ANANDRATHI

India I Equities

Technology
Company Update

Change in Estimates ☑ Target ☐ Reco ☐

16 June 2020

Mastek

Steep fall in US, but UK and Evosys make up lost ground; Buy

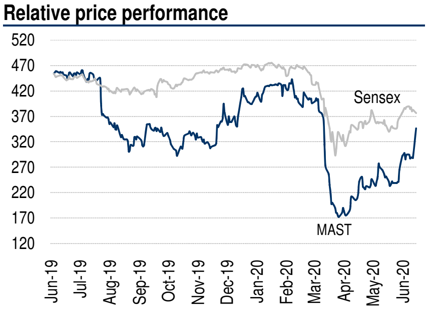
Rating: **Buy**
Target Price: ₹510
Share Price: ₹346

Key data	MAST IN / MAST.BO
52-week high / low	₹484 / 166
Sensex / Nifty	33229 / 9814
3-m average volume	$0.2m
Market cap	₹8bn / $110.5m
Shares outstanding	24m

Shareholding pattern (%)	Mar'20	Dec'19	Sep'19
Promoters	45.1	45.4	45.6
- of which, Pledged	-	-	-
Free float	54.9	54.6	54.4
- Foreign institutions	6.2	6.5	6.8
- Domestic institutions	14.9	12.4	11.3
- Public	33.8	35.7	36.3

Estimates revision (%)	FY21e	FY22e
Sales ($)	(8.4)	(6.9)
EBITDA	(0.4)	(2.7)
PAT	8.2	8.3

Relative price performance



Source: Bloomberg

Even as its US/retail slid 19% q/q despite a steady market till Feb (lockdown from 21st Mar), Mastek's $45.9m Q4 revenue (incl. ~1.6 months of Evosys': $12m) was up 34% q/q, 21% y/y (organic: down 0.7% q/q [flattish in CC], 10% y/y). UK (up 6.9% q/q) made up for the US while Evosys, integrated partially for the quarter, sustained the pace. The EBIT 15% margin was up 359bps q/q but the company spoke of only 12-13% on hiring amid travel restrictions. Not much change in est. EBIT as higher margins offset lower revenue. Target unchanged at ₹510 (10x FY22e).

First quarter of Evosys consolidation. Partially consolidated in Q4, Evosys was resilient in the macro environment. It brought $12m (annualized $80m+) in Q4, reflecting the seasonal pickup and ended FY20 with ~12% growth. The Evosys management tone was positive, expecting 18-20% growth in FY21. Ranked the 4th fastest-growing Indian company in the UK, it is climbing up ranks in Garner's magic quadrant for Oracle cloud services as well. Margins have fallen to 18-20% (from 22% in FY19), potentially on accelerated investments in the present context.

Crosses $200m in revenue (annualised), with 15% EBIT margin. Mastek ended FY20 positive. Its UK business delivered a 2nd straight quarter of 5%+ growth, almost reverting to Q4 FY19 levels; Evosys integration is on track (first joint win £4m). Mastek had ₹816m net cash (after the Evosys-payout) though supported by payables, and may see some reversal ahead. Q4 margins were also the highest after the hiving off, and client-concentration ratios (top-10 now at 51% of revenue, in line with midcaps) came down. The only negatives were US operations and high receivables, - both likely to correct in FY21.

Target retained at ₹510. With only a small change to our EBIT estimates and the US continuing to soften the organic performance, we maintain our target, valuing Mastek at 10x FY22 EPS (from 11x earlier). Mastek is likely to be in the -/+ 5% range in FY21; hence, expectations ride on Evosys. **Risk:** Loss of momentum at Evosys.

