ANANDRATHI

India I Equities

Technology
Company Update

Change in Estimates ☑ Target ☑ Reco ☐

26 July 2022

Sonata Software

Rating: **Buy**
Target Price: Rs.880
Share Price: Rs.693

Steady growth in Q1, margins show resilience; maintaining a Buy

Sonata's IT services revenue was $57m (TTM $215m), up 2% q/q (4% cc), 19% y/y organic (28% reported). Headcount (up 23% y/y) addition was just 36 as ~600 freshers will join in Q2/Q3. The margin was 22.4%, down 63bps q/q absorbing management costs, wage hikes and cross-currency. The margin outlook was more positive due to growth and rupee depreciation, and despite sales hiring ahead. The India business delivered high growth. No meaningful change in estimates; target revised to Rs880 (from Rs.1,020), 18x FY24e, reflecting Europe/Retail/Mfg dependence.

IT services growth driven by Hi-tech, Healthcare. Hi-Tech/ISV contribute 33.2% to IT services and is seeing growth acceleration in the last two quarters. In Q1 FY23, it delivered 4% q/q growth. Besides, Healthcare (4% of IT services), though on a small base, grew 10% q/q. Retail also grew but at the company average with management not anticipating weakness in this vertical now. Travel declined 1% q/q mostly on European currency billing. US sequential growth was slow compared to peers; new leadership hired for acceleration.

IT services margins at upper end of 20-22% guidance. IT services' Q1 EBITDA margin was 22.4%, (down 63bps q/q, but y/y up 113bps), absorbing the impact of the balance wage hikes and other sales/management-related costs. The wage hikes are scheduled in Q4 and attrition has already started coming off the peak. Management spoke about more senior management and sales hiring ahead but, given the tailwinds, should stay on course in terms of margin trajectories. Hence, we retain our margin estimates. Utilisation to be a little lower ahead as freshers join over the next two quarters.

Target revised to Rs880; retaining a Buy. Sonata's IT business is likely to clock a 17% CAGR, with margins expected to contract to ~21.3% (FY22 23.4%, Q1 22.4%), both largely unchanged. In its India business, Sonata is likely to record a 21% EBITDA CAGR, taking the consolidated FY24e EPS to Rs49. The stock trades at 14x FY24e EPS (6% FCF yield), which we find attractive. **Risk:** Supply-side challenges.

Key financials (YE Mar)	FY20	FY21	FY22	FY23e	FY24e
Sales (Rs m)	37,433	42,281	55,534	72,456	87,514
Net profit (Rs m)	2,770	2,440	3,765	4,413	5,101
EPS (Rs)	26.3	23.5	36.2	42.5	49.1
P/E (x)	26.0	29.5	19.1	16.3	14.1
EV / EBITDA (x)	16.4	16.6	13.0	10.6	9.2
P/BV (x)	10.8	8.0	6.6	5.6	4.8
RoE (%)	38.5	31.0	37.6	37.0	36.7
RoCE (%)	29.8	23.8	27.5	28.8	29.3
Dividend yield (%)	2.9	2.0	3.0	3.6	4.1
Net debt / equity (x)	-0.5	-0.7	-0.8	-0.8	-0.8

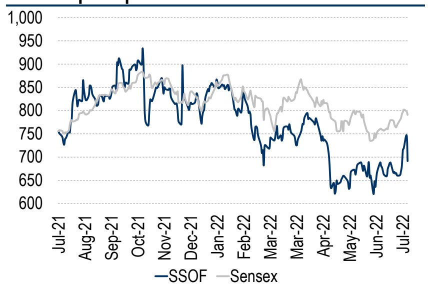
Source: Company, Anand Rathi Research

Key data	SSOF IN / SOFT.BO
52-week high / low	Rs.1030 / 610
Sensex / Nifty	55268 / 16484
3-m average volume	$1.3m
Market cap	Rs.73bn / $911.4m
Shares outstanding	105m

Shareholding pattern (%)	Jun'22	Mar'22	Dec'21
Promoters	28.2	28.2	28.2
- of which, Pledged			
Free float	71.8	71.8	71.8
- Foreign institutions	12.9	13.7	13.9
- Domestic institutions	15.0	14.7	14.7
- Public	44.0	43.4	43.2

Estimates revision (%)	FY23e	FY24e
Sales ($)	(0.0)	(0.3)
EBITDA	(3.4)	(2.1)
Net profit	(2.6)	(1.9)

Relative price performance



Source: Bloomberg

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Krishna Thakker
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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rs m)

Year-end: Mar	FY20	FY21	FY22	FY23e	FY24e
Revenues (US$m)	**534.4**	**575.7**	**755.2**	**931.4**	**1,120.5**
Growth (%)	**24.1**	**7.7**	**31.2**	**23.3**	**20.3**
Net revenues (Rs m)	37,433	42,281	55,534	72,456	87,514
Employee & Direct Costs	30,761	36,171	47,601	62,526	76,260
Gross Profit	6,672	6,110	7,933	9,930	11,255
Gross Margin %	17.82	14.45	14.29	13.71	12.86
SG&A	2,817	2,317	3,065	4,001	4,401
EBITDA	**3,855**	**3,794**	**4,868**	**5,929**	**6,853**
EBITDA margins (%)	10.3	9.0	8.8	8.2	7.8
- Depreciation	365	396	473	535	579
Other income	457	277	790	682	722
Interest Exp	152	154	180	149	149
PBT	3,795	3,522	5,004	5,928	6,847
Effective tax rate (%)	27	31	25	26	25
+ Associates/(Minorities)	-	-	-	-	-
Net Income	2,770	2,440	3,765	4,413	5,101
WANS	105	104	104	104	104
FDEPS (Rs/share)	26.3	23.5	36.2	42.5	49.1

Fig 2 – Balance sheet (Rs m)

