Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Mastek Ltd

Growth on the fast track

IT & ITES	Sharekhan code: MASTEK
Reco/View: Buy ↔	CMP: Rs. 3,319 · Price Target: Rs. 3,840 ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 21.77

Updated Jan 08, 2022

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

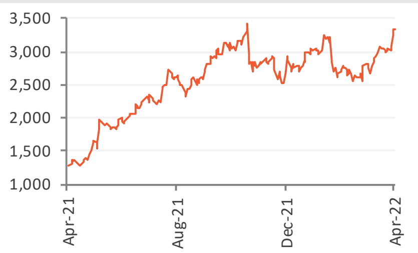
Source: Morningstar

Company details

Market cap:	Rs. 9,963 cr
52-week high/low:	Rs. 3,666 / 1,232
NSE volume: (No of shares)	1.1 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.9 cr

Shareholding (%)	as on 31-12-2021
Promoters	37.6
FII	6.7
DII	9.3
Others	46.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	18.1	10.0	6.4	160.7
Relative to Sensex	11.2	8.2	6.1	142.2

Sharekhan Research, Bloomberg

Summary

- We expect Mastek's revenue growth to accelerate in Q4FY22, as large deals ramp up, US business grows strongly and retail vertical recovers. EBITDA margin is likely to stay under pressure in near-term, owing to higher cost on backfilling attrition and retention.
- Deal win momentum with the UK government is expected continue in the medium term because of its strong qualified deal pipeline under the GBP 800 million framework, improved capabilities and rising spends on digital technologies.
- The company targets US revenue contribution to reach over 30% in the next three years from 18.5% currently, led by strong traction for D2X solutions, cross-selling/co-selling opportunities and improving deal sizes.
- We maintain a Buy on Mastek with a PT of Rs. 3,840 given strong earnings growth potential, steady deal wins, logo additions and M&A opportunities.

Our interaction with Mr. Arun Agrawal (Group CFO) of Mastek indicates that the company is well-placed to sustain strong growth momentum in FY2023E/FY2024E, led by a healthy order book, better client mining, logo wins, increasing deal size and strong demand. We expect the company's revenue growth to pick up in Q4FY2022, led by steady growth in the UK's public sector, ramp-up of large deals, healthy deal renewals and faster growth in the US business. Further, deal momentum under the GBP 800 million framework and addition of Fortune-1000 logos is likely to remain strong in Q4FY2022. The company won its biggest-ever GBP 60 million deal with National Health Services (NHS) Digital in Q3FY2022 and we expect Mastek's deal conversion to remain strong in the medium term considering its improved capabilities, strong relationships with customers in UK public sector and a robust deal pipeline.

- **Expect steady growth in UK public sector:** Mastek's overall size and tenure of deals in the UK public segment has been increasing given its strong relationship with the UK government, integrated solutions and cross-selling/co-sell opportunities. Mastek's deal win momentum with the UK government is expected continue in the medium term because of its strong qualified deal pipeline under the GBP 800 million framework, improved capabilities and rising spends on digital technologies. We believe increasing order size, strong order bookings, and better client mining, the company to clock strong revenue growth in its UK public segment going ahead.
- **US business set to race ahead:** US business revenues has been growing at a double-digit of above 20% y-o-y over the last three consecutive quarters, led by change in go-to-market approach (from vertical-centric to horizontal), hiring sales team, and strong traction for its integrated offerings in the digital commerce space. The company targets the USA revenue contribution to total revenue would reach over 30% in the next three years from 18.5% currently. Given strong traction for D2X solutions, cross-selling/co-selling opportunities and improving deal sizes, we believe that revenue growth in the US business would accelerate in FY2023.
- **Expect growth to pick up in Q4, margin to stay stressed:** In the past two quarters, Mastek's revenue growth was tepid on ramp down of projects and exit of small accounts in the Middle East. We believe revenue growth to accelerate to 4.5% q-o-q in Q4FY2022, led by ramp-up of large deals, strong growth in US business and recovery in retail vertical. Supply-side challenges, higher retention expenses, lateral hires and greater travel expenses are expected to weigh on margins in Q4FY2022, which is expected to be partially offset by operating leverage from strong growth and cost efficiencies.

