Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Mastek Ltd

Muted performance; Maintain Hold

IT & ITES	Sharekhan code: MASTEK
Reco/View: Hold ↔	CMP: Rs. 1,672 / Price Target: Rs. 1,900 ↓

↑ 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 Updated Oct 08, 2022	21.77

Medium Risk

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

Source: Morningstar

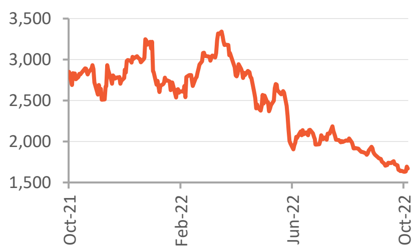
Company details

Market cap:	Rs. 5,030 cr
52-week high/low:	Rs. 3,411 / 1,612
NSE volume: (No of shares)	1.0 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.9 cr

Shareholding (%)

Promoters	37.3
FII	8.0
DII	5.7
Others	49.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-6.9	-18.7	-17.7	-41.3
Relative to Sensex	-6.2	-25.2	-23.5	-38.9

Sharekhan Research, Bloomberg

Summary

- Mastek reported Q2FY23 Revenue of $78.1 million which was up 20.4% on YoY basis in constant currency (CC) and 10.7% q-o-q- in CC led by positive momentum in existing business and acquisition of MST Solutions during the quarter while EBITDA at 17.2% margin declined sharply by 200 bps.
- The management stated that acquisition of MST Solutions is off to a terrific start strengthening their US business and have indicated that they are seeing significant potential in the growing Salesforce Customer 360 ecosystem particularly in Healthcare and State & Local Government industries.
- The management indicated that clients are preferring larger and integrated deals through strategic partnerships as demand environment features some element of caution due to macro-overhang. The management is optimistic on the UK public sector, healthcare vertical in the US and Manufacturing vertical.
- We continue to maintain Hold on Mastek with revised PT of Rs. 1900 given continued weakness in the Healthcare & Lifescience vertical, margin pressure and macro-overhang in its key geographies, which offsets benefit of healthy deal wins, logo additions and synergy benefits and improved ability to offer integrated solutions led by MST acquisition.

Mastek reported Q2FY23 Revenue of $78.1 million improving by 6.1% q-o-q and beat our estimates by 1.4%. The reported $ Revenues was up by 20.4 % on YoY basis in constant currency CC and up 10.7% q-o-q in CC led by positive momentum in the existing business and acquisition of MST during the quarter. EBITDA at 17.2% margins declined sharply by 200 bps due increment taken in the quarter and currency headwinds and continued investments in sales and capabilities. Adjusted net profit stood at Rs 53.8 down 30% on a q-o-q basis. Q2FY23 also saw lower other income, higher depreciation, lower utilisation, lower contribution from Top accounts compared to the previous quarter while number of Fortune-1000 clients improved, and attrition moderated. During Q2FY23, growth momentum was seen across Government & Education, Retail/Consumer, Manufacturing technology and Financial services verticals. However, Health & Life Sciences vertical continued to decline as it fell by 18.5% q-o-q for the third consecutive quarter. The management indicated that acquisition of MST Solutions is strengthening the US business and they are seeing higher potential in Healthcare and State & Local Government Industries. The management aspire to achieve 33% revenue contribution from US which is currently at 24.2%. The management cited that the growth momentum in UK public sector business is picking up with the contribution from MST Solutions acquisition and expects to see greater traction going forward. The margins of MST solutions going forward expected to be in the like Mastek's margin range of 18-20%.

Key positives

- Government & Education vertical grew by 11.3% q-o-q while Manufacturing & Technology vertical grew 22.4% q-o-q after a muted growth in previous quarter.
- LTM Attrition stood at 24.2% declining 80 bps q-o-q

Key negatives

- Healthcare & life sciences vertical continued to decline as it fell by 18.5% q-o-q
- Billable Utilization rate at 67.8% declined 90 bps q-o-q.

Management Commentary

- The management reiterated its aspiration to reach $1 billion annual revenue in the early part of the second half of the decade and commented that it would be achieved through a combination of organic and inorganic growth. The inorganic growth may be funded by raising capital too after initially funding it through internal accruals and debt.
- On the current geopolitical situation, the Management stated that they are deep rooted in the areas where they are present currently and hence it would be tough for competition as clients try to realign and reprioritize due to the macro-overhang.
- The management cited that on demand front although there is caution, they are seeing client preferences for larger and integrated deals. They are confident regarding UK public sector and bullish on healthcare vertical in US.