Year-end: Mar	FY20	FY21	FY22	FY23e	FY24e
Share capital	104	104	104	104	104
Net worth	6,697	9,055	10,992	12,844	14,984
Total debt (incl. Pref)	860	897	380	380	380
Minority interest	-	-	-	-	-
DTL/(Asset)	-244	-189	-261	-261	-261
Capital employed	**7,313**	**9,762**	**11,111**	**12,962**	**15,103**
Net tangible assets	1,186	999	1,233	1,179	1,244
Net Intangible assets	238	477	829	776	701
Goodwill	1,558	1,759	2,207	2,207	2,207
CWIP (tang. & intang.)	-	1	0	0	0
Long-term Assets (Liabilities)	-322	224	-180	-32	131
Investments (Financial)	135	760	1,586	1,745	1,919
Current Assets (ex Cash)	7,884	7,267	10,259	13,782	16,886
Cash	3,964	6,771	7,696	8,991	10,367
Current Liabilities	7,329	8,497	12,520	15,685	18,352
Working capital	554	-1,230	-2,261	-1,903	-1,466
Capital deployed	**7,313**	**9,762**	**11,111**	**12,962**	**15,103**
Contingent Liabilities	7,542	7,821	8,257	-	-

Fig 3 – Cash Flow statement (Rs m)

Year-end: Mar	FY20	FY21	FY22	FY23e	FY24e
PBT	3,795	3,522	5,004	5,928	6,847
+ Non-cash items	205	397	409	2	6
Operating profit before WC	4,000	3,919	5,413	5,930	6,854
- Incr./(decr.) in WC	-976	-1,775	-1,318	358	437
Others incuding taxes	-1,291	-1,267	-1,873	-1,663	-1,909
Operating cash-flow	3,686	4,426	4,858	3,908	4,508
- Capex (tangible + Intangible)	85	19	96	213	355
Free cash-flow	3,601	4,408	4,762	3,695	4,153
Acquisitions	-	-505	-498	-214	-215
- Dividend (including buyback & ta	3,541	407	1,869	2,561	2,961
+ Equity raised	-	-	-	-0	0
+ Debt raised	704	37	-517	-	-
- Fin Investments	-1,382	469	772	159	174
- Misc. Items (CFI + CFF)	167	259	180	-533	-572
Net cash-flow	1,978	2,806	926	1,294	1,376

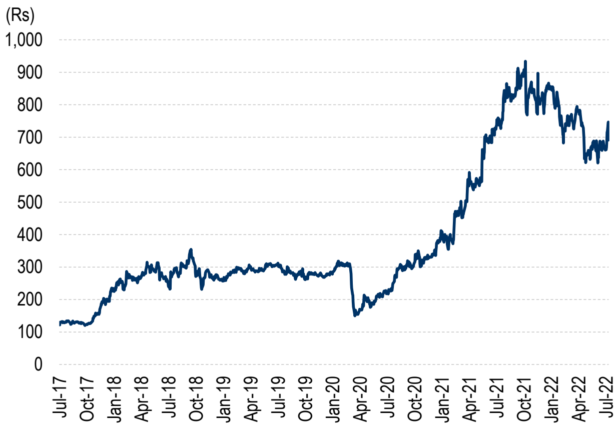
Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis

Year end Mar	FY20	FY21	FY22	FY23e	FY24e
P/E (x)	26.0	29.5	19.1	16.3	14.1
EV/EBITDA (x)	16.4	16.6	13.0	10.6	9.2
EV/sales (x)	1.8	1.5	1.1	0.9	0.7
P/B (x)	10.8	8.0	6.6	5.6	4.8
RoE (%)	38.5	31.0	37.6	37.0	36.7
RoCE (%) - After tax	29.8	23.8	27.5	28.8	29.3
RoIC (%) - After tax	53.3	57.6	91.9	101.7	105.2
DPS (Rs per share)	20.3	14.0	21.0	24.6	28.5
Dividend yield (%)	2.9	2.0	3.0	3.6	4.1
Dividend payout (%) - Inc. DDT	92.3	59.7	58.0	58.0	58.0
Net debt/equity (x)	-0.5	-0.7	-0.8	-0.8	-0.8
Receivables (days)	72	56	62	64	65
Inventory (days)					
Payables (days)	61	62	76	74	72
CFO:PAT %	133.1	181.4	129.0	88.6	88.4
FCF:PAT % - includ M&A payou	130.0	160.0	113.3	78.9	77.2

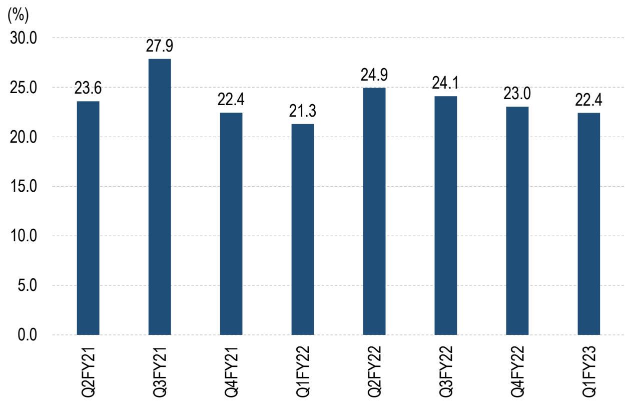
Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 6– IT Services' EBITDA margin (%)



