ANANDRATHI

India I Equities

Technology

Initiating Coverage

30 December 2014

Mastek

Achieving scale in the lucrative insurance space; Buy

Rating: **Buy**
Target Price: ₹620
Share Price: ₹411

Key takeaways

Majesco's scale and aggression to help it grow faster. We are positive about Mastek's new-found aggression in insurance solutions with its two recent acquisitions helping it achieve critical mass of US$100m in revenue and 150 customers. This is a lucrative market worth US$3.5bn, with Majesco being a strong vendor. Also, we believe that a US listing should help the company attract both, clients and talent, in the US, given the increased visibility. This shows the intent to benchmark with the best in the industry.

Majesco's high rankings make scaling-up easier. We believe Majesco has the ability to scale up as it is one of the few Indian product companies to be rated high by reputed analysts like Gartner and Celent in the US. Majesco operates in a market of vast opportunities and caters to insurance firms. The company is trying to increase business from top US insurers. This high-gross-margin business, if scaled up, can deliver high margins but is currently in the high-investment mode. For these reasons, these businesses are typically valued on EV:Sales with weighting given to sales growth.

UK govt's focus on mid-sizes should help Mastek accelerate growth. With US$83m revenue (1HFY15, annualised), Mastek is a mid-sized IT-services company, growing ~5% yoy and with 12% EBITDA margins. UK government's IT procurement policies became favourable for mid-sized vendors with the introduction of G-Cloud program in 2012, which should benefit Mastek (UK-Gov contributes 70% to revenue). Because of high cash-generation, we believe that Mastek will shift to a high-dividend business.

Sum-of-parts valuation as company gets demerged. We believe the best way to value Mastek is on a sum-of-parts basis as the two businesses have different characteristics and would be listed and valued variedly. We value the IT services business at 5x FY17e EV/EBITDA and the IT-product business at 2x FY17e EV:sales (at a 35% hold-co discount).

Our take. We believe that Mastek can generate significant medium-term shareholder value as it unlocks potential of the product business. Its focus on services will now be sharper, leading to better growth and cash generation. We initiate coverage, with a Buy. **Risks.** Delays in scale-up of Majesco.

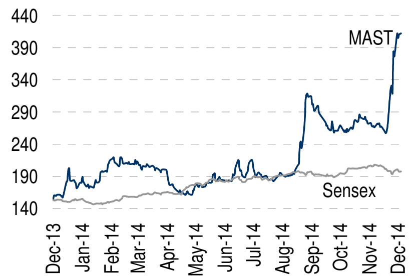
Key financials (YE Mar)	FY13	FY14	FY15e	FY16e	FY17e
Sales (US$m)	162	150	167	207	232
Sales (₹m)	8,884	9,230	10,102	12,392	13,880
Net profit (₹m)	566	518	166	341	564
EPS (₹)	21	21	7	15	25
Growth (%)	NM	-3	-65	105	66
PE (x)	16.2	17.7	55.2	26.9	16.2
PBV (x)	1.7	1.6	1.4	1.3	1.2
RoE (%)	11	9	3	5	8
RoCE (%) after tax	8	15	1	3	6
Dividend yield (%)	0	1	1	1	1

Source: Company, Anand Rathi Research

Key data	MAST IN / MAST.BO
52-week high / low	₹424 / ₹156
Sensex / Nifty	27242 / 8201
3-m average volume	US$4.6m
Market cap	₹9.1bn / US$0.14bn
Shares outstanding	22m

Shareholding pattern (%)	Sep '14	Jun '14	Mar '14
Promoters	51.61	51.77	51.92
- of which, Pledged			
Free Float	48.39	48.23	48.08
- Foreign Institutions	13.23	13.33	14.91
- Domestic Institutions	8.15	7.46	7.25
- Public	27.01	27.44	25.92

Relative price performance



Source: Bloomberg

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹ m)

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Revenues (US$m)	**162**	**150**	**167**	**207**	**232**
growth (%)	**19**	**-8**	**12**	**24**	**12**
Revenues (₹m)	8,884	9,230	10,102	12,392	13,880
growth (%)	35	4	9	23	12
Effective USD: ₹	54.7	61.6	60.4	59.9	59.9
Cost of Revenues	(6,738)	(6,843)	(8,043)	(9,942)	(10,920)
SG&A	(1,352)	(1,473)	(1,587)	(1,796)	(1,951)
EBITDA	**795**	**915**	**473**	**655**	**1,009**
EBITDA margins (%)	**8.9**	**9.9**	**4.7**	**5.3**	**7.3**
D&A	(294)	(329)	(351)	(363)	(403)
EBIT	**501**	**586**	**122**	**292**	**607**
EBIT margins (%)	**5.6**	**6.3**	**1.2**	**2.4**	**4.4**
Other income	181	98	161	196	196
Tax	(107)	(160)	(111)	(139)	(230)
ETR (%)	-16	-24	-40	-29	-29
Minority Interest	0	0	0	0	0
Net Profit	**566**	**518**	**166**	**341**	**564**
Net margins (%)	**6.4**	**5.6**	**1.6**	**2.7**	**4.1**
EPS (₹)	21	21	7	15	25
EPS growth (%)	-294	-3	-65	105	66

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Sources of Funds	**5,705**	**5,869**	**6,893**	**7,097**	**7,491**
Share capital	123	111	111	111	111
Reserves & Surplus	5,206	5,491	6,516	6,721	7,116
S/Hs Equity	5,329	5,602	6,627	6,832	7,227
Minority Interest	0	0	0	0	0
Total Debt	16	19	18	17	16
Other LT Liabilities	360	248	248	248	248
Application of Funds	**5,705**	**5,869**	**6,893**	**7,097**	**7,491**
Net Fixed Assets	766	729	916	910	907
Intangible Assets	1,729	1,883	2,941	2,941	2,941
Other LT Assets	618	646	678	712	747
Current Assets	4,303	4,280	4,114	4,385	4,841
Accounts Receivable	1,491	1,168	1,345	1,637	1,907
Unbilled Revenues	699	880	924	1,044	1,096
Cash & Investments	1,590	1,711	819	918	1,013
Other CAs	522	521	1,026	786	826
Current Liabilities	1,711	1,668	1,756	1,851	1,946
Accounts Payable	46	39	45	55	60
Unearned revenue	388	390	409	429	451
Other CLs	1,276	1,240	1,302	1,367	1,435

Source: Company, Anand Rathi Research

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Cash from Operations					
PBT	673	677	277	480	795
Operating Profit before WC	967	956	466	647	1,002
Chg in Trade Receivables	(120)	545	(177)	(292)	(270)
Chg in Other CA	(139)	(94)	(72)	120	(92)
Chg in Trade Payables	(75)	(286)	6	10	5
Chg in Other CL	(942)	-	81	86	90
Others including taxes	755	(230)	(143)	(173)	(266)
Net Cash from Operations	445	891	161	397	469
Cash from Investments					
Capex	(103)	(266)	(291)	(357)	(400)
Acquisitions	-	-	(824)	-	-
Investments & Others	(58)	(248)	161	396	196
Net Cash from Investing	(161)	(514)	(953)	39	(204)
Cash from Financing					
Equity Issuance (buyback)	(85)	(541)	-	(0)	0
Change in Borrowings	(45)	(4)	(1)	(1)	(1)
Dividends including DDT	(92)	(117)	(100)	(136)	(169)
Others	-	(6)	-	-	-
Net Cash from Financing	(223)	(668)	(101)	(137)	(170)

Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis @ ₹411

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Return Ratios					
RoCE (%) (post-tax)	8	15	1	3	6
RoIC (%) (post-tax)	11	22	1	3	7
RoE (%)	11	9	3	5	8
Cash Ratios					
CFO:Sales	5	10	2	3	3
AR days (incl. unbilled)	90	81	82	79	79
AP days	2	2	2	2	2
Dupont Analysis					
RoE (%)	11	9	3	5	8
EBIT Margin (%)	6	6	1	2	4
PBT/EBIT (%)	134	116	226	164	131
PAT/PBT (%)	84	76	60	71	71
Total Asset Turnover	165	160	157	173	182
Assets/Equity (%)	104	106	104	104	104
Valuation ratios					
P/E (x)	16.0	17.5	55.2	26.9	16.2
P/B (x)	1.7	1.6	1.4	1.3	1.2
EV/EBITDA (x)	9.3	8.1	15.8	11.4	7.4
EV / Operating CF (x)	16.6	8.3	46.2	18.8	15.9

Source: Company, Anand Rathi Research

Fig 5 – Key parameters

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Employees (EoP)	3,214	3,123	3,725	4,125	4,245
Rev/Employee (US$)	50,498	47,995	44,882	50,154	54,586
EBITDA/Employee (₹)	247,261	292,849	126,968	158,690	237,736

Source: Company, Anand Rathi Research

Fig 6 – Assumptions

Year-end: Mar	FY13	FY14	FY15e	FY16e	FY17e
Chg in Pricing %			0%	5%	6%
Blended Pricing (US$ per hour)	29	29	29	30	32
US$:₹	54.4	60.1	60.4	59.9	59.9

Source: Company, Anand Rathi Research

Note: FY13 represents financial period ending March 2013 using quarters disclosures.

Majesco's scale and aggression to help it grow faster

We are positive about Majesco's new-found aggression in insurance solutions through its two recent acquisitions, the insurance business of Agile Technologies (US$9m in revenue, 20 clients, 50 employees) and the NYSE-listed Cover-All Technologies (US$20m, 30, 150), giving it US$112m in revenue (at the present run-rate), critical mass to accelerate adoption and growth of its insurance business. The enlarged Majesco will have 150 customers, giving it opportunities to cross-sell offerings.

Recent acquisitions offer critical mass to Majesco to support growth

Agile Technologies has been a long-term partner of Majesco in many earlier customer engagements. With this acquisition, Majesco benefits from Agile's strong consulting and additional technology services. The acquisition is expected to be completed by Jan'15.

Cover-All Technologies, on the other hand, provides business-focused solutions to the property and casualty insurance sector. Being about a fourth of Majesco's size (in terms of revenue), we believe that Majesco will be able to integrate the teams comfortably, and being a much larger services provider, should also secure opportunities to cross-sell.

Fig 7 – US$ revenue and net profit of Cover-All Technologies

Year ended 31st Dec (US$m)	CY10	CY11	CY12	CY13	CY14 YTD
Revenues	**17**	**18**	**16**	**20**	**15**
Licenses	2	5	4	6	1
Support Services	8	8	8	8	6
Professional Services	7	4	4	6	8
Total Operating Expenses	**4**	**4**	**6**	**8**	**6**
Total Other (Income) Expense	0	0	0	0	0
Net Income (Loss)	3	1	-5	-3	1
Margins (%)	**17**	**7**	**31**	**-14**	**6**

Source: Company, Anand Rathi Research

The enlarged entity will retain the "Majesco" brand globally. The transaction is completely funded through equity, with Cover-All's stockholders getting 16.5% equity of the enlarged entity. The merged entity's shares will be listed on the NYSE.

Benefits of NYSE listing and of being in a large market

Majesco's NYSE listing is expected to benefit it from its greater visibility to clients, the media and potential employees. Majesco should then be able to attract, from its key market, the US, the best talent, a key ingredient for success of any products company. In our opinion, the NYSE listing also reflects the company's growth appetite and the management's intention to be benchmarked against the best in the industry in terms of growth.

The last piece of the puzzle is the large insurance market that Majesco operates in and the kind of recognition it secures from reputed independent analysts. We estimate the insurance solutions business at US$3.5bn, with one of the best operators commanding a revenue rate of US$350m, suggesting a large scattered market place. This should play out to benefit Majesco as it does not need to compete with the very large operators (defined as more than US$1bn) to grow in this market.

Fig 8 – Benefits for Majesco after the demerger

Scale of Operations
- More than US$100m in revenue
- 150 customers across regions

Cross-Selling Opportunities
- New clients and capabilities acquired through M&A
- Cross-selling of services can generate growth

Operating in a large scattered market
- Industry size: US$3.5bn
- Well-rated operators still below US$500m, suggesting headroom for growth

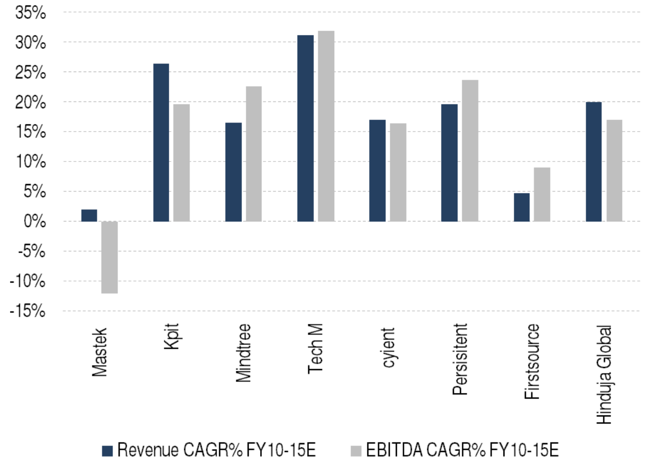
US listing to improve visibility
- Ability to attract clients in its largest market, the US
- Ability to attract key talent in the US
- US listing shows intent to compete and be compared with the best in the sector

Source: Company, Anand Rathi Research

Recent changes reflect the company's mounting growth appetite

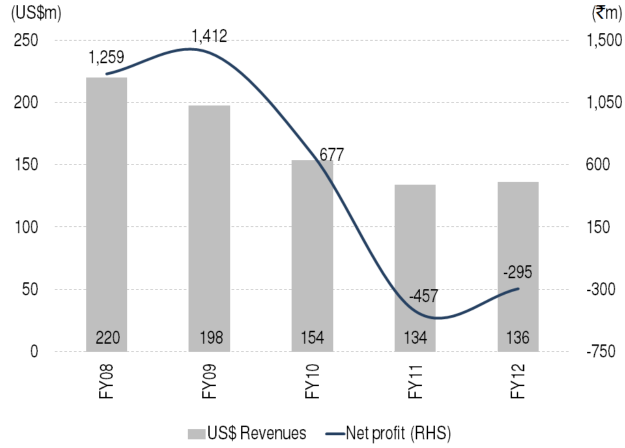
We believe that all these changes point toward wider changes within the company and to its growing appetite for growth. In the last five years it has undershot IT-service peers on key operating parameters such as revenue growth and margins. That has also led to its underperformance in shareholder wealth creation as measured by market cap.

