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Zacks Small-Cap Research

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Mastech Digital (NYSE Amer: MHH)

Mastech Digital Earnings Soar 54% Despite Down Revenues

Based on an EV to sales of 2.2xs, we believe MHH stock could be worth $39.40 per share.

Current Price (10/27/20)	$19.04
Valuation	**$39.40**

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 15% of sales this quarter and its run rate grew to $28.7 million, despite the pandemic delaying projects. The acquisition of AmberLeaf will add another $11 million to that run rate. We believe that overall business has begun to return to normal and the company's austerity has resulted in higher than normal profits near term.

SUMMARY DATA

52-Week High	**$28.67**
52-Week Low	**$5.80**
One-Year Return (%)	**177**
Beta	**0.6**
Average Daily Volume (sh)	**14,386**
Shares Outstanding (mil)	**11.3**
Market Capitalization ($mil)	**$217**
Short Interest Ratio (days)	**3.0**
Institutional Ownership (%)	**16**
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	**26.6**
P/E using 2020 Estimate	**15.6**
P/E using 2021 Estimate	**14.4**

Risk Level	**Above Average**
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	47 A	51 E	197 E
2021					247 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	$0.32 A	$0.33 E	$1.22 E
2021					$1.32 E

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

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WHAT'S NEW

Mastech Digital Reports Q3

Q3 was a repeat of Q2 in that margins came in higher than expected as costs remained in check. While revenues for the quarter were down 4% gross and operating margins improved resulting in an earnings increase of 53.8%. Some of the profitability gain was from higher rates on new assignments and some from continued austerity programs that are still in effect with no sign of abating just yet. Management claims its spending will pick up as its revenues do. In Q4 the company will benefit by the addition of AmberLeaf revenues and profits, albeit initially at lower than average corporate gross margins.

Specifically total revenues in Q3 declined 4% but total gross margin was 27.6% versus 24.9% a year ago and 26.2% in Q2 2019; gross margin dollars increased 6.2%. It has weathered the pandemic better than many of its competitors due to its conscious decision to focus on what it calls "digital technologies." These are described at leading edge sectors such as data and analytics, cloud computing, mobile, social and AI, and opposed to maintenance of legacy systems on mainframes and the like. It has gone from digital being 16% of sales in 2016 to 50% today with AmberLeaf pushing it an even higher percentage.

Looking at the two segments reveals, IT staffing decreased 5% to $40.2 million and was 85% of revenues. It had 1,037 billable consultants compared to 1,197 the year before and 1,035 in the second quarter of 2020. Gross margin for this segment improved to 22.6% from 21.4% last year and 22.4% in Q2 2020 as new assignments are added at higher rates and higher consultant utilization. Data and analytics grew 1% to $7.2 million or 15% of sales. Gross margins also improved in this segment to 55.9% from 45.7% a year ago. Gross margin dollars for this segment increased 24%. Part of the improvement in margin as well as lower revenues was due to reduced travel expense and it too had better consultant utilization.

In Q1 the company implemented austerity and surprisingly SG&A was again reduced this quarter albeit by only by $169,000 million sequentially. It was $8.9 million compared to $$9.3 million a year ago. The company said although expenses were down $1.1 million, it spent $800,000 on expanding the data and analytics platform.

Operating income increased 37.4% to $4.2 million and margin improved to 8.9% from 6.2% a year ago, and 7.6% in Q2 2020.

Other expense declined to $191,000 compared to $380,000 a year ago as the company pays off higher interest rate debt.

For the quarter the tax rate was at the expected rate of 25.5% range where we expect it to stay without factoring any more stock option exercises.

GAAP net income was $3.0 million, up 54% from a year ago. On a non-GAAP basis it was $4.0 million up 57%.

GAAP EPS was $0.25 diluted compared to $0.17 a year ago and $0.25 in Q2 2020. On a non-GAAP basis it was $0.33 versus $0.23. The fully diluted share count was 11.9 million up 7.0%.

Balance Sheet

The company ended the quarter with $4.0 million in cash, a quick ratio of 1.8xs, working capital of $17.0 million, and debt of $8.4 million. It reduced debt $6.1 million since last quarter and $18.7 million since last year at this time. It paid $9.5 million in cash to buy AmberLeaf after the quarter ended on October 1st.

Estimates

For 2020 we are lowering revenues to $197 million, but again increasing EPS estimates to $1.22 per share based on lower spending and higher gross margins. We had expected a bigger pick up in business by now. Although North America, where almost all of the IT staffing business is, is starting to grow, the rest of the world, continues to be shutdown or locked down either fully or partially. This is delaying the ability for the InfoTrellis business to start new projects and win contracts in the typical amount of time. In the mean time, it will work to bring AmberLeaf's gross margin from its current 35% up to InfoTrellis' 55% by better consultant utilization, higher prices, and reducing its use of outside consultants.