Source: Company, Anand Rathi Research

Result Highlights

Q1 FY23 Results at a Glance

Fig 7 – Q1 FY23 results

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23	Q/Q %	Y/Y %
Revenue ($ m)	174	132	251	197	231	17%	33%
Growth Y/Y %	38%	20%	32%	33%	33%		
Industry Y/Y % (est.)	20%	22%	21%	19%	17%		
Revenue (Rs m)	12,685	9,632	18,580	14,636	17,789	22%	40%
Effec. exchange rate	72.8	73.0	74.0	74.3	76.9	3%	6%
Rev($m) – IT Services	44.5	49.4	53.4	55.7	56.8	2%	28%
Growth Y/Y %	22%	27%	30%	27%	28%		
Rev($m) – Reselling Services	130.0	82.9	197.8	141.4	174.7	23%	34%
Growth Y/Y %	44%	17%	32%	35%	34%		
Employees (EoP)	4,250	4,850	5,025	5,158	5,208	1%	23%
Rev. prod. ($ '000/employee)	11.0	11.2	11.2	11.3	11.3	0%	3%
Billability (%)	78%	80%	81%	82%	82%	0 bps	400 bps
Attrition est. %	20%	24%	23%	30%	24%	-600 bps	400 bps
CoR (excl. D&A)	(11,024)	(7,706)	(16,458)	(12,414)	(15,350)	24%	39%
As % of revenue	-87%	-80%	-89%	-85%	-86%	-147 bps	61 bps
SG&A	(652)	(696)	(806)	(912)	(1,022)	12%	57%
As % of revenue.	-5%	-7%	-4%	-6%	-6%	48 bps	-61 bps
EBITDA	1,010	1,231	1,317	1,311	1,416	8%	40%
EBITDA margins %	8.0%	12.8%	7.1%	9.0%	8.0%	-99 bps	0 bps
IT Svcs EBITDA margins %	21.2%	24.9%	24.0%	22.8%	22.2%	-61 bps	97 bps
EBIT	911	1,114	1,190	1,180	1,287	9%	41%
EBIT margins %	7.2%	11.6%	6.4%	8.1%	7.2%	-83 bps	5 bps
IT Svcs EBIT margins %	18.8%	22.3%	21.4%	20.3%	19.8%	-46 bps	105 bps
Industry margins % (est.)	16.4%	17.2%	17.9%	17.3%	16.0%	-136 bps	-46 bps
Other income (excl. forex)	124	89	130	184	152	-18%	23%
Non-recurring / Forex	158	46	23	37	30	-18%	-81%
Interest expenses	(44)	(47)	(47)	(42)	(37)	-12%	-16%
PBT	1,148	1,202	1,296	1,359	1,431	5%	25%
PBT margins %	9.1%	12.5%	7.0%	9.3%	8.0%	-124 bps	-101 bps
Taxes	(281)	(290)	(319)	(349)	(354)	1%	26%
ETR %	-24%	-24%	-25%	-26%	-25%	100 bps	-25 bps
Associates / Minority	-	-	-	-	-		
Net income	867	912	977	1,009	1,078	7%	24%
Net margins (IT Services)%	19.7%	18.7%	18.0%	17.5%	17.4%	-9 bps	-227 bps
Industry net margins %	13.4%	13.5%	13.3%	13.7%	12.2%	-156 bps	-124 bps
EPS (Rs)	8.3	8.8	9.4	9.7	10.4	7%	24%

Source: Company, Anand Rathi Research Note: Attrition is estimated.

Fig 8 – Quarterly results (Rs m)

Year-end: Mar (Rs m)	Q1FY23	% chg. Q/Q	% chg. Y/Y	Q1 as % of FY23	FY22	FY22 % chg. Y/Y	FY23e % chg. Y/Y
Sales ($ m)	57	2.0	27.6	24	203	26.6	17.8
Sales	17,789	21.5	40.2	25	55,534	31.3	30.5
EBITDA	1,416	8.1	40.3	24	4,868	28.3	21.8
EBITDA margin (%)	8.0	-99bps	bps	-	8.8	-21bps	-58bps
EBIT	1,287	9.1	41.3	24	4,394	29.3	22.8
EBIT margin (%)	7.2	-83bps	5bps	-	7.9	-12bps	-47bps
PBT	1,431	5.4	24.7	24	5,004	42.1	18.5
Tax	(354)	1.3	25.9	23	(1,239)	14.5	22.2
Tax rate (%)	(24.7)	100bps	-25bps	-	(24.8)	596bps	-79bps
Net income	1,078	6.8	24.2	24	3,765	54.3	17.2

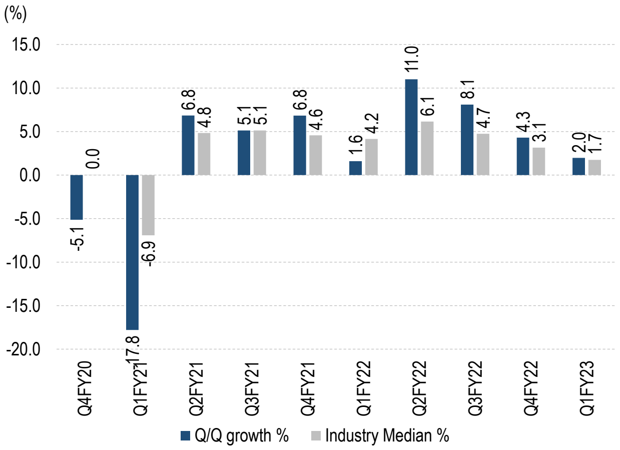
Source: Company, Anand Rathi Research

IT services growth in line with industry

Sonata's IT Services revenue growth this quarter was in line with the industry. In Q1 FY23, it grew 2% sequentially due to heavier cross -currency headwinds compared to some of its peers. It had been growing faster than the industry for the previous four quarters and delivered 5% q/q on a constant-currency basis. The company said that demand is robust but supply-side challenges are a concern. It expects the supply side to ease up a bit in H2.

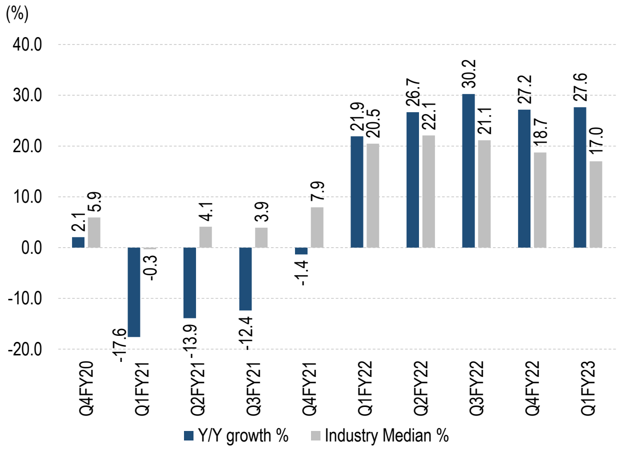
The growth was led by Hi-tech/ISV and Healthcare. From a y/y perspective, it delivered 28% revenue growth (19% organic), slightly ahead of the industry median.

