Mastech Digital, Inc.
Third Quarter 2022 Earnings
November 2, 2022

Operator
Greetings and welcome to the Mastech Digital, Inc, Third Quarter 2022 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 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, Jennifer Lacey, Manager of Legal Affairs for Mastech Digital, Inc.

Thank you. You may begin.

Jennifer Lacey
Thank you, Operator, and welcome to Mastech Digital's Third Quarter 2022 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 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 2021 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 Vivek for his comments on several recent noteworthy events.

Vivek Gupta
Thank you, Jennifer. Good morning, everyone.

First, let me address the press release that was issued last night related to a change in leadership and our Data Analytics Services business segment.

Ganeshan Venkateshwaran resigned yesterday from the Company, as the CEO of the Data and Analytics Services segment. Our Board accepted his resignation with immediate effect.

I will serve as the Chief Executive of the D&A Services business, until Ganeshan's successor is in place.

Secondly, as mentioned in this morning's third quarter earnings release, we experienced a cyber-security breach involving a single employee email account and which indirectly impacted two Mastech InfoTrellis clients. Our IT team identified the point of entry, decommissioned the affected laptop and email address and changed logins and passcodes for this email account. To be doubly sure and as a good business practice, we also engaged external advisors to relegate our findings and remedial action steps.

As part of this engagement, these experts are assisting us with forensic analysis to determine whether any "personally identifiable information", also known as PII, was compromised as a result of this breach. For any PII data determined to have been compromised, these advisors will be assisting us in determining the appropriate compliant steps required with respect to such PII data.

We have accrued a pretax loss reserve of $450,000 in the third quarter 2022 related to this event, which reserve includes the costs of engaging our external advisors, as well as an estimated other potential losses, relating to the breach.

Finally, in third quarter, 2022 we made a decision to close our underperforming operations in Singapore and Ireland and to rationalize our operating cost structure in the UK. Accordingly, we've reserved $120,000 of severance expense, related to these actions.

Let me now turn the call over to Jack for a detailed review of our third quarter, 2022, financial results.

Jack Cronin
Thanks, Vivek, and good morning, everyone.

During the third quarter of 2022, revenues totaled $63.2 million, compared to $59.5 million in the corresponding quarter of 2021. This 6% year over year increase reflected an 8% increase in the IT Staffing Services segment and a 4% decrease in our Data and Analytics Services Segment.

The 8% revenue improvement in IT Staffing reflected a higher level of consultants ongoing and a higher average fill rate, during the 2022 third quarter compared to corresponding quarter, a year ago.

The 4% revenue decline in Data and Analytics comes after a 26% year over year improvement during the previous quarter and, largely, reflects the timing of workable orders available in the second quarter versus the third quarter of 2022.

Gross profits in Q3, 2022, totaled $16.3 million, compared to $16.6 million in the third quarter of 2021. Gross profit as a percent of revenues in Q3, 2022, was 25.8%, compared to 27.9% in the 2021 third quarter. The decline in Q3, 2022, gross margins was largely due to lower utilization in the Data and Analytics Services segment, as we were unable to fully deploy the second quarter ramp-up of billable resources. Additionally, we incurred a project overrun of approximately $300,000 on a fixed price assignment scheduled to complete at year end.

GAAP net income for the third quarter of 2022 was $2.4 million, or $.20 per diluted share, compared to $3.4 million, or $.28 per diluted share in Q3, 2021. It should be noted that reserves for a cyber-security breach and severance expense associated with the closure of our Singapore and Ireland operations, as well as the rationalization of our cross structure in the UK had a negative impact on GAAP diluted earnings per share of approximately $0.04

Non-GAAP net income for the third quarter of 2022 was $4 million, or $.33 per diluted share, compared to $4.6 million, or $.38 per diluted share in Q3, 2021.

SG&A expense items not included in Q3 non-GAAP financial measures, net of cash benefits, are detailed in our third quarter, 2022, earnings release, which is available on our website.

