

**MASTEK**

INR 322

*Delivers on margins; sustenance is the key***ACCUMULATE**

Mastek announced its Q3FY08 results that were ahead of our estimates. Total revenues were up 10.2% and net profits up 29.4%, sequentially. These included revenues of INR 160 mn and insignificant net profit from STG - the company acquired during the quarter. Excluding these, revenues were up 2.7% Q-o-Q. The company reported strong EBITDA margins, an improvement of 200bps at 19.3%; however, we would like to highlight that excluding the one-time write-back and one-time acquisition-related cost, the EBITDA margin improvement was 1.2%. Mastek's EBITDA margins at the 18.5%-level are now at par with some of the best-in-class mid-tier peers in the IT services space.

Over the past few quarters Mastek has delivered results, that are in line with its guidance through the organic and inorganic route, This quarter saw a huge surprise especially on the 120bps margin expansion, which is historically the highest margin for the company. We believe the fixed price proportion of projects is increasingly improving the average realization for Mastek, which is aiding margin expansion. We also believe focus on improving the operational efficiency and stricter cost management with newly-defined processes and systems have led to an overall improvement in margins.

Though we see precursors to a structural shift in the company's execution engine, we would like to see the company delivering a sustained performance on the margin front as it has guided to sustaining EBITDA margins at 19-20% levels for next quarter and for FY09. We are concerned on the ramp-down of the NHS account that will start from July 2008 onwards, though the recent new deal wins and acquisition provide better growth visibility. Taking the above into consideration we have revised our EPS estimates upwards by 6% to INR 47 and by 9.7% to INR 51 for FY09E and FY10E, respectively. This implies a CAGR of ~ 10% over FY08-10E. At CMP of INR 322, the stock currently trades at a P/E of 6.9x and 6.4x our FY09E and FY10E earnings, respectively. We maintain our 'ACCUMULATE' recommendation.

#### Key highlights

- ◆ Revenues at INR 2.3 bn were up 10.2% Q-o-Q and 10.3% Y-o-Y. The STG acquisition contributed INR 160 mn to the topline. Net profit stood at INR 350.8 mn, up 29.4% Q-o-Q and down 12.9% Y-o-Y. STG contributed marginally to the bottomline (INR 10 mn).
- ◆ EBITDA stood at INR 451.2 mn, up 23.3% Q-o-Q and 23.5% Y-o-Y. EBITDA margins improved by 200bps Q-o-Q to 19.3%. However, we would like to highlight that excluding the one-time write-back and the one-time acquisition related cost, the EBITDA margin improvement was 1.2%.

#### Financials

Year to June	Q3FY08	Q2FY08	Growth %	Q3FY07	Growth %	FY08E	FY09E
Revenue (INR mn)	2,333	2,117	10.2	2,115	10.3	8,933	10,161
EBITDA (INR mn)	451	366	23.3	365	23.5	1,552	1,798
Rep. net profit (INR mn)	351	271	29.4	403	(12.9)	1,204	1,342
EPS basic (INR)	12.3	9.5	29.7	14.2	(12.9)	42.2	46.9
P/E (x)						7.6	6.9
EV/EBITDA (x)						5.0	3.8
Market cap / Rev. (x)						1.0	0.9

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Reuters : MAST.BO  
Bloomberg : MAST IN

#### Market Data

52-week range (INR) : 419 / 220  
Share in issue (mn) : 28.5  
M cap (INR bn/USD mn) : 8.9 / 230.3  
Avg. Daily Vol. BSE ('000) : 91.3

