India I Equities

Technology

Company Update

Change in Estimates ☑ Target ☑ Reco ☐

13 May 2020

Sonata Software

Rating: **Buy**
Target Price: ₹230
Share Price: ₹197

Amid travel turmoil, OPD, retail should help; Buy

Sonata's $44.4m Q4 revenue (down 5.1% q/q, up 2.1%y/y) reflects weakness in the Travel vertical, with one of the top accounts holding back 85% of the workload. The company expects revenue/profit to drop 15%/40% in H1, then gradually recover in H2. The Q4 EBIT margin (9.3%), up 119bps q/q, down 79bps y/y, reflects the revenue trajectory ahead. We trimour FY21e/FY22e and TP. Negatives seem priced in. We retain a Buy with an unchanged multiple (10x FY22e EPS).

Travel IT spending may resume in H2, OPD to partly offset declines. Sonata's great dependence on Travel (23% of revenue, down 13%q/q) and on Europe (30%, down 5%q/q) are prime concerns in the current context. However, one of its top travel clients is likely to resume operations, at least partly, from mid-Jun, while the UK has issued some guidelines for resuming international traffic (exact dates awaited). On this backdrop, OPD and other IT services are likely to be resilient given Sonata's great dependence on MS tech (~70% of IT services revenue). We estimate an 8% decline in IT services in FY21, 7% growth in FY22.

Margins in H2 to reflect benefits of variable cost structures. IT services' EBITDA margin (adj. for forex gains) was 19.3%, down 699bps q/q, down 614bps y/y on lower revenue and operational challenges related to on-site costs/utilisation (down 400bps q/q). The situation will worsen in H1 (the company talked of up to a 40% decline in profits) before recovering in H2, contingent on easing of travel/vacation restrictions in Europe. We are building in IT services margins of 18% in FY21 and 19% in FY22.

Retaining a Buy;target:₹230 (10x FY22e EPS). We are retaining our Buy based on the strong execution track record, expectations of some revival in travel-related expenditure in H2, and capital allocation discipline. On the negatives, client concentration is still high (top-10: 64% of revenue). Overall, we think the risk-reward is favourable at current valuations (8.7x FY22e EPS, 11% FY22e FCF yield, NIIT Tech trading at 15.6x FY22e EPS and 27% travel exposure). **Risks:** Client concentration, Travel vertical exposure.

Key financials (YE Mar)	FY18	FY19	FY20e	FY21e	FY22e
Sales (₹ m)	24,539	29,609	37,433	36,596	40,165
Net profit (₹ m)	1,925	2,492	2,770	2,158	2,420
EPS (₹)	18.3	23.7	26.3	20.5	23.0
PE (x)	10.9	8.4	7.6	9.7	8.7
EV / EBITDA (x)	7.8	5.4	4.7	5.9	5.2
PBV (x)	3.2	2.7	3.1	2.9	2.7
RoE (%)	31.1	35.1	38.5	31.1	32.5
RoCE (%)	24.4	30.4	29.8	22.1	24.1
Dividend yield (%)	5.3	6.4	8.5	6.6	7.4
Net debt / equity (x)	-0.8	-0.4	-0.5	-0.4	-0.4

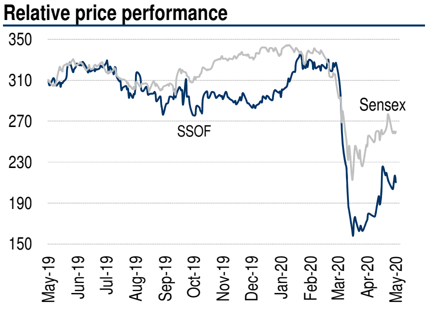
Source: Company, Anand Rathi Research

Key data	SSOF IN / SOFT.BO
52-week high / low	₹363 / 148
Sensex / Nifty	31371 / 9197
3-m average volume	$0.8m
Market cap	₹21bn / $275m
Shares outstanding	105m

