

Sonata Software (SSOF IN)

Rating: BUY | CMP: Rs406 | TP: Rs503

February 8, 2021

Q3FY21 Result Update

☑ Change in Estimates | ☑ Target | ■ Reco

Change in Estimates

	Current		Previous	
	FY22E	FY23E	FY22E	FY23E
Rating	BUY		BUY	
Target Price	503		437	
Sales (Rs. m)	47,668	52,742	40,294	44,351
% Chng.	18.3	18.9		
EBITDA (Rs. m)	4,587	5,063	3,844	4,093
% Chng.	19.3	23.7		
EPS (Rs.)	30.1	33.5	27.8	29.2
% Chng.	8.4	15.0		

Key Financials - Standalone

Y/e Mar	FY20	FY21E	FY22E	FY23E
Sales (Rs. m)	37,433	41,887	47,668	52,742
EBITDA (Rs. m)	3,728	3,814	4,587	5,063
Margin (%)	10.0	9.1	9.6	9.6
PAT (Rs. m)	2,797	2,331	3,128	3,480
EPS (Rs.)	27.0	22.5	30.1	33.5
Gr. (%)	12.4	(16.6)	34.2	11.3
DPS (Rs.)	13.5	11.1	15.1	16.8
Yield (%)	3.3	2.7	3.7	4.1
RoE (%)	34.6	25.6	30.7	30.2
RoCE (%)	40.6	36.8	40.7	40.2
EV/Sales (x)	0.9	0.8	0.7	0.6
EV/EBITDA (x)	9.4	8.9	7.1	6.1
PE (x)	15.1	18.1	13.5	12.1
P/BV (x)	4.9	4.4	3.9	3.5

Key Data

SOFT.BO | SSOF IN

52-W High / Low	Rs.435 / Rs.147
Sensex / Nifty	50,732 / 14,924
Market Cap	Rs.43bn/ \$ 586m
Shares Outstanding	105m
3M Avg. Daily Value	Rs.313m

Shareholding Pattern (%)

Promoter's	29.36
Foreign	11.88
Domestic Institution	14.42
Public & Others	44.34
Promoter Pledge (Rs bn)	-

Stock Performance (%)

	1M	6M	12M
Absolute	(0.2)	42.2	20.4
Relative	(4.7)	5.6	(2.4)

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Strong rebound in ISV business...

Quick Pointers:

- Growth in IT services was driven by ISV & Dynamics/AX service lines.
- Strong surprise in IT services EBITDA margin at 28.9% which was driven by improved realization, utilization, offshoring & revenue productivity.

Sonata's IT services revenue growth was driven by ISV (grew 15% QoQ), retail & travel. In terms of verticals, growth was led by ISV (independent software vendors) business (+15% QoQ USD, +8% YoY USD) which includes work done for Microsoft dynamic and other platform services clients. This is also reflected by strong growth in Digital Platformation Services (Microsoft & Open source), +11% QoQ USD. Overall consolidated revenues grew at healthy rate of 8.3% YoY USD led by strong growth in DPS (+110 QoQ USD, +12% YoY USD) and steady growth in IITS (5.1% QoQ USD, -12.4% YoY USD). IITS margins were highest ever at 29% led by improved realization, utilization, offshoring & revenue productivity. We believe that IITS margins will come down to steady levels ~26% once travel and facility costs come back. We expect healthy revenue momentum given huge opportunity in digital platforms & cloud. The compensation hike across the board, effective 1st Jan, will result in some headwinds to margins.

We expect IT services to register a CAGR of 11.6% over FY21-23E & growth in domestic business to register a CAGR of 10% over FY21-23E. We believe most of the loss of revenue from its top travel account has been factored & we can expect steady revenue momentum in FY22. We continue to value Sonata on 15X FY23 earnings to arrive at changed TP of INR 503 (earlier: 427). Sonata is currently trading at 13x/12x on FY22/23 earnings of INR 30/33.5. Maintain Buy.

