

CMP: ₹ 700

Target: ₹ 770 (10%)

Target Period: 12 months

July 28, 2022

HOLD

Margins may see downward trajectory

About the stock: Sonata Software (Sonata) offers IT services (30%) and product licensing & deployment (70%).

- The company provides IT services to travel, retail, agri & commodities and manufacturing and software vendors
- Net debt free and healthy double digit return ratio (with RoCE of >30%)

Q1FY23 Results: Sonata reported Q2FY23 numbers.

- IT services dollar revenues increased 2% QoQ, 3.9% in CC
- EBITDA margins in IT services declined 90 bps QoQ
- The company announced bonus shares in the 1:3 ratio

What should investors do? Sonata's share price has grown by ~5.4x over the past five years (from ~₹ 163 in July 2017 to ~₹ 700 levels in July 2022).

- We revised rating to **HOLD** from **BUY** on the stock

Target Price and Valuation: We value Sonata at ₹ 770 i.e. 17x P/E on FY24E EPS.

Key triggers for future price performance:

- Strong digital capabilities helping it for accelerated digital revenue growth enhancing digital revenue mix. i.e 73% of mix now vs 68% a year ago
- Upgrades in Microsoft Dynamics and tapping fortune 1000 clients in the medium to large category bode well for revenue growth
- Robust hiring trend & inorganic growth prompt us to build IT service dollar revenue growth of over 18.5% CAGR over FY22-24E

Alternate Stock Idea: Apart from Sonata, in our IT coverage we also like Infosys.

- Strong revenue guidance prompts us to be positive on the stock
- BUY with a target price of ₹ 1,760



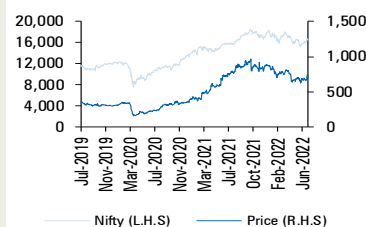
Particulars

Particular	Amount
Market Capitalization (₹ Crore)	7,273.0
Total Debt(₹ Crore)	38.0
Cash and Investments (₹ Crore)	914.4
EV (₹ Crore)	6,396.7
52 week H/L	1030 / 610
Equity capital	10.4
Face value	1.0

Shareholding pattern

	Sep-21	Dec-21	Mar-22	Jun-22
Promoters	28	28	28	28
FII	16	14	14	13
DII	13	14	15	15
Public	42	44	43	44

Price Chart



Recent event & key risks

- Announced bonus shares in 1:3 ratio
- Key Risk:** (i) Better than expected margins ii) Loss of key clients

