Mastek Ltd

Mixed Q1; Upgrade to Buy

IT & ITES	Sharekhan code: MASTEK
Reco/View: Buy ↑	CMP: Rs. 2,171
	Price Target: Rs. 2,400 ↑

↑ 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 Mar 08, 2023

Medium Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 6,627 cr
52-week high/low:	Rs. 2,254 / 1,475
NSE volume: (No of shares)	1.54 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.9 cr

Shareholding (%)

Promoters	36.8
FII	13.1
DII	4.8
Others	45.3

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	9.5	37.0	27.8	8.2
Relative to Sensex	3.3	24.4	17.6	-14.3

Sharekhan Research, Bloomberg

Summary

- Revenue stood at $88.1 million, up 0.4% q-o-q/20.2% y-o-y in constant currency (cc), in line with our estimate of $88 million. Revenue from operations stood at Rs 725.3 crore, up 2.3% q-o-q/27% y-o-y.
- EBITDA margin stood at 17.5%, down 20 bps q-o-q. The 20-bps reduction was largely due to increments which was offset by currency and other operating levers.
- 12-month order backlog stood at Rs 1,763.9 crore ($215 million), down 2.6% q-o-q /up 9.7% y-o-y in cc. The Company added 22 new clients in Q1FY24. LTM attrition rate at 20.4% moderated by 60 bps q-o-q. Utilisation (including trainees) improved to 77.6% from 73.8% in Q4FY23, up 380 bps.
- Despite the near-term challenges and uncertainty, we believe the company is well-positioned on account of their comprehensive portfolio, strong UK public sector relationships, momentum in the Americas and Middle East which give them the confidence to achieve stronger and industry-leading growth. Hence, we upgrade the stock to Buy with a revised price target of Rs 2400. At the CMP the stock trades at 20.6/16.2x its FY24/25E EPS.

Mastek reported Revenue at $88.1 million, up 0.4% q-o-q/20.2% y-o-y in constant currency (cc), in line with our estimates of $88 million. Revenue from operations stood at Rs 725.3 crore, up 2.3% q-o-q/27% y-o-y. Revenue growth was driven by demand for Digital Engineering, Experience, and Cloud Transformation services. EBIT margin fell slightly to 14.8%, down 15 bps q-o-q, missing our estimates of 15% by 25bps. EBITDA margin stood at 17.5%, down 20 bps q-o-q. The 20-bps reduction was largely due to increments which was offset by currency and other operating levers. Net Profit stood at Rs 70.1 crore, down 3.4% q-o-q/ 9.2% y-o-y, missing our estimate of Rs 75.9 crore. In terms of verticals, q-o-q growth was led by Government & Education, and Manufacturing which grew 5.9%/11.9% respectively which was offset by decline in Financial Services, Retail and Healthcare which fell 6.3%/3.0% and 6.4% respectively.12 months order backlog stood at Rs 1,763.9 crore ($215.0mn) , down 2.6% q-o-q in cc. The Company added 22 new clients in Q1FY24. Total active clients during Q1FY24 was 436 as compared to 464 in Q4FY23. During the quarter there was net reduction of 30 employees taking the headcount to 5592. LTM attrition rate at 20.4% moderated by 60 bps q-o-q. Utilisation (%) (including trainees) improved to 77.6% from 73.8% in Q4FY23, up 380 bps. Middle east recorded strong growth during the quarter, up 33.5% q-o-q/57% y-o-y. Key market Europe declined, down 1.2% q-o-q while US and ROW declined 0.5% /3.3% q-o-q respectively. The company announced that it has signed definitive agreement to acquire BizAnalytica, LLC - a data cloud & modernisation specialist. Despite near-term challenges and uncertainty, we believe the company is well-positioned on account of their comprehensive portfolio, strong UK public sector relationships, the critical programs in the government that the company operates and the momentum in the Americas and Middle East which give them the confidence to achieve stronger and industry-leading growth. Hence, we upgrade the stock to Buy with a revised price target of Rs 2,400. At the CMP the stock trades at 20.6/16.2x its FY24/25E EPS.

