-tech sector significantly and with dwindling downstream revenues, hi-tech sector clients had reduced their product development spend in CY09. However, in CY10, as the recessive conditions improve, this sector is expected to see an increased interest.

The Indian OPD service providers need to look beyond the traditional large US/European clients and focus on emerging geographies such as Japan and SMB clients in US/Europe. These clients prefer service provider partnerships as opposed to setting up own centres due to high set-up costs and management overheads.

OPD grew in line with the industry



Source: NASSCOM, PL Research

According to NASSCOM, the key growth drivers of OPD in India include

Domain Expertise – Availability of trained manpower and understanding of business context has helped vendors develop Centre of Excellence (CoE) to develop best practices and innovation.

Economic Viability - Setting up dedicated centres requires high capital costs – infrastructure, manpower, certification etc. Companies can only break even once a critical mass (around 500 people) is reached for any mid-sized engagement; an OPD venture makes most business sense.

Scalable Delivery - Most Indian vendors have long-term research/engineering capabilities with a proven scalable (both in terms of quality and quantity) delivery model, which in turn reduces time to market.

Mature Talent/Project Management Practices - Service providers are adept at managing large number of teams and projects, with clearly defined roles and responsibilities and further defined frameworks and quality processes such as six sigma and BS7799 etc.

Easy Exit - Open exit strategy provided by service providers can re-absorb employees in case engagement needs to close down.

India providing unique opportunity for OPD market

Research: NASSCOM, PL Research

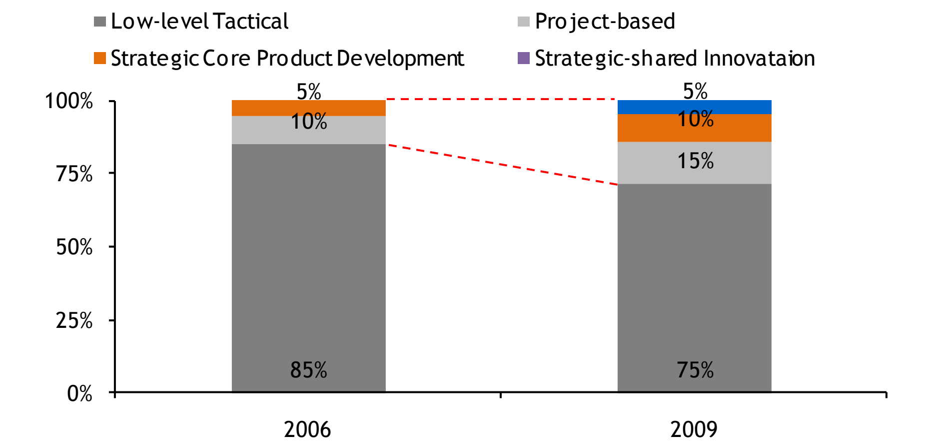
Product Engineering Service - Moving up the value chain

In 2005-06, most of the work offshored to the Indian supply base was low and of medium complexity, accounting for ~85% of the activities performed. As clients have gained confidence in engineering capability, companies are now offshoring higher complexity activities. Presently, it is estimated that medium and high complexity activities account for ~25% of the engineering work getting done in India. Strategic level work that involves high level product development and innovation has trebled in the last three years, from 5% to 15%.

Till 2005-06, very few customers utilized their global supply base in low cost locations as a source of innovation. Within the last 3-4 years, engineering supply base in countries like India and China have developed strong technical experience that has allowed them to innovate in several verticals. Suppliers in these locations are driving innovation, both at product level (new ways of designing a product) and a process level (faster and more efficient ways to engineer a product). Customers, viewing the potential that the Indian supply base offers, are now increasing utilizing Indian supply base offers as a source of innovative ideas.

Over the last 3-5 years, several customers have evolved from using offshoring for supporting processes to supporting complete products. Process-based support is generally a tactical play, where the customer maintains ownership of the product; however, the customer utilizes the support of a remote engineering centre for supporting parts of the product development value chain – i.e. testing, verification & validation, design, analyzes etc.

