Mastek Ltd (MASTEK)

CMP: ₹ 1695 | Target: ₹ 1520 (-10%) | Target Period: 12 months | **REDUCE**

January 18, 2023

Business in core markets continues to face headwinds

About the stock: Mastek Ltd (Mastek) offers data, apps, cloud services to public & private enterprise in the UK, US, Middle East, Asia Pacific and India.

- The company's recent acquisition of Evosys has enabled Mastek to provide end-to-end solutions and improves margins from ~14% to 21%
- Net debt free and healthy double digit return ratio (with RoCE of 20%)

Q3FY23 Results: Reported weak organic growth in Q3.

- Revenue grew 3.1% QoQ in CC terms with flat organic growth while in dollar terms revenue grew 2.6% QoQ
- EBITDA margin was flat sequentially at 17.3%
- Reported 12M order backlog of US$206.2 mn, up 10.2%QoQ

What should investors do? Mastek's share price has grown by ~4.1x over the past five years (from ~₹ 414 in January 2018 to ~₹ 1,695 levels in January 2023).

- We change our rating on the stock from HOLD to **REDUCE**

Target Price and Valuation: We value Mastek at ₹ 1,520 i.e. 13x P/E on FY25E EPS.

Key triggers for future price performance:

- Growth in new logo acquisition, increasing deal size, expansion of sales & marketing and market share gains to drive revenues
- Management change in the US region may help it to grow stronger & achieve desired revenue mix
- Acquisition of MST Solutions will help drive growth in the US region
- Expect revenues to grow at 8.2% CAGR in FY22-25E

Alternate Stock Idea: Apart from Mastek, in our IT coverage we also like Infosys.

- Key beneficiary of improved digital demand, industry leading revenue growth & healthy capital allocation prompt us to be positive
- BUY with a target price of ₹ 1,730

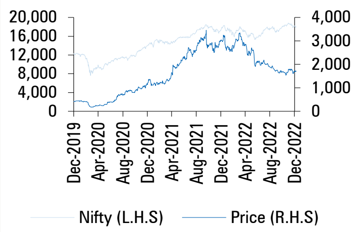
Particulars

Particulars	Amount
Market Capitalization (₹ Crore)	4,818.9
Total Debt (₹ Crore)	190.3
Cash and Investments (₹ Crore)	781.9
EV (₹ Crore)	4,227.2
52 week H/L	3413/ 1490
Equity capital (₹ Crore)	15.0
Face value	5.0

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoters	38	37	37	37
FII	5	7	8	13
DII	7	7	6	4
Public	50	49	49	46

Price Chart



Recent Event & Key risks

- Acquired 31 new logos in Q3 and 12M order back log up by 29.7% YoY in CC terms
- **Key Risk:** (i) US business ramp up better than expectation, (ii) Rebound in organic revenues

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Company Update

ICICI Securities – Retail Equity Research

Key Financial Summary

₹ Crore	FY21	FY22	5 Year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 Year CAGR (FY22-25E)
Net Sales	1,722	2,184	31.3	2,266	2,525	2,768	8.2
EBITDA	364	463	57.0	408	462	518	3.8
EBITDA Margins (%)	21.2	21.2		18.0	18.3	18.7	
Net Profit	209	295	55.5	263	311	349	5.8
EPS (₹)	82	104		88	103	116	
P/E	20.7	16.3		19.3	16.4	14.6	
RoNW (%)	24.4	27.5		20.5	20.1	19.1	
RoCE (%)	21.5	26.7		21.2	21.3	20.7	

Source: Company, ICICI Direct Research

Key takeaways of quarter and conference call highlights

- The company reported growth of 3.1% QoQ growth in CC term while dollar revenue came in at US$80.1 mn, up 2.6% QoQ with full quarterly revenue contribution of Metasoftech Solutions LLC, US (MST). The company indicated that the organic revenue growth was flattish, implying a weak performance of organic business in YTD December 2022. In rupee terms, revenue was at ₹ 658.7 crore, up 5.3% QoQ

- Geography wise UK (58.9% of the mix) reported muted growth of 0.1% QoQ while growth was driven by the US (27.8% of mix, up 360 bps QoQ) reporting growth of 21.2% QoQ. Growth was aided by full quarter contribution of MST. ME region also reported steady 10.6% sequential growth

