Zacks Small-Cap Research

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Mastech Digital (NYSE Amer: MHH)

MHH: Continued Economic Weakness Leads to Estimate Cuts Despite an Improving D&A Pipeline

Based on an industry average EV to sales of 1.8xs estimated 2023 revenues, we believe MHH stock could be worth $34.00 per share.

Current Price (5/2/2023)	$9.13
Valuation	**$34.00**

OUTLOOK

Mastech Digital, based outside Pittsburgh, PA is an IT staffing business with a data and analytics, consulting, and project management service serving blue-chip customers in the US. Both businesses have been affected by the rapid decline in the economy and IT hiring as customers pull back. The company trades well below its peers and we expect stock price appreciation when it returns to growth aided by stock buybacks. It also plans to grow through acquisition. The potential for recession is hurting the staffing industry and lowering valuations.

SUMMARY DATA

52-Week High	**$18.82**
52-Week Low	**$8.57**
One-Year Return (%)	**-51.4**
Beta	**0.7**
Average Daily Volume (sh)	**124,284**
Shares Outstanding (mil)	**11.6**
Market Capitalization ($mil)	**$106**
Short Interest Ratio (days)	**1.6**
Institutional Ownership (%)	**15**
Insider Ownership (%)	**63**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**8.4**
Earnings Per Share (%)	**15.4**
Dividend (%)	**N/A**
P/E using TTM EPS	**9.4**
P/E using 2023 Estimate	**15.7**
P/E using 2024 Estimate	**7.2**

Risk Level	**Above Average**
Type of Stock	**Small Value**
Industry	**IT Services**

ZACKS ESTIMATES

Revenue
(In millions of US$)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2021	$50 A	$54 A	$60 A	$59 A	$222 A
2022	$60 A	$62 A	$63 A	$57 A	$242 A
2023	$55 A	$55 E	$56 E	$59 E	$224 E
2024					$239 E

Non-GAAP Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2021	$0.19 A	$0.29 A	$0.38 A	$0.34 A	$1.19 A
2022	$0.28 A	$0.30 A	$0.33 A	$0.23 A	$1.13 A
2023	$0.12 A	$0.11 E	$0.15 E	$0.20 E	$0.58 E
2024					$1.26 E

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Mastech Digital Reports Q1 and Sees Slightly Improving Pipeline

Mastech reported a revenue decline of 8% in Q1 as customers, particularly in financial services, pulled back as the banking crisis continues. While 50% of Mastech's IT staffing consultants work for financial services companies, which include insurance companies and its largest customer CGI, they are primarily working for tier 1 banks such as PNC reducing risk. IT Staffing could see improved results if utilization improves. Data and Analytics has already shown sequential improvement as its pipeline and bookings improved throughout 2023. It also expects better utilization and margins in Q2 as evidenced by a gross margin in March of 42%.

While IT Staffing may take a hit in this impending recession, D&A should see continued demand. Mastech helps enterprises modernize their legacy IT systems to fend off competitors. Once they have modernized they can then use the new systems to unlock data to improve operations and cut costs.

The company has a stock buyback plan for 500,000 shares to be executed over the next two years with an extension possible. It is limited to buying 25% of the daily volume each day and at the moment that is only an average of about 30,000 shares per day making the process slow. To date, Mastech had not bought any shares due to extended blackout periods. Its blackout period ends two days after an earnings announcement and begins again when the quarter ends.

Mastech's enterprise value is now under $101 million-- or 0.5 times EV/2023 Estimated Sales. Its peers at 1.8xs. On a PE basis, the stock trades at 15.4 times 2023 non-GAAP EPS. We have again lowered our 2023 outlook in consideration of the weakening global economy and Q1 results.

Revenues Declined 8% in Q1 2023 Primary Due to IT Staffing Demand

Q1 2023 resulted in total revenues of $55.1 million down 7.9% from $59.8 million in Q1 2022. The IT staffing business declined to $45.7 million from $50.9 million a year ago and $48.1 million in Q4 2022. IT staffing was 83% of revenues and ended the quarter with 1,125 billable consultants compared to 1,305 the year before. D&A also declined year over year but improved sequentially to $9.4 million from $9.1 million in Q4 2022.

Gross margins declined to 24.5% from 24.8% in Q4 2022 as business demand and thus utilization weakened. Gross margin dollars were lower for both business segments.