Addressing our financial position, on September 30, 2022, we had cash balances on hand of $3.5 million, outstanding term loans of $2.2 million, no borrowings under our revolving credit facility and cash availability of $36.4 million, in addition to term loan capacity of up to an additional $20 million, under our revolving credit facility accordion feature. During the third quarter, we elected to pay $7.6 million of our outstanding term debt with excess cash balances on hand. Given our term loan repayment schedule, we expect to be debt free in early January of 2023.

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

Vivek Gupta
Thank you, Jack.

Clearly, we're not happy with the third quarter performance of our Data and Analytics Services business segment and view the decline in year-over-year revenues and sizable gross margin shortfalls as unacceptable. Moving forward, we need to focus more on new business development activities, strengthen our relationships with existing clients, align our billing workforce with secured workable orders, which we believe will, in turn, improve utilization and, proactively, monitor all fixed price assignments. We will endeavor to focus on these issues immediately in an effort to avoid such occurrences in the future.

Our IT Staffing Services segment continued to grow in the third quarter of 2022 at improved gross margins and at higher bill rates. We did, however, see some weakness in demand during the quarter, which resulted in a 30 billable consultant headcount decline. We will continue to monitor activity levels in Q4 to assess if this was an aberration or the beginning of a shift in market dynamics.

Lastly, I would like to mention that, during the 2022 third quarter with the central bank continuing to increase interest rates, we made the decision to pay $7.6 million of outstanding term loan in July. This action will lower our quarterly interest expense by approximately 100K, as we continue to deleverage our balance sheet in today's uncertain environment.

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.

Thank you. Our first question comes from the line of Lisa Thompson with Zack's. Please proceed with your question.

Lisa Thompson
Good morning.

Vivek Gupta
Hi, Lisa.

Lisa Thompson
You folks have certainly had a busy quarter.

Jack Cronin
That's for sure.

Vivek Gupta
Yeah, thanks, Lisa.

Lisa Thompson
Okay, so, I think we'd be interested in getting a little bit more clarity on what you think might be happening at D&A. You certainly have a lot of cash to make an acquisition is that something you could do and then bring in that business to run your current business?

And do you think that the weakness there is due possibly to people reigning in their plans to a recession or is that just missteps?

You elaborate a little more.

Vivek Gupta
Can you—can you just repeat the last part? I didn't quite get that part of the question.

Lisa Thompson
Do you think that say, the pipeline drying up, or whatever, is due to your own missteps, or is that from a recession where customers are pulling back their plans.

Vivek Gupta
Okay. So, Lisa, let me try and answer the second one, first. The second one is I think when I mentioned the demand reducing a bit, it's more on the IT Staffing side.

We’ve not seen evidence of that on the Data and Analytics side so far. It doesn’t mean it may not be there, but we haven’t seen evidence of that, so far.

Now, coming to the first part of the question, there is clearly some work to be done on the Data Analytics piece. As I mentioned, there are a bunch of things that we have identified that we need to focus on, including new business development, making sure that we are able to maximize what we can from our existing relationships with our existing clients and then making sure that we align the workforce to actual orders.

We did a bit of building up our resources in Q2, but we were not able to fully utilize them.

And then the last one which happened again coincidentally with the project overrun that we had in D&A.

So, these things really contributed to what turned out to be a not so good quarter for Data Analytics in Q3. But we are pretty confident, and we remain confident in the long-term growth prospects of the segment and the value of the solutions that we delivered to our customers and I’m confident that our team will effectively meet the current challenges and we will emerge as a better company, as a result of these efforts.

Lisa Thompson
Okay.

Vivek Gupta
So, does that answer your question, Lisa.

Lisa Thompson
Yes. Thank you. Did you book any new orders in that business, this quarter? I know you did $10 million last quarter.

Vivek Gupta
Yes, I think it was for a similar order. Jack, do you have the number.

Jack Cronin
Yes, I think it was a little bit over $8 million.

Lisa Thompson
Okay, great. And I know that Q4 is typically weaker because of the holidays. Can you give us a feel for what to expect, going on in Q4?

Vivek Gupta
So, Q4, indeed, is always seasonally a lower quarter because there are lots of holidays and there’s also a tendency for some customers to put folks on furloughs and this actually impacts

our IT Staffing, specifically. So, we do expect some amount of depression, decline I can say in Q4. But that's typically seasonal. And then also, a lot of assignment ends in the IT Staffing side, virtually, on the last day of the last week of the quarter, which have a little bit of impact on a carryforward into Q1.

