MASTECH DIGITAL INC.
Third Quarter 2017 Earnings Conference Call
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Operator: Greetings and welcome to the Mastech Digital Inc. Third Quarter 2017 Earnings call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Jennifer Ford-Lacey, Manager of Legal Affairs for Mastech Digital Inc. Thank you, Ms. Ford-Lacey, you may begin.

Ms. Jennifer Ford-Lacey: Thank you, operator, and welcome to Mastech Digital's third quarter 2017 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, and Jack Cronin, our Chief Financial Officer.

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 our 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 2016 annual report on Form 10-K filed with the Securities and Exchange Commission and available on their website at www.sec.gov.

Additionally, management has elected to provide 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 our 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 third quarter 2017 results.

Mr. Jack Cronin: Thanks Jen, and good morning. First off, I'd like to remind everyone that we completed our acquisition of the services division of Infotrellis on July 13th, 2017. This project-based data and analytics business is being accounted for as a separate reporting segment in accordance with ASC Topic 280, Disclosures About Segments of an Enterprise and Related Information. Thus, we will be reporting our financial results in the following two segments going forward - one, data and analytics services, which is the business we acquired in the Infotrellis transaction, and two, IT staffing services, our core legacy business.

Additionally, it should be noted that our operating results of the data and analytics business are included in our consolidated financial statements commencing with the acquisition closing date. Accordingly, our year-over-year comparables are advantaged in the 2017 periods when compared to 2016.

With that said, revenues for the third quarter of 2017 totaled $39.2 million and represented a 14.5 percent improvement over revenues of $34.3 million in the third quarter of 2016. Revenues from our data and analytics segment in the third quarter of 2017 totaled $4.1 million.

Activity levels in our IT staffing services segment were solid during the third quarter of 2017, and we were able to increase our global consultant base for the third consecutive quarter. Global consultant growth in Q3 totaled 27 consultants and put our nine-month 2017 consultant growth at 114 consultants, an increase of nearly 13 percent for the nine-month period ending September 30, 2017. Thus, Q3 2017 revenues from our IT staffing services business grew by approximately 3 percent over the third quarter of 2016.

Revenue growth in the third quarter of 2017 was tempered by two factors - one, a lower average bill rate, and two, lower consultant utilization largely due to the hurricanes in Florida and Texas, as well as higher vacation in Q3.

Gross profit for the third quarter of 2017 totaled $8.8 million compared to $6.9 million in the same period last year. Our gross margins for the third quarter of 2017 improved to 22.5 percent from 20.1 percent in the corresponding quarter of 2016. This entire improvement in margin reflected the addition of the data and analytics services business in the 2017 quarter, a business which has a gross margin profile that is materially higher than our IT staffing services business.

SG&A expenses were $8.6 million in the third quarter of 2017 and represented 21.9 percent of total revenues compared to $5.3 million or 15.5 percent of revenues in the third quarter of 2016. It should be noted that SG&A expenses in the 2017 period included approximately $1.7 million of transaction expenses related to our acquisition of Infotrellis. Excluding these expenses in the 2017 period, SG&A would have represented 17.5 percent of total revenues.

This adjusted two percentage point increase in SG&A as a percent of revenues over the 2016 quarter was due to an increased investment in sales and recruitment--in our sales and recruitment organization of our IT staffing services business to support growth and to improve our process capabilities, and two, the impact of a higher SG&A cost structure as a percent of revenue in our data and analytics service business.

GAAP net loss for the third quarter of 2017 was $136,000 or a loss of 3 cents per diluted share compared to a net income of $924,000 or 21 cents per diluted share in Q3 2016. Non-GAAP net income for the third quarter of 2017 was $1.4 million or 27 cents per diluted share compared to $1.1 million or 25 cents per diluted share in the corresponding quarter of 2016. The 26 cents diluted share number for Q3 2017 reflects on a weighted average basis the shares issued in the private placement transaction to fund the Infotrellis acquisition.