Our Call

Valuation – Strong growth outlook intact: Mastek remains confident of delivering strong revenue growth over FY2023 to FY2024E, backed by long-standing relationships with the UK public sector, cross-selling/co-sell opportunities, solid order bookings, improving deal sizes, faster acquisition of F-500/F-1000 clients and strong growth momentum in the US. We expect the company's US Dollar revenues and earnings to post CAGRs of 20% and 23%, respectively, over FY2022-FY2024E. At CMP, the stock trades at a valuation of 30x/24x its FY2023E/FY2024E EPS, looks attractive given strong earnings growth potential and M&A opportunity. We maintain a Buy on Mastek with an unchanged price target of Rs. 3,840.

Key Risks

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

Valuation (consolidated) Rs cr

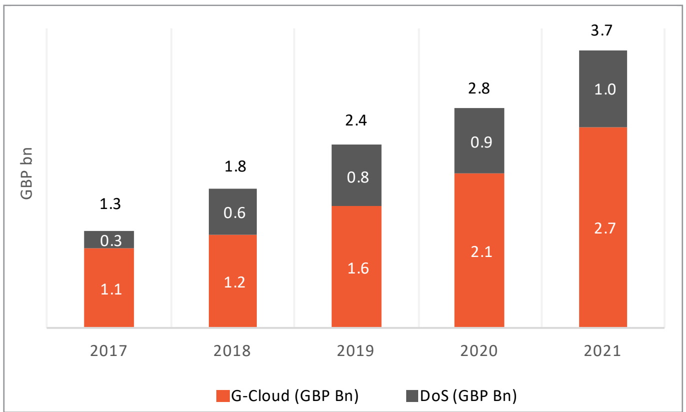
Particulars	FY21	FY22E	FY23E	FY24E
Revenue	1,721.9	2,180.1	2,703.4	3,259.9
OPM (%)	21.2	21.2	20.7	20.9
Adjusted PAT	209.4	289.3	360.0	438.6
% y-o-y growth	*57.5*	*38.2*	*24.4*	*21.8*
Adjusted EPS (Rs.)	81.9	100.7	113.9	137.4
P/E (x)	40.5	32.9	29.1	24.1
P/B (x)	9.9	8.8	7.8	6.3
EV/EBITDA (x)	22.9	18.0	14.9	12.3
RoNW (%)	25.4	29.9	29.6	28.9
RoCE (%)	22.1	25.8	27.4	28.8

Source: Company; Sharekhan estimates

Pace of UK public spending on technology to continue in CY2022

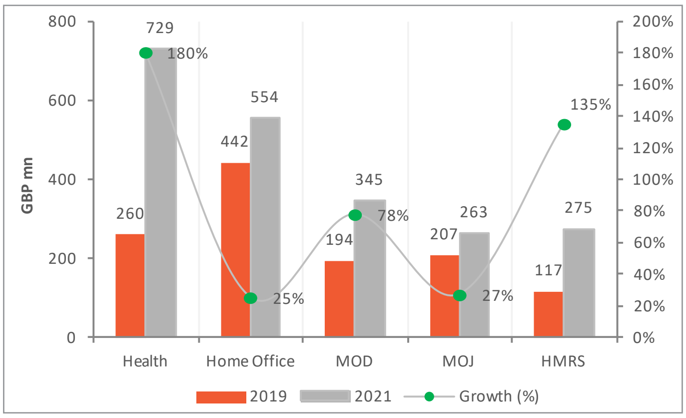
The UK public sector's total spends through both digital outcomes & specialists (DOS) and the G-Cloud framework clocked a 30% CAGR over CY2017 to CY2021, to reach GBP 3.7 billion. During CY2021, UK public sector's framework spends grew by 28% y-o-y. Acceleration in UK's public sector spends was led by greater adoption of digital technologies, investments in the UK's recovery, increasing spends on cloud technology and sharpening focus on strategic priorities. Health, Home office, Ministry of Defence, Ministry of Justice were the top technology spenders in UK public sector in CY2021. The UK public sector's spend on digital transformation initiatives and Cloud infrastructure is expected to remain strong in CY2022, led by modernisation of legacy systems, opening up of the economy and accelerated adoption of digitization across UK's government departments.