Research Analyst

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Key Financial Summary

(₹ Crore)	FY20	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	2 year CAGR (FY22-24E)
Net Sales	3,743	4,228	5,553	18.6%	6,682	7,799	18.5%
EBITDA	373	379	464	19.3%	524	648	18.2%
EBITDA Margin (%)	10.0	9.0	8.4		7.8	8.3	
PAT	277	244	376	19.1%	374	469	11.6%
EPS (₹)	26.7	23.5	36.2		36.0	45.1	
P/E (x)	26	30	19		19	16	
RoNW (%)	41.4	26.9	34.2		29.9	32.6	
RoCE (%)	44.7	33.5	39.8		35.5	39.2	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- IT service segment dollar revenues increased 2% QoQ to US\$56.8 million, (3.9% in CC terms) while rupee revenue came in at ₹ 436.8 crore, 5.5% QoQ growth. Product business revenues increased by 27.8% QoQ to ₹ 1,343.1 crore. Total revenues increased by 21.5% QoQ to ₹ 1,778.9 crore. The company indicated that due to supply side challenges some projects were delayed impacting revenue for the quarter
- IT service EBITDA margin (including other income) declined ~90 bps QoQ to 26.6% while that of product business declined by ~50 bps to 3.3%. Consolidated EBITDA margins declined by 150 bps to 9%. The company indicated that the margins were impacted by the wage hikes & investment in the new senior management team. The company indicated that it did wage hike for selected employees in Q3FY22 while wage hikes for senior management was done effective April 01,2022. The company indicated that investment in talent will continue in the subsequent quarters (which includes talent investments into recently opened delivery centres in Canada, Mexico and Ireland) and management expects FY23 margins to be in the range of 22-23% in IT services.
- IT services revenues were aided by the US, which reported 2% QoQ & 42.7% YoY growth. Europe region revenue declined by 2.7% QoQ while RoW grew by 6.8% growth. The company indicated that the cross currency impact on Europe region higher impacting the revenue
- The company has strengthened senior management team at the company. The company appointed Mr Samir Dhar as CEO from 8th April 2022. Mr Srikar Reddy will continue as MD and will transition to Mr Samir Dhar over the next 9-12 months. In his last role, he served as CEO of Global Markets and Industries at Virtusa. It also appointed Balaji Kumar as Chief Human Resource Officer; he joined in from LTI. The other appointment includes, Mr. Roshan Shetty as Chief Revenue Officer, Mr. Hemant Kumar Bhardwaj as Chief Marketing Officer.
- The company mentioned that Retail continue to be its focus vertical. The bifurcation of essential and non-essential tech spend is no more valid in the post pandemic world. The company said since footfalls coming back at the pre-covid levels, retailers are confident of continued spending. The client spend are focused on customer experience side, cloud transformation and data analytics.
- The company indicated that demand environment continue to be strong. Travel vertical is witnessing a traction with opening up economies & it expects travel to be recover back to pre covid levels by Q3. The company indicated that the demand for domestic cloud business & data analytics is increasing. The company is confident of achieving revenue growth of 20% in FY23 despite macroeconomic factors
- The company expects to enhance its wallet share in Microsoft account, its key customer. The company indicated that Microsoft would be doing its annual budgeting somewhere in Aug and the company is looking to align its investment accordingly for the next fiscal. For Microsoft it worked on 4 areas i) Microsoft product engineering ii) customer service function iii) internal IT team on dynamic and analytics implementation iv) consulting function.
- The company indicated that it will continue investing in the talent front to address the supply side challenges. The company mentioned that it had opened development centre in Canada, Mexico & Ireland. The company also indicate it will hire employees in US & Australia. The company also indicated that it will do campus hiring of 600 fresher's who are expected to join the company over next 2 quarters
- The company indicated that attrition was down on quarterly annualised basis & it expects it to moderate further. The company hired 50 net new

employees (36 in International & 14 in Domestic) taking its total employee strength to 5,208 (5,034 in International & 174 in domestic)

- The revenue from top clients of the company has witnessed some moderation. Top 5/10/20 client's revenues grew by 18.8/21.7%/25.9% respectively. Digital revenues contribution remained steady at 73%.
- The company informed that it had merged Sopris Systems, LLC a wholly owned subsidiary of Sonata Software North America into Sonata Software North America
- The company announced bonus shares in the ratio of 1:3, i.e. 1 bonus shares for every 3 shares held by the shareholders on the record date. The company indicated that bonus shares will be credited within 2 months from the Board approval i.e by 24th September 2022

Exhibit 1: P&L

	Q1FY23	Q4FY22	YoY (%)	Q4FY22	QoQ (%)	Comments
Revenue	1,779	1,269	40.2	1,464	21.5	IT services revenue grew by 5.5% QoQ while product revenues increased by 27.8% QoQ , resulting in 21.5% QoQ growth
Employee expenses	214	168	27.7	205	4.4	
Purchase of stock-in trade & other	1,321	935	41.3	1,036	27.5	
Gross Margin	244	166	46.8	222	9.7	
Gross margin (%)	13.7	13.1	61 bps	15.2	-147 bps	
Other expenses	102	65	56.8	114	(10.4)	
EBITDA	142	101	40.3	108	31.0	
EBITDA Margin (%)	8.0	8.0	0 bps	7.4	58 bps	EBITDA margin expansion was restricted due to higher employee expenses amid wage hikes
Depreciation & amortisation	13	10	31.1	13	(0.8)	
EBIT	129	91	41.3	95	35.4	
EBIT Margin (%)	7.2	7.2	5 bps	6.5	74 bps	
Other income (less interest)	14	24	(39.1)	41	(64.6)	
PBT	143	115	24.7	136	5.4	
Tax paid	35	28	25.9	35	1.3	
PAT	108	87	24.2	101	6.8	

