

August 1, 2024

Near term challenges; long term outlook intact...

About the stock: Sonata Software (Sonata) provides IT services and product licensing services to its clients in BFSI, HLS (Healthcare & Lifesciences), RMD (Retail, Manufacturing, Travel & Distribution & TMT) segments.

Q1FY25 Performance: Revenue for International IT services (IITS) in Q1FY25 came at US\$ 82.7 mn, up 1.3% QoQ/6.9% YoY (up 1.4% QoQ/7.5% YoY in CC terms) while EBITDA came at ₹128.8 crore, up 9.5%QoQ, with an EBITDA margin of 18.7%, up ~147 bps QoQ. At the company level, revenue was ₹2,527.4 crore up 15.3% QoQ and 25.4% YoY. EBITDA came at ₹176.2 crore, up 22.2% QoQ with an EBITDA margin of 6.9%, up 39 bps QoQ while PAT (before exceptional items) stood at ₹105.6 crore.

Investment Rationale:

- Positive long-term growth outlook:** The company expects Q2 to be stronger than Q1, with accelerated growth momentum anticipated from H2FY25. The management remains confident in achieving their \$1.5bn target, albeit delayed by 2-4 quarters post FY26. The IITS pipeline is healthy, supported by 3 large deals won across Healthcare, Manufacturing, and BFSI. Long-term growth is driven by AI, large deal traction & key client contributions. We expect IT services to grow at a 12.8% CAGR over FY24-26E in dollar terms with ~8.9% growth in FY25.
- Near-term challenges; Margin recovery likely in FY26:** The management highlighted that it would continue to face headwinds from delayed decision making, project completions in UK/Europe & softness in retail & manufacturing as well as a large deal won in healthcare which would be margin dilutive over the next 2-3 quarters due to the onsite model & upfront AI investment made. Further, the margins in Q2/Q3 are expected to be impacted by wage hikes. Nonetheless, IITS margins are likely to recover by FY26 to the normalised mid-20s levels vs. low 20s likely in FY25.
- Large deal wins, pipeline & client additions continue to sustain momentum:** Sonata faced some challenges in terms of delayed conversion of pipeline. However, it sustained its growth momentum with 3 large deals and 14 new clients. Another 49 large deals are under pursuit with 47% of active pipeline consisting of large deals. With a strong large deal pipeline, the company is poised for growth in the future with execution being key.

Rating and Target Price

- Sonata's long term growth momentum hinges on its large deal wins, robust pipeline, and advancements in AI. We maintain a positive outlook on the company, factoring in the near-term margin challenges and ongoing growth initiatives
- We maintain a BUY rating, valuing it at a target price of ₹ 770, with a higher multiple of 28x P/E on FY26E EPS compared to the previous 25x.

Key Financial Summary

(₹ Crore)	FY22	FY23	FY24	5 year CAGR (FY19-24)	FY25E	FY26E	2 year CAGR (FY24-26E)
Net Sales	5,553	7,449	8,613	23.8%	9,905	11,375	14.9%
EBITDA	464	604	727	3.5%	837	1,112	23.6%
EBITDA Margin (%)	8.4	8.1	8.4		8.4	9.8	
PAT	376	452	308		528	760	
Adjusted PAT	376	452	483	14.4%	528	760	25.4%
EPS (Rs.)	27.2	32.6	11.1		19.0	27.3	
P/E (x)	24	20	38		35	24	
RoNW (%)	34.2	34.7	21.9		31.0	34.6	
RoCE (%)	39.8	25.9	31.4		29.6	34.2	

Source: Company, ICICI Direct Research



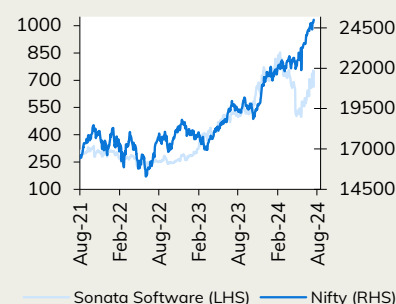
Particulars

Particulars	Amount
Market Cap (₹ Crore)	18,458
Total Debt (₹ Crore)	674
Cash and Invt (₹ Crore)	1,097
EV (₹ Crore)	18,035
52 week H/L	870 / 469
Equity capital (₹ Crore)	27.8
Face value	1.0

Shareholding pattern

	Jun-23	Sep-23	Dec-23	Mar-24
Promoters	28.2	28.2	28.2	28.2
FII	13.6	15.0	14.5	13.9
DII	14.3	16.4	17.6	17.6
Other	43.9	40.5	39.8	40.3

Price Chart



Key risks

- Lower than expected revenue and margin growth;
- Continued delay in deal closure

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Performance highlights and outlook

