30 July 2020

Mastek

Rating: **Buy**
Target Price: ₹780
Share Price: ₹521

Organic scale-up, capital allocation to create value; Buy

Mastek had a strong Q1: $50.8m revenue(up 9.7%q/q, 12.1% q/q CC) $33.2m organic revenue, down 3.3%q/q. Its scale will incrementally make performance resilient. The EBIT margin was 14.7% (down 31bps q/q, up 371bps y/y), to be managed in a narrow band. The backlog was $101m, to improve as the UK opens up. Given the recent acquisition, we expect prudence in capital allocation. And if it builds sales capability of Evosys company-wide, its multiple is likely to expand. We raise our FY21e/22e EBITDA 23/25% and assign a higher, 12x, multiple (earlier 10x) with a target of ₹780 (up from ₹510).

Evosys growing fast, 48 clients added in Q1. Fully consolidated in Q1, Evosys brought $17.6m (annualized $70m+) and is likely to accelerate ahead. The Evosys management sees traction in cloud migration and expects positive growth in FY21. Mastek's UK government business is doing well (60% of its UK business, up 5% q/q), but private is soft (may pick up in H2). Performance in Q2 would be stable with better order book with acceleration in H2.

EBIT margin to be maintained, incremental to be invested back.EBIT was ₹567m, up 12%q/q, 109%y/y). The EBIT margin benefited by ~50bps on savingsin travel/facility costs, largely sustainable, with surpluses likely to be re-invested in the business. Mastek would add 100+ freshers in Q2 to support growth. Net profit was ₹404m (up 19%q/q, 67%y/y). Other income benefited from R&D tax exemptions,offset by the higher tax rate.

Focus on FCF generation, debt-repayment. Mastek has made all payments related to 70% of Evosys (except equity, which will be issued in H2 FY21). It has ₹173m net cash, and the MJCO stake sale will add ₹2bn, which will be utilised to repay the debt.

Target raised to ₹780 (12x FY22e). Mastek is now better diversified, has lower client concentration and stronger cash generation. It can significantly unlock value through organic growth, realisation of synergies, and leveraging the newly-inducted management's capabilities for growth. **Risk:**Evosys integration.

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (₹ m)	8,172	10,332	10,715	15,395	17,007
Net profit (₹ m)	700	1,014	1,089	1,978	1,922
EPS (₹)	28.0	40.3	41.2	67.0	65.1
PE (x)	22.1	15.2	14.2	7.8	8.0
EV / EBITDA (x)	12.9	9.8	8.4	5.0	4.2
PBV (x)	2.5	1.9	1.7	1.2	1.1
RoE (%)	15.6	16.0	14.5	20.2	15.5
RoCE (%)	10.7	11.5	8.6	9.1	10.9
Dividend yield (%)	1.1	1.3	1.5	3.0	2.9
Net debt / equity (x)	-0.2	-0.2	-0.1	-0.3	-0.4

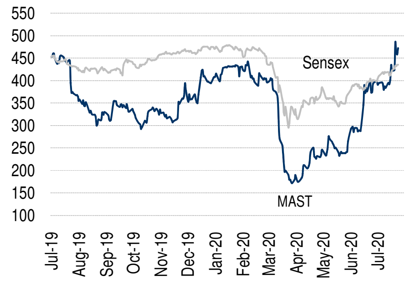
Source: Company, Anand Rathi Research

Key data	MAST IN / MAST.BO
52-week high / low	₹560 / 166
Sensex / Nifty	37736 / 11102
3-m average volume	$1.1m
Market cap	₹13bn / $170.7m
Shares outstanding	24m

Shareholding pattern (%)	Jun'20	Mar'20	Dec'19
Promoters	44.8	45.1	45.4
- of which, Pledged	-	-	-
Free float	55.2	54.9	54.6
- Foreign institutions	5.6	6.2	6.5
- Domestic institutions	15.3	14.9	12.4
- Public	34.3	33.8	35.7

Estimates revision (%)	FY20e	FY21e
Sales ($)	5.0	4.4
EBITDA	23.5	25.4
Net profit	67.5	28.8