UK public sector spend via both frameworks



Source: Sharekhan Research, industry research

Strong spend across top 5 organizations

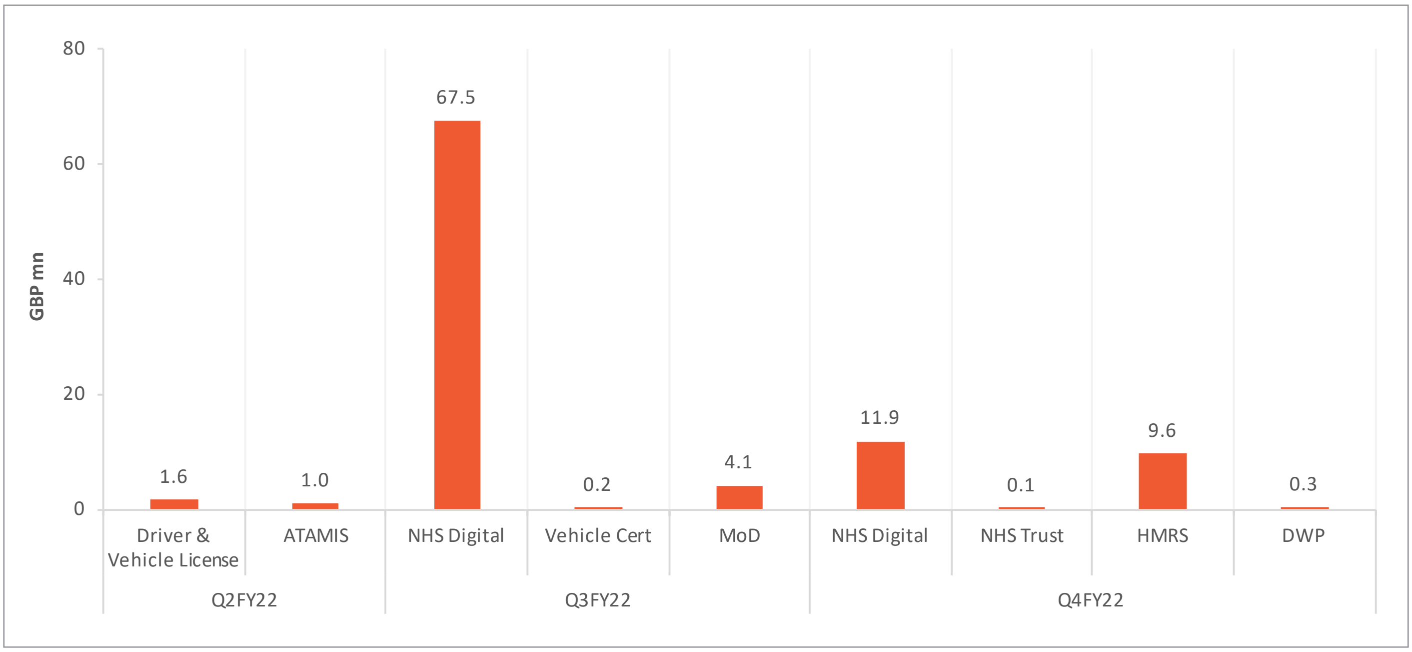


Source: Sharekhan Research, industry research

UK public sector: On a strong footing

The company's public-sector vertical has been growing strongly (~11% CQGR over Q2FY2020-Q2FY2022), led by strong execution, addition of logos, client mining and strong spending on digital technologies across the UK public sector. The company changed its reporting structure in revenue by vertical. Company's government and education, and healthcare and lifesciences vertical grew by 3.5%/30.6% q-o-q/y-o-y and 16.1%/31.1% q-o-q/y-o-y respectively in Q3FY2022, led by ramp-up of large deals and strong demand. During 9MFY2022, the incremental revenue of these two verticals contributed ~77% of the company's total incremental revenue. Further, management indicated that the overall size and tenure of the deals in the UK public segment has been increasing on its strong relationship with UK Government, integrated solutions and cross-selling/co-sell opportunities. The company signed few deals worth more than GBP 65 million with National Health Services Digital (including its biggest-ever GBP 45 million deal in November 2021) during Q3FY2022, which indicates the ramp down in NHS Digital account is now over. Further, order intake momentum from the UK government is expected continue in Q4FY2022 given its strong qualified deal pipeline with NHS Digital, improved capabilities and greater adoption of digital technologies across the public sector of UK. We believe that higher order sizes, strong order bookings, client additions, good client mining and a better mix of quality of revenue, will help Mastek deliver strong revenue growth in its UK public in Q4FY2022 and FY2023E.

Deal win momentum in UK public sector



Source: industry; Sharekhan Research

US business set to gallop

