Mastech Digital, Inc.
First Quarter 2023 Earnings Call
May 3, 2023

Operator
Greetings, and welcome to the Mastech Digital First Quarter 2023 Earnings Call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press “*”, “0” on your telephone keypad.

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Jen Lacey, General Counsel--Counsel for Mastech Digital. Thank you, Ms. Lacey, you may begin.

Jennifer Lacey
Thank you, Operator, and welcome to Mastech Digital's First Quarter 2023 Conference Call. If you have not yet received a copy of our earnings announcement, it can be obtained from our website, at www.mastechdigital.com.

With me on the call today are Vivek Gupta, Mastech Digital's Chief Executive Officer, Jack Cronin, our Chief Financial Officer, and Michael Fleishman, our recently appointed Chief Executive Officer of the company's Data and Analytics Services business segment.

I would like to remind everyone that statements made during this call that are not historical facts are forward-looking statements. These forward-looking statements include our financial, growth and liquidity projections, as well as statements about our plans, strategies, intentions and beliefs concerning the business, cash flows, costs and the markets in which we operate.

Without limiting the foregoing, the words believes, anticipates, plans, expects and similar expressions are intended to identify certain forward-looking statements. These statements are based on information currently available to us, and we assume no obligation to update these statements, as circumstances change.

There are risks and uncertainties that could cause actual events to differ, materially, from these forward-looking statements, including those listed in the company's 2022 annual report on Form 10-K filed with the Securities and Exchange Commission and available on its website at www.sec.gov.

Additionally, management has elected to provide certain non-GAAP financial measures to supplement our financial results presented on a GAAP basis. Specifically, we will provide non-GAAP net income and non-GAAP diluted earnings per share data, which we believe will provide greater transparency with respect to the key metrics used by management in operating the business. Reconciliations of these non-GAAP financial measures to their comparable GAAP measures are included in our earnings announcement, which can be obtained from our website at www.mastechdigital.com.

As a reminder, we will not be providing guidance during this call, nor will we provide guidance in any subsequent one-on-one meetings or calls.

I will now turn the call over to Jack for a review of our first quarter 2023 results.

Jack Cronin
Thanks, Jen, and good morning, everyone. First quarter 2023 was clearly a disappointing quarter for Mastech Digital. Revenues totaled $55.1 million, representing an 8% revenue decline, compared to $59.8 million reported in Q1 2022. Both of our business segments were impacted by economic uncertainty, including customer concerns regarding inflationary conditions and a possible recession.

Our Data and Analytics Services segment contributed revenues of $9.4 million, compared to $10.2 million in the 2022 first quarter, as order bookings in the second half of 2022 were short of expectations, which had an impact on our Q1 2023 results.

For the first quarter of 2023, revenues in our IT Staffing Services segment totaled $45.7 million, compared to $49.6 million in the first quarter of 2022. Demand declined during the quarter, which resulted in a reduction of 84 billable consultants.

Gross profit in the first quarter of 2023 totaled $13.5 million, compared to $15.9 million in the first quarter of 2022. Gross margins as a percent of revenue in Q1 2023 was 24.5%, compared to 26.7% in the 2022 first quarter. This margin variance was largely due to lower utilization and lower project margins on several long-term assignments in our Data and Analytics Services segment and a reduction in direct hire revenues and lower utilization rates on several financial clients in our IT Staffing Services segment.

GAAP net income for the first quarter of 2023 was $261,000, or $0.02 per diluted share, compared to $2.3 million, or $0.19 per diluted share, in Q1 2022.

Non-GAAP net income for Q1 2023 was $1.4 million, or $0.12 per diluted share, compared to $3.3 million, or $0.28 per diluted share in the first quarter of 2022.

SG&A expense items not included in Q1 non-GAAP financial measures, net of tax benefits, were one, stock-based compensation and, two, the amortization of acquired intangible assets, and they're detailed in our first quarter 2023 earnings release, which is available on our website.

It should be noted that both GAAP net income and non-GAAP net income in Q1 2023 were impacted by a $400,000 pretax expense for Professional Services related to an outstanding employment claim asserted by a former employee.

Addressing our financial position, at March 31, 2023, we had $9.1 million of cash balances on hand, no bank debt outstanding and borrowing availability of $31.5 million under our revolving credit facility. Our days sales outstanding measurement was 61 days at quarter-end, which is well within our target range of 60 to 65 days.