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (₹ m)	8,172	10,332	10,715	14,162	15,727
Net profit (₹ m)	700	1,014	1,089	1,180	1,492
EPS (₹)	28.0	40.3	41.2	39.8	50.3
PE (x)	14.7	10.1	9.4	8.7	6.9
EV / EBITDA (x)	8.4	6.3	5.4	4.0	3.4
PBV (x)	1.7	1.3	1.2	0.8	0.7
RoE (%)	15.6	16.0	14.5	12.5	12.8
RoCE (%)	10.7	11.5	8.6	8.5	9.5
Dividend yield (%)	1.7	1.9	2.2	2.7	3.4
Net debt / equity (x)	-0.2	-0.2	-0.1	-0.2	-0.3

Source: Company, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Revenues ($ m)	**127**	**148**	**150**	**193**	**214**
Growth (%)	***52***	***17***	**2**	**28**	**11**
Net revenues	8,172	10,332	10,715	14,162	15,727
Employee & direct costs	6,511	8,170	5,841	7,971	8,820
Gross profit	1,661	2,161	4,874	6,191	6,907
Gross margins (%)	20.3	20.9	45.5	43.7	43.9
SG&A	664	846	3,340	4,118	4,488
EBITDA	**997**	**1,315**	**1,534**	**2,073**	**2,419**
EBITDA margins (%)	***12.2***	***12.7***	14.3	14.6	15.4
- Depreciation	188	174	249	344	358
Other income	210	253	192	259	233
Interest expenses	59	61	36	182	46
PBT	960	1,334	1,441	1,805	2,249
Effective tax rate (%)	27	24	21	22	24
+ Associates / (minorities)	-	-	-50	-227	-227
Net income	**700**	**1,014**	**1,089**	**1,180**	**1,492**
WANS	25	25	26	30	30
FDEPS (₹ / sh)	**28.0**	**40.3**	**41.2**	**39.8**	**50.3**

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Share capital	119	120	121	143	143
Net worth	5,493	7,164	7,905	11,054	12,198
Debt	698	692	3,332	923	-
Minority interest	-	-	1,371	1,598	1,825
DTL/(Asset)	-255	-144	-226	-226	-226
Capital employed	**5,936**	**7,713**	**12,381**	**13,349**	**13,797**
Net tangible assets	459	456	762	624	496
Net intangible assets	250	243	1,039	1,039	1,039
Goodwill	1,080	976	6,766	6,766	6,766
CWIP (tang. &intang.)	21	14	17	17	17
Investments (strategic)					
Investments (financial)	1,177	1,502	1,938	2,034	2,136
Current assets (ex cash)	4,003	5,270	5,793	6,365	6,546
Cash	880	934	2,210	1,997	1,981
Current liabilities	1,934	1,681	6,143	5,494	5,184
Working capital	2,069	3,589	-350	871	1,362
Capital deployed	**5,936**	**7,713**	**12,381**	**13,349**	**13,797**
Contingent liabilities	36	-	-	-	-

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
PBT	960	1,334	1,441	1,805	2,249
+ Non-cash items	221	230	510	85	125
Oper. prof. before WC	1,181	1,563	1,951	1,890	2,374
- Incr./(decr.) in WC	449	507	-355	2,060	468
Others incl. taxes	-93	-306	-471	-398	-529
Operating cash-flow	**640**	**751**	**1,835**	**-567**	**1,377**
- Capex (tang. +intang.)	153	155	157	207	230
Free cash-flow	**488**	**596**	**1,679**	**-774**	**1,147**
Acquisitions	-55	-170	-4,256	-2,456	-
- Div.(incl. buyback & taxes)	**107**	**177**	**315**	**275**	**348**
+ Equity raised	24	29	21	2,245	0
+ Debt raised	41	6	2,371	48	-923
- Fin investments	64	238	-1,679	-741	125
- Misc. (CFI + CFF)	-73	-7	-95	-259	-233
Net cash-flow	400	52	1,274	-213	-16