Third quarter SG&A expense items not included in non-GAAP financial measures net of income tax benefits were, one, the amortization of acquired intangible assets, two, stock-based compensation, and three, in the 2017 period, acquisition transaction expenses that are detailed in our third quarter earnings release, which is available on our website.

Before I address our financial position, let me remind everybody that we closed two very important financing transactions concurrent with and in support of our July 13th acquisition of Infotrellis. First, we secured a $65 million credit facility to, one, provide debt financing for the acquisition, two, refinance our outstanding bank debt under our previous facility, and three, provide borrowing capacity for the future. Secondly, we completed a $6 million private placement of newly issued shares of the company's common stock to Mastech's co-founders and majority shareholders. Both of these transactions were instrumental to the completion of the Infotrellis acquisition.

Let me close by briefly addressing our financial position. At September 30th, 2017, we had $40.3 million of outstanding bank debt net of cash balances on hand, and our borrowing capacity approximated $10 million under our revolving credit facility. Our accounts receivable balance at September 30th, 2017 remained of top quality, and our days sales outstanding measurement was a healthy 56 days at quarter end.

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

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

First off, let me tell you how excited I am to have the Infotrellis business as a part of Mastech Digital. I'd like to take this opportunity to publicly welcome all of the talented associates of Infotrellis into the Mastech digital family - welcome.

While we are still in the proverbial honeymoon period with the Infotrellis integration, I can tell you that, culturally, this acquisition is a wonderful fit for Mastech Digital. Our value systems, work ethics, customer centricity, and pronounced desire to be successful are very much aligned. It was therefore no surprise that the integration progress to date has exceeded expectations in an accelerated fashion.

With respect to the potential that this acquisition holds for Mastech Digital, I'm extremely bullish. With an impressive leadership team, industry-leading delivery capabilities, and a strong pipeline of prospective opportunities, I'm very confident about the future of this very important business. As Jack mentioned, we will report the data and analytics services business as a separate reporting segment in accordance with GAAP rules, and equally important, to provide our stakeholders and potential stakeholders with the transparency and full disclosure that they should expect in evaluating our financial results.

In addition to Jack's comments on the data management and analytics business, I'd like to call your attention to our third quarter earnings release in which we have included supplemental financial information related to our reporting segments. We plan on continuing this supplemental financial information in future earnings releases.

With respect to our legacy IT staffing services business, I'm just as optimistic about our future. Demand for our services continues to be robust, our delivery capabilities at our offshore recruitment center are becoming more efficient by the day, and our recent investments in sales and recruitment expansion is providing positive results. Low utilization largely from the Florida and Texas hurricanes and some softness in bill rates clearly impacted our Q3 revenue performance. However, our consistent growth in our billable consultant base over the last three quarters and the expansion of digital technology revenues, which were 28 percent in Q3 of 2017 versus 20 percent in Q3 of 2016, not including the data and analytics business in this quarter, give me assurance that our longer term objectives are being achieved despite a few short-term hiccups.

In summary, clearly, there's a very high level of excitement and buzz throughout our organization today. Much of it stems from the near-term successes that we have had in growing our core business and the enthusiasm related to our recent acquisition. It is a good place for any organization to be. My personal objective is to keep the organization’s engines humming and the successes continuing across our expanded platform.

I will now open the session for your questions.

Operator: Thank you. Ladies and gentlemen, we'll now be conducting a question and answer session. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd 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. Again, that's star, one if you'd like to ask a question. One moment while we poll for questions.

Again, ladies and gentlemen, that's star, one if you'd like to ask a question.

Our first question comes from the line of Howard Rosencrans with Value Advisory LLC. Please proceed with your question.

Mr. Howard Rosencrans: Yes, Hi, Vivek, thank you. It looks like you had a nice quarter. In terms of the progression of the base--the data and analytics business look stellar with, I guess, about a 25 percent operating margin specific to that business. Can you give me an idea what the pro forma top line growth in that business is?

Mr. Vivek Gupta: Sure, Howard. I'll get Jack to respond to that if you can just give us a minute.

Mr. Jack Cronin: Howard, I'm not sure I understand the question - the historical growth or what we're looking at moving forward?

