Zacks Small-Cap Research

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August 2, 2023
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Mastech Digital (NYSE Amer: MHH)

MHH: Q2 Shows Further Deceleration of Demand as Economic Fears Hit Customers

Based on an industry average EV to sales of 1.9xs estimated 2023 revenues, we believe MHH stock could be worth $35.50 per share.

Current Price (8/1/2023)	$11.22
Valuation	**$35.50**

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 a recession, the banking crisis, and inflation is hurting the staffing industry and lowering sales and valuations.

SUMMARY DATA

52-Week High	**$16.36**
52-Week Low	**$8.57**
One-Year Return (%)	**-16.3**
Beta	**0.7**
Average Daily Volume (sh)	**10,026**
Shares Outstanding (mil)	**11.6**
Market Capitalization ($mil)	**$131**
Short Interest Ratio (days)	**0.7**
Institutional Ownership (%)	**17**
Insider Ownership (%)	**48**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**8.0**
Earnings Per Share (%)	**12.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**14.2**
P/E using 2023 Estimate	**26.1**
P/E using 2024 Estimate	**13.4**

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	$52 A	$50 E	$50 E	$207 E
2024					$220 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 A	$0.10 E	$0.10 E	$0.43 E
2024					$0.84 E

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Mastech Digital Reports Q2 and Improved Bookings for D&A

Mastech reported a year-over-year revenue decline of 16% in Q2 as customers, particularly in financial services, continued to pull back due to the worsening economy, inflation woes, and the continuing banking crisis. Customers continue to delay spending making forecasts even more uncertain. Revenues were also down sequentially for both businesses. The bright spots were improving gross margin due to utilization and an increase in booking for D&A. Bookings for the quarter were $10.1 million up $1.7 million from Q1 2023. While the company sees some improvement it has not been enough to consider it a trend. During the quarter started to buy back stock under its new program and purchased 62,000 shares. We expect further buybacks given the company's healthy cash position and return on investment at these stock prices.

This quarter the company expand its staffing offering and on May 31st it began placing engineering talent with customers. While it only has a few people in the field so far, it is a source of additional revenue that utilizes the same recruiting staff and sales agents and has similar economics to IT staffing.

Mastech's enterprise value is now under $101 million-- or 0.6 times EV/2023 Estimated Sales. Its peers at 1.9xs. On a PE basis, the stock trades at 13.4 times 2024 non-GAAP EPS. We have again lowered our 2023 outlook in consideration of the weakening global economy and Q2 results.

Revenues Declined 16% in Q2 2023 As Customers Pull Back Spending

Q2 2023 resulted in total revenues of $52.2 million down 16.0% from $62.1 million in Q2 2022. The IT staffing business declined to $43.4 million from $50.9 million a year ago and $45.7 million in Q1 2023. IT staffing was again 83% of revenues and ended the quarter with 1,041 billable consultants compared to 1,357 the year before. D&A also declined year over year and sequentially to $8.7 million from $9.4 million in Q1 2023.

Gross margins improved in both businesses, but declined to 26.1% from 27.0% in Q2 2022 as business demand and thus utilization weakened. They improved sequentially, however. Staffing went from 21.6% in Q1 2023 to 22.2% while D&A reported a margin of 45.6% compared to 38.5% in Q1 2023 due to improved utilization. Gross margin dollars were lower for both business segments year over year.

SG&A grew to $13.4 million compared to $13.2 million a year ago. The company plans to cut expenses further going forward, much of which is natural and the result of lower revenues. We expect expenses related to the unlawful termination issue to continue until resolution. It was $600,000 of costs in Q2. In the quarter the company took a one-time reserve expense for this issue of $3.1 million. This was the net amount of a $6 million balance sheet reserve netted against expected insurance proceeds.

The operating loss was $2.8 million versus a profit of $3.5 million last year. Other income was $50,000 compared to $68,000 a year ago. Included in this was $120,000 in interest income. We expect that amount to increase based on the company's $18 million in cash and growing, no debt, and current interest rates. For the quarter the tax rate was a credit of 22%, compared to a payment of 33% last year.

GAAP net loss was $2.2 million compared to a profit of $2.4 million last year. On a non-GAAP basis, it was $1.3 million down 64%. GAAP loss per share was $0.19 compared to EPS of $0.20 a year ago. On a non-GAAP basis, it was $0.11 versus $0.30. The fully diluted share count was 12.0 million, down 149,000 shares year over year aided by the stock buyback.