- Vertical wise government (41.4% of the mix) reported growth of 3.2% QoQ while financial services, health and manufacturing & tech reported growth of 13.3%, 14.4% & 8.2%, respectively. Retail sector revenue declined 6% QoQ while the company indicated that retail segment was impacted due to weakness in some clients due to macro headwinds & impact of furloughs

- The company reported flattish EBITDA margin of 17.3% compared to Q2. Mastek indicated that though the supply side challenges have started to ease out, margins were impacted by continuance of sub-contractor expenses as per the requirement of UK NHS business and onetime provision for certain doubtful debts

- The company indicated that it expects EBITDA margins to improve from Q4 onwards and indicated that the operating margin levers will be easing of supply side challenges due to lower attrition and increase in utilisation as freshers are being deployed on projects. The company indicated that it is aiming for high teens margin for FY24 in the range of 17-19%. Mastek also indicated that since it is targeting high growth in revenues in the medium term it will invest the additional margins earned above 19% back in business

- The company indicated that the organic health business in UK, which is contributed majorly by NHS, is still under stress due to a change in leadership at the organisation level and shortage of workers. Mastek indicated that pain in the business is likely to sustain in the next two to three quarters. The company indicated that it lost budgeted revenue potential of ~US$24 mn in NHS business till YTD December 2022. Mastek also indicated that it has been taking a few steps to mitigate the issue it is facing in NHS business by diversifying into other department verticals wherein it also won three deals but the ramp up for the same is yet to happen

- In the US organic business, the company indicated that its progress was below expectations as there was a delay in client mining & order booking. The company also indicated that performance was impacted due to the discontinuing of CX business by Oracle. However, on the inorganic front, the acquisition of MST has accelerated its overall growth in the US region. The company indicated that MST operates mainly in the health, government & manufacturing verticals and as the integration progresses it is witnessing cross-sell opportunities among the MST & Mastek's client. The company also indicated that it looking to grow aggressively in the US region both on the organic and inorganic front and expects a quarterly revenue run rate to hit US$24-25mn in Q4FY23

- In the Middle East region, the company indicated that it is witnessing increased traction after the Russia-Ukraine border conflict started. Mastek indicated that it is seeing increased demand for its services in the health segment in the Saudi Arabia and Dubai regions. The company indicated that it is looking to cut the tail of long clients, looking to focus on top 20-25 clients here and cut out low margin business here

- The company indicated that its 12M backlog has increased by 10.2% QoQ to US$206.2 mn while in CC terms the growth was 5.3%. Mastek indicated that the demand momentum has picked up at the end of the Q3 and the deals that were delayed in H1 are getting closed. The company also indicated that it has closed four to five deals of US$5 mn+. Also, the Oracle pipeline in the US & ME region is looking strong. The company also indicated that since the macro environment has deteriorated compared to last year, clients are reprioritising the cost optimisation & efficiency deals over discretionary spending along with breaking the large size deals into smaller ones. The company indicated that this will also help it to win some deals in future and provides a stable outlook in the medium term driven by growth in the UK & US regions

- The company added 31 new clients in this quarters taking the total client's addition for 9MFY23 to 84. The company indicated that out of the 31 clients that it added, six have more than US$1bn annual revenues. It will also provide them an opportunity to further strengthen their wallet share with them

- The company's LTM attrition continue to moderate. In Q3, the LTM attrition declined by 90 bps QoQ to 23.3% as the supply side challenges are easing out. Mastek indicated that utilisation declined by 120 bps QoQ to 73.7%. The company indicated that it aims to improve the utilisation to the level of 75-78% and will be one of the key levers for margin improvement

- The company's net headcount during the quarter declined by 123 taking the total headcount to 5,687 employees. Mastek indicated that the drop in employees was due to backfilling of open positions by internal realignments. The company indicated that it had hired good chunk of fresher in H1FY23 and after training they are being deployed in the projects in a gradual manner. It also indicated that it plans to make leadership changes in the US region and hire a sales team to ramp up the sales opportunity in the region

- The company mentioned that during the quarter it made a strategic investment in VolteoEdge, a SaaS company with an Enterprise ready Edge Intelligence Platform that works on data & connected devices for data extraction. The company indicated that these solutions along with the company's will provide prospective solution for ServiceNow clients

- The company mentioned that during the quarter it has purchased 33,446 CCPS of its subsidiary for a consideration of ₹ 120 crore. Mastek further indicated that the consideration is to be paid by ₹ 40 crore in cash with balance ₹ 80 crore by issuing equity shares

