

IT services numbers weak...

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%)

Q2FY23 Results: Sonata reported weak Q2FY23 numbers.

- IT services dollar revenues increased 1.8% QoQ & 3.9% in CC terms
- EBITDA margins in IT services declined 70 bps QoQ
- The company closed two large deals in Q2

What should investors do? Sonata's share price has grown by ~4.4x over the past five years (from ~₹ 116 in October 2017 to ~₹ 505 levels in October 2022).

- We maintain our **HOLD** rating on the stock

Target Price and Valuation: We value Sonata at ₹ 520 i.e. 16x P/E on FY25E EPS.

Key triggers for future price performance:

- Strong digital capabilities helping it in 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 and inorganic growth prompt us to build IT service dollar revenue growth of over 13.3% CAGR over FY22-25E

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

- Key beneficiary of improved digital demand, industry leading revenue growth and healthy capital allocation prompt us to be positive
- BUY with a target price of ₹ 1,670



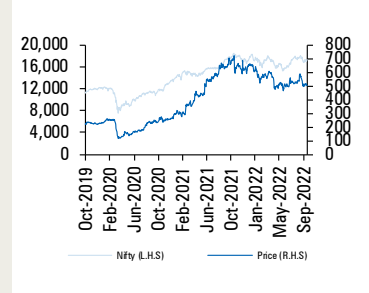
Particulars

Particular	Amount
Market Capitalization (₹ Crore)	6,999.7
Total Debt(₹ Crore)	38.0
Cash and Investments (₹ Crore)	914.4
EV (₹ Crore)	6,123.3
52 week H/L	768 / 458
Equity capital	13.9
Face value	1.0

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoters	28	28	28	28
FII	14	14	13	13
DII	14	15	15	13
Public	44	43	44	46

Price Chart (Adj. Bonus issue)



Recent event & key risks

- Closed two large deals in Q2
- Key Risk:** (i) Better-than-expected revenue growth ii) Continued supply side challenges

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Key Financial Summary

(₹ Crore)	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 year CAGR (FY22-25E)
Net Sales	4,228	5,553	18.6%	6,807	7,488	8,087	13.3%
EBITDA	379	464	19.3%	521	576	638	11.2%
EBITDA Margin (%)	9.0	8.4		7.7	7.7	7.9	
PAT	244	376	19.1%	371	417	453	6.4%
EPS (₹)	23.5	27.2		26.8	30.1	32.7	
P/E (x)	22	19		19	17	15	
RoNW (%)	26.9	34.2		29.7	29.5	28.4	
RoCE (%)	33.5	39.8		35.3	35.5	35.0	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- IT service segment dollar revenues increased 1.8% QoQ to US\$57.8 million, (3.9% in CC terms) while rupee revenue came in at ₹ 460.4 crore, up 5.4% QoQ. Product business revenues declined 22.6% QoQ to ₹ 1,040.2 crore. Consolidated revenues declined 15.9% QoQ to ₹ 1,495.9 crore
- IT service EBITDA margin (including other income) declined ~70 bps QoQ to 25.9% while that of product business increased ~120 bps to 4.5%. Consolidated EBITDA margins increased ~210 bps to 11.1%. The company indicated that persistent supply side headwinds & resumption of travel expenses impacted IT services margins
- The revenue for US region (56% of the mix) remained flat QoQ while Europe region reported a sharp decline of 7.9% QoQ. The company indicated that Europe region revenue was impacted due to cross currency impact. RoW region reported growth of 15.6% QoQ. Vertical wise, the company indicated that retail & travel were impacted due to cross currency impact reporting a decline of 1.1% & 9.4% QoQ. Also, commodity business declined 2.8% QoQ while growth was driven by distribution & manufacturing and ISV verticals, which grew 0.8% & 3% QoQ
- The revenue from top clients of the company continued to moderate with the top five, top 10, top 20 client's revenues declining 3.9%, 4.8%, 8.1% QoQ, respectively
- Digital revenues contribution remained at 73% & offshore mix increased to 75%, up 100 bps QoQ. The company indicated that it expects the offshore mix to remain steady at current levels
- The company's new CEO Sameer Dhar indicated that the company plans to double IT services revenue in the next four years (this implies growth at a CAGR of 18.9%). It also indicated that it may not necessarily include inorganic opportunities as the company is confident of current headcount as well deal pipeline to bring in that growth. However, Sonata did not rule out inorganic opportunity completely as it mentioned that it may still go for it, if it is a strategic fit for it. The company also clarified that it will not go for inorganic opportunities for scale benefit
- The company reported that it added 12 new clients during the quarter. Sonata also indicated that it closed two large multi-year annuity deals, out of which one is with a Sweden based company with annual turnover of US\$95 bn. The deal is of four years and the scope of work includes modernising their IT systems, bringing in sales efficiency, distribution management. It also mentioned that the deal is margin accretive as the margins in the deal are above company margins
- The company indicated that demand remains strong despite macroeconomic uncertainties. It mentioned that its pipeline remains robust and it is witnessing traction in cloud, data & automation. The company indicated that no projects are cancelled but it is witnessing delayed decision making in the few of new projects
- With the strong pipeline in place the company indicated that it has hired 800 employees in the last one year including ~300 freshers. The company indicated that it will continue to invest in its fresher's program and plans to hire 550 freshers in FY23 to address the supply side headwinds. However, the company also indicated that the supply side challenges in certain niche technical skills will persist and it will take a few quarters for it to normalise. Sonata further mentioned that attrition declined 200 bps during the quarter and expects the same to moderate, going forward
- The company, during the quarter, allotted bonus shares in the ratio of 1:3, i.e. one bonus shares for every three shares held by shareholders on the record date
- Sonata declared an interim dividend of ₹ 7/share