Relative price performance



Source: Bloomberg

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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**	**151**	**203**	**224**
Growth (%)	***52***	***17***	***2***	***34***	***10***
Net revenues	8,172	10,332	10,715	15,395	17,007
Employee & direct costs	6,511	8,170	5,841	8,242	9,022
Gross profit	1,661	2,161	4,874	7,153	7,986
Gross margins (%)	*20.3*	*20.9*	*45.5*	*46.5*	*47.0*
SG&A	664	846	3,340	4,593	4,952
EBITDA	**997**	**1,315**	**1,534**	**2,559**	**3,033**
EBITDA margins (%)	***12.2***	***12.7***	***14.3***	***16.6***	***17.8***
- Depreciation	188	174	249	463	482
Other income	210	253	192	1,146	423
Interest expenses	59	61	36	93	45
PBT	960	1,334	1,441	3,150	2,929
Effective tax rate (%)	*27*	*24*	*21*	*29*	*26*
+ Associates / (Minorities)	-	-	-50	-246	-246
Net income	**700**	**1,014**	**1,089**	**1,978**	**1,922**
WANS	25	25	26	30	30
FDEPS (₹ / sh)	**28.0**	**40.3**	**41.2**	**67.0**	**65.1**

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	11,665	13,139
Debt	698	692	3,332	923	-
Minority interest	-	-	1,371	1,617	1,863
DTL/(Asset)	-255	-144	-226	-226	-226
Capital employed	**5,936**	**7,713**	**12,381**	**13,979**	**14,775**
Net tangible assets	459	456	762	524	290
Net intangible assets	250	243	1,039	1,039	1,039
Goodwill	1,080	975	6,767	6,767	6,767
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	5,931	6,010
Cash	**880**	**934**	**2,210**	**3,202**	**3,837**
Current liabilities	1,934	1,681	6,143	5,535	5,321
Working capital	2,069	3,589	-350	397	689
Capital deployed	**5,936**	**7,713**	**12,381**	**13,979**	**14,775**
Contingent liabilities	36	92.7	-	-	-

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
PBT	960	1,334	1,441	3,150	2,929
+ Non-cash items	221	230	510	-683	59
Oper. prof. before WC	1,181	1,563	1,951	2,467	2,988
- Incr./(decr.) in WC	449	507	-355	1,901	285
Others incl. taxes	-93	-306	-471	-927	-762
Operating cash-flow	**640**	**751**	**1,835**	**-360**	**1,942**
- Capex (tang. +intang.)	153	155	157	225	248
Free cash-flow	**488**	**596**	**1,679**	**-585**	**1,693**
Acquisitions	-55	-170	-4,256	-2,456	-
- Div.(incl. buyback & taxes)	107	177	315	461	448
+ Equity raised	24	29	21	2,245	0
+ Debt raised	41	6	2,371	48	-923
- Fin investments	64	238	-1,679	-1,057	109
- Misc. (CFI + CFF)	-73	-7	-95	-1,146	-423
Net cash-flow	400	52	1,274	992	635

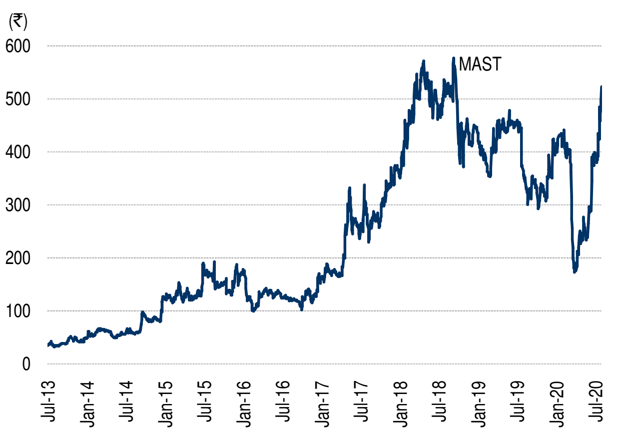
Source: Company, AnandRathi Research

Fig 4 – Ratio analysis

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
P/E (x)	**22.1**	**15.2**	**14.2**	**7.8**	**8.0**
EV / EBITDA (x)	**12.9**	**9.8**	**8.4**	**5.0**	**4.2**
EV / Sales (x)	1.5	1.2	1.2	0.6	0.5
P/B (x)	2.5	1.9	1.7	1.2	1.1
RoE (%)	**15.6**	**16.0**	**14.5**	**20.2**	**15.5**
RoCE (%) - after tax	10.7	11.5	8.6	9.1	10.9
RoIC (%) - after tax	15.7	16.4	11.9	12.9	16.0
DPS (₹ /sh)	**6.0**	**6.7**	**7.7**	**15.6**	**15.2**
Dividend yield (%)	1.1	1.3	1.5	3.0	2.9
Dividend payout (%) - incl. DDT	25.7	20.0	22.3	28.0	28.0
Net debt / equity (x)	-0.2	-0.2	-0.1	-0.3	-0.4
Receivables (days)	88	86	126	121	115
Inventory (days)	-	-	-	-	-
Payables (days)	10	4	42	20	15
CFO:PAT%	**91.5**	**74.0**	**161.2**	**-16.2**	**89.6**