After the Quarter

AmberLeaf Partners Acquisition

On October 1, 2020 Mastech Digital acquired AmberLeaf Partners, Inc. for $14.0 million. Of that, $9.5 million was paid in cash at closing, and up to $4.5 million in deferred payments could be paid over the next two years. The company had approximately $11 million in sales, was profitable, and cash flow positive. The deferred payments are contingent upon the acquired business achieving specific financial targets during the two years following the closing of the acquisition. AmberLeaf is a consulting company based in Chicago with approximately 40 employees and 40 to 50 clients. It provides managed services for companies for cloud-based applications including sales, marketing, and customer service. AmberLeaf's client base in general is comprised of companies smaller than Mastech's current data and analytics business usually services. AmberLeaf provides services that are typically sold to a marketing manager who wants actionable recommendations from its data and may not have the resources to do this analysis in house. This complements Mastech's D&A business, which sells to IT managers implementing data analysis systems. Like Mastech, AmberLeaf also sells on a contract basis: either time and materials or monthly recurring flat fee. While the company has not been growing Mastech believes with its resources and sales and marketing infrastructure, it can grow revenues at AmberLeaf and even cross sell to its current clients.

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 had been paying off debt through internally generated cash flow, which left it with increased debt capacity for asset purchases as well as cash to expand internationally as shown by its purchase of AmberLeaf.

- The economy continues to rebound from the pandemic and the demand for IT workers continues to increase. The data and analytics business in particular has continued to show healthy demand.

- MHH is trading at 0.9 times enterprise value to 2021 estimated sales. We believe by next year the stock price could move near a more fairly valued 2.2 times or $39.40.

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 and of AmberLeaf on October 1, 2020. 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 2.2 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 $39.41

.

Company	Ticker	Calendar Revenue 2021E	Calendar Revenue 2020E	LTM	EBIDTA Margin	EV/Sales 2021E	EV/Sales 2020E	EV/Sales LTM	Included in Average?	Enterprise Value
Accenture	ACN	47,600	44,300	44,330	16%	2.8	3.0	3.0	y	131,450
Cognizant	CTSH	17,310	16,540	16,760	20%	2.2	2.3	2.3	y	37,820
Computer Task Group	CTG	369	354	364	3%	0.2	0.2	0.2	y	77
Infosys	INFY	14,000	13,000	12,870	25%	4.1	4.4	4.4	y	57,000
Kforce Inc.	KFRC	1,380	1,380	1,360	6%	0.6	0.6	0.6	y	833
Wipro	WIT	8,800	8,300	8,400	24%	3.4	3.6	3.5	y	29,600
Average					15.7%	2.2	2.3	2.3		6,568

