Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Mastek Limited

Deal wins pave strong growth path

IT / IT services	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. 1,220**	
Price Target: **Rs. 1,400**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

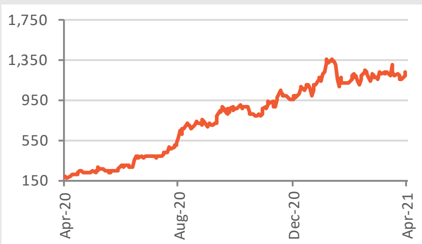
Company details

Market cap:	Rs. 3,079 cr
52-week high/low:	Rs. 1,460 / 175
NSE volume: (No of shares)	1.9 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.4 cr

Shareholding (%)

Promoters	44.3
FII	7.5
DII	16.2
Others	32.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.6	4.3	42.7	551.0
Relative to Sensex	3.9	0.2	11.8	475.1

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy on Mastek with a PT of Rs. 1,400 on a favourable risk-reward balance. Net cash is at ~17% of its current market capitalisation.
- The management is confident of maintaining sustainable strong growth momentum in the UK public sector and Evosys business in FY2022E. It sees strong traction in UK public sector for the digital transformation initiatives post Brexit.
- Mastek has successfully closed deals in both short-term and long-term digital projects with the UK government. We expect a strong recovery in order backlog in Q4FY2021, given recent deal signings with HMRC.
- Mastek is expected to deliver a strong revenue growth of 20% in FY2022E, led by strong growth momentum in public sector, healthy deal wins, cross-sell opportunities, traction for Evosys and a recovery in the US business.

We interacted with Mr. Arun Agrawal (Vice President, Finance) to understand the growth outlook for the UK public sector, traction for its Cloud-related offerings, strategies to reduce dependency on retail clients in the US, deal wins and margin trajectory. The management is confident of maintaining sustainable strong growth momentum in the UK public sector and Evosys businesses in FY2022E. The management indicated that it sees a good traction in the UK public sector for the digital transformation initiatives and cloud infrastructure, post Brexit as COVID-19 has had a limited effect on the UK government's existing digital projects. Further, there is an increase in short-term digital projects to address immediate requirements, especially within the UK National Health Service (NHS). For instance, Mastek was awarded a track-and-trace project related to COVID-19 from the NHS UK. Management also indicated that the joint go-to-market strategy with Evosys helped the company to win deals from the local governments of the UK. UK public sector (largest contributor to total revenues) has grown at CQGR of ~13% over last six quarters. We believe the growth momentum in UK public sector would continue FY2022E because of its focus on client mining strategies, widening of customer base by adding new logos, a robust deal pipeline and strong deal closure. Strong growth momentum in Evosys business is expected to continue in FY2022, given strong order booking, traction for its offering in Europe, Middle East and the UK, strong momentum of vertical SaaS (Software-as-a-Service) and new logo additions. While gradual recovery in US business is expected in FY2022E given cross-selling opportunity and sales team in place, the UK private sector is expected to deliver growth from Q1FY2022E onwards. The UK's Crown Commercial Services has appointed twelve suppliers (including Mastek) to build a new GBP 800 million digital capability for health framework. Given its strong presence in NHS in healthcare space in UK, Mastek is well poised to capture its share by participating in this digital transformation agenda of NHS. Further, media reports say that the HMRC has signed a contract (of GBP 8-9.8 million) with Mastek for all Customs, Borders and International (CB&I) live services for one year. However, we believe that there would be multiple vendors for this contract considering its size. We estimate USD revenue to grow at 6.2% q-o-q to $63.8 million on the back of strong growth in UK public sector and Evosys business, while EBITDA margins would decline by 170 bps q-o-q to 21.8% owing to a wage revision (two-month impact) and hiring at onsite locations.