Key positives

- Utilisation (%) (including trainees) improved to 77.6% from 73.8% in Q4FY23, up 380 bps.
- Contribution from Top 5 Clients improved by 120 bps to 30.8 from 29.6%, up 6.2% q-o-q.
- LTM Attrition moderated to 20.4% from 21% in Q4FY23 down 60 bps q-o-q.

Key negatives

- Active clients during the quarter fell to 436 from 464.
- Net reduction of 30 employees taking the headcount to 5592
- DSO (days) spiked to 101 from 93 in Q4FY23

Management Commentary

- The management expressed satisfaction with the order book in the US and Americas region, despite some deals taking longer to finalize. They anticipate a healthy revenue growth from the back-to-back order bookings in this geography. In the UK, they have significant deals in their pipeline that they are optimistic about.
- The company witnessed a strong uptick in their Middle East business due to recent order book closures and successful revenue conversion. However, their UK business was impacted by fewer working days . Nevertheless, they have a strong deal momentum in their US business, and they expect a much more robust quarter-on-quarter growth in Q2 as a result.
- The management stated that during the current quarter with increment, there may be some minor fluctuations in margin, but the company expects to return to a range of 17% to 19% by Q3 and Q4. This target is also the plan for the full year. The company stated that its growth outlook for quarter on quarter as well as year-on-year is strong and that it is aiming for industry-leading growth.

Revision in estimates – We have fined-tuned our revenue/margin estimates for FY24/25E to factor Q1FY24 performance.

Our Call

Valuation – Mixed Q1, Upgrade to Buy: Despite the uncertainty, tighter budget cycles that customers are going through, multiple levels of approval and the aggressive competition, we believe the company is well placed due to the completeness of their portfolio, the stronger relationships in the UK public sector, the critical programs in the government that the company operates as well as the momentum in both Americas and Middle East which is giving the management the confidence of being able to deliver stronger and industry-leading growth. We expect 14%/24% Sales and PAT CAGR over FY23-25E. Hence, we upgrade the stock to Buy with revised price target of Rs 2,400. At the CMP the stock trades at 20.6/16.2x its FY24/25E EPS.

Key Risks

Rupee appreciation and/or adverse cross-currency movements, Contagion effect of banking crisis and macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23	FY24E	FY25E
Revenue	2,183.8	2,563.4	2,932.2	3,329.5
OPM (%)	21.2	17.8	18.1	18.9
Adjusted PAT	295.1	267.7	325.7	414.6
% YoY growth	41.0	-9.3	21.7	27.3
Adjusted EPS (Rs)	103.4	86.6	105.4	134.1
P/E (x)	21.0	25.1	20.6	16.2
P/B (x)	5.8	4.0	3.5	3.0
EV/EBITDA	13.2	14.9	12.6	10.3
ROE (%)	30.6	19.4	18.0	19.9
ROCE (%)	27.3	20.3	18.2	20.1

