Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Mastek Limited

Well poised for growth

IT & ITES	Sharekhan code: MASTEK	Company Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 981**	
Price Target: **Rs. 1,200**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

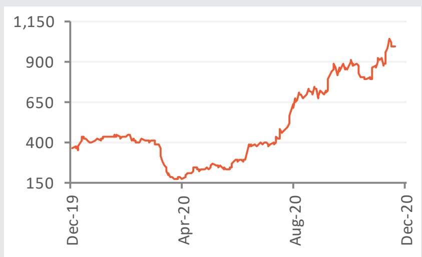
Company details

Market cap:	Rs. 2,429 cr
52-week high/low:	Rs. 1,075 / 170
NSE volume: (No of shares)	2.7 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.3 cr

Shareholding (%)

Promoters	44.6
FII	5.6
DII	14.1
Others	35.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	9.1	38.2	242.5	166.5
Relative to Sensex	(1.9)	20.6	209.9	156.0

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy rating on Mastek Limited (Mastek) with a revised price target (PT) of Rs. 1,200 as risk-reward ratio remains favourable. Cash & cash equivalents represent 18% of market capitalisation.
- Mastek is expected to maintain its strong growth momentum in Q3FY2021 despite furloughs, on a strong show by the UK public-sector business, growth in the US business and robust growth in Evosys business.
- Strong growth in the UK public business would be led by expansion of existing accounts and addition of new logos, while Evosys business growth will be driven by Oracle Cloud and providing end-to-end services with combined capability.
- We assume that a strong exit in FY2021E and anticipated recovery in UK private sector would create a strong platform to drive revenue growth in FY2022E. The management believes margins to be at 18-20% in FY2022.

We interacted with Mr. Abhishek Singh, group chief financial officer (CFO) of Mastek Limited, to understand long-term growth drivers, conversion of deal pipelines and margin outlook. Mastek is expected to maintain its strong growth momentum in Q3FY2021 despite furloughs, led by a strong growth in the UK public-sector business, anticipated growth in the US business and continued healthy growth in the Evosys business. The management mentioned that BREXIT has accelerated the requirements for technologies across UK government departments, on expected lines. Further, the pandemic has created new opportunities in the UK healthcare department as the newly formed National Institute for Health Protection (NIHP) has started focusing on driving COVID-19 test and trace initiatives. The management remains confident that the pace of order booking would continue in the UK public segment on the back of expansion of footprint in existing accounts, addition of new logos and strengthening the leadership position in this segment. Being an Oracle Platinum partner and given the absence of any legacy offerings (on-premise ERP offering), the management indicated that Evosys is well-poised to deliver strong growth in next 2-3 years. We believe that strong revenue growth in the Evosys business will be driven by strong momentum of the software-as-a-service (SaaS) vertical, a healthy growth rate in Oracle Cloud ERP/HCM, new logo wins, significant movement of SAP workloads to Oracle Cloud and ability to provide end-to-end services with the combined capability of Mastek and Evosys. Though there could be some near-term pressure for SaaS companies as enterprises delay to purchase software, but industry experts expect that the SaaS market would clock a 13% CAGR over the next five years. We assume that a strong exit in FY2021E and anticipated recovery in UK private sector would create a strong platform to drive revenue growth in FY2022E. Margins could sustain at a narrow band over the remaining quarters of FY2021, despite wage hikes and increased hiring. The management believes that EBITDA margin would be at 18-20% in coming years, as it would invest back excess profitability into the business to drive growth and some expenses could start coming back post normalisation.

Our Call

Valuation – Maintain Buy with a revised price target of Rs. 1,200: The management remains confident on growth prospects in the near to medium term, led by the expansion of existing logos and addition of new logos in the UK public-sector business, fully operational sales team to drive Oracle commerce business in the US, recovery of the UK private-sector business (in FY2022E) and strong show in the Evosys business. We believe that September 2020 quarter margin represents a peak (21.1% EBITDA margin) and it could sustain at a narrow band over the remaining quarters of FY2021 despite wage hikes. After receiving proceeds from the sale of Majesco USA's stake, the net cash remained at Rs. 450 crore that is 18% of its current market capitalisation. At CMP, the stock is trading at a reasonable valuation of 13x/11.5x its FY2022E/FY2023E EPS. Given strong growth potential and a healthy balance sheet, we maintain Buy rating on Mastek with a revised price target (PT) of Rs. 1,200.

