Mastek Ltd (MASTEK)

ICICI direct Research

CMP: ₹ 1672 Target: ₹ 1800 (8%) Target Period: 12 months

HOLD

October 23, 2022

Company Update

Acquisition aids growth; organic growth continues to be muted

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%)

Q2FY23 Results: Reported strong revenue growth in Q2FY23 aided by acquisition.

- Revenue grew 10.7% QoQ in CC terms and 6.1% in dollar terms
- EBITDA margin declined ~200 bps QoQ to 17.2%
- Reported 12M order backlog of US$187.1 mn, down 2.1%QoQ

What should investors do? Mastek's share price has grown by ~5.3x over the past five years (from ~₹ 318 in October 2017 to ~₹ 1,672 levels in October 2022).

- We maintain **HOLD** rating on the stock

Target Price and Valuation: We value Mastek at ₹ 1,800 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 US region
- Expect revenues to grow at 12.5% 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 ₹ 1,670

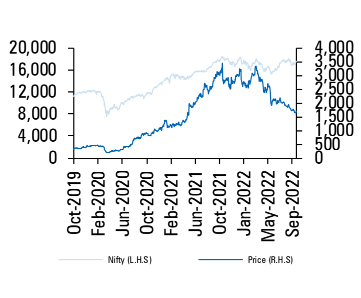
Particulars

Particulars	Amount
Market Capitalization (₹ Crore)	4,753.5
Total Debt (₹ Crore)	190.3
Cash and Investments (₹ Crore)	781.9
EV (₹ Crore)	4,161.8
52 week H/L	3413/ 1600
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

- MST acquisition completed
- **Key Risk:** (i) US business ramp up better than expectation, (ii) Slowdown in organic revenues

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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	2,442	2,742	3,110	12.5
EBITDA	364	463	57.0	464	526	603	9.3
EBITDA Margins (%)	21.2	21.2		19.0	19.2	19.4	
Net Profit	209	295	55.5	293	344	394	10.1
EPS (₹)	82	104		103	121	139	
P/E	20.4	16.1		16.2	13.8	12.1	
RoNW (%)	24.4	27.5		22.3	21.6	20.6	

Key takeaways of quarter and conference call highlights

- The company reported strong growth of 10.7% QoQ growth in CC term while dollar revenue came in at US$78.1 mn, up 6.1% QoQ ***(aided by acquisition, organic growth in low single digit QoQ)***. In rupee terms, revenue was at ₹ 625.3 crore, up 9.7% QoQ. Revenue includes one-month revenue from its acquired company Metasoftech Solutions LLC, US (MST)

- In terms of geographies, growth was led by the US region reporting growth of 40.9% QoQ while UK & ME regions reported growth of 1.3% & 4.1% QoQ, respectively

- In terms of verticals, all verticals except health & lifescience reported growth with government, retail, financial services & manufacturing reporting growth of 15%, 11.7%, 11.1% & 26.4% QoQ, respectively. Health & Lifescience continue to be under pressure and declined 15.7% QoQ

- The EBITDA margin declined ~200 bps QoQ to 17.2%. The company indicated that its margins in Q2 was impacted by implementation of wage hike, increase in sub-contractor costs due to ramp up & currency headwinds

- As far as the UK government market is concerned, the company mentioned that despite lot of geopolitical uncertainties unfolding in the market, it does not expect any material impact on its operations in the country. It has been operating in the market for last 18 years and they work on critical programs there such as border security, trade, visa application processing (process 5 million (mn) visa on annual basis), etc. It also said that it works closely with multiple layers in the government programs. Any changes in top layers should not impact its business and these relationships act as an entry barrier for the competition

- The company indicated that the Europe market (ex-UK) witnessed slower decision making across clients and but since major chunk of its business is in UK, it should not affect it materially. The company also mentioned that UK private market is doing well for it

- As far as the US market is concerned, the company indicated that its account mining strategy has started yielding results but it says that it is taking longer time than expected. The company said that its top 25 clients contribute 70% of revenue in the market and it is tracking this metric very closely. The company indicated that historically it was dependent heavily on Oracle to give it business in the market but now it is connecting clients directly. The company said that account mining of top 25 accounts remains a top priority. It is looking to capture Fortune 1000 clients, which grew 2.5x for it in the last few years. The company expects the US market to perform better in H2

