Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Mastek Ltd

Growth drivers to lead; Maintain Buy

IT & ITES	Sharekhan code: MASTEK
Reco/View: Buy ↔	CMP: **Rs. 2,769** — Price Target: **Rs. 3,235** ↑

↑ 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 14.95

Updated Aug 08, 2023

Low Risk

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

Source: Morningstar

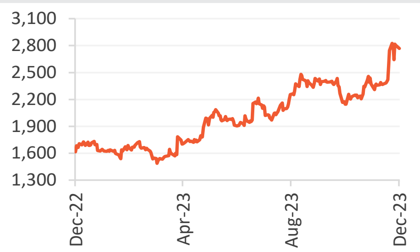
Company details

Market cap:	Rs. 8,485 cr
52-week high/low:	Rs. 2857/1475
NSE volume: (No of shares)	1.11 lakh
BSE code:	523704
NSE code:	MASTEK
Free float: (No of shares)	1.9 cr

Shareholding (%)

Promoters	36.5
FII	13.9
DII	6.0
Others	43.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	16.7	15.2	45.4	71.3
Relative to Sensex	8.5	7.0	32.1	53.5

Sharekhan Research, Bloomberg

Summary

- We maintain Buy with revised price target (PT) of Rs 3,235 (increase in PT reflects increase in target multiple to22x) owing to possible improvement in NHS, strong order booking in the resilient UK public sector, coupled with strong US growth profile and account mining efforts which will offer stronger revenue visibility for FY25 and aid in industry leading growth in addition to recovery in margin profile. At the CMP the stock trades at 23.8/18.8x its FY25/26E EPS.
- The company expects the US geography, Data & automation, AI service line and the Healthcare vertical to grow above the company's average growth, with the growth in US geography and Data & Automation service line expected to be driven by organic growth, account mining, and BizAnalytica, while growth in Healthcare vertical is expected to be driven by improvement in NHS, pipeline deals, and new opportunities.
- Opportunities due to policy changes, greater Cloud adoption by UK public sector departments and participation in emerging frameworks would further boost the core UK public sector that is already witnessing strong order booking.
- EBITDA margin is likely to gradually recover to 17-19% in the coming quarters on push from US growth, improving BizAnalytica margins, and implementation of various measures to aid margin recovery.

We interacted with Mastek Ltd's management to understand its growth prospects. The management highlighted that the US market, Data, Automation and AI service line and Healthcare vertical are set to grow above the company's average. While growth in US geography and Data, Automation and AI service line is anticipated to be aided by organic growth, account mining and growth from BizAnalytica, the healthcare vertical would ride on improvement in NHS account, pipeline deals and new opportunities. The company anticipates weakness in the NHS segment to bottom out. The weakness in NHS had impacted them in the last few quarters and had led them to be conservative on the NHS growth for FY24. Despite delays in decision making due to macroeconomic factors, the company has ongoing deals and discussions on new opportunities such as API integration, CRM for patient portals, and areas like secondary care and arm's length bodies (ALBs) that could set the tone for stronger FY25 for the NHS. The company anticipates that the growth profile of the US will contribute to the recovery of their margin profile, and is aiming to achieve a 17-19% EBITDA margin in the upcoming quarters by using levers such as grade harmonization mix, pyramid, and subcontractor costs. Hence, we maintain Buy with a revised price target (PT) of Rs 3,235 (increase in PT reflects increase in target multiple to22x) owing to possible improvement in NHS, strong order booking in the resilient UK public sector, coupled with strong US growth profile and account mining efforts which will offer stronger revenue visibility for FY25 and aid in industry leading growth in addition to recovery in margin profile. At CMP, the stock trades at 23.8/18.8x its FY25/26E EPS.