SG&A grew to $13.0 million compared to $12.6 million a year ago. $400,000 of the increase was from expenses due to the threat of an employee compensation lawsuit. D&A plans to spend more as it builds needed management and staffing while IT staffing is holding back on expenses. We expect expenses related to the unlawful termination issue to continue for the time being and SG&A to continue to grow through 2023.

Operating income declined to $532,000 versus $3.3 million last year. Other income was an expense of $53,000 compared to an expense of $60,000 a year ago. For the quarter the tax rate was 46%, compared to 28% last year. We expect the tax rate for the year to work out to the typical 27-28%.
GAAP net income was $261,000, down 89% from a year ago. On a non-GAAP basis, it was $1.4 million down 58%. GAAP EPS was $0.02 diluted compared to $0.19 a year ago and $0.13 in Q4 2022. On a non-GAAP basis, it was $0.12 versus $0.28. The fully diluted share count was 12.1 million, up 19,000 shares year over year. In the quarter the company bought back no stock due to extended blackout periods but called the current stock price a bargain and expects to buy back stock as the blackouts cease.

Balance Sheet

The company ended the year with $9.1 million in net cash, a quick ratio of 2.9xs, working capital of $35.6 million, and no debt. It paid back the remaining $1.1 million of its debt in January. That completes the repayment of the $10 million used to buy AmberLeaf. The company has positive free cash flow and considerable debt capacity. It currently has a borrowing availability of $31.5 million under a revolving credit facility. Additionally, its credit facility's accordion feature can provide it with up to an additional $20 million in term loan capacity for M&A activity.

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. It added to this business in Q4 2020 with the purchase of AmberLeaf. This business operates at a higher margin and is ultimately expected to be 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 leaves it with increasing debt capacity and cash to grow through acquisition.

- The economy has recently worsened and customers have pulled back on projects and reduced IT spending. However, the data & analytics business could reaccelerate under new management.

- Today MHH is trading at a fully diluted enterprise value of $121 million. That is 0.5 times its enterprise value to 2023 estimated sales versus its peers who trade at 1.8 times.

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 the UK; and it recruits and provides IT outsourcing through its locations in Noida and Chennai, India. On December 31, 2022, it had 1,071 North American employees and 624 employees offshore, in addition to 324 subcontracted professionals. Then 27% of the workforce was working under Mastech-sponsored H1-B temporary work permits. 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 data analytics, data management, and big data through its acquisition of InfoTrellis in 2017, and of AmberLeaf in 2020. It reports the earnings of these two segments. IT staffing is still the largest part of the company but the smaller and higher margin, data and analytics business should ultimately be an increasing percentage of total revenues going forward. This dynamic should result in continued accelerating margin expansion going forward, and this growth could result in an expansion of the stock’s PE ratio.