- The company declared an interim dividend of ₹ 7 per share and announced that record date for determining the eligible shareholders for payment of dividend will be February 1, 2023

Exhibit 1: P&L

	Q3FY23	Q3FY22	YoY (%)	Q2FY22	QoQ (%)	Comments
Revenue in USD mn	80.1	73.6	8.8	78.1	2.6	Revenue growth of 3.1% QoQ in CC terms with organic growth remaining flat
Revenue	658.7	551.9	19.3	625.3	5.3	
Employee expense	346.4	273.2	26.8	340.0	1.9	
Gross Margin	312.3	278.8	12.0	285.3	9.5	
Gross margin (%)	47.4	50.5	-310 bps	45.6	179 bps	
Other expense	198.6	162.5	22.2	177.9	11.6	
EBITDA	113.7	116.2	-2.2	107.4	5.9	
EBITDA Margin (%)	17.3	21.1	-380 bps	17.2	0 bps	EBITDA margin remains flat sequntially as sub-contract cost continues as per business specific requirements & one time provision of doubtful debts
Depreciation & amortisation	19.6	10.6	85.7	17.1	14.6	D&A increased on account of increased amotization of MST acquisition
EBIT	94.1	105.7	-10.9	90.3	4.2	
EBIT Margin (%)	14.3	19.1	-486 bps	14.4	-15 bps	
Other income (less interest)	-2.2	4.1	-153.4	1.7	-233.1	
PBT	91.9	109.8	-16.3	92.0	-0.1	
Tax paid	24.8	26.4	-6.0	31.1	-20.3	
PAT	67.1	83.4	-19.6	86.2	-22.1	PAT in Q2 was higher on account of higher other income

Source: Company, ICICI Direct Research

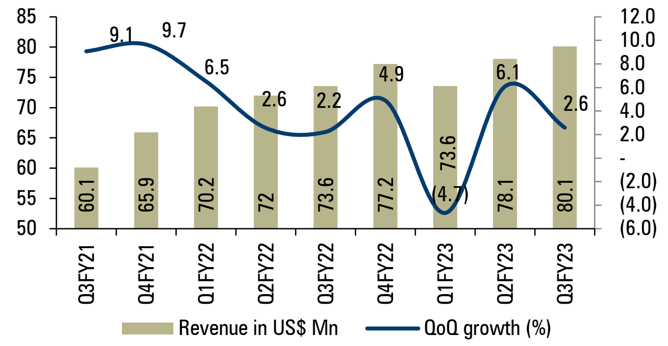
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	2,442.0	2,266	-7.2	2,742	2,525	-7.9	3,110	2,768	-11.0	Numbers cut on slower growth in key markets
EBITDA	464.0	408	-12.1	526	462	-12.2	603	518	-14.2	
EBITDA Margin (%)	19.0	18.0	-100 bps	19.2	18.3	-90 bps	19.4	18.7	-70 bps	Margins cut on normalisation of other expenses
PAT	293	263	-10.0	344	311	-9.6	394	349	-11.4	
EPS (₹)	102.9	87.6	-10.0	120.9	103.3	-9.6	138.5	116.1	-11.4	