Key risk

1) Integration issue from inorganic initiatives; 2) intense competition; and 3) currency risks.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	1,033.2	1,071.5	1,655.3	1,910.3	2,106.9
OPM (%)	12.7	14.5	19.6	19.7	19.8
Adjusted PAT	100.9	132.9	190.1	220.6	249.7
% y-o-y growth	44.3	31.7	43.0	16.0	13.2
Adjusted EPS (Rs.)	40.1	42.9	64.8	75.2	85.1
P/E (x)	21.5	20.1	13.3	11.5	10.1
P/B (x)	3.0	2.8	2.7	2.3	2.0
EV/EBITDA (x)	14.8	12.6	6.0	5.2	4.7
RoNW (%)	15.9	14.4	22.1	21.7	20.9
RoCE (%)	18.9	14.7	19.5	20.2	20.8

Source: Company; Sharekhan estimates

Evosys is well-poised to tap into large opportunities in Cloud

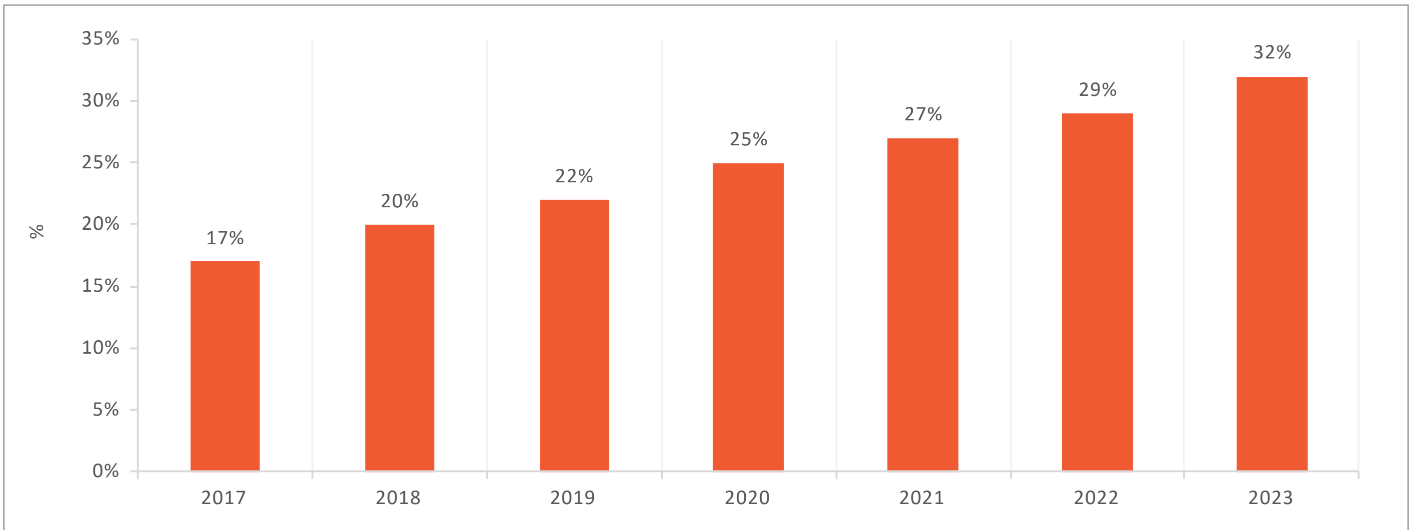
We recently interacted with Mastek's management to understand the company's growth prospects from the accelerated cloud adoption by enterprises and significant movement of SAP workloads to Oracle Cloud. As Evosys is an Oracle Platinum partner and given the absence of any legacy offerings (on premise ERP offerings), the management indicated Evosys is well poised to drive its growth in next 2-3 years. Further, growth would be driven by strong momentum of vertical SaaS (Software-as-a-Service), a healthy growth rate in Oracle Cloud ERP/HCM (named as magic quadrant leader by Gartner), new logo wins and ability to provide end-to-end services with the combined capability of Mastek and Evosys.

