Sonata Software Limited Conference Call FY2013 (Q2)

Event Date / Time: November 15, 2012 / 1130 hrs

CORPORATE PARTICIPANTS

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Moderator

Ladies and gentlemen good morning and welcome to the Sonata Software Second Quarter Earnings Conference Call. As a reminder, all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during this conference call please signal an operator by pressing '*' followed by '0' on your touchtone phone. Please note that this conference is being recorded. At this time I would like to hand over the conference to Mr. Srikar Reddy. Thank you and over to you sir.

Srikar Reddy

Good morning everybody and thank you for joining the analyst conference call for our second quarter. As I have communicated to you over our last couple of analyst calls, the focus for us in the current year has been four or five strategic initiatives; one of them was to continue to focus on our existing clients. Through this, we will build a strong sales engine in the geographies that are of interest to us. As we work with our alliances, we will invest in new technology and will continue to verticalize our business. I did report to you in our last conference call, on the progress we have made on some of these initiatives, and in today's call, I will give an update of where we are on each of these initiatives.

To start with, if you look at our results that we announced a couple of days back, we have shown growth in both our top line and bottom line in terms of EBITDA margins. Though we have shown growth, internally we are not very happy with where we have reached; we believe we had more headroom for growth.

We believe there are a couple of reasons for not achieving our own internal targets. The first being the challenges in the global economy, some of which we call as discretionary projects, from our clients or deferment of projects. And also the new sales engine we have hired; though the pipeline was built up, we didn't get the closures that we expected at the pace with which we were going.

Our pipeline continues to look healthy. On the alliances front our alliance with Microsoft has now actually started working in all the geographies. So now we need to focus on taking these models forward to a couple of other alliances. Geographically, we have seen our US and Asia-Pac business show some uptick. I did mention in my last conference call that we are strengthening our team in Europe and we have actually done it over the last few months; we have added three new people. So we believe that it will start adding up to our pipeline over the next few quarters.

Our Joint Venture in Qatar has not really started delivering expected results, that's because of the issues in the region, which most of you are aware of. We do believe that some of the constraints and concerns in the region with the election and other activities, so we think that the investment in the region will start picking up and we will see the JV start showing some results.

We continue to invest in verticalization of our business. As I said last time, we had couple of verticals like- Travel Tourism and Outsourced Product Development, but the other two verticals that we have focused on is Retail and Consumer Packaged Goods. We will continue to invest in verticalizing our service offerings and we will start seeing us through vertical go-to-market over the next couple of quarters.

Our investments in new technologies like mobility, cloud, analytics, social media will continue. This is a part of our strategy to invest in these new technology areas and align our offerings for the verticals primarily on these new technologies.

The other major focus for us was to improve our margins. Though we have shown improvement in our margins which is coming purely out of utilization, our margin has not really grown to the extent possible because of some Forex losses which Venkat will explain to you, and because of the delay in getting visas, our onsite cost for our consultants has increased. So these are the two reasons. Though our utilization went up, our margins didn't go up to the amount that we expected.

There are two main stories for this quarter; the first is that we have shown a dramatic turnaround on our Domestic Products and Services business. Basically, based on our strategy of changing our product mix and moving into more profitable service lines, we will continue to see this in our Domestic Products and Services business. The big decision that we have made this quarter, as most of you are aware of, is that we divested our stake in our joint venture with TUI InfoTec. As you are aware we made this investment about five years back, with four or five objectives, one was to establish ourselves in the TUI Group; second was to use this as an entry point to the German market; third was to leverage our infrastructure operations to grow our infrastructure business; and fourth was to leverage the domain which was there to strengthen our travel and tourism service offerings. As a journey over five years, we believe we met three of these objectives and we really couldn't make much headway in our plan for expansion in the German markets. There are many reasons for that; fundamentally to do with the way the German market operates, apart from the time that we took to transform the company from an internally focused company to an external focus company. You are aware that the company started delivering losses, then we had to fund the losses in restructuring cost and we could have stayed in and possibly could have shown results in the long term which was not very clear. So we had to make a decision along with our JV partner. We came to the conclusion, it is best that they buy it back from us, so we made the decision to sell it back to them. In totality if you see the results over the last five or six years we have recovered our investment from the Joint Venture through dividend and the business we obtained from that.