VALUATION

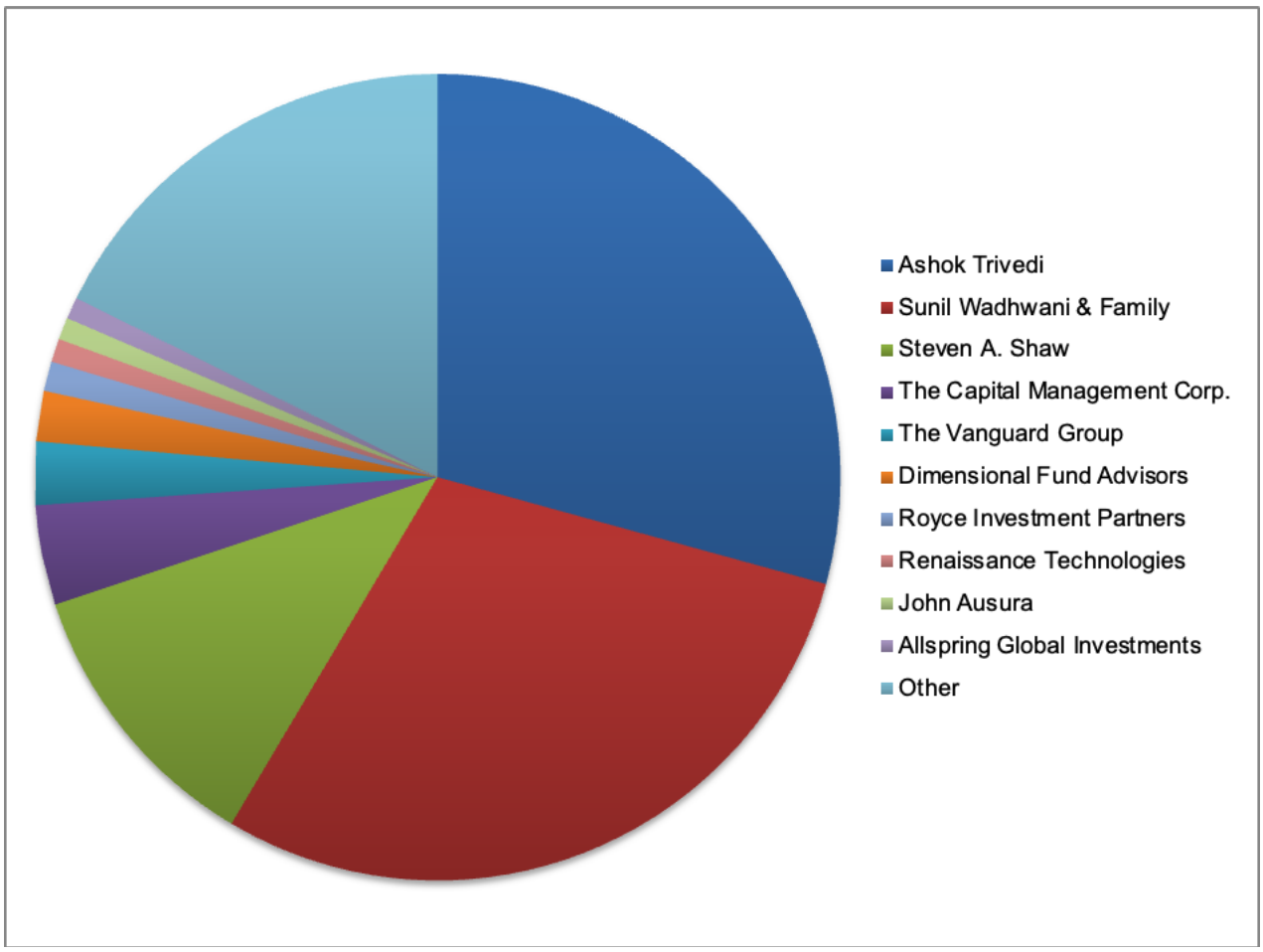
To value MHH we are using comparable peer companies that staff technology people. Their valuations now average 1.8 times EV to estimated 2023 sales. Using that average multiple and applying it to Mastech's forecasted 2023 revenues the stock would be worth a market cap of $412 million or $34 per share.

Company	Ticker	Calendar Revenue 2024E	Calendar Revenue 2023E	LTM	EBIDTA Margin	EV/Sales 2024E	EV/Sales 2023E	EV/Sales LTM	Included in Average?	Enterprise Value
Accenture	ACN	NA	65,800	63,140	17%	NA	2.6	2.7	y	172,500
Cognizant	CTSH	20,640	19,560	19,430	18%	1.4	1.5	1.5	y	29,300
Computer Task Group	CTG	331	319	325	5%	0.3	0.3	0.3	y	99
Infosys	INFY	NA	19,100	18,210	23%	NA	3.3	3.4	y	62,510
Kforce Inc.	KFRC	1,710	1,640	1,710	7%	0.7	0.7	0.7	y	1,220
Wipro	WIT	NA	11,300	11,200	17%	NA	2.1	2.1	y	23,400
Average					14.4%	1.1	1.8	1.8		44,271

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. Customers are bracing for a possible recession and have become more cautious with projects which has affected revenues and earnings and could continue to do so going forward.
- The company is almost entirely dependent on the US market in the IT staffing segment.
- The top ten clients represented 53% of sales in 2022. For 2022, only CGI exceeded 10% of revenues and contributed 22.2%. Approximately 50% of its IT staffing consultants work in the financial services business which includes insurance companies and CGI.
- Any regulatory changes regarding H-1B visas could eventually trickle down to Mastech's pool of potential consultants; approximately 27% 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 especially overseas could decrease this risk.
- The IT hiring market is hot and highly competitive. The company is having difficulty retaining consultants as their opportunities for employment have vastly increased recently. This demand exceeding supply could hurt the ability to hire and place staff and constrain revenue and earnings growth.
- The worldwide economy is facing a recession which could dampen demand.