Source: Company, AnandRathi Research

Fig 4 – Ratio analysis

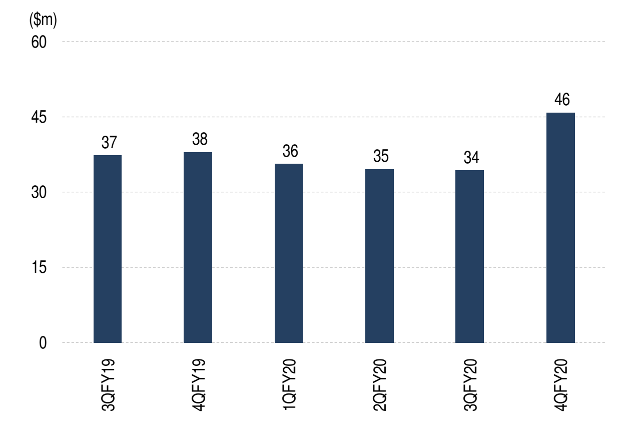
Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
P/E (x)	**14.7**	**10.1**	**9.4**	**8.7**	**6.9**
EV / EBITDA (x)	**8.4**	**6.3**	**5.4**	**4.0**	**3.4**
EV / Sales (x)	1.0	0.7	0.8	0.4	0.3
P/B (x)	1.7	1.3	1.2	0.8	0.7
RoE (%)	**15.6**	**16.0**	**14.5**	**12.5**	**12.8**
RoCE (%) - after tax	10.7	11.5	8.6	8.5	9.5
RoIC (%) - after tax	15.7	16.4	11.9	11.4	12.6
DPS (₹ /sh)	**6.0**	**6.7**	**7.7**	**9.3**	**11.7**
Dividend yield (%)	1.7	1.9	2.2	2.7	3.4
Dividend payout (%) - incl. DDT	25.7	20.0	22.3	28.0	28.0
Net debt / equity (x)	-0.2	-0.2	-0.1	-0.2	-0.3
Receivables (days)	**88**	**86**	126	136	130
Payables (days)					
CFO :PAT%	10	4	42	20	12
FCF : PAT%	**91.5**	**74.0**	**161.2**	**-40.3**	**80.1**

Source: Company, AnandRathi Research

Fig 5 – Price movement

Source: Bloomberg

Fig 6 – Mastek Revenue Performance



Source: Company

Result Highlights

Q4 FY20 Results at a Glance

Fig 7 – Segment-wise results

	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q/Q %	Y/Y %
Revenues ($ m)	**38**	**36**	**35**	**34**	**46**	**34%**	**21%**
Growth Y/Y %	**9%**	**-1%**	**-5%**	**-8%**	**21%**		
Evosys Acquisition ($ m)	NA	NA	NA	NA	12		
Revenues (₹ m)	**2,671**	**2,475**	**2,436**	**2,437**	**3,367**	**38%**	**26%**
Eff. exchange rate	70.4	69.6	70.4	71.1	73.4	3%	4%
Employees (EoP)	**2,069**	**2,035**	**1,937**	**1,880**	**3,404**	**81%**	**65%**
Revenue productivity ($ '000/employee)	18.2	17.2	17.0	17.7	24.4	38%	34%
Gross utilization (IT services)	79%	75%	75%	77%	75%	-130 bps	-350 bps
Attrition	17.9%	20.4%	24.1%	24.9%	23.2%		
CoR (excl. D&A)	(2,093)	(1,350)	(1,350)	(1,366)	(1,775)	30%	-15%
As % of revenue	-78%	-55%	-55%	-56%	-53%	332 bps	2565 bps
SG&A	(225)	(796)	(799)	(735)	(1,009)	37%	349%
As % of revenue	-8%	-32%	-33%	-30%	-30%	17 bps	-2157 bps
EBITDA	**353**	**329**	**287**	**336**	**582**	**73%**	**65%**
EBITDA margins %	**13.2%**	**13.3%**	**11.8%**	**13.8%**	**17.3%**	**349 bps**	**408 bps**
EBIT	**310**	**272**	**230**	**278**	**505**	**82%**	**63%**
EBIT margins %	**11.6%**	**11.0%**	**9.4%**	**11.4%**	**15.0%**	**359 bps**	**341 bps**
Other income	59	56	81	81	19	-77%	-69%
Forex gain / lossand exceptional items	16	(4)	10	(31)	(19)	-38%	-222%
Interest expense	-11	-8	-9	-8	-11	43%	4%
PBT	373	315	313	320	493	54%	32%
PBT margins %	14.0%	12.7%	12.8%	13.1%	14.6%	151 bps	67 bps
Taxes	(100)	(72)	(66)	(60)	(104)	72%	4%
ETR %	-26.6%	-23.0%	-21.2%	-18.8%	-21.0%	-223 bps	562 bps
PAT	**274**	**242**	**246**	**260**	**390**	**50%**	**42%**
PAT margins %	**10.3%**	**9.8%**	**10.1%**	**10.7%**	**11.6%**	**90 bps**	**131 bps**