Source: Company, ICICI Direct Research

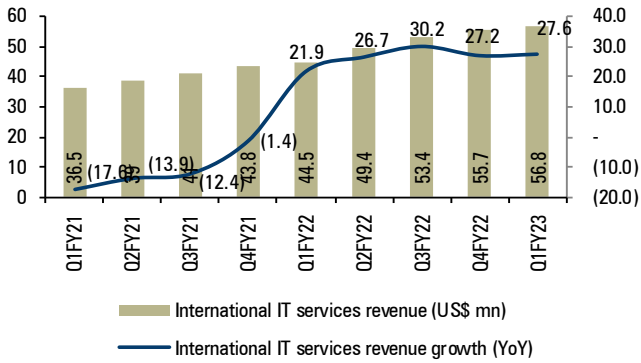
Exhibit 2: Change in estimates

(₹ Crore)	FY23E			FY24			Comments
	Old	New	% Change	Old	New	% Change	
Revenue	6,682	6,682	0.0	7,799	7,799	0.0	
EBITDA	524	524	0.0	648	648	0.0	
EBITDA Margin (%)	7.8	7.8	0 bps	8.3	8.3	0 bps	
PAT	374	374	0.0	469	469	0.0	
EPS (₹)	36.0	36.0	0.0	45.1	45.1	0.0	