Balance Sheet

The company ended the quarter with $18.6 million in net cash, a quick ratio of 2.5xs, working capital of $35.6 million, and no debt. The company has a positive free cash flow of $x.x million and considerable debt capacity. It currently has a borrowing availability of $23.9 million under its 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.

During the second quarter, Mastech purchased 62,361 shares of common stock at an average price of $9.15 ($570,603) under the share repurchase program. Its original stock buyback plan was 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. Its blackout period ends two days after an earnings announcement and begins again when the quarter ends.

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 has no debt and an increasing cash balance from 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 show improvement under new management.

- Today MHH is trading at a fully diluted enterprise value of $116 million. That is 0.6 times its enterprise value to 2023 estimated sales versus its peers who trade at 1.9 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 man-

agement, 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

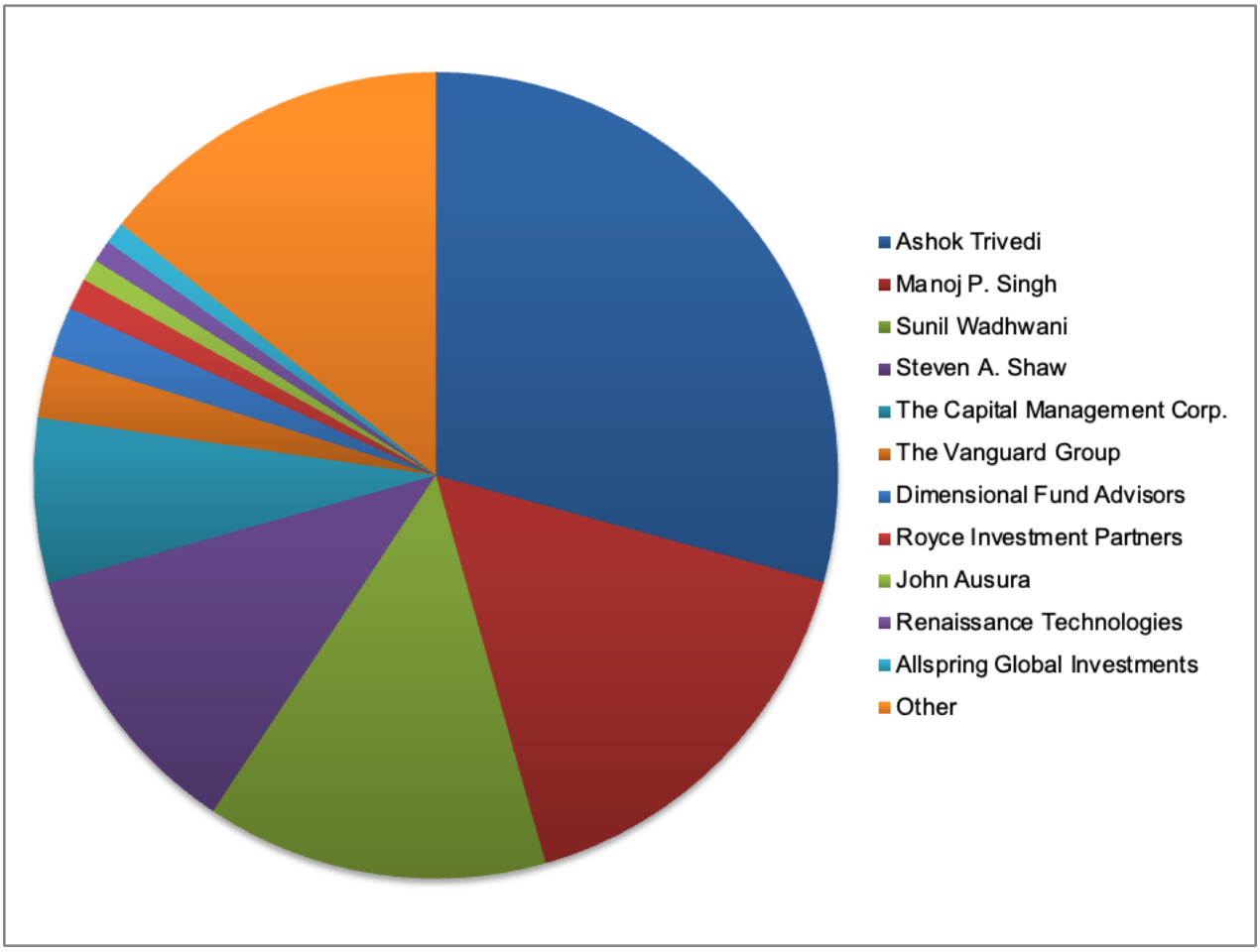
To value MHH we are using comparable peer companies that staff technology people. Their valuations now average 1.9 times EV to estimated 2023 sales. Using that average multiple and applying it to Mastech's forecasted 2023 revenues the stock would be worth a market cap of $412 million or $35.50 per share.