Source: Company, Anand Rathi Research

Fig 8 – Quarterly result(₹ m)

Year-end: Mar	Q4FY20	% Q/Q	% Y/Y	FY20	FY21	% Y/Y
Sales ($ m)	46	33.8	20.9	150	193	28.4
Sales	3,367	38.2	26.0	10,715	14,162	32.2
EBITDA	582	73.1	65.0	1,534	2,073	35.1
EBITDA margins (%)	17.3	349 bps	408 bps	14.3	14.6	32 bps
EBIT	505	81.6	63.1	1,285	1,729	34.5
EBIT margins (%)	15.0	359 bps	341 bps	12.0	12.2	21 bps
PBT	493	54.0	32.1	1,441	1,805	25.3
Tax	(104)	72.3	4.2	(303)	(398)	31.3
Tax rate (%)	(21.0)	-223 bps	562 bps	(21.0)	(22.0)	-102 bps
Net income	340	30.7	24.1	1,089	1,180	8.4

Source: Company

Conference-call takeaways

Mastek

- US will recover slower than other parts of the business. Expect recovery in H2. The UK government may see budget cuts of 15-20% on account of austerity.
- Mastek has moved to a 100% work-from-home model and therefore does not expect supply-side challenges ahead.
- For cost alignment, it is evaluating sub-contractor expenses, furloughs for some employees where billability seems difficult at the moment, and a freeze on hiring.
- With the measures described above, capacity will be aligned to demand by Q2 FY21.
- There has been some improvement in business momentum in the last few months as businesses normalise. While revenues may suffer, the pipeline has increased in Q1.
- In Q4 Mastek won its first joint deal with Evosys, worth £4m.

Evosys management

- Order book and client addition continues to be strong on Oracle technology.
- Expect continued growth momentum for Evosys. Business momentum in the Middle East is better than popular perception.
- Evosys had 10-12% growth in FY20 at an 18-20% margin.

Q1/FY21 outlook

- Both the US and UK are likely to be flattish in Q1. For FY21 though, Mastek organic may end in the -5% to +5% band.
- Evosys is looking at 18-20% growth for FY21.
- FY21 margins are likely to be in mid-teens (15-16%).

Notes from the last two quarters' conference calls

From Q3 FY20

- Project closures in the US and new deal sign-ups, delayed to the end of the quarter, led to the weak US performance. The company has won five new logos in that region.
- The delay in order closures during the pre-election period impacted the order backlog but clarity in terms of BRexit and thus improvement in public spending offers assurance regarding the order backlog improving in Q4.
- The company has fully written off the provision related to Cox and Kings, of ₹65m (₹45m impact in Q3, the rest in Q2).
- Headcount addition to begin from Q4.

From Q1 FY20

- The UK continues to be in difficult territory in terms of growth but Mastek should still deliver growth in FY20.

- While ramp-ups/execution are on the slower side, the strong order backlog offers assurance regarding FY20.
- Mastek is more on the discretionary side of IT spending and, therefore, was impacted more than others. With that, it still believes that growth would be better than Indian peers in the UK, given its digital footprint and high proportion of government business.
- Margins will be defended at 13-14% of revenues. Here, the key lever will be utilisation, which is way off from the recent peaks.
- Growth this year will be driven by acquisitions as the company looks to scale up fast amid slowing organic growth. This is also part of the 2020 vision, with aspirations of ~$200m revenue.
- The Majesco stake is expected to be liquidated in Q2 and the proceeds utilised for acquisitions.
- The $1.2m balance payment for TaisTech would be paid in FY20.
- Cash generation was low as the company paid out FY19 bonuses and earn-outs to the TaisTech promoters.

