"Sonata Software Limited Q4 FY18 Earnings Conference Call"

May 23, 2018

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Moderator: Good day, ladies and gentlemen, and a very warm welcome to Sonata Software Limited Q4 FY'18 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing "*" followed by "0" on your touchtone phone. Please note that this conference is being recorded. I am now glad to hand the conference over to Mr. Srikar Reddy from Sonata Software Limited. Thank you and over to you, Mr. Reddy.

P. Srikar Reddy: Thank you, Ali and Good Evening, Everybody and Welcome to the Analyst Call post the announcement of our results for the fourth quarter financial year '18, also it happens to be the last quarter. So our 'Results' are up on our website including the 'Analyst Deck.'

I have on the call with me on the call today, Prasanna, who is our CFO; Vikas -- Chief Operating Officer; Ranga – Chief Growth Officer and President of IBIS who is actually joining us from the US; Raju who is the Chief Delivery Officer and Sujit who heads our India business apart from Sathya who heads Finance and Kundan, the Company Secretary.

So considering it is also the overall results for the year, I thought I will quickly Sum Up the Year that went past in terms of Qualitatively before I hand over to Prasanna to take you through some of the Quantitative Details and then we will open it up for Questions-and-Answers. I think we also had the analyst briefing meeting in Bangalore, I think where we showcased our IP and the overall strategy of the company, which was really driven by what we did i.e., "Three Growth Engines" which is our Existing Customers, our Alliance-led growth Strategy and our IP-led Growth Strategy. We also formally launched our Platformation concept for digital transformation last year, the mainstream activity in terms of actually taking it to market and I did mention in my last call that we are seeing very good response to the concept of doing digital transformation by supplying platform-based business model.

Quickly, summing up the results for Q4, although the top-line, the International Services business appears a bit flat but like I mentioned in some of my earlier calls, in Q3, we did have the additional $1 million of what we call the SI or hardware sales. If we take it out, on the services business, we have had about 3-3.5% quarter growth in terms of dollar terms. We have also seen good margin improvement coming out of better operational efficiency and also higher offshore/onsite mix which has led to better operational efficiencies and better margins. So going forward, our theme is to continue to focus on being the Platformation partner for our clients, take new end partners and all our strategy going to be to ensure that we execute well on this strategy.

I will hand over to Prasanna to take you through some of the Quantitative Highlights and then we will open it up for Q&A.

Prasanna Oke: Srikar, thanks a lot and a warm welcome to all of you. Just to let you know our 'Results' have been posted on our website and this was yesterday. Our 'Investor Deck' is also up on the website.

Some key highlights of quarter gone by and we are also going to look at the full year. So on a consolidated basis for Q4, our revenue stood at Rs.626 crores, EBITDA at Rs.75.4 crores, overall PAT was Rs.54.8 crores with the sequential growth of about 11% and growth of 53% YoY basis.

For the full year, the revenue stood at Rs.2454 crores with the PAT of Rs.192.5 crores, that is the 23% growth YoY basis.

Looking at two segments and the way we have reported every time. For Q4, the INR revenues for International Services stood at Rs.241.8 crores. As Srikar mentioned once you adjust for the one-time pass-through, our sequential quarter growth was 3.2% in INR terms, USD revenues at about 2.7% in dollar terms. Revenue from Digital component which we have been measuring, is at 33%, one-third of our revenues coming from Digital side. IP-led revenues which we give this as a percentage, we have been doing this for the last four quarters, this had 15.6%, up from about 15% from the last two quarters. Overall EBITDA at 24.7%.

During the quarter we added about 12 new customers, four coming in from the US, four coming in from Europe and four from Asia and rest of the world.

For the full year, our revenues were Rs.928.4 crores, INR growth of about 13% and 18% in dollar terms for our International business, PAT at Rs.157 crores, growth of 28% YoY.

Looking at the Domestic Products and Services, our PAT for this quarter was Rs.9.7 crores, QoQ growth of 6%, YoY growth of 13% and for the full year PAT at Rs.35.8 crores, 6% growth YoY. Overall, our cash in hand is roughly about Rs.509 crores. Our DSOs remain in the range of about 40-days by International business and about 67-days for the Domestic business. So operationally this has been a good quarter for us. That is on the financial highlights.

I will hand it back to Ali to open up the floor for questions.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the Question-and-Answer Session. We will take the first question from the line of Mohit Jain from Anand Rathi. Please go ahead.

Mohit Jain: One is on the margins. Q3 Vs Q4 your margin should have gone up in IT Services purely because of higher offshore component which has not happened. So is there a one-time cost which is there in this quarter?