Shareholding pattern (%)	Mar'20	Dec'19	Sep'19
Promoters	28.2	28.2	28.2
- of which, Pledged	-	-	-
Free float	71.8	71.8	71.8
- Foreign institutions	11.7	12.3	12.8
- Domestic institutions	13.6	12.4	12.1
- Public	46.5	47.2	47.0

Estimates revision (%)	FY21e	FY22e
Sales($)	(7.0)	(7.2)
EBITDA	(4.5)	(5.3)
PAT	(3.6)	(6.1)

Relative price performance



Source: Bloomberg

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
Revenues ($ m)	384.4	430.8	534.4	499.2	547.9
Growth (%)	1	12	24	-7	10
Net revenues	24,539	29,609	37,433	36,596	40,165
Employee & direct costs	20,018	23,517	30,761	30,574	33,540
Gross profit	4,521	6,092	6,672	6,022	6,626
Gross margins %	18.4	20.6	17.8	16.5	16.5
SG&A	2,211	2,736	2,817	2,957	3,135
EBITDA	**2,310**	**3,356**	**3,855**	**3,064**	**3,491**
EBITDA margins (%)	**9.4**	**11.3**	**10.3**	**8.4**	**8.7**
- Depreciation	124	128	365	384	408
Other income	466	301	457	340	273
Interest expenses	48	34	152	138	130
PBT	2,604	3,494	3,795	2,882	3,226
Effective tax rate (%)	26.2	28.8	27.0	25.1	25.0
+ Associates / (Minorities)	4	4	-	-	-
Net income	**1,925**	**2,492**	**2,770**	**2,158**	**2,420**
WANS	105	105	105	105	105
FDEPS (₹ / sh)	18.3	23.7	26.3	20.5	23.0

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
Share capital	104	104	103	103	103
Net worth	6,533	7,683	6,696	7,181	7,725
Debt	187	156	860	860	860
Minority interest	-0	-	-	-	-
DTL/(Assets)	-124	-119	-244	-244	-244
Capital employed	**6,595**	**7,720**	**7,312**	**7,797**	**8,341**
Net tangible assets	231	220	1,186	883	563
Net intangible assets	101	322	344	344	344
Goodwill	807	1,452	1,452	1,452	1,452
CWIP (tang.&intang.)	3	6	-	-	-
Investments (strategic)					
Investments (financial)	1,984	1,464	135	149	164
Current assets (ex cash)	5,613	9,706	8,840	9,809	10,604
Cash	3,472	1,992	3,964	3,316	3,504
Current liabilities	5,616	7,442	8,608	8,155	8,288
Working capital	-3	2,264	232	1,655	2,316
Capital deployed	**6,595**	**7,720**	**7,312**	**7,797**	**8,341**
Contingent liabilities	6,608	-	-	-	-

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
PBT	2,604	3,494	3,795	2,882	3,226
+ Non-cash items	22	-339	187	182	265
Oper.prof. before WC	2,626	3,155	3,982	3,064	3,491
- Incr./(decr.) in WC	-904	2,350	-1,005	1,280	496
Others incl. taxes	-552	-867	-1,289	-867	-971
Operating cash-flow	**2,978**	**-62**	**3,698**	**918**	**2,024**
- Capex (tang. +intang.)	65	80	85	82	87
Free cash-flow	**2,913**	**-142**	**3,613**	**836**	**1,936**
Acquisitions	-134	-383	-43	-	-
- Div.(incl. buyback & taxes)	1,146	1,434	3,541	1,673	1,876
+ Equity raised	0	0	-	-	-
+ Debt raised	-215	-195	704	-	-
- Fin investments	661	-643	-1,382	14	15
- Misc. (CFI + CFF)	76	-29	16	-201	-143
Net cash-flow	681	-1,847	2,099	-649	189