#### Share Holding Pattern (%)

Promoters : 40.2  
MFs, Fls & Banks : 10.3  
Fls : 27.9  
Others : 21.6

- ◆ **Order book increased 12.2% Q-o-Q.** With new contracts from existing clients, Mastek’s order book increased to INR 4.06 bn, compared with INR 3.62 bn in the previous quarter.
- ◆ **11 new clients added in the quarter.** One of the 11 clients was added by STG, post acquisition. The active client count now stands at 94, compared with 41 a year ago.
- ◆ **Onsite utilization at 92.99% was marginally higher,** compared with 92.4% in the previous quarter. Offshore utilization at 74.69% from 73.59% in the previous quarter.
- ◆ **Mastek’s total headcount now stands at 3,999 employees,** compared with 3,678 in the previous quarter. Out of this, 350 people were from the STG acquisition. Attrition rate for the quarter stood at 17% (including trainees).
- ◆ **The number of clients contributing more than USD 1 mn has significantly increased** from 24 in Q2 to 40 in Q3. Eight additions to this client pool are on a purely organic basis.
- ◆ **Revenue guidance for Q4FY08 stands at INR 2.45–2.5 bn** and net profit at INR 370–380 mn. For the whole year, the company maintained its guidance of 35% (USD terms) for revenue growth.

**\* Client addition; highest ever**

During the quarter Mastek added 11 new clients that is the highest client addition in a quarter. Two of the new wins are actually based on the SOA based Elixir solution wins in the insurance industry. This is particularly notable since this solution will be launched only from July 08 onwards.

**Table 1: Quarterly client edition**

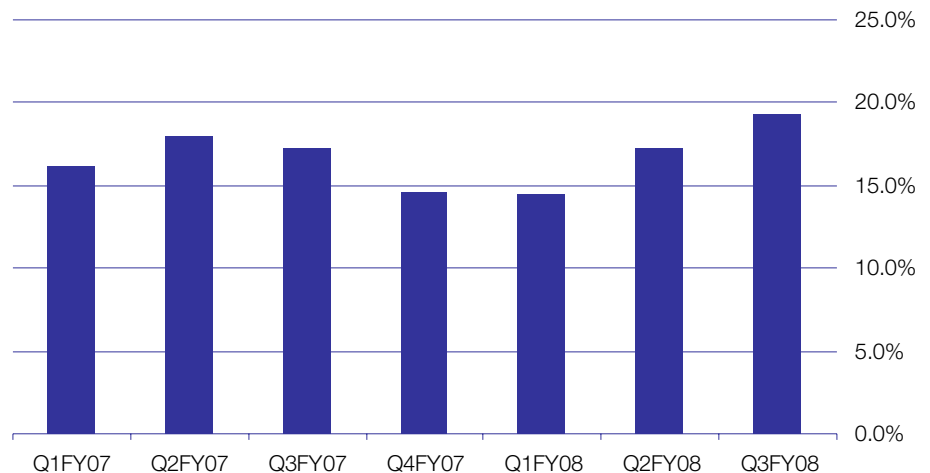
	Q1FY07	Q2FY07	Q3FY07	Q4 FY07	Q1FY08	Q2FY08	Q3 FY08
Client addition	3	1	4	4	2	4	11

Source: Company, Edelweiss research

**\* Sustenance key to success; having proved execution**

We had earlier highlighted execution as the key performance metric for Mastek, since historically the company has suffered due to delays. However, the company has during the quarter delivered strong operational improvement leading to respectful EBITDA margins. We believe sustenance of the margin, going forward, will be a key differentiator among the mid-tier players.