Fig 9 – Performance of Mastek versus other IT companies



Source: Company, Anand Rathi Research

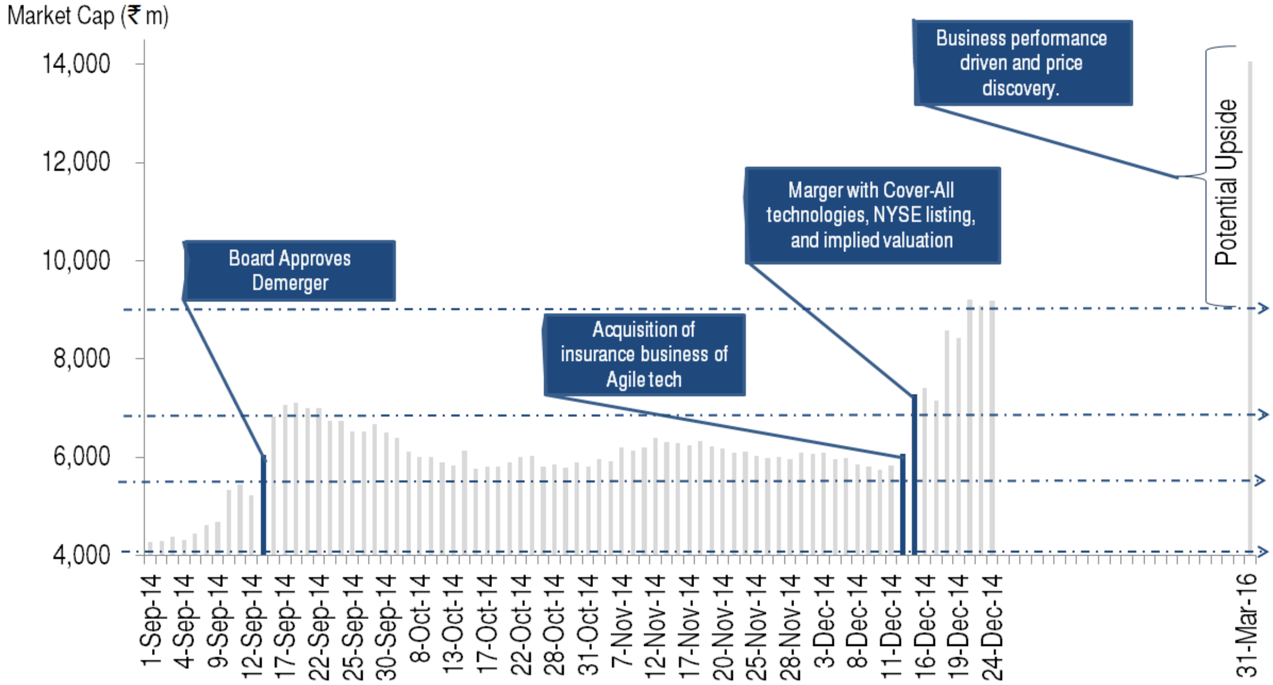
Fig 10 – Mastek consolidated US$ revenue and net profit



Source: Company, Anand Rathi Research
Note: FY11 onwards numbers calculated assuming fiscal ending March.

One of the key reasons for the underperformance was high client concentration (top-five clients brought in 55% of revenue in FY10). This resulted in a weak financial performance during the recession as two of its key clients, BT and Capita, altered their priorities in line with the spending freeze by the UK government. The company suffered a 12% revenue decline (FY11 March-ending versus FY10 June-ending) and reported a ₹457m loss for FY11 (calculated on fiscal ending March 2011), against the ₹677m profit in FY10.

Fig 11– Mastek: Potential upside based on business growth and price discovery of Majesco



Source: Company, Anand Rathi Research

The company has since gradually started reducing its dependence on a few clients for revenue. This has now come down – from 52% in FY11 to 39% in 2QFY15. Capita and BT continue to be some of its top-five clients and any increase in spending by the UK government on these two vendors would result in higher (consolidated) growth for Mastek.

Now, however, the company has started widening its management bandwidth and moving toward a more professionally-run business, with two people recently hired in sales for the UK business to increase participation in G-Cloud. Also, in the last three years, Atul Kanagat and Arun Maheshwari have been inducted onto the Board. Mr Kanagat has varied experience in multiple industries such as consulting (McKinsey) and audio (Harman International). Dr Maheshwari has extensive IT services experience and was instrumental in setting up CSC India. After that he started Finserv Global Services and was associated with other insurance-product companies such as Duck Creek and Fortegra. At present, Mastek has 10 members on its board, six of them independent.

Under the new set-up, our understanding is that Majesco may seek US-based senior-management-level hiring (perhaps from other product companies) as part of an investment plan to push growth. Apart from management and sales, Majesco may also look to hire product-development heads in the US to revamp its product line and throw up strong competition to established operators. We agree that it would be a huge cultural change but this is something much needed, we believe, for the company to move up to a higher growth trajectory. Interestingly, Majesco has the ability (it always had) but is now showing the strength and intent to make it happen.

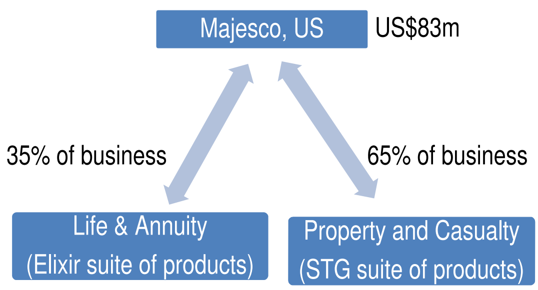
Majesco's high rankings to help scale-up

Majesco provides technology solutions (products and associated services) to US-based property and casualty (P&C) and life & annuity (L&A) insurance companies. It has 150 clients (including the two recent acquisitions) and two product families for the sector: STG for P&C and Elixir for L&A.

In FY08 (Mar'08), it acquired a 100% stake in the US-based Systems Task Group for US$29m in an-all cash deal. At acquisition, STG had 350 employees and 35 mid-sized and small P&C insurance carriers and helped Mastek build sizable operations in P&C.

The other platform, Elixir, was co-developed with Capita, one of Mastek's key clients in the UK, providing BPM (business process management) services to insurance clients. Mastek and Capita started developing this jointly in 2005 to build a scalable solution for efficiently managing insurance business operations for Capita's clients. However, as Capita's clients resisted moving to a new platform amid economic pressures, Mastek suffered from lower investment by Capita in the platform, resulting in revenue declining. It continued to invest in the Elixir suite, believing that the product would find demand as the economic environment improved. At present, Capita serves its clients on the old insurance platform with only one on Elixir. We believe that there is a possibility of Capita's clients moving to Elixir as they seek to upgrade legacy IT (in sync with peers).

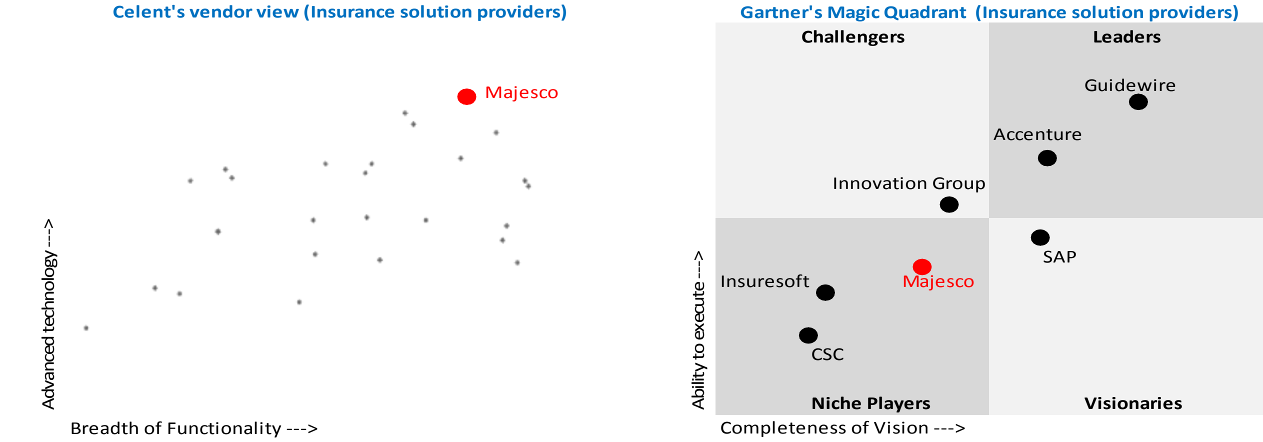
Fig 12 – Majesco is a technology-based insurance-focused IT-solutions provider



Source: Company, Anand Rathi Research

We find Majesco a valuable asset as it is one of the few Indian product companies to be highly rated by reputed analysts in the US and UK. Gartner rates Majesco among the top-three pure-play P&C insurance vendors, and Celent (a member of the Oliver Wyman group) rates the STG Policy module as the most advanced policy administration system after evaluating 42 policy administration systems in North America. Majesco boasts of 80 insurance installations in North America, excluding clients won through recent acquisitions. The company recently showcased its tech prowess through digital offering – STG on the Cloud – to clients and prospects in Chicago.