Prasanna Oke: If you look at the EBITDA, it is about 24.7% and EBITDA after removing FOREX and Other Income is about 20.8%. So we have grown by about 0.7% on the EBITDA excluding these 2 impacts.

Mohit Jain: But your offshore has gone up by 400 basis points, right?

Prasanna Oke: Our onsite/offshore mix, yes, they changed from 55 to 59%.

Mohit Jain: You are saying there is no one-time cost so to say, at the current offshore level this is the margin?

Prasanna Oke: Yes, Mohit, part of this increase in the overall has been on account of change in the mix.

Mohit Jain: Second thing is it looks like you have less number of active clients in this quarter versus last quarter?

Prasanna Oke: What we are trying to do is we look at clients who are generating more than 100k of revenues for us. I think what is happening is that even as we are getting new clients, what we are measuring and reporting is the active number of clients, but we had I think 99 clients this time, that's done exactly on any clients offering more than 100k of annualized revenues.

Mohit Jain: So going forward this exercise is done or should we expect some more?

Prasanna Oke: No-no, this is ongoing exercise, so as we will see some of the new clients which are starting to get revenues and getting into more than 100k of revenues, you will see that change of the clients moving up from 100 plus.

Mohit Jain: But for our kind of revenue aspiration of 15% to 20%, do you not think number of clients necessarily needs to go up by that percentage?

P. Srikar Reddy: No-no, number of clients need to go up but I think what he is saying is the number of clients have gone up, but I think he is saying that the number of clients who are more than 100k or whatever it is, that is what he is measuring and not the absolute number of clients. If we get clients who you bill like let us say $50,000 last quarter for whatever reasons, they are not coming into this list is what he is saying.

Mohit Jain: They are still active clients, but you are not counting it in your operating?

P. Srikar Reddy: Yes, they have been acquired but not been counted, that is correct.

Mohit Jain: So our calculation of revenue per client will go wrong, right, because there is no way you know that?

P. Srikar Reddy: I think we will correct it. We will report total number of clients vis-à-vis 100k clients. Your point is valid, absolutely, we agree with you.

Mohit Jain: The top-10 revenues were down this quarter. So anything happening there? What is the outlook for '19?

Prasanna Oke: Mohit, it has moved from 70% to 69%, so obviously we are seeing that small shift in our clients is not that our larger clients are not growing, or our top clients are not growing, we always find

1% kind of a shift as you have some new clients picking up some revenues but no, we do not see any issues there.

Mohit Jain: Absolute number wise, you still see growth in FY'19 Vs '18 on top-10 client basis?

P. Srikar Reddy: Yes, that is the plan, yes, that is correct.

Mohit Jain: Any outlook for next year that you can share?

P. Srikar Reddy: We do not give quantitative forward-looking statements. I think all our strategies are working in terms of our IP-led Platformation as a concept has been seeing good traction and our alliance-led strategy is working well in terms of acquisition of new customers. So qualitatively we earned traction pipeline and opportunities that we are working, which is growing. So qualitatively I feel positive about the next year.

Mohit Jain: Now currency moving to 67, 68, the margin wise…?

P. Srikar Reddy: I think the margins will go up without FOREX but with FOREX I am assuming they will be there or thereabout, that is where I keep saying please look at the margins holistically, because we have margins on the top-line but we will have FOREX, no gains or losses or something for us in the short-term, so because of the dollar and the covers of the past. I think with FOREX, my feeling is at least in the first two quarters, I will not see too much growth in margin but Q3 and Q4 is where we will expect to see better margins because of FOREX.

Mohit Jain: So you are saying no growth in margin at PBT level because EBITDA margin expansion will happen in Q1, right?

P. Srikar Reddy: So with FOREX, I would not see any margin improvement, Mohit, because we will not have the gain because our dollar maybe at about 66.50 or something like that for the first one or two quarters.

Mohit Jain: There is no plan for incremental investment, right, so whatever comes through in the form of better currency that you will pass on to PBT level?

P. Srikar Reddy: Our proportion of investments in non-direct operating cost will not be in the same trajectory. So to that extent, the margins on account of additional cost should not be a problem, but direct cost in terms of people associated with revenue should be proportionate but the non-direct cost will not be in the same proportion.

Mohit Jain: Sir, on the pricing side, like your revenue per employee is going up quite fast in the IT division. Any outlook there like pricing is going up? Even offshore and the blended pricing is looking up?

Prasanna Oke: Two, three things which are happening; one, we are looking at revenue growth versus our headcount growth, headcount growth is not as much, so the realization is better, IT-led growth is more, so we are realizing more and some component of IT also, so that helps on average person.

Mohit Jain: That should continue in '19 also, right or is there a change?

