

India

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Sonata Software

FY23 annual report analysis

- Large deal ramp-up and Quant Systems integration are key revenue tailwinds in FY24F while TMT vertical softness is a key headwind.
- Made it into Microsoft's exclusive inner circle. Ranked in the top 1% of partners.
- Investing in leadership, front-end sales, partnership and solutioning.

Annual report summary

Sonata Software's (SSOF) FY23 annual report highlights investments in key go-to-market solutions like Cloud, Data, Dynamics, Managed Services and Contact Centre with a focus on modernization and automation. The company is strengthening its solutions in key verticals (TMT, Manufacturing, Retail, Travel, BFSI and Healthcare & Lifesciences), and is investing in Generative AI capabilities. Investment in the leadership team, front-end sales, partnerships and solutioning is part of the US\$500m IT services revenue aspiration by the end of FY26F (vs. US\$241m in FY23). SSOF also aims to achieve US\$1bn revenue in domestic products business with a focus on increasing absolute operating profitability and sustaining healthy return ratios. FY24F revenue tailwinds include large deal ramp-up and integration of Quant Systems (acquired company) while TMT vertical softness is a key headwind. Other notable highlights include a) insourcing professional fee was up 67.5% yoy in FY23 and constitutes 11.6% of international IT services revenue (vs. 8.9% in FY22), b) operating cash flow (OCF) before working capital changes increased 14.1% yoy but net OCF declined 40.4% yoy due to increase in working capital requirement, c) net cash at Rs4,425m, and d) contingent liabilities rising by 5.5% in FY23 to Rs8.7bn (Rs63 per share).

Microsoft to continue aiding growth across businesses

Microsoft continues to lead the company's top 5 client list (IT services business) and remains its long-standing partner. Apart from being recognized into Microsoft's inner circle partner (ranked in top 1% of Microsoft partners), SSOF also became a Microsoft Cloud Partner. FY23 domestic products business growth was aided by Microsoft (grew 30% in revenue terms) and the number of customers utilizing Microsoft Infra Services & Managed Services grew 25%+.

Our view

Sonata Software's strategic focus on select verticals, large deals, client-mining initiatives, scaling partnerships and strengthening the geographical presence could aid growth momentum while domestic business focus remains on improving profitability and return ratios. Cash generation remains steady (net cash of ~Rs4.4bn) and the company has paid an average 50%+ dividend payout during FY14-23 (M&A pay-out could moderate the same in the short term). The stock trades at ~30x TTM P/E. We do not have coverage on the stock currently.



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Financial Summary

	Mar-19A	Mar-20A	Mar-21A	Mar-22A	Mar-23A
Revenue (Rsm)	29,609	37,433	42,281	55,534	74,491
Operating EBITDA (Rsm)	3,356	3,728	3,794	4,638	6,041
Net Profit (Rsm)	2,489	2,769	2,440	3,765	4,519
Core EPS (Rs)	18.0	20.0	17.6	27.2	32.6
Core EPS Growth	29.5%	11.3%	(11.9%)	54.3%	20.0%
FD Core P/E (x)	58.02	52.14	59.19	38.35	31.95
DPS (Rs)	12.8	20.3	14.0	21.0	15.8
Dividend Yield	0.40%	1.94%	1.34%	2.02%	1.51%
EV/EBITDA (x)	42.02	37.66	36.11	29.16	22.35
P/FCFE (x)	(1,014.73)	40.10	32.76	35.87	68.38
Net Gearing	(44.2%)	(59.9%)	(82.0%)	(83.2%)	(72.0%)
P/BV (x)	18.80	21.56	15.95	13.14	11.10
ROE	35.0%	38.5%	31.0%	37.6%	37.7%

% Change In Core EPS Estimates

InCred Research/Consensus EPS (x)

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Key takeaways from its MD and CEO