Fig 13 – Majesco highly rated by independent analysts

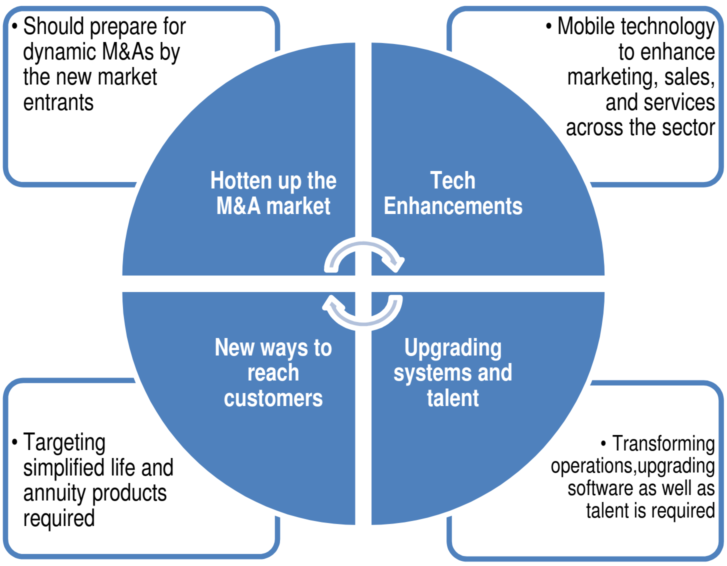


Source: Celent, Gartner, Anand Rathi Research

Note: The charts are re-constructed; hence, not built to scale. The object is to illustrate Majesco's position

Majesco operates in a large opportunity market as the global insurance market is now expected to be US$3.5bn (our estimate based on IT spending on insurance technology and P&C premiums). The largest market is the US (a 44% market share in premiums followed by Europe's 36%). This IT market is also one of the most complex and fragmented markets, with a large percentage of clients still running on legacy systems. Industry experts believe that if these insurers replace their legacy applications with one large integrated suite, it could result in 2.5% to 4.5% higher operating margins on account of the operational efficiencies gained.

Fig 14 – Trend in P&C insurance market



Source: Deloitte, Anand Rathi Research

Fig 15 – Majesco's operational model

Delivers solutions, products and services for the North American insurance sector with over two decades' experience

Operates on a license-based and managed services revenue model

Can opt for organic / inorganic growth opportunities

Need to invest for the next 2 years in the US insurance business

Ranked among the top-three pure-play vendors in P&C in North America

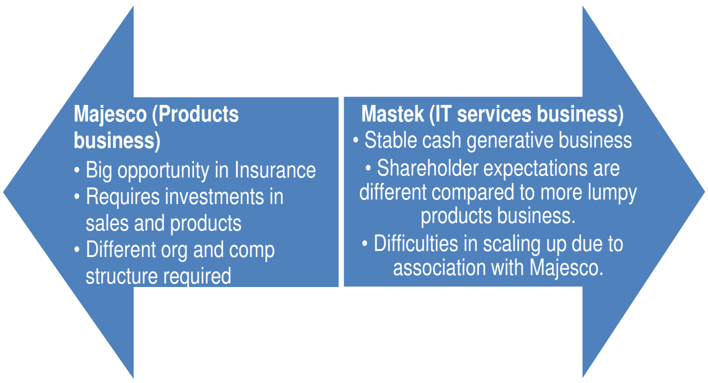
Source: Company, Anand Rathi Research

Insurance carriers in UK have on an average 10-14 core systems running concurrently and integrating data using a complex set of codes. These individual systems often have limitations regarding handling of data. Hence, they tend to restrict the scope of the analysis available to management and, in turn reduce competitiveness of the business. This puts pressure on insurers to invest more in IT-modernisation programmes to improve customer service, for better operational efficiencies and to remove limitations in data analysis helping management make better decisions to support growth. The context is not very different for US insurers. According to Gartner surveys, 61% of IT budgets of P&C insurers is spent on running the business, leaving little scope for new deployments. CIOs are looking to simplify their massive legacy IT deployments, which can only be done through modernising applications. This trend also features in Gartner's top-ten tech trends in the P&C insurance sector. We believe that the insurance IT modernisation opportunity will play out in favour of IT solution companies like Majesco and Guidewire.

The largest insurer in the P&C insurance market in the US is Guidewire, which has a slightly different business model from Majesco. Guidewire has US$350m in revenue, almost half from licensing fees. Such high reliance on licensing reflects its focus on products, leaving implementation to third-party vendors (IT service-providers such as Cognizant, PWC and Capgemini). Majesco derives significantly higher revenue from IT services (~70%), reflecting that software is currently being sold as a service rather than licensed out, and that Majesco undertakes implementation of its products at clients, perhaps reflecting its IT-services background.

Majesco currently caters primarily to mid-sized insurance firms (73 of its 80 clients are mid-sized insurance carriers) and has yet to build meaningful operations in top insurance firms (seven of the top-25 P&C insurance carriers are its clients). We believe this would require significant investments in the S&M team in the US and Europe (at present, 38 people are in sales in Majesco including marketing, pre-sales and account management, of which, 24 are based out of the US), product revamp (US$50m has been spent on product development in the last five years vs. Guidewire's US$67m in FY14 alone) and acquisitions to gain scale. Clearly, the company needs to accelerate investments in this business, and may require fund-raising in the US.

Fig 16 – Segregation of businesses to reduce the drag



Source: Company, Anand Rathi Research

Majesco is a high-gross-margin, high-investment business, with the potential to scale up significantly and generate strong cash flows. At present, the business commands a high gross margin, with R&D investments eating up another 13-14% of revenue. Majesco's R&D expenses are expected to be lower than US-based software-product companies because Majesco develops products in India, giving it a structural cost-advantage over its US peers. Majesco's EBITDA margin in 1HFY15 was -3.1%.

Given the high operating leverage in the business owing to high gross margins and high R&D costs, revenue growth may act as the strongest lever for margin expansion. And, if the company succeeds in achieving scale, it could deliver higher steady-state margins given the structural cost advantage of its India development centre.