Source: Company, AnandRathi Research

Fig 4 – Ratio analysis

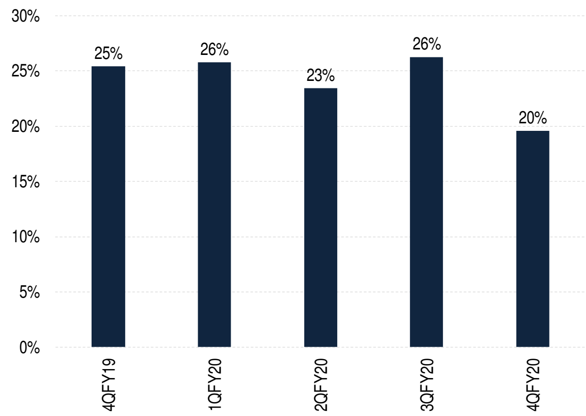
Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
P/E (x)	**10.9**	**8.4**	**7.6**	**9.7**	**8.7**
EV / EBITDA (x)	**7.8**	**5.4**	**4.7**	**5.9**	**5.2**
EV / Sales (x)	0.6	0.6	0.5	0.5	0.5
P/B (x)	3.2	2.7	3.1	2.9	2.7
RoE (%)	**31.1**	**35.1**	**38.5**	**31.1**	**32.5**
RoCE (%) - after tax	24.4	30.4	29.8	22.1	24.1
RoIC (%) - after tax	78.5	74.0	53.3	37.9	38.4
DPS (₹ /sh)	**10.5**	**12.8**	**17.0**	**13.3**	**14.9**
Dividend yield (%)	5.3	6.4	8.5	6.6	7.4
Dividend payout (%) - incl. DDT	68.9	64.6	64.6	64.6	64.6
Net debt / equity (x)	-0.8	-0.4	-0.5	-0.4	-0.4
Receivables (days)	65.1	105.5	72.6	82.6	80.6
Inventory (days)					
Payables (days)	71.0	81.7	61.1	56.1	51.1
CFO : PAT %	**155.0**	**-2.5**	**133.5**	**42.5**	**83.6**

Source: Company, AnandRathi Research

Fig 5 – Price movement

Source: Bloomberg

Fig 6– IT Services EBITDA margin %



Source: Company

Result Highlights

Q4 FY20 Results at a Glance

Fig 7 – Segment-wise results

(₹ m)	Q4 FY19	Q1 FY20	Q 2 FY20	Q3 FY20	Q4 FY20	Q/Q %	Y/Y %
Consolidated revenues ($m)	**120**	**128**	**103**	**176**	**127**	**-28%**	**6%**
Y/Y growth (%)	*23%*	*24%*	*20%*	*45%*	*6%*		
Consolidated Revenues	8,356	8,746	7,031	12,369	9,287	-25%	11%
Eff. exchange rate	69.9	68.7	69.0	70.5	73.3	4%	5%
Revenues ($m) – IT Services	**43.5**	**44.3**	**45.3**	**46.8**	**44.4**	**-5%**	**2%**
Revenues ($m) – Reselling Services	**76.8**	**83.5**	**57.8**	**129.4**	**82.8**	**-36%**	**8%**
Employees (EoP)	**4,042**	**4,011**	**4,181**	**4,177**	**4,211**		
Revenue productivity ($ '000/empl)	11.2	11.5	11.2	11.6	10.9	-6%	-2%
CoR (excl. D&A)	(6,682)	(7,173)	(5,424)	(10,573)	(7,591)	-28%	14%
as % of revenues	*-80%*	*-82%*	*-77%*	*-85%*	*-82%*	*375 bps*	*-176 bps*
SG&A	(789)	(677)	(702)	(699)	(739)	6%	-6%
as % of revenues	*-9%*	*-8%*	*-10%*	*-6%*	*-8%*	*-231 bps*	*149 bps*
EBITDA	**884**	**896**	**905**	**1,097**	**957**	**-13%**	**8%**
EBITDA margins %	***10.6%***	***10.2%***	***12.9%***	***8.9%***	***10.3%***	***144 bps***	***-27 bps***
EBIT	**844**	**807**	**813**	**1,005**	**865**	**-14%**	**2%**
EBIT margins %	***10.1%***	***9.2%***	***11.6%***	***8.1%***	***9.3%***	***119 bps***	***-79 bps***
Other income	84	168	208	86	(5)	-106%	-106%
PBT	921	936	987	1,048	824	-21%	-10%
PBT margins %	*11.0%*	*10.7%*	*14.0%*	*8.5%*	*8.9%*	*40 bps*	*-215 bps*
Taxes	(268)	(266)	(264)	(290)	(206)	-29%	-23%
ETR %	*-29%*	*-28%*	*-27%*	*-28%*	*-25%*	*260 bps*	*401 bps*
PAT	**654**	**670**	**723**	**759**	**618**	**-19%**	**-5%**
PAT margins %	***7.8%***	***7.7%***	***10.3%***	***6.1%***	***6.7%***	***52 bps***	***-117 bps***