Venkat will give you more details on the structure of the transaction. So, I believe that the decision has been good for both the parties financially. It has strengthened our position as a preferred supplier in the group and then it will help us focus on most growth oriented opportunities which will come to us as we go forward.

In a nutshell, that was the qualitative update for the quarter. I will now hand over the mic to Venkat to take you through some of the financials for the quarter, and then we can address your question. Thank you very much.

N. Venkatraman Thank you, Srikar. The results for the quarter are available on our website since last Friday, in the investor presentation, with detailed financials and metrics. I will now quickly take you through the financial highlights. Our consolidated revenue for the quarter was 378 crores, a 33% growth on a sequential basis and 49% on a year-over-year basis. EBITDA 15.07 crores which represented a growth of 26% on a sequential basis and 23% on a year-over-year basis and consolidated PAT was at 8.18 crores which is a 21% growth on a sequential basis and 31% on a year-over-year basis.

Now, quickly I will share with you the numbers for our two segments - International IT Services and Domestic Products business. We have eliminated TUI from the earlier quarters so that effective comparisons can be made. Like Srikar mentioned during the quarter we effectively found a solution to the TUI joint venture problem, that we have been facing over the last couple of quarters. From a financial perspective we have been taking losses on account of restructuring costs, and hence this quarter we closed the transaction where 50.1% shareholding that we held in this company was transferred back to TUI Group; TUI Travel PLC an amicable settlement, the transaction as we may call it. So the TUI transaction reads as we got €6 million in cash. We have got commitments in terms of business which is equivalent to €6 million of cash, but if that doesn't come through, we would get another additional €6 million; so it is a pro rata kind of formula, and on top of that there was a waiver of 3.5 million which was due from us towards the restructuring loss. Beyond this, as part of the deal structure, they have made us the preferred offshore vendor for IT Services within the TUI Travel Group and we will be signing up renewed offshore development center agreement with TUI InfoTec, which now goes back to TUI Travel on substantially the same terms as what we have today. Further, we had geographic limitations in terms of doing business in Germany and surrounding countries. Now with the transfer back of our shares, we have been freed from that and we will also be working with TUI InfoTec who will be taking us deeper into the TUI Group companies for getting us further work. So all in all this has been a relatively good transaction from our perspective.

Just to go back in history, we bought the 50.1% share in 2006 for about €18 million and post that, like Srikar mentioned over the last five to six years we have been getting dividends and we have been doing business with them on arms length basis. Coupled with both of them put together, we have recovered more than our investments in the joint venture. So both parties have been able to step away from the joint venture in an amicable fashion and the loss that we have recorded in the books of accounts reflects the accounting effect of the transaction; the accounting effect is essentially, the auditors have said that any contingent payments which is about €6 million that I talked about is not to be considered in the sale value. So while the book loss of €6 million comes in, we also have a certain credit, essentially because as part of the transaction TUI has also agreed to bear losses for the last 12 months. The losses that we have consolidated in the earlier quarter, reverses and goes back to TUI. You will see this transaction clearly articulated and disclosed in our financials as below the line item.

Post this transaction, now we have only two main segments which are essentially - International IT Services: which is our software services export business, and Domestic Products business: which we conduct through our 100% owned subsidiary -- Sonata Information Technology Limited.

Coming to the International Services segment, which contributes 22% of our total revenues, but 62% of our profit, even though smaller in terms of revenues it has had a substantial impact on the consolidated profits of the company. In this business, revenues for the quarter were 82 crores which have actually been flat on a sequential basis, whereas on a year-over-year basis we have shown a 24% growth. In constant currency we have been buffeted by wildly swinging foreign currency. So just to let you know that from a quantitative perspective in constant currency, US dollar revenues have shown a 1% decrease on a sequential basis and a 9% increase on Y-on-Y basis. EBITDA for the quarter stood at 11.21 crores which is a 10% improvement sequentially and a 2% improvement on a year-over-year basis. Now, on the PAT, we had 5.1 crores in the segment which is a drop of 14% on a sequential basis and 26% improvement on a year-over-year basis. The primary reason for the drop was a provision for tax which we had to make in Europe, which we have done this quarter.