Fig 17 – Guidewire financials

Year ending July 31 (US$ m)	FY11	FY12	FY13	FY14
Total revenues	172	232	301	350
COR	68	90	126	149
Gross profit	104	142	175	201
Operating expenses:				
Research and development	34	49	63	76
Sales and marketing	29	37	51	71
General and administrative	23	27	31	35
Litigation provision	10			
Total operating expenses	96	113	145	183
EBIT	9	29	30	18
Interest income	0	0	0	1
Other income (expenses), net	1	(1)	(0)	0
PBT	10	29	30	20
Tax	(26)	10	5	5
Net income	36	19	25	15

Source: Company, Anand Rathi Research

Fig 18 – Revenue growth of Majesco and EBITDA margins in the last three years

Majesco financials	FY12e	FY13e	FY14
Operating Revenue(US$ m)	51	68	75
YoY growth %	-8	34	10
Operating Revenue (₹ m)	2,830	3,696	4,487
YoY growth %	15	31	21
EBIDTA (before exceptional items)	(0.80)	230.46	265.22
EBITDA margin %	-0.03	6.24	5.91
New clients	13	6	4
Elixir platform wins	1	1	0
STG platform wins	3	3	3

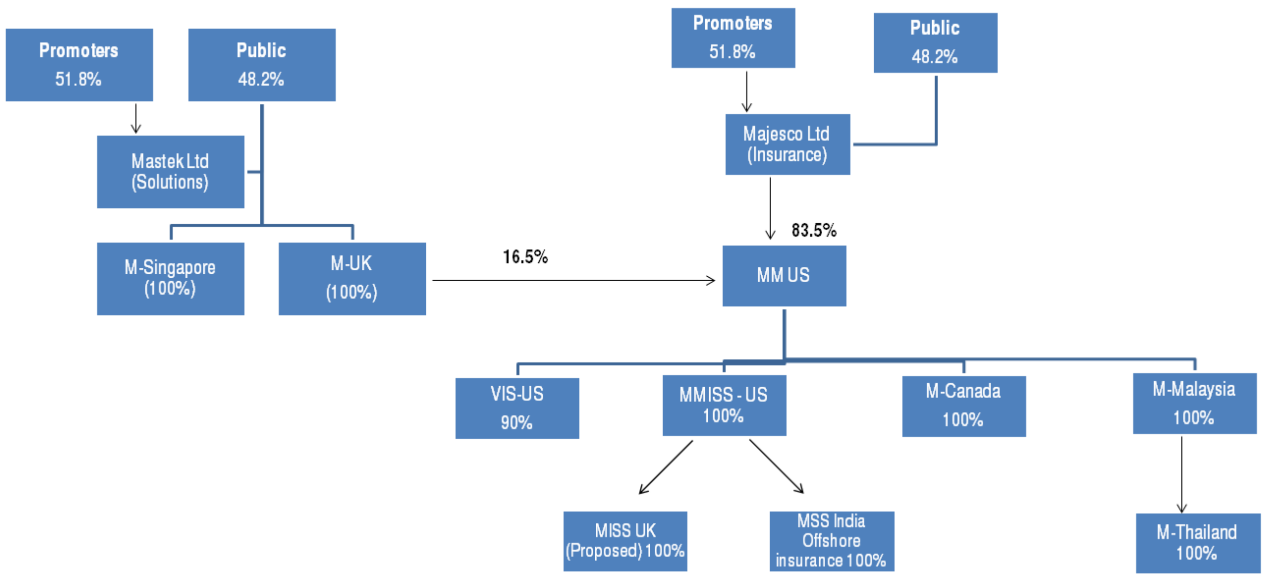
Source: Company, Anand Rathi Research

Note: FY12 and FY13 numbers are extrapolated for comparison purposes. Mastek only disclosed FY14 numbers for Majesco.

Elixir and STG wins do not represent all wins and are based on disclosures by the company through press releases.

With the new structure in place, Majesco will be able to raise capital independently in the US to invest in its product and expand faster. The earlier structure was somewhat restrictive in the sense that investors would have got exposure to both the businesses and not just the product business, and the true operating metrics and growth trajectory of the product business was somewhat hidden in the consolidated financials.

Fig 19 – New business structure to support growth



Source: Company, Anand Rathi Research

Note

Following the merger of Cover-All technologies, Majesco will issue additional shares to existing shareholders of Cover-All technologies to the tune of 16.5% equity of the enlarged entity, effectively reducing the stake of India-listed Majesco to 69.7%. Mastek, the India-listed IT services arm, will have a minority stake of 13.8% in the enlarged company. The shares issued to Cover-all technologies shareholders will be traded on NYSE.

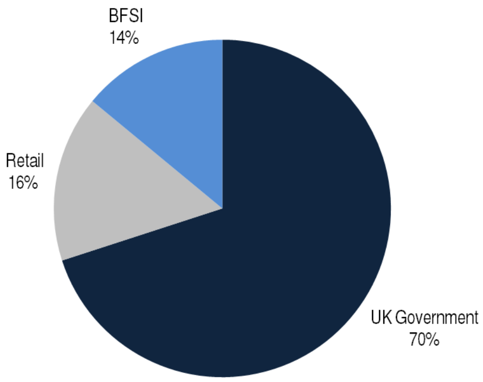
The transaction valued Majesco at 1.8x MCap: Sales as the shareholder's of Cover-All technologies (Market Cap US$34.2m) will get 16.5% of Majesco, thus benchmarking Majesco's valuation in the process. Extrapolating the transaction, Majesco got an implied valuation of US$207.3m (market capitalization).

UK government's focus on mid-sized players should help Mastek accelerate growth

Mastek is a mid-sized IT company providing traditional software services (largely ADM, including SMAC technologies) to industry verticals such as the UK government, BFSI and retail. Because of its size, it works with the UK government through large system integrators/outsourcers like BT and Capita.

Of service lines, Mastek currently offers ADM services with SMAC-based offerings. Of the verticals, apart from the UK government, it also operates in BFSI and retail, although these are relatively smaller.

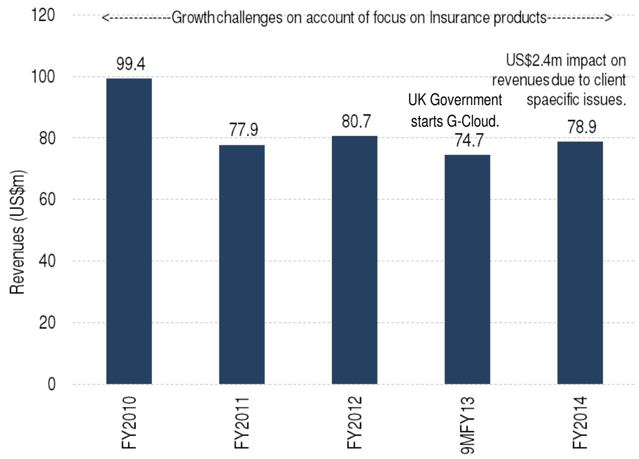
Fig 20 – Verticals split of business



Source: Company, Anand Rathi Research

Mastek's IT services has been faced with multiple growth challenges in the last few years, leading to subdued revenue growth. These headwinds can broadly be grouped into three categories: 1) management focus on building the insurance business, 2) UK government's budget cuts and erstwhile procurement policy, impacting the growth of mid-sized vendors like Mastek 3) client-specific challenges. However, we believe that these headwinds have started easing and, therefore, Mastek should observe growth acceleration over FY15-17.

Fig 21 – Unblocking growth bottlenecks in IT services



Source: Company, Anand Rathi Research

We discuss these headwinds and the mitigating factors below:

1. The management was focusing on building the insurance (Majesco) business. As the company had concentrated on building its brand on the products side, client perception about the services business was hit.

