

Aiming to reach, half a billion-dollar IT services revenues by FY26/27, acquires Quant systems

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%)

Key Highlights:

- Sonata's wholly owned US subsidiary signed a definitive agreement to acquire 100% stake in US based Quant Systems (QS) for total consideration of US\$ 160 mn (4.3x sales), US\$65 mn to be paid upfront while rest US\$95mn to be paid in next 2 years based on certain milestones.
- The acquisition is in line with Sonata's strategy to accelerate IT services growth from hereon as well as strengthening its offering in BFSI and Healthcare vertical
- Quant Systems's revenue grew 4x in last 2 years and growth going forward is also expected to be strong. EBITDA margins for the company are also healthy i.e., upwards of 30%.

What should investors do? Sonata's share price has grown by ~3x over the past five years (from ~₹ 238 in February 2018 to ~₹ 706 levels in February 2023).

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

Target Price and Valuation: We value Sonata at ₹ 835 i.e., 18x P/E on FY25E EPS.

Key triggers for future price performance:

- Acquisition of QS will strengthen Sonata offering in BFSI and Healthcare & Life science verticals which will aid the revenue growth of company
- It will also help in commanding better pricing as Quant Systems led data analytics, data engineering is already commanding premium billing rates
- Winning large deals and strong digital spending by the clients prompt us to build IT service dollar revenue growth of over 23.8% 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 ₹ 1,730



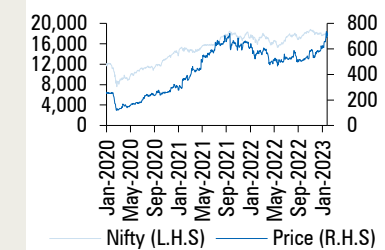
Particulars

Particular	Amount
Market Capitalization (₹ Crore)	9,785.7
Total Debt(₹ Crore)	38.0
Cash and Investments (₹ Crore)	914.4
EV (₹ Crore)	8,909.3
52 week H/L	753 / 458
Equity capital	13.9
Face value	1.0

Shareholding pattern

	Mar-22	Jun-22	Sep-22	Dec-22
Promoters	28	28	28	28
FII	14	13	13	13
DII	15	15	13	14
Public	43	44	46	45

Price Chart (Adj. Bonus issue)



Recent event & key risks

- Acquired Quant Systems for total consideration of US\$ 160 mn
- Key Risk:** (i) Lower-than-expected revenue growth (ii) Lower than expected margins

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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%	7,146	8,336	9,311	18.8%
EBITDA	379	464	19.3%	613	798	951	27.1%
EBITDA Margin (%)	9.0	8.4		8.6	9.6	10.2	
PAT	244	376	19.1%	443	544	655	20.3%
EPS (₹)	23.5	27.2		31.6	38.8	46.7	
P/E (x)	30	26		22	18	15	
RoNW (%)	26.9	34.2		34.7	36.4	37.3	
RoCE (%)	33.5	39.8		40.6	46.5	47.7	

