



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
Updated Apr 08, 2022 21.77

Medium Risk

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

Source: Morningstar

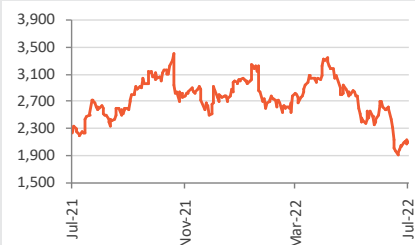
Company details

Market cap:	Rs. 6,277 cr
52-week high/low:	Rs. 3,666 / 1851
NSE volume: (No of shares)	0.9 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.9 cr

Shareholding (%)

Promoters	37.3
FII	8.4
DII	8.7
Others	45.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-22.6	-36.9	-30.6	-6.4
Relative to Sensex	-18.2	-26.2	-22.2	-7.5

Sharekhan Research, Bloomberg

Mastek Ltd

Weak growth outlook in near-term; Downgrade to Hold

IT & ITES

Sharekhan code: MASTEK

Reco/View: Hold



CMP: Rs. 2,089

Price Target: Rs. 2,400



Upgrade



Maintain



Downgrade

Summary

- We downgrade our rating on Mastek to Hold from Buy with a revised PT of Rs. 2,400, given near-term challenges in its large customers, margin pressure, and anticipated reduction in tech spends due to the inflationary environment.
- The recent restructuring activity in NHS (UK) would moderate growth of UK public sector in the near term, given delay in decision making. Further, ramp-up of deals won under Home Office was affected by supply-side challenges.
- Mastek has qualified to bid for deals under the GBP 4 billion digital transformation framework by Home Office. Mastek is expected to win deals under this framework, given its strong relationship with the UK government and enhanced capabilities.
- Client-related issues along with adverse cross-currency headwinds are expected to impact its growth momentum in Q1FY2023. Margin is expected to stay under pressure, given appreciation of Rupee against GBP and supply-side challenges.

Our interaction with Mr. Arun Agarwal (Group CFO) of Mastek Limited (Mastek) indicates that external factors such as restructuring activities in one its top clients (i.e UK NHS), supply-side challenges, and currency headwinds are likely to impact its growth momentum significantly in Q1FY2023. Further, order bookings are expected to remain weak in Q1 due to absence of deal inflows from the GBP 800 million digital capability framework. However, the company has qualified to bid for deals under the GBP 4 billion digital transformation framework by Home Office. Margin pressure is likely to play out owing to depreciation of GBP against INR, supply-side challenges, and higher-than-usual compensation increase. We have lowered our earnings estimates for FY2023E-FY2025E owing to client-related issues and anticipated slowdown in tech spending because of possible US recession even as management continues to see strong demand for digital transformation initiatives among customers.

- Client-related issues to weigh on growth:** Department of Health and Social Care (DHSC) is integrating all key digital bodies of NHS as part of the restructuring activity. The absorption of sub-departments of NHS into a large department and leadership changes during consolidation activities are expected to delay the decision-making process and ramp-up of existing projects. Hence, we do not expect any new deal wins under GBP 800 million digital capability framework over the next 1-2 quarters till normalization of the decision making. Revenue growth of Mastek's healthcare vertical (23% of its total revenue) is expected to remain muted in Q1FY2023 as NHS remains one of its top five customers. Further, management cited that the ramp-up of large deals won under Home Office department was delayed due to supply-side challenges. Hence, we forecast weak growth for UK public sector, given its client-related issues and supply-side challenges.
- Qualified for transformation framework:** Mastek has qualified to bid for deals under the GBP 4 billion digital transformation framework by Home Office. We believe Mastek is well positioned to win few large deals under the digital transformation framework similar to GBP 800 million digital capability framework by NHS, given its strong relationship with UK government, presence in other key procurement frameworks of UK government, and enhanced service capabilities.
- Expect weak Q1FY2023:** Mastek's UK public sector, which contributes the largest chunk of its revenue, is expected to report muted revenue growth in Q1FY2023 given concerns around its two largest customers (NHS and Home Office). Considering that over 65% of its total billings are in GBP, Mastek is likely to see pull down in reported USD revenue growth, given 6.6% depreciation of GBP against USD. On the margin front, it would be impacted in Q1 because of currency headwinds (appreciation of INR against GBP), supply-side challenges, and visa expenses. We forecast the company would report revenue growth of 0.5% q-o-q to \$77.6 million in Q1FY2023, while EBITDA margin would decline 60 bps q-o-q to 20.2%.