- Steady growth in IITS business:** International IT Services (IITS) revenue grew at a stable rate of 5.1% QoQ USD, -12.4% YoY USD, in-line with our estimates. In terms of verticals, growth was led by ISV (independent software vendors) business (+15% QoQ USD, +8% YoY USD) which includes work done for Microsoft dynamic and other platform services clients. This is also reflected by strong growth in Digital Platformation Services (Microsoft & Open source), +11% QoQ USD. Managed Cloud Services business also grew at strong rate of 14% QoQ USD, 4% YoY USD. We believe that due to accelerated demand for digital transformation, Platformation and cloud services business will continue to grow at strong pace for next 2-3 years.
- Strong rebound in DPS business:** Domestic Product Services (DPS) business positively surprised us with strong sequential recovery of +111% QoQ USD, +16% YoY USD driven by multi-year cloud-based annuity deals. Share of cloud based deals increased to 63%, +300 bps QoQ, while annuity deals increased to 68%, +200 bps QoQ. Historically, 3Q has experienced strong sequential growth with consequent dip in 4Q. We anticipate DPS revenues to grow by +16% YoY but decline sequentially by -36% in 4QFY21 in \$ terms.

Sonata has huge opportunity in Microsoft dynamic migration. With strong long-term relationship with Microsoft, Sonata has deep focus on Microsoft full-stack. Their proprietary tool for Microsoft dynamic migration is validated to be one of the best in the industry.

Number of Fortune 500 clients have steadily grown from 24 in 3QFY20 to 30 in 3QFY21. Sonata added a total of 8 new clients in this quarter.

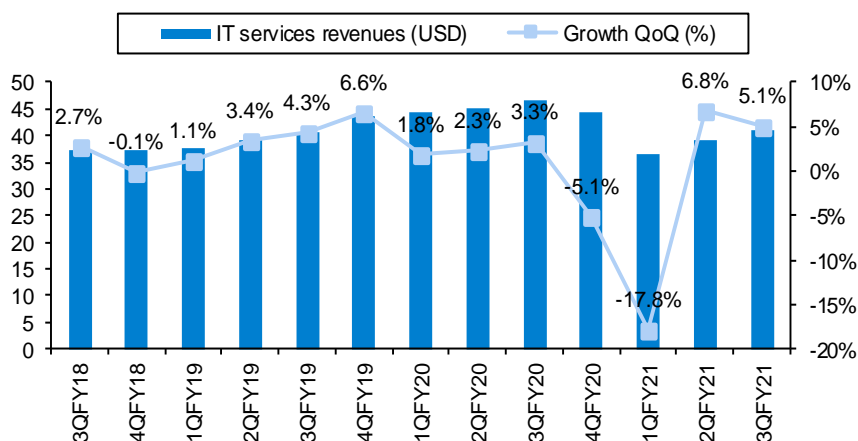
- **Sharp expansion in IITS margins, decline in DPS margins:** IITS EBITDA margins expanded by +450 bps QoQ, +120 bps YoY led by i) improved utilization of 89%, +200bps QoQ, and billability of 79% +200 bps QoQ ii) higher offshore mix of 65%, +200 bps QoQ iii) higher revenue per person (onsite/offshore: 7%/3% QoQ) and iv) better realization due to high end service mix. DPS EBITDA margins declined by 130 bps QoQ & 50 bps YoY leading to 240 bps QoQ & 70 bps YoY decline in consolidated EBIT margins. Going forward, travel and office costs will partially come back but management guided that margins will stay at slightly higher levels than pre-covid.
- **Strong growth in Digital & Platformation revenues:** Sonata has experienced strong acceleration of digital revenues, in last 4 quarters. (+12% QoQ USD, +47.5% YoY USD). This can be attributed to Sonata's approach to digitize the business using organically developed platforms (known as Platformation). Management also indicated huge opportunity in Microsoft dynamic migration. With strong long-term relationship with Microsoft, Sonata has deep focus on Microsoft full-stack. Their proprietary tool for Microsoft dynamic migration is validated to be one of the best in the industry.
- **Healthy new client addition:** Number of Fortune 500 clients have steadily grown from 24 in 3QFY20 to 30 in 3QFY21, reflecting strong sales ability. Sonata added a total of 8 new clients in this quarter. Revenue from top 10 clients grew by 7% QoQ USD whereas non-top 10 revenues de-grew by 3% QoQ USD.
- **Headcount addition to improve, strong cash collections:** Sonata added net headcount of 112 employees and they are on strong hiring trajectory. Attrition has lowered by 100 bps QoQ to 14%. Salary hike for FY21 has started from 1st Jan 2021.
- **Strong cash collections, lower DSO, healthy payout:** Rigour in cash collections led to consolidated DSO days of 47 (vs 55 in 2Q21 and 45 in 3Q20). Lower DSO was led by sharp reduction in IITS business DSO at 36 (vs 47 in 2Q21 & 42 in 3Q20). **Board declared interim dividend of INR 4/share maintaining 9MFY21 payout ratio in-line with recent past at ~62%.** They are also exploring M&A opportunities in i) to strengthen dynamics footprint ii) expand presence in Europe iii) healthcare vertical aligned to cloud and data and iv) captive center consolidation.
- **Settlement of contingent liabilities:** Sonata has settled long pending tax dispute worth Rs490m by paying taxes of Rs218m, thereby reducing contingent income-tax liabilities (FY20: Rs5136mn) by Rs490m. Post this settlement, there is only one large income tax case which has disputed amount of ~Rs2400m. The company is confident of not losing the case in Supreme court as they had won in the ITAT (reversed by high court).
- **Settlement of contingent liability led to higher tax expenses (ETR of 46%).** Therefore, PAT came at INR 540 mn (-6% QoQ, -31% YoY). Adjusted PAT removing the impact of one-time settlement of contingent liability is INR 758.5 (+32% QoQ, -3% YoY)