During the first quarter, we didn't execute on our share repurchase program, due to an extended trading blackout period. We expect to have the ability to execute on the share repurchase program in the near term.

I'll now turn the call over to Vivek for his comments.

Vivek Gupta
Good morning, everyone. Thank you, Jack, for the detailed financial review of our operating results for Q1 2023.

The first quarter of 2023 was a challenging quarter, to say the least. Our IT Staffing Services segment saw a notable decline in demand during Q1, as the possibility of a recession appears to be weighing heavily on clients' spending dynamics. With approximately half of our billing consultants employed in the financial services industry, recent bank failures have also had an adverse impact on our IT Staffing business.

Our Data Analytic--Analytics segment performance was also impacted, largely, due to the order booking shortfalls that occurred in the second half of 2022. Activity levels, however, were more robust with respect to the building of a pipeline of opportunities, during the first quarter. Michael will talk more about the state of affairs in the Data and Analytics Services business in a few minutes.

While we cannot say when the economic outlook will improve, we can say that our businesses remain fundamentally sound, our financial clients are among the strongest in the industry and we have a solid balance sheet and access to ample capital to fund our current business needs and support the share repurchase program we announced, earlier this year.

Let me now turn the call over to Michael for his comments related to the Data and Analytics Services segment. Over to you, Michael.

Michael Fleishman
Thanks, Vivek, and good morning, everyone. As Vivek mentioned, current economic conditions are strong headwinds for most businesses, today. However, in the Data and Analytics space, while economic conditions are notable, they are not as impactful as they are to the IT Staffing industry.

Areas of emphasis that I've been addressing since I joined Mastech Digital are: one, expanding the pipeline of opportunities; two, improving the efficiency of the sales engine/pipeline engine that we have across the company; three, filling needs in leadership talent; and four, enhancing communication across the various facets of the organization.

In a very short time, we have been able to upgrade leadership talent across sales, marketing, technology, as well as in delivery, expand and develop our sales engine, and improve communication across the entire organization. I am happy to say that our new messaging to existing clients and client prospects appears to be gaining traction.

While Q1 2023 results were well below our expectations, it is noteworthy to point out that revenues, bookings, gross margins and utilization rates all improved sequentially from the fourth quarter of 2022. Additionally, our pipeline notably increased in Q1, which we believe bodes well for us for the next few quarters.

While we do not give specific guidance, I am confident that we will continue to build our pipeline in the second quarter of 2023, and I believe that, going forward, we will be well positioned to win a fair portion of the enhanced pipeline of opportunities.

I'll now turn the call back over to Vivek.

Vivek Gupta
Thank you, Michael. Operator, this concludes our prepared remarks. We can take questions now.

Operator
Thank you. We will now be conducting a question-and-answer session. If you would like to ask a question, please press “*”, “1” on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press “*”, “2” if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset, before pressing the star keys.

One moment, please, while we pull for questions.

Our first question comes from the line of Lisa Thompson with Zacks Investment Research. Please proceed with your question.

Lisa Thompson
Good morning. I have a number of questions about the quarter. I'll start with probably the most important since everyone is wondering. You said that half of your consultants are on financial services-type companies. I assume that includes the 10% of CGI, right?

Vivek Gupta
Yes, it does.

Lisa Thompson
Can you describe a little bit how these financial customers are, just generically? I mean, there's a lot of concern about the second-tier banks as people pull deposits from them. Talk a little bit about maybe what you do for who.

Vivek Gupta
So, actually we are working with a lot of banks, the premier first-level banks, either directly or through systems integrators such as CGI that we mentioned. And we have our exposure to mid-level banks or regional-level banks is a lot lower. And it’s mainly, I think, one of our top banks is PNC Bank, by far. And then we have, after that, we have a few others in the premier, in the top-level banks.

So, the comment that I made a little earlier is that we feel that our financial customers are pretty strong and although we are all watching this banking crisis unfold, we are pretty confident that we will not be that affected. And once this crisis settles down, we will be back to what we've been doing in terms of servicing these customers.

Jack Cronin
Yes Lisa, we have some insurance companies that are included in the financial services segment and they're solid. And, you know, as far as the companies that had severe problems and were taken over by the government and were struggling, we have no exposure to those clients.

Lisa Thompson
Great. Good to hear. So how many consultants did you end the quarter with?

Vivek Gupta
Jack, do you have the exact number, what was the final number was?

Jack Cronin
At the end of the quarter?

Vivek Gupta
Yes.

Jack Cronin
Sure. Let me grab it here - in the IT Staffing Services segment 1,125.