Fig 9 – Growing faster than industry



Source: Company, Anand Rathi Research

Fig 10 – Strong y/y growth momentum



Source: Company, Anand Rathi Research

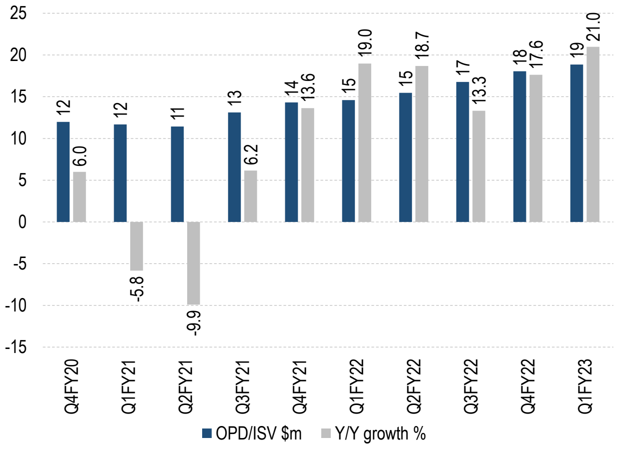
ISV leads the way; CPG/Retail grows at par with company; Travel declines, q/q

Sonata's strength lies in three verticals: ISV (33%), CPG/Retail/Manufacturing (35%) and Travel (9%). ISV recorded 21% y/y growth and relied on Microsoft as a key client. Growth here should persist as this is a high-growth vertical for the industry, more so after the pandemic accelerated cloud adoption. Management also said that the company has been growing well in the Microsoft account, with Q1 being seasonally strong as well.

CPG/Retail/Manufacturing growth was 30%+ y/y for the fifth consecutive quarter. This vertical contributed the most to growth in FY22, 38% y/y and grew 39% y/y in Q1 FY23. It benefited from the industry upswing, driven by the opening up of economies and from the Encore acquisition (the bulk of Encore revenues was accounted for in this vertical). This is a focus vertical for the company and, per management, it has a good pipeline and is expected to continue on the growth path.

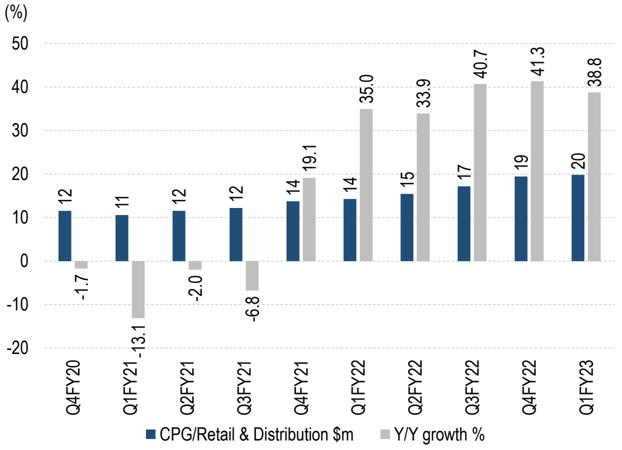
The growth outlook for this vertical is not as strong across the industry, given the rising macroeconomics concerns, although Sonata remains upbeat on it. Over the last few months, many retailers (from the US) have expressed concerns on weakness in discretionary consumer spending. While enterprise spending on software is strong, if this weakness persists, there is the risk of a spillover effect to software demand as well. Some of this weakness was visible in service lines such as MS Dynamic Services (up only 0.7% q/q).

Fig 11 – ISV leads the way for growth



Source: Company, Anand Rathi Research

Fig 12 – CPG/Retail y/y growth strong, aided by Encore

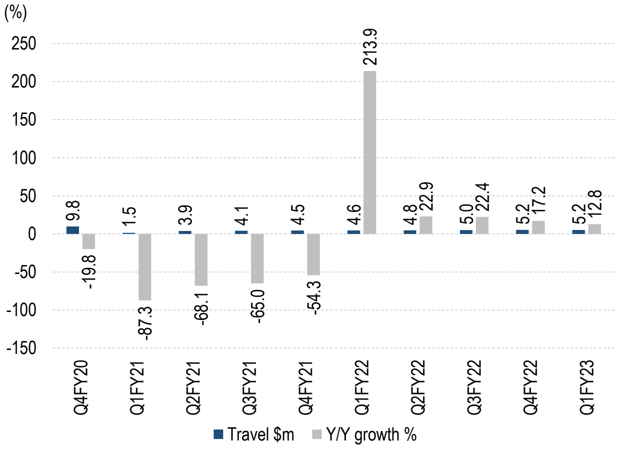


Source: Company, Anand Rathi Research

The Travel vertical grew 13% y/y in Q1, although q/q it was down 1%. This was because key clients in this vertical are in Europe; hence, heavy cross-currency headwinds were observed. The company expects travel clients to start investing/spending from Q2/Q3. This vertical is now at 44% of pre-pandemic levels (Q1 FY23 vs Q3 FY20). We expect this vertical to be 55% of FY20 revenues by FY24. This is a deviation from other IT companies where their travel vertical revenues are close to pre-pandemic highs. Sonata so far (two years after the pandemic) has been unable to diversify to other clients within this vertical. On a relatively longer view, the Travel vertical is likely to grow ~13% over FY23-FY24. In Q1, travel recorded slightly better growth than the company (on a constant-currency basis) but was impacted by cross-currency in Europe.

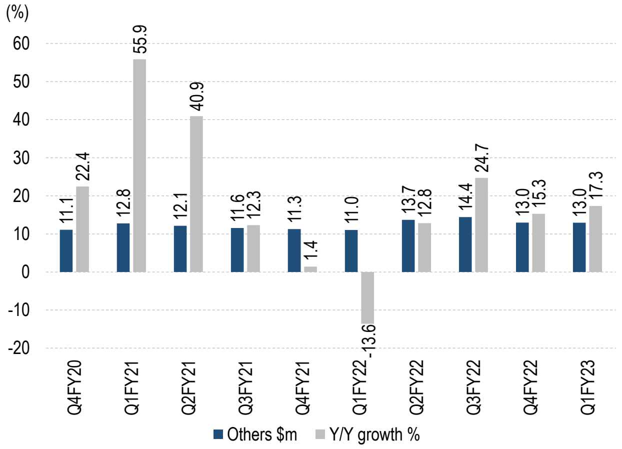
In Q1, Healthcare saw good growth, up 10% q/q to $2.2m. The Others vertical primarily includes Commodity & Services, Logistics, Health Care and 'Others'.