Source: Company, Anand Rathi Research

Fig 8 – Quarterly results(₹ m)

Year-end: Mar (₹ m)	Q4FY20	% qoq	% yoy	FY20	FY21	% yoy
Sales ($ m) IT services	44	(5.1)	2.1	181	166	(8.0)
Sales consolidated	9,287	(24.9)	11.1	37,433	36,596	(2.2)
EBITDA	957	(12.7)	8.3	3,855	3,064	(20.5)
EBITDA margins (%)	10.3	144 bps	-27 bps	10.3	8.4	-193 bps
EBIT	865	(14.0)	2.5	3,490	2,680	(23.2)
EBIT margins (%)	9.3	119 bps	-79 bps	9.3	7.3	-200 bps
PBT	824	(21.4)	(10.5)	3,795	2,882	(24.1)
Tax	(206)	(28.8)	(22.8)	(1,026)	(724)	(29.5)
Tax rate (%)	(25.0)	260 bps	401 bps	(27.0)	(25.1)	192 bps
Net income	618	(18.5)	(5.4)	2,770	2,158	(22.1)

Source: Company

Conference-Call Takeaways

Company

- IT services revenues declined 3.9% q/q in constant currency.
- The recently acquired GAP busters (revenue:~$9.8m) has also been impacted by Covid-19 as it has mostly clients in the retail space.
- While the top travel client has suspended 85% of its business, Sonata is not seeing issues with the other top-10 clients.
- All its employees are working from home.
- Mortgage and utility companies are starting up new projects on the IT side.
- Overall, its outlook on OPD is positive as it is mostly on the cloud /collaboration side and is more aligned to the non-discretionary side.
- The company will get more visibility and stability, post-Q1.
- It will see higher cost structures in Q1FY20 as some of the employees are stuck at on-site locations.
- Sonata expects to maintain the profitability of its domestic business on an absolute-EBITDA basis.
- Given the new tax regime, the company will decide the mode of distribution of cash in future, but now will conserve cash on the books.

Notes from the last quarters' conference calls

From Q3 FY20

- The company is seeing healthy gross-profit growth in its domestic business and is optimistic about this business.
- Sonata is a value-added reseller domestically; hence, it expects to maintain its profitability on an absolute-EBITDA basis and not on a percentage-margin basis.
- Scalable was flat sequentially and Sopris saw some q/q growth in the quarter. Scalable acquired some new clients in Australia in the quarter.
- IT services headcount addition to resume from next quarter to support growth as utilisation has peaked and the business is linear with no meaningful price increases.
- The company believes that, while top clients may slow down quarterly, leading to fluctuations (such as in OPD and travel in Q3), overall, its outlook on these clients and, thereby, verticals is positive from a medium-term perspective.
- Growth in Q3 was generated by "others", which include BFSI and healthcare, as these are too small to be disclosed separately.
- IT services margins are running ahead of management's comfort zone due to forex gains and extremely optimised operations. The company believes that this can be maintained at ~24% even if these variables turn negative.
- The company has decided to move to the new tax regime. Given the

timing and deferred taxes, however, the FY20 tax rate would be higher.