**Chart 1: EBITDA margin at its highest level in the quarter**

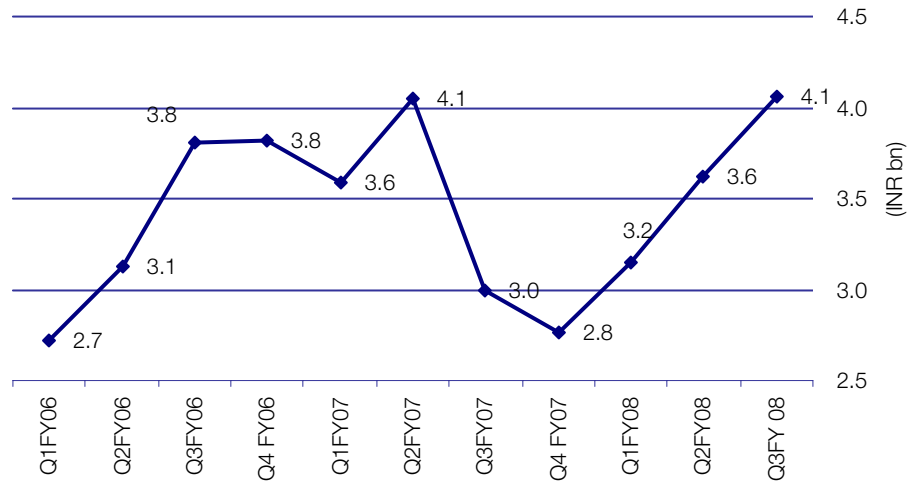


Source: Company, Edelweiss research

\* **Order book build-up aided by new deal wins**

During the quarter, Mastek signed a few new contracts, including one UK government defence deal in partnership with Thales UK. Another new deal was from Legal & General, which marks Mastek's foray into the non-life insurance segment. The order book now stands at INR 4.06 bn, up from INR 3.62 bn in the previous quarter.

**Chart 2: Order book trend**



Source: Company, Edelweiss research

\* **Revision in estimates**

We have revised our estimates incorporating the STG acquisition leading to increase in EPS estimates by 6% and 9.7% for FY09E and FY10E, respectively.

**Table 2: Revised estimates**

	Earlier		Revised		% change	
	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Revenue (INR mn)	9,880	10,798	10,161	11,533	2.8	6.8
Net profit (INR mn)	1,265	1,327	1,342	1,457	6.1	9.8
EPS (INR)	44.2	46.2	46.9	50.7	6.0	9.7

Source: Edelweiss research

\* **Valuations and outlook: Maintain Accumulate**

We estimate Mastek to post EPS of INR 47 and INR 51 for FY09E and FY10E, respectively. At CMP of INR 322, the stock trades at a P/E of 6.9 and 6.4x and EV/EBITDA of 3.8x and 2.7x on our FY09E and FY10E earnings, respectively. We continue to maintain our 'ACCUMULATE' recommendation on the stock.

Financials snapshot								(INR mn)
Year to June	Q3FY08	Q2FY08	Growth %	Q3FY07	Growth %	FY08E	FY09E	FY10E
Total revenues	2,333	2,117	10.2	2,115	10.3	8,933	10,161	11,533
Staff costs	1,253	1,274	(1.7)	1,301	(3.7)	5,228	6,086	6,805
Programming charges	0	0		109		73	406	461
Travel & conveyance	105	82	28.0	113	(7.0)	400	579	634
Other costs	525	394	33.1	228	130.1	1,680	1,290	1,557
Total operating expenditure	1,882	1,751	7.5	1,750	7.6	7,381	8,362	9,457
EBITDA	451	366	23.3	365	23.5	1,552	1,798	2,076
Depreciation	87	84	3.8	74	17.1	330	380	427
EBIT	364	282	29.0	291	25.2	1,223	1,418	1,649
Other income	55	43	27.7	198	(72.1)	217	200	180
Interest	17	2	923.5	2	656.5	36	43	35
PBT	402	324	24.2	487	(17.4)	1,403	1,575	1,794
Tax	53	52	2.9	59	(9.7)	199	233	337
PAT bef. minority interest	349	272	28.2	428	(18.4)	1,204	1,342	1,457
Losses in equity affiliates	0	0		0		0	0	0
Minority interest	(2)	1	(272.7)	25	(107.6)	0	0	0
Extra-ordinary income	0	0						
Net profit	351	271	29.4	403	(12.9)	1,204	1,342	1,457
EPS basic (INR)	12.3	9.5	29.7	14.2	(12.9)	42.2	46.9	50.7
<b>As % of net revenues</b>								
Total operating expenditure	80.7	82.7		82.7		82.6	82.3	82.0
EBITDA	19.3	17.3		17.3		17.4	17.7	18.0
EBIT	15.6	13.3		13.8		13.7	14.0	14.3
Net profit	15.0	12.8		19.0		13.5	13.2	12.6
Tax rate	13.3	16.0		12.1		14.2	14.8	18.8

## Company Description

Mastek is a software solutions and integration services provider and is among the top-20 IT software and service exporters from India. The company provides enterprise solutions to insurance, government, and financial services organizations worldwide. Mastek has a differentiated position in its insurance practice with its well-adopted solution framework—Elixir. This Elixir platform has a business layer to cater to the requirements of various insurance types such as life, health, and pension. With its principal offshore delivery facility based at Mumbai, India, Mastek operates across the US, Europe, Japan, and Asia Pacific regions. The company's last twelve month revenues stood at INR 8.3 bn (USD 208.5 mn) and employs around 4,000 people.