After the appointment of Hiral Chandrana as CEO, US business revenue has been growing at a double-digit of above 20% y-o-y over the last three consecutive quarters, led by change in go-to-market approach (from vertical-centric to horizontal), hiring sales and marketing team, improving partnership and alliance ecosystem, expanding its offering in new areas and strong traction for integrated offerings in digital commerce space. Further, the company's strong capability in Oracle cloud migration along with its ability to cross-sell digital commerce and transformation services is helping the company to win deals in the USA. Mastek is also leveraging its Digital Commerce customer base in the USA to gain more wallet share by providing new service offerings (including Business Intelligence & Analytics, Quality Assurance Automation and Robotic Process Automation). The company targets the USA revenue contribution to total revenue would reach at 30%+ over next three years from 18.5% currently. Management cited that the average deal size in the USA has improved to $5 million from $500K. Given strong traction for D2X solutions, cross-sell/co-sell opportunities and improving deal sizes, we believe that revenue growth in the US business would remain strong in FY2023.

Growth outlook intact

Mastek has been witnessing a strong traction around three strategic bets (data and analytics, healthcare and automation), Oracle cloud business, cross-sell/co-sell opportunities and large deals. Increasing deal size, strong growth in healthcare and lifesciences vertical and higher wallet share is the result of the company's proficiency in Oracle Cloud migration capability and strong digital offerings around data, analytics and DevOps. Further, the company's focus on large/mid-sized markets and Fortune-1000 clients has started showing results as the company added ten Fortune-1000 clients over the last two quarters (17 F-1000 clients versus six in Q3FY2021). We believe the company would continue to acquire F-1000 customers initially with a small annual engagement and then it would focus to convert it to multi-million annual engagements. With an improvement in average deal size, strong order bookings, addition of new logos (especially more F-1000 logos), strong growth momentum in US business and long-standing relationships with UK government, we expect Mastek is likely deliver strong revenue growth CAGR of 20.3% over FY2022E-FY2024E.

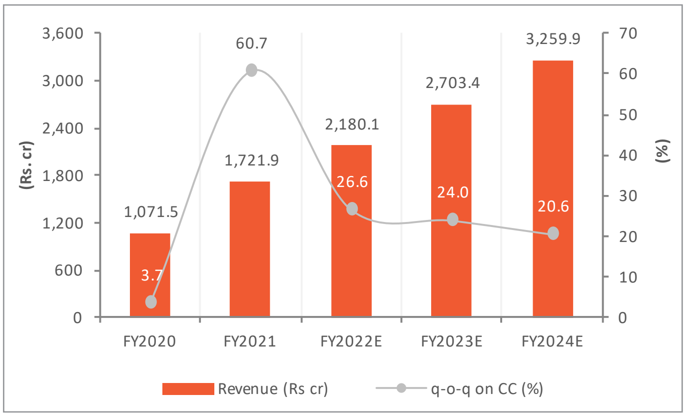
Q4 to see strong growth, though margin would stay stressed