Our Call

Valuation – Maintain Buy with a price target of Rs. 1,400: Mastek is expected to deliver strong growth in FY2022E, led by strong growth momentum in public sector, higher large deal wins through its joint go-to-market strategy, cross-sale opportunities in UK, traction for Evosys offering and recovery in the US business. EBITDA margin is expected to remain at high-teens as it would invest back excess profitability into the business to drive growth. We expect US Dollar revenue and earnings to grow at a CAGR of 16% and 12%, respectively over FY2021-FY2023E. Net cash levels remained at Rs. 521 crore as of December 31, 2020, which is 17% of its current market capitalisation. At CMP, the stock is trading at a reasonable valuation of 14x/12x its FY2022E/FY2023E EPS. Given strong growth potential and a healthy balance sheet, we maintain a Buy rating on Mastek with a price target (PT) of Rs. 1,400.

Key Risks

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

Valuation Rs cr

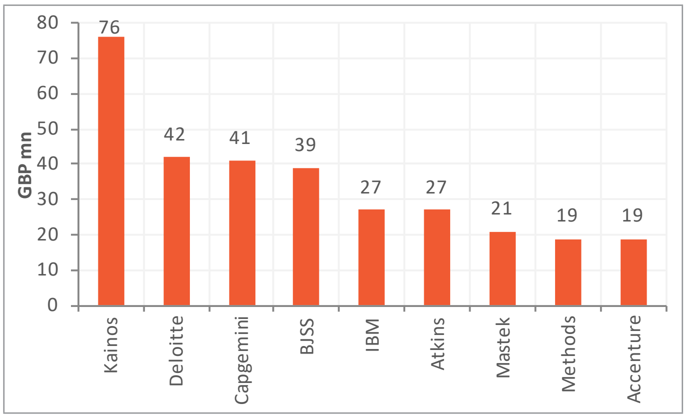
Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	1,033.2	1,071.5	1,703.9	2,053.2	2,282.6
OPM (%)	12.7	14.5	21.1	19.7	19.8
Adjusted PAT	100.9	132.9	204.7	219.5	257.4
% y-o-y growth	*44.3*	*31.7*	*54.0*	*7.2*	*17.3*
Adjusted EPS (Rs.)	40.1	42.9	77.1	88.1	103.2
P/E (x)	30.4	28.4	15.8	13.9	11.8
P/B (x)	4.3	3.9	3.4	2.7	2.3
EV/EBITDA (x)	22.3	18.8	8.1	7.2	6.5
RoNW (%)	15.9	14.4	23.6	21.4	21.3
RoCE (%)	18.9	14.7	21.4	20.9	21.4

Source: Company; Sharekhan estimates

Strong growth outlook for the UK Government business

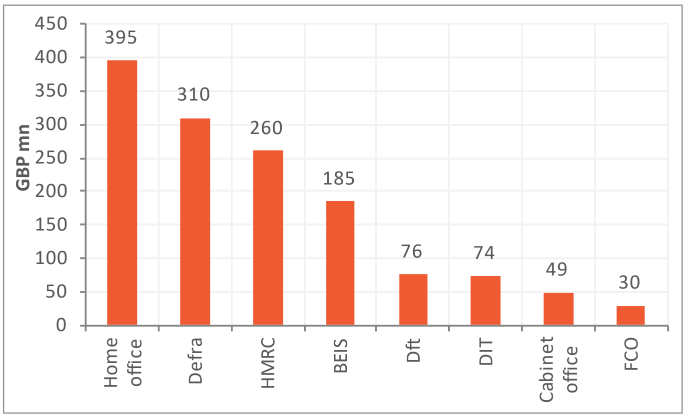
Mastek's management remains confident on the growth momentum of the UK public sector business considering its strong leadership team in UK, successful track record of delivering large projects to UK public sector, long-standing relationship with the UK government, whose digital spends are rising. UK public sector's spends remain over ~GBP 12 billion per annum in the IT services and software space, which provides a huge headroom for growth as Mastek services to three of the top four UK public sector spenders (central, local, healthcare and defence). Mastek has strong presence in the NHS (National Health Service) UK and healthcare spends by the UK government are increasing by 3% every year. Mastek is engaged with the UK government in a track-and-trace project related to COVID-19. Further, management highlighted that the joint go-to-market (GTM) strategy with Evosys helped Mastek win deals from the local governments of the UK. The management indicated that it sees good traction in the UK public sector business for digital transformation initiatives and cloud infrastructure post Brexit. The government business (33% of its total revenue in Q3FY2021) has clocked a CQGR of 13% over last six quarters. We believe the growth momentum would continue FY2022E because of its focus on client mining strategies, widening of its customer base by adding new logos, robust deal pipeline and strong deal closures (both in the short term and long term).