- Sonata Software aims to achieve US\$1.5bn in revenue by the end of FY26F, of which US\$500m will be from international IT services led by opportunities from modernization and scaling of BFSI (~8% of IT services revenue) & Healthcare (~11% of IT services revenue) verticals and US\$1bn from the domestic IT (FY23 revenue was ~US\$695m).
- The company won its largest-ever deal with a TCV of US\$160m to modernize clients' IT estate, and also won eight other large contracts during FY23.
- Integrated Quant Systems (largest-ever acquisition) which aided enterprise data capabilities and added one large client each in BFSI and Healthcare.
- Invested in key go-to-market solutions like Cloud, Data, Dynamics, Managed Services and Contact Centre with a focus on modernization and automation. Strengthening solutions in key verticals (TMT, Manufacturing, Retail, Travel, BFSI and Healthcare) and investing in Generative AI capabilities.
- Sonata software implemented a two-in-a box P&L model to build deeper leadership talent in the company and launched One-Sonata program to drive synergies across businesses.
- Outlook remains strong despite macroeconomic concerns and decision making delay.

Other key takeaways

- Sonata Software is committed to building and sustaining strong alliances with major cloud providers like Microsoft, AWS, Google and Salesforce. The company is a Microsoft Cloud Partner with certifications in Azure infrastructure, digital and app innovation, business applications, data & AI, modern work, and security.
- Sonata's Generative AI uses large language models to enable the modernization journey of customers in the areas of customer experience enhancement, employee experience, operations, compliance and engineering. Its Lightning platform enables customers to explore Gen AI through industry-specific proof-of-concept projects. The company won its first engagement on Gen AI in 3Q.
- Ranked in the top 1% of Microsoft partners being an Inner Circle Partner.
- Partnerships accounted for more than 50% of the deal pipeline, up 2x on a yoy basis.
- The company plans to expand its partner landscape by onboarding 50 or more partners across a diverse range of large ISVs (Independent Software Vendors), platforms, and startups. This broadened network could enable the company to leverage the expertise, joint go-to-market (GTM) strategies, and access to specialized talent offered by partners.
- Established Chief Digital Officer (CDO) and Chief Technology Officer (CTO) organizations to drive revenue growth objectives over the next three years.
- Cloud and Digital services could comprise 60% of total services revenue by 2027F.

Key takeaways from MD&A

- Large deal ramp-up and integration of Quant Systems are key revenue tailwinds in FY24F while softness in TMT is a key headwind. Overall, Sonata expects revenue performance in top 25% of quartile and margin in top 10%.
- IT spending has moderated across sectors but opportunities remain buoyant for modernization, consolidation and in emerging technologies.
- Though the labour market has largely eased, supply in niche segments remains challenging.
- Despite high inflation and talent pressure, offshore locations such as India would continue to offer meaningful cost arbitrage.

- The company continues to invest in front-end sales, tech consulting, ecosystem partnerships, and focused geographies and verticals.
- Sonata Software continued to grow harvest verticals – TMT, and Retail & Manufacturing and is investing in building strong sales and delivery capabilities in invest verticals – Healthcare & Lifesciences (HLS) and Banking & Financial Services & Insurance (BFSI) where it sees strong growth opportunities over the next three-to-five years.
- Strengthens leadership team in the US to bring more focus on industry verticals and partnership with ecosystem partners.
- The outlook on IT spending in the BFSI sector is positive, as companies continue to prioritize digital transformation and customer experience.
- HLS clients are leveraging the company's expertise in enhancing member experience, enabling proactive services to enhance member care, reimagining existing applications and building scalable platforms ensuring compliance.
- **Microsoft** continues to lead the company's top-5 clients list and remains its long-standing partner. Over the last 30 years, Sonata has successfully delivered across consulting services, product engineering, implementation of Microsoft products like MS Dynamics and Customer Services support. The company has built best-in-class modernization solutions around Microsoft Azure, Data, Dynamics, and Digital Contact Centre. In FY23, the company not only figured itself in the exclusive inner circle, but also became a Microsoft Cloud Partner. The Sonata team got an opportunity to work with the Microsoft team on a couple of key initiatives that are going to create a paradigm shift in the area of data and AI.
- Sonata has verticalized the US operations towards key industry verticals – Telecom, Media, and Technology (TMT), Retail & Manufacturing (RM), Banking, Financial Services, and Insurance (BFSI), and Healthcare and Life Sciences (HLS). Geo structure continues for UK, Europe, APAC, and ANZ geographies with focus on key industry verticals. Also expanded in the Nordic region.
- Added 10+ new clients with three of them moved in to the top 5 list.
- Strengthens its sales and solution investments in the UK and Europe in FY23. The company has set up a new development centre in Ireland to boost growth by delivering services locally for the UK and Ireland markets and it also acts as a nearshore delivery centre for the Europe region.
- ANZ is a strategic location for Sonata given investments in local presence and delivery capacity across key customer locations in Brisbane, Melbourne, and Sydney. Over the years, Sonata has made significant progress in the Retail, Manufacturing and TMT industries in the region. During FY23, it expanded talent base in the region significantly and delivered multiple transformation programs for top clients in this region. Sonata has signed multiple large deals and sees significant opportunities to grow and expand presence in the ANZ region.
- **India business** - Growth was aided by Microsoft business (grew 30% in revenue terms) and the number of existing customers renewing large and multi-year contracts. Additional licenses & new products grew by 20% yoy from its existing customers. Customers utilizing Microsoft Infra Services and Managed Services grew by more than 25%.