Our Call

Valuation – Growth to slow down in the near term: We have revised downwards our earnings estimates for FY2023-FY2025E by 4-11%, given increasing external factors, adjustment to our USD revenue by factoring in adverse cross-currency headwinds, and increasing macro concerns. At the CMP, the stock trades at a valuation of 19x/17x its FY2023E/FY2024E EPS, trading in-line with its two-year average valuation. Hence, we have lowered our target multiple in-line with our reduction in target multiples of leading mid-cap companies because of near-term growth headwinds, expected moderation in order bookings in the UK public sector, margin pressure, and reduction in discretionary spends by the public sector due to inflationary environment. However, we continue to like Mastek considering cross-selling/co-sell opportunities, enhanced service offerings, faster addition of F-1000 logos, and M&A opportunity. We downgrade our rating on Mastek to Hold from Buy with a revised price target (PT) of Rs. 2,400.

Key Risks

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

Valuation (Consolidated)

Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	2,183.8	2,581.0	2,889.0	3,323.2
OPM (%)	21.2	20.2	20.3	20.6
Adjusted PAT	295.1	342.3	391.6	469.6
% y-o-y growth	41.0	16.0	14.4	19.9
Adjusted EPS (Rs.)	103.4	110.7	125.4	150.4
P/E (x)	20.2	18.9	16.7	13.9
P/B (x)	5.6	4.9	4.0	3.3
EV/EBITDA (x)	12.6	10.5	8.8	7.0
RoNW (%)	30.6	28.5	26.5	26.1
RoCE (%)	27.5	27.8	27.2	27.6

Source: Company; Sharekhan estimates

Restructuring in NHS to weigh on its healthcare vertical's growth in the near term

Department of Health and Social Care (DHSC) of UK is embarking on a radical scheme of reforms by integrating all key digital bodies of NHS with the aim of accelerating digital transformation of the NHS as part of a major restructuring plan. Hence, we expect changes in strategies, ambitious agenda of digital transformation, ownership of digital programme, delivery departments, and leadership in NHS. The absorption of sub-departments of NHS into a large department and leadership changes during consolidation activities will have an impact in terms of delay in decision making for the new transformation programme and ramp-up of existing projects. Though the company had secured a large deal (GBP 45 million) under the new GBP 800 million digital capability framework by NHS in Q3FY2022, we do not expect any new deal wins in NHS over the next 1-2 quarters till normalisation of decision making. Further, revenue growth of Mastek's healthcare vertical (23% of its total revenue) is expected to remain muted in Q1FY2023 due to delay in ramp-up of some of its existing programmes and absence of any new deal wins.

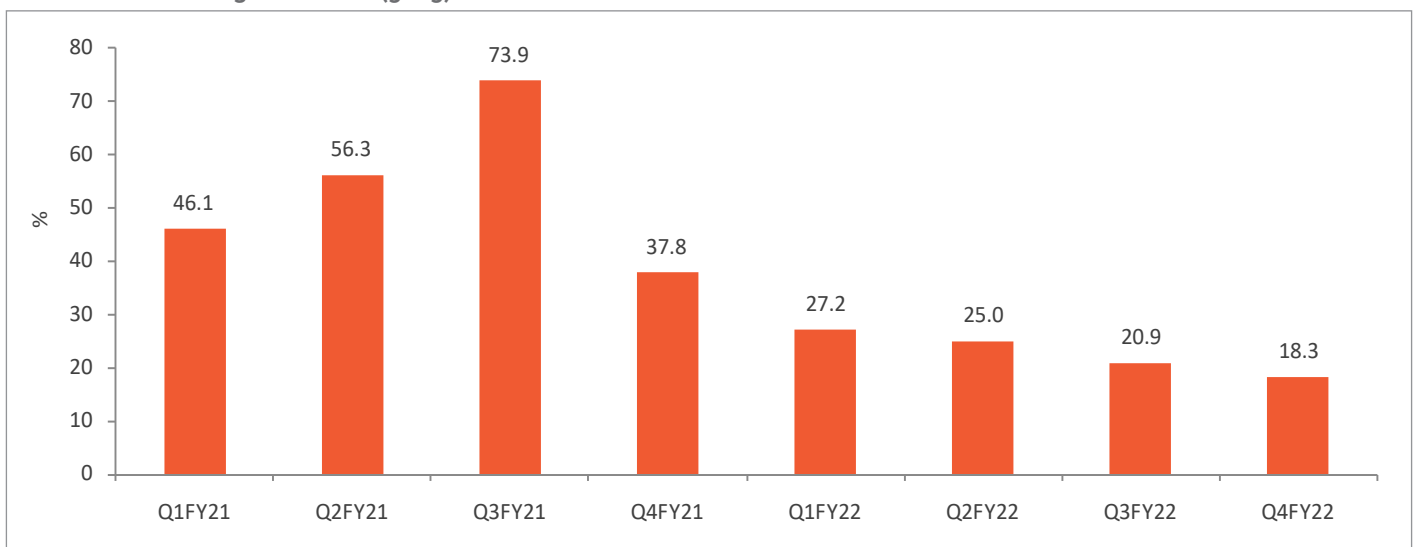
Supply-side issues hit execution in UK; Qualified to bid for GBP 4 billion transformation framework