- As far as healthcare vertical is concerned, the company indicated it provides four services including digital and shared services. It provides these services across UK, US and Middle East. The company indicated that decision making has been slower in the last couple of quarters and it is impacting the growth. It also indicated that deal constructs also going through major changes including more spread out deals now vs. two to three years time frame. In this vertical, it had won account in US (e.g. it recently revamped member portal of 'Banner Health' client). Working on customer experience program for the client. The company also indicated that healthcare vertical in the UK is now open to shift some part of their programs to offshoring. The company is targeting 30% revenue mix from this vertical by FY26. This includes healthcare part of its recently acquired company MST that also has healthcare. Current level is bottom. We expect growth and reaching 30% for healthcare and life sciences as a vertical

- The company expects to acquire 10% Evosys stake as per the earlier agreement and expects the transaction to be funded through its own cash as Mastek expects healthy cash generation in H2. Mastek is also open to small tuck in acquisitions in the future. For US$1 bn revenue target, which it is looking to reach in second half of the decade, the company is looking to raise funds to achieve this target and they will raise it at an appropriate time

- The company also indicated that it is looking to rationalise client numbers as it has a long tail of clients. Mastek is also looking to rationalise those accounts where scalability is the issue. The company have identified 40-45 such accounts and has assigned the responsibility of the same on one of its top executives. In these 40-45 accounts, 10 are from UK, while US and MEA has 20-25 and 10 clients, respectively

- It has added 20 clients in this quarters, out of which five clients have annual revenues of more than US$1 bn

- The company's LTM declined 80 bps QoQ to 24.2% and utilisation excluding trainees declined 250 bps QoQ to 75%

- The company's net headcount during the quarter increased by 257 taking the total headcount to 5,810. Mastek indicated that employee addition was including the employees of MST. The company also indicated that its total organic headcount has declined during the quarter as it is not backfilling the positions, which are now vacant

- During the quarter, the company completed the acquisition of MST. Mastek had acquired MST for US$76.6 mn. Its revenue for CY21 was US$24.6m. The company's current quarter revenue includes one-month revenue contribution of MST and next quarters revenue will include full contribution of MST. The company indicated that it is getting exposure to new sub verticals with MST like local government in US states

Exhibit 1: P&L

	Q2FY23	Q2FY22	YoY (%)	Q1FY22	QoQ (%)	Comments
Revenue in USD mn	78.1	72.0	8.4	73.6	6.1	Revenue growth of 10.7% QoQ in CC terms aided by acquisition, organic growth in single digit QoQ
Revenue	625.3	533.9	17.1	570.3	9.7	
Employee expense	340.0	273.9	24.2	308.8	10.1	
Gross Margin	285.3	260.1	9.7	261.5	9.1	
Gross margin (%)	45.6	48.7	-308 bps	45.9	-23 bps	
other expense	177.9	147.3	20.8	152.3	16.8	
EBITDA	107.4	112.8	-4.8	109.2	-1.7	
EBITDA Margin (%)	17.2	21.1	-395 bps	19.2	-207 bps	EBITDA margins impacted by wage hike
Depreciation & amortisation	17.1	10.4	64.0	11.1	54.1	
EBIT	90.3	102.4	-11.8	98.1	-8.0	
EBIT Margin (%)	14.4	19.2	-473 bps	17.2	-277 bps	
Other income (less interest)	1.7	5.9	-71.7	23.8	-93.0	
PBT	92.0	108.3	-15.0	121.9	-24.6	
Tax paid	31.1	26.7	16.4	37.6	-17.2	
PAT	86.2	81.5	5.7	84.4	2.2	

Source: Company, ICICI Direct Research

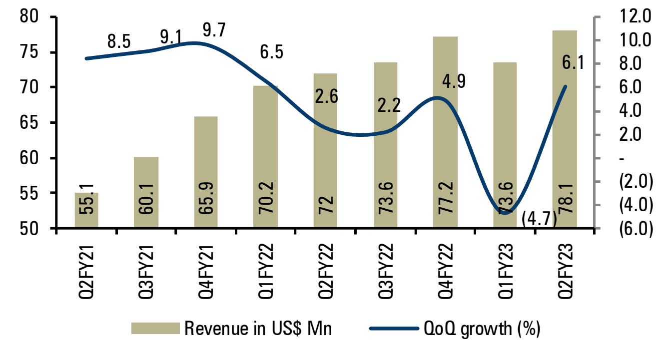
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	2,442.0	2,442	0.0	2,871	2,742	-4.5	3,110	Numbers re-aligned as per H1 performance
EBITDA	464.0	464	0.0	546	526	-3.5	603	
EBITDA Margin (%)	19.0	19.0	0 bps	19.0	19.2	20 bps	19.4	Margins estimating upward on moderation of attrition lowering backfilling costs
PAT	293	293	0.0	355	344	-3.2	394	
EPS (₹)	102.9	102.9	0.0	124.9	120.9	-3.2	138.5	

