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Zacks Small-Cap Research

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Mastech Digital (NYSE Amer: MHH)

Q2 Austerity and Lower Taxes Bring Greater Than Expected Profit to the Bottom Line

Based on an EV to sales of 2xs, we believe MHH stock could be worth $31.00 per share.

OUTLOOK

Mastech Digital, based outside Pittsburgh, PA is an IT staffing business with a growing data and analytics consulting and project management service serving blue chip customers in the US. The data and analytics business, Mastech InfoTrellis, was 14% of sales this quarter and its run rate grew from $26.6 million to $27.1 million, despite the pandemic delaying projects. We believe that business has begun to return to normal and the company's austerity has resulted in higher than normal profits near term.

Current Price (07/31/20)	$21.50
Valuation	**$31.00**

SUMMARY DATA

52-Week High	**$28.67**
52-Week Low	**$5.38**
One-Year Return (%)	**239**
Beta	**0.8**
Average Daily Volume (sh)	**53,119**
Shares Outstanding (mil)	**11.3**
Market Capitalization ($mil)	**$245**
Short Interest Ratio (days)	**1.5**
Institutional Ownership (%)	**14**
Insider Ownership (%)	**63**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**12.3**
Earnings Per Share (%)	**20.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**20.5**
P/E using 2020 Estimate	**19.4**
P/E using 2021 Estimate	**16.9**

Risk Level	**High**
Type of Stock	**Small-Growth**
Industry	**IT Services**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	43 A	45 A	44 A	45 A	177 A
2019	45 A	48 A	50 A	50 A	194 A
2020	50 A	48 A	48 E	52 E	198 E
2021					235 E

Non-GAAP Earnings Per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	$0.18 A	$0.21 A	$0.20 A	$0.16 A	$0.74 A
2019	$0.15 A	$0.20 A	$0.23 A	$0.26 A	$0.82 A
2020	$0.23 A	$0.33 A	$0.28 E	$0.29 E	$1.11 E
2021					$1.27 E

Zacks Projected EPS Growth Rate - Next 5 Years % **15**

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Lower Expenses Leads to an Earning Beat at Mastech Digital

While revenues were close to our estimate for Q2, an unexpected improvement in gross margin combined with austerity programs led to an earnings beat. Back in March the company reported that staffing was only slightly affected with cancellations but that some companies paused their plans to start Data and Analytics projects or to sign new contracts. Business soon resumed as businesses shifted to remote working and the company was able to sign $10 million in new data and analytics contracts in Q2 for projects ranging from six to eighteen months.

On June 2, 2020 Mastech Digital launched a remote staffing service offering, branded as "MAS-REMOTE." This service allows Mastech Digital to offer the top 10% handpicked talent in the US to work remotely on customers' projects. In contrast to remote working from home, the talent does not relocate to the customer's geographic area, but permanently works remotely. For Mastech, this opens its pool of talent worldwide, not just the US. The market is ready for this product having been forced to experiment with remote working and having found good success.

Total revenues in Q2 declined 2% but total gross margin was 26.6% versus 24.9% a year ago and 25.2% in Q1 2019 and gross margin dollars increased 5%.

Looking at the two segments reveals, IT staffing decreased 2% to $41 million and was 86% of revenues. It had 1,035 billable consultants compared to 1,113 the year before and 1,100 in the first quarter of 2020. Gross margin for this segment improved to 22.4% from 21.5% last year and 21.5% in Q1 2020 as the bill/pay spread improved.

Data and analytics grew 2% to $6.8 million or 14% of sales. Gross margins also improved in this segment to 52.2% from 46.1% a year ago. Gross margin dollars for this segment increased 15.2%. Part of the improvement in margin as well as lower revenues was due to reduced travel expense. Typically the company would have booked $300,000 - $400,000 in travel expense to clients at cost, so no travel reduced revenues by that amount and reduced cost of revenue by the same amount. We expect the same phenomena for Q3 at this point since travel has not restarted.

In Q1 the company implemented austerity and SG&A was reduced by $1.3 million sequentially. Spending was even below the $9.5 million in Q2 of 2019. The company is still under austerity so we do not expect spending to increase much in Q3 2020.