Source: Company, ICICI Direct Research

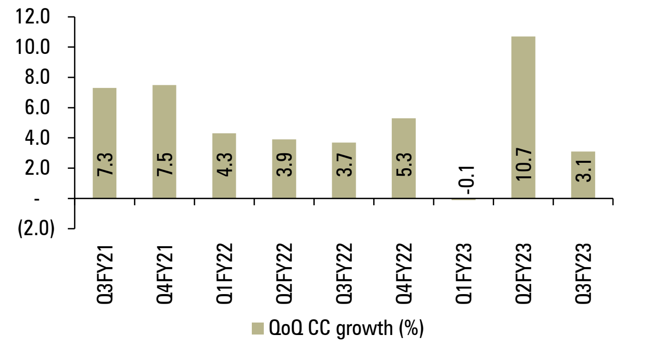
Key Metrics

Exhibit 3: Organic growth flat



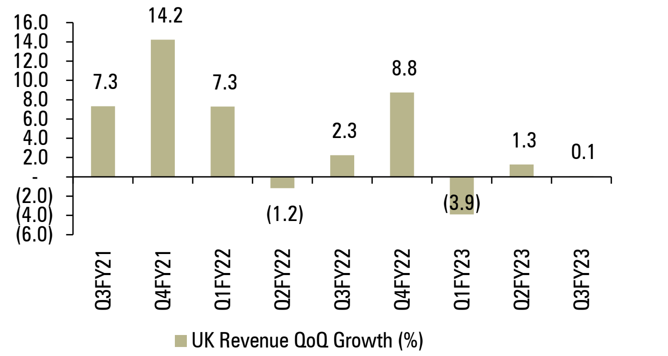
Source: Company, ICICI Direct Research

Exhibit 4: QoQ CC growth declines in Q3



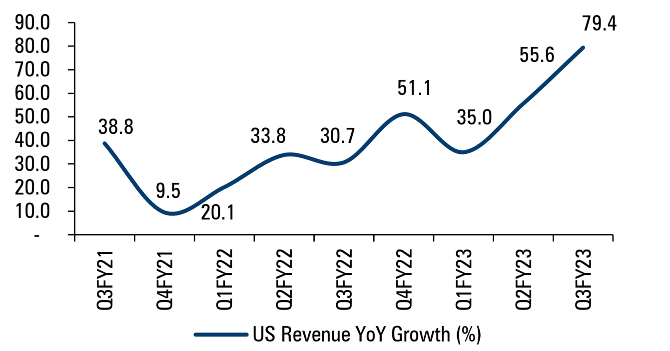
Source: Company, ICICI Direct Research

Exhibit 5: UK region impacted by NHS headwinds



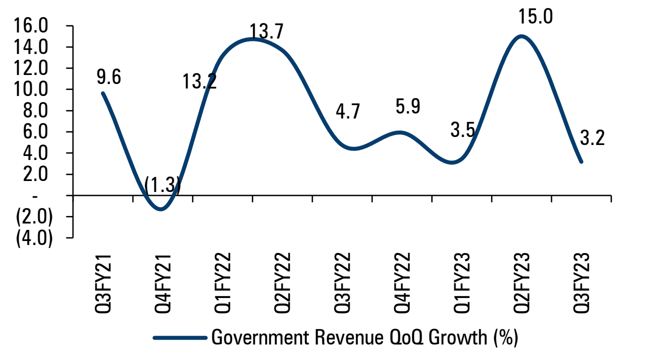
Source: Company, ICICI Direct Research

Exhibit 6: MST acquisition aids US growth



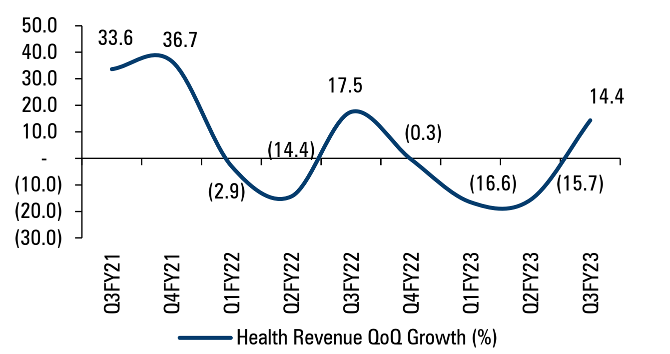
Source: Company, ICICI Direct Research

Exhibit 7: Government revenue declines in Q3



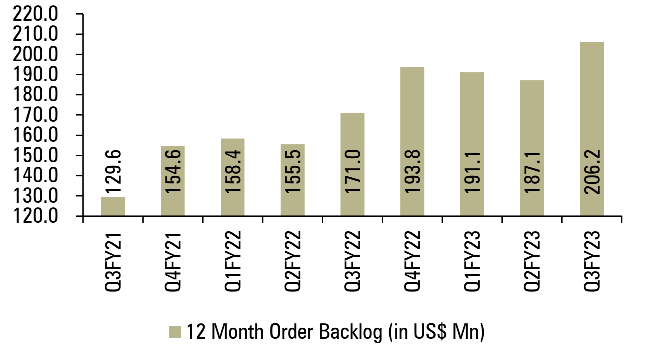
Source: Company, ICICI Direct Research

Exhibit 8: Health vertical recover on favourable basis in Q3



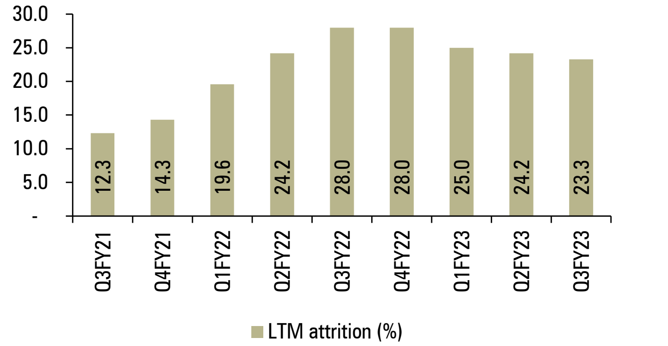
Source: Company, ICICI Direct Research

Exhibit 9: 12-month order backlog up by 5.3% QoQ



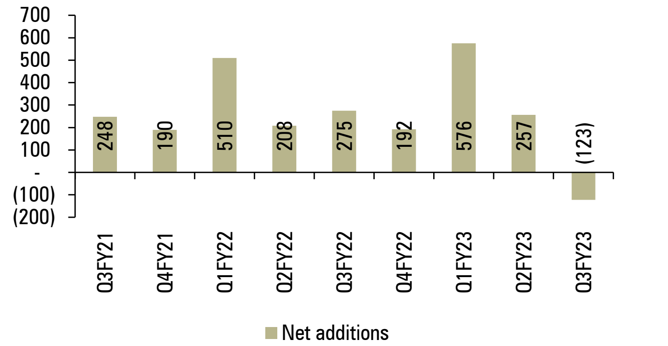
Source: Company, ICICI Direct Research

Exhibit 10: LTM attrition continues to moderate



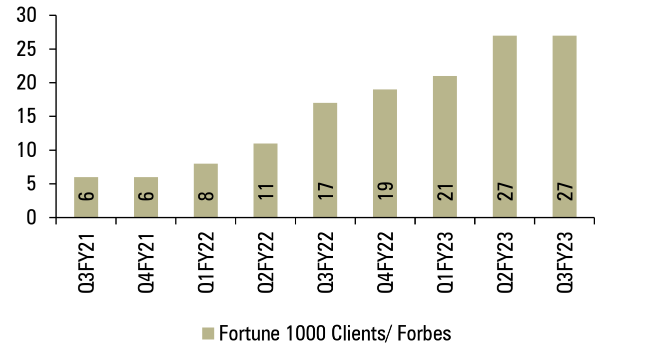
Source: Company, ICICI Direct Research

Exhibit 11: Net employee declines due to lateral fulfilment



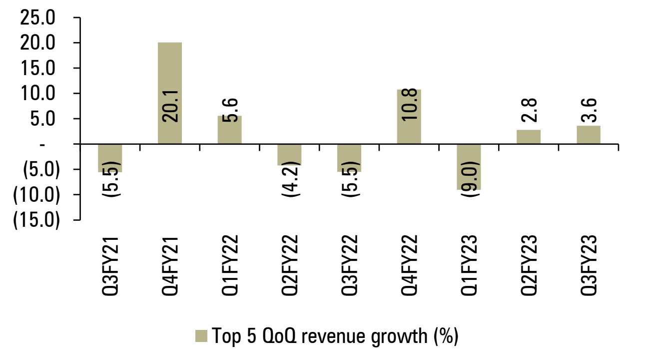
Source: Company, ICICI Direct Research

Exhibit 12: Fortune 1000/ Forbes clients trend



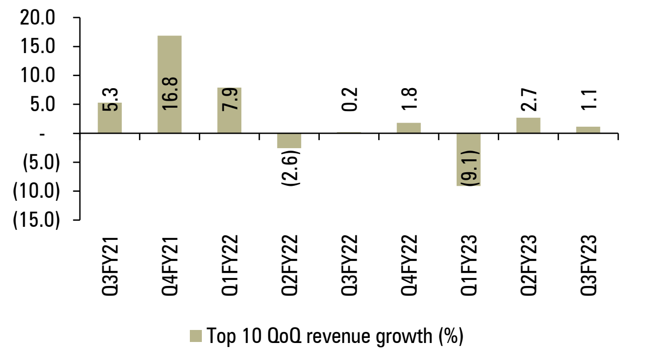
Source: Company, ICICI Direct Research

Exhibit 13: Top five client's revenue growth trend



Source: Company, ICICI Direct Research

Exhibit 14: Top 10 client's revenue growth trend



Source: Company, ICICI Direct Research

Financial summary