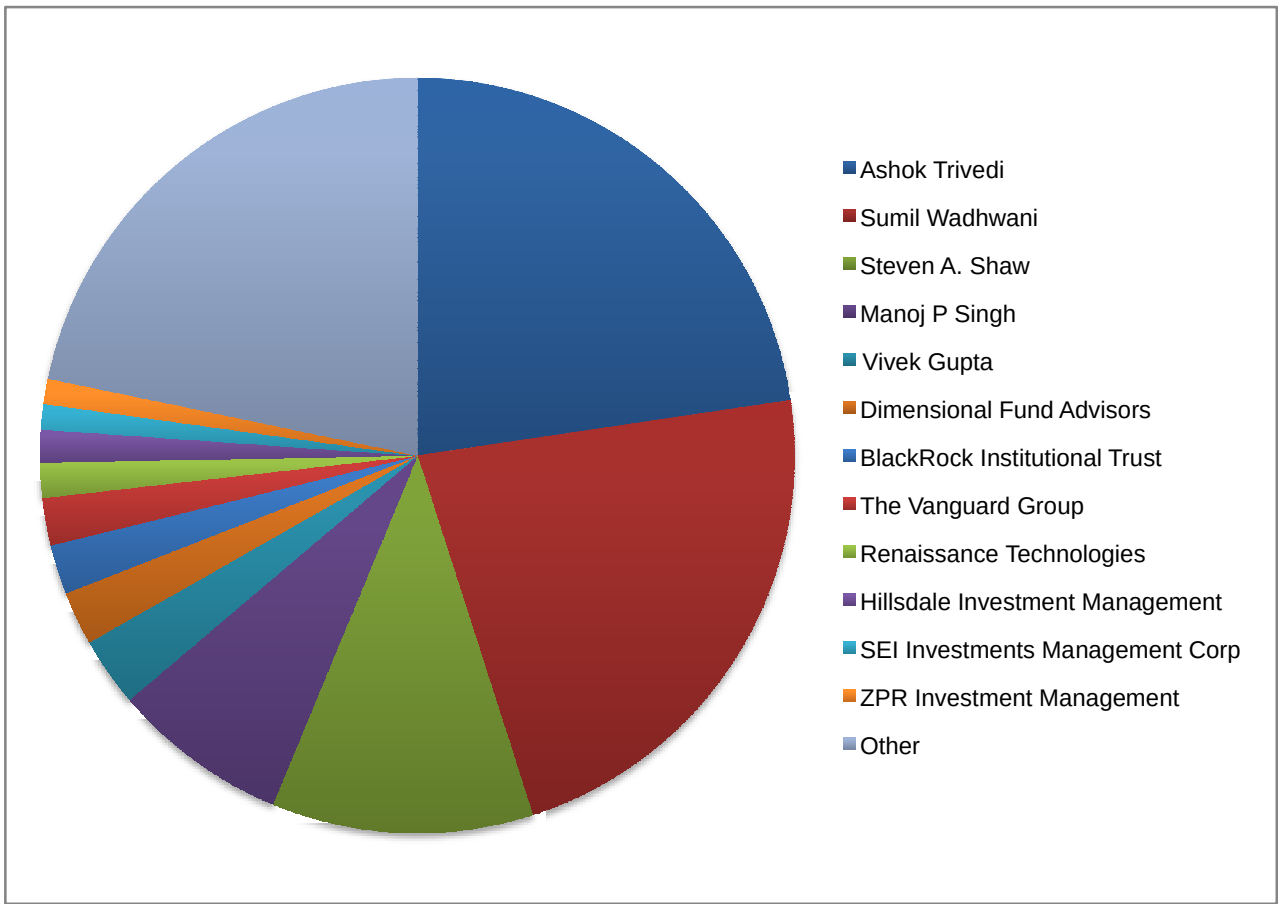
	Projected Revenue 2021E	Projected Revenue 2020E	Projected Revenue TTM	EV/Sales 2021E	EV/Sales 2020E	EV/Sales TTM	Valuation Range Low	Valuation Range High
	247	197	196	2.2	2.3	2.3	457	460
YoY growth								

Conclusion of Enterprise Value	**$458,294,663**
Market Value	**$448,529,663**
Fully diluted shares	11,381,000
Price per Share	**$39.41**