Operating income (subtracting the gain on evaluation of contingent consideration liability in 2019) increased 44% to $3.6 million and margin improved to 7.6% from 5.2% a year ago, and 4.9% in Q1 2020.

Other expense declined to $157,000 compared to $507,000 a year ago as the company pays off higher interest rate debt.

For the quarter the tax rate was lower than expected due to the exercise of stock, which results in a favorable tax treatment and reduced the tax rate to 14%. The company expects the second half of the year to still be in the 25-26% range without factoring any more stock option exercises.

GAAP net income was $3.0 million, down 50% from a year ago. On a non-GAAP basis it was $3.9 million up 79%.

GAAP EPS was $0.25 diluted compared to $0.53 a year ago and $0.16 in Q1 2020. On a non-GAAP basis it was $0.33 versus $0.20. The fully diluted share count was 11.9 million up 7.0%.

Balance Sheet

The company ended the quarter with $4.7 million in cash, a quick ratio of 1.8Xs, working capital of $17.1 million, and debt of $14.5 million. It reduced debt $7.4 million since last quarter and $18.3 million since last year at this time. Management feels it has enough liquidity to handle the effects of the pandemic.

Estimates

For 2020 we are maintaining revenues at $198 million, but increasing EPS estimates to $1.11 per share based on lower spending and higher gross margins.

KEY POINTS

- Mastech Digital had historically been an IT staffing company, but it entered the data and analytics business in 2017 with its purchase of InfoTrellis. This business is higher margin and faster growing than IT staffing and is becoming an increasingly bigger part of total sales. This math should lead to accelerating earnings growth as well as a higher valuation for the stock.
- Mastech plans to augment its internal growth with acquisitions in the data and analytics space to expand its capabilities. It has been paying off debt through internally generated cash flow, which leaves it with increased debt capacity for asset purchases as well as cash to expand internationally.
- The economy continues robust and IT workers continue to be in short supply leading to continued demand from customers.
- On a PE multiple MHH is trading at 1.1 times enterprise value to 2021 estimated sales. We believe that given its non-pandemic growth, by next year that the stock price could move near 2.0 times or $31.00.

OVERVIEW

Mastech Digital is a minority-owned IT services company headquartered in Moon Township, PA with offices in the US, Canada and India. It has domestic sales offices in: Chicago; Boston; Orlando; Tampa; Dallas; Atlanta; Houston; Freemont, CA; and Toronto, in addition to its headquarters near Pittsburgh. Internationally, the company has a sales presence in Singapore; Ireland and in the UK; and it recruits and provides IT outsourcing through its locations in Noida and Chennai, India. The company currently has approximately 1,100 North American employees and 400 employees offshore, in addition to over 180 subcontracted professionals. Originally, it was the IT staffing business of iGATE Capital Corp., a public company that was sold to Capgemini in 2015 for $4+ billion in cash. Mastech Digital had been previously spun off as a separate public company from iGATE in 2008. Since then it has also become a consultant, project manager and VAR in the data analytics, data management and big data through its acquisition of InfoTrellis on July 13, 2017. It reports earnings of these two segments. IT staffing is still the largest part of the company but the smaller, faster growing, and higher margin, data and analytics business is an increasing percent of total revenues. This dynamic should result in continued accelerating earnings growth in 2021, and this growth could result in an expansion of the stock's PE ratio.

VALUATION

The pandemic has caused quite a divergence in prospects and valuations for staffing companies based on their vertical markets. Those that depend on a physical presence, health care, manufacturing, warehousing, and general office staff have been severely hurt, while those that focus on IT have thrived as they easily can have staff work remotely. If we take those focused on the tech vertical we see and average of 2.0 times EV to sales. These companies also enjoy higher EBITDA margins. Using that average multiple and applying it to Mastech's forecasted revenues the stock is worth $31.00.