From Q4 FY19

- The ramp-down in one of its past contracts has hit its annual revenues by $2m, causing $0.5m lower quarterly revenues from now.
- As Chief Business Officer, the company hired Dennis Badman, who was earlier with Fujitsu's European Services division. This, we believe, will help Mastek scale up and bring new logos into the UK.
- The company has clocked higher growth in maintenance services as many contracts have been converted to maintenance mode now, with the end of the development phase.
- The company wrote back $3.8m toward contingent consideration, now no longer payable to TaisTech as earn-out settlement as the acquisition fell short of initial expectations.
- The number of clients has shrunk q/q, from 165 to 157, on account of a rationalisation of Indigo Blue clients.
- The hedge book is £7.5m, at an average rate of ₹95.9.
- FY20 ETR of 23-24%.

From Q3 FY19

- Added 14 new logos in Q3 FY19, predominantly in the UK.
- Utilisation in the quarter was down 75.5%, against 79.7% in Q2. Management talked about utilisation ahead at 75-80%.
- The UK government is increasing its investments in digitisation and, as the company is one of the top-10 suppliers to the UK government, it is seeing more revenue visibility from the UK.
- It is looking to increase its headcount to capture demand ahead.
- It is looking at utilising the cash from the Majesco stake sale on M&A opportunities.
- The hedge book is £8.3m, at an average rate of ₹94.3.
- Management has put in place a recovery plan to ensure growth in the US from Q4.

From Q2 FY19

- Mastek expects its growth trajectory to continue at the same pace owing to its strong position in the UK. It expects its US operations to start accelerating with a lag of 1-2 quarters as investments start yielding results.
- It believes it can improve on its engagement size with clients on the digital side as the market matures and digital-deal sizes grow. This would enable it to deepen its relationships and improve its prospects of higher offshore as well, thereby benefiting both revenue assurance and higher margins.
- It hiked wages in the quarter, resulting in a sequential decline in margins.

Factsheet

Fig 9 – Revenue by area

(%)	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20
North America	22	26	27	23	19
UK	77	73	72	76	69
India	2	2	2	1	5
ME	0	0	0	0	7
APAC (RotW)	0	0	0	0	0

Source: Company

Fig 10 – Revenue by verticals

(%)	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20
BFSI	18	17	18	17	14
Government	42	40	40	44	49
IT & Others	5	6	5	5	15
Retail	34	38	38	34	22

Source: Company

Fig 11 – Client concentration

(%)	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20
Top-5 clients	42	40	40	43	36
Top-10 clients	59	58	57	63	51

Source: Company

Fig 12 – Workforce

(%)	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20
Technical	1,748	1,725	1,632	1,573	2,884
Technical support	87	94	85	91	123
Marketing	80	67	65	61	169
Support	154	149	155	155	228
Utilisation % (gross)	79	75	75	77	75
12-mthorder backlog ($ m)	77.4	89.2	89.0	66.3	103.8
No. of active clients	157	154	144	143	436
Revenue per active client ($ m)	0.2	0.2	0.2	0.2	0.1

Source: Company

Valuations

A small IT services company, Mastek is trying to morph into a mid-sized one, relying on both organic and inorganic initiatives. It is run by professionals and the promoters had set a vision for it to turn into a $200m revenue company by FY20. This it achieved by Q4 with the Evosys acquisition ($67m revenue in FY20, growing ~12%).

Mastek is now looking at its next leg of growth by acceleration in its UK business (as BRexit is behind), rejuvenating its US business (new leadership inducted, sales reinforcement through Evosys), and realising synergies (cross sales and cost efficiencies) with Evosys. Also, in the process it issued significant equity to Evosys' promoters, thereby making them an integral part of company management.

As Mastek's operating parameters and business characteristics converge to the sectoral metrics, we value it on a one-year-forward PE basis as a primary valuation method and on an FCF/EV basis as a secondary valuation method. The stock now trades at 7x FY22e EPS and 14% FCF/EV yield. While this reflects its current weak operating performance on an organic basis and the risks associated with a large acquisition such as Evosys, we find the valuations attractive and believe that Mastek can trade at 10x FY22e EPS, as it gradually returns to a growth trajectory (in line with the sector) and scales up to midcap levels, thereby reducing quarterly fluctuations.