Fig 22 – Management's strong focus on the insurance business

"Seeing traction in Insurance services part of the business where in addition to the Insurance product we have a very domain focused Insurance services which we are targeting to our existing customers and that is also seeing pretty good traction quarter-over-quarter" ***(2QFY15 concall)***

"Solutions business has kept pretty stable but services has taken a drop and it is intended because services is the low margin more commoditized kind of business which is highly linear so that has gone down" ***(4QFY14 concall)***

"If we take the US, bulk of our investment is happening in the Property & Casualty Insurance, next is in the Life & Annuity and then small amount is spent on Services right now" ***(3QFY14 concall)***

"The entire strategy of the company is moving away from commoditized services to high high-end solutions which are industry-based and vertical focus as well as vertical businesses" ***(1QFY14 concall)***

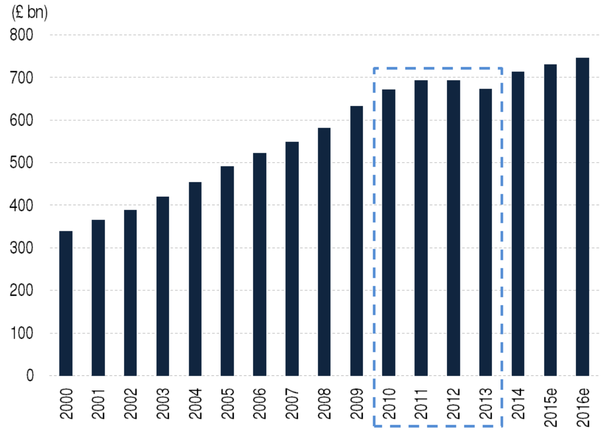
"Most Indian companies tend to operate in IT Services. Mastek, however, has followed a different path. Being committed to building a valuable company, we have always chosen to be in the high value end of the business – now with industry specific solution offerings" ***(2013 Annual report)***

Source: Company, Anand Rathi Research

Mitigation: The splitting up of the two businesses should help offset this disadvantage. Also, branding of the products and services businesses will now be separate

2. The UK government cut budgets in 2011, affecting many vendors, including Mastek.

Fig 23 – UK government spending and projections



Source: http://www.ukpublicspending.co.uk, Anand Rathi Research

Mitigation: UK government's new procurement policy favours IT midcaps as services can now be directly procured by them. Following this, mid-sized companies' dependence on select large vendors would go down, thereby reducing pressure on pricing.

As mentioned above, the UK government is attempting to reduce its dependence on few large vendors (According to data-analysis firm Spend Network, seven of the top-ten suppliers in any part of government are large IT companies such as HP, Capgemini, Capita and BT). To achieve its objective of turning more efficient, the UK government is splitting large contracts into smaller ones in anticipation of increased vendor competition and, hence, better pricing of contracts. This policy shift is expected to benefit mid-sized IT service providers such as Mastek (which obtains ~70% of its revenue from the UK government).

To support this shift in policy, the government is simplifying procedures for procuring IT services, making it more accessible for mid-sized IT companies like Mastek. The increase in mid-sized suppliers can be estimated from the fact that, in 2012, there were just 23 suppliers in the prestigious G-Cloud programme, increasing to 1,200 in 2014. Mastek is one of the vendors in the G-Cloud programme and has an enviable track record of delivering 95% of the projects on time and within the budget. In 2014, Mastek won four orders from the UK government under the G-Cloud programme (typical two-year contracts), specifically designed for mid-sized vendors.

Lastly, as government spending is expected to be normalised, growth should return.

3. Client-specific challenges due to vendor consolidation

Mastek was faced with declines in its IT-services business on account of sharp ramp-downs in certain clients over the last few years, including the US$2.5m/quarter ramp-down toward the end of FY14, and continuing into FY15.

Fig 24 – Ramp-downs faced by the company

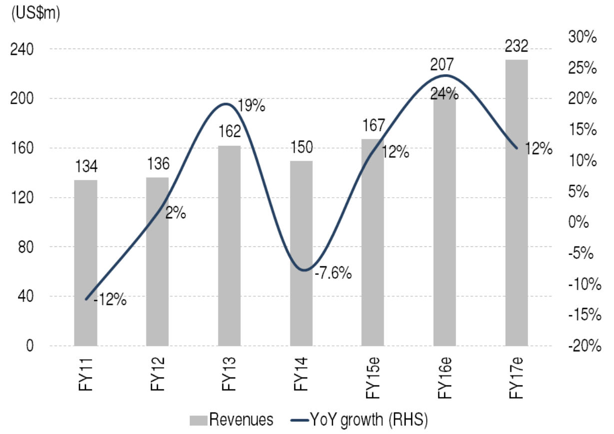
Date	Name	Reason	Impact
FY10	BT	70% work complete by FY09 but, due to UK government spending cut, no additional business came from BT	Affected 70% of the IT services revenue
FY11	Capita	Capita reviewing its strategy	Affected revenue for 4QFY11 and onward in the range of £1.2m to £1.4m per quarter
FY14	A major US customer	Re-prioritizing its multi-vendor transformation programme	To result in the work being put on hold, as a result affecting the revenue of the US business

Source: Company Reports, Anand Rathi Research

Mitigation: We do not expect client ramp-downs to recur every year as the prime reason for this specific ramp-down was aggressive pricing, typically a function of slow growth. We see a trend toward smaller contract sizes and in favour of niche service providers. This should help companies such as Mastek in expanding market share.

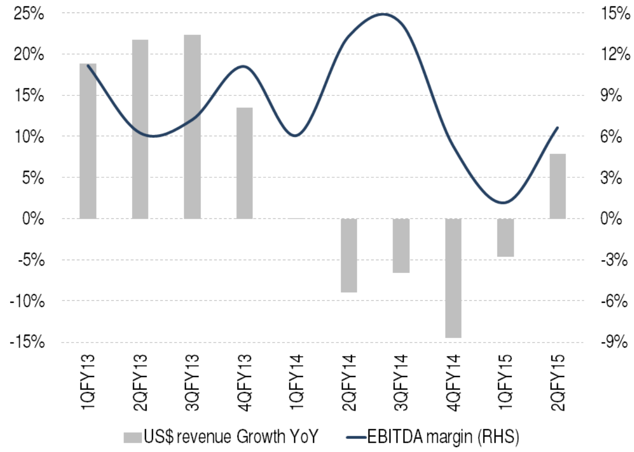
In summary, in IT services, bottlenecks to growth were seen, which, we believe, are now being unblocked and, when clubbed with the new management's sharper focus on the business, should generate positive results for the company. The chart below summarises our revenue expectations from Mastek's IT services business.

Fig 25 – Consolidated Rev performance and expectations



Source: Company, Anand Rathi Research
Note: FY16 growth includes Majesco's inorganic initiatives. Our growth expectations include 9% growth for the IT services business (Mastek) and 12-14% growth for the solutions business (Majesco).

Fig 26 – Consolidated Revenue growth and EBITDA margin



Source: Company, Anand Rathi Research

In terms of margins, this business is expected to be stable, with a 12% EBITDA margin in 1HFY15 (vs. 14.4% in FY14). Margins in 1HFY15 suffered due to revenue loss and to revenue reversal (milestone-based project costs were re-stated), because of the client challenges mentioned above. This situation is expected to improve as new business closes the revenue gap and project starts achieve milestones due to the revised costs.

Therefore, as the company begins to see growth again, assuming no recurring client-specific challenges, the EBITDA margin is expected to inch up to 13%, after factoring in cost of growth as the company builds its sales team separately.

Fig 27 – Mastek compared with other mid-cap IT companies

	Revenue (US$ m)			EBITDA margin (%)			EPS (₹)			RoE (%)
Company	FY15e	FY16e	FY17e	FY15e	FY16e	FY17e	FY15e	FY16e	FY17e	
Mastek	167	207	232	4.7%	5.3%	7.3%	7.3	15.0	24.9	3.9
Mindtree	590	678	781	19.3%	20.5%	20.4%	61	72	81	26.7
KPIT Tech	498	559	624	13.2%	14.1%	15.3%	13	15	18	19.4
Persistent	312	374	449	22.5%	24.6%	25.4%	76	91	117	22.7
Cyient	441	503	572	16.8%	16.7%	16.2%	31	33	36	20.3
NIIT Tech	387	427	472	14.7%	15.6%	16.0%	32	40	46	19.1
Eclerx	151	172	198	37.2%	37.3%	36.6%	83	97	105	49.8
Firstsource	521	579	644	12.8%	13.8%	13.7%	4	5	5	11.3
Hinduja	465	528	600	12.0%	12.8%	12.8%	75	89	104	10.3

Source: Company reports, Bloomberg, Anand Rathi Research

Moreover, the uncertainties of capital allocation to the products business (earlier part of the consolidated business) are no longer a hurdle. Management can now focus only on growing the IT-services business and on dividend payout, as cash generation in the IT-services company is robust.