Source: Company, ICICI Direct Research

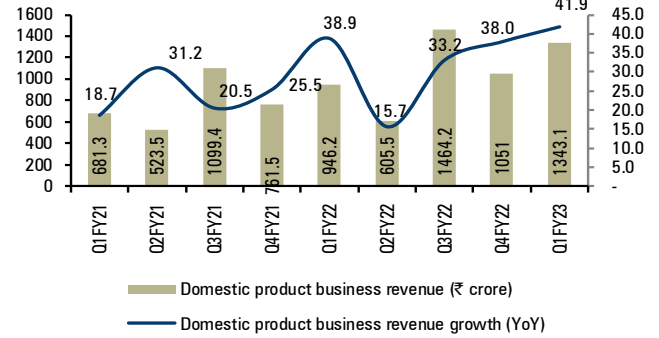
Key Metrics

Exhibit 3: International IT services revenue with YoY growth



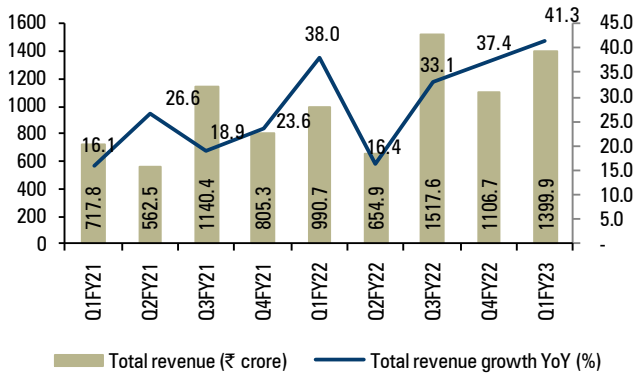
Source: Company, ICICI Direct Research

Exhibit 4: Domestic product business with YoY growth



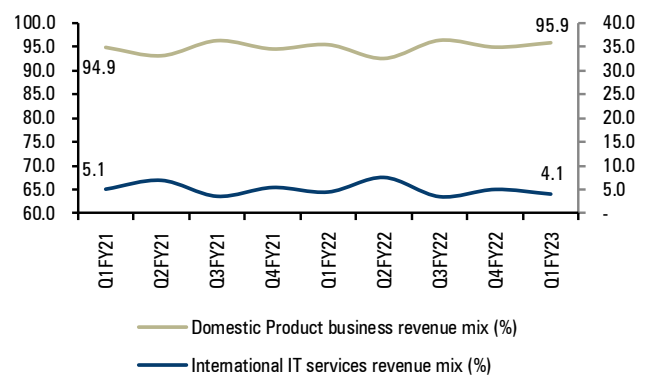
Source: Company, ICICI Direct Research

Exhibit 5: Total revenue with YoY growth



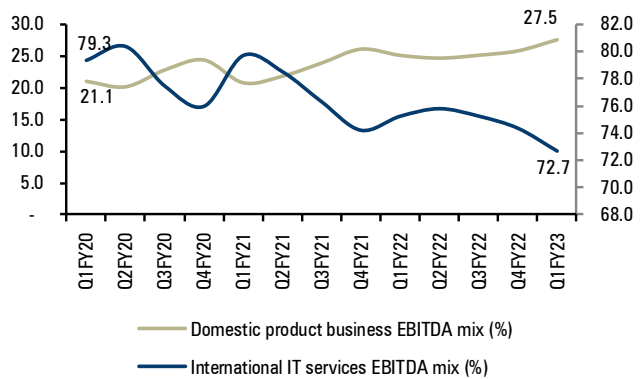
Source: Company, ICICI Direct Research

Exhibit 6: Revenue Mix



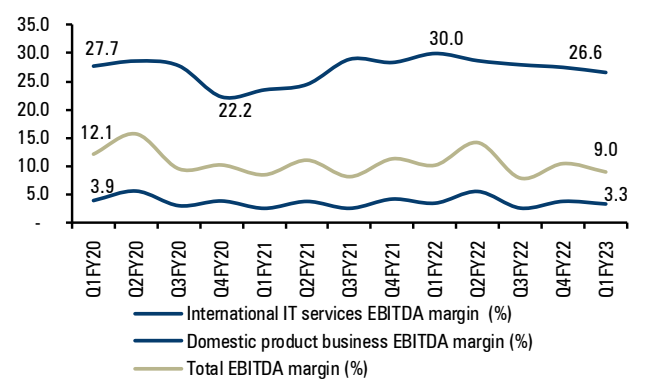
Source: Company, ICICI Direct Research

Exhibit 7: EBITDA Mix Trend



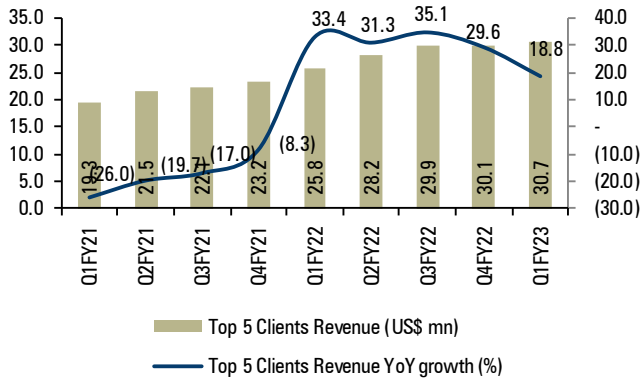
Source: Company, ICICI Direct Research

Exhibit 8: EBITDA Margin Trend



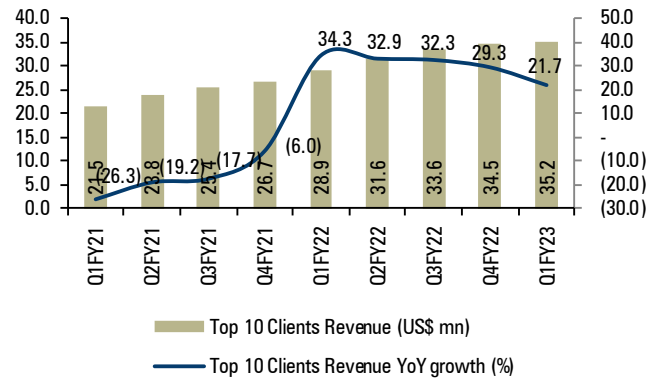