Figure 1: Leadership addition in FY23

Name	Designation
Samir Dhir	MD & CEO
Raghav Dave	Head of Sales - HLS, US
Roshan Kumar Shetty	Chief Revenue Officer
Rajashekhara Tavarakere	Delivery Head - UK, Ireland and Europe
Anthony Lange	Global Partner Officer
Keerthi Rannore	Head of Global Talent Acquisition
Balaji Kumar	Chief Human Resources Officer
Anand Nair	Head of Sales - APAC
Hemant Kumar Bhardwaj	Chief Marketing Officer
Ashok Mysore	VP - Cloud Growth business, SITL
Sathish Nuggu	Senior VP - Client Services Delivery Portfolio
Murthy Mulugu	Head of IP Engineering
Manu Swami	Head of Technology (Markets)
Sharvari Lingayat	Head of Global Business - HR
Santos Jha	Head of Sales - BFSI, US

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Employee metrics

- Sonata Software hired 2,100 employees in FY23, including ~500 freshers, with the overall employee count at 6,000+.
- On boarded several key leaders across different functions globally to strengthen the leadership pipeline.
- The company invested an average 7.3 training days per employee in FY23. 493 freshers completed a rigorous three-month training program. 100 employees were trained and certified in various AWS skills and ~250 are Azure-certified.
- Launchpad the company's onboarding program for campus hires was revamped to enable them with better client-facing skills.
- The company recently launched SCALE, or Sonata Career Academy for Learning Excellence, to build the right skill mix to execute projects and prepare for emerging technologies. Training completion and certifications doubled since the launch of the program.
- The performance management process was strengthened and launched as PACE (Performance and Career Enablement) for timely goal-setting, feedback, review and rewards.
- Talent development and nurturing – revamped existing recognition program to expand its scope and added more categories to make it attractive.
- Identifies top 15 colleges within and outside India to deepen its relationship for synergies and provide a steady supply of talent.

Acquisition

- Sonata Software acquired a 100% stake in Quant Systems Inc., an US-based IT solutions and software company. The purchase consideration was US\$159m, with a cash consideration of US\$70.7m and US\$88.3m as contingent consideration payable over a span of two years. Goodwill comprises Rs8,622.3m out of a total consideration of Rs13,034.8m. Transaction cost of Rs126.7m has been recognized in FY23 P&L.
- Quant's revenue in CY22 was US\$37m with a mid-30's EBITDA margin. The acquisition added two clients (one each from BFSI and HLS verticals) to the company's top-5 client list (IT services business).
- The acquisition provided access to the talent pool of Salesforce experts, data privacy specialists, and engineering professionals in the US. Also, augmented nearshore capabilities in Mexico and Costa Rica.