Source: Company, ICICI Direct Research

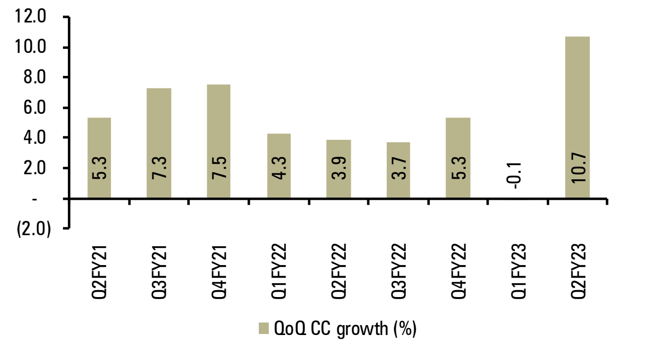
Key Metrics

Exhibit 3: Acquisition aids revenue



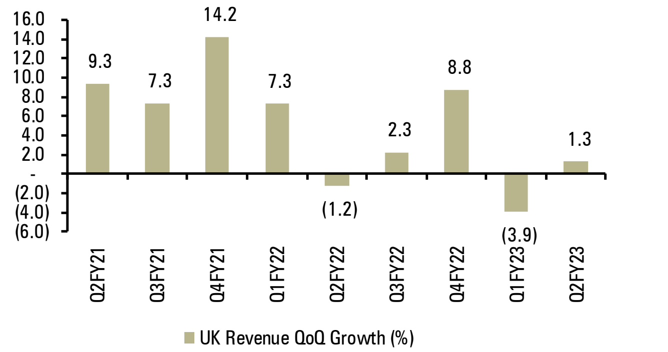
Source: Company, ICICI Direct Research

Exhibit 4: QoQ CC growth



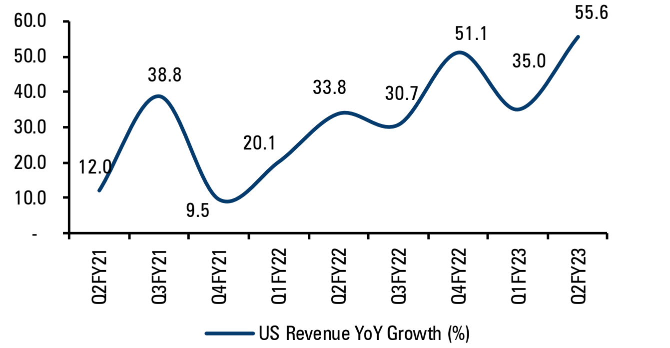
Source: Company, ICICI Direct Research

Exhibit 5: UK has been muted



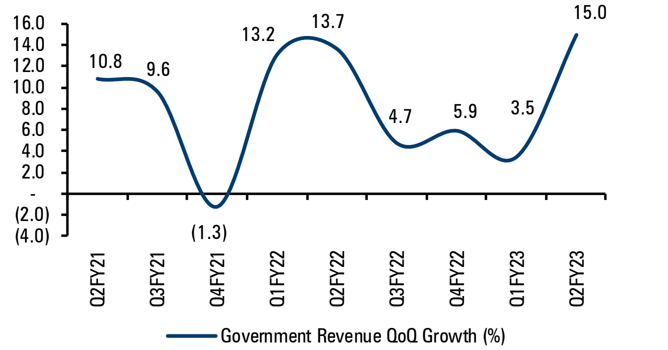
Source: Company, ICICI Direct Research

Exhibit 6: Acquisition aids US



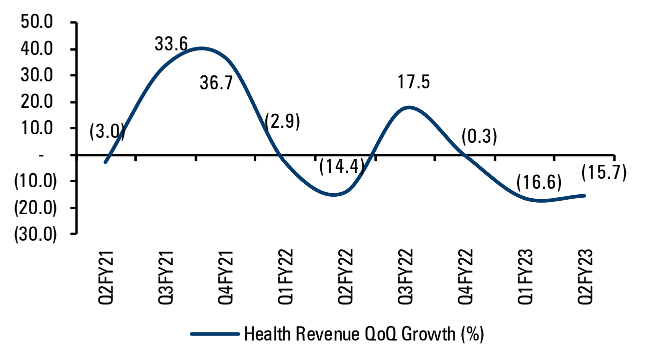
Source: Company, ICICI Direct Research

Exhibit 7: Government QoQ revenue growth



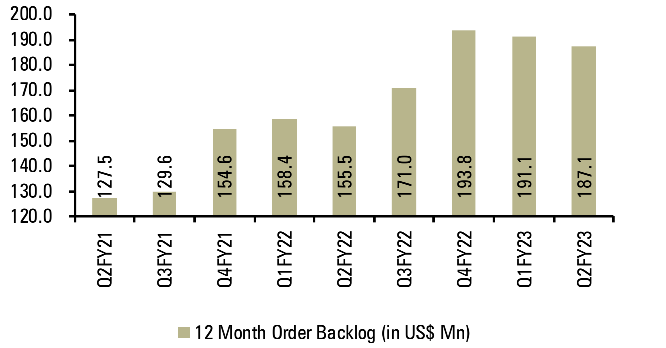
Source: Company, ICICI Direct Research

Exhibit 8: Health vertical remains stressed



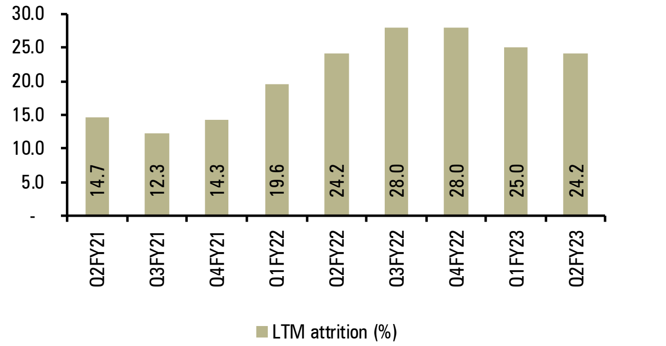
Source: Company, ICICI Direct Research

Exhibit 9: Twelve-month order backlog



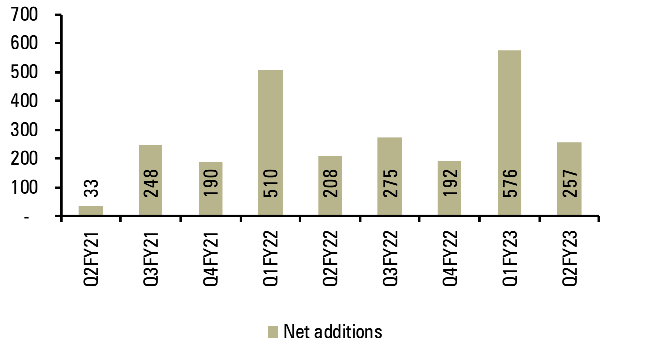
Source: Company, ICICI Direct Research

Exhibit 10: LTM attrition moderating



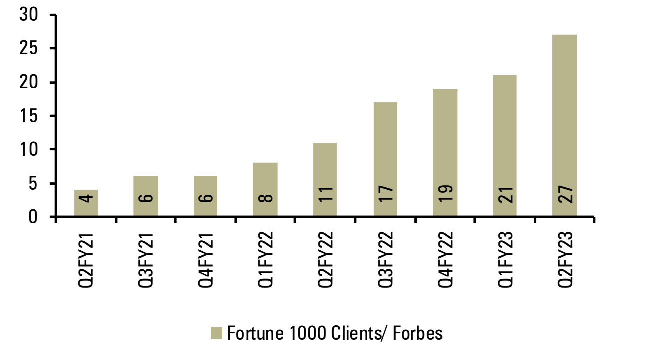
Source: Company, ICICI Direct Research

Exhibit 11: Aided by acquisition; core business declined



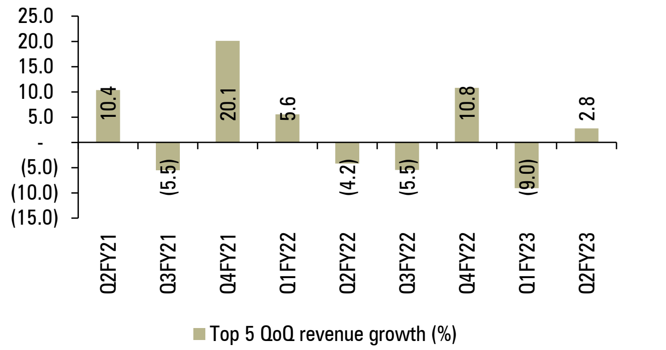
Source: Company, ICICI Direct Research

Exhibit 12: Fortune 1000/ Forbes clients increasing



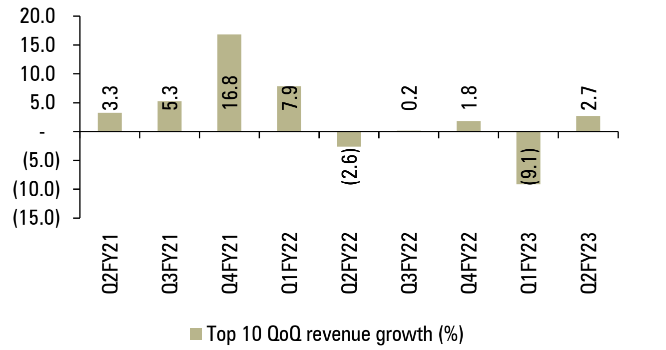
Source: Company, ICICI Direct Research

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**	**2,442**	**2,742**	**3,110**
Growth (%)	27	12	12	13
COGS (employee expenses)	1,095	1,294	1,448	1,636