Digital outcomes framework FY21, Mastek dominates



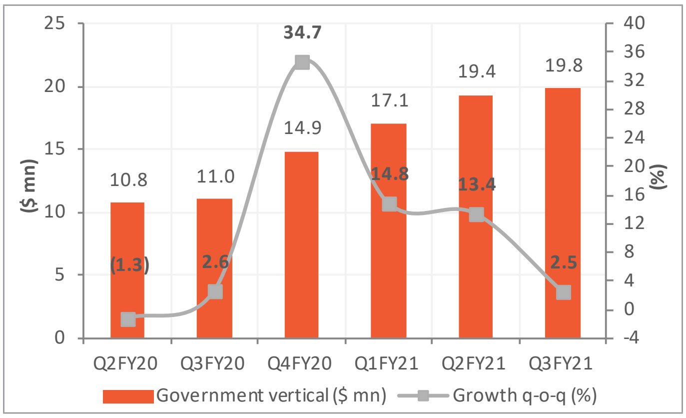
Source: Company, Sharekhan Research

Depts receiving additional EU Exit funding



Source: Company, Sharekhan Research

Government vertical revenue ($mn) & growth (%)



Source: Company, Sharekhan Research

Expect strong recovery in order backlog in Q4FY2021, deal pipeline remains encouraging

COVID-19 has had a limited effect on the UK government's existing digital projects, which is reflected in the improvement in order book position over last three quarters (up 28% to $129.6 million from $101.3 million in Q1FY2021). Further, the management indicated that it has done successful deal closures in both short-term and long-term digital projects with the UK government during the quarter. There is an increase in short-term digital projects to address the immediate requirements, especially within the NHS.

The UK's Crown Commercial Services has appointed twelve suppliers (including Mastek) to build a new GBP 800 million digital capability for health framework. The framework is due to run for four years with no option to extend. Given its strong presence in the UK NHS, Mastek is well-poised to capture its share by participating UK government's ambitious digital transformation agenda for NHS. Further, media report says that HMRC has signed for a GBP 10 million deal with suppliers to support its customs and border services and it also entered into a contract with Mastek for all Customs, Borders and International (CB&I) live services. The contract has come into effect on March 4, 2021 for one year and its estimated contract size of GBP 8-9.8 million. However, we believe that there would multiple vendors for this contract.

Management believes that the deal TCVs would remain strong going ahead as it continues to see traction for its offering from both UK central and local government departments and strong demand for Cloud infrastructure.

Evosys set to tap into large opportunities in Cloud

As Evosys is an Oracle Platinum partner and there aren't any legacy offerings (on premise ERP offerings), we believe Evosys is well-poised to drive its growth in next 2-3 years on the back of large opportunities in the cloud-migration space, strong order booking, healthy deal pipeline and opportunity to migrate from SAP customers to Oracle cloud. The company has created a dedicated sales team to migrate customers from SAP to Oracle cloud. As Oracle has opened up local data centers in the Middle East, the management expects higher cloud adoption in this region in coming quarters. It also expects strong demand for these services from Canada and European countries. The management focuses three key verticals such as 1) healthcare and lifesciences, 2) manufacturing and 3) construction. The management expects strong growth momentum in Evosys to continue in FY2022, given strong order booking, healthy deal pipeline, traction for its offering in Europe, Middle East and UK, strong momentum of vertical SaaS (Software-as-a-Service) and new logo additions. The management indicated that Evosys margin is expected to remain at 20-23%.