Lisa Thompson
Okay. And then can you explain what happened with the tax rate this quarter? What's up with that?

Vivek Gupta
The tax rate.

Jack Cronin
Lisa, you know, we had some losses in the in the foreign subsidiaries. And we provided what accounting calls valuation allowances for them, which means we don't recognize the benefit associated with some of those losses. And because our pretax income was very low this quarter, the percentage of our effective tax rate got exaggerated by some of those valuation allowances that we made.

Lisa Thompson
So, do you think the year still comes out to, like, 27.5%?

Jack Cronin
I think the year--I think the year comes out more in line with what we've had in the past, which is 27, 28. It may be a little bit more but it's not going to be 45%.

Lisa Thompson
Okay, alright. And

Jack Cronin
--For the full year, Lisa, for the full year.

Lisa Thompson
Right, so SG&A, it was a little high, and you said you have $400,000 in the quarter for legal expenses, I guess. Does that same level of expense continue, until the case is settled?

Jack Cronin
I think it continues for a while. I don't know it's going to be some level of professional services expense associated with this matter, the employment claim matter in Q2.

Lisa Thompson
All right. And do you have any plans at all, like pulling back on expenses like you did during the pandemic level?

Jack Cronin
In IT Staffing, we are pulling back, right now. If you look at our sales and operating expenses, and operating in IT Staffing recruiting cost that was reduced by 600,000, or about 8% of revenues, which is the revenue decline that we experienced in IT Staffing.

The only negative was we got hit with higher corporate-related expenses, and its largely insurance programs. And, cybersecurity insurances is on the rise like crazy. And we had some increases in public costs. The sort of expenses that we don't have full control over.

So, you know, we are making an attempt to--to reduce our SG&A expenses in IT Staffing.

On the Data and Analytics Services segment, we had an increase of 600,000 in the quarter, year-over-year, but 400,000 was the professional services expense related to the employment claim. And, going forward, D&A is going to invest in SG&A.

So, there's going to be an increase in Q2 and Q3, at least over the next couple of quarters because we're bringing in new talent and filling some of the leadership gaps that we had or that were identified by Michael. So, to get where we want to be, going forward, we have to make these investments, now.

Lisa Thompson
Okay. So hopefully, that results in higher gross margins along the way, too.

Jack Cronin
I would hope so.

Lisa Thompson
Okay. Alright, I think that’s all my questions. Thank you.

Jack Cronin
Thank you.

Vivek Gupta
Thank you, Lisa.

Operator
Thank you. Our next question comes from the line of Marc Riddick with Sidoti. Please proceed with your question.

Marc Riddick
Hey, good morning.

Vivek Gupta
Hi, Marc.

Jack Cronin
Hi, Marc.

Marc Riddick
I was wondering and certainly it's understandable given the environment to maybe shy away from this a little bit. But in the past, you certainly have looked at the potential for acquisitions to boost your future opportunities.

I was wondering if you could talk a little bit about maybe what you're thinking about right now and maybe what the pipeline may look like and what the appetite is for doing something in the near term.

Vivek Gupta
Well, Marc, I mean, acquisition is very much part of our plan. That hasn't changed. It's just that at this point in time, there are a couple of things that we are working with. One is, of course, , the decline that we spoke about on the IT Staffing side, and we are very carefully looking at our costs and seeing how we realign the organization as we address the decline in demand.

On the other side, on the Data Analytics side, Michael has been on board for a few months now, and he's put in place a number of initiatives that he spoke about.

And, I think we are just going to give ourselves a little bit more time before we come back to the process of the acquisitions one more time. But, it's not off the table, but I think it's really a question of a little bit more time before we get back to it.

Marc Riddick
Okay. Great. Then I was wondering if you could talk a little bit about maybe--you talked about the improvement, sequentially. I was wondering if you could talk a little bit about the cadence through the quarter. Is there any read-throughs that we should be thinking about there?

Vivek Gupta
Sorry, Marc. I didn't fully understand your question.

Marc Riddick
The cadence of activity, like by month, I guess, through the quarter. Do you know, was it flattish? Did it improve? Did it get worse when you went from January, February through March?

Vivek Gupta
Okay. So, I think this question, if you're talking about the buying pattern from our customers, the order bookings?

Marc Riddick
Yes.

Vivek Gupta
Yes, okay. So, let me touch upon the IT Staffing, and then I'm going to let Michael respond to how he's seeing the Data Analytics side.