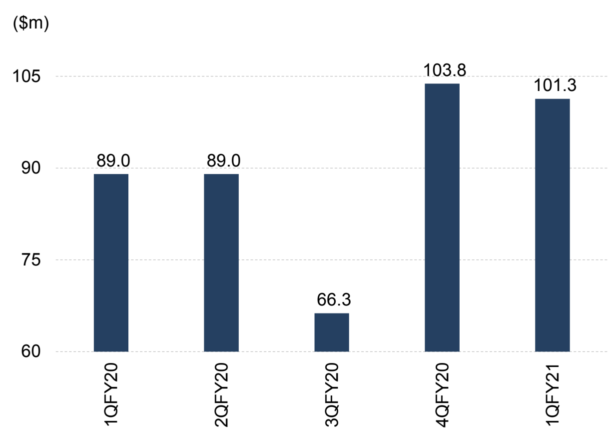
Source: Company, AnandRathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 6 – Order backlog



Source: Company

Result Highlights

Q1FY21 Results at a Glance

Fig 7 – Segment-wise results

	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q/Q %	Y/Y %
Revenues (US$mn)	**36**	**35**	**34**	**46**	**51**	**9.7%**	**43.1%**
Growth YoY %	***-2%***	***-5%***	***-8%***	***22%***	***43%***		
Volume growth %							
Revenues (Rsmn)	**2,475**	**2,436**	**2,437**	**3,367**	**3,861**	**14.7%**	**56.0%**
Eff. exchange rate	69.7	70.4	71.1	72.7	76.0	4.5%	9.0%
Employees (EoP)	**2,035**	**1,937**	**1,880**	**3,404**	**3,321**	**-2.4%**	**63.2%**
Revenue Productivity (US$ 000/employee)	17.2	17.0	17.7	24.6	14.9	-39.4%	-13.0%
Gross Utilization (IT services)	75%	75%	77%	75%	77%	190 bps	270 bps
Attrition							
CoR (excluding D&A)	(1,350)	(1,350)	(1,366)	(1,775)	(2,037)	14.7%	50.9%
As % of Revenues	-55%	-55%	-56%	-53%	-53%	-3 bps	178 bps
SG&A	(796)	(799)	(735)	(1,009)	(1,143)	13.2%	43.5%
As % of Revenues	-32%	-33%	-30%	-30%	-30%	38 bps	257 bps
EBITDA	**329**	**287**	**336**	**582**	**681**	**17.0%**	**107.1%**
EBITDA margins %	***13.3%***	***11.8%***	***13.8%***	***17.3%***	***17.6%***	***35 bps***	***435 bps***
EBIT	**272**	**230**	**278**	**505**	**567**	**12.3%**	**108.8%**
EBIT margins %	***11.0%***	***9.4%***	***11.4%***	***15.0%***	***14.7%***	***-31 bps***	***372 bps***
Other Income	56	81	81	19	163	778.9%	191.9%
Forex gain/loss and exceptional items	(4)	10	(31)	(19)	4	-123.2%	-200.0%
Interest expense	-8	-9	-8	-11	-25	119.3%	204.9%
PBT	315	313	320	493	709	43.8%	125.3%
PBT margins %	12.7%	12.8%	13.1%	14.6%	18.4%	372 bps	565 bps
Taxes	(72)	(66)	(60)	(104)	(243)	134.7%	236.2%
ETR %	-23.0%	-21.2%	-18.8%	-21.0%	-34.3%	-1329 bps	-1132 bps
PAT	**242**	**246**	**260**	**390**	**466**	**19.6%**	**92.2%**
PAT Margin %	***9.8%***	***10.1%***	***10.7%***	***11.6%***	***12.1%***	***50 bps***	***227 bps***