Expect strong growth in FY2022, but margins could normalise

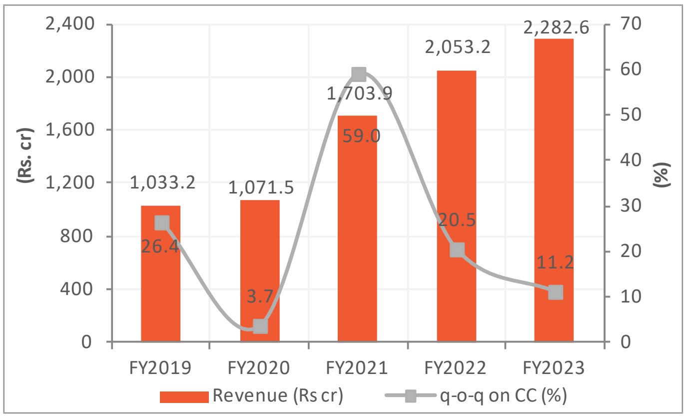
Mastek is expected to deliver strong growth in FY2022E, led by strong growth momentum in public sector, higher large deal wins through its joint GTM strategy, cross-sell opportunities in the UK, traction for the Evosys offering and recovery in the US business. The company added eight non-retail customers in the US business, which is expected to reduce sectoral concentration in the US and drive the growth. Given cross-sales opportunity, joint GTM strategy with Evosys and sales-team in-place, management expects gradual recovery in revenue growth in US business going ahead. The management aims to maintain EBITDA margin at high-teens as it would invest back excess profitability into the business to drive growth. Further, the management indicated it expects possibilities of higher offshoring in the UK public sector.

Expect UK public sector to drive growth in Q4; margin to decline owing to wage hikes and hiring

We expect sustainable growth momentum in UK public sector in Q4FY2021 because of ramp-up of earlier deal wins, while the US business and UK private sector business are expected to remain weak. However, management expect the decline in UK private sector would be bottomed out during the quarter. We expect overall margins to decline owing to two-month impact of wage revision (was effective from December 1, 2020) and an increase in onshore hiring due to travel restriction. We estimate USD revenue to grow at 6.2% q-o-q to $63.8 million, while EBITDA margin would decline by 170 bps q-o-q to 21.8%.

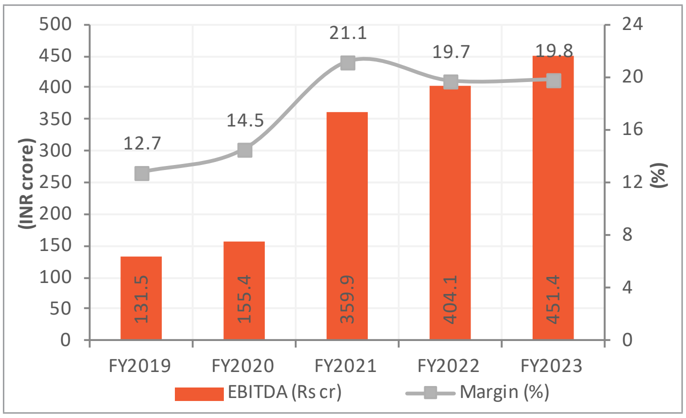
Financials in charts

Revenue (Rs. crore) and growth (%)