Exhibit 1: Q3FY21 Result Summary

Particulars (Rs mn)	3QFY21	2QFY21	QoQ gr.	3QFY20	YoY gr.
IT services Revenues (USD mn)	41	39	5.1%	46.8	-12.4%
IT services Revenues (INR mn)	3009	2881	4.4%	3298	-8.8%
Domestic Products (USD mn)	150	71	111.4%	129	15.8%
Domestic Products (INR mn)	10994	5235	110.0%	9120	20.5%
Total consol Revenues(INR mn)	14003	8038	74.2%	12369	13.2%
IT Services EBITDA	871	704	23.7%	916	-4.9%
<i>IT services EBITDA Margins</i>	<i>28.9%</i>	<i>24.4%</i>	<i>451 bps</i>	<i>27.8%</i>	<i>117 bps</i>
Domestic Products EBITDA	273	196	39.3%	270	1.1%
<i>Domestic Products EBITDA Margins</i>	<i>2.5%</i>	<i>3.7%</i>	<i>-126 bps</i>	<i>3.0%</i>	<i>-48 bps</i>
Consol EBITDA	1112	876	26.9%	1097	1.3%
<i>Consolidated EBITDA Margins (%)</i>	<i>7.9%</i>	<i>10.9%</i>	<i>-296 bps</i>	<i>8.9%</i>	<i>-93 bps</i>
PAT	540	575	-6.0%	785	-31.2%
EPS (Rs)	5.2	5.5	-6.0%	7.6	-31.2%