- **Opportunities and Growth drivers:** The company emphasized that growth above the company average is anticipated for the US geography, Data, automation and AI service line, and Healthcare vertical. The growth in US geography and Data & Automation service line is anticipated to be aided by organic growth, account mining and growth from BizAnalytica, while the Healthcare vertical would ride on improvement in NHS account, pipeline deals and new opportunities. US geography revenues grew 48% y-o-y for H1FY24 with revenue contribution of 26.9%. The Healthcare vertical grew 9% y-o-y while the data automation and AI services was flat y-o-y for H1FY24. The 12-month order backlog was Rs 1,862 crore in Q2FY24, reflecting growth of 22.3% in rupee terms and 13.4% in constant currency terms on Y-o-Y basis. The company envisages opportunities in the UK public sector from policy changes and is strategically prioritising its efforts. Further, as numerous departments are in the initial early phases of cloud adoption, the potential for additional opportunities is anticipated through partnerships with Salesforce and Snowflake. Also, participation in emerging frameworks like the digital specialist and data and analytics frameworks suggests potential opportunities lie in substantial multi-billion frameworks. The company is seeing good demand and traction in data and hence the recent Biz Analytica acquisition is expected to aid growth on that front. For Q3FY24, although Mastek would be impacted by furloughs, we estimate the company to report sequential revenue growth of 3.6% to $ 95.9 million aided by BizAnalytica's acquisition. EBITDA margin is expected to improve by ~70 bps q-o-q to 16.8%.
- **NHS business:** The company anticipates bottoming out in NHS that had impacted them in the last few quarters which led them to be conservative on NHS growth for FY24. Despite macro-overhang led delays in decision making, the company has few deals in pipeline and conversations on new opportunities such as API integration, CRM for patient portals and newer interesting areas like secondary care and arm's length bodies (ALBs). The deals and potential order book can set the stage for a stronger FY25 for the NHS.
- **Impetus on margin recovery:** The company expects EBITDA margin which was impacted by wage hike, one time integration cost and low margin profile of BizAnalytica in Q2FY24 to recover gradually. The low margin profile of BizAnalytica is expected to gradually improve going forward. The company believes the growth profile of US will aid margin recovery. The company expects to regain 17-19% EBITDA margin profile in the coming quarters. The company indicated there are several levers that would aid in margin recovery such grade harmonisation mix, pyramid, subcontractor costs etc. The sub-contractor cost in the UK public sector business is unique due to specific requirements and available skills, leading to higher sub-contractor costs as a percentage of revenue. Efforts are underway to continuously improve margins, including opportunities to convert subcontractors to employees and enhance talent acquisition.

Our Call

Valuation – Maintain Buy with revised PT of Rs 3,235: Post Management interaction, we believe the possible improvement in NHS, strong order booking from resilient UK public sector, coupled with strong US growth profile and account mining efforts will offer stronger revenue visibility for FY25 and aid in industry leading growth for the company in addition to recovery in margin profile. Further, multiple opportunities due to policy changes, increased adoption of cloud by Public sector departments, participation in the emerging framework and newer areas in Healthcare will provide new avenues of growth .We expect Sales/PAT CAGR of 18.2/19.3% over FY23-26E. Hence, we maintain a Buy with a revised price target (PT) of Rs 3,235 (increase in PT reflects increase in target multiple to22x). At CMP, the stock trades at 23.8/18.8x its FY25/26E 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	FY26E
Revenue	2,183.8	2,563.4	3,119.1	3,633.7	4,230.8
OPM (%)	21.2	17.8	16.8	17.0	17.9
Adjusted PAT	295.1	267.7	291.8	359.6	454.8
% YoY growth	41.0	-9.3	9.0	23.3	26.5
Adjusted EPS (Rs)	103.4	86.6	94.4	116.3	147.1
P/E (x)	26.8	32.0	29.3	23.8	18.8
P/B (x)	7.4	5.1	4.5	3.9	3.4
EV/EBITDA	17.2	19.0	16.5	13.6	11.3
ROE (%)	30.6	19.4	16.1	17.7	19.4
ROCE (%)	27.3	20.3	17.6	19.3	21.5