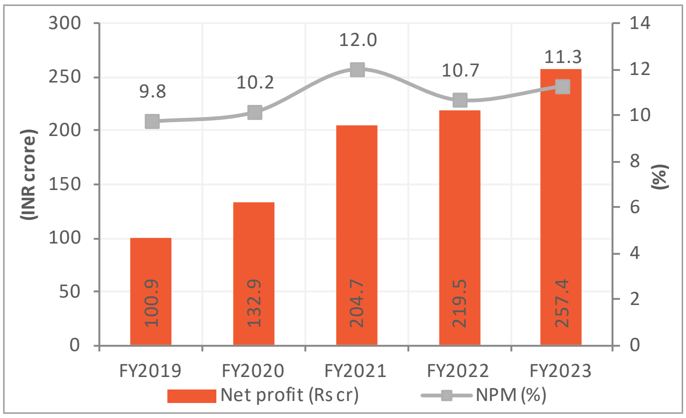
Source: Company, Sharekhan Research

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



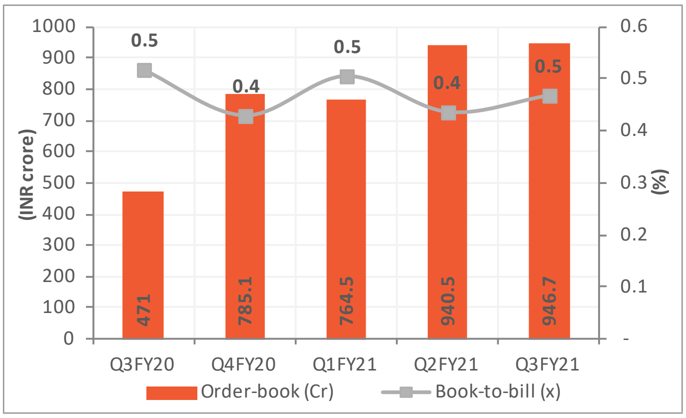
Source: Company, Sharekhan Research

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



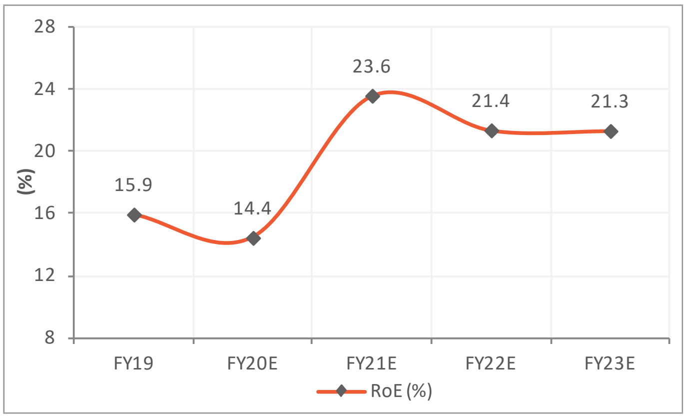
Source: Company, Sharekhan Research

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



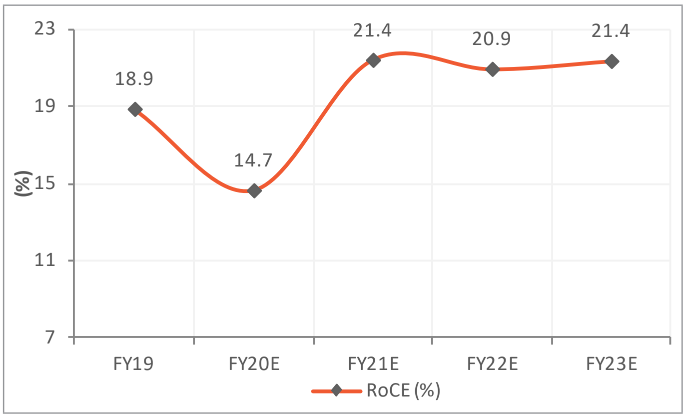
Source: Company, Sharekhan Research

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, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Gartner estimates that the size of the 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.

