MASTECH HOLDINGS, INC.

Q1 2015 Earnings Call

May 12, 2015

Operator: Greetings and welcome to Mastech Holding Inc. First Quarter 2015 Earnings Conference 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, 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 Holdings, Inc. Thank you, Ms. Ford Lacey. You may begin.

Ms. Jennifer Ford Lacey: Thank you, operator, and welcome to Mastech's First Quarter 2015 Conference Call. If you have not yet received a copy of our earnings announcement, it can be obtained from our website at www.mastech.com.

With me on the call today are Kevin Horner, Mastech'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 2014 Annual Report on Form 10-K, filed with the Securities and Exchange Commission and available on their website at www.sec.gov.

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 2015 results.

Mr. Jack Cronin: Thanks, Jen, and good morning everyone. Revenues for the first quarter of 2015 totaled $27.1 million, which were 6 percent below first quarter 2014 revenues. The revenue decline largely reflected a high level of assignment ends in December 2014, which impacted the number of consultants-on-billing that we entered the New Year with. Our average bill rate for the first quarter of 2015 of $74.46 was approximately 1 percent higher when compared to the corresponding quarter of 2014.

Activity levels were solid for most of the quarter after a slow start in early January. Given a tightening supply of IT professionals, our assignment win rate was a little late in Q1 2015 compared to historical averages.

Gross profits for the first quarter of 2015 totaled $4.7 million, or 17.3 percent of revenues, compared to $5.2 million, or 18.2 percent of revenues, during the same period last year. Our gross profit dollar decline was due to less consultants-on-billing in the 2015 quarter compared to the first quarter of 2014 as well as a lower overall gross margin percentage.

Our first quarter 2015 gross margin percentage was impacted by higher bench cost related to the start-up of our technology practice and higher benefit cost related to the Affordable Care Act.

On new assignments, we've adjusted our pricing to recover these higher benefit costs. However, we haven't been as successful in getting bill rate increases on existing assignments, thus the reason for the negative impact on margins in the short-term.

SG&A expenses were $4.1 million in the first quarter of 2015 when adjusting for severance costs of $305,000 incurred due to a change in sales leadership. Adjusted SG&A expenses represented 15 percent of total revenues in the first quarter of 2015 compared to 13.4 percent of revenues in the corresponding quarter of 2014. This increase in SG&A expense reflects additions to our offshore recruitment staff and investment in our sales organization to support our technology practice.

Net income for the first quarter of 2015 was $195,000 or 04 cents per diluted share compared to $869,000 or 20 cents per diluted share in the first quarter of 2014. It should be noted that the previously mentioned severance charge negatively impacted diluted earnings per share by 5 cents.

Addressing our financial position at March 31st, 2015, we had cash balances on hand of approximately $2.9 million, no outstanding borrowings and over $16.4 million of borrowing capacity under our existing credit facility. We currently have a commitment from PNC Bank to increase our existing $20 million credit facility to $26 million in support of our recently announced plans to acquire Hudson Global U.S. IT staffing business.

I will now turn the call over to Kevin for his comments.

Mr. Kevin Horner: Thanks, Jack, and good morning, all. First, I would like to comment on our first quarter performance, and then I'll give you some of my thoughts on our recently announced agreement to acquire the U.S. IT staffing business of Hudson Global.

With respect to first quarter, we made changes to our sales organization in early March. In connection with these changes, I assumed the role of Chief Revenue Officer in addition to my CEO responsibilities. While we certainly have much work to do, I'm feeling very good about what we have accomplished in just a few months and how the organization is responding to the change.

As we clearly stated in our Q4 earnings call, year-over-year comparables would be unfavorable for the first half of 2015. I do want to point out that our COB headcount was essentially unchanged during in Q1, and more importantly, soundly positive in the last half of the quarter. The supply side of our business continues to be our largest challenge as IT talent become more and more scarce in relation to demand. Simply put, recruiting capacity and capability both need to increase, and our sales organization needs to be at its absolute best given the available talent in the market. With our low cost recruitment engine, I believe these market dynamics will actually put us in a better competitive position as compared to many of our peers.

Gross margins were disappointing in Q1 and were impacted by two cost items, which should not have the same negative impact in future periods that they had in Q1 - namely, higher bench costs from our start-up technology practice and the cost of compliance with the Affordable Care Act.

Moving forward, bench cost in our technology practice will be significantly lower than in Q1, and the higher healthcare cost of ACA will largely be recovered by higher bill rates on new assignments. Additionally, it should be noted that, as you all know, Q1 gross margins are historically lower than subsequent quarterly gross margins due to the impact of higher payroll taxes in Q1.

As Jack mentioned, operating expense in the first quarter 2015 was impacted negatively by $305,000 in severance expense as we have the cost of adding additional recruitment capacity and additional sales capacity in both our new business development space and in our technology practice area. We still view the sales related cost we have added to the business as investments in growth. We're expecting to make those investments pay off in Q2 and Q3 of this year.