Evosys is a leading Oracle Cloud implementation and consultancy company serving more than 1,000 Oracle Cloud customers across more than 30 countries. An Oracle Platinum partner, Evosys provides solution offerings such as Oracle HCM Cloud, Oracle ERP Cloud, Oracle SCM Cloud, Oracle CX, Oracle EPM Cloud, PaaS solutions (including custom built solutions), AI, IoT, and machine learning.

Pandemic accelerates move to the Cloud, expect SaaS market to accelerate

The COVID-19 pandemic has acted as a catalyst in accelerating demand for cloud transformation among enterprises. Indian IT service providers generate revenue by helping enterprises migrate to the Cloud framework including services such as data management, processes and applications transformation, digital transformation, creating multi-cloud environment and offering products and platforms. Cloud spending is estimated to grow by 19% for 2020 and overall cloud spending as a percentage of IT spending would move from 25% in 2020 to 32% in 2023.

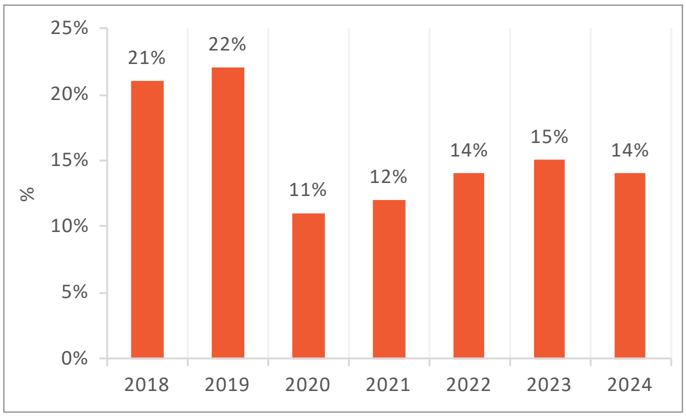
Overall cloud spending as % of IT spending



Source: Gartner, Sharekhan Research

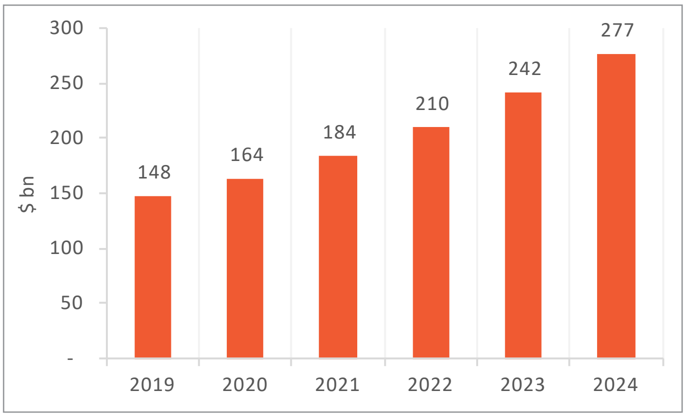
Delivery of software applications on the cloud as a service is classified into 1) horizontal business applications (e.g. customer relationship management [CRM], enterprise resource planning [ERP] and human capital management [HRM]), 2) horizontal infrastructure applications (e.g. security, testing, data management) and 3) vertical-specific business applications (e.g. healthcare applications, e-commerce enablement). Iaas/PaaS companies are currently growing faster than SaaS companies given strong growth in cloud infra spend. Though there could be some near-term pressure for SaaS companies as enterprises delay to purchase software, but industry experts expect SaaS market would clock a 13% CAGR over the next five years.