## Investment Theme

Mastek's Elixir platform caters to the requirements in the insurance practice types such as life, health and pensions. Apart from this, it also handles multiple operational activities such as claim processing, underwriting, and policy administration. With increased traction in the insurance vertical, and Mastek's efforts to establish tie ups with large BPO companies, we believe it (Elixir) has the potential to become an important source of growth and margin improvement. The company's experience in executing/negotiating government contracts has led it to take its e-governance solutions to the US market. A successful endeavor in this region will have a higher-than-proportionate impact on its margins.

## Key Risks

The key risks to our investment theme include a) a slowdown in UK geography; b) high dependence on the top five clients; any reduction in its spending will affect the company's growth, c) wage inflation leading to higher attrition and d) appreciation of INR against GBP and EURO.

## Financial Statements

Income statement					(INR mn)
Year to June	FY06	FY07	FY08E	FY09E	FY10E
Revenues	6,884	7,945	8,933	10,161	11,533
Staff cost	4,214	4,850	5,228	6,086	6,805
Programming charges	248	249	73	406	461
Travel & conveyance	382	441	400	579	634
Other costs	855	1,086	1,680	1,290	1,557
Total operating expenses	5,700	6,626	7,381	8,362	9,457
EBITDA	1,184	1,319	1,552	1,798	2,076
Depreciation	291	299	330	380	427
Operating income (EBIT)	893	1,020	1,223	1,418	1,649
Other income	128	327	217	200	180
Interest	9	9	36	43	35
PBT	1,012	1,338	1,403	1,575	1,794
Provision for tax	169	201	199	233	337
Adjusted PAT	843	1,137	1,204	1,342	1,457
Share of profit in associate	(35)	(24)	0	0	0
Minority interest	(117)	(43)	(0)	0	0
Reported net profit	691	1,069	1,204	1,342	1,457
EPS (Basic)	24.8	31.8	42.2	46.9	50.7
Dividend (%)	89.7	112.4	133.1	150.0	120.0
Dividend pay out (%)	20.4	16.9	18.4	18.7	13.8

### Common size metrics -as % of revenues

Year to June	FY06	FY07	FY08E	FY09E	FY10E
Staff cost	61.2	61.0	58.5	59.9	59.0
Total operating expenses	82.8	83.4	82.6	82.3	82.0
EBITDA margin	17.2	16.6	17.4	17.7	18.0
Operating margin	13.0	12.8	13.7	14.0	14.3
Net profit margin	10.0	13.5	13.5	13.2	12.6

### Growth metrics(%)

Year to June	FY06	FY07	FY08E	FY09E	FY10E
Net sales	21.4	15.4	12.4	13.7	13.5
EBITDA	34.0	11.4	17.7	15.9	15.4
Adjusted net profit	31.1	34.8	5.9	11.5	8.6
Reported net profit	29.3	54.8	12.6	11.5	8.6

### Cash flow statement

Cash flow statement					(INR mn)
Year to June	FY06	FY07	FY08E	FY09E	FY10E
Cash flow from operations	1,243	1,178	1,512	1,722	1,884
Cash for working capital	(355)	(279)	(221)	160	204
Net operating cash flow (A)	888	899	1,291	1,882	2,088
Net purchase of fixed assets	(377)	(381)	(354)	(520)	(520)
Net purchase of investments	(95)	(571)	(150)	(150)	(150)
Cash flow from investments(B)	(473)	(952)	(504)	(670)	(670)
Dividends	(252)	(213)	(222)	(251)	(201)
Proceeds from issue of equity	48	50	6	8	8
Proceeds from LTB/STB	(9)	(6)	(4)	0	0
Cash flow from financing (C)	(213)	(168)	(219)	(243)	(193)
Exchange rate differences (d)	89	(55)	0	0	0
Change in cash(A+B+C) + (d)	292	(276)	568	969	1,225