Financials to start improving

Mastek's IT services business has suffered in the past perhaps because of the management's twin focus on building the products and services businesses and the perceived dependence of the IT-services business on the success of the products business. With the impending split and segregation of sales and management between the two businesses, we expect the focus on IT services to sharpen from what it was in the past. Therefore, we expect better growth ahead. These growth figures are not comparable with the industry for the following reasons:

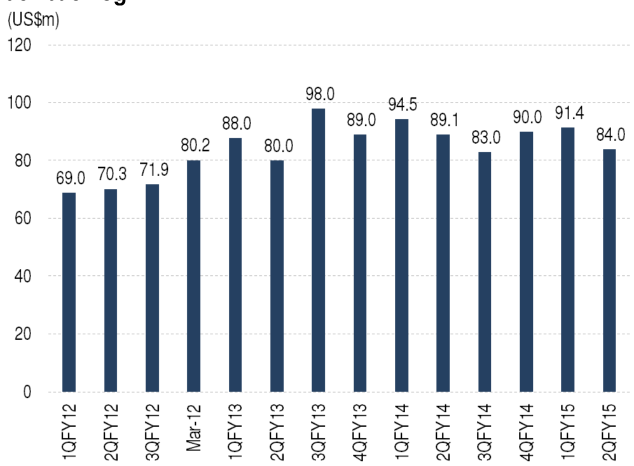
1. The company is in transition. This means that the new organisation structure, sales and marketing teams, etc., will take time to settle down before growth can accelerate.
2. The present exposure of the company to one vertical with a sub-scale services portfolio may hamper its ability to deliver growth.

Fig 28 – IT services segment growth and margin expectation

	FY14	FY15e	FY16e	FY17e
IT and Other services revenue (US$ m)	79	85	93	101
Yoy growth %	(21)	8	9	9
margin expectations %	14	12	13	13

Source: Company reports, Anand Rathi research

Fig 29 – Order backlog



Source: Company, Anand Rathi research

Clearly, we are more positive on the products business. Here, analyst rankings assure us that the present capability/competitive positioning of the product and the target market are large. We believe that Majesco, with the required investment in product and sales, can scale up growth to double digits (our estimate 12-14%). Given the high gross margins in the business and a high fixed-cost base, investors should look at the EV-to-sales ratio as a valuation parameter, without perhaps worrying too much about margins at this stage. This is usually the case with small fast-growing product companies.

Fig 30 – Segment-wise business performance and our expectations

	FY12	FY13	FY14	FY15e	FY16e	FY17e
Revenue (US$ m)	136	162	150	167	207	232
Insurance	51	51	75	86	118	134
IT Services	81	75	79	85	93	101
Eliminations	5	(4)	(4)	(4)	(4)	(4)
Revenue growth %	2	19	-8	12	24	12
Insurance	-8	34	10	5	12	14
IT Services	4	23	-21	8	9	9
EBITDA margins %	0	9	10	5	5	7
Insurance	NA	NA	5.9	-3	-1	3
IT Services	NA	NA	14.4	12	13	13

Source: Company Reports, Anand Rathi estimates

During FY12-14, the company's dollar revenue came at a 5% CAGR. With significant opportunities in the product and IT-services sub-segments, we expect revenues, supported by volume growth, to come at a 16% CAGR over FY14-17 including through inorganic initiatives. In 2QFY15, the company reported US$ revenue growing 8.0% yoy, with a 6.7% EBITDA margin. But, as the insurance business would require a product revamp and, hence, greater investment, margins are likely to be hit in coming years. We have valued Majesco business on sales growth without worrying about margins. This is usually the case with small fast-growing product companies. We expect the company to report 4-7% EBITDA margins till FY17.

The stock now trades at a P/E ratio of 16.2x FY17e earnings. This, we believe, is attractive if the company demonstrates the kind of growth accelerations and improvements we are expecting, supported by the splitting of Mastek's consolidated business and by a focus on cross-selling insurance services to 150 customers.

At our sum-of-parts-based target price of ₹620, the share would trade at 24.5x FY17e EPS of ₹24.9. The target price is based on 2x price-to-sales for the soon-to-be NYSE-listed products business, with a 35% holding-company discount, and 5x EV/EBITDA for the IT-services business.

Fig 31 – Sum-of-parts valuation

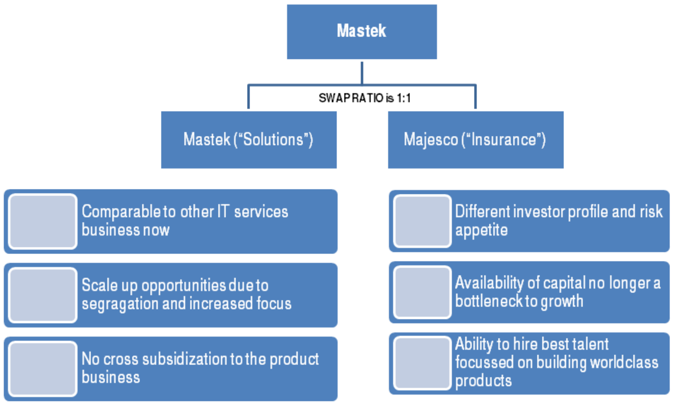
Sum-of-parts	Financial parameter	Valuation Methodology	Holding-company discount %	Implied Value (₹ m)
Insurance Solutions	US$134.1m	EV:Sales of 2:1	35	7,414 (a 69.7% stake)
IT Services	₹741.4m	EV/EBITDA of 5.0x 13.8% stake in Majesco	0	6,617 (including a 13.8% stake in Majesco
			EV of the company	14,031
			Price per share (₹)	**620**

Source: Anand Rathi Research

Sum-of-parts valuation, hold-co discounts

We believe the best way to value Mastek is on a sum-of-parts basis as the two businesses have widely different characteristics and are likely be valued and listed separately.

Fig 32 – The splitting off – and the transaction rationale



Source: Company reports, Anand Rathi

The hived-off IT services business will be more comparable to existing listed IT-services businesses. The lack of growth in this business and past underperformance is expected to weigh on the target multiples, in our opinion. We value the IT-services business at 5x FY17e EV/EBITDA, a 30% discount to other mid-caps, reflecting the slower growth. This gives us an EV (IT services) of ₹4,359m and the balance 13.8% stake in US-listed Majesco would fetch another ₹2,258m for the company, assuming no holding-company discounts.

Fig 33 – Valuations of Mastek with mid-cap IT

	Revenue CAGR %	EBITDA CAGR %	PE		EV/EBITDA	
Company	FY15-17e	FY15-17e	FY16e	FY17e	FY16e	FY17e
Mastek	18	46	27.6	16.7	11.6	7.5
Hexaware	15	17	14.6	12.7	9.7	8.5
Mindtree	15	18	17.2	15.3	11.7	10.2
KPIT Tech	12	20	13.7	11.2	8.6	7.1
Persistent	20	27	17.6	13.8	10.8	8.7
Cyient	14	11	16.0	14.6	10.5	9.5
NIIT Tech	11	15	8.6	7.6	4.6	4.0
Eclerx	14	14	13.2	12.2	8.9	7.9
Firstsource	11	15	7.1	6.2	6.7	6.0
Hinduja	13	17	7.3	6.2	3.6	3.1

Source: Bloomberg, Company, Anand Rathi Research
Note: Bloomberg estimates of companies we do not cover. Pricing data as of 24-Dec-2014

As discussed earlier, we believe that significant value can be created in IT products, where acceleration in revenue growth amid a supportive IT-spending curve may trigger shareholder-value creation. Also, after the split, given Mr Sudhakar's focus on building an IP-led business model, we believe that significant management bandwidth would be allotted to the products business alone, with no distractions from the traditional IT-services business.