Exhibit 1: P&L

	Q2FY23	Q2FY22	YoY (%)	Q1FY22	QoQ (%)	Comments
Revenue	1,496	963	55.3	1,779	(15.9)	IT services reported 3.9% QoQ CC growth while rupee revenues grew by 5.4% QoQ while Products business (lumpy in nature) reported decline of 22.6% QoQ , resulting in 15.9% QoQ overall revenue decline
Employee expenses	222	175	27.0	214	3.7	
Purchase of stock-in trade & other	1,019	596	71.1	1,321	(22.9)	
Gross Margin	255	193	32.3	244	4.5	
Gross margin (%)	17.0	20.0	-297 bps	13.7	332 bps	
Other expenses	100	70	44.0	102	(2.0)	
EBITDA	155	123	25.7	142	9.2	
EBITDA Margin (%)	10.3	12.8	-244 bps	8.0	237 bps	EBITDA margins for IT services declined ~70bps QoQ while that of lumpy product business improved 125bps QoQ
Depreciation & amortisation	14	12	16.4	13	5.0	
EBIT	141	111	26.6	129	9.6	
EBIT Margin (%)	9.4	11.6	-214 bps	7.2	219 bps	
Other income (less interest)	7	9	(16.8)	14	(49.4)	
PBT	148	120	23.4	143	3.6	
Tax paid	36	29	22.9	35	0.7	
PAT	113	91	23.6	108	4.6	

Source: Company, ICICI Direct Research

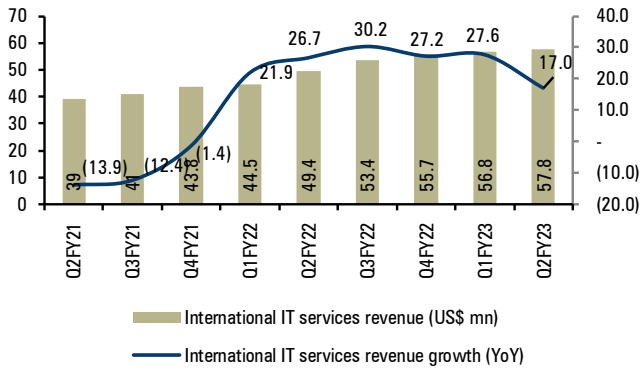
Exhibit 2: Change in estimates

(₹ Crore)	FY23E			FY24E			FY25E	Comments
	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	6,682	6,807	1.9	7,799	7,488	-4.0	8,087	Numbers re-aligned as per weak H1 performance
EBITDA	524	521	-0.5	648	576	-11.0	638	
EBITDA Margin (%)	7.8	7.7	-18 bps	8.3	7.7	-61 bps	7.9	
PAT	374	371	-0.7	469	417	-11.1	453	
EPS (₹)	26.7	26.8	-0.7	33.5	30.1	-11.1	32.7	