Exhibit 15: Profit and loss statement ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Net Sales	**2,184**	**2,266**	**2,525**	**2,768**
Growth (%)	27	4	11	10
COGS (employee expenses)	1,095	1,224	1,356	1,481
Other expenses	626	634	707	769
Total Operating Expenditure	1,721	1,858	2,063	2,250
EBITDA	**463**	**408**	**462**	**518**
Growth (%)	27	(12)	13	12
Depreciation	43	62	69	76
Net Other Income	28	67	95	112
PBT	448	413	488	554
Total Tax	115	103	122	138
Exceptional item	-	-	-	-
Adjusted PAT	**295**	**263**	**311**	**349**
Growth (%)	41	(11)	18	12
Adjusted EPS (₹)	103.8	87.6	103.3	116.1

Source: Company, ICICI Direct Research

Exhibit 16: Cash flow statement ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Profit before tax	**333**	**367**	**433**	**488**
Add: Depreciation	43	62	69	76
(Inc)/dec in Current Assets	(175)	(28)	(88)	(83)
Inc/(dec) in CL and Provisions	66	40	127	120
Taxes paid	(109)	(103)	(122)	(138)
CF from operating activities	**273**	**302**	**364**	**401**
(Inc)/dec in Inv. (+) Int inc (+) Goodwill	464	75	103	120
(Inc)/dec in Fixed Assets	(484)	(34)	(38)	(42)
CF from investing activities	**(20)**	**41**	**65**	**78**
Issue/(Buy back) of Equity	2	-	-	-
Dividend paid & dividend tax	(48)	(47)	(56)	(63)
Others	(75)	8	8	8
CF from financing activities	**(128)**	**(52)**	**(60)**	**(67)**
Net Cash flow	119	291	369	412
Exchange difference	(6)	-	-	-
Opening Cash	608	727	1,017	1,387
Closing Cash	**727**	**1,017**	**1,387**	**1,799**

Source: Company, ICICI Direct Research

Exhibit 17: Balance sheet ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Liabilities				
Equity Capital	15	15	15	15
Reserve and Surplus	1,056	1,272	1,527	1,813
Total Shareholders funds	1,071	1,287	1,542	1,829
Minority interest	150	196	251	318