Mr. Howard Rosencrans: Well, both, actually. I was curious if the top line of $4 million in that business during the quarter--I know you lost 13 days, but can you sort of give us an apples to apples as to how much that business grew year to year in the quarter.

Mr. Jack Cronin: Yes, I get it. If we had a full quarter in Q3 of 2017, the revenue numbers would be closer to 4.7 million, 4.8 million, in that range.

Mr. Howard Rosencrans: Right, but I'm trying to understand the year to year comparison as to what-- Q3 '16 looked like for that business?

Mr. Jack Cronin: No, I don't have that handy. I can certainly get that information. We have that information and I can tell you that it likely declined in Q3 of 2017.

Mr. Howard Rosencrans: The data and analytics?

Mr. Jack Cronin: In the analytics business, correct.

Mr. Howard Rosencrans: --Okay--I'm sorry, go ahead. What was that attributable to, please?

Mr. Jack Cronin: No, I was going to say, I can get that information - I know that it declined year over year.

Mr. Howard Rosencrans: Okay. Where do you see the business-any idea where that business ran for the nine months versus the nine months, and where do you see it going from a top line growth perspective going forward, just specific to the data and analytics piece?

Mr. Jack Cronin: The one thing that I want to say is, historically, when we purchased the company, they had one thing that we found out in our due diligence about the business is it had some lumpiness to it, right? And when we acquired the company and the purchase--at least the cash purchase price that we negotiated was really based on where the business was when we acquired it, what was the run rate, etc., etc. So, I mean, we certainly looked at their history and were encouraged by where they were and where they'd been, but we essentially paid for a $21 million annual revenue company that would deliver roughly $6 million of EBITDA, and that was our cash purchase price of around $36 million, a multiple of six times EBITDA. That's our stake in the ground with respect to this business. I'll let Vivek give his expectations going forward but certainly, we expect that space to grow. It's a hot space. We have confidence in the leadership that we brought with the new company. I think it's going to grow. Vivek, why don't you give your comments on that?

Mr. Vivek Gupta: Thanks, Jack. Yes, I completely agree with what Jack has said. We would not like to give guidance for the future, but I can tell you that this company is in a very hot space. Data and analytics business globally is at $130 billion in size, and it's growing at a rate of 11.7 percent CAGR, and it's predicted to grow over the next four or five years. So, it's a hot space to be in, and we do expect that the synergies that the two entities bring together with them becoming part of the Mastech Digital platform, we should be able to boost in sales and put it on a growth path. So, I don't know if that answers your question, Howard?

Mr. Howard Rosencrans: Sure. So, I mean, hopefully, we can at least grow in line with the industry and gain some share, I guess? Would that be fair to say or--in the data and analytics business?

Mr. Vivek Gupta: Yes, I would guess that we would expect this to be keeping pace with the industry growth.

Mr. Howard Rosencrans: Okay. In terms of your IT staffing services business, it seems like you have done a nice turnaround there and that business is starting to improve. You were able to get top line growth. I believe this was the first time you were able to achieve year-to-year top line growth in a while. Could you tell us how much you lost, or just give us an estimate of how much you lost to the hurricanes in the quarter?

Mr. Jack Cronin: Our expectations of revenue based on our billable headcount, we were about a percent and a half below what our expectations were and we know there were two factors. We know there was downtime in Florida, and there was downtime in Texas, and we also know that our vacations were for whatever reason higher in this Q3 than they were in the previous year. Maybe it’s timing, but nonetheless, we know that our expected revenues were down 1.5 percent - our actual was down 1.5 percent from where we thought it should be, based on our headcount. An educated guess would say that probably the hurricane was 50 percent of the problem and the higher vacations were 50 percent of the problem. With respect to our W2R resources, if they're in Florida and they're off, we don't pay them, so we lose a little bit of visibility. We can make the assumption that it was due to the hurricane, but it could have been that they just had a planned vacation. So, it's really hard to capture specifically which hours pertain to vacation and which hours specifically pertained to the hurricanes. But, in total, I would say we lost 1.5 percent of revenues.