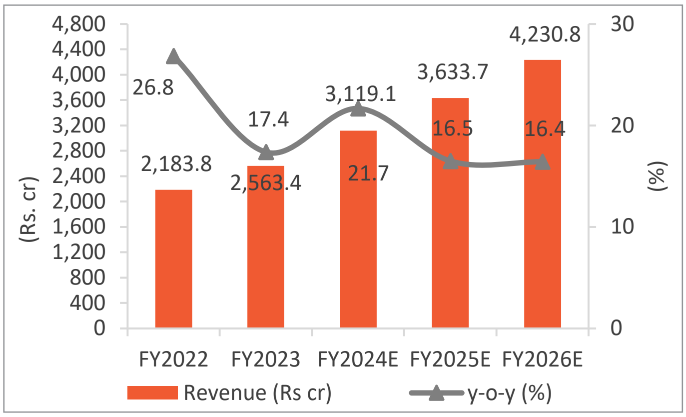
Source: Company; Sharekhan estimates

Key Takeaways

- In terms of geography, the company believes that US will grow faster than the company average both organically and through acquisitions. They anticipate the healthcare industry vertical to exhibit faster growth than the company average, and they also foresee accelerated growth in data automation and AI services compared to the company average.
- Mastek believes that while other verticals and service lines will grow, the company has specific focus on the above from geography, vertical and service line perspective and firmly believe that these three would outperform the company.
- The company aspires to become a $1bn organization by FY28-FY29 growing both organically as well as inorganically.
- The company plans to undertake certain acquisitions not this year but down the road in certain areas where it is felt they need to have more capabilities both from vertical and service line perspective and even from a geography standpoint where they would look at acquisitions to fit into overall aspirations.
- Subcontractor mix, grade harmonization, trimming tail accounts, currency tailwinds are operating margin levers that will aid the company to recover to the earlier company margin profile of 17-19%. Additionally, as the company's non-government business grows there will be more offshoring leading to further improvement in margin profile. Utilisation is broadly there in the right percentage, so the management sees very limited scope in that direction.
- The company continues to witness decision elongated decision making and increased deal scrutiny which is in-line with the industry.
- Mastek expects Q3 to be impacted due to furloughs but anticipates stronger growth in Q4.
- It has identified 30 global accounts from account mining perspective with dedicated playbook, account manager and delivery manager aligned to them. The company wants to focus on growing from existing account and rely less on new account intake.

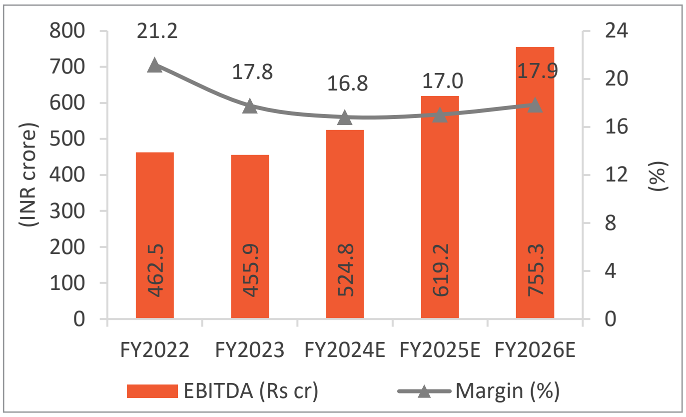
Financials in charts

Revenue (Rs. crore) and growth (%)