Company	Ticker	Revenue 2021E	Revenue 2020E	LTM	EBIDTA Margin	EV/Sales 2021E	EV/Sales 2020E	EV/Sales LTM	Included in Average?	Enterprise Value
Accenture	ACN	46,800	44,500	44,550	16%	3.0	3.2	3.1	y	140,300
Cognizant	CTSH	17,120	16,400	16,760	20%	2.1	2.2	2.2	y	36,200
Computer Task Group	CTG	368	353	373	3%	0.2	0.2	0.2	y	71
Infosys	INFY	13,800	12,800	12,770	24%	3.7	4.0	4.0	y	51,620
Kforce Inc.	KFRC	1,240	1,240	1,350	6%	0.6	0.6	0.6	y	756
Wipro	WIT	8,640	8,160	8,170	24%	2.1	2.2	2.2	y	18,131
Average					15.7%	2.0	2.1	2.1		6,298

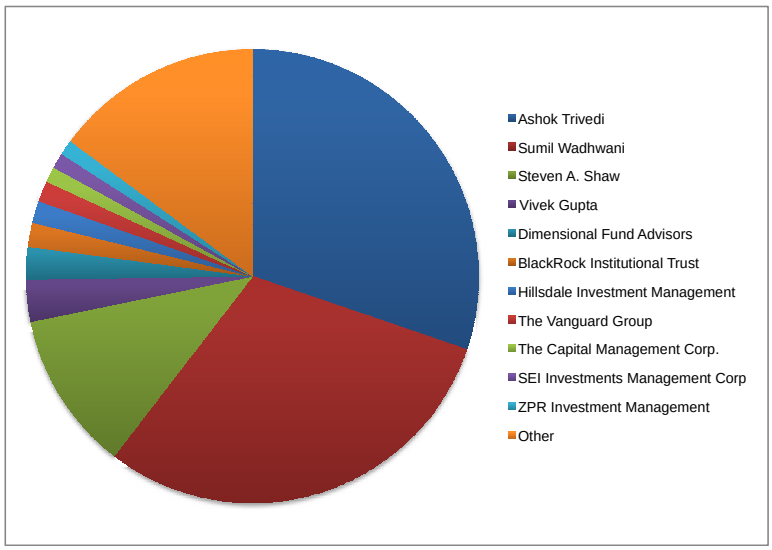
	Projected Revenue 2021E	Projected Revenue 2020E	Projected Revenue TTM	EV/Sales 2021E	EV/Sales 2020E	EV/Sales TTM	Valuation Range Low	Valuation Range High
	235	198	151	2.0	2.1	2.1	309	409
YoY growth								

Conclusion of Enterprise Value	**$359,055,638**
Market Value	**$349,290,638**
Fully diluted shares	11,271,000
Price per Share	**$30.99**

RISKS

- The company is subject to the business cycle and tends to do better when the economy is robust or at the end of a recession when companies are reluctant to bring on full time hires. The current pandemic, which has resulted in business interruptions, makes it difficult to gage the current business climate both short and long term.
- The company is almost entirely dependent on the US market in the IT staffing segment.
- The top ten clients represent approximately 45% of sales with CGI being over 11.3%.
- Any regulatory changes regarding H-1B visas could eventually trickle down to Mastech's pool of potential consultants; approximately 40% of its employee base is sourced from those currently holding these visas. Although there is talk about changes to visa grants for new entries into the US, Mastech sources its workforce base from those that already have the appropriate visas. A greater acceptance of remote working could decrease this risk.