The company's revenue performance was unexciting over last two quarters (Q2 and Q3 of FY2022) in a strong demand environment, due to ramp down of projects in its UK NHS account, delay in deliveries due to supply-side issues and exiting of some small accounts in the Middle East region. However, the company's deal win momentum has picked up in the UK NHS account under GBP 800-million digital capability framework since November 2021. We believe the company's revenue growth to accelerate to 4.5% q-o-q to $76.8 million, led by ramp-up of large deals, steady growth in UK public sector, strong growth momentum in US business and recovery in retail vertical (absence of seasonality).

Supply-side challenges, higher retention expenses, lateral hires and investments on building capability and sales are expected to weigh on margins in Q4FY2022. We believe margin levers such as strong revenue growth and cost optimization could partially offset the pressure to a certain extent. We forecast the EBITDA margin would be at 20.9% in Q4FY2022 versus 21.3% in 9MFY2022. Given return of travel and facility expenses, augmentation of delivery capability and investments on building capability and sales & marketing, management expects 50-100 bps negative impact on margins in medium term. We estimate the EBITDA margin at 20.7% in FY2023E versus 21.2% in FY2022E.

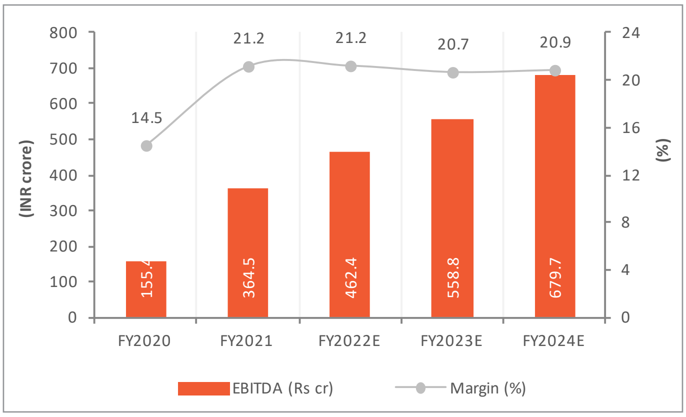
Financials in charts

Revenue (Rs. crore) and growth (%)



