April 21, 2020

Mastek Limited: Ratings reaffirmed; outlook revised from Positive to Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long term fund-based	4.0	4.0	[ICRA]A+; reaffirmed, Outlook revised from Positive to Stable
Short term non-fund based	9.0	9.0	[ICRA]A1+; reaffirmed
Long term/short term fund-based/non-fund based	6.0	6.0	[ICRA]A+ / [ICRA]A1+; reaffirmed, Outlook revised from Positive to Stable
Total	**19.0**	**19.0**	

**Instrument details are provided in Annexure-1*

Rationale

On February 8, 2020 Mastek Limited had announced acquisition of Evolutionary Systems Private Limited (Evosys) in a two-stage transaction. The first leg of the transaction involves cash buyout of the Evosys Middle East business (46% of Evosys' total revenue in FY2019) by Mastek Arabia FZ LLC for a cash consideration of $65 million (~Rs. 460 crore). Under the second leg of the transaction, its business from the rest of the world (RoW) including India, the US and UK markets will be demerged and consequently merged into Trans American Information Systems Private Limited (100% subsidiary of Mastek Limited). In consideration of demerger, the promoters of Evosys will get 15% stake, amounting ~Rs. 220 crore in Mastek Limited through issuance of new shares. Thus, the total consideration of ~Rs. 680 crore ($96.6 million) for 70% economic interest will be paid by Mastek for the proposed acquisition. The balance 30% stake of Evosys will be acquired over the next three years, in equal tranches, at a pre-agreed formula, based on the financial performance. Acquisition of residual stake will be via mix of cash and equity.

Post the completion of the transaction, the promoter shareholding will come down to 38.45% in Mastek from the existing 45.2%. The transaction is subject to the necessary statutory and regulatory approvals. As per the management, the combined entity will have a stronger portfolio and expanded digital offerings and act as a customer acquisition engine through enhanced reach in the addressable markets and segments, reducing geographical concentration risk. Evosys generated revenues of $60 million, approximately Rs. 420.0 crore, with EBITDA greater than 20% during FY2019.

The revision in outlook reflects the risks related to the relatively large acquisition of Evosys by Mastek and the likely impact on revenue growth and profitability, given the weakening global macro-economic outlook due to the fallout of the novel coronavirus outbreak.

The ratings continue to favourably factor the strong track record in Government and retail verticals. The ratings continue to factor in its high financial flexibility and comfortable liquidity position reflected in the cash and cash equivalents of greater than Rs. 300 crore as on March 31, 2020 with moderate scheduled debt repayment in FY2021. Additionally, the company, at a consolidated level, holds stake in Majesco US, through its subsidiary, Mastek UK, the market value of which is approximately Rs. 80.0 crore as on March 31, 2020. Mastek's entry into the Middle East and Continental European markets through the acquisition of Evosys is likely to help the company to diversify its revenue mix, apart from improving its scale. Nevertheless, the ability of the company to manage the expanded geographic portfolio and maximise returns from the acquisition remains to be seen. The ratings also favourably factor in its strong presence in Government and retail verticals, along with client acquisition in the financial services vertical, which has aided its organic revenue growth.

The ratings remain constrained by the economic fallout on account of the COVID-19 outbreak, which could impact the company's performance in FY2021 given the weakening macro-economic outlook. Furthermore, integration challenges owing to acquisition of Evosys is expected to take time in improving financial performance post completion of the transaction. ICRA will monitor the potential integration challenges and any impact on the earnings profile of the merged entity. The ratings are further constrained by the margin pressures caused by forex fluctuation. However, the company's policy of hedging a good portion of its receivables provides comfort. The ratings also factor in the challenges from intense competition from larger Indian IT services companies and other small and mid-sized companies in the respective markets. Mastek's ability to sustain organic revenue growth and consequently profitability improvement at increased scale will remain crucial.

Credit strengths

Vertical-focused company, targeting Government and retail spaces - The company has a strong track record in Government and retail verticals with each generating 44% and 34% of the total sales, respectively, in Q3 FY2020. Certain critical departments such as the Home Office and Health (where Mastek already has successful relationships) are expected to have a bigger share of IT spends to support changes in existing systems and create new systems post Brexit, which will provide significant growth opportunities for the company. In addition, strong presence of Evosys in the local UK government could help Mastek access some new departments of the UK Government in the medium term. However, given the severity of the coronavirus outbreak in both the US and the UK, there could be likely deferral in government spends in the UK and impact on discretionary spends in both the markets.