OWNERSHIP



Source: Zacks Investment Research

INCOME STATEMENT

	Q1 2019 31-Mar	Q2 2019 30-Jun	Q3 2019 30-Sep	Q4 2019 31-Dec	Q1 2020 31-Mar	Q2 2020 30-Jun	Q3 2020E 30-Sep	Q4 2020E 31-Dec	2018	2019	2020E	2021E
Billable consultants	1,116	1,113	1,197	1,167	1,100	1,035	1,197	1,200	1,100	1,165	900	1,500
Average bill rate per hour	74.56	74.75	74.60	NA	NA	NA			73.01	74.97	73.00	74.70
IT Staffing Services	39,431	41,818	42,463	43,199	43,065	40,811	40,500	44,000	153,361	166,911	168,376	198,000
Yr-to-yr Growth	7%	8%	10%	10%	9%	-2%	-5%	2%	11%	9%	1%	18%
IT Staffing Gross Margin	8,202	8,991	9,087	9,245	9,259	9,142	8,910	9,680	32,326	35,524	36,991	43,560
Gross Margin %	21%	21.5%	21.4%	21.4%	21.5%	22.4%	22.0%	22.0%	21.1%	21.3%	22.0%	22.0%
Data & Analytics Services	5,768	6,654	7,080	7,161	7,360	6,772	7,100	7,900	23,803	26,663	29,132	36,600
Yr-to-yr Growth	-12%	9%	22%	34%	28%	2%	0%	10%	159%	12%	9%	26%
Data & Analytics Gross Margin	2,624	3,067	3,236	3,516	3,467	3,535	3,710	3,713	10,477	12,444	14,425	17,385
Gross Margin %	46%	46.1%	46%	49%	47%	52%	52%	47%	44.0%	46.7%	49.5%	48%
Revenue	**$45,199**	**$48,472**	**$49,543**	**$50,360**	**$50,425**	**$47,583**	**$47,600**	**$51,900**	**$177,164**	**$193,574**	**$197,508**	**$234,600**
Yr-to-yr Growth	4%	8%	12%	13%	12%	-2%	-4%	3%	20%	9.3%	2.0%	18.8%
Cost of revenue	34,364	36,418	37,214	37,597	37,706	34,927	34,980	38,507	134,636	145,593	146,120	173,655
Gross profit	10,835	12,054	12,329	12,763	12,719	12,656	12,620	13,393	42,528	47,981	51,388	60,945
Gross Margin %	24.0%	24.9%	24.9%	24.5%	25.2%	26.6%	26.5%	25.8%	24.0%	24.8%	26.0%	26.0%
SG&A	8,965	9,544	9,259	9,295	10,243	9,042	9,500	10,000	32,221	37,063	38,785	45,000
Impairment of goodwill	0	0	0	0	0	0	0	0	9,738	0	0	0
Revaluation of contingent consideration liabilty	0	(6,069)	0	0	0	0	0	0	(11,056)	(6,069)	0	0
Total operating expenses	8,965	3,475	9,259	9,295	10,243	9,042	9,500	10,000	30,903	30,994	38,785	45,000
Operating income:	1,870	8,579	3,070	3,468	2,476	3,614	3,120	3,393	11,625	16,987	12,603	15,945
Operating margin	4.1%	17.7%	6.2%	6.9%	4.9%	7.6%	6.6%	6.5%	6.6%	8.8%	6.4%	6.8%
Other income:												
Interest income	(539)	(468)	(413)	NA	NA	NA	NA	NA	(2,171)	NA	(583)	(400)
Other income	(15)	(39)	33	NA	NA	NA	NA	NA	(40)	NA	-	-
Total other income	(554)	(507)	(380)	(327)	(226)	(157)	(100)	(100)	(2,211)	(1,768)	(583)	(400)
Income before income taxes	1,316	8,072	2,690	3,141	2,250	3,457	3,020	3,293	9,414	15,219	12,020	15,545
Pretax Margin	2.9%	16.7%	5.4%	6.2%	4.5%	7.3%	6.3%	6.3%	5.3%	7.9%	6.1%	6.6%
Income taxes	352	2,114	741	867	381	488	740	807	2,723	4,074	2,416	4,197
Tax rate	27%	26%	28%	28%	17%	14%	25%	25%	28.9%	26.8%	20%	26%
Net income	964	5,958	1,949	2,274	1,869	2,969	2,280	2,486	6,691	11,145	9,604	11,348
Yr-over-Yr	-30%	112%	20%	160%	94%	-50%	17%	9%	312%	67%	-14%	18%
Stk based compensation	236	267	263	170	456	612	612	612	470	936	1,100	1,100
One-time expenses	431	(4,046)	338	(224)	377	328	424	424	1,088	(5,518)	1,553	1,700
Non-GAAP Income	1,631	2,179	2,550	2,891	2,702	3,909	3,316	3,522	8,249	9,251	12,257	14,148
Yr-over-Yr	-17%	-5%	16%	63%	66%	79%	30%	22%	79%	12.1%	32%	15%
Net income per share:												
Primary EPS	0.09	0.54	0.18	0.21	0.17	0.26	0.20	0.22	0.61	1.01	0.87	1.02
Diluted EPS	0.09	0.53	0.17	0.20	0.16	0.25	0.19	0.21	0.60	0.99	0.87	1.02
Diluted Non-GAAP EPS	0.15	0.20	0.23	0.26	0.23	0.33	0.28	0.29	0.74	0.82	1.11	1.27
	-18%	-6%	16%	61%	59%	68%	21%	14%	60%	11%	35%	15%
Shares												
Basic	10,998	11,022	11,039	11,049	11,127	11,271	11,281	11,291	10,950	11,029	$11,049	$11,100
Yr-over-Yr	0.7%	0.9%	0.7%	0.5%	1.2%	2.3%	2.2%	2.2%	10.3%	1%	0%	0%
Diluted	11,218	11,164	11,205	11,314	11,675	11,948	11,998	12,048	11,161	11,232	11,050	11,101
Yr-over-Yr	1.4%	0.2%	-0.1%	1.1%	4.1%	7.0%	7.1%	6.5%	11.6%	1%	-2%	0%