OWNERSHIP


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Sunil Wadhwani & Family
Steven A. Shaw
The Capital Management Corp.
The Vanguard Group
Dimensional Fund Advisors
Royce Investment Partners
Renaissance Technologies
John Ausura
Allspring Global Investments
Other

INCOME STATEMENT

Billable consultants	1,305	1,357	1,314	1,208	1,125	1,120	1,154	1,188	1,267	1,208	1,188	1,236
IT Staffing Services	49,603	50,867	53,074	48,100	45,668	45,000	45,000	48,000	183,673	201,644	183,668	192,851
Yr-to-yr Growth	21%	14%	8%	-2%	-8%	-12%	-15%	0%	12%	10%	-10%	5%
IT Staffing Gross Margin	11,359	11,852	12,313	10,823	9,864	9,720	9,900	10,560	40,867	46,378	40,044	45,127
Gross Margin %	22.9%	23.3%	23.2%	22.5%	21.6%	21.6%	22.0%	22.0%	22.2%	23.0%	21.8%	23.4%
Data & Analytics Services	10,152	11,250	10,076	9,116	9,395	9,600	10,700	10,700	38,339	40,594	40,395	46,454
Yr-to-yr Growth	15.4%	25.7%	-4.2%	-9.5%	-7.5%	-14.7%	6.2%	17.4%	26.8%	5.9%	-0.5%	15%
Data & Analytics Gross Margin	4,589	4,905	3,990	3,373	3,617	4,032	4,515	4,601	18,554	16,847	16,765	20,904
Gross Margin %	45.2%	43.6%	39.6%	37.0%	38.5%	42.0%	42.2%	43.0%	48.4%	41.5%	41.5%	45.0%
Revenue	**$59,755**	**$62,117**	**$63,150**	**$57,216**	**$55,063**	**$54,600**	**$55,700**	**$58,700**	**$222,012**	**$242,238**	**$224,063**	**$239,306**
Yr-to-yr Growth	20.1%	15.8%	6.1%	-3.1%	-7.9%	-12.1%	-11.8%	2.6%	14%	9.1%	-8.1%	7%
Cost of revenue	43,823	45,371	46,863	42,998	41,581	45,371	46,863	43,539	162,568	179,055	167,253	173,274
Gross profit	15,932	16,746	16,287	14,218	13,482	13,752	14,415	15,161	59,444	63,183	56,810	66,032
Gross Margin %	26.7%	27.0%	25.8%	24.8%	24.5%	25.2%	25.9%	25.8%	26.8%	26.1%	25.4%	27.6%
SG&A	12,625	13,198	12,930	12,231	12,950	13,000	13,100	13,100	44,716	50,984	52,150	52,000
Revaluation of contingent consideration liabilty	0	0	0	0	0	0	0	0	(2,882)	0	0	0
Total operating expenses	12,625	13,198	12,930	12,231	12,950	13,000	13,100	13,100	41,834	50,984	52,150	52,000
Operating income:	3,307	3,548	3,357	1,987	532	752	1,315	2,061	17,610	12,199	4,660	14,032
Operating margin	5.5%	5.7%	5.3%	3.5%	1.0%	1.4%	2.4%	3.5%	7.9%	5.0%	2.1%	5.9%
Other income:												
Total other income	(60)	68	0	284	(53)	0	0	0	(724)	292	(53)	200
Income before income taxes	3,247	3,616	3,357	2,271	479	752	1,315	2,061	16,886	12,491	4,607	14,232
Pretax Margin	5.4%	5.8%	5.3%	4.0%	0.9%	1.4%	2.4%	3.5%	7.6%	5.2%	2.1%	5.9%
Income taxes	915	1,180	951	733	218	205	358	561	4,665	3,779	1,341	3,914
Tax rate	28%	33%	28%	32%	46%	27%	27%	27%	28%	30%	29%	28%
Net income	2,332	2,436	2,406	1,538	261	547	958	1,500	12,221	8,712	3,266	10,318
Yr-over-Yr	95%	-35%	-29%	-60%	-89%	-78%	-60%	-2%	11%	-28.7%	-166.8%	216%
Stk based compensation	526	792	776	171	835	500	500	500	2,212	2,225	2,335	2,500
One-time expenses plus amortization	452	346	853	1,059	305	305	305	305	(160)	2,750	1,220	1,601
Non-GAAP Income	3,310	3,574	4,035	2,768	1,401	1,352	1,763	2,305	14,273	13,687	6,821	14,418
Yr-over-Yr	48%	4%	-12%	-31%	-58%	-62%	-56%	-17%	11%	-4%	-100.7%	111%
Net income per share:												
Primary EPS	0.20	0.21	0.21	0.13	0.02	0.05	0.08	0.13	1.07	0.75	0.28	0.91
Diluted EPS	0.19	0.20	0.20	0.13	0.02	0.05	0.08	0.13	1.02	0.72	0.28	0.90
Diluted Non-GAAP EPS	0.28	0.30	0.33	0.23	0.12	0.11	0.15	0.20	1.19	1.13	0.58	1.26
	47%	3%	-12%	-32%	-58%	-61%	-55%	-12%	11%	-5%	-95.3%	117%
Shares												
Basic	11,509	11,607	11,616	11,620	11,638	11,538	11,438	11,338	11,436	11,588	11,488	11,338
Yr-over-Yr	0.8%	1.4%	1.5%	1.5%	1.1%	-0.6%	-1.5%	-2.4%	1%	1%	-0.9%	-1%
Diluted	12,035	12,110	12,084	12,063	12,054	11,854	11,654	11,454	$12,007	12,077	11,754	11,454
Yr-over-Yr	0.3%	0.9%	0.5%	0.2%	0.2%	-2.1%	-3.6%	-5.0%	0%	1%	-2.7%	-3%

