India Ratings & Research
A Fitch Group Company

India Ratings Assigns Sonata Software 'IND AA-'; Outlook Stable

08

DEC 2021

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India Ratings and Research (Ind-Ra) has assigned Sonata Software Limited (SSL) a Long-Term Issuer Rating of 'IND AA-'. The Outlook is Stable. The instrument-wise rating actions are as follows:

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating/Outlook	Rating Action
Fund based working capital	-	-	-	INR1015	IND AA-/Stable	Assigned
Non fund based working capital	-	-	-	INR880	IND A1+	Assigned

Ind-Ra has taken a consolidated view of SSL and its subsidiaries including Sonata Information Technology Ltd (SITL; 100% owned by SSL; IND AA-/Stable), together known as Sonata Group, given the strong operating, strategic and legal linkages among them. Ind-Ra believes the linkages are strong among SSL and its subsidiaries since cash flows are fungible between these entities as evident from the cash flow movement through up steaming of dividends to parents by its subsidiaries and the parental support to subsidiaries though non-convertible debentures/inter-corporate deposits to manage cash flows and/or receivables. Moreover, the treasury functions are also common among SSL and its subsidiaries and SSL has extended guarantees on behalf of some of its subsidiaries to major vendors.

KEY RATING DRIVERS

Robust Business Profile: Sonata Group's robust business profile comprises a mix of software distribution and the IT software service businesses. The software distribution business, housed under SITL, is primarily the domestic business of the group in which it enjoys an established position. This domestic business focuses on the distribution of packaged software/applications of technology giants such as Microsoft Corporation, Oracle Corporation and SAP SE and contributed 69% to the consolidated revenue of the group at end-1HFY22 (FY21: 72%, FY20: 67%, FY19: 63%). SITL is one of the largest software vendors in India for Microsoft Corporation India Private Limited and has a market share of 22%-24%. While SITL has non-exclusive arrangements for the distribution of these software/applications, the group benefits from its established position in the industry and a longstanding relationship of over three decades with Microsoft and Oracle, among others.

The IT software service business contributed 31% to consolidated revenue at end-1HFY22 (FY21: 28%, FY20: 33%, FY19: 37%)) and is housed under SITL's parent SSL and the parents' international subsidiaries and is present predominantly in the international markets. The group has built and acquired tools and frameworks around popular technology platforms namely Microsoft Azure, Microsoft Dynamics AX, Microsoft Dynamics 365 and SAP Hybris, among others, to cater to the sector-specific needs of its customers such as Brick & Click (retail platform), Rezopia (digital travel platform), Kartopia (e-commerce platform), Halosys (mobility platform) and CTRM (commodity platform). This helps SSL maintain a strong position in its IT software service business. Also, in Ind-Ra's view, the group's business profile is supported by its exposure to fast-growing digital service business and a well-diversified revenue base. Furthermore, the group derives about 67% of its software service revenue from the digital service business as compared to 40%-50% for other Indian IT peers, giving the group an opportunity to grow faster than its peers and meaningfully reduce technology obsolescence risk.

Strong Financial Performance: The consolidated revenue grew at a CAGR of 13.8% to INR42,280 million and EBITDA at a CAGR of around 19% to INR3,793 million over FY17-FY21. The revenue growth was largely attributable to the group's software distribution business, which grew at a CAGR of 18% over FY17-FY21, as compared to 10% growth in the IT software service business. The EBITDA growth was supported by a 13% and 20% CAGR growth in the software distribution business and IT software service business segments, respectively.

The consolidated EBITDA margins remained in the range of 9.0-11.0% over FY19-FY21 and stood at around 9% in FY21 (FY20: 10%, FY19: 11%). This was supported by strong EBITDA margins of the international business (FY21: 24%, FY20: 22%, FY19: 23%) which grew in FY21 due to operating efficiencies, along with a reduction in traveling cost and rental expenses owing to COVID-19-led disruptions. The group reported moderate EBITDA margins from domestic business over the FY19-FY21 (FY21: 3%, FY20: 4%, FY19: 4%) due to the trading nature of the business. During 1HFY22, the group reported consolidated EBITDA margins of 10%, with the IT software service business reporting 23% and the software distribution business 4%. Despite the likely yoy moderation in the EBITDA margins in FY22, as the group resumes some of the normal business operations (i.e. higher traveling, and sales and marketing expenses), the agency expects the margins to remain healthy over the medium term due to the management`s consistent focus towards reducing some operating cost

Strong Credit Metrics: The group's credit metrics remained strong over FY18-FY21, due to the increase in the absolute EBITDA and low interest cost. The interest coverage (operating EBITDA/gross interest expense) improved to 24.65x in FY21 (FY20: 24.56x), despite a marginal increase in finance cost to INR153.90 million (INR151.80 million), due to an increase in the EBITDA to INR3,793 million (INR3,728 million). The total debt, including lease rental, reduced to INR1,850.10 million in FY21 (FY20: INR1,871.80 million), despite a marginal increase in the working capital requirement, primarily due to a decrease in the lease rental liability. The company remained net debt negative in FY21. Ind-Ra expects the credit metrics to remain strong over the medium term on the back of the likely healthy operating profits, the low cost of debt and low debt requirement.