BALANCE SHEET

	Jun. 30, 2020	Mar. 31, 2020	Qtr-Qtr % Growth	Jun. 30, 2019	Yr-Yr % Growth
Current assets:					
Cash and equivalents	**$ 4,743**	**$ 2,575**	84.2%	**$ 3,869**	66.3%
Accounts receivable, net	31,208	33,596	-7.1%	25,730	16.0%
Unbilled receivables	0	0	NM	10,061	-100.0%
Prepaid expenses & other curr assets	1,224	1,036	18.1%	1,349	-11.5%
Total current assets	37,175	37,207	-0.1%	41,009	-11.1%
Equipment, software and leasehold net	2,230	2,393	-6.8%	1,730	-2.1%
Right-of-use assets	3,978	4,348	-8.5%	4,980	-18.4%
Non-current deposits	385	388	-0.8%	447	-26.9%
Goodwill, net	26,106	26,106	0.0%	26,106	0.0%
Intangible assets, net	18,708	19,377	-3.5%	21,394	-12.2%
Total assets	88,582	89,819	-1.4%	96,374	-9.0%
Current liabilities:					
Current portion of long-term debt, net	**4,575**	**8,537**	-46.4%	**4,575**	86.6%
Acconts payable	3,073	3,440	-10.7%	3,909	-12.5%
Accrued payroll and related costs	9,616	9,456	1.7%	10,088	24.2%
Current portion of operating lease liability	1,295	1,392	-7.0%	1,339	1.8%
Other accrued liabilities	1,554	764	103.4%	1,097	-50.6%
Deferred revenue	0	0	0.0%	174	-100.0%
Total current liabilities	20,113	23,589	-14.7%	21,182	-7.3%
Long-term debt, net	**9,933**	**13,358**	-25.6%	**28,366**	-60.3%
Lease liability	2,760	3,019	-8.6%	3,736	-23.8%
Long term accrued income taxes	185	185	0.0%	204	-9.3%
Long term payroll tax liability	1,495	0	NM	0	NM
Long term deferred income taxes	837	843	-0.7%	1,157	NM
Total liabilities	35,323	40,994	-13.8%	54,645	-35.2%
Stockholders' equity					
Common stock	130	128	1.6%	127	1.6%
Additional paid-in capital	24,432	22,950	6.5%	21,437	8.9%
Retained earnings	33,597	30,628	9.7%	24,536	64.9%
Accumulated other comp loss	(713)	(694)	2.7%	(184)	362.7%
Treasury stock, at cost	(4,187)	(4,187)	0.0%	(4,187)	0.3%
Total stockholders' equity	53,259	48,825	9.1%	41,729	37.7%
Total liabilities and stockholders' equity	88,582	89,819	-1.4%	96,374	-9.0%
Current and quick ratio	1.8	1.6	17.2%	1.9	-4.1%
Working Capital	17,062	13,618	25.3%	19,827	-17.0%
Net cash	4,743	2,575	84.2%	3,869	66.3%
Debt	14,508	21,895	-33.7%	32,941	-42.7%
Debt/TA	16%	24%	-32.8%	34%	-37.1%