Other expenses	626	684	768	871
Total Operating Expenditure	1,721	1,978	2,216	2,507
EBITDA	**463**	**464**	**526**	**603**
Growth (%)	27	0	13	15
Depreciation	43	67	75	86
Net Other Income	28	67	95	112
PBT	448	464	546	630
Total Tax	115	125	148	170
Exceptional item	-	-	-	-
Adjusted PAT	**295**	**293**	**344**	**394**
Growth (%)	41	(1)	17	15
Adjusted EPS (₹)	103.8	102.9	120.9	138.5

Source: Company, ICICI Direct Research

Exhibit 16: Cash flow statement ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Profit before tax	**333**	**418**	**491**	**564**
Add: Depreciation	43	67	75	86
(Inc)/dec in Current Assets	(175)	(88)	(102)	(125)
Inc/(dec) in CL and Provisions	66	127	148	182
Taxes paid	(109)	(125)	(148)	(170)
CF from operating activities	**273**	**363**	**409**	**474**
(Inc)/dec in Inv. (+) Int inc (+) Goodwill	464	75	103	120
(Inc)/dec in Fixed Assets	(484)	(37)	(41)	(47)
CF from investing activities	**(20)**	**38**	**62**	**73**
Issue/(Buy back) of Equity	2	-	-	-
Dividend paid & dividend tax	(48)	(53)	(62)	(71)
Others	(75)	8	8	8
CF from financing activities	**(128)**	**(57)**	**(66)**	**(75)**
Net Cash flow	119	344	405	472
Exchange difference	(6)	-	-	-
Opening Cash	608	727	1,071	1,476
Closing Cash	**727**	**1,071**	**1,476**	**1,948**

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	1,296	1,578	1,901
Total Shareholders funds	1,071	1,311	1,593	1,916
Minority interest	150	196	251	318
Total Debt	190	190	190	190