<b>Balance sheet</b>					(INR mn)
<b>Year to June</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08E</b>	<b>FY09E</b>	<b>FY10E</b>
<b>Assets</b>					
Cash & marketable securities	656	894	1,462	2,431	3,655
Account receivable	2,111	2,129	2,570	2,839	3,160
Loans and advances	129	137	197	237	284
Total current assets	2,897	3,160	4,228	5,507	7,099
Gross fixed assets	2,142	1,921	2,471	2,971	3,471
Accumulated depreciation	(1,219)	(1,209)	(1,539)	(1,919)	(2,345)
Net fixed assets	923	712	932	1,052	1,126
Capital WIP	62	316	120	140	160
Deferred tax asset	115	89	110	110	110
Investment	826	1,096	1,246	1,396	1,546
<b>Application of funds</b>	<b>4,822</b>	<b>5,372</b>	<b>6,637</b>	<b>8,205</b>	<b>10,040</b>
<b>Liabilities &amp; shareholder funds</b>					
Currency liabilities	1,320	1,368	1,618	1,974	2,408
Provisions	428	484	514	627	764
Total current liabilities & provisions	1,748	1,852	2,132	2,601	3,173
Borrowings	11	4	0	0	0
Minority interest	296	0	0	0	0
Share capital	141	142	143	143	144
Reserves & surplus	2,626	3,374	4,362	5,461	6,724
<b>Total equity &amp; liabilities</b>	<b>4,822</b>	<b>5,372</b>	<b>6,637</b>	<b>8,205</b>	<b>10,040</b>

<b>Ratios</b>					
<b>Year to June</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08E</b>	<b>FY09E</b>	<b>FY10E</b>
ROE	28.3	34.0	30.0	26.6	23.4
ROCE	28.4	34.1	30.6	27.1	23.7
Debtor days	112	98	105	102	100
Fixed asset T/O	8.5	9.7	10.9	10.2	10.6

<b>Valuation</b>					
<b>Year to June</b>	<b>FY06</b>	<b>FY07</b>	<b>FY08E</b>	<b>FY09E</b>	<b>FY10E</b>
EPS (INR)(Fully diluted)	24.8	31.8	42.2	46.9	50.7
BVPS (INR)	99.1	104.5	157.8	195.7	239.0
PER	13.0	10.1	7.6	6.9	6.4
Pr/CF	9.3	6.7	6.0	5.3	4.9
P/BV	3.3	2.6	2.0	1.6	1.3
EV/EBITDA	7.2	6.3	5.0	3.8	2.7
EV/Net sales	1.2	1.0	0.9	0.7	0.5

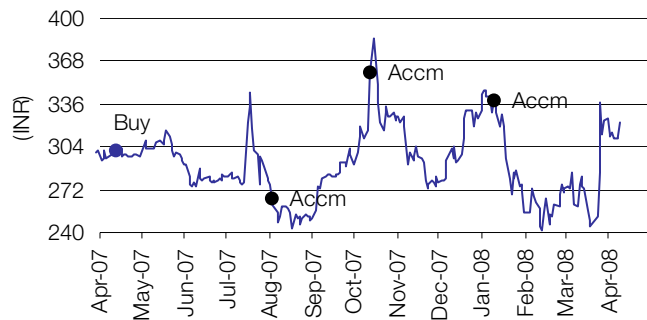
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**Coverage group(s) of stocks by primary analyst(s): Information Technology:**

Geometric, HCL Tech, Hexaware, i-flex, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, Take Solutions and Wipro

**Mastek**



**Recent Research**

Date	Company	Title	Price (INR)	Recos
04-Apr-08	IT	Navigating through troubled waters; Result Preview		
26-Mar-08	Infosys Technologies	To guide or not to guide? Company Update	1,496	Accum.
22-Feb-08	Hexaware Technologies	Out of woods, growth prospects appear reasonable; Result Update	83	Buy
21-Feb-08	Infosys Technologies	Budgets still uncertain, near-term visibility hazy; Visit Update	1,630	Accum.

**Distribution of Ratings / Market Cap**

**Edelweiss Research Coverage Universe**

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	107	45	18	3	193

\* 13 stocks under review / 7 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	104	69	20

**Rating Interpretation**

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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