Near-term pressure in SaaS market, growth to revive



Source: Company, Sharekhan Research

SaaS market size estimates



Source: Company, Sharekhan Research

We expect strong growth momentum to continue in Q3FY2021

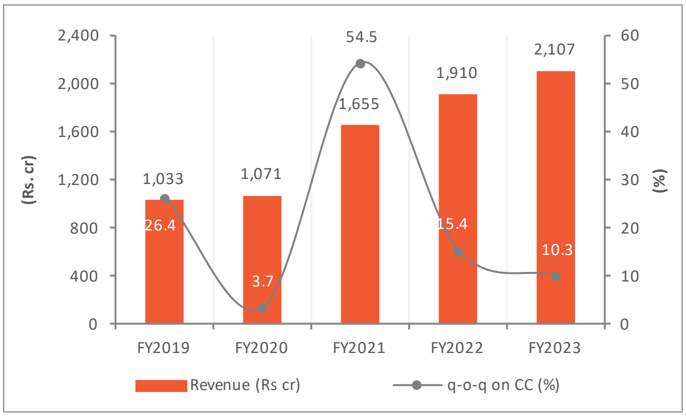
We assume Mastek would continue delivering strong growth in Q3FY2021 despite furloughs, led by increasing demand from the UK public segment in the wake of Brexit, fully operational sales team in the US and continued strong demand for Oracle Suite and Cloud migration. The management witnesses significant increase in demand for digital transformation projects across the departments (especially from Home office, Ministry of Defence, HM Revenue & Customs and ministry of Justice) of UK government owing to recent Brexit developments. Further, the pandemic has created strong demand from the UK healthcare department as the newly formed National Institute for Health Protection (NIHP) department started focusing on driving COVID-19 'test and trace' initiatives across the UK. With its recruitment for senior position for the UK public sector, expansion of footprints in its existing relationships and addition of new logos, the management remains confident that strong growth momentum in UK public sector would continue in next few years. The Evosys business is expected to deliver strong growth on the back of higher cloud migration, cross-sell opportunities and co-sell opportunities (joint go-to-market strategy). The management reiterated that H2FY2021 better compared to H1FY2021, led by strong show in UK public sector, recovery in Middle East (ME) business, strong demand for Oracle Cloud and movement of SAP to Oracle Cloud. We believe that strong growth momentum in H2FY2021 and recovery in UK private sector would create a platform to drive growth momentum in FY2022E.

Margin expansion can be sustained in 2HFY2021, but it could moderate in FY2022

Mastek has been surprising positively with the expansion of margin in the last four consecutive quarters on the back of strong revenue growth, aggressive cost management and reduction of variable expenses. However, we believe that the September 2020 quarter margin represents a peak (21.1% EBITDA margin in Q2FY2021) and could sustain at a narrow band over the remaining quarters of FY2021 given wage hikes (effective from October 1, 2020) and increased hiring. Benefits from cost savings in travel, administrative expenses, lower selling & marketing costs and higher offshoring revenues are expected to fade away over a period of time, though it may not return to pre-COVID level even after normalcy. The management believes that EBITDA margin would be at 18-20% in coming years, as it would invest back excess profitability into the business to drive growth and some expenses could start coming back after normalisation.

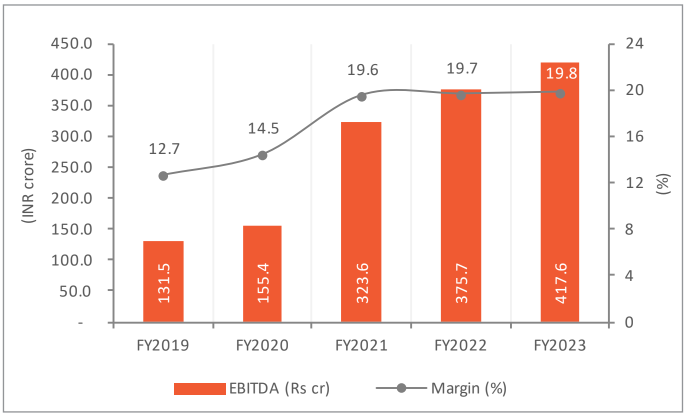
Financials in charts

Revenue (Rs. crore) and growth (%)



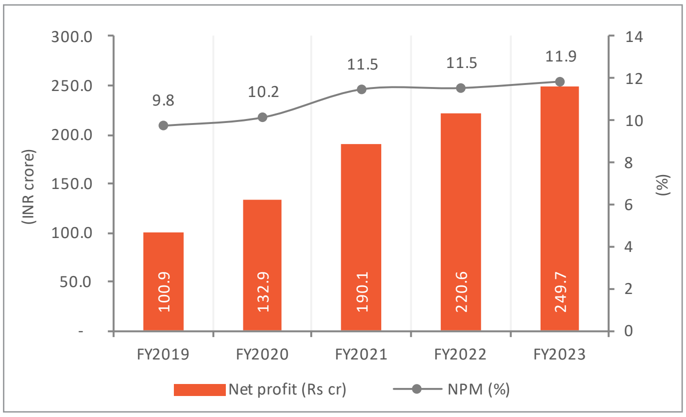
Source: Company, Sharekhan Research

EBITDA (Rs. cr) and EBITDA margin (%)