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	65,000	63,550	17%	NA	3.0	3.1	y	197,100
Cognizant	CTSH	20,380	19,460	19,410	18%	1.6	1.7	1.7	y	32,440
Computer Task Group	CTG	323	314	314	4%	0.4	0.4	0.4	y	123
Infosys	INFY	NA	18,700	18,210	23%	NA	3.8	3.9	y	71,050
Kforce Inc.	KFRC	1,530	1,590	1,700	7%	0.8	0.8	0.7	y	1,240
Wipro	WIT	NA	11,350	10,721	17%	NA	2.0	2.1	y	22,610
Average					14.4%	1.2	1.9	2.0		50,326

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 56% of sales in Q1 2023. In that quarter, only CGI exceeded 10% of revenues and it contributed 25.3%; in Q2 it was 24.0% of sales. 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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The Vanguard Group
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Renaissance Technologies
Allspring Global Investments
Other

INCOME STATEMENT

	Q1 2022 31-Mar	Q2 2022 30-Jun	Q3 2022 30-Sep	Q4 2022 31-Dec	Q1 2023 31-Mar	Q2 2023 30-Jun	Q3 2023E 30-Sep	Q4 2023E 31-Dec	2021	2022	2023E	2024E
Billable consultants	1,305	1,357	1,314	1,208	1,125	1,041	1,021	1,020	1,267	1,208	1,020	1,061
IT Staffing Services	49,603	50,867	53,074	48,100	45,668	43,431	41,000	41,000	183,673	201,644	171,099	179,654
Yr-to-yr Growth	21%	14%	8%	-2%	-8%	-15%	-23%	-15%	12%	10%	-18%	5%
IT Staffing Gross Margin	11,359	11,852	12,313	10,823	9,864	9,642	9,102	9,102	40,867	46,378	37,710	42,039
Gross Margin %	22.9%	23.3%	23.2%	22.5%	21.6%	22.2%	22.2%	22.2%	22.2%	23.0%	22.0%	23.4%
Data & Analytics Services	10,152	11,250	10,076	9,116	9,395	8,773	8,700	8,700	38,339	40,594	35,568	39,943
Yr-to-yr Growth	15.4%	25.7%	-4.2%	-9.5%	-7.5%	-22.0%	-13.7%	-4.6%	26.8%	5.9%	-14.1%	12%
Data & Analytics Gross Margin	4,589	4,905	3,990	3,373	3,617	4,000	3,915	3,915	18,554	16,847	15,448	17,974
Gross Margin %	45.2%	43.6%	39.6%	37.0%	38.5%	45.6%	45.0%	45.0%	48.4%	41.5%	43.4%	45.0%
Revenue	**$59,755**	**$62,117**	**$63,150**	**$57,216**	**$55,063**	**$52,204**	**$49,700**	**$49,700**	**$222,012**	**$242,238**	**$206,667**	**$219,597**
Yr-to-yr Growth	20.1%	15.8%	6.1%	-3.1%	-7.9%	-16.0%	-21.3%	-13.1%	14%	9.1%	-17.2%	6%
Cost of revenue	43,823	45,371	46,863	42,998	41,581	38,560	36,683	36,683	162,568	179,055	153,509	159,584