Total Debt	190	190	190	190
Other liabilities	294	305	339	372
Total Liabilities	**1,706**	**1,979**	**2,323**	**2,708**
Assets				
Total Fixed Assets	841	825	805	783
Investments	52	52	52	52
Other non current assets	79	80	81	82
Debtors	436	452	504	552
Loans and Advances	-	-	-	-
Cash & investments	782	1,072	1,441	1,854
Other current assets	298	309	344	377
Total Current Assets	1,515	1,833	2,289	2,783
Current liabilities	755	783	873	957
Provisions	28	29	32	35
Total Current Liabilities	783	812	905	992
Net Current Assets	733	1,021	1,384	1,791
Application of Funds	**1,706**	**1,978**	**2,323**	**2,708**

Source: Company, ICICI Direct Research

Exhibit 18: Key ratios ₹ crore

	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS	103.8	87.6	103.3	116.1
Cash EPS	122.0	108.3	126.4	141.4
BV	376.8	428.1	512.8	608.0
DPS	19.0	15.8	18.6	20.9
Cash Per Share	262.4	338.3	461.0	598.1
Operating Ratios (%)				
EBITDA Margin	21.2	18.0	18.3	18.7
PBT Margin	20.5	18.2	19.3	20.0
PAT Margin	13.5	11.6	12.3	12.6
Inventory days	-	-	-	-
Debtor days	73	73	73	73
Creditor days	28	28	28	28
Return Ratios (%)				
RoE	27.5	20.5	20.1	19.1
RoCE	26.7	21.2	21.3	20.7
RoIC	45.4	38.1	44.5	51.7
Valuation Ratios (x)				
P/E	16.3	19.3	16.4	14.6
EV / EBITDA	9.1	9.7	7.7	6.1
EV / Net Sales	1.9	1.7	1.4	1.1
Market Cap / Sales	2.2	2.1	1.9	1.7
Price to Book Value	4.4	4.0	3.3	2.8
Solvency Ratios				
Debt/EBITDA	0.4	0.5	0.4	0.4
Debt / Equity	0.2	0.1	0.1	0.1
Current Ratio	0.9	0.9	0.9	0.9
Quick Ratio	0.9	0.9	0.9	0.9

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%

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ANALYST CERTIFICATION

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