While we evaluate the financials of this business, I would like to highlight one fact in the foreign currency. We have a significant amount of money or assets overseas, so there is a restatement effect which comes every quarter, which is either positive or negative. Our EBITDA has improved year-over-year, but you should consider the fact that this quarter we have been hit with an exchange restatement loss of 1.1 crores whereas in the previous quarters it was a gain of 5.4 crores and 7.7 crores a year ago respectively. So this wild swing which Srikar was referring to is what has impacted our margins, but we have made this largely through improvement in operating margins and utilization. Utilization was at 80%, and we would like it to be higher, and we are also focusing on improving billabilities of the employees.

With regards to our pipeline, it looks quite healthy. We have added six customers in the previous quarter and two in this quarter, and we are working on quite a few of other new names which will hopefully fructify in the coming quarters.

The DSO has been about 72 days in this current quarter compared to 64 days. That is essentially because of transition in contract which has happened in between the subsidiaries of our customer. We had a closing headcount of 2,252 employees as against 2,122in the last quarter.

Domestic Products and Services: this is essentially the business that we do within India; it contributes to 77% of our revenues and 38% of the profits. Revenue for this quarter was at 291 crores which was a sequential growth of 42% and 55% on a year-over-year basis. Services revenue was about 9.2 crores which have again grown by about 35% on a sequential basis and 80% on a year-over-year basis. EBITDA for the quarter was about 3.86 crores compared to 1.75 crores last quarter and 1.24 lakhs a year ago; so this is the substantial improvement that Srikar was talking about. We have been talking about realigning of product portfolio and also weeding out projects which were non-profitable or which was loss making. All of this has been completed in the last year. We have taken the negative effects of all these clean up which has been done in the last year and we are now on a path for improved profitability.

PAT for the quarter was 3.13 crores as against 90 lakhs last quarter and a loss of 57 lakhs a year ago. So, the percentages are fairly very large in terms of growth. We have had a positive impact on our cash flow because of changes in withholding tax law. As I updated you last quarter, now when we sell software in India there are no more withholding tax requirements, which was a cause for real concern in the domestic market, as it blocks quite a bit of our working capital. Day sales outstanding and working capital efficiencies are key metric that we follow in this business including credit those we grant to our customers. Our day sales outstanding stood at about 85 days compared to 53 days last quarter. The significant jump was on account of one large transaction for which we are doing follow up, which has been subsequently collected and the DSO now stands at about 60 days.

Coming to cash balances, we have got about 125 crores of cash in the International Services business. As far as SITL, Domestic Products business is concerned, it's a wild swing, but we have entered the quarter with 5 crores of cash and borrowings of about 40 crores for working capital purposes.

In the Domestics Services business we have a large part of our capital which is about 127 crores stuck as TDS refund, which is due to us. We are pursuing that in all earnestness and hopefully we should get some bit of it back, very soon.

The Board of Directors have declared an interim dividend of 50 paise per share which is 50%. This shows the confidence of the Board on how we are likely to perform in the coming quarters and dividend should be dispatched after 27th of this month. With that I come to the end of my part. Thank you. And I will now hand it over to Srikar for closing comments and questions.

Srikar Reddy Thank you Venkat. Just forgot to mention in the beginning of the meeting, that apart from me, Venkatraman who is our CFO, we also have with us on the call, Sathyanarayana- who is the Head of Finance, Priya-who is Company Secretary, and Swati Sengupta- Head of our Corporate Marketing. The platform is now open for questions.

Moderator Thank you sir. Participants we will now begin with the question-and-answer session. We have the first question from the line of Chetan Wadia from JHP Securities, please go ahead.