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	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020E			
	31-Mar	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	2019	2020E	2021E
Billable consultants	1,116	1,113	1,197	1,167	1,100	1,035	1,037	1,050	1,165	1,050	1,500
Average bill rate per hour	74.56	74.75	74.60	NA	NA	NA	NA	NA	74.97	NA	74.70
IT Staffing Services	39,431	41,818	42,463	43,199	43,065	40,811	40,207	41,000	166,911	165,083	198,000
Yr-to-yr Growth	7%	8%	10%	10%	9%	-2%	-5%	-5%	9%	-1%	20%
IT Staffing Gross Margin	8,202	8,991	9,087	9,245	9,259	9,142	9,087	9,307	35,524	36,794	43,560
Gross Margin %	21%	21.5%	21.4%	21.4%	21.5%	22.4%	22.6%	22.7%	21.3%	22.3%	22.0%
Data & Analytics Services	5,768	6,654	7,080	7,161	7,360	6,772	7,176	10,300	26,663	31,608	48,600
Yr-to-yr Growth	-12%	9%	22%	34%	28%	2%	1%	44%	12%	19%	54%
Data & Analytics Gross Margin	2,624	3,067	3,236	3,516	3,467	3,535	4,011	5,768	12,444	16,781	23,085
Gross Margin %	46%	46%	46%	49%	47%	52%	56%	56%	46.7%	53.1%	48%
Revenue	**$45,199**	**$48,472**	**$49,543**	**$50,360**	**$50,425**	**$47,583**	**$47,383**	**$51,300**	**$193,574**	**$196,691**	**$246,600**
Yr-to-yr Growth	4%	8%	12%	13%	12%	-2%	-4%	2%	9.3%	1.6%	25.4%
Cost of revenue	34,364	36,418	37,214	37,597	37,706	34,927	34,293	36,892	145,593	143,818	179,955
Gross profit	10,835	12,054	12,329	12,763	12,719	12,656	13,090	14,409	47,981	52,874	66,645
Gross Margin %	24.0%	24.9%	24.9%	24.5%	25.2%	26.6%	27.6%	28.1%	24.8%	26.9%	27.0%
SG&A	8,965	9,544	9,259	9,295	10,243	9,042	8,873	9,850	37,063	38,008	50,000
Impairment of goodwill	0	0	0	0	0	0	0	0	0	0	0
Revaluation of contingent consideration liabilty	0	(6,069)	0	0	0	0	0	0	(6,069)	0	0
Total operating expenses	8,965	3,475	9,259	9,295	10,243	9,042	8,873	9,850	30,994	38,008	50,000
Operating income:	1,870	8,579	3,070	3,468	2,476	3,614	4,217	4,559	16,987	14,866	16,645
Operating margin	4.1%	17.7%	6.2%	6.9%	4.9%	7.6%	8.9%	8.9%	8.8%	7.6%	6.7%
Other income:											
Interest income	(539)	(468)	(413)	NA	NA	NA	NA	NA	NA	(1,024)	(400)
Other income	(15)	(39)	33	NA	NA	NA	NA	NA	NA	-	-
Total other income	(554)	(507)	(380)	(327)	(226)	(157)	(191)	(450)	(1,768)	(1,024)	(400)
Income before income taxes	1,316	8,072	2,690	3,141	2,250	3,457	4,026	4,109	15,219	13,842	16,245
Pretax Margin	2.9%	16.7%	5.4%	6.2%	4.5%	7.3%	8.5%	8.0%	7.9%	7.0%	6.6%
Income taxes	352	2,114	741	867	381	488	1,028	1,007	4,074	2,904	4,386
Tax rate	27%	26%	28%	28%	17%	14%	26%	25%	26.8%	21%	26%
Net income	964	5,958	1,949	2,274	1,869	2,969	2,998	3,102	11,145	10,938	11,859
Yr-over-Yr	-30%	112%	20%	160%	94%	-50%	54%	36%	67%	-2%	8%
Stk based compensation	236	267	263	170	456	612	462	462	936	1,100	1,100
One-time expenses	431	(4,046)	338	(224)	377	328	386	386	(5,518)	1,477	1,700
Non-GAAP Income	1,631	2,179	2,550	2,891	2,702	3,909	3,846	3,950	9,251	13,515	14,659
Yr-over-Yr	-17%	-5%	16%	63%	66%	79%	51%	37%	12.1%	46%	8%
Net income per share:											
Primary EPS	0.09	0.54	0.18	0.21	0.17	0.26	0.26	0.27	1.01	0.99	1.07
Diluted EPS	0.09	0.53	0.17	0.20	0.16	0.25	0.25	0.26	0.99	0.99	1.07
Diluted Non-GAAP EPS	0.15	0.20	0.23	0.26	0.23	0.33	0.32	0.33	0.82	1.22	1.32
	-18%	-6%	16%	61%	59%	68%	40%	28%	11%	49%	8%

BALANCE SHEET

	Sept. 30, 2020	Jun. 30, 2020	Qtr-Qtr % Growth	Sept. 30, 2019	Yr-Yr % Growth
Current assets:					
Cash and equivalents	**$ 4,014**	**$ 4,743**	-15.4%	**$ 1,963**	104.5%
Accounts receivable, net	31,258	31,208	0.2%	26,537	17.8%
Unbilled receivables	0	0	0.0%	8,423	-100.0%
Prepaid expenses & other curr assets	2,647	1,224	116.3%	1,392	90.2%
Total current assets	37,919	37,175	2.0%	38,315	-1.0%
Equipment, software and leasehold net	2,133	2,230	-4.3%	1,749	22.0%
Right-of-use assets	3,642	3,978	-8.4%	4,993	-27.1%
Non-current deposits	392	385	1.8%	410	-4.4%
Goodwill, net	26,106	26,106	0.0%	26,106	0.0%
Intangible assets, net	18,052	18,708	-3.5%	20,721	-12.9%
Total assets	88,244	88,582	-0.4%	93,079	-5.2%
Current liabilities:					
Current portion of long-term debt, net	**4,575**	**4,575**	0.0%	**4,575**	0.0%
Acconts payable	3,114	3,073	1.3%	4,359	-28.6%
Accrued payroll and related costs	11,325	9,616	17.8%	9,828	15.2%
Current portion of operating lease liability	1,188	1,295	-8.3%	1,407	-15.6%
Other accrued liabilities	739	1,554	-52.4%	1,329	-44.4%
Deferred revenue	0	0	0.0%	246	-100.0%
Total current liabilities	20,941	20,113	4.1%	21,744	-3.7%
Long-term debt, net	**3,865**	**9,933**	-61.1%	**22,547**	-82.9%
Lease liability	2,558	2,760	-7.3%	3,686	-30.6%
Long term accrued income taxes	185	185	0.0%	204	-9.3%
Long term payroll tax liability	3,107	1,495	107.8%	0	NM
Long term deferred income taxes	726	837	-13.3%	1,082	-32.9%
Total liabilities	31,382	35,323	-11.2%	49,263	-36.3%
Stockholders' equity					
Common stock	130	130	0.0%	127	2.4%
Additional paid-in capital	24,901	24,432	1.9%	21,700	14.8%
Retained earnings	36,595	33,597	8.9%	26,485	38.2%
Accumulated other comp loss	(577)	(713)	-19.1%	(309)	86.7%
Treasury stock, at cost	(4,187)	(4,187)	0.0%	(4,187)	0.0%
Total stockholders' equity	56,862	53,259	6.8%	43,816	29.8%
Total liabilities and stockholders' equity	88,244	88,582	-0.4%	93,079	-5.2%
Current and quick ratio	1.8	1.8	-2.0%	1.8	2.8%
Working Capital	16,978	17,062	-0.5%	16,571	2.5%
Net cash	4,014	4,743	-15.4%	1,963	104.5%
Debt	8,440	14,508	-41.8%	27,122	-68.9%
Debt/TA	10%	16%	-41.6%	29%	-67.2%