Geographic and revenue diversification post inorganic initiatives in 2016 and 2020 - The contribution of revenues from North America increased from 3% in Q3 FY2017 to 23.1% in Q3 FY2020. Mastek, after the acquisition of TAISTech, has a presence in digital commerce enabling implementations and support for the Oracle ATG and Oracle Commerce Cloud applications. Further, acquisition of Evosys in Q4 FY2020 is expected to enhance its addressable market in Middle East, Continental Europe and the local government of UK through cross-selling and up-selling of Mastek's service offerings. Thus, post completion of the transaction, Evosys could act as a customer acquisition engine for Mastek in the medium term.

Credit challenges

Any adverse impact on revenues and profitability due to the economic fallout of coronavirus outbreak across its key markets – Owing to the ongoing pandemic, the near-term macro-economic outlook across geographies, predominantly in the US and Europe, has weakened considerably with likely adverse impact on GDP growth for CY2020. The timing and pace of recovery in these markets would be critical for Mastek's growth trajectory as there could be deferral in government spends, while private sector spends may witness curtailment. Any diversion of government spends to other high priority areas in the current scenario could also be a negative factor. An adverse macro-economic scenario may not only lead to reduction in discretionary spends by clients, but also pricing pressure, and impact its margins, going forward. Furthermore, the company generated approximately 63% of its revenues in Q3 FY2020 from its top 10 clients, thus any client exit may have an adverse impact on its revenues and profitability.

Successful integration of Evosys acquisition and generation of adequate return from same – Owing to the acquisition of Evosys, Mastek is exposed to risks emanating from integration related issues in the near term. Though the previous acquisition of TAISTech Group in 2016 did not pan out as per the company's expectation, the company management believes they have undertaken a more thorough due diligence this time to make the acquisition work. Mastek is expected to increase its market presence in terms of a wider product reach, bigger clientele base, operational synergy and a higher scale with the proposed acquisition. A higher scale may help in further reduction of costs. Going forward, the improvement in Mastek's financial performance after the absorption of the proposed transaction will remain a key driver.

Exposed to intense competition and currency fluctuations; although policy of hedging large portion of receivables provides comfort - The company faces intense competition from the larger Indian IT services companies and other small and mid-sized companies in the respective markets. Further, most of the revenues of the company is in foreign currency (GBP and US dollar), exposing it to foreign currency fluctuations. However, as per the company, ~70% of its revenues come from onshore operations, providing a natural hedge; moreover, its margins are protected to that extent. Also, the company hedges a good portion of its net receivables through forward contracts as part of its hedging policy.

Liquidity position: Strong

Mastek generates an average cash flow from operations of Rs. 50-60 crore supported by moderate operating profitability of 12-13% and moderate working capital requirements. Despite the acquisition resulting in a cash outflow of Rs. 460.0 crore, Mastek's liquidity profile remains strong, as reflected in its estimated cash and cash equivalent of greater than Rs. 300.0 crore as on March 31, 2020. Additionally, the company at a consolidated level, holds stake in Majesco US, through its subsidiary, Mastek UK, the market value of which stood at Rs. 80.0 crore as on March 31, 2020, adding to the liquidity comfort. The company's recurring cash flow from operations and its cash balances are expected to be adequate to service its scheduled debt repayments of Rs. 17.2 crore in FY2021 and Rs. 62.2 crore in FY2022. Further, liquidity is supported by undrawn working capital fund-based limits of Rs. 10 crore.

Rating sensitivities

Positive triggers - ICRA could upgrade Mastek's rating if the company exhibits sustained improvement in business profile, supported by increase in scale and diversification of revenues across business segments through recent acquisition of Evosys while generating adequate returns.

Negative triggers - Negative pressure on Mastek's ratings may arise, if any significant reduction in the company's revenues and profitability weakens the company's RoCE. The ratings may also be downgraded if any increase in working capital intensity impacts the liquidity position, or any further debt-funded acquisitions weaken the debt coverage indicators. A prolonged lockdown due to the COVID-19 outbreak leading to weak macro-economic prospects in the company's key markets, coupled with weaker than expected returns from Evosys, will also be a negative trigger.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Information Technology (Services) Industry
Parent/Group Support	Not Applicable
Consolidation/Standalone	The rating is based on consolidated financial statements of the rated entity.