- Revenue Performance:** Revenue for IITS in Q1FY25 came at US\$ 82.7 mn, up 1.3%QoQ/6.9%YoY (up 1.4% QoQ/7.5% YoY in CC terms) while in rupee terms the IITS revenue stood at ₹687.8 crore, up 1.3% QoQ. At the company level, overall revenue was ₹2,527.4 crore, up 15.3% QoQ and 25.4% YoY.
- Margin Performance:** IITS reported an EBITDA of ₹128.8 crore, up 9.5%QoQ, with an EBITDA margin of 18.7%, up ~147 bps QoQ while at company level it reported EBITDA of ₹ 176.2 crore, up 22.2% QoQ with EBITDA margin of 6.9% and PAT before exceptional items of ₹ 105.6 crore with PAT margin of 4.2%, down 80 bps QoQ.
- Geography Performance:** Geography wise on a QoQ basis the growth was led by USA (72% of the mix) which grew by 4.1% while Europe (13% of the mix) & ROW (15% of the mix) declined by 6% and 5.1% respectively.
- Segmental Performance and Outlook:** Segment wise growth was led by BFSI (16% of the mix), TMT (36% of the mix) & Emerging (4% of the mix) which grew by 15.68%, 1.22%, and 1.22% respectively while Healthcare (10% of the mix) and Retail & Manufacturing (34% of the mix) declined by 15.65% and 1.67% QoQ respectively.
 - BFSI:** The company is seeing green shoots in the discretionary spend in small to mid-sized projects in BFSI segment, especially in banking.
 - Healthcare:** The large deal won in the segment is a 7-year AI model driven deal for the company, wherein they will modernize the healthcare company's technology infrastructure. It is expected to be margin dilutive in the short term (2-3 quarters) because of the onsite model and the upfront AI investment made for the project. Management stated that, this deal is important for the company moving ahead as it is one of the largest deals of the recent times.
 - Other verticals:** The Hi-Tech and TMT segments are seeing an uptick as well. However, Retail would continue to be soft for 2-3 quarters.
- Revenue and Margin Outlook:** The company expects Q2 to be stronger than Q1, with accelerated growth momentum anticipated from H2FY25. The management remains confident in achieving their \$1.5bn target, albeit delayed by 2-4 quarters post FY26. The IITS pipeline is healthy, supported by 3 large deals won across Healthcare, Manufacturing, and BFSI. Long-term growth is driven by AI, large deal traction & key client contributions, with margins expected to normalize by FY26 after initially remaining in low 20s due to investments in large deals & AI projects. Further, the margins in Q2/Q3 are expected to be impacted by wage hikes.
- GenAI/AI:** Management reiterated that **20% of the revenue is expected to come from AI services in the next three years**. Approximately, **67% of their employees are GenAI level 1 trained**. Further, the company's **Harmoni.AI** has deployed 40 programs and is pursuing a large deal with a tech behemoth. They have also partnered with an AI cross functional organisation to drive AI across Sonata and partner with CTO and sales organisation to accelerate their go to market strategy and research.
- Microsoft Fabric:** Sonata is an integral part of Microsoft Fabric, a data analytics platform launched in November 2023, with a 46 mn pipeline across 80+ clients and a team of 450+ Microsoft certified Azure data professionals and 150+ DP 600 certified professionals. Sonata **won 5 mid-size deals in the quarter, through their Microsoft dynamics**.
- Deal Wins and Pipeline:** During the quarter, the company won 3 large deals in Healthcare, Manufacturing and BFSI and is pursuing to win another 49 large deals, with 22 in Retail & manufacturing, 12 in Healthcare, 11 in TMT and 4 in BFSI.

- **Client mix:** Sonata's top 10 clients (50% of mix) further de-grew by 7.8% YoY & top 20 clients (60% of mix) de-grew by 7% YoY. Further, Sonata added 14 new clients during the quarter.
- **Attrition rate:** The company has added net 203 employees (including 150 campus hires) for the quarter, taking the total headcount to 6,619 employees.

Exhibit 1: Quarter Performance

	Q1FY25	Q1FY24	YoY (%)	Q4FY24	QoQ (%)	Comments
Revenue	2,527	2,016	25.4	2,192	15.3	IT services reported 1.4% QoQ CC growth while rupee revenues were up by 1.3% QoQ while Domestic Products business grew by 22% QoQ
Employee expenses	369	326	13.2	331	11.5	
Purchase of stock-in trade	1,787	1,361	31.3	1,487	20.2	
Gross Margin	371	329	12.9	374	(0.7)	
Gross margin (%)	14.7	16.3	-163 bps	17.0	-237 bps	
Other expenses	195	150	29.5	229	(15.1)	
EBITDA	176	178	(1.2)	144	22.2	
EBITDA Margin (%)	7.0	8.8	-187 bps	6.6	39 bps	EBITDA margins for IT services declined ~147 bps QoQ to 18.7% impacted by increase in onsite mix and investment in AI (Healthcare large deal).
Depreciation & amortisation	33	31	6.6	34	(1.2)	
EBIT	143	147	(2.8)	110	29.4	
EBIT Margin (%)	5.7	7.3	-164 bps	5.0	61 bps	
Other income (less interest)	(1)	7	(115.8)	33	(103.5)	
PBT	142	154	(8.2)	144	(1.3)	
Tax paid	36	34	5.4	33	8.7	
PAT	106	120	(12.1)	110	(4.3)	