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	3 Mo Ended Jun 30, 2020
Cash flows from operating activities:								
Net income	6,691	964	5,958	1,949	2,274	11,145	1,869	2,959
Adjustments to reconcile net income to net cash provided by operating activities:								
Depreciation and amortization	3,182	839	869	869	857	3,434	873	868
Bad debt expense	10	-	30	50	-	80	-	-
Interest amortization of deferred financing costs	100	26	26	26	26	104	26	26
Stock-based compensation	470	236	267	263	170	936	456	612
Deferred income taxes, net	171	(95)	1,549	(75)	(57)	1,322	(182)	(6)
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)	14
Change in operating assets and liabilities:								
Accounts receivable & unbilled receivables	(7,428)	(1,051)	3,310	781	2,608	5,648	(1,244)	2,388
Prepaid expenses and other current assets	283	110	(248)	(52)	(196)	(386)	492	(169)
Accounts payable	(901)	(196)	(22)	450	(332)	(100)	(587)	(367)
Accrued payroll	(1,241)	(112)	2,472	(260)	(1,926)	174	1,554	1,655
Other accrued liabilities	(461)	327	(448)	232	(375)	(264)	(276)	668
Deferred revenues	(172)	80	(164)	72	(9)	(21)	(151)	122
Net cash used by operating activities	(471)	1,128	7,625	4,310	3,021	16,084	2,795	8,770
Cash flows from Investing activities:								
(Payment for) recovery of non-current deposits	(285)	9	84	37	5	135	17	3
Capital expenditures	(771)	(404)	(190)	(292)	(128)	(1,014)	(119)	(36)
Net cash used in investing activities	(1,056)	(395)	(106)	(255)	(123)	(879)	(102)	(33)
Cash flows from Financing activities:								
Borrowings on revolving credit facility, net	4,526	656	(4,183)	(4,701)	4,252	(3,976)	(2,244)	(2,307)
(Repayments) on term loan facility	(4,003)	(1,144)	(1,144)	(1,144)	(6,143)	(9,575)	(1,144)	(5,106)
Proceeds from the issuance of common shares	-		106	-	62	168	-	107
Payment of deferred financing costs	(71)	-	-	-	-	-	-	-
Purchase of treasury stock	(20)		(13)	-	-	(13)	-	-
Proceeds from the exericise of stock options	118	-	-	-	7	7	556	765
Net cash provided by financing activities	550	(488)	(5,234)	(5,845)	(1,822)	(13,389)	(2,832)	(6,541)
Effect of exchange rate changes of cash	(207)	9	36	(116)	(58)	(129)	(267)	(38)
Net change - cash	(1,184)	254	2,321	(1,906)	1,018	1,687	(406)	2,168
Cash, beginning of quarter	2,478	1,294	1,548	3,869	1,963	1,294	2,981	2,575
Cash, end of period	1,294	1,548	3,869	1,963	2,981	2,981	2,575	4,743
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	4,473
Free cash flow	8,678	1,566	2,535	2,795	3,123	10,019	2,888	4,437

HISTORICAL STOCK PRICE



Source: Zacks Investment Research

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