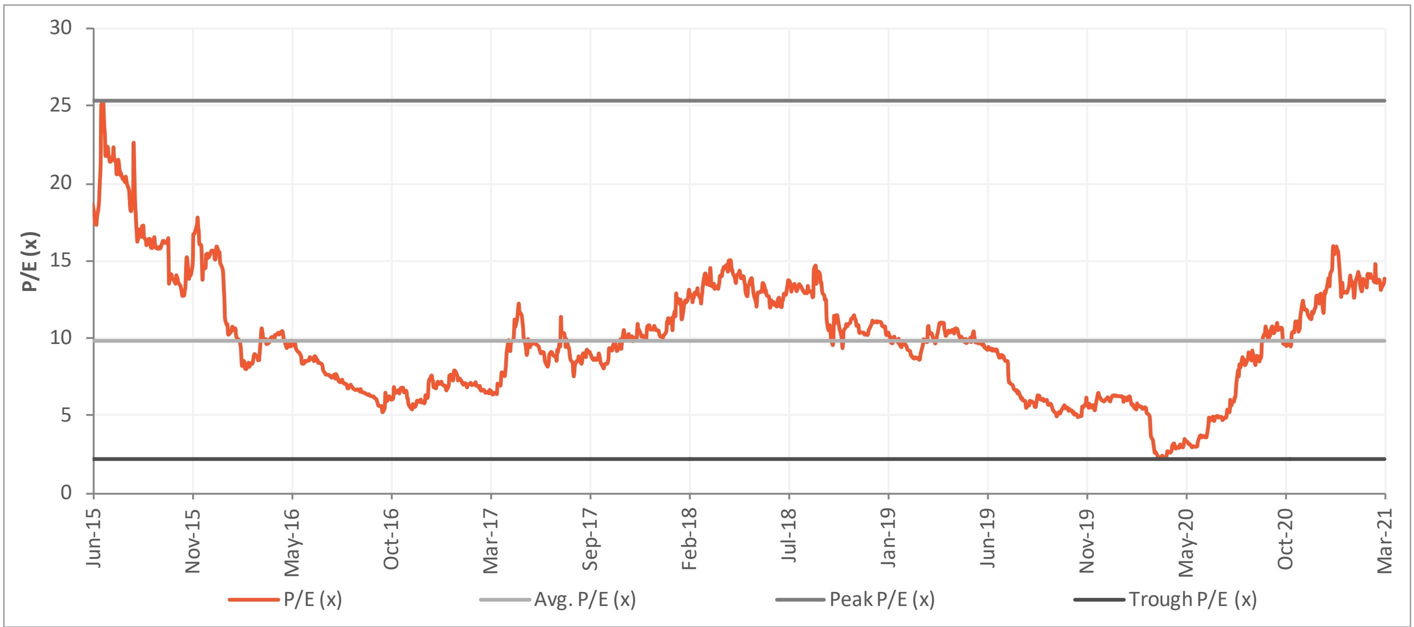
■ Company outlook – Focus on improving annuity type deals

Mastek has created a consistent and predictable revenue stream from the 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

Mastek is expected to deliver strong growth in FY2022E, led by strong growth momentum in public sector, higher large deal wins through its joint go-to-market strategy, cross-sale opportunities in UK, traction for Evosys offering and recovery in the US business. EBITDA margin is expected to remain at high-teens as it would invest back excess profitability into the business to drive growth. We expect US Dollar revenue and earnings to grow at a CAGR of 16% and 12%, respectively over FY2021-FY2023E. Net cash levels remained at Rs. 521 crore as of December 31, 2020, which is 17% of its current market capitalisation. At CMP, the stock is trading at a reasonable valuation of 14x/12x its FY2022E/FY2023E EPS. Given strong growth potential and a healthy balance sheet, we maintain a Buy rating on Mastek with a price target (PT) of Rs. 1,400.

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	253	28	7,013	22.9	17.5	12.2	9.8	3.3	3.0	15.7	18.3
Persistent Systems	1,919	8	14,664	33.7	26.3	21.2	16.8	5.6	5.1	17.3	20.2
Mastek	1,220	3	3,079	15.8	13.9	8.1	7.2	3.4	2.7	23.6	21.4

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 12 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

Ashank Desai	Group CEO
Abhishek Singh	Business leader
Umang Nahata	CEO, Evosys
Narasimha Murthy	Group Chief Delivery Officer
Arun Agarwal	Vice President, Finance

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	IDFC Mutual Fund/India	3.33
2	ABAKKUS GROWTH FUND	3.25
3	KACHOLIA ASHISH	2.84
4	Dimensional Fund Advisors LP	0.72
5	ICICI Prudential Asset Management	0.70
6	Edelweiss Asset Management Ltd	0.29
7	Investment trust of India	0.27
8	BOI AXA investment Managers	0.26
9	Nippon Life India Asset Management	0.81
10	Quant Money managers	0.26

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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