Source: Company, ICICI Direct Research

Exhibit 9: Top 5 Clients revenue with YoY growth



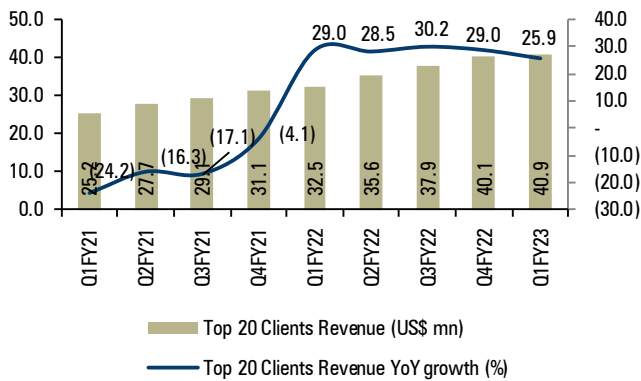
Source: Company, ICICI Direct Research

Exhibit 10: Top 10 Clients revenue with YoY growth



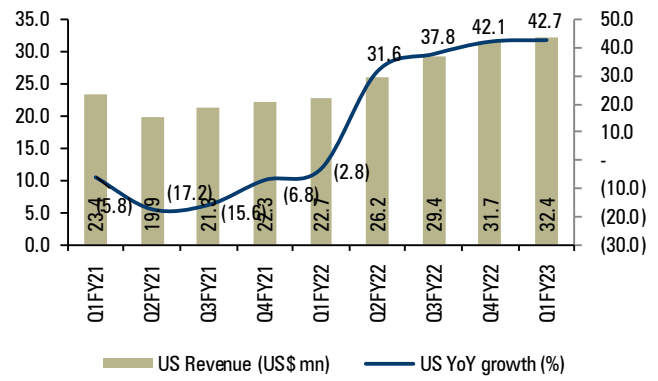
Source: Company, ICICI Direct Research

Exhibit 11: Top 20 Clients revenue with YoY growth



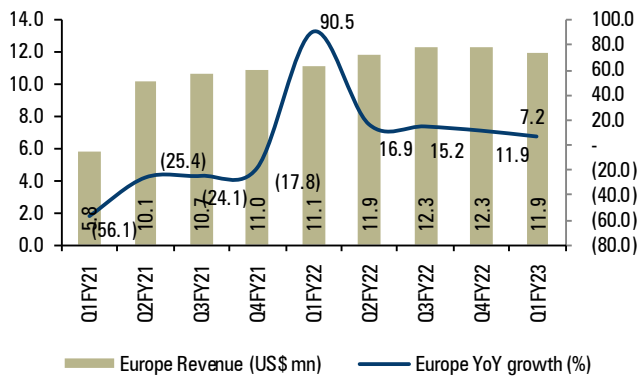
Source: Company, ICICI Direct Research

Exhibit 12: US Revenue with YoY growth



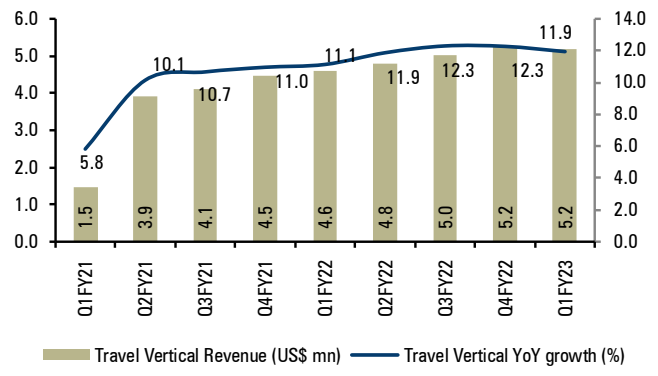
Source: Company, ICICI Direct Research

Exhibit 13: Europe revenue with YoY growth



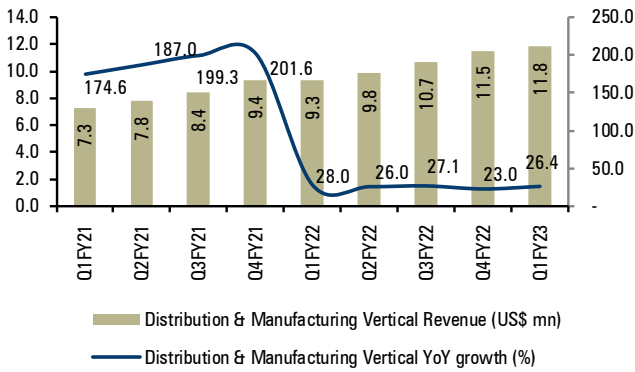
Source: Company, ICICI Direct Research

Exhibit 14: Travel Revenue with YoY growth



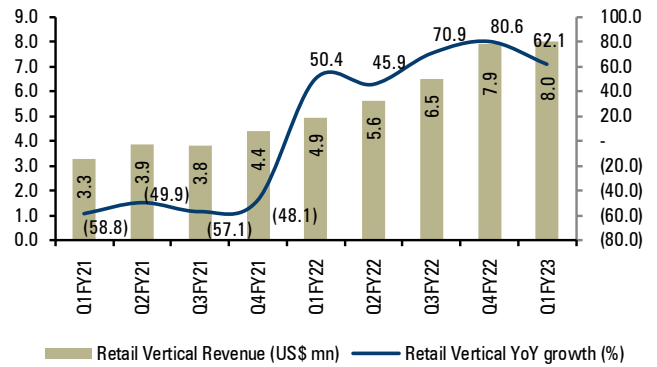
Source: Company, ICICI Direct Research