Gross profit	15,932	16,746	16,287	14,218	13,482	13,644	13,017	13,017	59,444	63,183	53,158	60,013
Gross Margin %	26.7%	27.0%	25.8%	24.8%	24.5%	26.1%	26.2%	26.2%	26.8%	26.1%	25.7%	27.3%
SG&A	12,625	13,198	12,930	12,231	12,950	13,372	13,000	13,000	44,716	50,984	52,322	52,000
Impairment of goodwill	0	0	0	0	0	0	0	0	0	0	0	0
Revaluation of contingent consideration liabilty	0	0	0	0	0	0	0	0	(2,882)	0	0	0
Employment-related claim, net	0	0	0	0	0	3,100	0	0	0	0	3,100	0
Total operating expenses	12,625	13,198	12,930	12,231	12,950	16,472	13,000	13,000	41,834	50,984	55,422	52,000
Operating income:	3,307	3,548	3,357	1,987	532	(2,828)	17	17	17,610	12,199	(2,264)	8,013
Operating margin	5.5%	5.7%	5.3%	3.5%	1.0%	-5.4%	0.0%	0.0%	7.9%	5.0%	-1.1%	3.6%
Other income:												
Total other income	(60)	68	0	284	(53)	50	50	50	(724)	292	97	200
Income before income taxes	3,247	3,616	3,357	2,271	479	(2,778)	67	67	16,886	12,491	(2,167)	8,213
Pretax Margin	5.4%	5.8%	5.3%	4.0%	0.9%	-5.3%	0.1%	0.1%	7.6%	5.2%	-1.0%	3.7%
Income taxes	915	1,180	951	733	218	(605)	0	0	4,665	3,779	(387)	2,259
Tax rate	28%	33%	28%	32%	46%	22%	0%	0%	28%	30%	18%	28%
Net income	2,332	2,436	2,406	1,538	261	(2,173)	67	67	12,221	8,712	(1,780)	5,955
Yr-over-Yr	95%	-35%	-29%	-60%	-89%	-189%	-97%	-96%	11%	-28.7%	589.3%	-434%
Stk based compensation	526	792	776	171	835	842	842	842	2,212	2,225	3,361	2,500
One-time expenses plus amortization	452	346	853	1,059	305	2,622	305	305	(160)	2,750	3,537	1,601
Non-GAAP Income	3,310	3,574	4,035	2,768	1,401	1,291	1,214	1,214	14,273	13,687	5,118	10,055
Yr-over-Yr	48%	4%	-12%	-31%	-58%	-64%	-70%	-56%	11%	-4%	-167.5%	96%
Net income per share:												
Primary EPS	0.20	0.21	0.21	0.13	0.02	(0.19)	0.01	0.01	1.07	0.75	(0.15)	0.52
Diluted EPS	0.19	0.20	0.20	0.13	0.02	(0.18)	0.01	0.01	1.02	0.72	(0.15)	0.50
Diluted Non-GAAP EPS	0.28	0.30	0.33	0.23	0.12	0.11	0.10	0.10	1.19	1.13	0.43	0.84
	47%	3%	-12%	-32%	-58%	-63%	-69%	-56%	11%	-5%	-165.1%	97%
Shares												
Basic	11,509	11,607	11,616	11,620	11,638	11,620	11,570	11,520	11,436	11,588	11,587	11,520
Yr-over-Yr	0.8%	1.4%	1.5%	1.5%	1.1%	0.1%	-0.4%	-0.9%	1%	1%	0.0%	-1%
Diluted	12,035	12,110	12,084	12,063	12,054	11,961	11,911	11,950	$12,007	12,077	11,969	11,950
Yr-over-Yr	0.3%	0.9%	0.5%	0.2%	0.2%	-1.2%	-1.4%	-0.9%	0%	1%	-0.9%	0%