Fig 13 – Travel vertical down q/q on cross-on



Source: Company, Anand Rathi Research

Fig 14 – 'Others' grew at par with the company



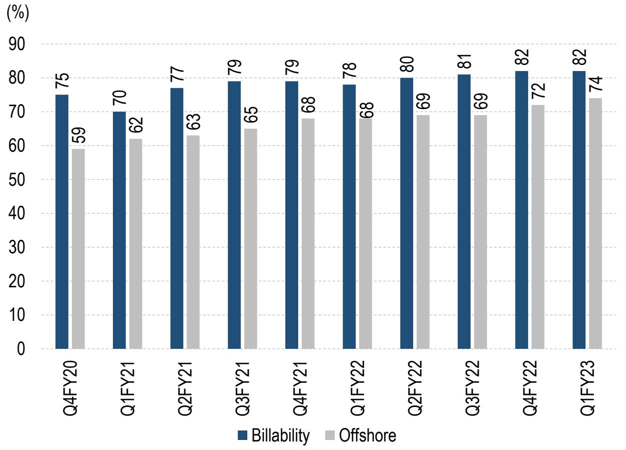
Source: Company, Anand Rathi Research

Manpower addition slow, productivity steady

Sonata added 36 employees in Q1 (933 in LTM), ending with similar utilisation, 82% in Q1 FY23, a four-year high. Hiring was low in the last few quarters. The company said it plans to hire ~600 freshers in the next two quarters; hence, hiring in Q1 was muted.

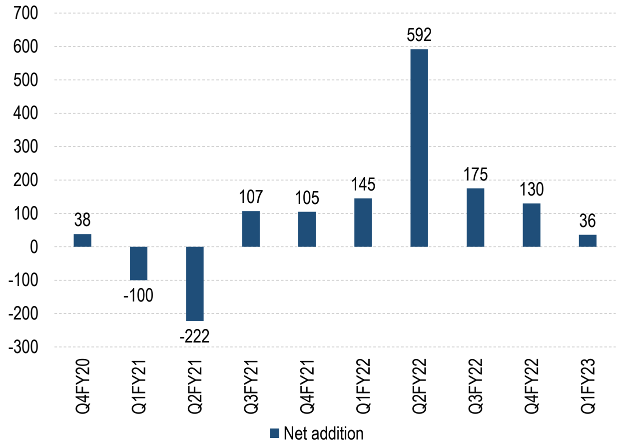
Margins contracted due to wage hikes and senior management hiring, partially absorbing costs through higher offshoring and better sales growth. The company planned for wage hikes in Jan (Q4), by when, we expect supply-side pressures to ease. Attrition fell in Q1 (~24%, per management) and is expected to continue to fall in coming quarters.

Fig 15 – Utilization and Offshore (by Rev) at highs



Source: Company, Anand Rathi Research

Fig 16 – Net addition slows on fresher hiring ahead

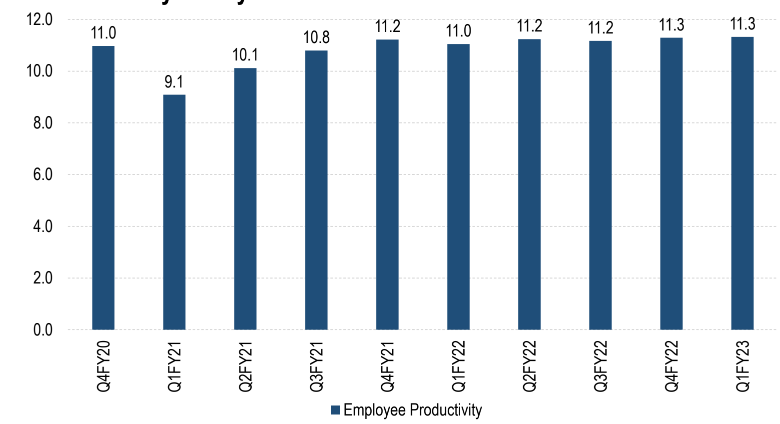


Source: Company, Anand Rathi Research

From an employee-productivity perspective, Sonata has been steady for the last six quarters, reflecting the interplay of higher offshoring and utilisation. In revenue, it currently delivers 74% of its services from offshore (up from 68% a year back). From a utilisation perspective, it appears that it has no headroom to further improve, also amid supply-side issues.

Productivity was flat q/q but up 3% y/y and, in the medium term, the company is seeking higher realisations. Offshore productivity has risen in the last five quarters. However, the chances of higher billing rates ahead are relatively lower now given the perceived/anticipated weakness in Retail, CPG, Manufacturing. Onsite productivity has been largely stable in the past three quarters.

Fig 17 – Productivity steady



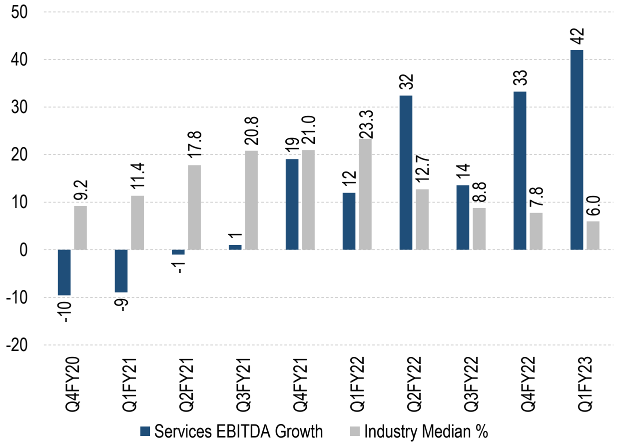
Source: Company, Anand Rathi Research

IT Services EBITDA, NI growth beat industry

Sonata delivered 42% y/y EBITDA growth in Q1 FY23, outstripping the industry. This is despite contraction in margins in Q1. The IT services margin was down sequentially (63bps) to 22.4%, largely due to wage hikes and hiring of senior management.