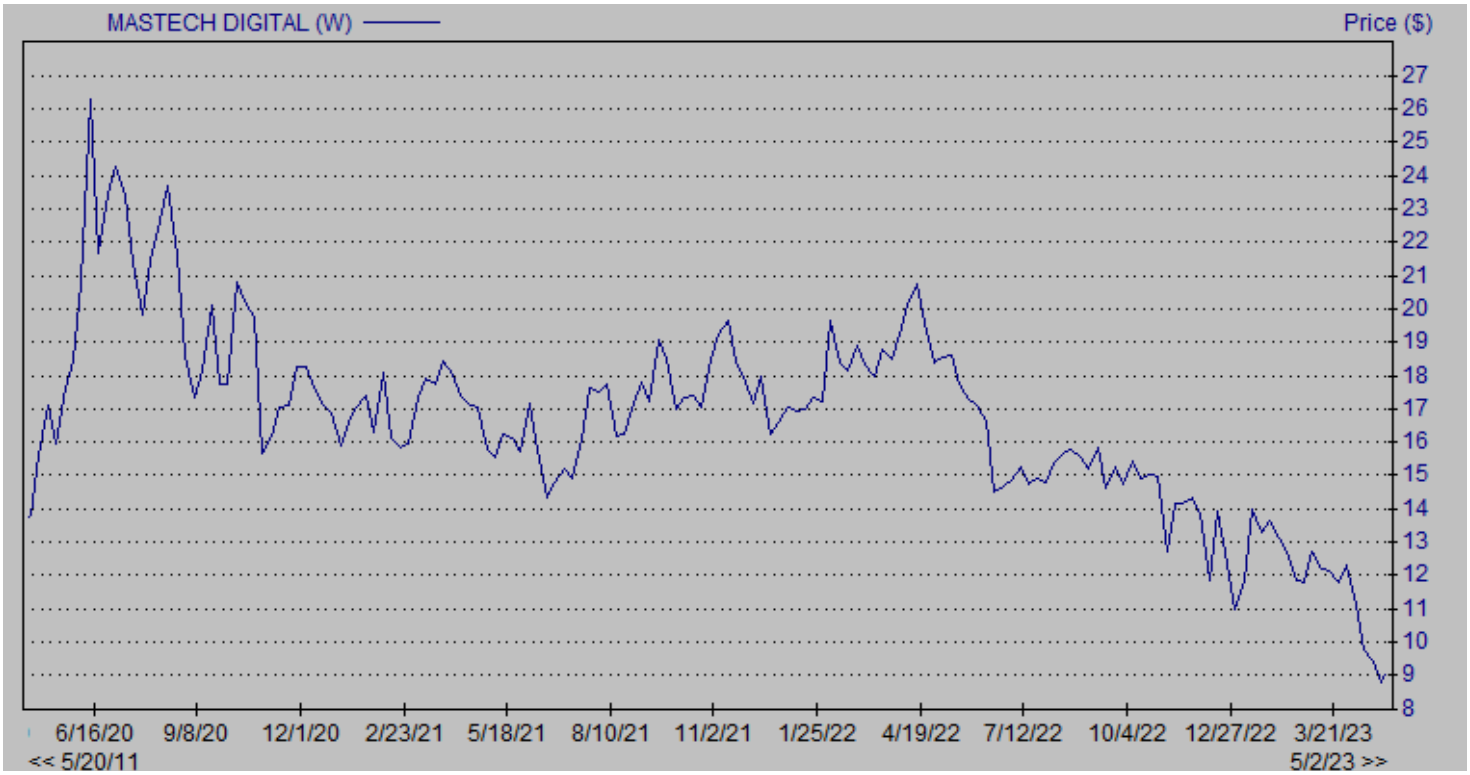
BALANCE SHEET

	Mar. 31, 2023	Dec 31, 2022	Qtr-Qtr % Growth	Mar. 31, 2022	Yr-Yr % Growth
Current assets:					
Cash and equivalents	**$ 9,097**	**$ 7,057**	28.9%	**$ 7,185**	26.6%
Accounts receivable, net	42,078	42,322	-0.6%	46,838	-10.2%
Prepaid expenses & other curr assets	3,353	3,795	-11.6%	3,191	5.1%
Total current assets	54,528	53,174	2.5%	57,214	-4.7%
Equipment, software and leasehold net	2,446	2,665	-8.2%	3,540	-30.9%
Right-of-use assets	3,504	3,886	-9.8%	5,033	-30.4%
Deferred financing costs, net	275	293	-6.1%	0	NA
Non-current deposits	491	578	-15.1%	511	-3.9%
Goodwill, net	32,510	32,510	0.0%	32,510	0.0%
Intangible assets, net	15,080	15,773	-4.4%	17,968	-16.1%
Total assets	108,834	108,879	0.0%	116,776	-6.8%
Current liabilities:					
Current portion of long-term debt, net	**0**	**1,100**	-100.0%	**4,400**	-100.0%
Accounts payable	4,688	4,475	4.8%	6,242	-24.9%
Accrued payroll and related costs	11,481	11,085	3.6%	13,367	-14.1%
Current portion of operating lease liability	1,470	1,504	-2.3%	1,571	-6.4%