Source: Company, Anand Rathi Research

Fig 8 – Quarterly result(₹ m)

Year-end: Mar	Q1FY21	% Q/Q	% Y/Y	FY20	FY21	% Y/Y
Sales ($ m)	51	9.7	43.1	151	203	34.4
Sales	3,861	14.7	56.0	10,715	15,395	43.7
EBITDA	681	17.0	107.1	1,534	2,559	66.8
EBITDA margins (%)	18	35 bps	435 bps	14.3	16.6	231 bps
EBIT	567	12.3	108.8	1,285	2,096	63.1
EBIT margins (%)	15	-31 bps	372 bps	12.0	13.6	162 bps
PBT	709	43.8	125.3	1,441	3,150	118.6
Tax	(243)	134.7	236.2	(303)	(927)	206.1
Tax rate (%)	(34)	-1329 bps	-1132 bps	(21.0)	(29.4)	-841 bps
Net income	404	18.9	66.8	1,089	1,978	81.6

Source: Company, Anand Rathi Research

Conference-call takeaways

Mastek

- The US continues to be challenged in the retail vertical. However, sales reorganization is complete from Mastek's perspective. The company will benefit once the retail market in the US improves.
- The UK is looking for austerity measures; hence, pricing pressure is expected ahead. However, large deal/vendor consolidation opportunities are opening up with one such deal signed in July. UK private continues to see challenges and is under pressure. Clients are looking at higher offshoring there.
- Evosys is growing fast on Oracle cloud technologies implementation
- Mastek has moved to a 100% work-from-home model but in future will deploy a hybrid pattern of working.
- Receivables days (including Evosys) were brought down remarkably by nine q/q to generate strong cash flow.
- Of the order backlog of $101.3m, 55%came from Evosys. Mastek has signed a $5.5m deal with one of the leading healthcare clients, which will be accounted for in the Sep order-backlog. The deal pipeline is strong currently.
- Debt repayment of $6m was made during Q1.
- The order book and client addition continues to be strong on Oracle technology with large cross-selling opportunities available to cross-sell Mastek IT (ADM, testing, data analytics) Services to Evosys' clients.
- It won 48 clients, of which 23 were in the US, eight in the UK, six in the Middle East and the rest in the ROW with 12-18 months tenures.
- Other income has 40% Treasury and rental income, the rest being R&D incentives (to be received once a year).

Outlook

- Q2 to see sustained performance;Q3 to see acceleration in revenues.
- The EBIT margin is likely to be in a narrow range (from Q1 as the base) and higher profit will be ploughed back into the business.
- ETR to be 22-23%.

Notes from the last quarters' conference calls

From Q4 FY20

- 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.
- 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.
- 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, while the UK may be flattish) and Evosys to see 10-12% growth over FY20 with 18-20% margin.
- Evosys is looking at 18-20% growth for FY21.
- FY21 margins are likely to be in mid-teens (15-16% range)

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 Q1FY20

- 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 Q2and the proceeds utilised for acquisitions.
- The $1.2m balance payment for TaisTech would be paid inFY20.
- 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 Tais Tech 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 Q3FY19, 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 Q2FY19

- 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.
- Ithikedwages in the quarter, resulting in a sequential decline in margins.

Factsheet

Fig 9 – Revenue, by area

(%)	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21
North America	26	27	23	19	17
UK	73	72	76	69	65
India	2	2	1	5	4
ME	0	0	0	7	14

Source: Company

Fig 10 – Revenue, by verticals

(%)	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21
BFSI	17	18	17	14	13
Government	40	40	44	49	54
IT & Others	6	5	5	15	16
Retail	38	38	34	22	18

Source: Company

Fig 11 – Client concentration

(%)	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21
Top-5 clients	40	40	43	36	35
Top-10 clients	58	57	63	51	48

Source: Company

Fig 12 – Workforce

(%)	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21
Technical	1,725	1,632	1,573	2,884	2,803
Technical support	94	85	91	123	107
Marketing	67	65	61	169	182
Support	149	155	155	228	229
Utilisation % (gross)	75	75	77	75	77
12-mthorder backlog ($ m)	89.0	89.0	66.3	103.8	101.3
No. of active clients	154	144	143	436	504
Revenue per active client ($ m)	0.2	0.2	0.2	0.1	0.1

Source: Company

Valuations

A small IT Services company ($200m revenue), Mastek is trying to morph into a mid-sized one ($500m revenue), relying on both organic and inorganic measures. 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 Q4FY20 with the Evosys acquisition ($67m revenuein FY20, growing ~12%).In Q1FY21, it reported $50m in quarterly revenues.