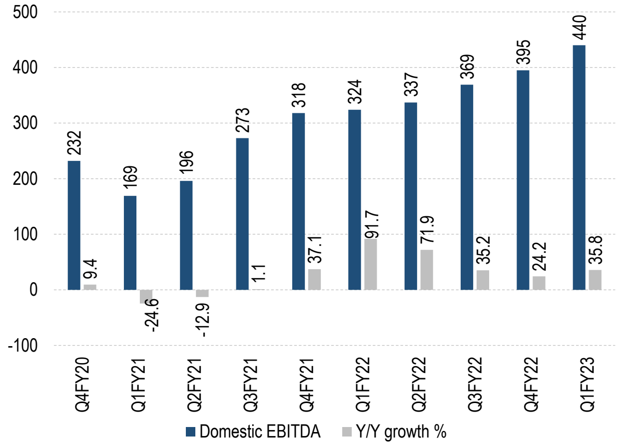
Domestic services EBITDA grew 36% y/y and has been growing y/y for the last seven quarters. The margin was 3.3% (3.8% the prior quarter, 3.4% a year ago) but this division's performance is measured on absolute EBITDA growth, which continues to be strong.

Fig 18 – EBITDA growth higher than industry



Source: Company, Anand Rathi Research

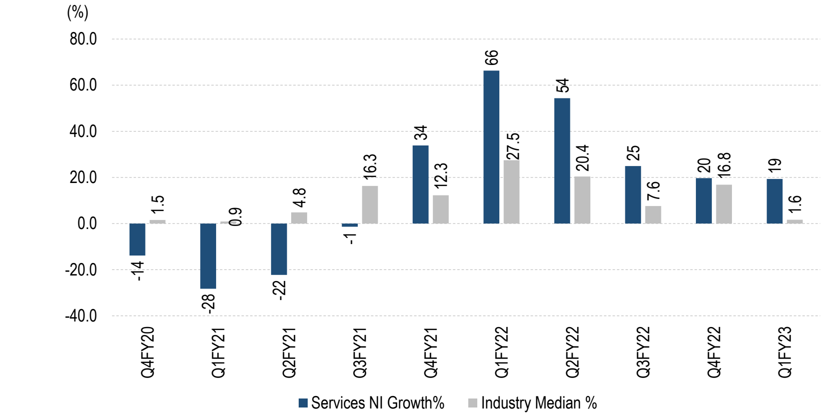
Fig 19 – Domestic EBITDA growth strong



Source: Company, Anand Rathi Research

NI (IT services) grew ahead of the industry for the sixth consecutive quarter though aided by the Encore acquisition (~8-9% of Sonata's revenues at time of acquisition). The tax rate was ~25% in Q1 and is expected at ~25% ahead.

Fig 20 – NI growth higher than industry

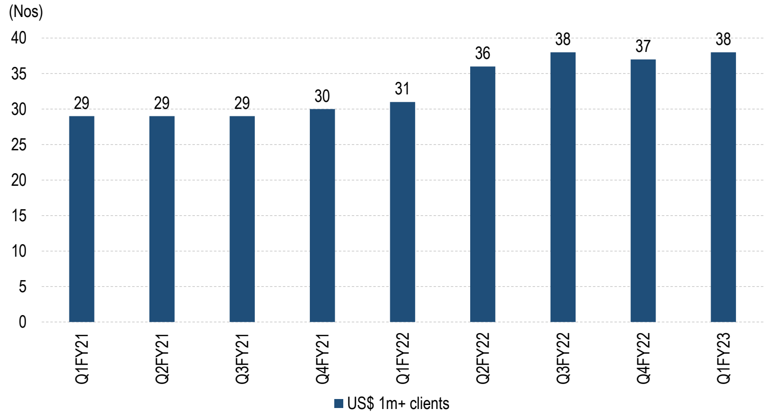


Source: Company, Anand Rathi Research

Sonata operates in mid-segment clients and hence only discloses $1m+ clients. It added seven in the $1m+ bracket in the last 12 months, taking such client count to 38.

Sonata also counts 39 Fortune-500 companies as clients and this figure has steadily risen (38 in Q4 FY22, 35 in Q1 FY22).

Fig 21 – $1m+ clients



Source: Company, Anand Rathi Research

Conference-Call Takeaways

Q1 FY23

Company

- Overall demand is steady, but supply side is a concern. Expect improvement in supply side in H2.
- Confident of the domestic business doing well, on both volumes and profitability
- The Retail vertical is a focus for the company and the pipeline is good. Expect this vertical to continue on the growth path.
- Management expects Travel clients to start investing/spending from Q2/Q3. On a constant-currency basis, Travel recorded slightly better growth than the company. Impacted due to cross-currency in Europe.
- The Microsoft account has been growing well and Sonata continues to see market-share gains from competition in the Microsoft relationship. Work with Microsoft includes SLO, CRM, Power Platform, non-dynamics on customer support, internal IT (data analytics and dynamic implementation) and consulting.
- Margins drop due to salary increased and senior management investments. Wage hike is planned for Jan. This covers junior level employees.
- Attrition to continue to fall in coming quarters.
- Will invest in newly opened centres in Canada, Ireland and Mexico in Q2 and Q3.
- Expect accelerated headcount increase over the next two quarters. The company plans to on-board 600 freshers in the next two quarters. It is building centres in LA and Canada and also hiring in the US and Australia.

Notes from the last quarters' conference calls

Q4 FY22

- Revenue growth could have been better were supply better. Missed out on 2-2.5% revenue due to supply-side challenges. Supply to impact revenue growth in Q1 FY23, not beyond.
- Management is seeing good opportunity to grow, with clients added.
- Travel client to grow in FY23 (business is back to normal per management)
- Million dollar clients down due to 1-2 customer contracts ending. It haven't lost the client; should return in Q1.
- Margin was lower due to hikes in Jan. Management to increase investments across the board (capability, marketing, etc.) in FY23. Expect margins to be impacted a little bit.
- ~400 freshers added in FY22; hiring 45% more in FY23. Freshers will be joining Sonata on 1st Jul.
- Supply-side issue being addressed by way cross-training, going to tier-2 cities for talent, and other measures. The company expects this supply-side issue to be fixed by Q2 FY23.
- Increase in offshoring helped ease margin contraction
- Attrition at 27% for FY22, 30% for Q4.

- Utilization to come down ahead.
- Leadership update: Sameer Dhir announced as CEO in Apr. Global sales officer (London) to be appointed soon. On 2nd May, Roshan Shetty (at Infosys previously for 23 years) was appointed Chief Revenue Officer.
- Canada and Ireland global delivery centres slow due to the pandemic. Ahead, should be better utilised.
- The company has planned capex for the new facility where it is located (Bengaluru) and capex to expand the Ireland and Canada delivery centres. Canada has 12 people; Ireland just starting to hire.
- The company has started investing in Amazon and Google Tech stack and continues to invest in Microsoft Tech stack. It is also investing in cloud and data Microsoft stack as it turns its focus there.
- Guided to growth at similar levels (~18-20%)
- Management guided to 20-22% EBITDA margin.