Other accrued liabilities	1,338	1,393	-3.9%	1,222	9.5%
Total current liabilities	18,977	19,557	-3.0%	26,802	-29.2%
Long-term debt, net	**0**	**0**	0.0%	**7,252**	-100.0%
Lease liability	1,874	2,294	-18.3%	3,677	-49.0%
Long term accrued income taxes	105	105	0.0%	125	-16.0%
Long term deferred income taxes	674	920	-26.7%	888	-24.1%
Total liabilities	21,630	22,876	-5.4%	38,744	-44.2%
Stockholders' equity					
Common stock	133	133	0.0%	133	0.0%
Additional paid-in capital	32,894	32,059	2.6%	29,667	10.9%
Retained earnings	59,814	59,553	0.4%	53,173	12.5%
Accumulated other comp loss	(1,550)	(1,555)	-0.3%	(754)	105.6%
Treasury stock, at cost	(4,187)	(4,187)	0.0%	(4,187)	0.0%
Total stockholders' equity	87,104	86,003	1.3%	78,032	11.6%
Total liabilities and stockholders' equity	108,734	108,879	-0.1%	116,776	-6.9%
Current and quick ratio	2.9	2.7	5.7%	2.1	34.6%
Working Capital	35,551	33,617	5.8%	30,412	16.9%
Net cash	9,097	7,057	28.9%	7,185	26.6%
Debt	0	1,100	-100.0%	11,652	-100.0%
Debt/TA	0%	1%	-100.0%	10%	-100.0%