Improved service delivery – moving up the value chain



Source: NASSCOM, PL Research

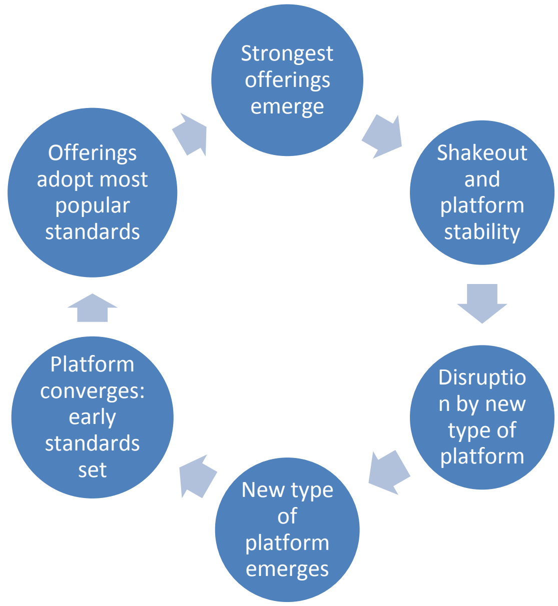
Cloud – the xing thing!

Cloud services offer a very big addressable market. A recent report from IDC forecasts the server revenue from private cloud implementations to grow from US$7.3bn in 2009 to US$11.8bn in 2014. This projection is much larger than the public cloud category, which IDC expects to reach US$714m in 2014.

Research firm Gartner, too, believes that despite the economies of scale offered by public cloud providers, private cloud services will prevail for the foreseeable future, while public cloud offerings mature. Through 2012, IT organisations will spend more money on private cloud computing investments, than on offerings from public cloud providers. A Zinnov study, meanwhile, estimates the global cloud computing market to be over US$70bn by 2015.

The Indian market, according to Springboard Research, would register CAGR at 76% between 2007 and 2011 and reach US$260m (around Rs1,300cr) by 2011. India, with its ecosystem of over 1,300 independent software vendors (ISVs), 1.4m developers and more than 11,000 system integrators (SIs and custom software development organisations), can cash in on the opportunity. An additional 3,00,000 jobs related to cloud services are estimated to be created in India over the next five years.

The Computing Platform Lifecycle: Cloud to bring disruption in product lifecycle



Research: ZDNET, PL Research

Software Product Development, till now, has been moving slowly and steadily towards an increasingly commoditized, virtualized and open sourced future. Cloud computing in its present form shortened the product lifecycle. In these uncertain times, CEO needs to contain cost by squeezing vendors using pay-per-use model (SaaS, PaaS, IaaS).

Since data is a part of cloud infrastructure and not a part of application, replacement software component will become easier. In this scenario Software Vendors have limited lock-in for their products. Hence, application software must be built 1) Quickly 2) Upgraded continuously 3) Have new features otherwise be replaced 4) Componentization and Service Oriented Architectures will be standard design philosophies. Hence, software vendors need to operate fast and at a lower cost. Consequently, OPD become critical for their business yielding success of PSYS business models.

Financials

Income Statement (Rs m)