Q3 FY22

- The company expects attrition to start tapering from the next quarter.
- Margins were flattish despite strong revenue growth due to compensation correction and employee addition.
- Salary corrections done in Q3. Have announced wage hikes for FY23 in Q4 (for certain band of employees) and Q1 (for the other employees).
- Travel slowed down; should return in Mar/Apr. Q4 to be flattish; expect growth to bounce back in Q1.
- Development centres not growing at anticipated pace due to travel restrictions. This should start kicking in.
- Confident of strong growth in the domestic business.
- Offshore mix to hold at current level for some time.
- Attrition at 22-23%; seeing it flatten during the quarter.
- Impact of Rs35m-40m due to compensation hikes in Q3.
- DSO higher in Q3 on account of holidays; expect it to come down in Q4.
- Domestic DSO to be 32-33 days (34 in Q3).
- Sub-contracting costs were $4.5m in Q3.
- IP-led revenue contribution has come down as other revenues grew faster, driven by acquisitions.
- FY23 fresher hiring to be 20% of total, 40% higher than in FY22.
- Encore revenue was $4.3m-4.4m in Q3.
- Evaluating M&As on an ongoing basis.
- Medium-term EBITDA margin of 23-25% for IT Services
- Expect annual earnings growth of 10-15% in the Domestic business

Q2 FY22

- In Q2 invested in cloud and cyber security side of the practice
- The company continues to see growth in digital business

- Management has decided to continue to invest in senior talent
- Domestic business seeing growth as many Indian companies are doing deals around cloud adoption
- Domestic business has good cash collection and very good RoCE
- Management to continue to invest in sales and marketing
- Organic growth on International services was 5-5.5% in Q2
- Travel client stagnated due to supply-side issues; otherwise outlook good. Europe travel recovering, can reach 100% of FY19 levels in 1-2 quarters, demand is picking up.
- Seeing unified distribution of growth; no one vertical to be driver
- International business subcontracting costs came down this quarter compared to Q1.
- Utilization to be stable at current level for the next 2-3 quarters
- Net addition of 300 people in Q2 (excluding Encore), expect net addition at similar levels ahead. Hiring gross 600 people a quarter for the next few quarters
- Compensation review partially to be done in Q3 and Q4
- Increased recruiting team from 15 to 50
- Domestic business to grow steadily
- International business growth outlook is robust; continues to grow at revenue and PAT level as the company manages supply-side constraints
- Overall, management is seeing robust demand
- Margin to be retained at current levels but needs to be cautious of supply-side challenges; long-term margins to be better

Q1 FY22

- IT Services growth promising on the back of deals won and demand pipeline. Demand is robust, expect 3-4% q/q growth in revenue (international business) ahead.
- Encore has a largeannuity business and ~18%EBITDA margin. Encore revenues consolidated with Sonata from 1stAug; per quarter likely to add $3m revenue and $500,000 in EBITDA approx. in Q2.
- Domestic business 4-5% growth in absolute EBITDA q/q is what the company is targeting.
- EBITDA at 25-26% pre-foreign exchange and other income for its international services.
- Azure offering is currently number one in cloud mixfor Sonata on the domestic side. It is growing fast and is likely to be a growth driver.
- Encore IT gives it delivery operations in Chennai will be helpful to Sonata from diversity and attrition-management perspectives.
- Growth to resume from Q2
- Margins to be maintained at current levels for IT Services.

Factsheet

Fig 22 – Revenue split (IT Services only)

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
ADM	27.1	26.1	25.8	26.6	26.3
Test	9.8	9.9	9.0	7.6	7.8
AX	29.3	29.4	30.1	30.5	30.1
ERP	0.8	0.6	0.3	0.1	0.1
IMS	14.2	15.2	15.8	16.1	16.6
BI	13.1	13.2	13.7	14.0	14.1
E commerce	5.0	5.0	5.0	5.0	5.0
Rezopia	0.7	0.6	0.3	0.0	0.0
Digital	68.0	70.0	72.0	73.0	73.0

Source: Company, Anand Rathi Research

Fig 23 – Revenue-split, by domain (IT Services only)

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
OPD / ISV	32.8	31.3	31.4	32.4	33.2
Travel & Tourism	10.3	9.7	9.4	9.4	9.1
CPG/Retail & Distribution	32.1	31.3	32.2	34.9	34.9
Others	24.8	24.9	24.1	19.7	18.9
Healthcare	0.0	2.8	2.9	3.6	3.9

Source: Company, Anand Rathi Research Note: CPG vertical includes Distribution & Manufacturing, Retail (Essential) and Retail (Non Essential). Others vertical includes Commodity business & Service Industry, Logistics and Others.

Fig 24 – Revenue-split, by region (IT Services only)

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
North America	51.0	53.0	55.0	57.0	57.0
Europe	25.0	24.0	23.0	22.0	21.0
RoW	24.0	23.0	22.0	21.0	22.0

Source: Company, Anand Rathi Research

Fig 25 – Revenue-split, by segment

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
IT services	26	37	21	28	25
Domestic Business	74	63	79	72	75

Source: Company, Anand Rathi Research

Fig 26 – Client profiles (LTM) (IT Services only)

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
Client profiling					
Top 5	58.0	57.0	56.0	54.0	54.0
Top 10	65.0	64.0	63.0	62.0	62.0
Top 20	73.0	72.0	71.0	72.0	72.0
$1m+	31	36	38	37	38
Active Clients	177	214	225	237	247

Source: Company, Anand Rathi Research

Fig 27 – Workforce

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
Employee Movement					
Employees (EoP) - IT Services	4,101	4,693	4,868	4,998	5,034
Employees (EoP)- Domestic	149	157	157	160	174
Net Adds (Qtr)	145	592	175	130	36
Billability (%)	78.0%	80.0%	81.0%	82.0%	82.0%
Attrition % est.	20.0%	24.0%	23.0%	30.0%	24.0%

Source: Company, Anand Rathi Research Note: Attrition is estimated.