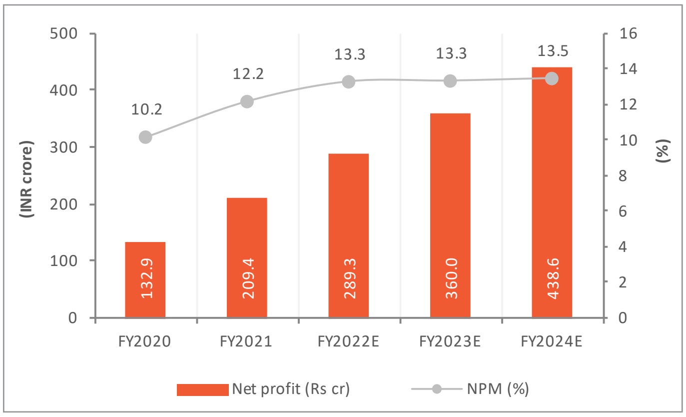
Source: Company, Sharekhan Research

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



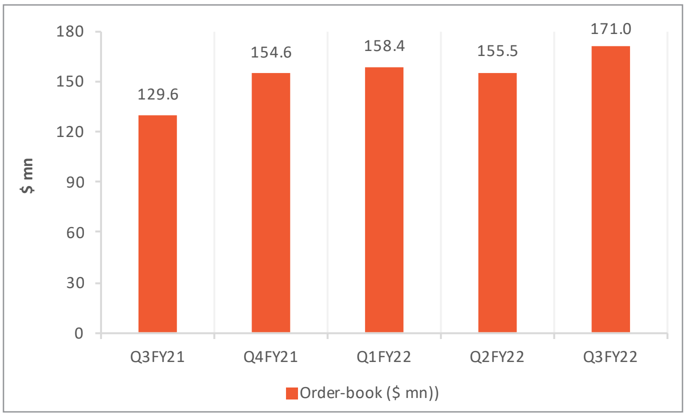
Source: Company, Sharekhan Research

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



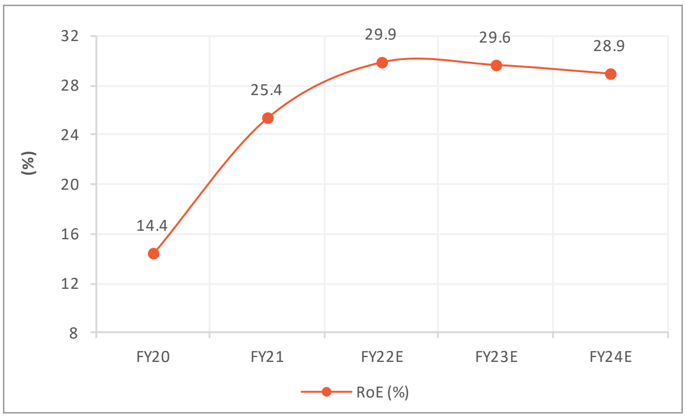
Source: Company, Sharekhan Research

Order-book ($ mn)



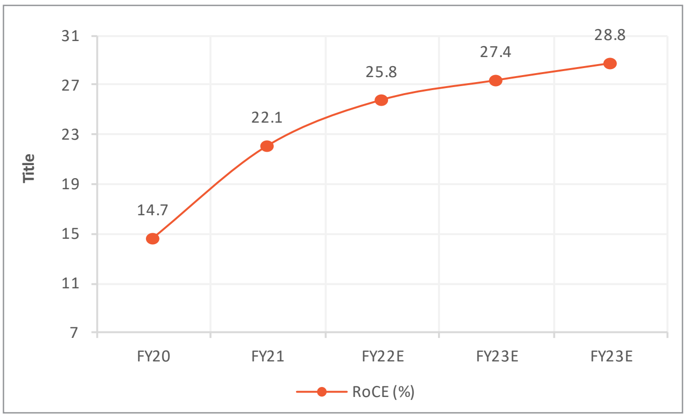
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Expect acceleration in technology spending going forward

After initial disruptions amid the COVID-19 pandemic, the need for business continuity, operational resilience and the switch to digital transactions has led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved over CY2010-CY2020. 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. The UK's software and IT Services (SITS) spend (public and private) is ~GBP 47 billion, of which the UK public sector's spend is ~25% (~GBP 12 billion). Hence, we believe there is a huge headroom for Mastek to grow in the UK, as it currently gets less than 10% of total spends of Home Office and NHS Digital.