Mastek's attrition rate (on last 12-month basis) increased to 28% in Q4FY2022 from 14.3% in Q4FY2021 because of supply-side challenges. Due to ongoing supply-side issues, management indicated the ramp-up of large deals won under Home Office department was delayed during the quarter. Hence, we believe overall growth of the UK public sector will remain weak in Q1FY2023. However, the company has qualified among the top 40 IT vendors to bid for deals under the GBP 4 billion digital transformation framework. We believe Mastek is well positioned to win few large deals under this digital transformation framework, given its deep relationship with the UK government, presence in key procurement frameworks of the UK government, and enhanced service capabilities.

Growth to be impacted in Q1FY2023

Mastek's UK public sector, which contributes the largest chunk of its revenue, is expected to report muted revenue growth in Q1FY2023 given concerns around its two largest customers (NHS and Home Office). Its UK public sector's growth would be impacted by delay in decision making for new transformation programmes, postponement of ramp-up of certain large deals won in earlier quarters, and supply-side issues. However, the company's investments in building niche capabilities, focus on specialised areas, enhanced services capability, and integrated digital solutions would help it sustain its growth momentum in the UK private sector and US business. As more than 65% of its total billings are in GBP, the company is likely to see sharp pull down in reported USD revenue growth given 6.6% depreciation of GBP against USD. We forecast the company would report revenue growth of 0.5% q-o-q to \$77.6 million in Q1FY2023.

Mastek' CC revenue growth trend (y-o-y)