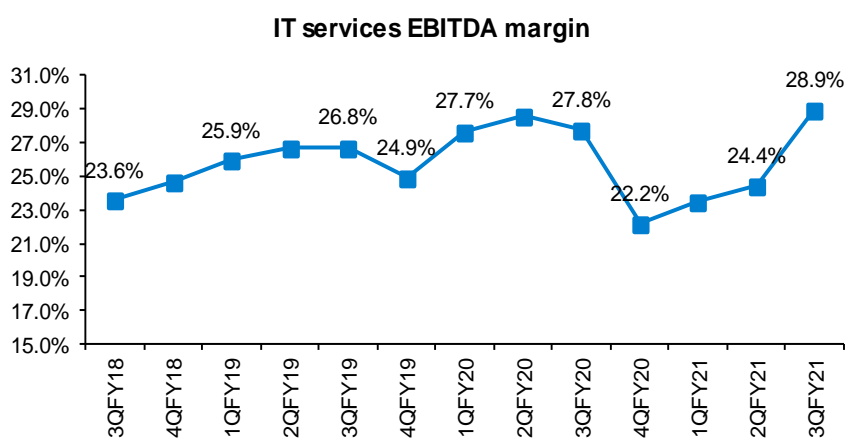
Source: Company, PL

Exhibit 2: Steady recovery in IT services revenues

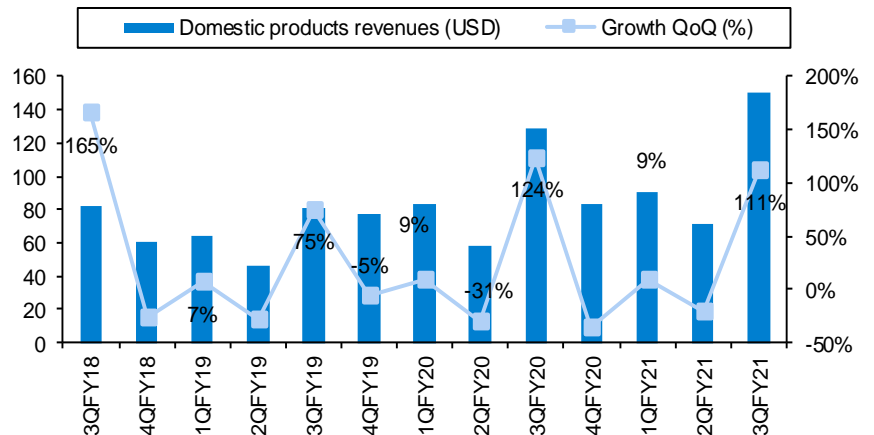


Source: Company, PL

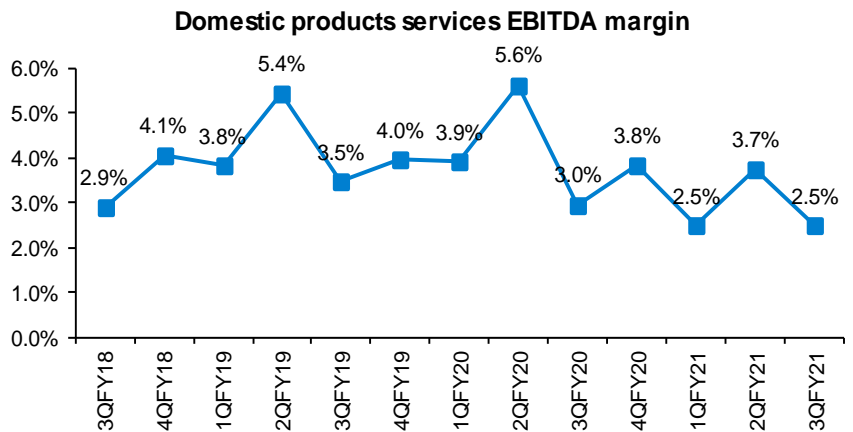
Exhibit 3: Sharp expansion in IT services EBITDA margin