Fig 28 – Revenue-split, by delivery location

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
Delivery Type(%)					
On-site	32	31	31	28	26
Offshore	68	69	69	72	74

Source: Company, Anand Rathi Research

Fig 29 – Key segments' growth Y/Y (%)

	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
Domain					
OPD / ISV	19%	19%	13%	18%	21%
Travel & Tourism	214%	23%	22%	17%	13%
CPG/Retail & Distribution	35%	34%	41%	41%	39%
Others	-14%	1%	11%	-3%	-3%
Region					
North America	-3%	32%	38%	42%	43%
Europe	90%	17%	15%	12%	7%
RoW	46%	27%	30%	11%	17%

Source: Company, Anand Rathi Research

Valuations

The stock quotes at 14x FY24e EPS of Rs49. Sonata's IT services FY22 revenue was up 27% (Q1 up 2% q/q, 19% y/y). We expect this division to record a 17% CAGR over FY22-24 despite the Travel division's FY24e revenue at 55% of FY20's. The domestic business would register a 24% CAGR over FY22-24, the focus being only on margins and RoE. ISV and Retail delivered growth in IT services but concerns are emerging regarding the retail sector. Travel recovery for Sonata is much slower than those of larger peers like Mindtree and Coforge. Despite these challenges, consolidated EBIT/PAT are likely to clock 19%/16% CAGRs over FY22-24.

We value the stock on a PE basis as the bulk of profits arises from IT Services. We expect the company to end FY24 with an EPS of Rs49. We expect a 22% revenue CAGR over FY22-24. The IT services' margin should be 20-22% in FY23 and FY24 as management deals with supply-side challenges and increases investments across the board (capability, marketing, etc.).

Sonata is seeing strong growth in its domestic revenue (33% in FY22, 42% in Q1 FY23) and margins (4% EBITDA margin in FY22, 3.3% in Q1 FY23), outstripping competition. Notably, working capital has come down steeply and RoEs have shot up, leading to a case of a higher multiple to the domestic business, while taking a sum-of-parts approach to the two businesses.

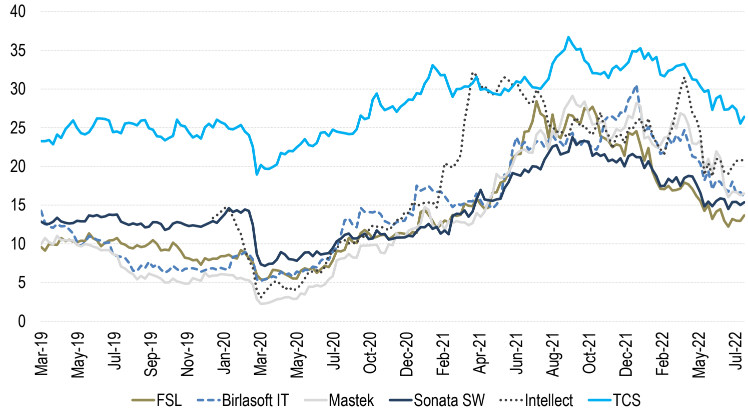
We value the company at a consolidated target PE of 18x FY24e, which implies 20x PE for IT Services (on a sum-of-parts basis).

Fig 30 – Change in estimates (Rs m)

(Rs m)	FY23			FY24		
	New	Old	% Change	New	Old	% Change
Revenue ($ m)	931	932	(0.0)	1,121	1,124	(0.3)
Revenues - IT ($ m)	239	241	(0.9)	276	282	(2.1)
Revenues	72,456	71,870	0.8	87,514	86,710	0.9
EBITDA	5,929	6,139	(3.4)	6,853	7,002	(2.1)
EBITDA margins %	8.2%	8.5%	-36 bps	7.8%	8.1%	-24 bps
EBIT	5,395	5,589	(3.5)	6,275	6,407	(2.1)
EBIT margins %	7.4%	7.8%	-33 bps	7.2%	7.4%	-22 bps
PBT	5,928	6,041	(1.9)	6,847	6,934	(1.2)
Net profit	4,413	4,531	(2.6)	5,101	5,200	(1.9)

Source: Anand Rathi Research

Fig 31– PE band



Source: Bloomberg, Anand Rathi Research

Risk

- Supply-side challenges.

Appendix

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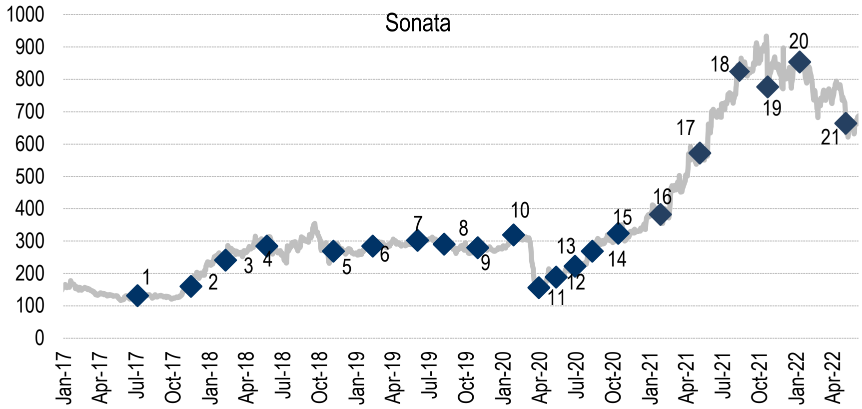

	Date	Rating	TP (Rs)	Share Price (Rs)
6	11-Feb-19	Buy	400	310
7	1-Jun-19	Hold	400	355
8	8-Aug-19	Buy	390	315
9	31-Oct-19	Buy	380	315
10	28-Jan-20	Hold	390	349
11	31-Mar-20	Buy	250	164
12	13-May-20	Buy	230	197
13	29-Jun-20	Hold	270	226
14	11-Aug-20	Buy	330	283
15	15-Oct-20	Buy	410	357
16	7-Feb-21	Buy	500	406
17	14-May-21	Hold	680	588
18	6-Aug-21	Hold	860	813
19	20-Oct-22	Buy	1,070	920
20	19-Jan-22	Buy	1,050	862
21	9-May-22	Buy	1,020	660

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