Chetan Wadia My question to you is that, with respect to Qatar you said as far as the US is concerned it is a matter of status quo, things remain as they were, in the Europe the things are kind of not so favorable. So with respect to Qatar and other Asian countries how important is this region for you in terms of growth in the time ahead?

Srikar Reddy Very good question! The region is important for us and our growth. We use Qatar as a base to enter the region. We believe that there is tremendous potential in the region to grow, especially to start with Qatar because, I believe it is one of the fastest growing economies in the world, and there are some big investments which are coming up for various reasons apart from 20-20 World Cup. So like I said, yes, for us I think even if we get revenue of over $20 million – $25 million for our Services business, it is a significant portion of size as we go forward.

Chetan Wadia My second question is can you explain the restructuring cost of 43 crores. What is the base for this entry in the June quarter sequentially?

Sathyaranayana Last quarter there was a restructuring cost which in fact has got reversed in the current quarter on account of deconsolidation of TUI Infotec GmbH financials

N. Venkatraman In last quarter we had consolidated TUI Financials, and net of minority interest we had taken a restructuring cost because they had taken a total restructuring cost of about 43 crores in the books and we took 50.1% share of that into our financials. Now, this quarter since TUI InfoTec is now no longer a part of the consolidated entity. If we took economic benefits in the past, we have to also give up the economic benefits that we have in the current quarter because as part of the share purchase agreement they said they will bear the losses and we don't need to bear any further losses. So that's why it is really an impact on our consolidated financials. Last quarter when we took it and we clarified that it doesn't impact our cash flows it does not have impact on our going concern and continuity and all of those aspects. So, from a presentation perspective when it gets deconsolidated, the loss also goes back with that. We have clearly shown this as a line item in the press release; if you look at the press release the segmental results and the deconsolidation effect is clearly drawn.

Chetan Wadia My third question would be: Can you just give me the cash and debt number once again with respect to International and Domestic?

N. Venkatraman In our International Services business we have got about 125 crores of cash. We do give ICDs to the Domestic business on an arm's length basis. We do lend money to our Domestic business because of the timing difference that they have in terms of buying and selling the products. So I am adding that into the cash balance of International Services. On the Domestic front we have got 5 crores of cash balance at the end of the quarter and we have an ICD of 70 crores that I just talked about and on top of that we have the working capital gap of 40 crores through two large deals that we closed at the end of the quarter.

N. Venkatraman 70 crores of ICD has been subsequently repaid also.

Chetan Wadia And finally to Mr. Reddy: On the Microsoft, you said that you are trying to replicate the model to other geographies and other areas as well. So can you just elaborate on that to which other geographies are you trying to target?

Srikar Reddy No, what I said was as far as our alliance strategy is concerned that is working with Microsoft in all the geos, that means the geographies which we operate in let's say the US, Europe, Asia Pacific and Qatar, so we are now aligned with the local offices and based on certain services which we specialize in so we have now agreed, go-to-market plan and based on that we have actually started winning some business. Now, we have to replicate this model to some of our other alliances like SAP, Oracle, IBM, HP and Hybris. So we need to now focus our energies and the efforts of our marketing team to pick up one more alliance and then replicate the same model which we have done with Microsoft across the geographies. That is what I said.

Moderator Thank you. We have the next question from the line of Kashyap Pujara from Axis Capital, please go ahead.

Kashyap Pujara If you can just throw some light on the capital allocation plan going forward as to what kind of incremental investments which we will be making in the next couple of years based on whatever technology ramp ups that you have pointed out, if you can give some CAPEX intensity?