In summary, while certainly not pleased with Q1's year-over-year declines, I've seen many of the cost elements that negatively impacted the first quarter 2015 results as transitory, and I'm looking forward to meaning improvements in operating profits in coming quarters. Lastly, we're seeing meaningful consultant-on-billing growth in the latter half of Q1 and now into Q2. So, I'm encouraged as we walk into Q2.

Now, I'd like to offer some comments on the Hudson announcement that was made yesterday.

As we announced yesterday, we have signed a definitive asset purchase agreement to acquire the U.S. IT Staffing business of Hudson Global. The transaction is subject to customary closing conditions and expected to close in the second quarter of 2015. In my view, this is a perfect acquisition for Mastech. As I have mentioned many times, acquisitions are a significant component of our growth strategy, and while Jack and I have looked at many target companies over the last year, I believe that far and away this acquisition is the most compelling that we have seen for Mastech.

I see attributes of the two organizations complementing each other's strengths and mitigating each other's weaknesses. Without diving too deep given the public nature of both of our businesses and the acquisition is not closed, strategically, I see the following advantages for our company.

First and foremost is an in fusion of capable talent. I've been impressed with the leadership that we will be inheriting as well as the talent of both the sales and the recruiting organizations in Hudson IT. As we looked for the right talent over the last two years - as we looked for the right acquisition over the last two years - talent, the lack thereof, was the factor that usually made us walk away.

Number two, Hudson has a strong stable of retail clients, which complements our business model. As you all know, our current business model is more aligned with the wholesale channel. I see an immediate opportunity to leverage our offshore sourcing capabilities to enhance client service within Hudson. Hudson has a domestic recruiting focus - again, a great complement to our offshore recruiting model in an area that we wanted to grow strategically during 2015 to better service the direct client market.

Number four, as we alluded in our press release, this isn't a synergistic cost savings transaction, this is a synergistic growth transaction. Not only do we plan on keeping all Hudson's sales and recruiting staffing intact, we also want them to utilize the benefits of our business model and our SGA model to enhance services to their clients.

From a financial perspective, we believe the acquisition will, A, be immediately accretive to earnings, B, increase our revenues by close to 30 percent and, C, impact gross margin percentage favorably. So, we will immediately add to our portfolio a high concentration of retail revenues and a robust pump placement business.

In summary, I couldn't be more excited about this opportunity and look forward to announcing our closing later in the quarter.

At this time, I would like to open it up for questions.

Operator: Thank you. At this time, we will conduct a question-and-answer session. If you would 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 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. Once again, that's star, one to ask a question at this time. One moment please while we poll for our first question.

Once again, ladies and gentlemen, that's star, one to ask a question at this time.

Our first question comes from David Polonitza with AB Value Management. Please proceed with your question.

Mr. David Polonitza: Hey, guys, good morning. Just wonder if you can just explain a little bit why Mastech was looking at acquisition candidates and what is the benefit of improving or increasing your footprint now in the retail space, and how you'll be able to leverage your existing infrastructure to improve this acquisition?

Mr. Kevin Horner: Sure, Dave. Let me take a shot at that and Jack, if you have anything to add, please do. One, obviously, we're trying to be a bit careful because the acquisition didn't close but let me offer what I can right now, Dave.

We've talked in the past about a growth strategy for Mastech that includes basically four prongs or four quadrants of activity. The first quadrant is growing with our existing client base and driving growth in there at 1.5 times market.

The second quadrant is adding new larger scale customers that are VMS, MSP style customers that fit in our high volume, low cost speed recruiting model. The third quadrant of growth was really all about growing in-depth in the technology practice and growing from a retail client base. As you all know, our business is 75 percent wholesale and 25 percent retail today.

Our long-term vision is to drive that to a balance that looks pretty much 50/50. We don't expect to get there overnight - much more of a three to five year approach.

But we see high value in having a retail client base, as well as having a wholesale client base. There are a couple of obvious reasons, right? And if you look at any of our publicly traded peer groups who have a much higher retail base than we do, you can see gross margin impacts of that retail base are interesting, and we like those.

We believe that, first and foremost, we can bring a retail client base into our business and then using our low cost SG&A model service through our offshore sourcing business and our offshore sourcing group, so we can actually make that onshore recruiting organization a bit stronger, and a bit broader by supporting it with a sourcing organization that's working while folks in the U.S. are sleeping.

Hudson recruiters will then wake up in the morning with sourced candidates that they can then go create relationships with and so on and so forth. So, we believe that retail client base is a huge component of our long-term strategy to grow the company significantly.

Our fourth quadrant was really to acquire the fill-in gaps for one of those first three quadrants, and that's where the Hudson acquisition fits in our overall growth strategy.

It's a play to actually add retail client base, add strong talent, and add a couple of customer facing markets that we frankly don't have today.

The business that we are acquiring has offices in Boston, Chicago, Orlando and Tampa. The only office overlap that we have with them is in Chicago and our presence in Chicago is fairly small in comparison. So, I really like the fact that there's virtually no end-client overlap and there's no physical overlap between the two businesses.

So, Dave, I think all of those things are rationale for how the acquisition fits into our strategy and why we would look at a business like Hudson IT, it's extremely favorably.

Mr. David Polonitza: Thanks. Just, one more question--would you guys be looking at further acquisition candidates once, the integration of this potential acquisition has been completed?