- Attrition has come down q/q.

From Q2 FY20

- The company has appointed a new CFO, JagannathanChakravarthi, earlier CFO of Mindtree and Carborundum Universal.
- Scalable and Sopris will take another 3-4 quarters to be fully integrated and grow. We expect growth from FY21.
- Money has been deployed in the domestic business, where DSO days are more; thus, cash-flow generation has been lower. Management believes that the rise in working capital is due to the weak Indian economy and the credit risk is on the company's balance sheet.
- It expects cash-flows to improve in H2 as receivable days have stabilised or else growth in the domestic business will shrink.
- Revenue growth from Europe is still a challenge due to the weak currency.
- The average on-site billing rate is $75/hr; offshore, $25.
- The company is seeking to strengthen its US sales force.
- Forex gain was ₹106.2m in the quarter.

From Q1 FY20

- In Q1, Scalable and Sopris brought respectively $1m and $1.4m to revenues. During this period, both were EBITDA neutral.
- While revenue growth was slow, management thinks it's just a timing issue and expects growth to return in Q2.
- Revenue growth from Europe/travel was weak, but the company believes it's still growing well, barring currency movements.
- Excl. the Ind-AS impact, the EBITDA margin in IT services was 24% (vs. 27.7% reported). Similarly, for the domestic-products business, the adj. EBITDA margin was 6%, vs. 4% reported.
- The company expects growth in IT services to pick up from Q2.
- Forex gain was ₹92m, vs. a ₹24m loss the quarter prior.

From Q4 FY19

- In Q4, Scalable and Sopris brought respectively $1m and $1.7m to revenue. During this period, both were EBITDA neutral. Management expects revenue from these acquisitions to pick up from this Oct.
- Both Scalable and Sopris are on-site heavy. Management endeavours to move them offshore for better margins.
- Revenue from Scalable largely pertains to the retail and distribution vertical, whereas Sopris is in a new vertical.
- The planned wage hike would be in two phases: one in Q2, the other in Q3. The quantum is likely to be similar to that last year.

- Forex loss was ₹33m, halved from ₹66m the quarter prior.
- Debtor days surged considerably, largely from the domestic business owing to the significant billing at the quarter's end, and will be collected in Q1FY20.
- Of the 3,886 employees in the IT business,427 are on the SG&A side, the rest on the delivery side.
- Of the additions, 75% are net additions; the rest, replacements.
- To drive digital growth (36% of revenues), new members with digital specialisations have been brought on board: GyanBardhanPattnaik from L&T Technology Services, and Sridhar Rao Vedala to drive digital in Europe.

From Q3 FY19

- IBIS revenue was $1.3m, against $1.6 the quarter prior, hurt by the holiday season. Q3 and Q2 FY19 EBITDA margins were respectively ~9.5% and 14-15%. Broadly, on an annual basis, annuity-based revenue would be ~$2m; the rest belongs to project-based revenue, which has led to the volatile performance.
- Cross-currency headwinds impacted IT services revenue; CC growth in IT services was ~5% q/q.
- Revenue of ₹10m came from the Scalable Data System, acquired in Dec'18. The Sopris acquisition is in progress.
- The company has achieved its optimum (86%) utilisation, leaving no scope for further improvement.
- Q3 digital revenue contribution was 35% (32% a year ago).
- Forex loss for the quarter was ₹64m, restricting profit growth for the quarter to 3% q/q.
- Nine clients were added during Q3, five in the US and two each in Europe and Asia.
- Margins in IT services are likely to be ~22-23%.