Revision in estimates – We have fined tuned our revenue/margin estimates for FY23/24/25 owing to macro headwinds and INR-USD reset. We have lowered the PAT estimates to factor higher depreciation due to the MST solutions acquisition.

Our Call

Valuation – Muted Q2, Maintain Hold. We continue to maintain Hold on Mastek with revised PT of Rs. 1900 given continued weakness in the Healthcare & Lifescience vertical, margin pressure and macro-overhang in its key geographies, which offsets benefit of healthy deal wins, logo additions and synergy benefits and improved ability to offer integrated solutions led by MST acquisition.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US would have an adverse impact on its earnings. Further, macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	2,183.8	2,613.2	2,909.0	3,438.4
OPM (%)	21.2	19.4	19.4	19.6
Adjusted PAT	295.1	316.7	357.4	444.1
% y-o-y growth	*41.0*	*7.3*	*12.9*	*24.2*
Adjusted EPS (Rs.)	103.4	102.3	114.4	140.8
P/E (x)	16.2	16.3	14.6	11.9
P/B (x)	4.5	4.0	3.3	2.8
EV/EBITDA (x)	9.6	8.1	6.8	5.4
RoNW (%)	30.6	26.6	24.7	25.4
RoCE (%)	27.5	27.5	26.1	27.7

Source: Company; Sharekhan estimates

Key results highlights

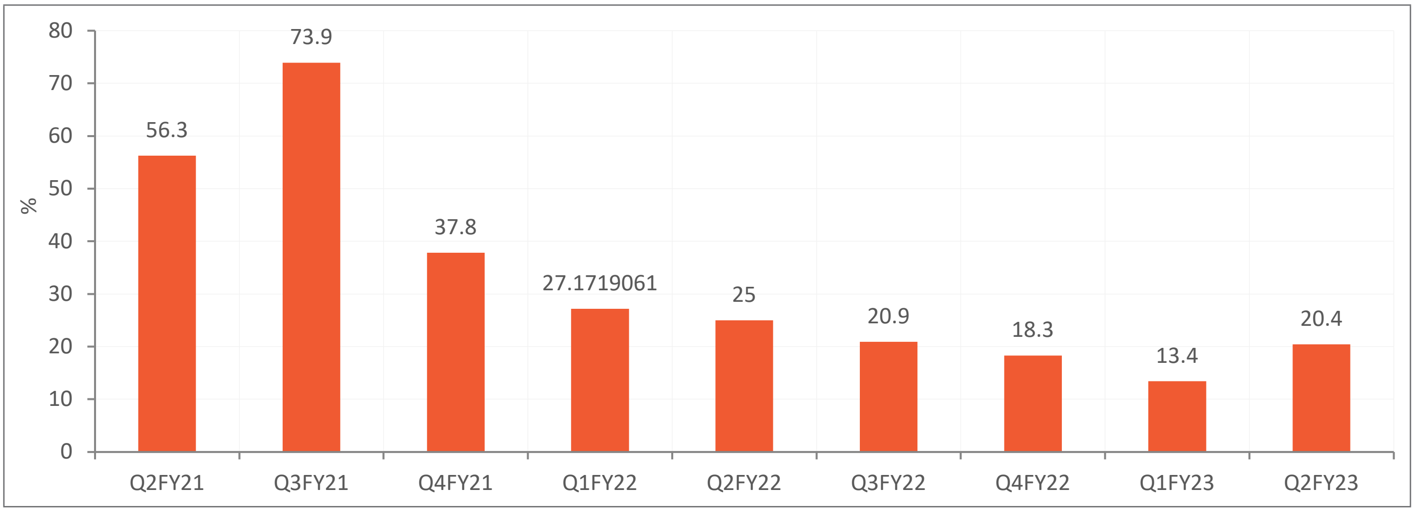
- **12 months order backlog stable:** 12 months order backlog was Rs 1,522.0 crore ($187.1 mn) as on 30th September, 2022 as compared to Rs 1,509.3 crore ($191.1 mn) in Q1FY23, reflecting a growth of 0.8% in rupee terms and 3.4% in constant currency terms on Q-o-Q basis and Rs 1,154.3 crore ($155.5 mn) in Q2FY22, reflecting a growth of 31.9% in rupee terms and 35.4% in constant currency terms on Y-o-Y basis.
- **Expect growth to accelerate in US:** The acquisition of MST Solutions is expected to strengthen the US business of the company. The company in Q2FY23 reported strong revenue growth of 40% q-o-q. The company aspires to have revenue contribution of 33% from US going forward from the current contribution at 24%.
- **UK political environment:** Management cited that they are deep root in the areas they are present Hence it would be tough for the competition as clients look to realign and prioritize their business requirements.
- **Trends on verticals:** During Q2FY23, growth momentum continued in Government & Education, Retail/ Consumer, Manufacturing Technology and Financial Services vertical growing 11.3%, 8.1%, 22.4% and 7% q-o-q respectively. Revenues from Healthcare & Life Sciences vertical continued to decline for third quarter in a row declining 18.5% on q-o-q. However, post the MST acquisition the Management expects the UK Public sector to see ramp up and is bullish on Healthcare Vertical in the US.
- **New accounts added:** Mastek added 20 new clients in Q2FY23. Total active clients during Q2FY23 were 449 as compared to 402 in Q1FY23.
- **Hiring momentum stable, attrition moderates:** Net additions for Q2FY23 stood at 257 employees taking the headcount to 5810 LTM Attrition rate at 24.2% has also moderated by 80 bps q-o-q in Q2FY23. The management intends to continue hiring freshers as it wants to keep right resources given higher deal pipeline and order backlog.
- **Cash Balance:** Total cash, cash equivalents and fair value of Mutual Funds stood at Rs 351.6 crore as on September 30, 2022 as compared to Rs. 664.6 crore at the end of 30th June, 2022. The reduction in cash balance reflects payment made for acquisition of MST Solutions and dividend payout during the quarter.