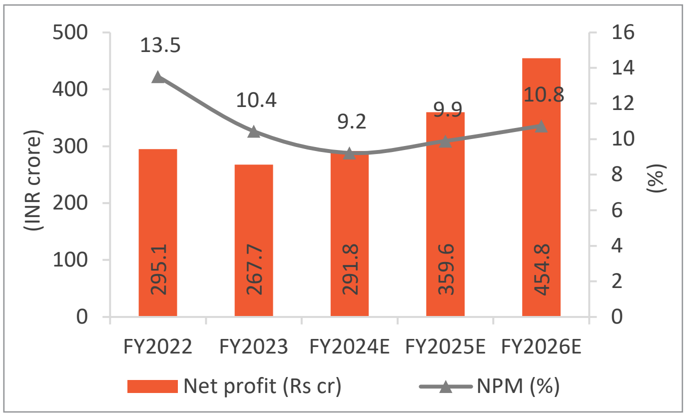
Source: Company, Sharekhan Research

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



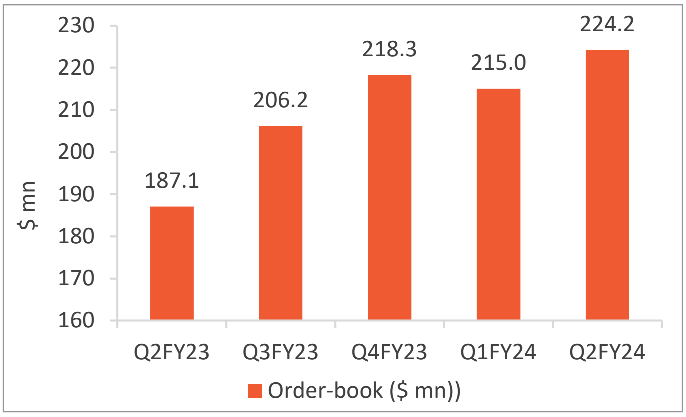
Source: Company, Sharekhan Research

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



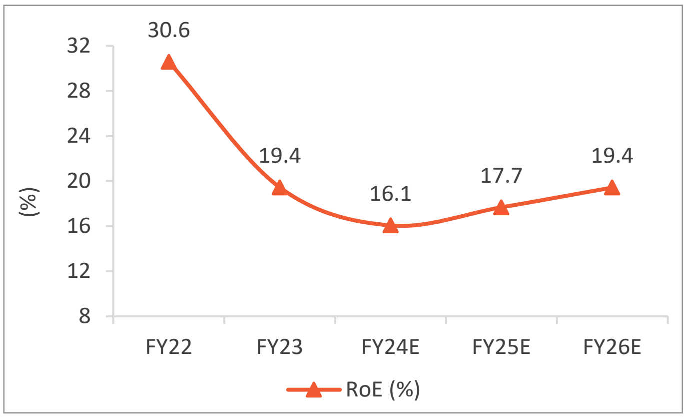
Source: Company, Sharekhan Research

Order-book ($ mn)



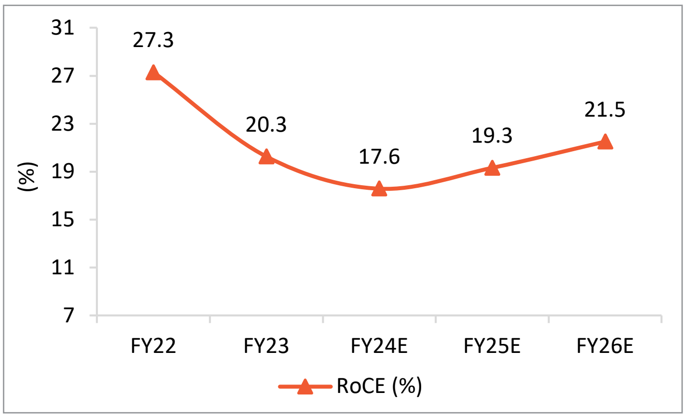
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - 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.