Y/e March	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E	FY13E
Overseas Revenues	-	2,986	4,042	5,752	5,698	-	-	-
Domestic Revenues	-	30	93	186	313	-	-	-
Total Revenues	**2,165**	**3,123**	**4,249**	**5,938**	**6,012**	**6,864**	**8,209**	**10,148**
Personnel expenses	1,168	1,743	2,711	3,324	3,687	4,309	5,263	6,535
Operating and other expenses	425	574	637	1,701	860	992	1,165	1,415
Total Expenditure	1,593	2,318	3,349	5,025	4,548	5,301	6,428	7,950
Operating Profit (EBITDA)	**572**	**805**	**900**	**914**	**1,464**	**1,563**	**1,781**	**2,198**
Operating Margin (EBITDA Margin) (%)	*26.4*	*25.8*	*21.2*	*15.4*	*24.3*	*22.8*	*21.7*	*21.7*
Depreciation	187	270	280	297	335	381	431	483
Depreciation (as % of sales)	*8.6*	*8.6*	*6.6*	*5.0*	*5.6*	*5.5*	*5.2*	*4.8*
EBIT	**385**	**535**	**620**	**617**	**1,128**	**1,183**	**1,350**	**1,715**
EBIT Margin (%)	*17.8*	*17.1*	*14.6*	*10.4*	*18.8*	*17.2*	*16.5*	*16.9*
Other Income	23	21	269	69	112	278	356	441
Interest	9	1	-	-	-	-	-	-
PBT	**399**	**555**	**889**	**685**	**1,241**	**1,461**	**1,706**	**2,156**
PBT Margin (%)	*18.4*	*17.8*	*20.9*	*11.5*	*20.6*	*21.3*	*20.8*	*21.2*
Prov. For Taxes	9	18	22	10	91	146	341	431
Tax (as % of PBT)	*2.2*	*3.3*	*2.5*	*1.4*	*7.3*	*10.0*	*20.0*	*20.0*
Net Profit	**391**	**537**	**867**	**676**	**1,150**	**1,315**	**1,365**	**1,725**
Exceptional items	-	20	-	15	-	-	-	-
Prior period depreciation	-	38	-	-	-	-	-	-
PAT	**391**	**555**	**867**	**661**	**1,150**	**1,315**	**1,365**	**1,725**
NPM (%)	*18.0*	*17.8*	*20.4*	*11.1*	*19.1*	*19.2*	*16.6*	*17.0*
Outstanding Equity Shares -Basic (m)	20.7	20.7	20.7	20.7	35.7	35.7	35.7	35.7
Outstanding Equity Shares- Diluted (m)	21.2	21.2	21.2	21.2	35.7	35.7	35.7	35.7
Basic EPS (Rs)	**18.9**	**26.8**	**41.9**	**31.9**	**32.2**	**36.8**	**38.2**	**48.3**
Diluted EPS (Rs)	**18.5**	**26.2**	**41.0**	**31.2**	**32.2**	**36.8**	**38.2**	**48.3**

Source: Company Data, PL Research

Balance Sheet (Rs m)

Y/e March	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E	FY13E
Sources of Funds								
Share Capital	102	102	359	359	400	400	400	400
Stock options outstanding	-	-	-	21	32	32	32	32
Reserves and Surplus	1,912	2,414	2,927	3,569	6,003	7,246	8,551	10,204
Total Shareholder's fund	2,015	2,517	3,286	3,948	6,435	7,678	8,983	10,636
Total Capital Employed	**2,015**	**2,517**	**3,286**	**3,948**	**6,435**	**7,678**	**8,983**	**10,636**
Application of Funds								
Fixed Assets								
Gross Block	2,007	2,640	2,928	3,372	3,715	4,230	4,784	5,367
Accumulated Depreciation	783	1,026	1,286	1,573	1,881	2,262	2,692	3,175
Net Block	1,223	1,614	1,643	1,800	1,834	1,968	2,091	2,192
Capital Work-in-Progress	267	131	331	377	485	93	111	132
Total Fixed Asset	1,490	1,745	1,973	2,177	2,318	2,060	2,202	2,324
Goodwill	-	-	-	-	-	-	-	-
Investments	115	247	692	880	1,562	1,562	1,562	1,562
Deferred Tax Assets, Net	(6)	(1)	(3)	20	7	7	7	7
CURRENT ASSETS ,LOANS & ADVANCES								
Sundry Debtors	393	523	745	1,034	1,363	1,843	2,159	2,613
Cash & Bank Balances	39	113	113	165	1,918	2,885	3,945	5,348
Other Current Asset	21	56	89	130	340	282	315	361
Total Current Assets	712	957	1,351	1,784	4,258	5,648	7,056	8,961
CURRENT LIABILITIES AND PROVISIONS								
Current Liabilities	246	353	562	568	1,394	1,316	1,529	1,835
Provisions	50	79	165	346	317	282	315	382
Net Current Assets	416	525	623	870	2,548	4,049	5,212	6,743
Total Capital Employed	**2,015**	**2,517**	**3,286**	**3,948**	**6,435**	**7,678**	**8,983**	**10,636**