Results (Consolidated) Rs cr

Particulars	Q2FY23	Q2FY22	Q1FY23	Y-o-Y %	Q-o-Q %
Revenues In INR	**625.3**	**533.9**	**570.3**	**17.1**	**9.7**
Employee benefits expense	340.0	273.9	308.8	24.2	10.1
Other expenses	177.9	147.3	152.3	20.8	16.8
EBITDA	**107.4**	**112.8**	**109.2**	**-4.8**	**-1.7**
Depreciation & amortization	17.1	10.4	11.1	64.0	54.1
EBIT	**90.3**	**102.4**	**98.1**	**-11.8**	**-8.0**
Other Income	6.9	7.7	25.8	-10.4	-73.2
Finance costs	5.3	1.9	2.0	183.8	166.5
PBT	**92.0**	**108.3**	**121.9**	**-15.0**	**-24.6**
Tax Provision	31.1	26.7	37.6	16.4	-17.2
PAT	**60.9**	**81.5**	**84.4**	**-25.3**	**-27.8**
Minority interest	-7.1	-9.2	-7.2		
EO	25.3	0.0	0.0		
Net profit	**79.1**	**72.3**	**77.2**	**9.4**	**2.5**
Adjusted net profit	**53.8**	**72.3**	**77.2**	**-25.6**	**-30.3**
EPS (Rs)	25.8	26.9	25.1	-4.1	2.6
Margin (%)					
EBITDA	17.2	21.1	19.2	-395	-198
EBIT	14.4	19.2	17.2	-473	-277
NPM	8.6	13.5	13.5	-494	-493
Tax rate	33.8	24.7	30.8	912	300