And also, what's your plan to really drive organic growth of the existing business? Obviously, the first quarter, there were a lot of areas that you worked on. But, overall, how do you see your company--your legacy business and now this new business achieving that growth rate that you're hoping to achieve with respect to the industry?

Mr. Kevin Horner: I'll answer that several ways, and I may have to be a little bit cryptic here just because the deal isn't closed. In our legacy business, in the Mastech business, I think you all know from our last call, we made two really significant leadership changes in the organization.

First, we moved Sameer Srivastava, who was running our alliance channel out of India, into a role where he's now the Managing Director in India and he's running all the recruiting.

First and foremost, Sameer's role inside of our company since the beginning of January has been to bring a disciplined focus to the way we on-board train and develop our recruiting organization. Sameer and his team have worked on that pretty hard over the last 90 to 100 days. As you would guess, those kinds of changes aren't simple to make.

I think I've quoted some numbers for this group before, so let me do that again. We've built a recruiting efficiency index. We took several variables around the recruiting process into consideration and created kind of a batting average, if you will say.

And in 2012 that batting average for our team was about 25 percent, a 250 batting average. Over the last two years, we've driven significant amount of change through the recruiting organization and moved that batting average to about 500.

What we determined in the fourth quarter of 2014 is that if we wanted that batting average to look more like 750, then we had to make a step change in the way we manage the organization and with the quality of the people who are managing the organization and with onsite onshore leadership there in India, because that organization had historically been managed out of our COO channel from 9,000 miles away. And that's part of what we want.

So, we made that first major change. As any change is, it was tough to do because we took people that the folks executing the process had looked at it and said, boy, I'm being way more successful today than I was a year-and-a-half ago. And we decided that the time to make that step change is when you're actually being successful, not when the sky is falling. So, we made that change.

It's taken a little bit of time, but we're now seeing a much better quality of candidates in our proposals an*d* we're working on getting our throughput, our time to respond back up to where, we need it to be in the market.

So, Dave, the long and the short of it is the side of that answer around growing organically with our current business is actually getting the changes implemented that's merely driving in the recruitment organization. Like any other major change in the business, I'm expecting that we are beginning to see the results in Q2 and full on support for the change will probably show up late Q2, early Q3, just based on the large scale change management initiative that we're the middle of. So, that's number one.

Number two, as mentioned a couple of times now, we've continued to invest on the sales side. We've brought in about seven or eight new sales folks over the last, 120 days, 140 days and, each of those folks is now beginning to find their feet and beginning to actually close some business. I'm pretty excited from that perspective that we have legacy business that is now poised to grow both from a new business development standpoint and from the tech practice area, didn't talk much about that ---we've gotten the folks off the bench that Jack mentioned, that hurt our gross margin in the first quarter, got folks out on project filling and we've changed our model a little bit in that we're going to do a little bit less bench moving forward for Q2 and

Q3 and probably into Q4 than we have up until now and use the market a little bit more to make the sales force practice work, and I'm convinced that'll be fine.

Then, lastly, you talked about how you think about organic growth with the newly acquired business. This is where I want to be careful--we have several thoughts about how our businesses are complementary. And when we close this one, I'll be more than happy to talk in a little more depth about some of what we see.

As already said, immediately, I think we can help the existing Hudson recruiters on the day of close with our sourcing organization that's located offshore and that we can immediately begin to add potential candidate volume for those folks so that they can go out and create relationships with candidates in the market that they may not have been exposed before.

Then the second thing that we will examine with the Hudson sales team and the Hudson leadership team as they come over into Mastech is, we'll take a look at each and every one of the existing Hudson customers and we will assess if there is an opportunity to take a potentially dormant Hudson customer that actually runs a big chunk of the business through an MSP or a VMS and work that directly through the Mastech model.

That's an opportunity of sales synergy that we can bring. We are way early in the process, and I don't want to confuse anyone or scare anyone that we're going to change accounts around because that's not the plan. The plan is for Hudson to roll into Mastech as a self contained business. There are no changes that are happening from the sales and recruiting perspective. We brought all of the sales team. We brought all of the recruiting team, and really will plug-in our finance, HR, legal and IT back office functionality into the sales and recruiting folks from Hudson.

I expect there'll be a bit of synergy there given our SG&A model versus most of our peers but nothing on the sales and recruiting side. We bought the business for the sales people, and we bought the business for the recruiters. We bought the business for those folks.

Mr. David Polonitza: Great. Thank you.

Operator: Once again, ladies and gentlemen, to ask a question at this time, please press star, one on your telephone keypad. One moment while we poll for more questions.

Once again, that's star, one at this time.

There are no further questions in queue at this time. I would like to turn the call back over to management for closing comments.

Mr. Kevin Horner: Thanks, operator, and thanks to all for participating today. Please join our call in late July as we talk about the second quarter and watch for the close announcement. As we've noted in our press release, we expect the transaction to close some time in the second quarter. Again, I'm very, very excited for the business as we move forward into the second half of 2015. Thanks very much.

Operator: Thank you. This does conclude today's teleconference. You may disconnect your lines at this time, and have a great day.