Liquidity Indicator - **Adequate**: The group's liquidity position is supported by strong cash levels, positive cash flow from operations (CFO) and a moderate capex requirements. The group had cash and cash equivalent of INR7,695 million at end-IHFY22 (FYE20: INR7,212 million, FYE20: INR3,911 million), against lease payment obligations of around INR210.9 million in FY22. The company did not have any long-term debt at FYE21. The average peak utilisation of the working capital limits remained moderate at 72% during the 12 months ended September 2021, due to the cash surplus and moderate working capital requirements. The group's free cash flow has been volatile (FY21: INR3,844 million, FY20: negative INR201.20 million, FY19: negative INR1,559.50 million, FY18: INR1,742.80 million), mainly on account of dividend payments. However, the dividend has only been paid out of surplus cash and the group has refrained from raising any debt to fund dividend payments in the past. The group has also completed an acquisition in FY22 and paid INR522 million during 1HFY22 for which, it raised USD5.5 million of term loans. The deferred payables of INR679 million for this acquisition are to be paid over the next three years. The ratings factor in Ind-Ra's expectation of the ability of Sonata Group to continue to generate positive CFO of INR2 billion-3 billion over the medium term. While Sonata Group intends to continue to distribute dividend and could resort to some small, inorganic acquisitions, the agency believes these will not be materially debt funded; this is a key rating monitorable.

Moderate Geographical and Customer Concentration: Sonata Group generates a majority of its international business revenue from the US (1HFY22: 52%, FY21: 55%, FY20: 54%, FY19: 57%) while the EU/UK region is the second largest contributor (25%, 23%, 23%, 31%). However, this is true for most Indian IT companies. Furthermore, the group's strong presence in the software distribution business, which is largely the domestic business, mitigates the concertation risk partially. Moreover, Sonata Group's revenue is well diversified across clients and industry groups with the top 10 customers contributing 61% to the total revenue in FY21 and the top industry groups contributing 33%, in line with other IT peers. The diversification will help in weathering any slowdown across any specific client or industry group.

Intense Competition in IT industry: Sonata Group faces intense competition from tier-1 IT players and well-established tier-2 players, which limits its pricing/bargaining power with customers. Additionally, the trading nature of its low-margin distribution business can drag its profits. However, Ind-Ra takes comfort from the company's longstanding relationships with its clientele and around 30 years of operational track record with strong promoters.

Currency Fluctuations. The group has a hedging policy in place, which enables it to hedge 60%-70% of its foreign currency on a rolling 12-month basis given the group earn 28%-30% of its revenue in foreign currency from its international segment. SSL benefited from the currency impact based on the exchange rates during FY21-FY17 (FY21: INR31.1 million, FY20: INR421.2 million, FY19: INR13.5 million).

Standalone Profile: SSL recorded a revenue of INR7,814.1 million in FY21 (FY20: INR8,768.4 million) and EBITDA of INR2,341.1 million (INR2,031.2 million).

RATING SENSITIVITIES

Positive: A steady increase in the revenue and profitability while maintaining the credit metrics will be positive for the ratings.

Negative: Developments that could, individually or collectively, lead to a negative rating action include:
- a decline in the revenue and profitability or an elongation of the net working capital cycle on a sustained basis
- any significant debt-funded acquisition and/or higher-than-expected dividend payments, leading to the consolidated net leverage exceeding 1.25x on a sustained basis

COMPANY PROFILE

Incorporated in 1986, SSL is headquartered in Bengaluru. The company provides services in business intelligence and analytics, application development management, mobility, cloud, social media, testing, applications for enterprise services (enterprise resource planning and customer relationship management) and infrastructure management services.

CONSOLIDATED FINANCIAL SUMMARY

Particulars	FY21	FY20
Revenue (INR million)	42,280.80	37,432.60
Operating EBITDA (INR million)	3,793.50	3,728.10
EBITDA margin (%)	8.97	9.96
Gross interest coverage (x)	24.65	24.56
Net leverage (x)	-1.41	-0.55
Source: Ind-Ra; SSL		

BANK WISE FACILITIES DETAILS

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COMPLEXITY LEVEL OF INSTRUMENTS

Instrument	Complexity Indicator
Fund-based working capital limits	Low
Non Fund-based working capital limits	Low

For details on the complexity levels of the instruments, please visit https://www.indiaratings.co.in/complexity-indicators.

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Applicable Criteria

Corporate Rating Methodology
Parent and Subsidiary Rating Linkage
Short-Term Ratings Criteria for Non-Financial Corporates

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