P. Srikar Reddy: Very tough to predict. Obviously, it is based on our revenue mix and it is changing to do more higher value but will not make any affirmative statement on this at this point in time, Mohit.

Moderator: Thank you. We will take the next question from the line of Sachin Kasera from Lucky Investment Managers. Please go ahead.

Sachin Kasera: Just a couple of questions; one is from the previous participant, I am also little confused that if our offshore has moved up from 55 to 59, should the margins not have expanded much more than what you mentioned on QoQ basis ex of FOREX?

Prasanna Oke: Sachin, that is what we are saying that when you are moving part of the margin expansion that we have had is on account of the offshore. There are some costs which will be there, whether they are one-time cost, it is a very small number at this point of time, right but the onsite/offshore mix change has definitely impacted us positively. As you will see, going as we obtain this, it could translate something better, but at this point of time it is a very small part of it, but it is definitely improvement in the margin on account of the mix change.

Sachin Kasera: Secondly, this onshore/offshore you see sustaining improving further or remain at current level for the next two, three quarters?

P. Srikar Reddy: I think we will have to take this at this level, there could be some marginal improvement, but I think this is a good benchmark to stay with.

Sachin Kasera: Second question sir was on utilization. At 85.5 to almost five, six quarters, so we can sustain this 85 or you think utilization can come down little from the current level?

P. Srikar Reddy: Utilization I think has been fairly significantly high level, so I guess we will stay there, there is not much scope for improvement.

Sachin Kasera: Last question is around currency. We have seen some weakening of the currency, but you mentioned that we have hedged. So if you could give us some sense on when do we start, at what level are we hedged and from which quarter do we start to see the benefit of the weakening of rupee vis-à-vis both the dollar and euro?

P. Srikar Reddy: As I said, Q3, Q4 onwards will we see the true benefit, Q1, Q2 there are older hedges which are more or less little lower than the current spot market rate for the dollar.

Sachin Kasera: But Q4 our realization for dollar was 69 and Euro and Pound was 76 and 87. How do you see this for the next three, four quarters – will it keep on improving?

P. Srikar Reddy: Yes, it will keep on improving, Q1 will be at 66.80, Q2 will be 67, Q3 is 67.66, Q4 is 68.42.

Sachin Kasera: Lower than what you reported in Q4, the Q4 was 69?

P. Srikar Reddy: Yes, in Q4, the realization was 69.

Sachin Kasera: Will you be able to quantify the amount of hedges we have sir?

P. Srikar Reddy: Further we go into the future it will be about 70%, in the meanwhile at least it will be about 85%, 90%.

Sachin Kasera: 85%, 90% for the first half and 70% for the full year, that is what you are indicating?

Prasanna Oke: For the full year roughly about 70, 75% and immediate quarter is in the range of 85, 90 and going down to about 65, 70 for the last two quarters.

Sachin Kasera: On this IP-led revenues, how do you see because we have seen some improvement in the last three, four quarters, it is 15.5, are you looking at closer to 18, 19 when we exit FY'19?

P. Srikar Reddy: 18, 19% right is at about 15.6%, yes, that is the attempt we have been saying that we need to increase it, that is the plan, yes.

Moderator: Thank you. We will take the next question from the line of Vipul Shah, individual investor. Please go ahead.

Vipul Shah: Give me IBIS revenue and EBITDA for this quarter and what was the corresponding figure for last quarter?

Prasanna Oke: IBIS revenues improved in this quarter, up from Rs.14 crores last time to about Rs.16.3 crores, our EBITDA has improved from about 15% to about 17%. So we are saying in line with business.

Vipul Shah: Continuous improvement we are seeing in IBIS right?

Prasanna Oke: The last four quarters if you look, yes, there has been an improvement and we are now getting to the EBITDA levels of what we usually get in the US business.

Vipul Shah: How many million dollars we have hedged, can you repeat that figure please?

Prasanna Oke: Our total hedges will be in the range of about $65 million spread across quarters, it is more towards immediate quarters, lesser towards end quarters.

Vipul Shah: What should be our revenue per software engineer per year in dollars at the exit rate of March quarter?

Prasanna Oke: We will get back to you on this.

Moderator: Thank you. We will take the next question from the line of Jay Daniel from Entropy. Please go ahead.

Jay Daniel: On a full year basis, dollar/revenue growth is 18% YoY and this run rate Sonata should get to 200 million aspirational target by financial year ended March 2020 which is the year you had held out when you had first mentioned this target. So, would I be right in stating this?