Mastek is now looking at its next leg of growth by acceleration in its UK business (as BRexit is behind and the UK recovers from Covid-19), 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 management.

As Mastek's operating parameters and business characteristics converge to sectoral metrics, we value it on a one-year-forward PE as a primary valuation method and on FCF/EV as a secondary valuation method. The stock nowtrades at 8x FY22e EPS and 13% FCF/EV yield. While this reflects its current weak operating performance (although it has improved in the last six months) on an organic basis and the risks associated with a large acquisition such as Evosys, we find the valuationsattractive and believe that Mastek can trade at 12x FY22eEPS (10x earlier)as it gradually returns to a growth trajectory (inline with the sector) and scales up to mid-cap levels, thereby reducing quarterly fluctuations.

Mastekhas 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 15% by FY22.

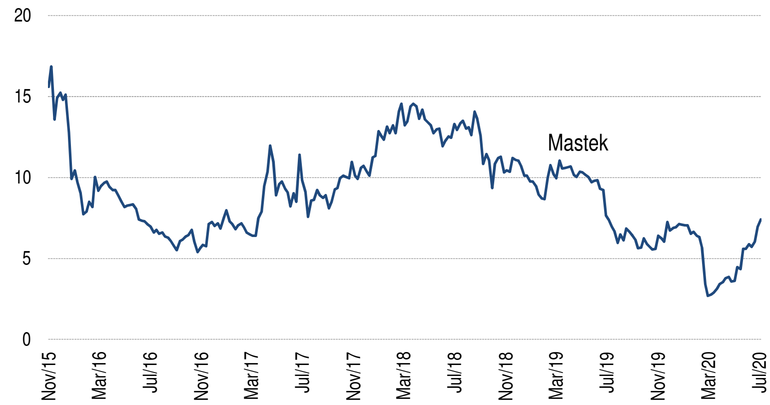
We value the core business at 12x FY22e EPS,on expectation of growth returning and steady profitability,and arrive at a target of ₹780.

Fig 13 – Change in estimates(₹m)

	FY21			FY22		
	New	Old	*Chg %*	New	Old	*Chg %*
Revenues ($m)	203	193	5.0	224	214	4.4
Revenues	15,395	14,162	8.7	17,007	15,727	8.1
EBITDA	2,559	2,073	23.5	3,033	2,419	25.4
EBITDA margins %	16.6%	14.6%	199 bps	17.8%	15.4%	245 bps
EBIT	2,096	1,729	21.3	2,552	2,061	23.8
EBIT margins %	13.6%	12.2%	141 bps	15.0%	13.1%	190 bps
Other income	1,054	77	1,275.7	378	188	101.5
PBT	3,150	1,805	74.5	2,929	2,249	30.3
Net profit	1,978	1,180	67.5	1,922	1,492	28.8

Source: Anand Rathi Research

Fig 14– PE band



Source: Bloomberg, Anand Rathi Research

Risk

- Evosys integration.

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.

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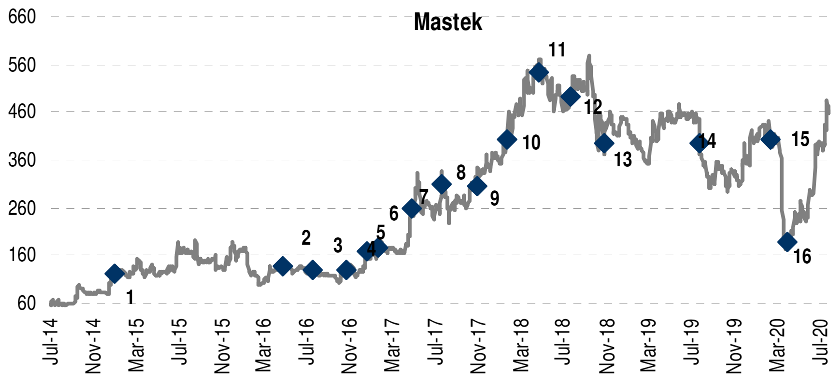
Rating and Target Price History (as of 30 July 2020)



	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

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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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