From Q2 FY19

- IBIS revenue was ~$2.3m, with an 18% margin.
- Margins in IT services would be ~22-23% in FY19.
- The IT services strategy to provide business solutions along with IPs (Rezopia, Halosys, Brick & Click, Retina) is yielding results. This is a major differentiator for Sonata, and is the basis of its platformation strategy (digital transformation through platform+services).

From Q1 FY19

- Ahead, the IT services margin is likely to be a steady 23.5%, as the company is seeing growth through its IPstrategy, digital spending in retail and support from currency.
- M&A is likely in FY19, which will be small and carried out through internal accruals.
- Sonata invests 2.5–3% of its revenue in IP development. This is done continuously and is likely to continue within this range.

Factsheet

Fig 9 – Revenue split

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
ADM	24.0	23.0	27.0	26.0	24.0
Test	17.0	16.0	15.0	15.0	14.0
AX	22.0	26.0	26.0	28.0	28.0
ERP	4.0	4.0	4.0	4.0	4.0
IMS	16.0	14.0	12.0	12.0	14.0
BI	8.0	9.0	9.0	8.0	8.0
E-commerce	6.0	5.0	5.0	5.0	5.0
Rezopia	3.0	2.0	2.0	2.0	2.0
Digital	36.0	36.0	37.0	38.0	38.0

Source: Company

Fig 10 – Revenue-split, by domain

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
OPD / ISV	26.0	28.0	28.0	25.0	26.0
Travel & Tourism	28.0	26.0	27.0	25.0	23.0
CPG / Retail & Distribution	27.0	27.5	26.0	28.0	28.0
Others	19.0	18.5	19.0	22.0	23.0

Source: Company

Fig 11 – Revenue-split, by region

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
North America	55.0	56.0	53.0	54.0	54.0
Europe	32.0	30.0	30.0	30.0	30.0
Asia-Pacific	13.0	14.0	17.0	16.0	16.0

Source: Company

Fig 12 – Revenue-split, by service line

(%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
IT Services	36	35	44	27	35
Domestic business	64	65	56	73	65

Source: Company

Fig 13 – Client profiles (LTM)

Client profiling (%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Top-5	61.0	59.0	59.0	57.0	57.0
Top-10	68.0	66.0	65.0	66.0	64.0
Top-20	76.0	75.0	73.0	75.0	73.0

Source: Company

Fig 14 – Workforce

Employee movement (%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
Employees (EoP) - IT services	3,886	3,863	4,036	4,028	4,066
Employees (EoP)- asset leveraged	156	148	145	149	145
Net additions (Qtr)	75	-31	170	-4	34
Utilisation %	*86.0%*	*86.2%*	*88.0%*	*89.0%*	*85.0%*
Attrition % est.	*17.4%*	*17.6%*	*16.2%*	*15.5%*	*16.9%*

Source: Company

Fig 15 – Revenue-split, by delivery type and billing rates

Delivery type (%)	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20
On-site	43	44	44	42	41
Offshore	57	56	56	58	59

Source: Company

Valuations

The stock currently trades at ₹8.7x FY22e EPS of ₹23. For FY20, Sonata clocked 6% revenue growth in its IT services.We expect the IT and the domestic-products divisions toregisterrespectively -1% and 2% CAGRs over FY20-22. Growth in the domestic segment is more opportunistic, with the focus being only on margins and RoE. In terms of its IT services, OPD looks better than other divisions.

We value the stock on a PE basis as the bulk of its profit arises from IT services. We expect the company to end FY22 with an EPS of ₹23. Although we expect a 1% revenue CAGR over FY20-22, margin expansion in IT services from now would be difficult, given that the recovery in travel and retail will be prolonged.