But on the IT Staffing side, there has been some pickup in demand from Q4. That's when I compare Q1 with the last, the previous quarter, but it's not been significant enough to move the needle. So, we are hoping that we'll see more as we go forward. But again, no one has a crystal ball.

So, we are still at a point where the demand is way lower than what the demand was a year ago. So that's the situation as far as the IT Staffing.

And Michael, can you talk about the D&A side?

Michael Fleishman
Sure. From a Data and Analytics perspective, we're specifically focused on data modernization as a piece of digital transformation, overall.

Within the data modernization space, within the Forbes 1500 or even the Forbes 2000, the amount of demand, even in light of a potential recession, is not going to impact the amount of opportunity that we have in front of us, not only across our existing customers but also within potential new logo prospects that we're also targeting.

So simple answer, no, not foreseeing any decline in demand that would impact our potential ability to drive net new opportunity that will also drive net new growth within the Data and Analytics segment, if that answers your question, Marc.

Marc Riddick
Yes, no that's helpful. And further, it's good to have you on the call and welcome. I was wondering if actually you could sort of give me a sense of are you seeing much in the way of the types of assignments, shipping? Are you beginning to see customers that are maybe shifting

from an offensive to a defensive posture? Or are they sort of focusing more maybe on cost savings efforts or things of that nature? Or is it too early for that?

Michael Fleishman
Marc, specifically for Data and Analytics or specifically for IT Staffing numbers?

Marc Riddick
Yes, just specifically within Data and Analytics, I was thinking about.

Michael Fleishman
I mean, when you look at digital transformation you've got basically two sides of a coin, right. You've got application modernization and then you have the data modernization aspect.

Customers are focusing on both, but the lion's share is around application modernization, first and foremost, and then working on the data modernization once they have their applications modernized.

And to answer your question about, are they on offense or defense, it is very much so they're trying to be proactive in modernizing their overall solutions and their ability to unlock decisioning from their data more so than they are about trying to save money. Because if they don't modernize now, if they don't invest now to make the modernization initiatives, then they're not going to be able to be competitive in the marketplace, which will impact their ability to continue to make money and grow from their own perspectives.

And so, it's not really it is about cost savings, but it's about cost savings through modernization, and that modernization requires investment, first. So, it's a little bit of chicken before the egg or egg before the chicken, but they have to modernize. They have to. It's either modernize and survive or have your business taken up by those that modernized faster or didn't need to modernize in the first place because they were new entrants and don't have the legacy challenges that you had. That's the situation in the market. And that situation is fairly applicable across all industries.

Marc Riddick
Okay. And then last one for me. You made mention as far as the share repurchase, you sort of had a blackout period there. Could you sort of maybe talk generally as to maybe what your thought process is there or maybe expectations are? I mean, certainly, we've seen a pullback in opportunities, as far as a share price to work with, but I was wondering if you would sort of talk about maybe you know, sort of big-picture thoughts as to the authorization and goals there. Thanks.

Jack Cronin
Yes, we had the share buyback program, approved by the Board, 500,000 shares, over a 2-year period. The Board and management feels that our stock price is depressed over the long term,

and I think there's an opportunity to pick up shares at what we believe is a bargain share price. So, we plan on moving forward with that. Current market conditions aren't scaring us off, and that's our intention.

Marc Riddick
Okay, great. Thank you very much.

Vivek Gupta
Thank you, Marc.

Operator
Thank you. Our next question comes from the line of Ross Davisson, with Banneton Capital. Please proceed with your question.

Ross Davison
Hi, guys, good morning. First question was just building on the sort of trend or feeling of bookings and revenue through the quarter. Anything in April sort of changing with that? Have you noticed either or positive or negative in each segment in terms of, like, the revenue cadence or bookings cadence?

Vivek Gupta
Okay. Ross, let me again talk about the IT Staffing, first. On the IT Staffing, we actually have not seen much of a change from what we saw in the previous three months, or previous quarter. So, we are where we are in terms of bookings.

As far as the Data Analytics side is concerned, Michael, would you want to give some color to that?

Michael Fleishman
I would say that the slope in from Q4 to Q1, is trending in the right direction. And without going into specifics, in April that slope is the same. It's keeping our eye on the ball and maintaining the focus with our existing customers and also in trying to get net new bookings, to not only continue to maintain that slope into the rest of the quarter, but also to try and make it a little steeper in the upper direction.