Other liabilities	294	328	369	418
Total Liabilities	**1,706**	**2,026**	**2,403**	**2,842**
Assets				
Total Fixed Assets	841	823	800	774
Investments	52	52	52	52
Other non current assets	79	80	82	83
Debtors	436	487	547	620
Loans and Advances	-	-	-	-
Cash & investments	782	1,125	1,530	2,003
Other current assets	298	333	374	424
Total Current Assets	1,515	1,945	2,451	3,047
Current liabilities	755	844	948	1,075
Provisions	28	31	35	40
Total Current Liabilities	783	875	983	1,115
Net Current Assets	733	1,070	1,469	1,933
Application of Funds	**1,706**	**2,026**	**2,403**	**2,842**

Source: Company, ICICI Direct Research

Exhibit 18: Key ratios ₹ crore

	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS	103.8	102.9	120.9	138.5
Cash EPS	122.0	129.9	151.3	173.0
BV	376.8	461.3	560.4	674.0
DPS	19.0	18.5	21.8	24.9
Cash Per Share	262.4	386.4	532.6	703.1
Operating Ratios (%)				
EBITDA Margin	21.2	19.0	19.2	19.4
PBT Margin	20.5	19.0	19.9	20.3
PAT Margin	13.5	12.0	12.5	12.7
Inventory days	-	-	-	-
Debtor days	73	73	73	73
Creditor days	28	28	28	28
Return Ratios (%)				
RoE	27.5	22.3	21.6	20.6
RoCE	26.7	23.3	23.0	22.4
RoIC	45.4	44.1	51.7	61.7
Valuation Ratios (x)				
P/E	16.1	16.2	13.8	12.1
EV / EBITDA	9.0	8.2	6.5	4.9
EV / Net Sales	1.9	1.6	1.2	0.9
Market Cap / Sales	2.2	1.9	1.7	1.5
Price to Book Value	4.3	3.5	2.9	2.4
Solvency Ratios				
Debt/EBITDA	0.4	0.4	0.4	0.3
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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