Mr. Howard Rosencrans: Okay. Because the segment data you give doesn't exactly match with the overall, so it's a little tough to pull this out, but-- gross margins improved it looks like about 200, 250 basis points. Can you give us an idea, is the IT staffing, is the gross margin percentage in that business I assume the gross margin percentage in that business has also improved from last year.

Mr. Jack Cronin: It's flat, Howard. It's 20 percent in Q3 '17, and I think it was 20.1 percent in Q3 2016. The bump up is strictly the impact of the consolidation of Infotrellis, whose margin profile is tremendously higher than the staffing business. I think in Q3, it was 44.2 percent.

Mr. Howard Rosencrans: I see, okay. Okay. And you have continued to invest in SG&A. You commented that SG&A was up about 200 basis points year to year, some of which was IT staffing and I guess a small piece of which was data analytics. When are you guys hoping that, your SG&A as a percentage I guess overall will start to flatten out year to year so we can see the value of the investment that you're making there?

Mr. Vivek Gupta: Howard, let's look at the two pieces separately. The core business I have mentioned now in the previous earnings calls of 2017 that we deliberately decided to sort of invest in the say--in expanding the sales and recruitment organization this year, and we've seen the results of that. And that is, I guess partly responsible for that 2 percent increase over how it was last year. But, we've seen the benefit of that. We've achieved in the first three quarters of this year a headcount of 114.

But, to answer your question, we expect that our sort of business will grow into 15.5 kind of range that we had last year, which means that as our top line grows, we do not necessarily--we will not necessarily have a commensurate growth in the SG&A expenses, and hopefully, we should see over the next year or so, we will be able to start coming closer to where we were. Having said that, I should also say that last year's numbers may not be the benchmark because we were on the lower side, so it could be--the ideal positioning could be somewhere in the middle, so that is as far as the core business is concerned. The newly acquired data and analytics business has a higher SG&A and that's been the model, and they also enjoy a much higher gross margin, so they are able to sort of justify that higher SG&A. We expect will continue to be there a little higher than on the core business side. So, when you put the two things together, and as we grow together as one large expanded organization, we should be able to grow into a lower SG&A over a period of time.

Mr. Howard Rosencrans: All right, I noticed from your pro forma filing, the 8-K that you filed in September, it looks like the pro forma EPS from the combined business was--I believe it was \$1.30 or \$1.29 in 2016. That's quite a base to be working off of. It's a pretty substantial EPS base, and I guess the two businesses themselves are going to--the profitability in IT staffing seems to have improved already and sequentially, and hopefully, with that going down, that business will continue to grow after a couple of tough years and the data integrity analytics piece that piece you're hopeful will grow in line with the 12 percent CAGR. So, it sounds like on the horizon, you probably get - I don't know, \$1.50 or so on a pro forma basis for 2017, and then if we can really start to leverage the SG&A investments, you can go up meaningfully from there. Is that a fair assessment of where we're going from here?

Mr. Jack Cronin: If the data and analytics segment perform at the levels in the pro forma, that's where we would be going from here. Again--and that level, a revenue base of around 25 million, and right now at a run rate basis, based on what we paid for the company, we're at around 20 million. So, the answer is if the data and analytics business grows to the pro forma numbers, I think your analysis is proper.

Mr. Howard Rosencrans: Great, thank you. Keep up the great work. Thank you. It sounds like an exciting acquisition, and I'm thrilled to see the core legacy business starting to improve. Thank you.

Mr. Vivek Gupta: Thanks, Howard.

Operator: Thank you. Ladies and gentlemen, again, if you would like to ask a question, please press star, one on your telephone keypad. One moment while we poll for questions.

There are no further questions at this time. I'd like to turn the floor back to management for closing comments.

Mr. Vivek Gupta: Thank you. So, if there are no further questions, I would like to thank everyone for joining our call today, and we look forward to sharing our fourth quarter 2017 results with you in early February 2018. Thank you.

Operator: This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.