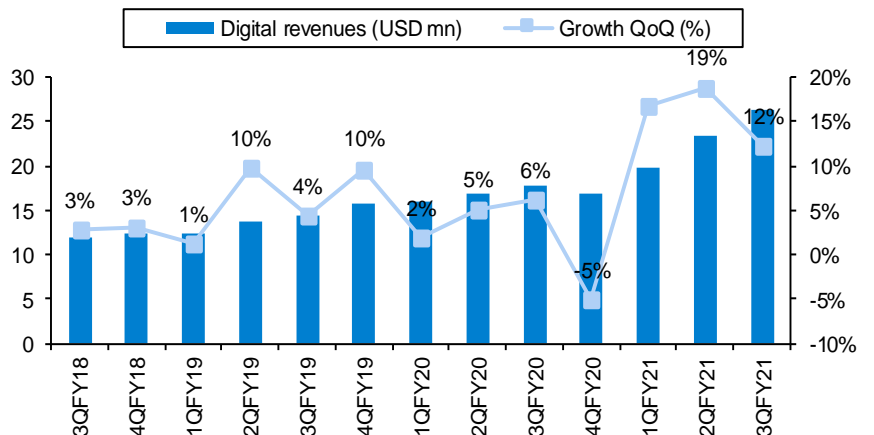
Source: Company, PL

Exhibit 4: Strong revenue growth in DPS aided by seasonally strong demand


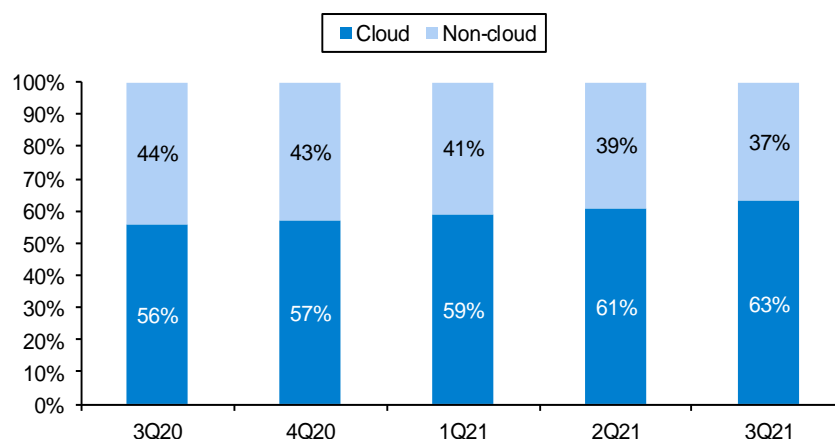
Source: Company, PL

Exhibit 5: Decline in DPS EBITDA margins


Source: Company, PL

Exhibit 6: IITS digital has grown at accelerated since last 4 quarters


Source: Company, PL

Exhibit 7: Increasing share of cloud in DPS revenues


Source: Company, PL

Exhibit 8: IIT Business service line wise revenues

USD in Mn	3QFY21	2QFY21	QoQ gr.	3QFY20	YoY gr.
Data & Analytics	4.92	4.84	2%	3.46	42%
IMS	2.01	2.18	-8%	2.39	-16%
Microsoft Dynamic Services	11.52	10.88	6%	12.68	-9%
Open Source Digital Platform Services	4.35	3.74	16%	6.69	-35%
Managed Cloud Services	3.73	3.28	14%	3.60	4%
Microsoft Digital Platformation Services	8.16	7.49	9%	8.14	0%
Modern Validation and Dev Eng Mgmt Ser	4.80	4.80	0%	7.30	-34%
Other ERP Services	0.70	0.90	-22%	1.68	-59%
Other Services	0.82	0.94	-12%	0.84	-3%
Total	41.00	39	5%	47	-12%
-as a % of sales					
Data & Analytics	12%	12%	-40 bps	7%	460 bps
IMS	5%	6%	-70 bps	5%	-20 bps
Microsoft Dynamic Services	28%	28%	20 bps	27%	100 bps
Open Source Digital Platform Services	11%	10%	100 bps	14%	-370 bps
Managed Cloud Services	9%	8%	70 bps	8%	140 bps
Microsoft Digital Platformation Services	20%	19%	70 bps	17%	250 bps
Modern Validation and Dev Eng Mgmt Ser	12%	12%	-60 bps	16%	-390 bps
Other ERP Services	2%	2%	-60 bps	4%	-190 bps
Other Services	2%	2%	-40 bps	2%	20 bps

Source: Company, PL

Exhibit 9: IITS vertical wise revenues

USD in Mn	3QFY21	2QFY21	QoQ gr.	3QFY20	YoY gr.
ISV	13	11	15%	12	8%
Travel	4	4	5%	11	-63%
Distribution & Manufacturing	8	8	8%	9	-5%
Retail (Essential)	3	3	14%	1	134%
Retail (Non-essential)	1	1	-38%	1	-62%
Commodity business and Service industry	3	2	25%	3	2%
Others	9	10	-12%	9	-2%
Total	41	39	5%	47	-12%
-as a % of sales					
ISV	32%	29%	270 bps	26%	600 bps
Travel	10%	10%	0 bps	24%	-1400 bps
Distribution & Manufacturing	21%	20%	50 bps	19%	150 bps
Retail (Essential)	8%	7%	60 bps	3%	500 bps
Retail (Non-essential)	1%	2%	-90 bps	3%	-170 bps
Commodity business and Service industry	7%	6%	110 bps	6%	100 bps
Others	21%	25%	-400 bps	19%	220 bps