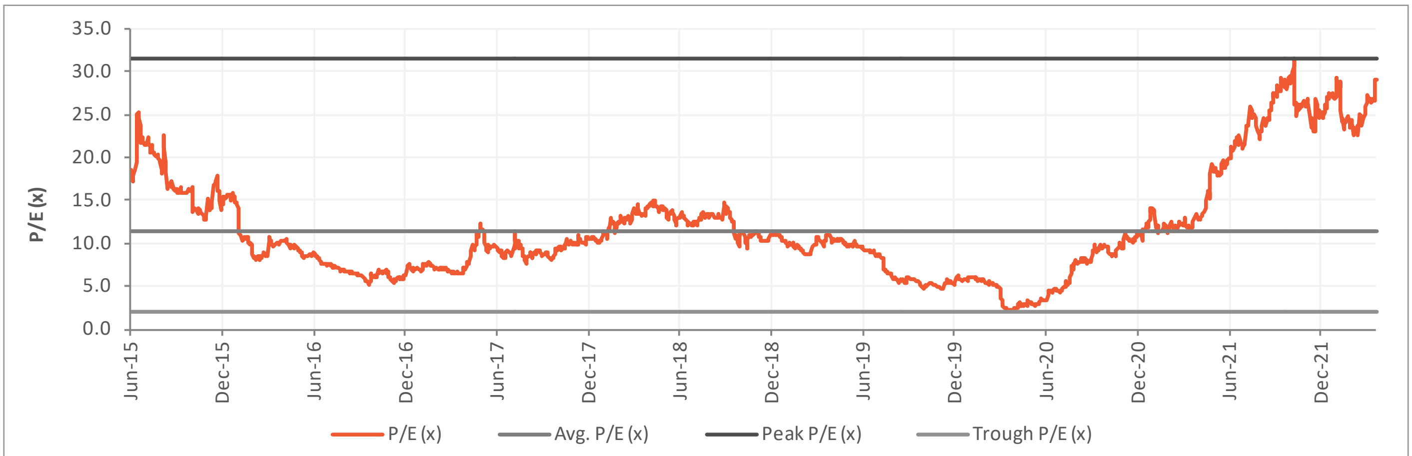
■ Company Outlook – Focus on improving annuity type deals

Mastek has created a consistent and predictable revenue stream from the UK's public sector over the past few years, thanks to the introduction of Digital Outcomes and Specialists (DoS) framework by the UK government (replacement of Digital Services-2 framework in 2016). The management indicated that revenue growth momentum in the UK public sector would continue in coming quarters on account of higher spends by the UK government sector and addition of logos. Further, the growth momentum in the US business to accelerate because of strong demand for its integrated digital commerce solutions, increasing deal size and new client additions.

■ Valuation – Strong growth outlook intact

Mastek remains confident of delivering strong revenue growth over FY2023 to FY2024E, backed by long-standing relationships with the UK public sector, cross-selling/co-sell opportunities, solid order bookings, improving deal sizes, faster acquisition of F-500/F-1000 clients and strong growth momentum in the US. We expect the company's US Dollar revenues and earnings to post CAGRs of 20% and 23%, respectively, over FY2022-FY2024E. At CMP, the stock trades at a valuation of 30x/24x its FY2023E/FY2024E EPS, looks attractive given strong earnings growth potential and M&A opportunity. We maintain a Buy on Mastek with an unchanged price target of Rs. 3,840.

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/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Birlasoft	467	28	13,052	29.5	24.0	19.0	14.8	5.3	4.7	19.3	20.9
L&T Infotech	6,170	18	1,08,142	46.5	37.3	34.8	28.4	10.8	8.3	28.8	32.7
Mastek	3,319	3	9,963	32.9	29.1	18.0	14.9	8.8	7.7	29.9	29.6

Source: Company, Sharekhan Research

About company

Established in 1982, Mastek provides IT services to five verticals – government (mostly caters to the UK government), retail, health, financial, and others. 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 and financial 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& Europe, as 66.3% of its revenue comes from this region, followed by the US/ME/RoW with contribution to total revenue of 18.5%/9.2%/6%, respectively. During February 2020, the company acquired Evolutionary Systems (Evosys) through its subsidiaries, which provided access to new geographies as well as fast-growing segments.

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%. Mastek focuses on accelerating its revenue momentum in the US.

Key Risks

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

Hiral Chandrana	Global CEO
Abhishek Singh	President UK & Europe
Umang Nahata	CEO, Evosys
Narasimha Murthy	Group Chief Delivery Officer
Arun Agarwal	Group CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ABAKKUS GROWTH FUND	2.31
2	KACHOLIA ASHISH	2.00
3	IDFC Mutual Fund/India	1.04
4	Dimensional Fund Advisors LP	0.67
5	Tata Asset Management Limited	0.33
6	Edelweiss Asset Management Ltd	0.24
7	BlackRock Inc	0.19
8	ICICI Prudential Asset Management	0.15
9	HSBC Asset Management	0.13
10	Principal Financial Group Inc	0.11

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

Sharekhan

by BNP PARIBAS

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