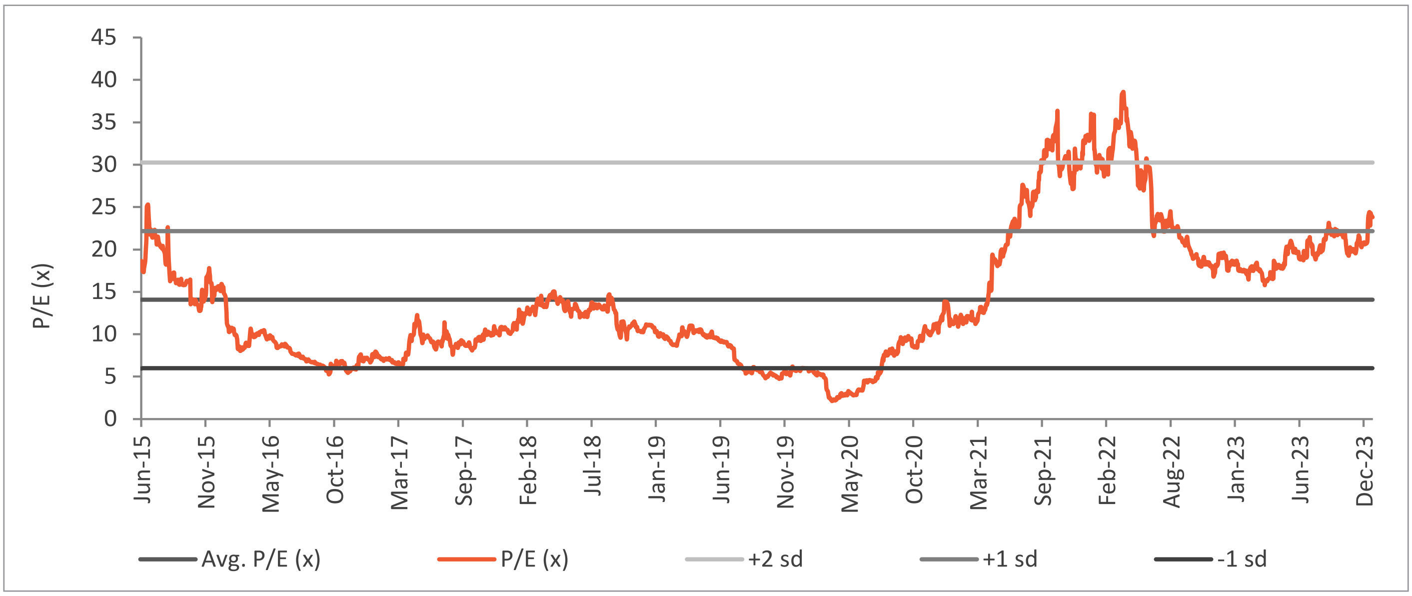
■ Company outlook - Long-term outlook intact

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 - Maintain Buy with revised PT of Rs. 3,235

Post Management interaction, we believe the possible improvement in NHS, strong order booking from resilient UK public sector, coupled with strong US growth profile and account mining efforts will offer stronger revenue visibility for FY25 and aid in industry leading growth for the company in addition to recovery in margin profile. Further, multiple opportunities due to policy changes, increased adoption of cloud by Public sector departments, participation in the emerging framework and newer areas in Healthcare will provide new avenues of growth .We expect Sales/PAT CAGR of 18.2/19.3% over FY23-26E. Hence, we maintain a Buy with a revised price target (PT) of Rs. 3,235 (increase in PT reflects increase in target multiple to22x). At CMP, the stock trades at 23.8/18.8x its FY25/26E 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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Capital Group Cos Inc	8.0
2	Vanguard Group Inc	2.5
3	ABAKKUS GROWTH FUND 1	1.6
4	Abakkus Emerging Opportunities Fun	1.6
5	BlackRock Inc	0.9
6	ICICI Prudential Asset Management	0.8
7	Dimensional Fund Advisors LP	0.7
8	Tata Asset Management Pvt Ltd	0.5
9	Norges Bank	0.3
10	JM Financial Asset Management Ltd	0.1

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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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.

Correspondence/Administrative Office: Gigaplex IT Park, Unit No 1001, 10th Floor, Building No.9, TTC Industrial Area, Digha, Airoli-West, Navi Mumbai – 400 708. Tel: 022 61169000 / 61150000, Fax No. 61169699.

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Compliance Officer: Ms. Binkle Oza; Tel: 022-62263303; email id: complianceofficer@sharekhan.com

For any complaints/grievance, email us at igc@sharekhan.com or you may even call Customer Service desk on - 022- 41523200 / 022-69920600