Source: Company, PL

Exhibit 10: IITS Revenue contribution by Geography (%)

Revenue mix geography (%)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
America	59	58	60	58	56	55	56	53	54	54	64	51	52
Europe	27	28	29	30	32	32	30	30	30	30	16	26	26
RoW	14	14	11	12	12	13	14	17	16	16	20	23	22

Source: Company, PL

Exhibit 11: IITS Client Metrics

Revenue mix by clients (%)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
Top 5 Clients	46.3%	40.9%	43.8%	43.3%	45.0%	40.0%	44.6%	44.3%	42.3%	41.5%	40.8%	41.6%	37.8%
Top 10 Clients	55.3%	49.9%	53.7%	52.4%	54.6%	50.2%	52.6%	53.4%	51.1%	49.9%	49.0%	50.5%	47.0%
Top 20 Clients	44.7%	50.1%	46.3%	47.6%	45.4%	49.8%	47.4%	46.6%	48.9%	50.1%	51.0%	49.5%	53.0%

Source: Company, PL

Exhibit 12: Other Operating Metrics

Headcount	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
IT Services	3296	3313	3454	3679	3812	3886	4000	4036	4028	4066	3966	3744	3851
Products	163	163	161	157	155	156	150	143	149	145	145	141	146
Total	3459	3476	3615	3836	3967	4042	4150	4179	4177	4211	4111	3885	3997
International Services	39	40	41	42	40	41	41	44	42	47	57	47	36
Domestic Products	64	68	84	48	42	47	33	43	47	52	59	63	57
Total DSO Days	56	58	69	45	41	44	37	44	45	50	58	55	47

Source: Company, PL

Financials

Income Statement (Rs m)

Y/e Mar	FY20	FY21E	FY22E	FY23E
Net Revenues	37,433	41,887	47,668	52,742
YoY gr. (%)	26.4	11.9	13.8	10.6
Employee Cost	24,158	28,801	29,258	32,384
Gross Profit	13,275	13,087	18,411	20,359
Margin (%)	35.5	31.2	38.6	38.6
SG&A Expenses	-	-	-	-
Other Expenses	2,944	2,633	4,290	4,747
EBITDA	3,728	3,814	4,587	5,063
YoY gr. (%)	11.1	2.3	20.3	10.4
Margin (%)	10.0	9.1	9.6	9.6
Depreciation and Amortization	365	392	360	360
EBIT	3,363	3,422	4,227	4,703
Margin (%)	9.0	8.2	8.9	8.9
Net Interest	151	148	120	120
Other Income	584	118	120	120
Profit Before Tax	3,796	3,392	4,227	4,703
Margin (%)	10.1	8.1	8.9	8.9
Total Tax	999	1,061	1,099	1,223
Effective tax rate (%)	26.3	31.3	26.0	26.0
Profit after tax	2,797	2,331	3,128	3,480
Minority interest	-	-	-	-
Share Profit from Associate	-	-	-	-
Adjusted PAT	2,797	2,331	3,128	3,480
YoY gr. (%)	12.4	(16.6)	34.2	11.3
Margin (%)	7.5	5.6	6.6	6.6
Extra Ord. Income / (Exp)	-	-	-	-
Reported PAT	2,797	2,331	3,128	3,480
YoY gr. (%)	12.4	(16.6)	34.2	11.3
Margin (%)	7.5	5.6	6.6	6.6
Other Comprehensive Income	-	-	-	-
Total Comprehensive Income	2,797	2,331	3,128	3,480
Equity Shares O/s (m)	104	104	104	104
EPS (Rs)	27.0	22.5	30.1	33.5

Source: Company Data, PL Research

Balance Sheet Abstract (Rs m)