P. Srikar Reddy: Yes, absolutely, if we get this trend and everything works, we should get there, I agree with you.

Jay Daniel: Net borrowings at Rs.509 crores of cash is huge, it is 78% of capital employed and if one removes goodwill and intangibles it is 88%, proposed dividend will only take away around Rs.83 crores. Could not the higher payout being considered because you were sitting on Rs.50 of cash but you are paying out only Rs.6.75?

P. Srikar Reddy: Net of borrowings and working capital gap in our India business, I think the free cash is about Rs.420 crores, that is also quite large, I agree with you. So I think we have had this policy of between 50-60% of the current year's profit. That is what we are staying with in terms of the dividend payout. From next time onwards, we report ROCE, which is with and without cash, so that you get the operating return on capital employed because the cash does not really earn much, 6%, 7% or whatever it is. So we will report these ratios next time onwards so that you will see ROCE with and without cash.

Jay Daniel: Can you consider one-time dividend to remove the cash from your books?

P. Srikar Reddy: As I said, this is the policy we have been operating for quite some time now in terms of dividend distribution. Hopefully, we will find some good use for the cash in the current year.

Jay Daniel: What I understand is Sonata's platform-driven strategy is kind of unique. Is there any similar sized international companies in this space that we could use as a kind of referral?

P. Srikar Reddy: Everybody is talking about it, at least the big consulting firms, McKenzie has put out a lot of reports recently on platform-based businesses. Some traction is becoming mainstream, something from Accenture, so it is becoming mainstream in the international world of creating digital businesses by creating platform. You can Google it, otherwise I can ask somebody to send these out to you.

Jay Daniel: In terms of margins on the levers that are available, are we maxed out or can we further improve with higher value add work?

P. Srikar Reddy: The levers are really more IP itself, services mix, but the IP component of the revenue could have some levers left but utilization and services mix I think more or less maxed out.

Moderator: Thank you. We will take the next question from the line of Vipul Shah, individual investor. Please go ahead.

Vipul Shah: I understand that ours is not a typical service company, but still can you share with us the order backlog at the end of March quarter in terms of dollars?

Prasanna Oke: Vipul, when you get into the year ahead we have a coverage of close to about 85% for the upcoming year, so we do not give the order backlog in dollar terms but what we are saying is about 85% is covered as we get to the next year and then we will get component of revenues which is coming from new customers and then expansion in the existing customers.

Vipul Shah: Still I am not able to understand you fully, what you are trying to say is 85% of next year's revenue or firm orders with you, that is roughly?

P. Srikar Reddy: That is what he is saying, that is correct.

Moderator: Thank you. We will take the next question from the line of Sunil Jain from Nirmal Bang Securities. Please go ahead.

Sunil Jain: Sir, my question relate to FOREX gain/loss which is there in the quarter. Can you quantify it exactly how much is there and where it is lying?

Sathyanarayana. R: For the current quarter we have got overall FOREX gain of about Rs.7 crores at the consolidated level, that is in other income.

Sunil Jain: Going forward, you say that the rates and all we can see FOREX loss?

Sathyanarayana. R: Yes, immediate quarter I think we may see a FOREX loss.

Moderator: Thank you. We will take the next question from the line of Nishit Maliya from Anvil Shares & Stocks Broking. Please go ahead.

Nishit Maliya: I am sorry, I missed starting of the call. I was just wondering about the domestic products and services. This quarter seems to have got about (+4%) margins. How do we see the margins on the domestic products?

P. Srikar Reddy: I think I have been mentioning this in last eight to ten quarterly calls, that is the domestic business we manage the business on absolute margin, not a percentage margin of the revenue, so the margin could vary based upon some large transactions which happen or do not happen, that impacts the percentage margins. So very difficult to predict although the attempt is to improve the margin on a yearly basis. So if you even it out on yearly basis I think one can look at the margin in a more wholistic fashion. So the plan is to improve the margins on a yearly basis. Quarterly it will be very difficult because some quarters we have large transactions and some quarters we do not have large transactions.

Nishit Maliya: So you give the segmental India and other than India, right, and in the presentation it says domestic products and services and IT products and services, so what portion of the India business is the domestic products and services and what portion is IT Services?

P. Srikar Reddy: From next quarter onwards, we will actually combine the services into one group so that you will have a proper view. So currently the services component in the India business planned for the for year would be about $4, $5 million.

Moderator: Thank you very much. That was the last question in queue. I now hand the conference over to the management for their closing comments.

P. Srikar Reddy: Right, so thank you all very much for joining the call and thanks for your questions and thanks for your support. We look forward to hearing from you in our next call. Thank you, all again.

Moderator: Thank you. Ladies and gentlemen, on behalf of Sonata Software Limited, that concludes this conference call for today. Thank you for joining us and you may now disconnect your lines.