CASH FLOWS

	Year 2018	3 Mo Ended Mar 31, 2019	3 Mo Ended Jun 30, 2019	3 Mo Ended Sep 30, 2019	3 Mo Ended Dec 31, 2019	Year 2019	3 Mo Ended Mar 31, 2020
Cash flows from operating activities:							
Net income	6,691	964	5,958	1,949	2,274	11,145	1,869
Adjustments to reconcile net income to net cash provided by operating activities:							
Depreciation and amortization	3,182	839	869	869	857	3,434	873
Bad debt expense	10	-	30	50	-	80	-
Interest amortization of deferred financing costs	100	26	26	26	26	104	26
Stock-based compensation	470	236	267	263	170	936	456
Deferred income taxes, net	171	(95)	1,549	(75)	(57)	1,322	(182)
Impairment of goodwill	9,738	-	-	-	-	-	-
Reevaluation of contingent consideration liability	(11,056)	-	(6,069)	-	-	(6,069)	-
Loss on disposition of fixed assets	7	-	-	-	-	-	2
Long term accrued income taxes	136	-	-	-	(19)	(19)	-
Operating lease assets and liabilities, net	-	-	95	5	-	100	(37)
Change in operating assets and liabilities:							
Accounts receivable & unbilled receivables	(7,428)	(1,051)	3,310	781	2,608	5,648	(1,244)
Prepaid expenses and other current assets	283	110	(248)	(52)	(196)	(386)	492
Accounts payable	(901)	(196)	(22)	450	(332)	(100)	(587)
Accrued payroll	(1,241)	(112)	2,472	(260)	(1,926)	174	1,554
Other accrued liabilities	(461)	327	(448)	232	(375)	(264)	(276)
Deferred revenues	(172)	80	(164)	72	(9)	(21)	(151)
Net cash used by operating activities	(471)	1,128	7,625	4,310	3,021	16,084	2,795
Cash flows from Investing activities:							
(Payment for) recovery of non-current deposits	(285)	9	84	37	5	135	17
Capital expenditures	(771)	(404)	(190)	(292)	(128)	(1,014)	(119)
Net cash used in investing activities	(1,056)	(395)	(106)	(255)	(123)	(879)	(102)
Cash flows from Financing activities:							
Borrowings on revolving credit facility, net	4,526	656	(4,183)	(4,701)	4,252	(3,976)	(2,244)
(Repayments) on term loan facility	(4,003)	(1,144)	(1,144)	(1,144)	(6,143)	(9,575)	(1,144)
Proceeds from the issuance of common shares	-		106	-	62	168	-
Payment of deferred financing costs	(71)	-	-	-	-	-	-
Purchase of treasury stock	(20)		(13)	-	-	(13)	-
Proceeds from the exericise of stock options	118	-	-	-	7	7	556
Net cash provided by financing activities	550	(488)	(5,234)	(5,845)	(1,822)	(13,389)	(2,832)
Effect of exchange rate changes of cash	(207)	9	36	(116)	(58)	(129)	(267)
Net change - cash	(1,184)	254	2,321	(1,906)	1,018	1,687	(406)
Cash, beginning of quarter	2,478	1,294	1,548	3,869	1,963	1,294	2,981
Cash, end of period	1,294	1,548	3,869	1,963	2,981	2,981	2,575
Supplemental information:							
Interest paid	2,060	-	-	-	-	1,780	-
Income taxes paid	2,031	-	-	-	-	2,634	-
Cash Flow	9,449	1,970	2,725	3,087	3,251	11,033	3,007
Free cash flow	8,678	1,566	2,535	2,795	3,123	10,019	2,888

HISTORICAL STOCK PRICE



Source: Zacks Investment Research

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