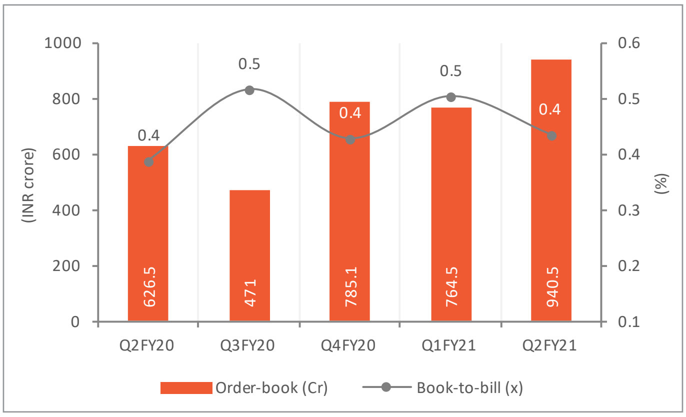
Source: Company, Sharekhan Research

Net profit (Rs. cr) and NPM (%)



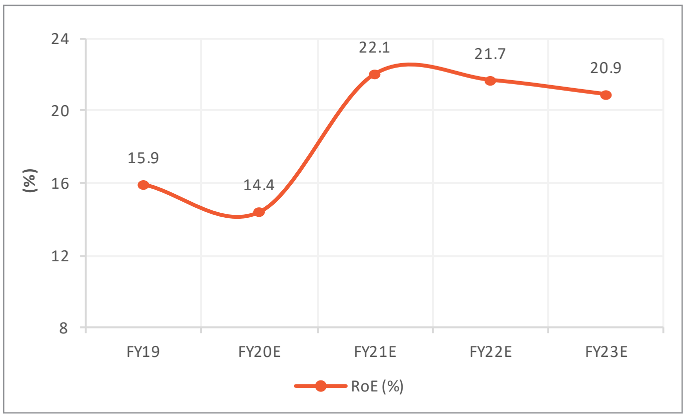
Source: Company, Sharekhan Research

Order-book (Rs. Cr) & Book-to-bill (x)



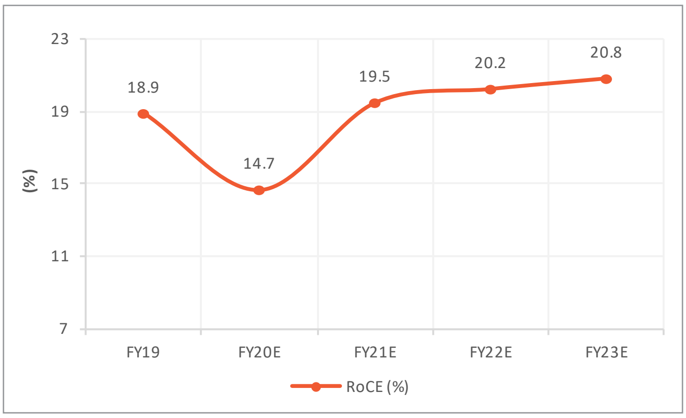
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Expect acceleration in technology spends going forward

Industry analysts such as Gartner estimates IT services spending to grow by 5-8% over CY2021-CY2024E as compared to an average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Gartner estimates that cloud consulting and integration (C&I) services will double from $98 billion in 2018 to $184 billion in 2022 (at a 17% CAGR) with migration at 70% of the market size. UK's software and IT Services (SITS) spend (Public + Private) is ~GBP 47 billion, of which UK public sector's spend is ~25% (~GBP 11.5 billion) and digital spend is ~23%. Hence, we believe there is huge headroom for Mastek to grow in the UK, as it currently gets less than 5% of total spends of Home Office and NHS Digital.