Source: Company, ICICI Direct Research

Rationale of Acquisition & conference call highlights

- New CEO in Q3FY23 earnings call had indicated that they are looking to double IT services revenue growth in next 3-4 years and key levers for the same are:
 - 1) Winning large deals & large accounts;
 - 2) Continue expanding services portfolio and develop a strong partner ecosystem to guide modernization outcomes,
 - 3) Strengthen its presence in BFSI and Healthcare & Life science verticals
- **Acquisition & about the company:** In line with these strategic levers, Sonata announced that Sonata Software North America (wholly owned subsidiary) of the company signed definitive agreement to purchase Quant systems (QS), Texas US based IT service corporation. The total consideration for the same would be US\$ 160 mn (4.3x of CY22 Revenue), out of which US\$ 65 mn will be paid upfront & US\$ 95 mn will be deferred achievement-based payout over the next 2 years. The company also mentioned that there could be some additional payments over this US\$160mn which would be given achieving additional targets (unquantified). Sonata also indicated that the acquisition will be completed in 30 days subject to closing conditions,
- QS founded in 2008 was started as a consulting company. In the initial years QS focused on doing small projects on consulting in the range of US\$100-150K & in the last 4-5 years it scaled its operations by doing downstream operations like data engineering, data transfer & data modernization to cloud. QS over last few years has also built its capabilities across Enterprise Data Analytics, cloud modernization, cyber security, salesforce, AWS, Data privacy, Adobe, Snowflake and digital mobile apps. QS has also built differentiated IP's for Salesforce (Workbox.io) & Chabot (Lisa) technologies,
- QS has domain expertise & marquee clients across the verticals of BFSI, Healthcare & Lifesciences, consumer and retail. QS has over 300 employees across its delivery centres in USA, India & Costa Rica, the company mentioned that out 300 employees ~125 are onsite employees,
- QS reported >100% CAGR revenue growth in CY20-22 reaching US\$37mn in CY22. The company indicated that EBITDA margin for the QS is upwards of 30%. Sonata indicated that for CY23 & CY24 QS's revenue is expected to grow by 30-35% and EBITDA margin is expected to be in range of 30-35%,
- The company indicated that strong growth for QS in last 2 years as well as higher revenue per employee could be attributed to data analytics, data engineering, data privacy work projects which they have started recently as it commands a premium billing rate. Sonata also indicated that lower end of the billing rates for QS on-site employees are even higher than highest billing rate currently being given to Sonata onsite employees,
- QS will enable Sonata's key strategic driver to win large deals & it will also strengthen its presence in BFSI and healthcare verticals,
- With this acquisition Sonata has gained 2 of the Top 5 clients from day 1 (1 each from BFSI and Healthcare vertical) while also indicating that both the accounts have annual digital spend of US\$ 1+bn each,
- The acquisition will also help Sonata to strengthen its technical capabilities in enterprise data analytics, cloud modernization, cyber security, salesforce & data privacy. Sonata also mentioned that the acquisition will help to build its partnership with Salesforce, Snowflake & multiple data partners,
- QS's Lisachatbot will broaden Sonata's platformation strategy by enabling omnichannel experience integrating enterprise systems, contact centre and support system solutions while the Workbox IP will help to expand digital document management for banking & healthcare clients,
- Sonata indicated that it doesn't see major overlapping business in BFSI & Healthcare verticals after the acquisition and the acquisition will provide cross-sell opportunities to the clients of Sonata & QS. Sonata further

indicated in cross-sell opportunity it can take its capability in automation & platformation to QS's clients & QS's capability in enterprise data & data privacy to Sonata's clients,

- Sonata mentioned that data platform & data services are multi-year contracts & with QS expertise in data & analytics Sonata can built a strong pipeline of annuity contracts which could reduce the volatility impact of its platformation business,
- **Funding & Future M&A plans:** Sonata mentioned that the upfront payment of US\$ 65 mn will be paid by availing a short-term loan which will be repaid in next 12-15 months. The company indicated despite having cash on the books, it has opted for short term debt due to operational issues related to approval from RBI to transfer the funds to US subsidiary. However, the company is confident that this issue is likely resolve in the time period mentioned and the company will repay the debt. The company also indicated that they expect both Sonata and QS will continue to generate strong cash flow in the future and will take care of the deferred payment to be paid,
- On the future dividend policy, the company mentioned that going forward the company is likely to maintain dividend in absolute amount but the dividend pay-out % is likely to moderate,
- On future M&A strategy, the company mentioned that they will continue to look assets but for the time being, they will focus on integration of QS

Exhibit 1: Change in estimates

(₹ Crore)	FY23E			FY24E			FY25E			Comments
	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	7,146	7,146	0.0	7,994	8,336	4.3	8,834	9,311	5.4	Numbers incorporating Quant acquisition and revenue growth guidance for next 4 years
EBITDA	613	613	0.0	656	798	21.8	785	951	21.2	
EBITDA Margin (%)	8.6	8.6	0 bps	8.2	9.6	138 bps	8.9	10.2	133 bps	Margins are likely see upward trajectory as Quant margins are higher then Sonata margins
PAT	438	443	1.3	475	544	14.6	567	655	15.6	
EPS (₹)	31.2	31.6	1.3	33.9	38.8	14.6	40.4	46.7	15.6	