Srikar Reddy It is not very capital intense, it is really aligned to our business. So right now we have a capacity of about 2800 seats, so I think we have a spare capacity of about 500 seats. So that means that's the CAPEX which has already incurred both in terms of space and interiors, etc. So that should take care of whatever growth we may have over the next two to three quarters in terms of actual people. Then we will start investing for the future capacity, basis future requirements. We normally invest in capacity, in blocks of 500, which give us the economies of scale. Our next plan would be to then acquire a facility. We do not buy it, we will just lease it in blocks of 500 and then we will invest whatever it takes and there is a standard rate of Rs. 2,000 – Rs. 3,000 a square foot or whatever which is the CAPEX which is required. So that is the big CAPEX in terms of infrastructure; the rest of it we don't capitalize. So if all our R&D expenditure or new technologies we don't capitalize, we have just put it as expenses, so there is no capitalizing as such. There will be investment but that's very internal in nature in terms of what percentage of our revenues delivers in developing new technologies and new markets or whatever that is. So, one investment I mean it is not going to be significant, we are going to be developing a solution center which we want to showcase for demonstrating all our verticals and horizontal technologies and our facility in Bangalore that won't be much, it would not be more than a million or million-and-a-half dollar, so that's about it really.

Kashyap Pujara So considering that you don't have too much of capital intensity going forward in the near-term and you have some spare capacity also, if I remember right you did mention in the call right now that you have a possibility, you are already having 120 odd crores of cash, you have close to the similar amount lying in the tax side which you are working hard to take the refund and you have also mentioned that apart from the €6 million, you have another €6 million of business commitment and if that doesn't materialize the cash proportionate to that amount can come through. So, you seem to have a reasonable amount of liquidity at hand. So would it be fair to assume that you will be returning this cash to the shareholders, I mean in terms of dividend payouts or going forward or buybacks I mean what is the plan on that?

Srikar Reddy I think honestly Kashyap that's the decision the Board will make. At an operating level I think we are looking at an inorganic strategy so we will definitely use some of the cash in an inorganic strategy. Other decisions known as increasing dividends and share buyback and all, are not really strategic decisions for the company. My focus is to really strategize to grow the business, investing in new technologies, investing in markets and expand our operations. So I do believe that yes there are a lot of opportunities out there in the market and we have focused on that and we will look at anything in the offering, but we believe its an integral part of our strategy and we will do that.

Kashyap Pujara So there is nothing immediate term inorganic plan that is lined up?

Srikar Reddy There is an immediate organic plan but there is nothing in the pipeline.

Kashyap Pujara Secondly if you can just give some idea as to how the business is moving globally, are we seeing a pricing pressure to garner more growth and how are you seeing your relationships with your key clients? If I am not mistaken your top 10 clients do account a large part of your revenue. So how is that moving ahead in terms of pricing?

Srikar Reddy I don't know whether I can make any statement on that. It can be really extrapolated in the distant future, as of today we don't see any pricing pressure. That also comes through because I think a reasonable basket of our services are very specialized in nature, I mean we do hybris, Axapta, Mobility, so on and so forth. So one is because the nature of our services and as of this moment we are not seeing any pricing pressure. I did mention in my call that we are seeing a little deferment of what we call discretionary expenditure from our client. That means new projects are getting a little deferred, what could have started a few months ago have not started so that is one trend we are seeing; not too sure how long will that continue but that's the trend we are seeing as of now.

Kashyap Pujara If any guidance if you want to give out as to what kind of growth that we expect within and now that TUI is also out what kind of normalized margins can we look at going forward?

Srikar Reddy As you know Kashyap, we don't make forward-looking statements, and we don't give guidance. All I can say that I have said it in the past conference calls also that we have a great team of people here and they are all focused, always working and we all got our heads together to focus on growth. So I do believe that the efforts of this team will result positively as we go forward but as a policy we don't give guidance.

Kashyap Pujara If you can just throw some light on the hedging policy, if you can just explain as to how you go about doing that?

R. Sathyanarayana Yes, currently what we do is we cover our receivables with simple forward contracts for a year, and we cover our net receivables to the extent of 75% to 80% coverage we are keeping 20% - 25% open.

Moderator Thank you. We have the next question from the line of Nihar Shah from Enam Holdings, please go ahead.

Nihar Shah My first question was this 125 crores cash that you have said is on your balance sheet that includes the €6 million pay out that you have received from TUI InfoTec so far, is that correct?

N. Venkatraman No. There are two parts, Nihar. We have to get €6 million in cash that's the part one and the part two is we will have to get business if that does not materialize we will get another 6 million. So first 6 million, 2 million euros have come, that's come after the balance sheet date. This 125 crores does not include that 2 million that's come in.