And this is the seasonal view. Jack, is there anything else that I missed?

Jack Cronin
Lisa, I just want to make one comment on D&A. There's no denying that the third quarter was a bit disappointing. We did revenues of $10.1 million, well below what we were hoping for, but you've got to remember that in the second quarter, our revenues were $11.3 million and in the first half of the year, we were averaging about $10 million. So, yes, the third quarter was a disappointment, but it's not like the business is falling off the cliff.

Lisa Thompson
So, do you expect it to grow sequentially, this quarter, or not?

Jack Cronin
I would, yes, I would say that I think it would be flat to slightly up in Q4.

Lisa Thompson
Okay, that's up. And I know you've gone, you know, have been in this rodeo quite a while here, as far as recessions coming up. Is there any actions you take, if you start seeing weakness, globally?

Vivek Gupta
Yes, so, Lisa, we are already leaning to tighten our belts as they say, because we see that almost all our clients, and I'm talking more on the IT Staffing side, being extra cautious in there, you know, in the current uncertain conditions. And, the likely possibility of a recession. Now, while the large-scale projects are not being cut, our largescale headcount reductions are not happening. Our customers and partners are definitely tightening the cost structure and they are pushing out or shrinking or even canceling some projects, some IT projects. So, that's what we are seeing. But in anticipation of that sort of happening or the recession really happening and customers taking some drastic steps, we will already started tightening our belts and in terms of anything that can be deferred in terms of our costs, we are looking at ways of doing that.

Lisa Thompson
Great, thank you. That's all my questions.

Vivek Gupta
Thanks, Lisa.

Operator
As a reminder, if you would like to ask a question, press "*", "1" on your telephone keypad.

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.

Marc Riddick
So, I was wondering if you could talk a little bit about the decision as far as the closing of Singapore and Ireland and some of the financials or some of the details that we might need to address with that decision.

Vivek Gupta
Yeah, sure, Marc. Jack has been constantly driving that initiative. So, I'm going to let Jack talk to you about this.

Jack Cronin
Sure, Marc. If I two plus years ago, we established Singapore, Ireland and the UK subsidiaries on expected strength of a global partnership that we had with a major client. And shortly thereafter, COVID hit, and the business really never took off, as we expected. In 2021, we made some gains in the UK, but the other two entities continued to underperform. So, we entered 2022 and the Singapore operation and the Ireland operation continued to operate at a loss. And recently, we decided that it was really time to cut date. We had other areas in the U.S. to spend our money, rather than trying to grow a couple subsidiaries that we just couldn't grow. The UK has gained some traction in both 2021 and 2022. But we really haven't been turning the profit that we expected. And that's why we made the decision to sort of rationalize our cost structure in the UK as we go into 2023. But that's the short of it.

Marc Riddick
Oh, okay. And then, could you sort of remind us, and the headcount was sort of growing, going into the summer and there was a ramp up on staffing. So, can you sort of bring us as to where we are at the end of the third quarter and where we might be, as far as headcount in staffing?

Vivek Gupta
Sure, Marc. As I mentioned that we had a 30 billable consultant headcount decline in Q3. The point to be noted is that our assignment starts continued to be very high. I would say, even in this Q3, it was probably one of the top five or six quarters since, I guess, last six, seven years.

So, we are sort of not at the record level that was a couple of quarters ago, but they're still pretty high.

The problem isn't this equation when you are doing the net growth, it's just the number of starts, minus the number of assignment ends. The assignment ends have been high. And I think that some of it is, you know, based on what I mentioned a little earlier, as the customers are trying to tighten their belts, they are really asking themselves the question, do we need some of the projects to continue. So, we've had an exceptionally high number of ends of assignments in the quarter. And so very high, sorry, high starts but very high ends sort of ended up making it into a negative 30 kind of number. But we are watching this closely to see if there's something which is sort of a one-off kind of a thing or is this now going to be a pattern of the market dynamics, going forward.

Marc Riddick
Okay. And then, you made comments either it might have been both in the presentation and the prepared remarks around billable rates. Can you sort, a little more, to what you're seeing there on bill rates and maybe how that sort of played out in the quarter?