Remuneration

- Mr. Samir Dhir has been appointed as a whole-time director and CEO, effective 9 May 2022. Subsequently, he was appointed as MD & CEO, effective 14 Feb 2023. His remuneration in FY23 was Rs121.7m, comprising Rs101.3m as salary and Rs20.4m as commission.

- The percentage increase in median remuneration of employees was 12.2% in FY23 vs. 13% in FY22. The average increase in remuneration, ex-managerial personnel, was 11.94% in FY23 vs. 10% in FY22.

Contingent liabilities

- Contingent liabilities were up 5.5% in FY23 at Rs8,708m (~Rs63 per share) led by guarantees (Rs3,953m; up 8.3% yoy) followed by disputed demands of the income-tax department (Rs4,054m; up 4.2% yoy), disputed demands of services tax (Rs103m; unchanged) and other claims not acknowledged as debt (Rs598m; down 2.7% yoy).

ESG metrics

- Sonata Software witnessed a 45.5% reduction in energy consumption from the base-line year 2019-20.
- The company witnessed a 36% reduction in emissions from the base-line year 2019-20.
- 42.2% of total energy consumption was from renewable sources.
- The company has seven board members with only one-woman director. Two are executive directors, two are non-executive directors and three are independent directors (~43%).

Key financials

- In FY23, INR reported revenue was up 34.1% vs. 31.3% growth in FY22 to Rs74.5bn, led by a 36.2% growth in domestic products & services business and a 28.6% growth in international IT services business (up 18.7% in US\$ terms at US\$241m).
- FY23 EBITDA was up 30.3% yoy at Rs6.04bn with an 8.1% EBITDA margin vs. 8.4% in FY22. Employee expenses were up 26.6% yoy at Rs9,331m and formed 12.5% of overall revenue (48.6% of IT services revenue). PAT was up 20% yoy at Rs4.5bn.
- Operating cash flow was down 40.4% yoy at Rs2.6bn. Free cash flow was down 48.4% yoy at Rs2.27bn.
- Gross cash stood at Rs9.3bn (up 2.4% yoy) while gross debt stood at Rs4.9bn (up 1198.9% yoy). Net cash was at Rs4.4bn.
- Gross tangibles were up by 28.4% at Rs806m led by plant & equipment (Rs492.8m; up 44.9% yoy), furniture & fixtures (Rs80.3m; up 32.1% yoy), office equipment (Rs81.5m; up 29.6% yoy) offset by leasehold improvements (Rs123.5m; down 9.1% yoy)
- Goodwill was up by 397.6% at Rs10.98bn led by the acquisition (Rs8.6bn). Gross intangibles were up by 346.5% at Rs5,656m led by customer relations (Rs4,392m; up 646.6% yoy) and contracts-in-progress (Rs809m; up 261.6% yoy). Customer relations and contracts-in-progress uptick was led by acquisitions. Goodwill and intangibles form 36.8% of the balance sheet size.

BY THE NUMBERS

Profit & Loss					
(Rs mn)	Mar-19A	Mar-20A	Mar-21A	Mar-22A	Mar-23A
Total Net Revenues	29,609	37,433	42,281	55,534	74,491
Gross Profit	6,117	6,672	6,110	7,933	10,603
Operating EBITDA	3,356	3,728	3,794	4,638	6,041
Depreciation And Amortisation	(128)	(365)	(396)	(473)	(591)
Operating EBIT	3,228	3,363	3,398	4,165	5,450
Financial Income/(Expense)	267	432	124	839	523
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)					
Profit Before Tax (pre-EI)	3,495	3,795	3,522	5,004	5,973
Exceptional Items					
Pre-tax Profit	3,495	3,795	3,522	5,004	5,973
Taxation	(1,006)	(1,026)	(1,082)	(1,239)	(1,454)
Exceptional Income - post-tax					
Profit After Tax	2,489	2,769	2,440	3,765	4,519
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	2,489	2,769	2,440	3,765	4,519
Recurring Net Profit	2,489	2,769	2,440	3,765	4,519
Fully Diluted Recurring Net Profit	2,489	2,769	2,440	3,765	4,519