Nihar Shah This is 2 million which is part of the 6 million in business that you are expecting from them?

N. Venkatraman No, that's what I said, the deal is 12 million, 6 million in cash payable over a period of three years to our subsidiary, 6 million additionally if business doesn't come through they will pay us another 6 million. The 6 million comes in three years. So the first 2 million have already come in and it is lying with Sonata Europe.

Nihar Shah My second question is on the tax matter, where you have money outstanding with the tax authorities. Can you throw some light on what's been the sort of progress over there and what are your expectations on the resolution of this matter?

N. Venkatraman On the tax matter, the entire tax issue on our domestic company which is Sonata Information Technology Limited can be reduced to two issues, one is payment for software whether it is royalty or not, and if it is royalty where we are supposed to deduct tax and pay to the government undertaking. So the question of whether it is royalty or not is lying with the government and lying with the Supreme Court in the SLP**.** Entire industry is waiting to hear on that from the Supreme Court. Now let's say if that case goes against us, there is no real tax impact on us because the tax that has already been paid by Microsoft, who got the money when we imported the products to India. So the question that whether it is a royalty or not, does not have a cash impact on us. But there is a contract provision in the Income Tax Act which says that any such payment which has been made on which tax has not been deducted has to be disallowed in the financials of the company. So on that basis there has been a disallowance in our books and they have raised the demand of 140 crores on us. Now, that just to break it over two financial years of 2008 – 2009 and 2007 – 2008, we have won the case for 2007 – 2008 and also 2008 – 2009, so we are just waiting for the final orders to come into our hands. Once it comes into your hands then you will have to proceed and progress on the next steps of getting the refund.

Nihar Shah So the total refund could be close to about 140-odd crores?

N. Venkatraman No, it is about 125 crores, but please understand that tax refunds are by financial years and we have to fight each year and get it, so let us say 20, 20, 20, 30 but the fact of the case remains the same. But you still have to go 20 times or 15 times or whatever, you have to file for it year-by-year and fight for it year-by-year. And also we would like you to read the financial disclosures we have given in our annual report which gives you a complete breakdown and the current status and how confident we are on winning this.

Moderator Thank you. We have the next question from the line of Deepak Agarwal from Impetus Advisors, please go ahead.

Deepak Agarwal I wanted the breakup of long-term loans and advances of 191 crores?

R. Sathyanarayana Are referring to the consolidated number.

Deepak Agarwal Consolidated, 191 crores.

R. Sathyanarayana Yes, this is basically the Income Tax refund, we should get this back from the Income Tax Authorities i.e.125 crores.

N. Venkatraman The largest component of that is the TDS refund, which has been classified there.

Moderator We have Mr. Akhil Jain from Aditya Birla Money, please go ahead.

Akhil Jain Yes, I was going through your presentation and I was wondering why the rupee realization rate is at 48 for this quarter?

R. Sathyanarayana Because we had covered through forward contracts, we had taken this cover one year back.

Akhil Jain So the rupee actually started depreciating from Q3 FY12 onwards last year. So, if you have a one-year forward cover, from now on I guess your realization rates should start increasing?

Srikar Reddy Not really, I think our realization rates will improve only in Q1 next year. I think the rupee was in the 50 range till about February–March of this year.

Akhil Jain Again it had appreciated in Q4 FY12?

Srikar Reddy Yes, the rate will be higher from Q1 next year.

Akhil Jain So, this is Q1 you said in terms of CY12 or financial year you are saying?

N. Venkatraman Financial year '14.

Akhil Jain So from next year April 2013?

N. Venkatraman Yes, you are right.

Moderator Thank you. As there are no further questions from the participants I would now like to hand the floor back to Mr. Srikar Reddy for closing comments. Over to you sir.

Srikar Reddy Thank you all very much for joining us on the call and we continue to look forward to your support and seeing you again in the next conference call.

Moderator Thank you sir. Ladies and gentlemen on behalf of Sonata Software that concludes this conference call.