Vivek Gupta
So, the bill rates, you know, happy that we've been able to steadily increase the bill rates over the last three, four quarters and we've got the benefit of that. It's again, a market is out of demand versus supply. When the supply was limited, demand has been much higher for these resources that drives up the import price, the price that we pay on, what we pay our consultants and, in turn, what the customers are willing to pay, as well. So, that has been to our advantage. It's really, again, a function of how this dynamic demand versus supply changes, over the next few quarters. That may sort of bring some kind of price pressure, but we so far, it's been all very positive, and we've got the benefit of.

Marc Riddick
Okay. And then, can you pass a dispute on—if I remember quickly, sort of the timing of some technology spending and implementation that took place earlier in the year and sort of, you know, could you sort of bring us up to speed, sort of where we are there and what you might be expecting for the remainder of the year?

Jack Cronin
Yes, In our Data and Analytics Services segment, we implemented in earlier in the year our order pull cloud system. And we did an implementation and that concluded at the end of April. We spent a little bit of money to get the bugs out in the second quarter. But that's pretty much completed, right now.

Marc Riddick
Okay. And so, what we might be looking at Capex, sorry, yes, for Capex for the year.

Jack Cronin
CapEx is going to go, I mean, compared to what we spent over the last first half of the year, CapEx is going to go down.

Marc Riddick
Okay. All right, so, it'll be a little less than or about the same as last year--

Jack Cronin
--Um-hmm.

Marc Riddick
For this year?

Jack Cronin
Let me look at the statements real quick, here. So, for the first nine months of 2022, we had Capex of about$ 800,000. In 2021, nine months, is about the same thing, it's about $900,000. So, I would expect that we end up the year about a million, a million, probably a million.

Marc Riddick
Okay, got you. And, just, so, if we could go back to sort of the demand environment that you're looking at on IT Staffing, can you sort of bring us up to speed maybe on what you're seeing as far as your customer verticals and are there any sort of standout kind of the positive or negative that you're seeing there as far as their activity? I mean, I understand you're seeing, in general, as far as, you know, folks are kind of slowing down a bit. But are there any particular areas that are maybe more active in that behavior or vice versa that are noticeable?

Vivek Gupta
Sure, Marc. actually, the drop is virtually across the board. It's really, dark drop in demand what we have seen on the tightening of the built that I have been saying is, across the board, it's really all customers in virtually all verticals. So, there is no clear pattern emerging that is one more than the other. Although, financial services specifically that vertical is showing a lot more concern, and we're having a lot more conversations in that space. But every customer is being extra cautious, I mean, these conditions right now. And, as I mentioned, no major large-scale cutting has been seen, so far, in terms of huge headcount reductions, something that we saw in 2020, or large projects being canceled. But we are seeing a smaller sort of actions, such as pushing out projects, not canceling them. But or shaking the sides of the projects or breaking up the projects into smaller phases. And then, sort of committing to only one phase at a time, sort of with they have the option of sort of pulling the plug, if they need to, halfway through the whole process. And there has been some cancellation of some IT projects. But those have been few and far between. That's what we are seeing, at this point in time. So, there's no clear pattern. It's everybody is sort of waiting to see what actually happens. But there is some conversation, I can see almost every organization has made their contingency plan that should things really get bad, what are the steps they will take.

Marc Riddick
Okay. And then, the last one for me is, if you can sort of bring us up to speed on maybe what you're thinking about for Data and Analytics, as far as the acquisition siding of things. And this is something that, you know, earlier in the year with the new leadership, I know, you were sort of looking at the pipeline and looking at priorities and, obviously, the news is quite fresh. But maybe sort of give us some thoughts as to sort of maybe where you are, what your thoughts are, what the potential acquisition pipeline, the health of it a desirability or pricing maybe sort of just sort of bring us up to speed on maybe what your thought are there.