Source: Company, ICICI Direct Research

Financial summary

Exhibit 2: Profit and loss statement					₹ crore
(Year-end March)	FY22	FY23E	FY24E	FY25E	
Total Revenues	5,553	7,146	8,336	9,311	
Growth (%)	31.3	28.7	16.6	11.7	
Total Operating Expenditure	5,090	6,534	7,538	8,360	
EBITDA	464	613	798	951	
Growth (%)	22.2	32.1	30.3	19.1	
Depreciation & Amortization	47	57	67	74	
Other Income	102	46	58	58	
Interest costs	18	18	66	73	
PBT before Exceptional Items	500	583	723	862	
Growth (%)	42.1	16.6	24.0	19.1	
Tax	124	140	179	207	
PAT before Exceptional Items	376	443	544	655	
Exceptional items	-	-	-	-	
PAT before MI	376	443	544	655	
Minority Int & Pft. from associate	-	-	-	-	
PAT	376	443	544	655	
Growth (%)	54	18	23	20	
EPS	27.2	31.6	38.8	46.7	
EPS (Growth %)	16	16	23	20	

Source: Company, ICICI Direct Research

Exhibit 3: Cash flow statement					₹ crore
(Year-end March)	FY22	FY23E	FY24E	FY25E	
Net profit before Tax	500	583	723	862	
Depreciation & Amortization	47	57	67	74	
WC changes	100	(81)	(0)	(0)	
Other non cash adju.	(6)	(28)	8	15	
Income taxes paid	(156)	(140)	(179)	(207)	
CF from operations	486	392	619	744	
Capital expenditure	(10)	(25)	(29)	(33)	
Δ in investments	(126)	-	-	-	
Other investing cash flow	17	46	58	58	
CF from investing Activities	(119)	21	29	25	
Issue of equity	-	-	-	-	
Δ in debt funds/lease liabilities	(81)	(24)	(24)	(24)	
Dividends paid	(187)	(266)	(326)	(393)	
Other financing cash flow	(3)	(18)	(66)	(73)	
CF from Financial Activities	(271)	(308)	(416)	(489)	
Δ in cash and cash bank balance	96	105	231	280	
Effect of exchange rate changes	(3)	-	-	-	
Opening cash	677	770	875	1,105	
Closing cash	770	875	1,105	1,385	

Source: Company, ICICI Direct Research

Exhibit 4: Balance sheet					₹ crore
(Year-end March)	FY22	FY23E	FY24E	FY25E	
Equity	10	14	14	14	
Reserves & Surplus	1,089	1,263	1,480	1,742	
Networth	1,099	1,277	1,494	1,756	
Minority Interest	-	-	-	-	
LT liabilities & provisions	166	166	166	166	
Total Debt	38	38	38	38	
Source of funds	1,303	1,481	1,698	1,960	
Net fixed assets	206	198	184	166	
Goodwill	221	221	221	221	
Long term loans and advances	-	-	-	-	
Other non current assets	188	250	285	314	
Loans and advances	-	-	-	-	
Inventories	-	-	-	-	
Current Investments	145	145	145	145	
Debtors	893	1,041	1,214	1,356	
Cash & Cash equivalents	770	875	1,105	1,385	
Other current assets	133	187	219	244	
Current liabilities	1,223	1,390	1,622	1,811	
Provisions	29	46	54	60	
Net current assets	688	811	1,008	1,259	
Application of funds	1,303	1,481	1,698	1,960	

Source: Company, ICICI Direct Research

Exhibit 5: Key ratios					₹ crore
(Year-end March)	FY22	FY23E	FY24E	FY25E	
Per share data (₹)					
EPS-diluted	27.2	31.6	38.8	46.7	
Cash per share	55.5	62.4	78.8	98.8	
BV	79.3	91.0	106.6	125.2	
DPS	16.3	19.0	23.3	28.0	
Operating Ratios (%)					
EBITDA Margin	8.4	8.6	9.6	10.2	
Adjusted PBT Margin	9.0	8.2	8.7	9.3	
Adjusted PAT Margin	6.8	6.2	6.5	7.0	
Return Ratios (%)					
RoNW	34.2	34.7	36.4	37.3	
RoCE	39.8	40.6	46.5	47.7	
RoIC	107.1	120.5	163.3	203.7	
Valuation Ratios (x)					
P/E	26.0	22.3	18.2	15.1	
EV / EBITDA	19.2	14.4	10.7	8.7	
Price to Book Value	8.9	7.8	6.6	5.6	
EV/Total Revenues	1.6	1.2	1.0	0.9	
MCap/Total Revenues	1.8	1.4	1.2	1.1	
Turnover Ratios					
Debtor days	59	53	53	53	
Creditors days	69	56	56	56	
Solvency Ratios					
Debt/EBITDA	0.1	0.1	0.0	0.0	
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	0.0	0.0	

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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