■ Company Outlook – Focus on improving annuity type deals

Mastek has created a consistent and predictable revenue stream from UK's public sector over the past few years, thanks to introduction of Digital Outcomes and Specialists (DOS) framework by the UK government (replacement of Digital Services-2 framework in 2016). Management indicated that revenue growth momentum in the UK public sector would continue in coming quarters on account of higher spends in UK governments and addition of new logos. Further, management indicated that Evosys revenue would maintain the growth momentum because of strong demand for cloud migration.

■ Valuation – Reasonable valuation

The management remains confident on growth prospects in the near to medium term, led by the expansion of existing logos and addition of new logos in the UK public-sector business, fully operational sales team to drive Oracle commerce business in the US, recovery of the UK private-sector business (in FY2022E) and strong show in the Evosys business. We believe that September 2020 quarter margin represents a peak (21.1% EBITDA margin) and it could sustain at a narrow band over the remaining quarters of FY2021 despite wage hikes. After receiving proceeds from the sale of Majesco USA's stake, the net cash remained at Rs. 450 crore that is 18% of its current market capitalisation. At CMP, the stock is trading at a reasonable valuation of 13x/11.5x its FY2022E/FY2023E EPS. Given strong growth potential and a healthy balance sheet, we maintain Buy rating on Mastek with a revised price target (PT) of Rs. 1,200.

One-year forward P/E (x) band

Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Birlasoft	188	28	5,211	18.4	14.4	9.2	7.5	2.5	2.2	14.5	16.7
Persistent Systems	1,219	8	9,317	22.1	18.0	13.5	11.1	3.6	3.2	16.8	18.8
Mastek	981	2	2,429	15.1	13.0	6.9	6.0	3.1	2.6	22.1	21.7

Source: Company, Sharekhan estimates

About company

Established in 1982, Mastek provides IT services to four verticals – government (mostly caters to the UK government), retail, financial, and information technology (IT) services. Mastek continues to be ranked among the top three vendors in delivering agile development services to the UK government on digital, G-Cloud, and GDS frameworks. The company primarily provides digital solutions to its retail (ex. Oracle Cloud Commerce platform) and financial clients (primarily wealth management and digital banking clients), while it helps the government to reduce cost and time in delivery in the UK. On the region front, the company is positioned largely in the UK, as 67% of its revenue comes from this region, followed by the US/ME/RoW with contribution to total revenue of 18%/11%/4%, respectively. In September 2014, demerger of insurance products and service business of Mastek formed a new company named Majesco Limited.

Investment theme

Mastek has a long-standing relationship with the UK government as it was working as a subcontractor to large IT companies for execution of UK government's projects earlier. This long-term relationship and excellent execution capabilities make Mastek a prime beneficiary of UK government's digital spends. We expect strong order pipeline along with significant headroom for growth with the UK public sector (spend is ~GBP 11.5 billion), higher client mining of top accounts, and cross/up-sell opportunities to drive strong growth for Mastek going forward. Further, Mastek has been largely participating for digital contracts of UK public and private sector, where UK digital spending is growing at 30%. With the acquisition of TAIS Tech, which marks its entry in the US, Mastek focuses on accelerating its revenue momentum in the US.

Key Risks

1) High dependence on the UK market; 2) headwinds in cross-currency (especially GBP/INR) fluctuations; and 3) intense competition may adversely impact our estimates.

Additional Data

Key management personnel

John Owen	Group CEO
Abhishek Singh	Group CFO
Prahlad Koti	MD UK
Hiren Shah	Senior VP - Service Lines
Dennis Badman	Chief Business Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	IDFC Mutual Fund/India	4.32
2	ABAKKUS GROWTH FUND	3.16
3	KACHOLIA ASHISH	2.86
4	Motilal Oswal Asset Management Co	1.78
5	Reliance Capital Trustee Co Ltd	1.11
6	Maheshwari Arun K	0.94
7	Dimensional Fund Advisors LP	0.93
8	Edelweiss Asset Management Ltd	0.89
9	Samsung Life Insurance Co Ltd	0.53
10	ICICI Prudential Asset Management	0.33

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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