Source: Company; Sharekhan estimates

Key results highlights

- **12-month order backlog:** 12 months order backlog was Rs 1,763.9 crore ($215.0 million) in Q1FY24, as compared to 1,509.3 crores ($191.1 million) in Q1FY23, up 16.9% in rupee terms and 9.7% in constant currency terms on y-o-y basis and Rs 1,794.1 crore ($218.3million) in Q4FY23, down 1.7% in rupee terms and decline of 2.6% in constant currency terms on q-o-q basis.
- **Demand Environment:** Middle East and USA have shown robust performance, while the UK was impacted by fewer working days in the quarter. The mining strategy is progressing well in the USA, UK, and Middle East. The Middle East's sequential growth exceeded 30%, driven by increased demand and funding due to the Ukrainian/Russian war, making it an attractive area for healthy diversification. The company has plans to enhance margins further in the Middle East.
- **Trends across markets:** Middle East recorded strong growth, up 33.5% q-o-q/57% y-o-y. Key market Europe declined, down 1.2% q-o-q while US and ROW declined 0.5% /3.3% q-o-q.
- **Trends on verticals:** Sequential growth was led by Government & Education, and Manufacturing, which grew 5.9%/11.9% respectively which was offset by decline in Financial Services, Retail and Healthcare, which fell 6.3% / 3.0% and 6.4% respectively.
- **New accounts added:** The company added 22 new clients in Q1FY24. Total active clients during Q1FY24 were 436 as compared to 464 in Q4FY23.
- **Attrition moderates, Utilisation improves:** Net reduction of 30 employees took the headcount to 5592. LTM attrition rate at 20.4% moderated by 60 bps q-o-q. Utilisation (%) (including trainees) improved to 77.6% from 73.8% in Q4FY23, up 380 bps.
- **Cash balance:** The total cash, cash equivalents and fair value of Mutual Funds stood at Rs 220.2 crore in Q1FY24 compared to Rs. 270 crore in Q4FY23. DSO(days) stood at 101 compared to 93 in Q4FY23 .
- **BizAnalytica acquisition:** Mastek Inc. has informed that it has approved to sign the definitive Membership Interest Purchase Agreement to acquire the 100% Membership Interest of BizAnalytica LLC. BizAnalytica LLC is an independent data cloud and modernisation specialist in the Americas region. The purchase consideration includes an upfront payment of $16.72 million and an earn-out of up to $24.0 million subject to achieving financial targets.

Results (Consolidated) Rs cr

Particulars	Q1FY24	Q1FY23	Q4FY23	Y-o-Y %	Q-o-Q %
Revenues In USD (mn)	**88.1**	**73.6**	**86.3**	**19.6**	**2.1**
Revenues In INR	**725.3**	**570.3**	**709.2**	**27.2**	**2.3**
Employee benefits expense	390.5	308.8	380.7	26.5	2.6
Other expenses	207.7	152.3	202.9	36.4	2.4
EBITDA	**127.0**	**109.2**	**125.5**	**16.3**	**1.2**
Depreciation & amortization	19.7	11.1	19.6	77.6	0.5
EBIT	**107.3**	**98.1**	**105.9**	**9.3**	**1.3**
Other Income	2.4	25.8	-0.4	-90.8	-675.6
Finance costs	9.3	2.0	9.3	372.6	0.5
PBT	**100.3**	**121.9**	**96.3**	**-17.7**	**4.2**
Tax Provision	26.8	37.6	23.7	-28.6	13.3
PAT	**73.5**	**84.4**	**72.6**	**-12.8**	**1.3**
Minority interest	-3.4	-7.2	0.0		
EO	0.0	0.0	0.0		
Net profit	**70.1**	**77.2**	**72.6**	**-9.2**	**-3.4**
Adjusted net profit	**70.1**	**77.2**	**72.6**	**-9.2**	**-3.4**
EPS (Rs)	22.7	25.1	23.5	-9.9	-3.4
Margin (%)					
EBITDA	17.5	19.2	17.7	-164	-19
EBIT	14.8	17.2	14.9	-241	-14
NPM	9.7	13.5	10.2	-387	-57
Tax rate	26.7	30.8	24.6	-409	214

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Persisting multiple global headwinds turning outlook for FY24E uncertain

Owing to multiple global headwinds the outlook for FY24E looks uncertain, and the recovery could be gradual in the coming quarters. Hence, concerns relating to macro headwinds are unlikely to abate anytime soon thus restricting any material outperformance for Indian IT companies.