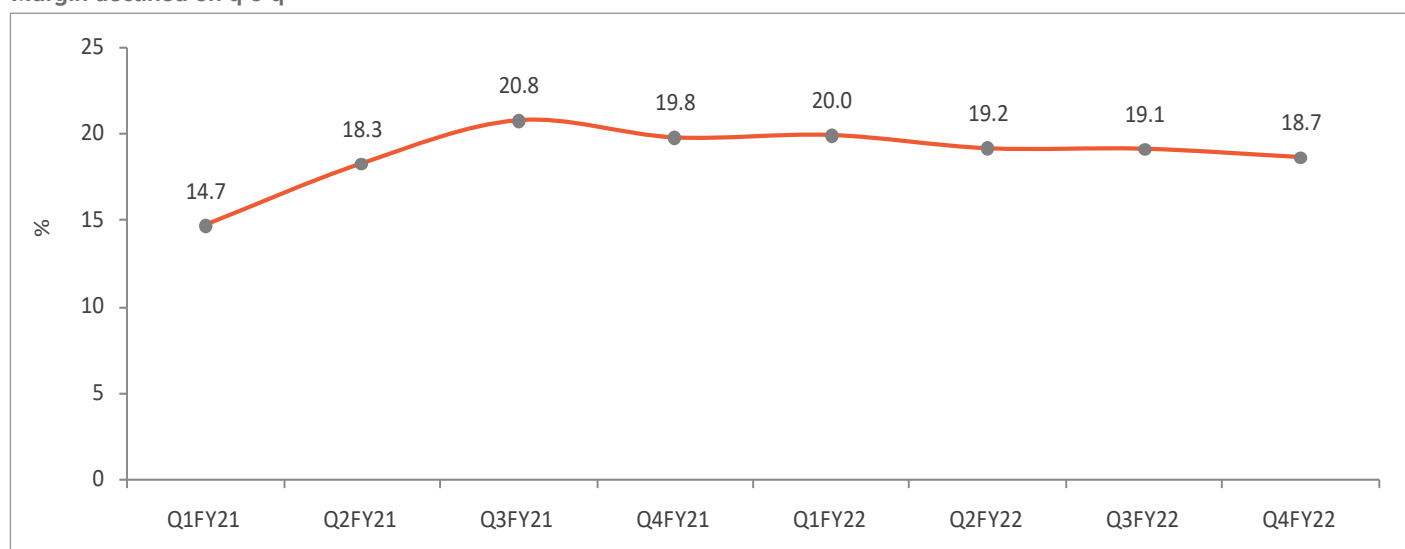


Source: Company, Sharekhan Research

Margins likely to stay under stress in the near term

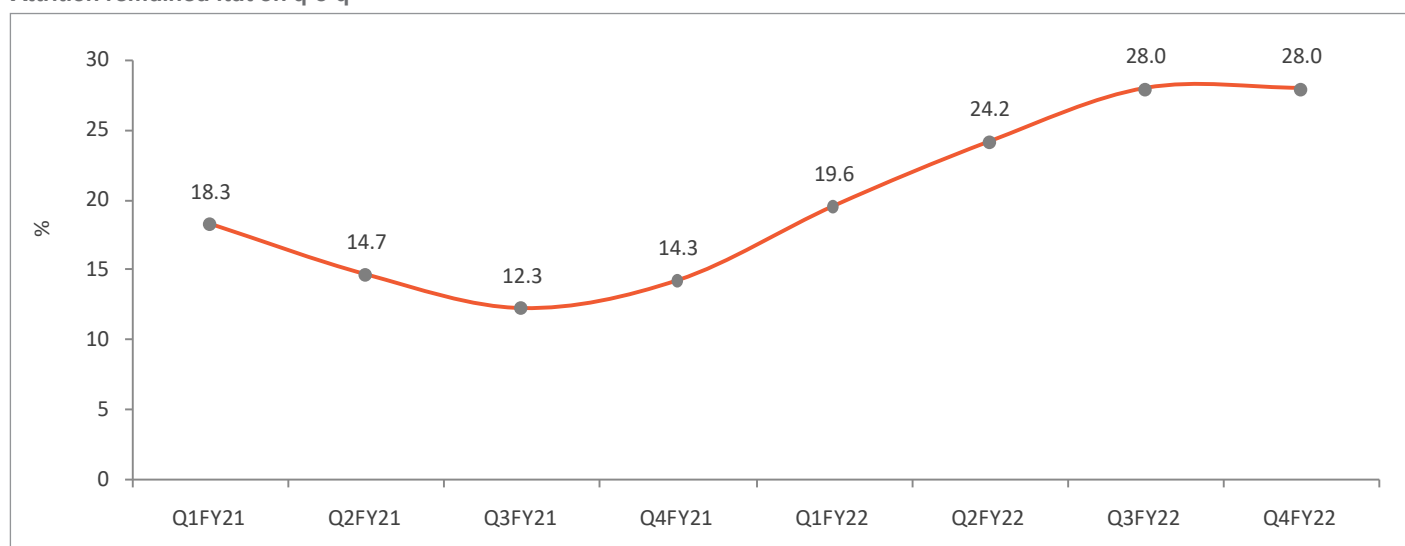
Mastek cited that some deliveries especially under the UK public sector were impacted by lack of talent availability and supply-side challenges. Notably, the company's EBITDA margin declined by 50 bps q-o-q and 110 bps y-o-y to 20.8% in Q4FY2022 due to higher expenses to backfill attrition and higher traveling expenses. We believe margin will be further affected in Q1FY2023 due to currency headwinds (appreciation of INR against GBP), supply-side challenges, and visa expenses. We forecast the company's EBITDA margin would decline 60 bps q-o-q to 20.2% in Q1FY2023. Further, the company is expected to roll out wage revision across the organisation effective July 1, 2022, which would be higher than FY2022. Effectively, we have lowered our margin estimates to 20.4% and 20.7% for FY2023E and FY2024E, respectively.

Margin declined on q-o-q



Source: Company, Sharekhan Research

Attrition remained flat on q-o-q



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Expect acceleration in technology spending going forward

Broad-based spending on digital transformation and cloud-related technologies across industries and geographies are expected to maintain demand momentum in CY2022. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% in the next four years as compared to the average of 4.3% achieved over 2011-2020. Consulting (+11%) and application implementation and managed services (+9%) are expected to grow faster than BPO (+7%) and infra implementation and managed services (+4%) in CY2022E. 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 around GBP 14 billion. Hence, we believe there is a huge headroom for Mastek to grow in the UK, as it currently gets less than 15% of total spends of Home Office and NHS.