Source: Company, ICICI Direct Research

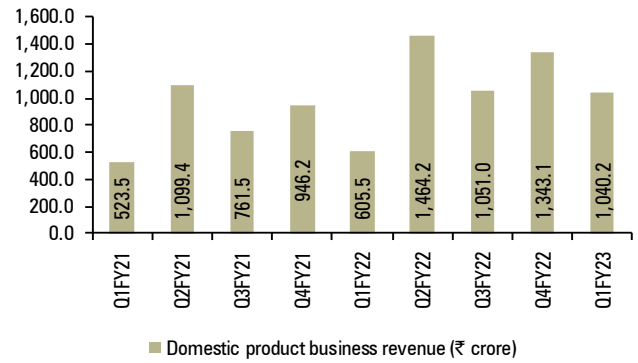
Key Metrics

Exhibit 3: IT services witness moderation



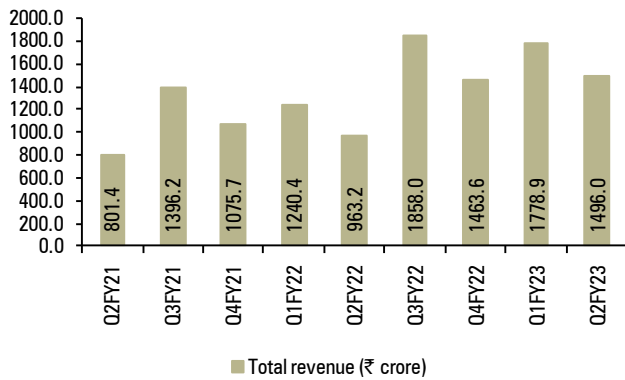
Source: Company, ICICI Direct Research

Exhibit 4: Lumpy numbers for product business



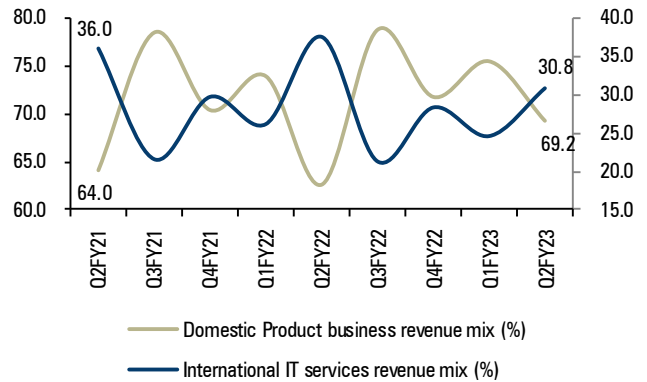
Source: Company, ICICI Direct Research

Exhibit 5: Total revenue with YoY growth



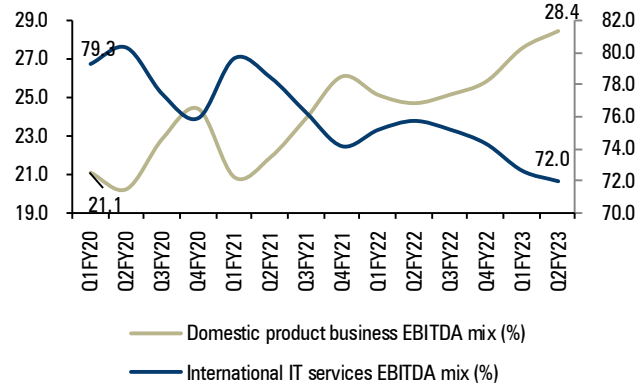
Source: Company, ICICI Direct Research

Exhibit 6: Revenue mix of IT services coming down



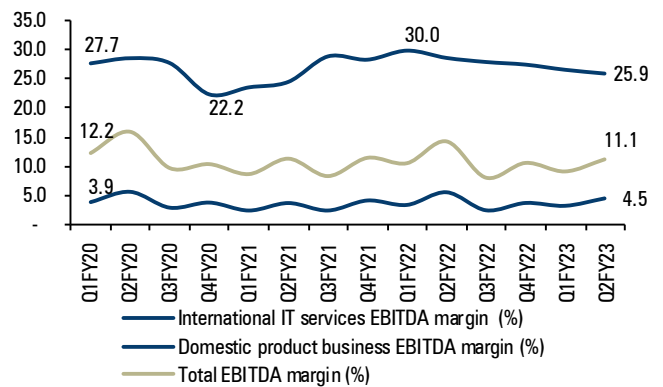
Source: Company, ICICI Direct Research

Exhibit 7: As is EBITDA mix



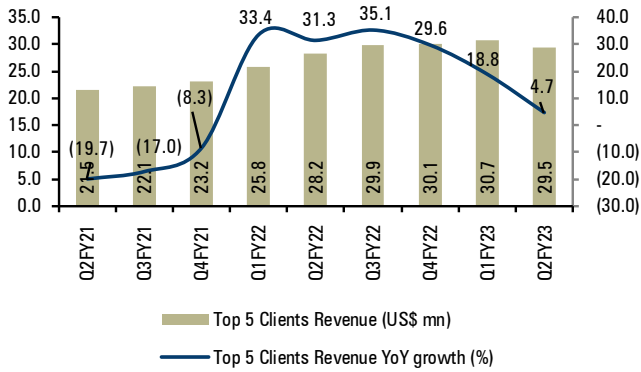
Source: Company, ICICI Direct Research

Exhibit 8: As is EBITDA margins for IT services coming down