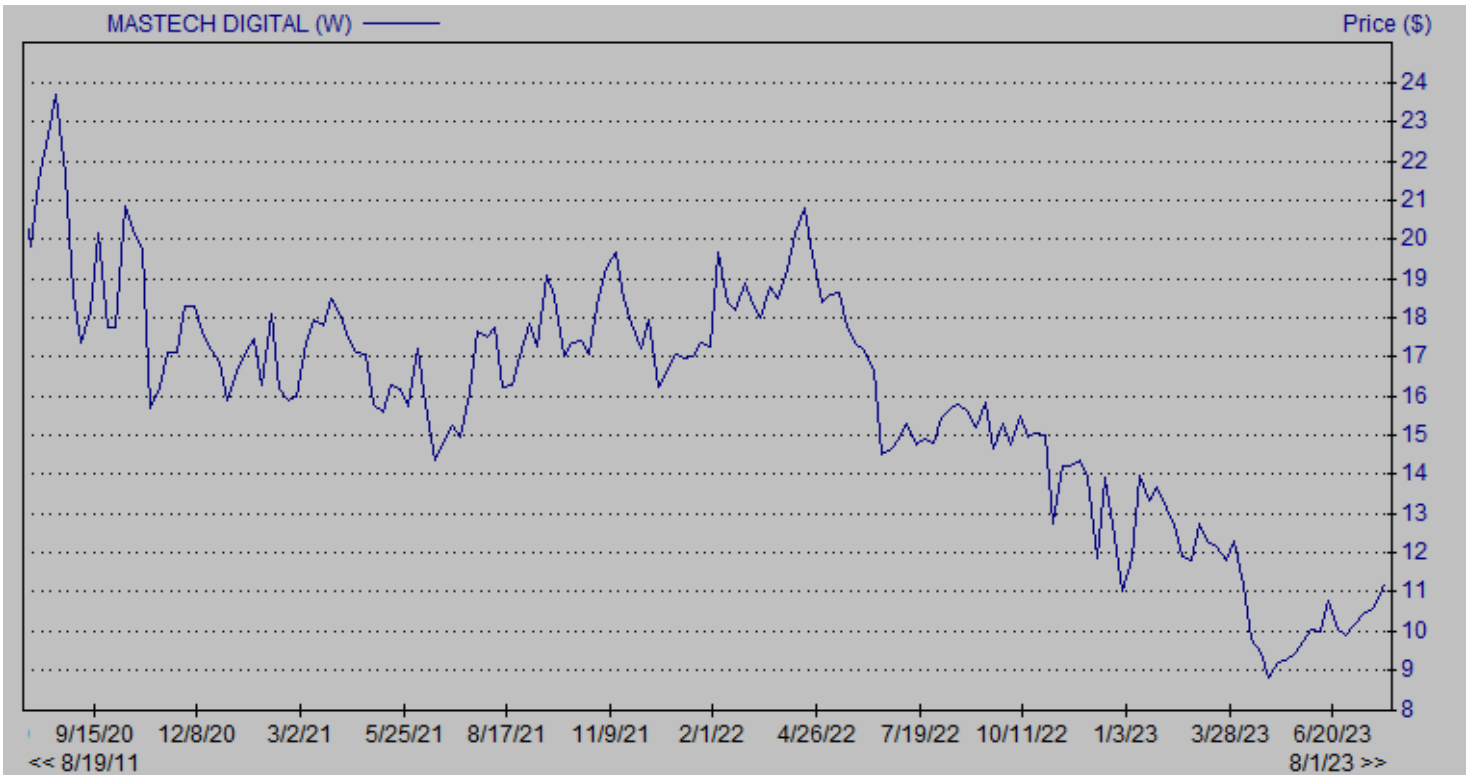
BALANCE SHEET

	June 30, 2023	Mar. 31, 2023	Qtr-Qtr % Growth	June 30, 2022	Yr-Yr % Growth
Current assets:					
Cash and equivalents	**$ 18,614**	**$ 9,097**	104.6%	**$ 6,722**	176.9%
Accounts receivable, net	32,718	42,078	-22.2%	51,208	-36.1%
Insurance recovery	2,200	0	NA	0	NA
Prepaid expenses & other curr assets	4,759	3,353	41.9%	3,102	53.4%
Total current assets	58,291	54,528	6.9%	61,032	-4.5%
Equipment, software and leasehold net	2,143	2,446	-12.4%	3,291	-34.9%
Right-of-use assets	3,118	3,504	-11.0%	4,641	-32.8%
Deferred financing costs, net	256	275	-6.9%	0	NA
Non-current deposits	512	491	4.3%	491	4.3%
Goodwill, net	32,510	32,510	0.0%	32,510	0.0%
Intangible assets, net	14,387	15,080	-4.6%	17,176	-16.2%
Total assets	111,217	108,834	2.2%	119,141	-6.7%
Current liabilities:					
Current portion of long-term debt, net	**0**	**0**	0.0%	**4,400**	-100.0%
Accounts payable	4,382	4,688	-6.5%	6,724	-34.8%
Accrued payroll and related costs	9,949	11,481	-13.3%	13,250	-24.9%
Employment-related claim liability	6,000	0	NA	0	NA
Current portion of operating lease liability	1,228	1,470	-16.5%	1,530	-19.7%
Other accrued liabilities	1,919	1,338	43.4%	1,417	35.4%
Total current liabilities	23,478	18,977	23.7%	27,321	-14.1%
Long-term debt, net	**0**	**0**	0.0%	**6,170**	-100.0%
Lease liability	1,851	1,874	-1.2%	3,179	-41.8%
Long term accrued income taxes	69	105	-34.3%	125	-44.8%
Long term deferred income taxes	480	674	-28.8%	816	-41.2%
Total liabilities	25,878	21,630	19.6%	37,611	-31.2%
Stockholders' equity					
Common stock	133	133	0.0%	133	0.0%
Additional paid-in capital	33,886	32,894	3.0%	31,048	9.1%
Retained earnings	57,641	59,814	-3.6%	55,609	3.7%
Accumulated other comp loss	(1,562)	(1,550)	0.8%	(1,073)	45.6%
Treasury stock, at cost	(4,759)	(4,187)	13.7%	(4,187)	13.7%
Total stockholders' equity	85,339	87,104	-2.0%	81,530	4.7%
Total liabilities and stockholders' equity	111,217	108,734	2.3%	119,141	-6.7%
Current and quick ratio	2.5	2.9	-13.6%	2.2	11.1%
Working Capital	34,813	35,551	-2.1%	33,711	3.3%
Net cash	18,614	9,097	104.6%	6,722	176.9%
Debt	0	0	0.0%	10,570	-100.0%
Debt/TA	0%	0%	0.0%	9%	-100.0%