Source: Company Data, PL Research

Cash Flow (Rs m)

Y/e March	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E	FY13E
PBT & Extra-ordinary items	385	555	889	685	1,241	1,461	1,706	2,156
Adjustments for:	-	-	-	-	-	-	-	-
Profit on sale of investments	-	(0)	3	15	(2)	-	-	-
Provision for Income tax	(0)	-	(0)	(0)	(18)	-	-	-
Loss on sale of fixed assets	0	(4)	(1)	(15)	8	-	-	-
Movements in working capital :	-	-	-	-	-	-	-	-
(Inc.) in sundry debtors	(110)	(208)	(228)	(398)	(397)	-	-	-
(Inc.) in other current assets	0	(26)	(33)	(40)	9	-	-	-
Dec. / (Inc.) in loans and advances	(99)	(6)	(46)	26	23	-	-	-
(Dec.) / Inc. in current liab. and prov.	89	219	261	11	863	(142)	(121)	(149)
Direct taxes paid (net of refunds)	(21)	(13)	(151)	(123)	(248)	(146)	(341)	(431)
Cash from Operations	**463**	**852**	**967**	**684**	**1,611**	**1,554**	**1,674**	**2,059**
Purchase of fixed assets	(918)	(629)	(488)	(490)	(476)	(515)	(554)	(584)
Proceeds from sale of fixed assets	17	12	3	16	1	-	-	-
Purchase of investments	(1,778)	(1,082)	(2,431)	(5,504)	(7,089)	-	-	-
Sale / maturity of investments	1,771	950	1,980	5,340	6,379	-	-	-
Purchase of investment in subsidiaries	-	-	-	-	1	-	-	-
Dividends received	11	7	25	44	43	-	-	-
Cash from Investing Activities	**(896)**	**(741)**	**(910)**	**(594)**	**(1,142)**	**(515)**	**(554)**	**(584)**
Proceeds from issuance of share capital	23	0	0	-	41	-	-	-
Interest income	905	-	0	-	1,242	-	-	-
Dividends paid	(21)	(32)	(6)	(32)	(22)	(54)	(61)	(71)
Tax on dividend paid	(3)	(4)	(43)	(4)	(5)	-	-	-
Interest paid	(22)	(1)	(7)	-	-	-	-	-
Others	(464)	-	-	-	8	-	-	-
Cash from Financing Activities	**417**	**(37)**	**(56)**	**(36)**	**1,264**	**(54)**	**(61)**	**(71)**
Effect Of Forex Differences	-	-	(0)	(0)	(0)	-	-	-
Inc/(Dec) in Cash	**(16)**	**73**	**0**	**54**	**1,733**	**986**	**1,059**	**1,404**
Cash At the beginning of the Period	**60**	**39**	**113**	**113**	**167**	**1,900**	**2,885**	**3,945**
Cash From Acquisition	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Cash At the end of the period	**45**	**113**	**113**	**167**	**1,900**	**2,885**	**3,945**	**5,348**