Ross Davisson
Great. that's helpful. Thank you. And Michael, specifically on D&A, I think that you had said something about, it's improving but, like are you seeing anything in terms of lengthened sales cycles or anything like that? I know, people need to do data modernization, but are they sort of delaying any decisioning just because of the economy?

Michael Fleishman
So, I would say, no, they're not delaying the decisioning. What I will tell you, potentially, is impacting them is if they have 10 projects on the table because of concerns in the economy maybe they're holding back on their lowest priority project or their lowest two priority projects, but the other eight are still moving forward. That, we're seeing, for sure. But that's to be expected in any kind of uncertainty in the economy. And we've seen that multiple times, even pre-COVID and certainly through COVID. As far as the sales cycle itself, no change to the sales cycle. It's still--it's about the same.

Ross Davisson
Okay. Great. And then, Vivek, in IT Staffing, you referenced the banking sort of turmoil as being, especially a problem given all the constitution of financial services. Most of the actual crisis was in March. Were you seeing financial services challenges or anything in particular about financial services in terms of challenges ahead of that activity in March with SVB and the other bank?

Vivek Gupta
Well, I think the financial services sector was being very cautious, anyway. And we saw that not just in January and February, but we saw that in Q4, too. But it kind of got heightened in March. And then it continued. And we've seen April has been, I guess, in some ways, worse than. So yes, it was happening.

There was the tightening of the belt was happening. A lot of projects were being put on the back burner. Focus was keeping the banks running, rather than building the bank, as the terminology they use. And then things changed a little bit, became intensified in March and continued in April.

Ross Davisson
Okay. And then the last question I had, was just on gross margin in Data Analytics. It was down, and we talked a little bit about this, but just to build on that. You know, it was down a lot year-over-year, and I think it was up a little bit, sequentially. But you mentioned utilization, and also, I think you said lower margin in some long-term engagements.

Can you just explain more about the latter one there? Like, are those new engagements that are just at a lower margin? Is there something changing about those long-term engagements? What is that, exactly?

Michael Fleishman
Yes, I'm sorry. Go ahead, Vivek.

Vivek Gupta
Yes, no. go ahead, Michael.

Michael Fleishman
Okay, so, what I would say is, it's actually both. It's actually both, right. And on one hand, we've got a heavy focus on ensuring that our utilization is improving and increasing. Utilization has a direct, an immediate direct impact to gross margin, right.

So, a maniacal focus on utilization across the board, a maniacal focus on long-term projects to ensure that we're automating and driving automation, driving accelerators, being able to do the project internally better, faster, cheaper, and more efficiently, which is also improving margins on longer-term engagements. And we're doing those engagements for lack of a better word, we're doing those engagements better, right, and more efficiently, internally.

So, a heavy, heavy focus on that, as well as a heavy focus on all net new business to ensure that we're winning business on value and not on price, right, which also helps drive better margins.

Jack Cronin
Yes, add me add to that. Specifically with respect to our gross margins, in Q4, our gross margins were 37%. And in Q1 of 2023, our gross margins were 38.5%. So, we improved from the sequential quarter. But if you look at where we ended March, and even February we were pretty close to where we ended March, our March gross margins were a little bit over 42%. So, it's a margin improvement that you really can't see specifically in Q1 financials, but it's there.

And as far as the long-term assignments that I was talking about, we have a handful of multi--multiple-year assignments that we refer to as Center of Excellent Projects. Some of these projects have escalation clauses and some of them don't. And the couple that don't have escalation clauses, we're seeing some cost increase that we can't recover through a higher bill rate. And so, it's impacting our overall gross margins somewhat, but it's not the norm.

Ross Davisson
Yes, that makes a lot of sense. That's really helpful. And just on the cadence of gross margin through the quarter, is that improvement coming from utilization, I guess? Like, anything specific driving that improvement because it, I guess bookings are improving. Anyway, Jack, anything you could say around that? Like, what's driving that improvement?

Jack Cronin
Yes, I mean, utilization is definitely a driver, and I think our project margins were up, as well. Michael, was that a fair statement?

Michael Fleishman
It is.

Ross Davisson
Okay, thank you so much, I appreciate it.

Vivek Gupta
Thank you, Ross.

Operator
Thank you. There are no further questions at this time. I'd like to turn the floor back--back over to Vivek for closing comments.

Vivek Gupta
Okay. thank you, Operator. If there are no further questions, I would like to thank you for joining our call today, and we look forward to sharing our second quarter 2023 results with you in early August. Thank you.

Operator
This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.