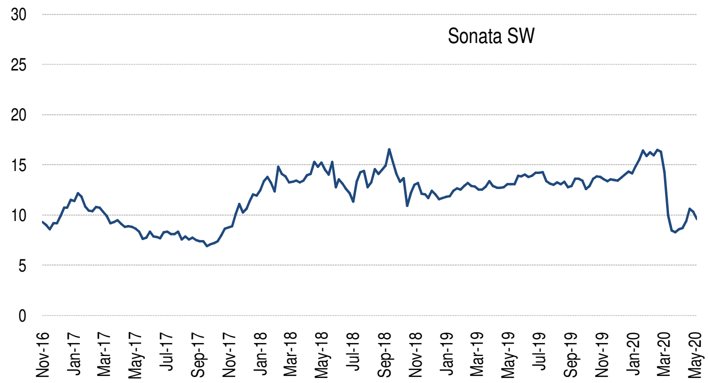
Given that the loss of revenue from its top travel client has already been factored in and that we are hoping for a recovery in H2 whentravel restrictions are lifted, we value the company ata target PE of 10x FY22e (the lower side of valuations given little assurance of revenues). On the recent fall in the price of the stock and past execution capability of management, we maintain ourBuy recommendation. Capital allocation remains rock solid.

Fig 16–Change in estimates(₹m)

	FY21			FY22		
	New	Old	Chg %	New	Old	Chg %
Revenues ($ m)	499	537	(7.0)	548	590	(7.2)
Revenues - IT ($m)	166	171	(2.9)	178	184	(3.3)
Revenues	36,596	38,796	(5.7)	40,165	42,662	(5.9)
EBITDA	3,064	3,209	(4.5)	3,491	3,686	(5.3)
EBITDA margins %	*8.4%*	*8.3%*	*10 bps*	*8.7%*	*8.6%*	*5 bps*
EBIT	2,680	2,825	(5.1)	3,083	3,279	(6.0)
EBIT margins %	*7.3%*	*7.3%*	*4 bps*	*7.7%*	*7.7%*	*-1 bps*
PBT	2,882	3,005	(4.1)	3,226	3,434	(6.1)
Net profit	2,158	2,238	(3.6)	2,420	2,576	(6.1)

Source: Anand Rathi Research

Fig 17– PE band



Source: Bloomberg, Anand Rathi Research

Risk

- Client concentration
- Travel vertical exposure.

Appendix

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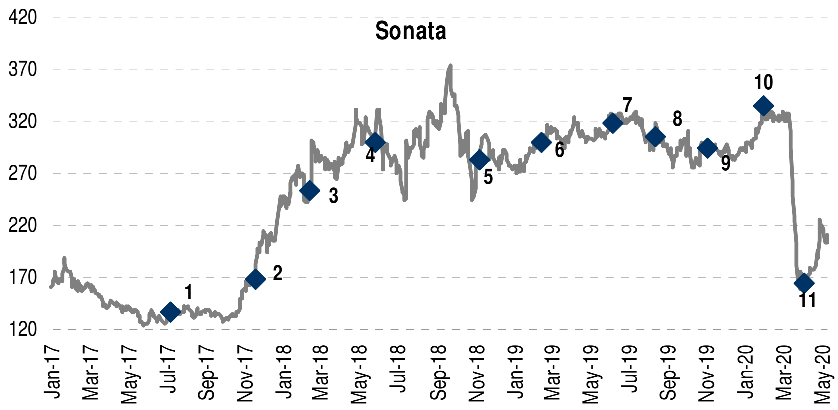

	Date	Rating	TP (₹)	Share Price (₹)
1	05-Jul-17	Buy	220	156
2	15-Nov-17	Buy	240	195
3	09-Feb-18	Hold	320	284
4	23-May-18	Hold	380	341
5	05-Nov-18	Buy	370	310
6	11-Feb-19	Buy	400	310
7	01-Jun-19	Hold	400	355
8	08-Aug-19	Buy	390	315
9	31-Oct-19	Buy	380	315
10	28-Jan-20	Hold	390	349
11	31-Mar-20	Buy	250	164

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Ratings Guide (12 months)	Buy	Hold	Sell
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