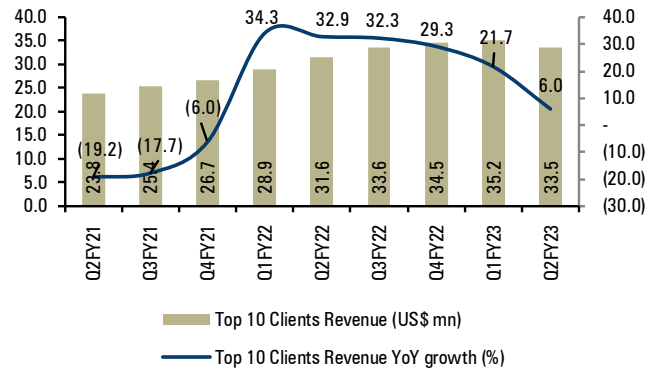
Source: Company, ICICI Direct Research

Exhibit 9: Top five clients numbers weak



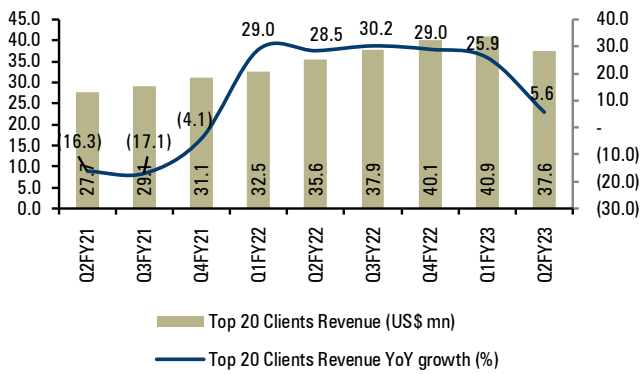
Source: Company, ICICI Direct Research

Exhibit 10: Same for Top 10



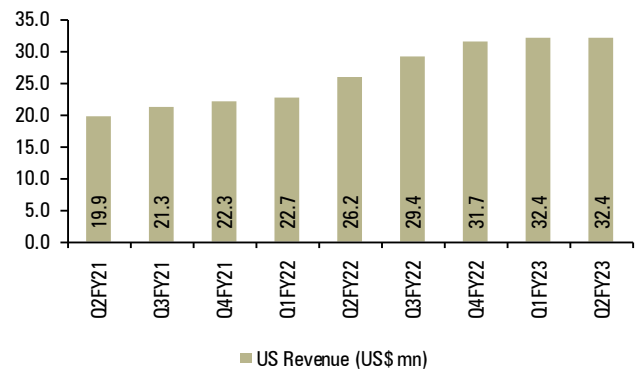
Source: Company, ICICI Direct Research

Exhibit 11: As well as Top 20 customers



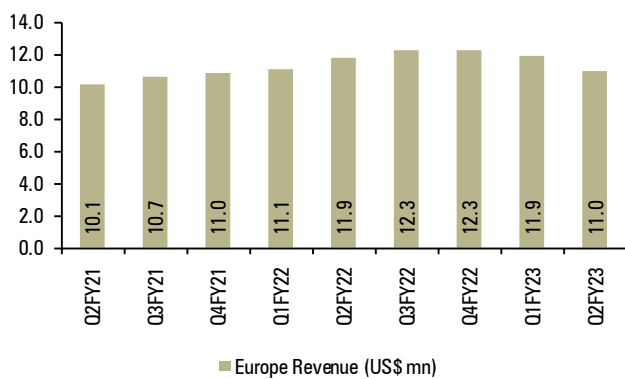
Source: Company, ICICI Direct Research

Exhibit 12: US revenue flat QoQ



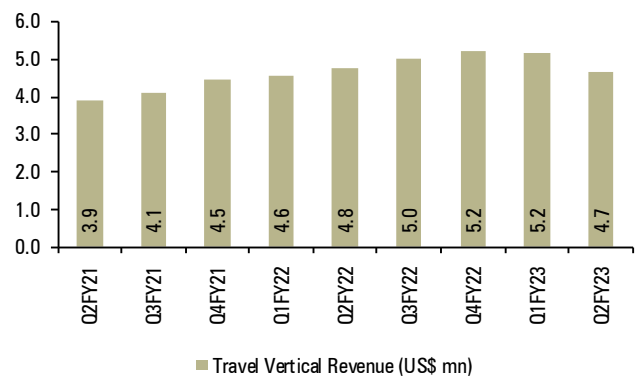
Source: Company, ICICI Direct Research

Exhibit 13: While Europe sees moderation in last three quarters



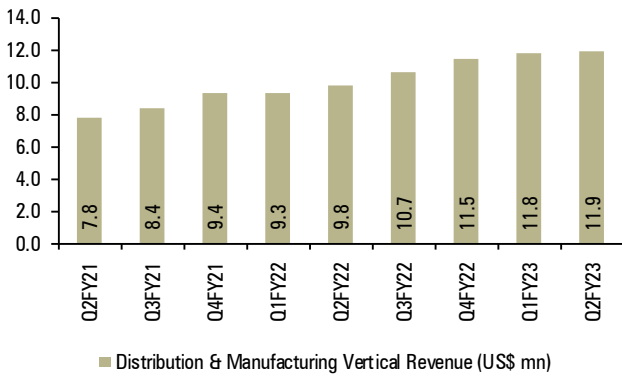
Source: Company, ICICI Direct Research

Exhibit 14: Travel revenue down in Q2