Source: Company Data, PL Research

Key Ratios

Y/e March	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E	FY13E
P&L Ratios								
FV/Sales	6.5	4.4	3.2	2.3	2.3	1.9	1.6	1.3
FV/EBITDA	24.5	17.1	15.3	15.0	9.3	8.5	7.5	6.2
FV/EBITA	36.4	25.8	22.2	22.3	12.0	11.3	9.9	7.9
FV/ Net Profit	35.8	24.8	15.9	20.3	11.8	10.2	9.8	7.9
Price to Cash								
Price to Ops CF	30.6	16.6	14.6	20.7	8.8	9.1	8.5	6.9
Price to FCF	(32.0)	63.0	28.8	108.7	12.0	13.6	12.6	9.6
Price to Change in Cash	(897.5)	193.2	64,332.0	261.5	8.2	14.4	13.4	10.1
Returns on Capital Ratios								
RoCE %	19.1	21.3	18.9	15.6	17.5	15.4	15.0	16.1
RoIC %	18.2	20.6	24.9	15.8	17.5	16.4	14.5	15.5
RoE %	19.4	22.1	26.4	16.7	17.9	17.1	15.2	16.2
RoA %	16.9	18.8	21.6	13.6	14.1	14.2	12.6	13.4
Earning Quality								
FCF/Sales	(0.2)	0.1	0.1	0.0	0.2	0.2	0.1	0.1
FCF/EBITDA	(0.8)	0.3	0.5	0.1	0.8	0.7	0.6	0.7
FCF/EBIT	(1.2)	0.4	0.8	0.2	1.0	0.9	0.8	0.9
Per Share Ratios								
P/E (FD, pre excepts)	21.0	14.8	9.5	12.4	12.3	10.8	10.4	8.2
Dividend Yield	NA	0.4	0.6	0.4	0.2	0.4	0.4	0.5
Price to Book (FD)	NA	3.3	2.5	2.1	2.2	1.8	1.6	1.3
Leverage & Solvency								
Current Ratio	2.4	2.2	1.9	2.0	2.5	3.5	3.8	4.0
Quick Ratio	1.1	1.0	0.8	0.8	1.7	2.4	2.7	2.9
Net Debt/(Cash) (Reported)	(154.7)	(359.6)	(804.9)	(1,045.5)	(3,479.5)	(4,447.1)	(5,506.4)	(6,910.0)
Debt/Equity	-	-	-	-	-	-	-	-
Net Debt/Equity	(7.7)	(14.3)	(24.5)	(26.5)	(54.1)	(57.9)	(61.3)	(65.0)
Net Debt to EBITDA	(27.1)	(44.7)	(89.4)	(114.4)	(237.7)	(284.5)	(309.2)	(314.3)
Asset Turnover	93.7	105.9	105.9	122.1	73.8	74.0	75.8	79.0
Avg Total Assets/Avg. Total Equity	106.9	100.0	97.6	98.7	94.4	74.2	71.4	70.0

Source: Company Data, PL Research

Company Background

PSYS is one of the market leaders in outsourced software product development services. PSYS, an OPD specialty company, is offering customers the benefits of offshore OPD delivery. The company designs, develops and maintains software systems and solutions, creates new applications and enhances the functionality of customers' existing software products. They deliver services across all stages of the product life-cycle, which enables them to work with a wide-range of customers and allows them to develop, enhance and deploy their customers' software products.

PSYS has depth of experience in the focused areas of telecommunications, life sciences and infrastructure and systems. The company has invested and plans to continuously invest in new technologies and frameworks in the areas of cloud computing, analytics, enterprise collaboration and enterprise mobility. The company has contributed to the development of over 3000 products releases for their customers over the past five years.

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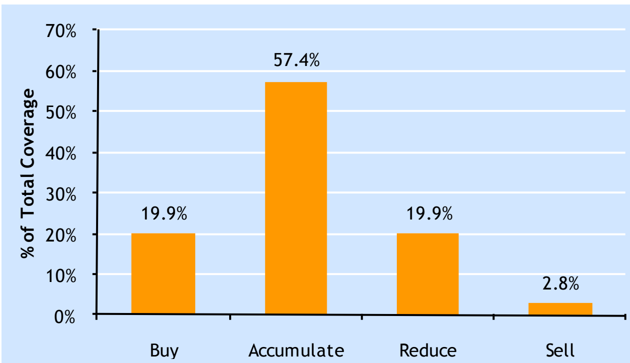

PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly

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