This may turn out to be a huge positive for the company when taken in conjunction with its willingness to hire external talent to build up a formidable business. Therefore, we believe that the IT-products business should be valued at 2x FY17e sales to derive our implied EV (IT products) of ₹7,414 after adjusting for Mastek's stake in the Indian entity and the holding-company discount.

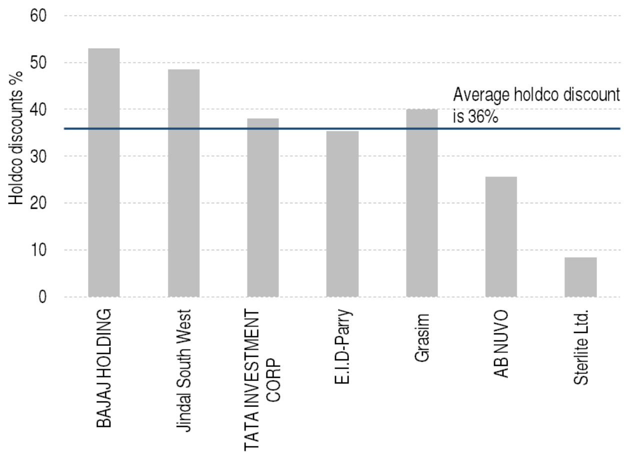
Fig 34 – Relative valuation table on product companies in the US

	Market Data			Revenue (US$ m)			EBITDA margin %			EPS (₹)			EV/Sales		EV/EBITDA		Revenue CAGR %
Company	Returns (LTM) %	M Cap (US$ m)	EV (US$ m)	CY14e	CY15e	CY16e	CY14e	CY15e	CY16e	CY14e	CY15e	CY16e	CY14e	CY15e	CY14e	CY15e	CY14-16e
Cover-All	**-15**	32	32	20	NA	NA	16.3	NA	NA	-	NA	NA	1.6	NA	9.9	NA	NA
Guidewire	6	3567	3123	345	378	418	18.1	16.3	18.6	(0)	(0)	0	9.1	7.6	50.0	50.6	10
Benefit Focus	-45	819	764	136	172	216	-35.5	-23.6	-10.3	(3)	(2)	(2)	5.6	3.3	(15.9)	(18.8)	26
Solera Holdings	-27	3486	4516	986	1,157	1,247	42.3	41.5	42.2	0	1	1	4.6	3.7	10.8	9.4	13
Ebix	17	624	623	207	231	NA	42.5	37.4	NA	2	2	NA	3.0	2.5	7.1	7.2	12
Symbility Solutions	-14	68	56	24	21	NA	10.6	-2.5	NA	-	(0)	NA	2.3	2.7	21.9	NM	-15
MEAN	-13						16	14	17				4.4	3.9	14.0	12.1	9
MEDIAN	-15						17	16	19				3.8	3.3	10.4	8.3	12

Source: Bloomberg, Anand Rathi
Note: Bloomberg estimates of companies. Pricing data as of 24-Dec-2014

Therefore, our fair enterprise value for Mastek comes out at ₹14,031m, leading to a target price of ₹620, offering a 51% upward potential from the present price. We are applying a holding-company discount of 35% to arrive at Majesco's EV (the India-listed one) but are not applying it to Mastek's minority stake in the US-listed Majesco on possibility of sale of that stake at some stage (It's a minority stake of 13.8%). The share-swap ratio between Mastek and Majesco is 1:1, which would result in identical shareholding for the two companies, initially.

Fig 35 – Current holding-company discounts in India



Source: Bloomberg, Ace Equity, Anand Rathi
Note: Pricing data as of December -2014

Company Factsheet

Fig 36 – Factsheet

Year-end: Mar	1QFY14	2QFY14	3QFY14	4QFY14	1QFY15	2QFY15
Revenues (US$ m)	38	37	38	36	37	40
Revenue by area (%)						
North America	48	48	46	40	37	38
UK	44	46	48	52	55	52
India	7	5	4	6	8	10
APAC (RoW)	1	1	2	2	0	0
Revenue by vertical (%)						
BFSI	48	49	53	47	43	44
Government	26	25	23	31	34	28
Other FI	13	11	10	9	10	13
IT & Others	13	15	14	14	13	15
Revenue breakup (%)						
IT Services	24	19	14	15	15	15
Solutions	33	35	36	43	47	45
Verticals Products	43	46	50	42	38	41
Horizontals Products	0	0	0	0	0	0
Client Concentration (%)						
Top-5 Clients	48	50	47	41	42	39
Top 10 Clients	61	62	62	56	58	57
Headcount distribution by location (%)						
Onsite	24	24	24	26	27	24
Offshore	76	76	76	74	73	76
Workforce						
Technical	2,656	2,654	2,590	2,596	2,678	2,914
Technical Support	340	255	258	245	267	244
Marketing	78	83	84	86	85	81
Support	197	193	196	196	193	186
Utilization % (Total)	80	81	81	83	85	87

Source: Company Reports, Anand Rathi

Company Background & Management

Founded in 1982 by Ashank Desai, R. Sundar and Ketan Mehta in Mumbai, and one of the first software companies in India, Mastek's focus is on business applications in BFSI, government and retail. At present, it has more than 3,000 employees. Its operations span India, the U.S., Canada, the U.K. and Asia-Pacific.

Board of Directors

Sudhakar Ram (Chairman, MD and CEO) was awarded a silver medal by the Indian Institute of Management (IIM), Calcutta. Prior to joining, was CIO of Rediffusion Dentsu Young & Rubicam. Is also the lead contributor to the 'The New Constructs' blog.

Of the ten directors, six are independent.

Key management personnel

Ketan Mehta (CEO, North America) has an MBA degree from the Indian Institute of Management (IIM), Ahmedabad. Responsible for M&A and joint ventures. Led and played a key role in the Mastek and Deloitte Consulting joint venture, as well as the STG and Vector acquisitions.

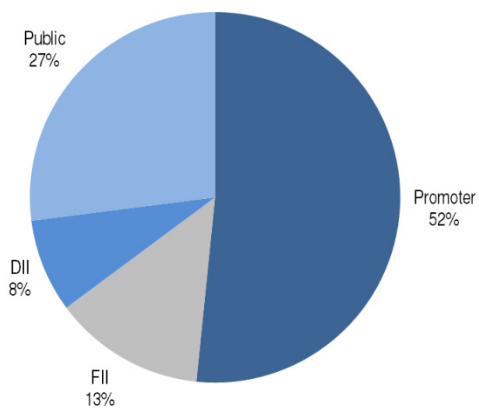
Farid Kazani (Group CFO) has more than 22 years' experience in corporate finance. Prior to joining Mastek, was CFO at Firstsource Solutions and handled a $100-million IPO and a $275-million FCCB issue there. Has also worked with RPG Enterprises, BPL Mobile, Marico Industries and NOCIL.

Kalpana Jaishankar (Senior vice-president and Group Head-HR) has more than 20 years' experience in HR. Earlier, was vice-president (corporate HR) at Patni Computer Systems. Her work experience covers performance management, employee engagement, compensation and career development.

Auditors

PricewaterhouseCoopers

Fig 37 – Shareholding pattern



Source: BSE, Anand Rathi

Appendix

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Large Caps (>US$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US$1bn)	>25%	5-25%	<5%

Anand Rathi Research Ratings Distribution (as of 29 December 2014)	Buy	Hold	Sell
Anand Rathi Research stock coverage (196)	60%	27%	13%
% who are investment banking clients	4%	0%	0%

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