CASH FLOWS

	Year 2020	3 Mo Ended Mar 31, 2021	3 Mo Ended Jun 30, 2021	3 Mo Ended Sep 30, 2021	3 Mo Ended Dec 31, 2021	Year 2021	3 Mo Ended Mar 31, 2022	3 Mo Ended Jun 30, 2022	3 Mo Ended Sep 30, 2022	3 Mo Ended Dec 31, 2022	Year 2022
Cash flows from operating activities:											
Net income	9,861	1,194	3,738	3,406	3,883	12,221	2,332	2,436	2,406	1,538	8,712
Adjustments to reconcile net income to net cash provided by operating activities:											
Depreciation and amortization	3,589	997	999	988	995	3,979	1,020	1,108	1,123	944	4,195
Bad debt expense	-	-	-	150	(20)	130	-	-	50	-	50
Interest amortization of deferred financing costs	284	20	21	20	21	82	18	18	19	18	73
Stock-based compensation	2,021	621	757	693	141	2,212	526	752	776	171	2,225
Deferred income taxes, net	(1,821)	(8)	341	480	248	1,061	623	(72)	(55)	159	655
Impairment of goodwill	-	-	-	-	-	-	-	-	-	-	-
Reevaluation of contingent consideration liability	-	-	(1,982)	-	(900)	(2,882)	-	-	-	-	-
Loss on disposition of fixed assets	4	-	-	5	4	9	-	-	-	-	-
Long term accrued income taxes	(20)	-	-	-	(40)	(40)	-	-	(20)	-	(20)
Operating lease assets and liabilities, net	18	12	129	58	(26)	173	(76)	(147)	(132)	(24)	(379)
Change in operating assets and liabilities:											
Accounts receivable & unbilled receivables	2,133	(4,072)	(2,378)	(6,941)	2,002	(11,389)	(3,445)	(4,370)	718	8,118	1,021
Prepaid expenses and other current assets	251	108	(2,178)	(755)	281	(2,544)	699	89	(731)	38	95
Accounts payable	(1,613)	1,326	723	304	12	2,365	1,288	482	(893)	(1,356)	(479)
Accrued payroll	6,287	508	(421)	3,091	(3,607)	(429)	(873)	(117)	2,378	(4,543)	(3,155)
Other accrued liabilities	91	141	(377)	223	215	202	(448)	169	87	151	(41)
Deferred revenues	146	(73)	32	9	98	66	(101)	26	81	(343)	(337)
Net cash used by operating activities	21,231	774	(596)	1,731	3,307	5,216	1,563	374	5,807	4,871	12,615
Cash flows from Investing activities:											
Acquisition of Amberleaf, net	(9,345)	-	-	-	-	-	-	-	-	-	-
(Payment for) recovery of non-current deposits	9	(63)	(136)	(2)	2	(199)	84	20	(80)	(7)	17
Capital expenditures	(298)	(128)	(198)	(525)	(1,044)	(1,895)	(730)	(67)	(22)	(16)	(835)
Proceeds from sale of fixed assets	-	-	-	10	-	10	-	-	-	-	-
Net cash used in investing activities	(9,634)	(191)	(334)	(517)	(1,042)	(2,084)	(646)	(47)	(102)	(23)	(818)
Cash flows from Financing activities:											
Borrowings on revolving credit facility, net	(9,551)	-	-	-	-	-	-	-	-	-	-
Borrowing on term loan facility	17,500	-	-	-	-	-	-	-	-	-	-
(Repayments) on term loan facility	(15,969)	(1,100)	(1,100)	(1,100)	(1,100)	(4,400)	(1,100)	(1,100)	(8,700)	(1,100)	(12,000)
Proceeds from the issuance of common shares	222	-	181	-	120	301	-	199	(10)	74	263
Payment of deferred financing costs	(246)	-	-	-	(223)	(223)	-	-	-	-	-
Purchase of treasury stock	-	-	-	-	-	-	-	-	-	-	-
Proceeds from the exericise of stock options	1,330	101	4	-	124	229	893	430	-	-	1,323
Net cash provided by financing activities	(6,714)	(999)	(915)	(1,100)	(1,079)	(4,093)	(207)	(471)	(8,710)	(1,026)	(10,414)
Effect of exchange rate changes of cash	(187)	(19)	(95)	31	(11)	(94)	(147)	(319)	(235)	(247)	(948)
Net change - cash	4,696	(435)	(1,940)	145	1,175	(1,055)	563	(463)	(3,240)	3,575	435
Cash, beginning of quarter	2,981	7,677	7,242	5,302	5,447	7,677	6,622	7,185	6,722	3,482	6,622
Cash, end of period	7,677	7,242	5,302	5,447	6,622	6,622	7,185	6,722	3,482	7,057	7,057
Supplemental information:											
Interest paid	779	-	-	-	-	623	-	-	-	-	324
Income taxes paid	2,681	-	-	-	-	3,831	-	-	-	-	2,164
Cash Flow	13,936	2,836	4,003	5,800	4,306	16,945	4,443	4,095	4,167	2,806	15,511
Free cash flow	13,638	2,708	3,805	5,275	3,262	15,050	3,713	4,028	4,145	2,790	14,676

HISTORICAL STOCK PRICE



Source: Zacks Investment Research

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