Y/e Mar	FY20	FY21E	FY22E	FY23E
Non-Current Assets				
Gross Block	745	835	925	1,015
Tangibles	531	603	675	747
Intangibles	215	233	251	269
Acc: Dep / Amortization	726	1,117	1,477	1,837
Tangibles	478	734	970	1,205
Intangibles	248	383	508	632
Net fixed assets	20	(282)	(552)	(822)
Tangibles	53	(131)	(295)	(458)
Intangibles	(33)	(151)	(257)	(364)
Capital Work In Progress	3	3	3	3
Goodwill	807	807	807	807
Non-Current Investments	1,096	1,196	1,296	1,396
Net Deferred tax assets	124	124	124	124
Other Non-Current Assets	636	636	636	636
Current Assets				
Investments	1,400	1,450	1,500	1,550
Inventories	-	-	-	-
Trade receivables	6,047	6,767	7,701	8,521
Cash & Bank Balance	5,787	6,922	8,377	9,963
Other Current Assets	360	360	360	360
Total Assets	16,721	18,424	20,693	22,979
Equity				
Equity Share Capital	104	104	104	104
Other Equity	8,543	9,461	10,712	12,104
Total Network	8,647	9,565	10,816	12,208
Non-Current Liabilities				
Long Term borrowings	187	187	187	187
Provisions	-	-	-	-
Other non current liabilities	103	103	103	103
Current Liabilities				
ST Debt / Current of LT Debt	-	-	-	-
Trade payables	6,594	7,378	8,397	9,291
Other current liabilities	1,167	1,167	1,167	1,167
Total Equity & Liabilities	16,721	18,424	20,693	22,979

Source: Company Data, PL Research

Cash Flow (Rs m)

Y/e Mar	FY20	FY21E	FY22E	FY23E
PBT	3,796	3,356	4,227	4,703
Add. Depreciation	365	392	360	360
Add. Interest	151	148	120	120
Less Financial Other Income	584	118	120	120
Add. Other	(584)	(118)	(120)	(120)
Op. profit before WC changes	3,728	3,778	4,587	5,063
Net Changes-WC	114	65	84	74
Direct tax	(999)	(1,061)	(1,099)	(1,223)
Net cash from Op. activities	2,844	2,782	3,572	3,915
Capital expenditures	(90)	(90)	(90)	(90)
Interest / Dividend Income	584	118	120	120
Others	(150)	(150)	(150)	(150)
Net Cash from Inv. activities	344	(122)	(120)	(120)
Issue of share cap. / premium	-	-	-	-
Debt changes	-	-	-	-
Dividend paid	(1,678)	(1,377)	(1,876)	(2,088)
Interest paid	(151)	(148)	(120)	(120)
Others	-	-	-	-
Net cash from Fin. activities	(1,829)	(1,525)	(1,996)	(2,208)
Net change in cash	1,358	1,135	1,456	1,586
Free Cash Flow	2,754	2,692	3,482	3,825

Source: Company Data, PL Research

Quarterly Financials (Rs m)

Y/e Mar	Q4FY20	Q1FY21	Q2FY21	Q3FY21
Net Revenue	9,287	9,524	8,038	14,003
YoY gr. (%)	11.1	8.9	14.3	13.2
Raw Material Expenses	5,890	6,654	5,073	10,755
Gross Profit	3,397	2,870	2,965	3,248
Margin (%)	36.6	30.1	36.9	23.2
EBITDA	830	781	873	1,151
YoY gr. (%)	(6.1)	(12.9)	(3.6)	4.9
Margin (%)	8.9	8.2	10.9	8.2
Depreciation / Depletion	92	102	101	99
EBIT	738	678	772	1,051
Margin (%)	7.9	7.1	9.6	7.5
Net Interest	35	34	38	46
Other Income	122	31	24	33
Profit before Tax	825	675	759	1,038
Margin (%)	8.9	7.1	9.4	7.4
Total Tax	206	177	187	458
Effective tax rate (%)	25.0	26.1	24.6	44.2
Profit after Tax	618	499	572	579
Minority interest	-	-	-	-
Share Profit from Associates	-	-	-	-
Adjusted PAT	618	499	572	579
YoY gr. (%)	(5.4)	(25.6)	(20.8)	(26.3)
Margin (%)	6.7	5.2	7.1	4.1
Extra Ord. Income / (Exp)	-	-	-	-
Reported PAT	618	499	572	579
YoY gr. (%)	(5.4)	(25.6)	(20.8)	(26.3)
Margin (%)	6.7	5.2	7.1	4.1
Other Comprehensive Income	-	-	-	-
Total Comprehensive Income	618	499	572	579
Avg. Shares O/s (m)	104	104	104	104
EPS (Rs)	6.0	4.8	5.5	5.6