Vivek Gupta
Sure, Marc. I mean, acquisition is definitely in our plan. We will, as I said before, we would be doing the acquisition on the Data and Analytics side. Specifically, one of the areas that is something that in some ways, we would now want to wait for the new leader to be on board and make sure that the selection criteria for the acquisition aligns with the strategies of the new leader. So, I think what this really means as a part of, for us, we have to put this sort of on the back burner for a couple of quarters. And then, we will, at the first opportunity once the new leader settles down, we would want to reactivate our plan and go back to it. So not much has changed. It's just the timeline has gotten extended a little bit.

Marc Riddick
Got you. Thank you.

Vivek Gupta
Thanks, Marc.

Operator
Our next question comes from the line of Ross Davidson with Benetan (PH) Capital. Please proceed with your question.

Ross Davidson
Hi, good morning, Vivek and Jack.

Vivek Gupta
Hey, Ross.

Jack Cronin
Hi.

Ross Davidson
Hey, so, I was just curious if you could just talk a little bit more about Data Analytics, specifically. And if I recall correctly, it seemed like, you know, with Q2 results, you had ramped up some headcount and you alluded to sort of the underutilization of that increase in staff, if I understood you, correctly, for this quarter.

I'm curious to see if you can elaborate on maybe what changed or sort of how that maybe imbalance happened because it seemed like demand and expectations were a little bit more robust in Q2. And you, it seemed like maybe you expected some growth. And I'm curious what changed more specifically through the quarter that led to that you know, shortfall, if you will.

Vivek Gupta
Sure, Ross. So, in Q2, we had ramped up resources in anticipation of some projects to be started in Q3. And we didn't quite get all the projects signed in time. And we had a situation where we had excess resources than what could be used against workable orders. It's really as simple as that. We have to make, keep the engine running, and we've got to make sure that the order booking that we have from this point onwards aligns with all of the other resources that we have, aligns with the orders that we are expecting. So, I guess that misstep is something that we are already working on and correcting, so that we don't have this drop in utilization, as it developed. And also again, lumpiness, which has come in the revenue is how do we make sure that the revenues don't drop. So, it's a bit of these multiple things that have happened, I guess, which contributed to where we are with Data and analytics.

Ross Davidson
That's helpful. I mean, it sounds like you characterize it as a misstep. In retrospect, hindsight is, of course, 20/20, but do you feel like—there's some idiosyncratic risk is always going to be there where, you know, you're going to have to make some judgment calls about staffing up. But do you feel like maybe it sounds like you feel like that you could have done better, in terms of anticipation. Is that a fair take away of how you would characterize it?

Vivek Gupta
I would actually say that's correct. We maybe we shouldn't have ramped up that much and at the same time, we should have had an order book or a pipeline robust enough to be able to sustain that. So, we have an issue on both sides and we've identified that and we're ready working on addressing those.

Ross Davidson
Great, thanks on that. And then, I just wanted to ask about the fixed-price overrun, just understand, kind of what high-level kind of leads to that overrun and then, is that you said it was going to expected to end at the end of the. Is that something you continue to--you expect to recur any sort of like systemic thing you're watching, related to that, that overrun?

Vivek Gupta
Ross, the good news is that the overrun is over. We're not going to have that carrying forward that's correct and the other thing I want to really stress, when we do fix price projects on any organization that has fixed-price projects, there's always the odd project which gives you a little bit of grief value, you underestimated or some other reason, you end up spending more resources on that project. One point which is really important is that this is the second project in the last five years, since we acquired Infotrellis, which has given us, which has gone into an overrun and I would say that the last one was actually many years ago. So, I would say, while it's not good to have any overrun going into this overrun having just had two in the last five years, speaks volumes about the quality of delivery that we have in the organization. Of course, when you look at this closely, we are already looking at all fixed-price projects, very closely, to see that we are able to spot and identify any other potential problem project very, very early but this is where we are.

Ross Davidson
Great. That's helpful. Alright, thanks. That's all I have. Appreciate it.

Vivek Gupta
Thank you, Ross.

Operator
Thank you. We have no further questions at this time. I would now like to turn the floor back over to management for closing comments.

Vivek Gupta
Thank you, Operator. If there are no further questions, I would like to thank you all for joining our call, today. And we look forward to sharing our fourth quarter, 2022, results with you in early February.

Thank you.

Operator
Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines, at this time. Thank you for your participation and have a wonderful day.