Exhibit 15: D&M Revenue with YoY growth



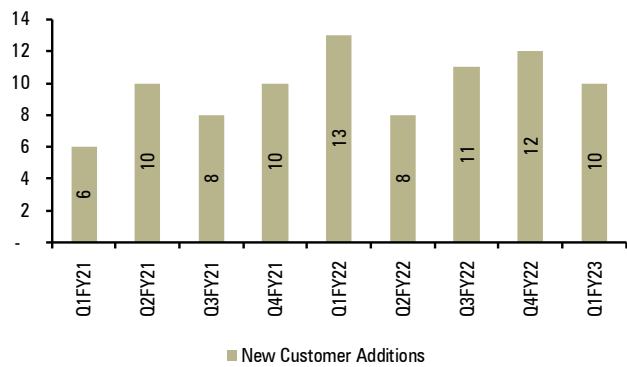
Source: Company, ICICI Direct Research

Exhibit 16: Retail Revenue with YoY growth



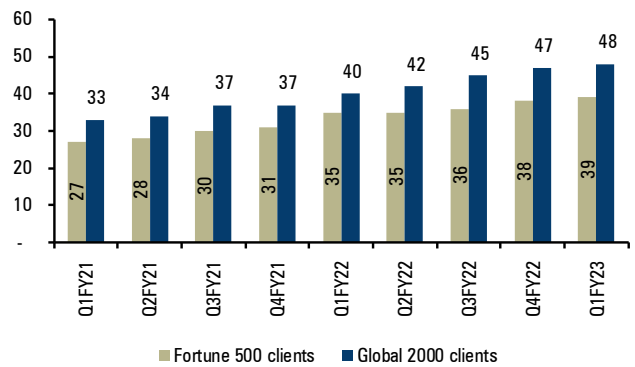
Source: Company, ICICI Direct Research

Exhibit 17: New customers addition trend



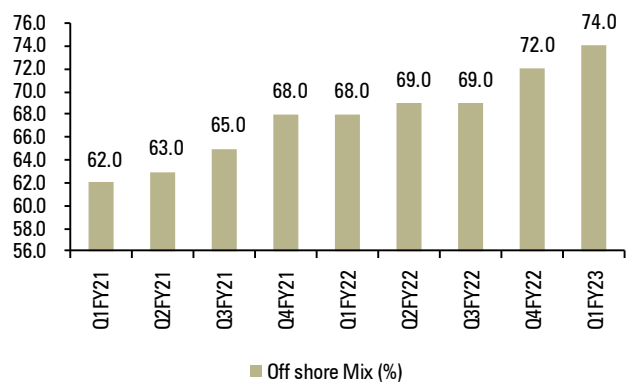
Source: Company, ICICI Direct Research

Exhibit 18: Fortune 500 & Global 2000 clients trend



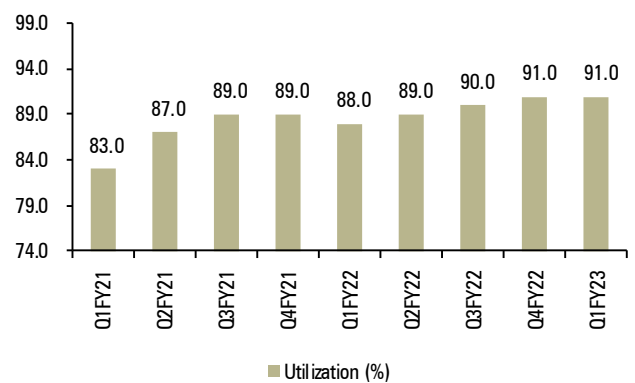
Source: Company, ICICI Direct Research

Exhibit 19: Off shore mix trend



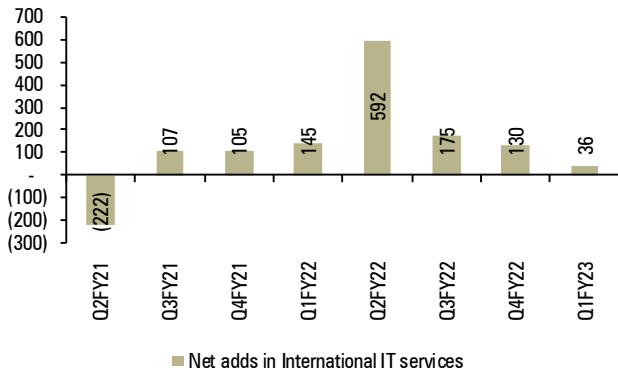
Source: Company, ICICI Direct Research

Exhibit 20: Utilization trend



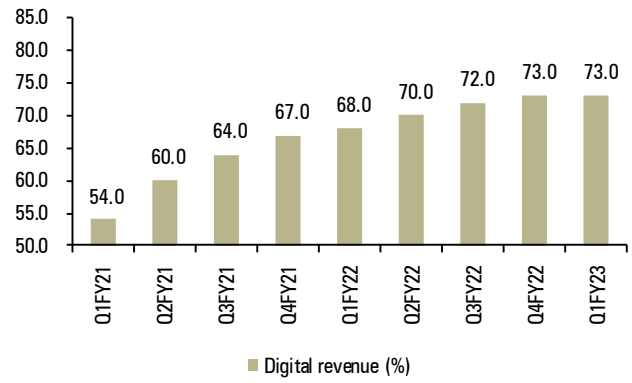
Source: Company, ICICI Direct Research

Exhibit 21: No. of employees (International)



Source: Company, ICICI Direct Research

Exhibit 22: Digital revenue mix



Source: Company, ICICI Direct Research

Financial summary

Exhibit 23: Profit and loss statement					₹ crore
(Year-end March)	FY21	FY22	FY23E	FY24E	
Total Revenues	4,228	5,553	6,682	7,799	
Growth (%)	13.0	31.3	20.3	16.7	
Total Operating Expenditure	3,849	5,090	6,158	7,152	
EBITDA	379	464	524	648	
Growth (%)	1.8	22.2	13.0	23.6	
Depreciation & Amortization	40	47	53	62	
Other Income	28	102	46	58	
Interest costs	15	18	18	18	
PBT before Exceptional Items	352	500	498	625	
Growth (%)	(7.2)	42.1	(0.4)	25.4	
Tax	108	124	125	156	
PAT before Exceptional Items	244	376	374	469	
Exceptional items	-	-	-	-	
PAT before MI	244	376	374	469	
Minority Int & Pft. from associates	-	-	-	-	
PAT	244	376	374	469	
Growth (%)	(12)	54	(1)	25	
EPS	23.5	36.2	36.0	45.1	
EPS (Growth %)	(12)	54	(1)	25	