CASH FLOWS

	Year 2020	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	3 Mo Ended Mar 31, 2023
Cash flows from operating activities:								
Net income	9,861	12,221	2,332	2,436	2,406	1,538	8,712	261
Adjustments to reconcile net income to net cash provided by operating activities:								
Depreciation and amortization	3,589	3,979	1,020	1,108	1,123	944	4,195	1,014
Bad debt expense	-	130	-	-	50	-	50	-
Interest amortization of deferred financing costs	284	82	18	18	19	18	73	18
Stock-based compensation	2,021	2,212	526	752	776	171	2,225	835
Deferred income taxes, net	(1,821)	1,061	623	(72)	(55)	159	655	(245)
Impairment of goodwill	-	-	-	-	-	-	-	-
Reevaluation of contingent consideration liability	-	(2,882)	-	-	-	-	-	-
Loss on disposition of fixed assets	4	9	-	-	-	-	-	1
Long term accrued income taxes	(20)	(40)	-	-	(20)	-	(20)	-
Operating lease assets and liabilities, net	18	173	(76)	(147)	(132)	(24)	(379)	12
Change in operating assets and liabilities:								
Accounts receivable & unbilled receivables	2,133	(11,389)	(3,445)	(4,370)	718	8,118	1,021	245
Prepaid expenses and other current assets	251	(2,544)	699	89	(731)	38	95	452
Accounts payable	(1,613)	2,365	1,288	482	(893)	(1,356)	(479)	210
Accrued payroll	6,287	(429)	(873)	(117)	2,378	(4,543)	(3,155)	385
Other accrued liabilities	91	202	(448)	169	87	151	(41)	(262)
Deferred revenues	146	66	(101)	26	81	(343)	(337)	205
Net cash used by operating activities	21,231	5,216	1,563	374	5,807	4,871	12,615	3,131
Cash flows from Investing activities:								
Acquisition of Amberleaf, net	(9,345)	-	-	-	-	-	-	-
(Payment for) recovery of non-current deposits	9	(199)	84	20	(80)	(7)	17	90
Capital expenditures	(298)	(1,895)	(730)	(67)	(22)	(16)	(835)	(97)
Proceeds from sale of fixed assets	-	10	-	-	-	-	-	-
Net cash used in investing activities	(9,634)	(2,084)	(646)	(47)	(102)	(23)	(818)	(7)
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)	(4,400)	(1,100)	(1,100)	(8,700)	(1,100)	(12,000)	(1,100)
Proceeds from the issuance of common shares	222	301	-	199	(10)	74	263	-
Payment of deferred financing costs	(246)	(223)	-	-	-	-	-	-
Purchase of treasury stock	-	-	-	-	-	-	-	-
Proceeds from the exericise of stock options	1,330	229	893	430	-	-	1,323	-
Net cash provided by financing activities	(6,714)	(4,093)	(207)	(471)	(8,710)	(1,026)	(10,414)	(1,100)
Effect of exchange rate changes of cash	(187)	(94)	(147)	(319)	(235)	(247)	(948)	16
Net change - cash	4,696	(1,055)	563	(463)	(3,240)	3,575	435	2,040
Cash, beginning of quarter	2,981	7,677	6,622	7,185	6,722	3,482	6,622	7,057
Cash, end of period	7,677	6,622	7,185	6,722	3,482	7,057	7,057	9,097
Supplemental information:								
Interest paid	779	623	-	-	-	-	324	-
Income taxes paid	2,681	3,831	-	-	-	-	2,164	-
Cash Flow	13,936	16,945	4,443	4,095	4,167	2,806	15,511	1,896
Free cash flow	13,638	15,050	3,713	4,028	4,145	2,790	14,676	1,799

HISTORICAL STOCK PRICE



Source: Zacks Investment Research

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