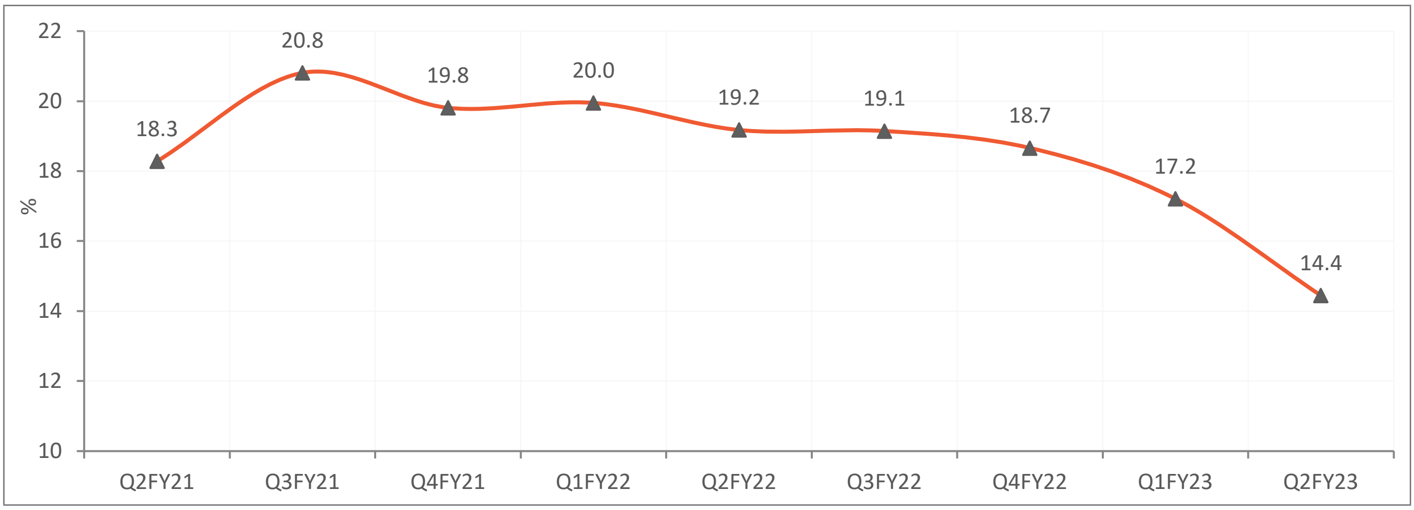
Source: Company; Sharekhan Research

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



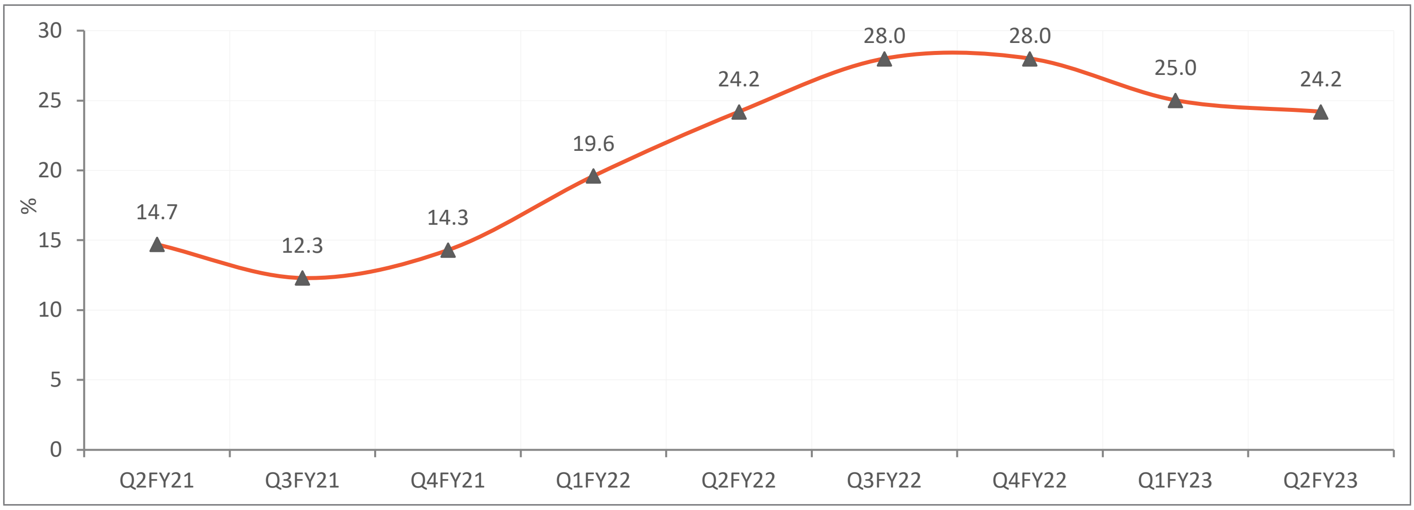
Source: Company, Sharekhan Research

Margin declined on q-o-q



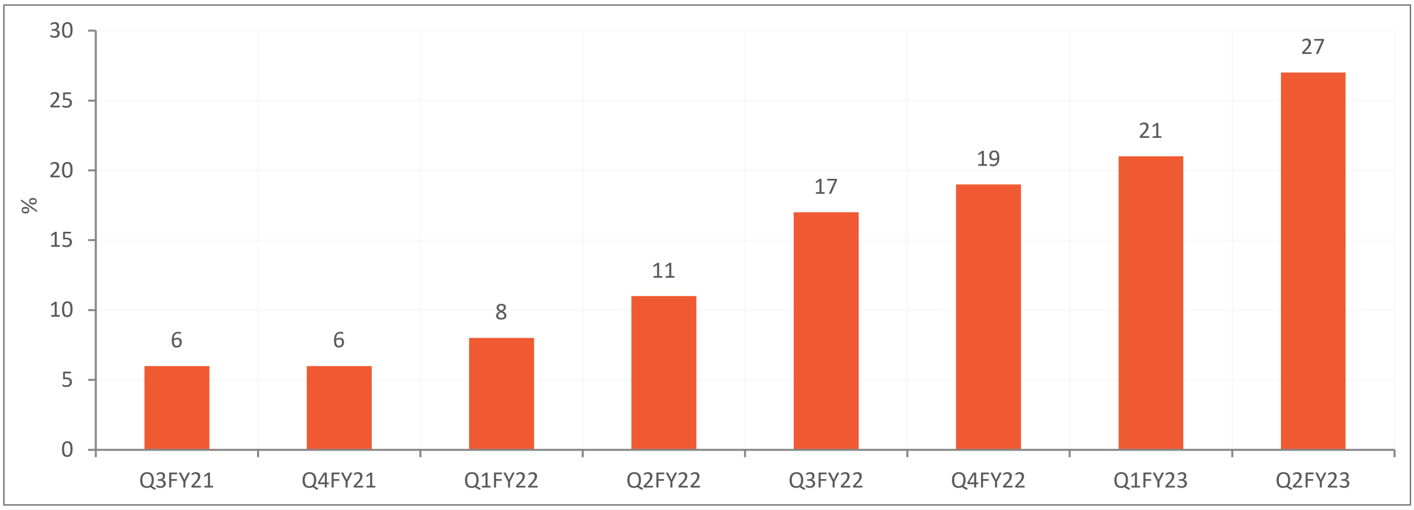
Source: Company, Sharekhan Research

Attrition moderated on q-o-q



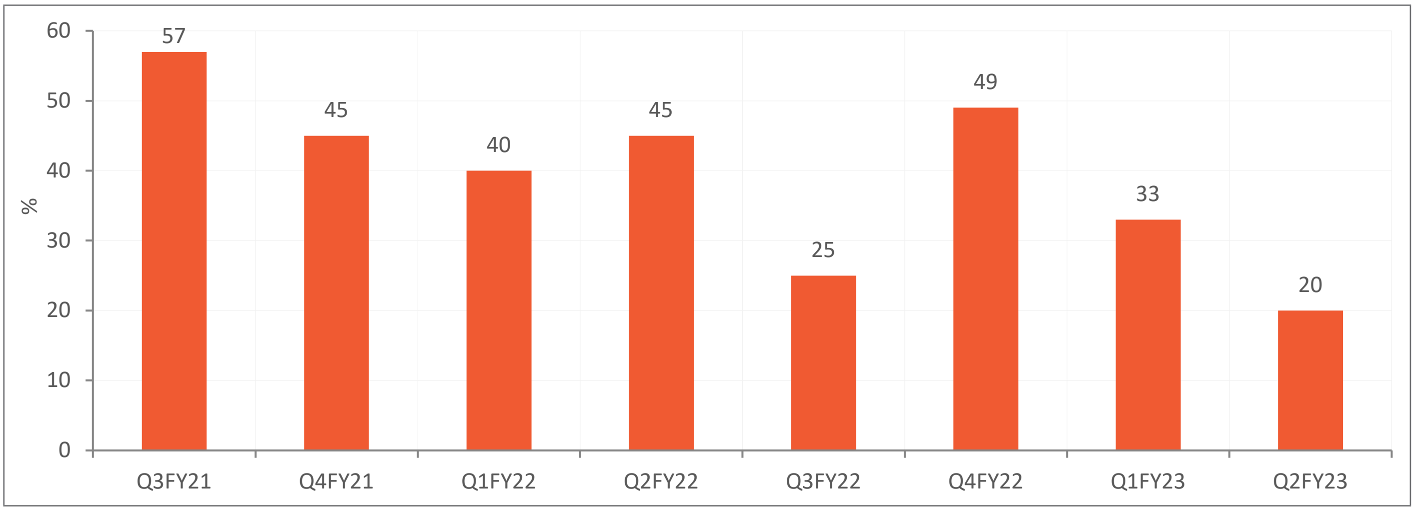
Source: Company, Sharekhan Research

Number of Fortune 1000 clients



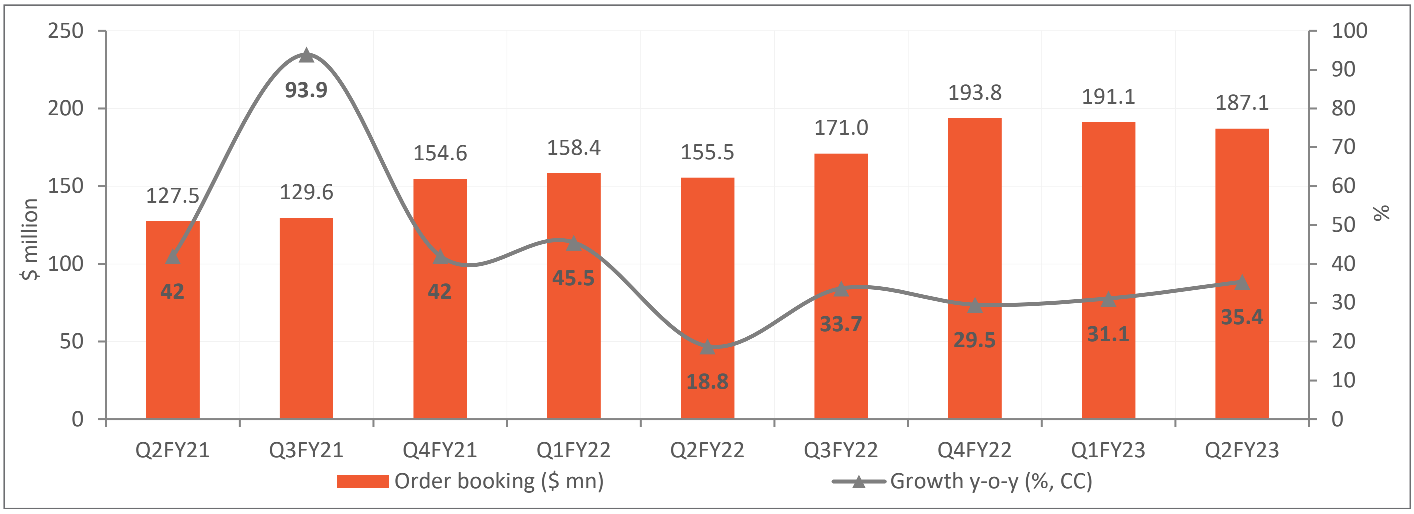
Source: Company, Sharekhan Research

Number of new clients addition



Source: Company, Sharekhan Research

Order booking ($ mn) and growth (%)



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 infrastructure 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 – Muted Q2, Maintain Hold

We continue to maintain Hold on Mastek with revised PT of Rs. 1900 given continued weakness in the Healthcare & Lifescience vertical, margin pressure and macro-overhang in its key geographies, which offsets benefit of healthy deal wins, logo additions and synergy benefits and improved ability to offer integrated solutions led by MST acquisition.

One-year forward P/E (x) band

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 67.1% of its revenue comes from this region, followed by the US/ME/RoW with contribution to total revenue of 18.8%/9.2%/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) Rupee appreciation and/or adverse cross-currency movements, 2) constraint in local talent supply in the US would have an adverse impact on its earnings and 3) macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

Additional Data

Key management personnel

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

Source: Company Website

Top 9 shareholders

Sr. No.	Holder Name	Holding (%)
1	The Vanguard Group Inc.	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	0.23
7	Edelweiss Asset Management Limited	0.20
8	ICICI Prudential Asset Management	0.20
9	HSBC Asset Management	0.12

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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Compliance Officer: Ms. Binkle Oza; Tel: 022–61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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