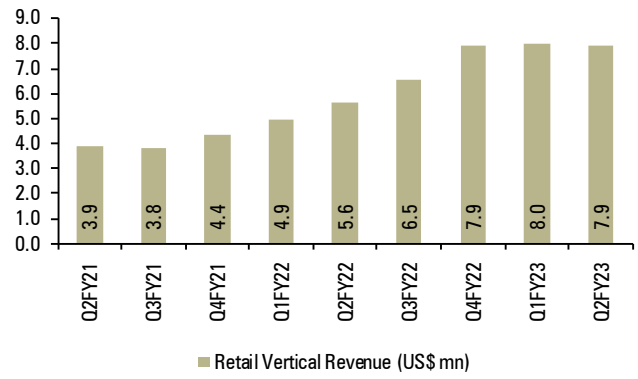
Source: Company, ICICI Direct Research

Exhibit 15: While D&M Revenue sees uptick



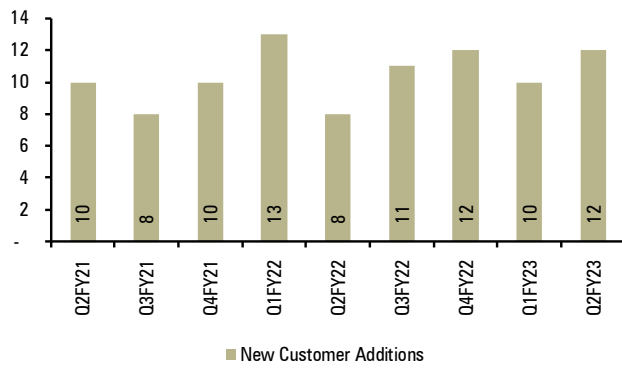
Source: Company, ICICI Direct Research

Exhibit 16: Retail revenue tad down



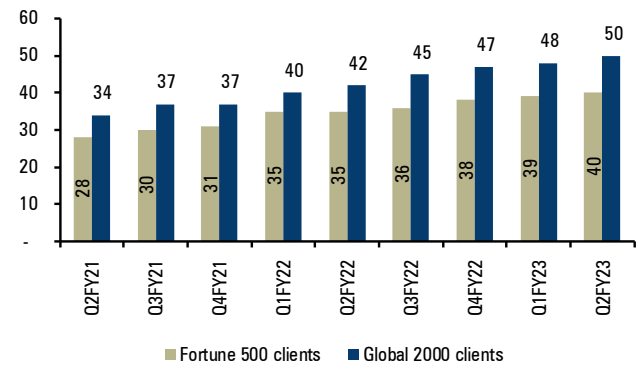
Source: Company, ICICI Direct Research

Exhibit 17: New customers addition trend



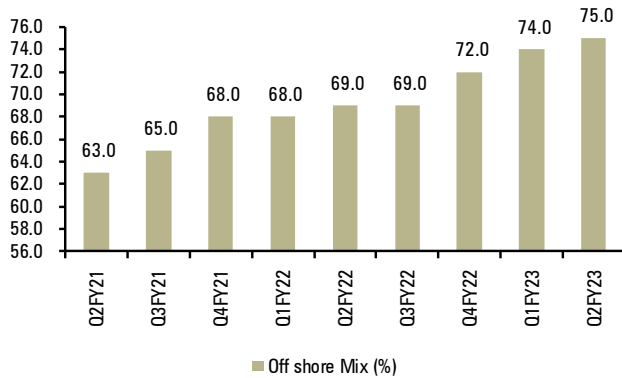
Source: Company, ICICI Direct Research

Exhibit 18: Fortune 500 & Global 2000 clients trend



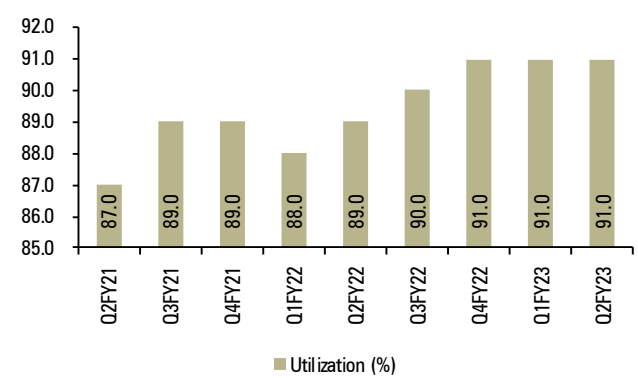
Source: Company, ICICI Direct Research

Exhibit 19: Off shore mix trend



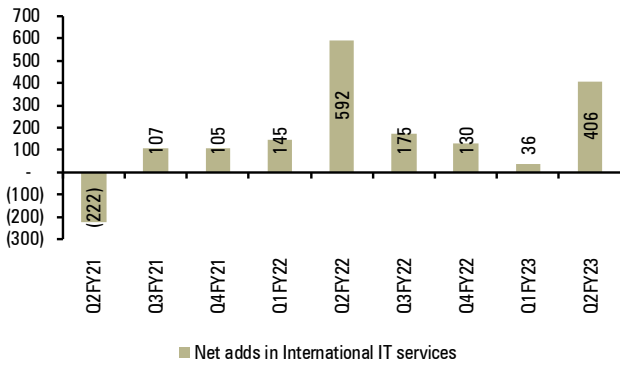
Source: Company, ICICI Direct Research

Exhibit 20: Utilisation sees improvement



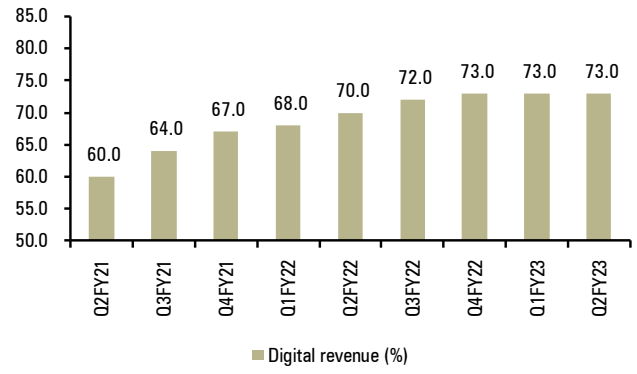
Source: Company, ICICI Direct Research

Exhibit 21: International headcount sees uptick



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)	FY22	FY23E	FY24E	FY25E
Total Revenues	5,553	6,807	7,488	8,087
Growth (%)	31.3	22.6	10.0	8.0
Total Operating Expenditure	5,090	6,286	6,912	7,450
EBITDA	464	521	576	638
Growth (%)	22.2	12.4	10.5	10.7
Depreciation & Amortization	47	54	60	65
Other Income	102	46	58	58
Interest costs	18	18	18	18
PBT before Exceptional Items	500	495	556	613
Growth (%)	42.1	(1.1)	12.4	10.2
Tax	124	124	139	159
PAT before Exceptional Items	376	371	417	453
Exceptional items	-	-	-	-
PAT before MI	376	371	417	453
Minority Int & Pft. from associate	-	-	-	-
PAT	376	371	417	453
Growth (%)	54	(1)	12	9
EPS	27.2	26.8	30.1	32.7
EPS (Growth %)	16	(1)	12	9