The IT services division has suffered in the past, perhaps because of management's twin focus on building the products and services businesses. After the split, the company has focused on growing the IT services business, though business concentration in terms of the UK and the government businesses are key concerns.

Mastek has over the last few years consistently expanded its operating margins, with the EBIT margin moving up from 9.9% in FY18 to 12% in FY20. We expect it to keep inching up at the current pace and touch 13.1% by FY22.

We value the core business at 10x FY22e EPS, on expectation of growth returning and steady profitability, and arrive at a target of ₹510.

Fig 13 – Change in estimates (₹ m)

	FY21			FY22		
	New	Old	*Chg %*	New	Old	*Chg %*
Revenues ($m)	193	211	(8.4)	214	230	(6.9)
Revenues	14,162	15,229	(7.0)	15,727	16,642	(5.5)
EBITDA	2,073	2,081	(0.4)	2,419	2,486	(2.7)
EBITDA margins %	14.6	13.7	97bps	15.4	14.9	45bps
EBIT	1,729	1,682	2.8	2,061	2,070	(0.4)
EBIT margins %	12.2	11.0	116bps	13.1	12.4	67bps
Other income	77	(18)	(526.3)	188	(5)	(3,777.2)
PBT	1,805	1,664	8.5	2,249	2,065	8.9
Net profit	1,180	1,091	8.2	1,492	1,378	8.3

Source: Anand Rathi Research

Fig 14 – PE band

Source: Bloomberg, Anand Rathi Research

Risk

- Loss of momentum at Evosys.

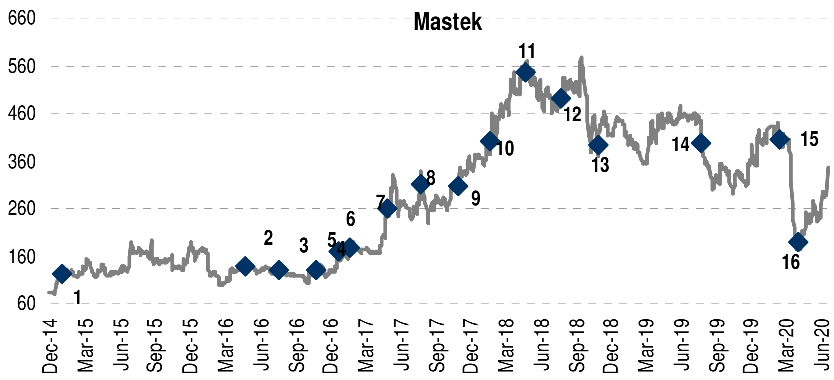
Appendix

Analyst Certification

The views expressed in this Research Report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report. The research analysts are bound by stringent internal regulations and also legal and statutory requirements of the Securities and Exchange Board of India (hereinafter "SEBI") and the analysts' compensation are completely delinked from all the other companies and/or entities of Anand Rathi, and have no bearing whatsoever on any recommendation that they have given in the Research Report.

Important Disclosures on subject companies

Rating and Target Price History (as of 16 June 2020)



	Date	Rating	TP (₹)	Share Price (₹)
1	30-Dec-14	Buy	170	135
2	20-Apr-16	Hold	170	148
3	15-Jul-16	Hold	160	140
4	19-Oct-16	Hold	170	149
5	19-Dec-16	Buy	220	176
6	17-Jan-17	Buy	235	192
7	25-Apr-17	Buy	325	282
8	20-Jul-17	Hold	355	359
9	26-Oct-17	Hold	370	359
10	19-Jan-18	Buy	520	394
11	19-Apr-18	Hold	650	587
12	19-Jul-18	Buy	730	501
13	25-Oct-18	Buy	670	413
14	23-Jul-19	Buy	650	457
15	12-Feb-20	Buy	620	419
16	31-Mar-20	Buy	510	190

Anand Rathi Ratings Definitions

Analysts' ratings and the corresponding expected returns take into account our definitions of Large Caps (>US$1bn) and Mid/Small Caps (<US$1bn) as described in the Ratings Table below:

Ratings Guide (12 months)

	Buy	Hold	Sell
Large Caps (>US$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US$1bn)	>25%	5-25%	<5%

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