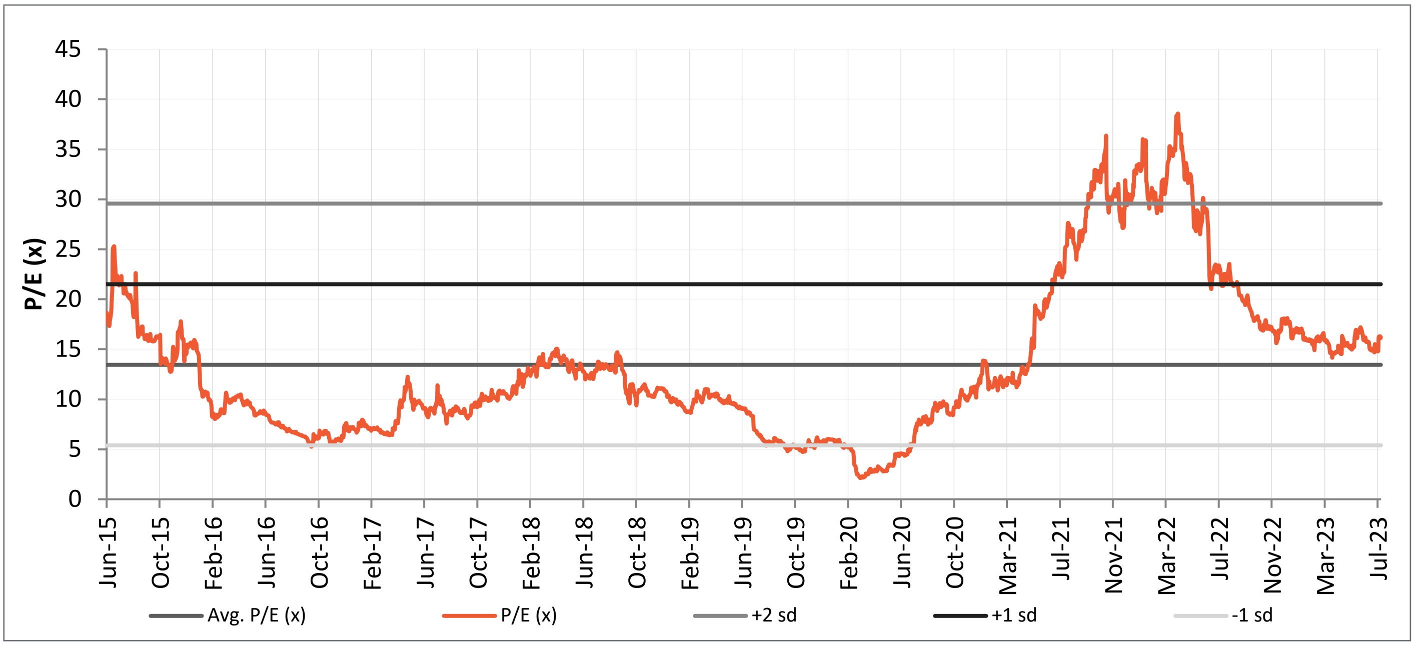
■ Company Outlook – Long-term outlook intact

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 – Mixed Q1, Upgrade to Buy.

Despite the uncertainty, tighter budget cycles that customers are going through, multiple levels of approval and the aggressive competition, we believe the company is well placed due to the completeness of their portfolio, the stronger relationships in the UK public sector, the critical programs in the government that the company operates as well as the momentum in both Americas and Middle East which is giving the management the confidence of being able to deliver stronger and industry-leading growth. We expect 14%/24% Sales and PAT CAGR over FY23-25E. Hence, we upgrade the stock to Buy with revised price target of Rs 2,400. At the CMP the stock trades at 20.6/16.2x its FY24/25E EPS.

One-year forward P/E (x) band



Source: 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)Contagion effect of banking crisis 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
Vijay Iyer	President Americas
Prameela Kalive	Chief Operating Officer
Arun Agarwal	Group CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Capital Group Cos Inc	7.86
2	Vanguard Group Inc	2.02
3	Abakkus Growth Fund 1	1.63
4	Abakkus Emerging Opportunities Fund	1.6
5	BlackRock Inc	0.79
6	ICICI Prudential Asset Management	0.79
7	Dimensional Fund Advisors LP	0.64
8	Norges Bank	0.31
9	Edelweiss Asset Management Ltd	0.2
10	WisdomTree Inc	0.09

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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Registration and Contact Details: Name of Research Analyst - Sharekhan Limited, Research Analyst Regn No.: INH000006183. (CIN): - U99999MH1995PLC087498. Registered Office: The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA. Tel: 022-6115000.

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Compliance Officer: Ms. Binkle Oza; Tel: 022-61169602; email id: complianceofficer@sharekhan.com

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