Source: Company, ICICI Direct Research

Exhibit 24: Cash flow statement				
	₹ crore			
(Year-end March)	FY22	FY23E	FY24E	FY25E
Net profit before Tax	500	495	556	613
Depreciation & Amortization	47	54	60	65
WC changes	100	(81)	(0)	(0)
Other non cash adju.	(6)	(28)	(40)	(40)
Income taxes paid	(156)	(124)	(139)	(159)
CF from operations	486	317	437	478
Capital expenditure	(10)	(24)	(26)	(28)
Δ in investments	(126)	-	-	-
Other investing cash flow	17	46	58	58
CF from investing Activities	(119)	22	32	29
Issue of equity	-	-	-	-
Δ in debt funds/lease liabilities	(81)	(24)	(24)	(24)
Dividends paid	(187)	(223)	(250)	(272)
Other financing cash flow	(3)	(18)	(18)	(18)
CF from Financial Activities	(271)	(265)	(292)	(314)
Δ in cash and cash bank balance	96	75	176	194
Effect of exchange rate changes	(3)	-	-	-
Opening cash	677	770	844	1,021
Closing cash	770	844	1,021	1,214

Source: Company, ICICI Direct Research

Exhibit 25: Balance sheet				
	₹ crore			
(Year-end March)	FY22	FY23E	FY24E	FY25E
Equity	10	14	14	14
Reserves & Surplus	1,089	1,234	1,400	1,582
Networth	1,099	1,248	1,414	1,596
Minority Interest	-	-	-	-
LT liabilities & provisions	166	166	166	166
Total Debt	38	38	38	38
Source of funds	1,303	1,452	1,618	1,800
Net fixed assets	206	199	190	177
Goodwill	221	221	221	221
Long term loans and advances	-	-	-	-
Other non current assets	188	240	260	278
Loans and advances	-	-	-	-
Inventories	-	-	-	-
Current Investments	145	145	145	145
Debtors	893	991	1,091	1,178
Cash & Cash equivalents	770	844	1,021	1,214
Other current assets	133	179	196	212
Current liabilities	1,223	1,324	1,457	1,573
Provisions	29	44	48	52
Net current assets	688	791	948	1,124
Application of funds	1,303	1,452	1,618	1,800

Source: Company, ICICI Direct Research

Exhibit 26: Key ratios				
	₹ crore			
(Year-end March)	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS-diluted	27.2	26.8	30.1	32.7
Cash per share	55.5	60.9	73.6	87.6
BV	79.3	90.0	102.0	115.1
DPS	16.3	16.1	18.0	19.6
Operating Ratios (%)				
EBITDA Margin	8.4	7.7	7.7	7.9
Adjusted PBT Margin	9.0	7.3	7.4	7.6
Adjusted PAT Margin	6.8	5.5	5.6	5.6
Return Ratios (%)				
RoNW	34.2	29.7	29.5	28.4
RoCE	39.8	35.3	35.5	35.0
RoIC	107.1	100.9	113.9	130.0
Valuation Ratios (x)				
P/E	18.6	18.9	16.8	15.4
EV / EBITDA	13.2	11.6	10.2	8.9
Price to Book Value	6.4	5.6	4.9	4.4
EV/Total Revenues	1.1	0.9	0.8	0.7
MCap/Total Revenues	1.3	1.0	0.9	0.9
Turnover Ratios				
Debtor days	59	53	53	53
Creditors days	69	56	56	56
Solvency Ratios				
Debt/EBITDA	0.1	0.1	0.1	0.1
Total Debt / Equity	0.0	0.0	0.0	0.0
Current Ratio	1.5	1.6	1.6	1.7
Quick Ratio	1.5	1.6	1.6	1.7
Debt / EBITDA	0.1	0.1	0.1	0.1

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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