Source: Company Data, PL Research

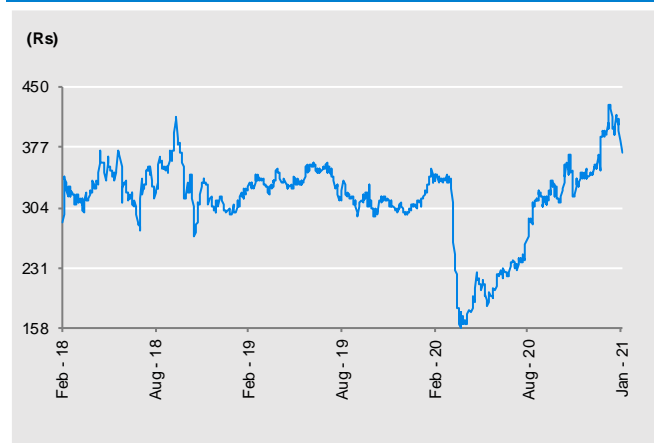
Key Financial Metrics

Y/e Mar	FY20	FY21E	FY22E	FY23E
Per Share(Rs)				
EPS	27.0	22.5	30.1	33.5
CEPS	30.5	26.2	33.6	37.0
BVPS	83.3	92.2	104.2	117.6
FCF	26.5	25.9	33.6	36.9
DPS	13.5	11.1	15.1	16.8
Return Ratio(%)				
RoCE	40.6	36.8	40.7	40.2
ROIC	150.4	170.3	277.7	394.5
RoE	34.6	25.6	30.7	30.2
Balance Sheet				
Net Debt : Equity (x)	(0.8)	(0.9)	(0.9)	(0.9)
Debtor (Days)	59	59	59	59
Valuation(x)				
PER	15.1	18.1	13.5	12.1
P/B	4.9	4.4	3.9	3.5
P/CEPS	30.5	26.2	33.6	37.0
EV/EBITDA	9.4	8.9	7.1	6.1
EV/Sales	0.9	0.8	0.7	0.6
Dividend Yield (%)	3.3	2.7	3.7	4.1

Source: Company Data, PL Research

Price Chart

Recommendation History



No.	Date	Rating	TP (Rs.)	Share Price (Rs.)
1	04-Jan-21	BUY	437	393
2	23-Nov-20	BUY	427	339
3	05-Oct-20	BUY	436	311
4	02-Sep-20	Accumulate	357	308

Analyst Coverage Universe

Sr. No.	Company Name	Rating	TP (Rs)	Share Price (Rs)
1	Coforge	BUY	3,051	2,420
2	Cyient	BUY	681	508
3	HCL Technologies	BUY	1,160	990
4	Infosys	BUY	1,611	1,387
5	L&T Technology Services	BUY	3,057	2,658
6	Larsen & Toubro Infotech	BUY	4,364	4,091
7	Mindtree	BUY	1,940	1,664
8	Mphasis	BUY	1,902	1,590
9	Persistent Systems	BUY	1,727	1,524
10	Redington (India)	BUY	138	133
11	Sonata Software	BUY	437	393
12	Tata Consultancy Services	BUY	3,358	2,928
13	TeamLease Services	BUY	2,931	2,666
14	Tech Mahindra	BUY	1,138	961
15	Wipro	BUY	493	459
16	Zensar Technologies	BUY	257	243

PL's Recommendation Nomenclature (Absolute Performance)

Buy	: > 15%
Accumulate	: 5% to 15%
Hold	: +5% to -5%
Reduce	: -5% to -15%
Sell	: < -15%
Not Rated (NR)	: No specific call on the stock
Under Review (UR)	: Rating likely to change shortly

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