Source: Company, ICICI Direct Research

Exhibit 24: Cash flow statement					₹ crore
(Year-end March)	FY21	FY22	FY23E	FY24E	
Net profit before Tax	352	500	498	625	
Depreciation & Amortization	40	47	53	62	
WC changes	184	100	(81)	(0)	
Other non cash adju.	0	(6)	(28)	(40)	
Income taxes paid	(133)	(156)	(125)	(156)	
CF from operations	443	486	319	491	
Capital expenditure	(2)	(10)	(23)	(27)	
Δ in investments	(110)	(126)	-	-	
Other investing cash flow	9	17	46	58	
CF from investing Activities	(102)	(119)	22	30	
Issue of equity					
Δ in debt funds/lease liabilities	(18)	(81)	(24)	(24)	
Dividends paid	(41)	(187)	(224)	(281)	
Other financing cash flow	(3)	(3)	(18)	(18)	
CF from Financial Activities	(62)	(271)	(266)	(323)	
Δ in cash and cash bank balance	279	96	75	198	
Effect of exchange rate changes	2	(3)	-	-	
Opening cash	396	677	770	845	
Closing cash	677	770	845	1,043	

Source: Company, ICICI Direct Research

Exhibit 25: Balance sheet					₹ crore
(Year-end March)	FY21	FY22	FY23E	FY24E	
Per share data (₹)					
EPS-diluted	23.5	36.2	36.0	45.1	
Cash per share	65.2	74.1	81.3	100.4	
BV	87.2	105.8	120.2	138.2	
DPS	14.0	21.7	21.6	27.1	
Operating Ratios (%)					
EBITDA Margin	9.0	8.4	7.8	8.3	
Adjusted PBT Margin	8.3	9.0	7.5	8.0	
Adjusted PAT Margin	5.8	6.8	5.6	6.0	
Return Ratios (%)					
RoNW	26.9	34.2	29.9	32.6	
RoCE	33.5	39.8	35.5	39.2	
RoIC	95.8	107.1	101.6	129.4	
Valuation Ratios (x)					
P/E	31.6	20.5	20.6	16.4	
EV / EBITDA	18.5	14.7	12.9	10.1	
Price to Book Value	8.5	7.0	6.2	5.4	
EV/Total Revenues	1.7	1.2	1.0	0.8	
MCap/Total Revenues	1.8	1.4	1.2	1.0	
Turnover Ratios					
Debtor days	53	59	53	53	
Creditors days	56	69	56	56	
Solvency Ratios					
Debt/EBITDA	0.2	0.1	0.1	0.1	
Total Debt / Equity	0.1	0.0	0.0	0.0	
Current Ratio	1.7	1.5	1.6	1.6	
Quick Ratio	1.7	1.5	1.6	1.6	
Debt / EBITDA	0.2	0.1	0.1	0.1	

Source: Company, ICICI Direct Research

Exhibit 26: Key ratios					₹ crore
(Year-end March)	FY21	FY22	FY23E	FY24E	
Per share data (₹)					
EPS-diluted	23.5	36.2	36.0	45.1	
Cash per share	65.2	74.1	81.3	100.4	
BV	87.2	105.8	120.2	138.2	
DPS	14.0	21.7	21.6	27.1	
Operating Ratios (%)					
EBITDA Margin	9.0	8.4	7.8	8.3	
Adjusted PBT Margin	8.3	9.0	7.5	8.0	
Adjusted PAT Margin	5.8	6.8	5.6	6.0	
Return Ratios (%)					
RoNW	26.9	34.2	29.9	32.6	
RoCE	33.5	39.8	35.5	39.2	
RoIC	95.8	107.1	101.6	129.4	
Valuation Ratios (x)					
P/E	31.6	20.5	20.6	16.4	
EV / EBITDA	18.5	14.7	12.9	10.1	
Price to Book Value	8.5	7.0	6.2	5.4	
EV/Total Revenues	1.7	1.2	1.0	0.8	
MCap/Total Revenues	1.8	1.4	1.2	1.0	
Turnover Ratios					
Debtor days	53	59	53	53	
Creditors days	56	69	56	56	
Solvency Ratios					
Debt/EBITDA	0.2	0.1	0.1	0.1	
Total Debt / Equity	0.1	0.0	0.0	0.0	
Current Ratio	1.7	1.5	1.6	1.6	
Quick Ratio	1.7	1.5	1.6	1.6	
Debt / EBITDA	0.2	0.1	0.1	0.1	

Source: Company, ICICI Direct Research

RATING RATIONALE

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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