About the company

Mastek Limited (formerly known as Management and Software Technology Private Limited) was incorporated in 1982. It is an IT company providing enterprise solutions to Government / public sector, retail sector and financial services. Mastek's portfolio includes business and technology services, comprising IT consulting, application development, systems integration, application management outsourcing, testing, data warehousing and business intelligence, application security, customer relationship management (CRM) services and legacy modernisation. In December 2016, Mastek acquired the TAISTech Group, a digital commerce services player who provides strategic consulting, commerce implementations and support for the Oracle Commerce and Oracle Commerce Cloud applications to retail players in the USA. The company is headed by Mr. John Owen, the Group CEO. As on December 31, 2019, its total employee strength stood at 1,880. Mastek registered revenue of Rs. 734.8 crore and PAT of Rs. 74.9 crore during 9M FY2020, at a consolidated level.

About Evosys

Headquartered in Ahmedabad, Gujarat, Evosys was founded in 2006 by Umang Nahata and Rakesh Raman. Evosys possesses 13 years of experience and has over 1,000 Oracle Cloud customers across over 30 countries with around 300 active customers. Evosys is an Oracle platinum partner for implementation of (Enterprise Resource Planning (ERP), Human Capital Management (HCM) and Supply Chain Management (SCM) suites. It focuses on Oracle Cloud implementation and consultancy, providing a gamut of solutions like Oracle HCM Cloud, Oracle ERP Cloud, Oracle SCM Cloud, Oracle CX, Oracle EPM Cloud, PaaS solutions (including custom-built solutions), AI, IoT and machine learning. Its customer portfolio spans healthcare, finance, logistics, manufacturing and distribution companies across public and private sectors. During FY2019, the company generated 60% of its revenue from cloud practice and the rest from on premise and licensing services. (Evosys generated revenues of $60 million, approximately Rs. 420.0 crore, registering EBITDA greater than 20% during FY2019.)

Key financial indicators (audited)

	FY2018	FY2019
Operating Income (Rs. crore)	817.2	1,033.2
PAT (Rs. crore)	70.0	101.5
OPBDIT/OI (%)	12.3%	12.8%
RoCE (%)	17.5%	19.9%
Total Outside Liabilities/Tangible Net Worth (times)	0.4	0.3
Total Debt/OPBDIT (times)	0.7	0.5
Interest Coverage (times)	17.2	21.6
DSCR	15.3	5.5

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years			
		Type	Amount Rated	Amount Outstanding	Rating	FY2020	FY2019	FY2018	
					21-April-20	12-Sep-19	3-Aug-18	21-Aug-17	1-Aug-17
1	Long term fund-based	Long Term	4.0	-	[ICRA]A+(Stable)	[ICRA]A+ (Positive)	[ICRA]A+ (Positive)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
2	Short term non-fund based	Short term	9.0	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
3	Long term/short term fund-based/non-fund based	Long term/Short term	6.0	-	[ICRA]A+(Stable)/ [ICRA]A1+;	[ICRA]A +(Positive)/ [ICRA]A1+	[ICRA]A+ (Positive)/ [ICRA]A1+	[ICRA]A+ (Stable)/ [ICRA]A1+	[ICRA]A+ (Stable)/ [ICRA]A1+

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Long term fund-based	-	NA	-	4.0	[ICRA]A+(Stable)
-	Short term non-fund based	-	NA	-	9.0	[ICRA]A1+
-	Long term/short term fund-based/non-fund based	-	NA	-	6.0	[ICRA]A+(Stable)/[ICRA]A1+

Source: Mastek Limited

Annexure-2: List of entities considered for consolidated analysis (As on March 31, 2019)

Company Name	Ownership	Consolidation Approach
Trans American Information Systems Private Limited	100.0%	Full Consolidation
Mastek (UK) Limited	100.0%	Full Consolidation
IndigoBlue Consulting Limited	100.0%	Full Consolidation
Mastek Inc.	100.0%	Full Consolidation
TAISTech LLC, USA	100.0%	Full Consolidation
Trans American Information Systems Inc. USA	100.0%	Full Consolidation

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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For more information, visit www.icra.in

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