Cash Flow					
(Rs mn)	Mar-19A	Mar-20A	Mar-21A	Mar-22A	Mar-23A
EBITDA	3,356	3,728	3,794	4,638	6,041
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(2,415)	976	1,840	623	(1,766)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense	(102)	422	279	600	187
Other Operating Cashflow					
Net Interest (Paid)/Received	(34)	(152)	(154)	(180)	(185)
Tax Paid	(867)	(1,289)	(1,332)	(1,559)	(1,754)
Cashflow From Operations	(62)	3,686	4,426	4,122	2,522
Capex	(80)	(85)	(19)	(96)	(411)
Disposals Of FAs/subsidiaries					
Acq. Of Subsidiaries/investments					
Other Investing Cashflow	194	1,475	(1,122)	(737)	(8,143)
Cash Flow From Investing	113	1,391	(1,141)	(833)	(8,553)
Debt Raised/(repaid)					
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid	(1,434)	(3,541)	(407)	(1,869)	(2,324)
Preferred Dividends					
Other Financing Cashflow	(226)	443	(215)	(837)	4,191
Cash Flow From Financing	(1,661)	(3,098)	(621)	(2,706)	1,867
Total Cash Generated	(1,609)	1,978	2,664	583	(4,164)
Free Cashflow To Equity	(142)	3,601	4,408	4,026	2,112
Free Cashflow To Firm	85	5,228	3,439	3,469	(5,846)

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS...cont'd

Balance Sheet					
(Rs mn)	Mar-19A	Mar-20A	Mar-21A	Mar-22A	Mar-23A
Total Cash And Equivalents	3,394	4,012	7,425	9,144	9,361
Total Debtors	8,558	7,408	6,525	9,220	12,362
Inventories					
Total Other Current Assets	516	476	742	1,080	2,428
Total Current Assets	12,468	11,896	14,692	19,443	24,151
Fixed Assets	226	1,186	1,002	1,233	1,316
Total Investments	253	294	301	518	559
Intangible Assets	1,774	1,796	2,236	3,036	16,015
Total Other Non-Current Assets	560	993	1,239	1,362	1,528
Total Non-current Assets	2,813	4,269	4,777	6,149	19,418
Short-term Debt					
Current Portion of Long-Term Debt					
Total Creditors	5,873	5,619	6,510	10,547	12,949
Other Current Liabilities	1,290	2,692	2,884	2,393	8,685
Total Current Liabilities	7,163	8,311	9,394	12,940	21,633
Total Long-term Debt					
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	435	1,157	1,021	1,660	8,929
Total Non-current Liabilities	435	1,157	1,021	1,660	8,929
Total Provisions					
Total Liabilities	7,598	9,468	10,415	14,600	30,562
Shareholders Equity	7,683	6,697	9,055	10,992	13,007
Minority Interests					
Total Equity	7,683	6,697	9,055	10,992	13,007

Key Ratios					
	Mar-19A	Mar-20A	Mar-21A	Mar-22A	Mar-23A
Revenue Growth	20.7%	26.4%	13.0%	31.3%	34.1%
Operating EBITDA Growth	45.3%	11.1%	1.8%	22.3%	30.2%
Operating EBITDA Margin	11.3%	10.0%	9.0%	8.4%	8.1%
Net Cash Per Share (Rs)	24.49	28.96	53.59	65.99	67.56
BVPS (Rs)	55.45	48.33	65.35	79.33	93.87
Gross Interest Cover	95.23	22.14	22.09	23.09	29.40
Effective Tax Rate	28.8%	27.0%	30.7%	24.8%	24.3%
Net Dividend Payout Ratio	23.4%	101.3%	79.5%	77.3%	48.3%
Accounts Receivables Days	79.72	77.84	60.14	51.74	52.87
Inventory Days					
Accounts Payables Days	79.21	68.18	61.19	65.40	67.12
ROIC (%)	195.3%	54.9%	66.4%	133.4%	137.9%
ROCE (%)	31.9%	34.1%	29.9%	31.3%	34.4%
Return On Average Assets	16.7%	15.6%	13.2%	13.9%	11.9%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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