Source: Company, ICICI Direct Research

Financial Summary

Exhibit 2: Profit and loss statement					₹ crore
(Year-end March)	FY23	FY24	FY25E	FY26E	
Total Revenues	7,449	8,613	9,905	11,375	
Growth (%)	34.1	15.6	15.0	14.8	
Total Op Expenditure	6,845	7,886	9,069	10,263	
EBITDA	604	727	837	1,112	
Growth (%)	30.3	20.4	15.0	32.9	
Depr & Amortization	59	132	138	148	
Other Income	71	126	69	94	
Interest costs	19	85	74	58	
PBT before Excep Items	597	636	694	1,000	
Growth (%)	19.4	6.5	9.1	44.2	
Tax	145	153	166	240	
PAT before Excep Items	452	483	528	760	
Exceptional items	-	(175)	-	-	
PAT before MI	452	308	528	760	
Minority Int & Pft. from associ	-	-	-	-	
PAT	452	308	528	760	
Growth (%)	20	(32)	71	44	
EPS	32.6	11.1	19.0	27.3	
EPS (Growth %)	20	(66)	71	44	

Source: Company, ICICI Direct Research

Exhibit 3: Cash flow statement					₹ crore
(Year-end March)	FY23	FY24	FY25E	FY26E	
Net profit before Tax	597	461	694	1,000	
Depreciation & Amortization	59	132	138	148	
WC changes	(177)	(209)	86	97	
Other non cash adju.	(36)	159	5	(36)	
Income taxes paid	(175)	(262)	(166)	(240)	
CF from Operations	268	281	756	969	
Capital expenditure	(41)	0	(35)	(40)	
Δ in investments	(852)	(88)	-	-	
Other investing cash flow	38	33	69	94	
CF from Investing Activities	(855)	(54)	34	55	
Issue of equity	-	14	-	-	
Δ in debt funds/lease liabilities	421	139	(24)	(24)	
Dividends paid	(232)	(215)	(230)	(266)	
Other financing cash flow	(2)	(46)	(74)	(58)	
CF from Financial Activities	187	(109)	(328)	(348)	
Δ in cash & cash bank balance	(400)	118	462	676	
Effect of exchange rate change:	(4)	1	-	-	
Opening cash	734	417	865	1,327	
Closing cash	730	865	1,327	2,003	

Source: Company, ICICI Direct Research

Exhibit 4: Balance Sheet					₹ crore
(Year-end March)	FY23	FY24	FY25E	FY26E	
Equity	14	28	28	28	
Reserves & Surplus	1,287	1,379	1,676	2,170	
Networth	1,301	1,406	1,704	2,198	
Minority Interest	-	-	-	-	
LT liabilities & provisions	588	219	219	219	
Total Debt	494	674	674	674	
Source of funds	2,382	2,299	2,597	3,091	
Assets					
Net fixed assets	635	558	478	394	
Goodwill	1,098	1,113	1,113	1,113	
Long term loans	-	-	-	-	
Other non current assets	209	403	448	499	
Loans and advances	-	-	-	-	
Inventories	29	98	113	129	
Current Investments	206	232	232	232	
Debtors	1,236	1,605	1,846	2,120	
Cash & Cash equivalents	730	865	1,327	2,003	
Other current assets	214	275	317	364	
Current liabilities	1,944	2,813	3,235	3,715	
Provisions	31	37	43	49	
Net current assets	440	226	557	1,084	
Application of funds	2,382	2,299	2,597	3,091	

Source: Company, ICICI Direct Research

Exhibit 5: Key ratios				
(Year-end March)	FY23	FY24	FY25E	FY26E
Per share data (₹)				
EPS-diluted	32.6	11.1	19.0	27.3
Cash per share	52.6	31.1	47.7	72.1
BV	93.7	50.6	61.3	79.1
DPS	15.8	7.9	8.3	9.6
Operating Ratios (%)				
EBITDA Margin	8.1	8.4	8.4	9.8
Adjusted PBT Margin	8.0	7.4	7.0	8.8
Adjusted PAT Margin	6.1	3.6	5.3	6.7
Return Ratios (%)				
RoNW	34.7	21.9	31.0	34.6
RoCE	25.9	31.4	29.6	34.2
RoIC	37.7	49.5	67.4	112.6
Valuation Ratios (x)				
P/E	20.4	38.2	35.0	24.3
EV / EBITDA	29.8	24.8	21.0	15.2
Price to Book Value	7.1	13.1	10.8	8.4
EV/Total Revenues	2.4	2.1	1.8	1.5
MCap/Total Revenues	2.5	2.1	1.9	1.6
Turnover Ratios				
Debtor days	61	68	68	68
Creditors days	63	60	60	60
Solvency Ratios				
Debt/EBITDA	0.8	0.9	0.8	0.6
Total Debt / Equity	0.4	0.5	0.4	0.3
Current Ratio	1.2	1.1	1.2	1.3
Quick Ratio	1.2	1.0	1.1	1.3
Debt / EBITDA	0.8	0.9	0.8	0.6

Source: Company, ICICI Direct Research

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Sell: <-15%



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