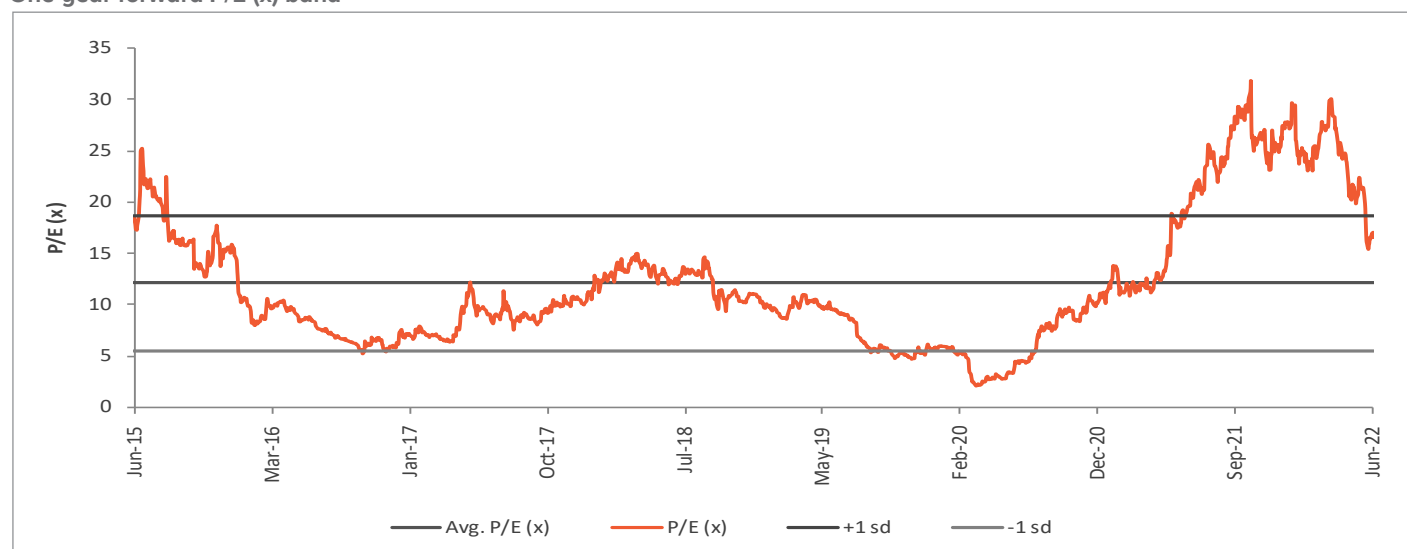
■ Company outlook - Long-term outlook intact

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). Management indicated that revenue growth momentum in the UK public sector would continue in the coming quarters on account of higher spends on digital-transformation initiatives by UK government sector and addition of logos. Further, growth momentum in the US business is expected to accelerate because of strong demand for its integrated digital commerce solutions, increasing deal size, and new client additions.

■ Valuation - Growth to slow down in the near term

We have revised downwards our earnings estimates for FY2023-FY2025E by 4-11%, given increasing external factors, adjustment to our USD revenue by factoring in adverse cross-currency headwinds, and increasing macro concerns. At the CMP, the stock trades at a valuation of 19x/17x its FY2023E/FY2024E EPS, trading in-line with its two-year average valuation. Hence, we have lowered our target multiple in-line with our reduction in target multiples of leading mid-cap companies because of near-term growth headwinds, expected moderation in order bookings in the UK public sector, margin pressure, and reduction in discretionary spends by the public sector due to inflationary environment. However, we continue to like Mastek considering cross-selling/co-sell opportunities, enhanced service offerings, faster addition of F-1000 logos, and M&A opportunity. We downgrade our rating on Mastek to Hold from Buy with a revised PT of Rs. 2,400.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
Birlasoft	350	28	9,792	18.4	15.2	12.0	9.8	3.5	3.1	19.2	19.9
Persistent Systems	3,314	8	25,330	29.5	23.6	20.2	15.4	6.5	5.6	23.7	25.4
Mastek	2,089	3	6,277	18.9	16.7	10.5	8.8	4.9	4.0	28.5	26.5

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 and Europe, as 66.3% of its revenue comes from this region, followed by the US/ME/RoW with contribution to total revenue of 18.4%/8.2%/4.9%, 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

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

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

Source: Company

Top shareholders

Sr. No.	Holder Name	Holding (%)
1	Vanguard Group Inc/The	2.32
2	ABAKKUS GROWTH FUND	2.31
3	ABAKKUS Emerging opportunity fund	1.88
4	Dimensional Fund Advisors LP	0.70
5	BlackRock Inc	0.57
6	IDFC Mutual Fund/India	0.54
7	Edelweiss Asset Management Ltd	0.20
8	ICICI Prudential Asset Management	0.18
9	HSBC Asset Management	0.12

Source: Bloomberg

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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 deteriorating 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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