MASTECH

Q4 2015 Earnings Call

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Operator: Greetings and welcome to the Mastech Q4 2015 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 star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ms. Jennifer Ford Lacey, Manager of Legal Affairs for Mastech Holdings. Thank you, Ms. Lacey. You may begin.

Ms. Jennifer Ford Lacey: Thank you, operator, and welcome to Mastech's fourth 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.

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.mastech.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 fourth quarter and full year 2015 results.

Mr. Jack Cronin: Thanks, Jen, and good morning. First off, I'd like to remind everyone that our June 2015 acquisition of Hudson IT is reflected in our financial results effective as of the acquisition date and accordingly has benefited our year-over-year comparables. With that backdrop, revenues for the fourth quarter of 2015 totaled $32.5 million compared to $28.5 million in the fourth quarter of 2014. This 14 percent year-over-year increase in revenues was entirely attributable to our Hudson IT acquisition.

Activity levels during the quarter were slightly below the previous quarter and included some holiday related weakness in the latter part of December. Despite solid overall demand, we had a net decline in our billable consultant base of 47 consultants during the quarter. This reflected a combination of a higher level of assignment ends, which historically occur in fourth quarter, and a disappointing start performance, which Kevin will talk more about in his prepared comments.

Gross profits for the fourth quarter of 2015 totaled $6.7 million or 20.6 percent of revenues compared to $5.2 million or 18.3 percent of revenues during the same period last year. Our gross profit dollar increase reflected non-organic revenues in the 2015 quarter. Additionally, fourth quarter 2015 was positively impacted by approximately $100,000 of lower benefit costs due to the favorable claims experience related to our self-insured healthcare program.

Our year-over-year gross margin comparables benefited from Hudson IT's strong retail client base, which generally carries higher gross margins than in our wholesale channel. Additionally, our gross margins on new starts continued to trend up in Q4, and this coupled with a lower benefit cost further contributed to our overall gross margin improvement during the quarter.

SG&A expenses were $4.5 million in the fourth quarter of 2015 and represented 13.8 percent of total revenues compared to $3.9 million in the fourth quarter of 2014. The increase in SG&A expenses in the 2015 quarter compared to the corresponding quarter of 2014 reflected SG&A expenses related to the Hudson IT operations. It should be noted that third quarter 2015 SG&A expenses, or previous quarter, totaled $5.3 million or 15.5 percent of total revenues and represented the first full quarter to include all the SG&A expenses associated with the Hudson IT operations.

Our lower SG&A expenses of approximately $800,000 in Q4 2015 compared to Q3 2015 was due to the following items - one, lower staff salary expense of approximately a $100,000 due to non-regrettable employee attrition and higher vacation time off, two, lower variable compensation expense of approximately $400,000--this is a combination of lower sales commissions, management incentives and stock-based compensation--three, lower travel and marketing expenses of approximately $200,000, and four, an elimination of $100,000 of transaction--excuse me--transition service cost associated with the Hudson IT acquisition that we incurred in Q3 2015. These SG&A expense reductions played a significant role in driving our GAAP and non-GAAP net income in the fourth quarter of 2015.

To that point, GAAP net income for the fourth quarter of 2015 was $1.3 million or 29 cents per diluted share compared to $782,000 or 18 cents per diluted share in the fourth quarter of 2014. Non-GAAP net income for the fourth quarter of 2015 was 1.4 million or 31 cents per diluted share compared to $804,000 or 18 cents per diluted share in the corresponding 2014 quarter.

Fourth quarter SG&A expense items not included in the non-GAAP financial measures net of tax benefits were amortization of acquired intangibles and stock-based compensation expense and are detailed in our Q4 earnings release, which is available on our website.

Addressing our full year results, 2015 revenues totaled $123.5 million and represented a 9 percent increase over 2014 revenues of 113.5 million. This increase reflected our June 2015 acquisition of Hudson IT. Organically, revenues decreased by approximately 5 percent in 2015 due to the decline in our billable consultant base. Gross profits in 2015 were $23.8 million compared to $20.8 million in 2014. Gross margins as of percent of revenues were 19.3 percent in 2015 compared to 18.3 percent in 2014. Both the higher gross profit dollars and gross margin percentage are largely attributable to the Hudson IT acquisition.

GAAP net income for the full year 2015 totaled $2.8 million or 62 cents per diluted share compared to $3.4 million or 77 cents per diluted share in 2014. Non-GAAP net income for 2015 totaled $3.8 million or 85 cents per diluted share compared to $3.6 million or 81 cents per diluted share for the full year 2014.

Full year SG&A expense items not included in non-GAAP financial measures net of tax benefits were the amortization of acquired intangible assets, stock-based compensation expense, acquisition transaction cost and severance cost. Again, a detailed reconciliation of our non-GAAP measures compared to their comparable GAAP measures are included in our earnings release and available on our website.

At December 31, 2015, we had $11.7 million of outstanding bank debt net of cash balances on hand. Our borrowing availability at year-end 2015 was approximately $11 million under our existing revolving credit line. During Q4 2015, net bank debt declined by $3.8 million.

Lastly, our accounts receivable balance at December 31, 2015 remains of top quality. With client contract assignment matters related to our asset purchase of Hudson IT largely behind us, our days sales outstanding measurement is starting to return to pre-acquisition levels.

I'll 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 fourth quarter performance, and then I'll give you my perspective on the full year 2015 and where I see Mastech headed into 2016.

With respect to the fourth quarter, I would summarize Jack's detailed comments in the following way. Number one, our Hudson IT acquisition is providing the kinds of results that we hoped for when we acquired the business in June of 2015. Thus far, I'm very happy with this transaction.

Number two, gross margins continue to expand beyond the impact related to the acquisition, which pleases me. Albeit, we had some help during the quarter from our self-insured healthcare program. Three, we've done a good job of managing our SG&A expenses in Q4 from eliminating marginal producers, to encouraging the use of vacations during the slow holiday season, to tightening up on travel, marketing and supported related expenditures.

Our fourth quarter SG&A expense performance also shows the positive impact of having a leveraged compensation structure in place, with lower commissions, management incentives and stock-based compensation expense responding to a lower than expected growth rate for the business. However, despite a solid earnings performance in fourth quarter of 2015, our consultants on billing continued to decline, which was disappointing for me.

While historically the fourth quarter is a high project ends quarter, and we've generally come to expect some COB deterioration, my disappointment was squarely on the starts side of our business. We need to do better turning demand into new starts in 2016. We'll talk a little bit about our plans around that in a minute.

Addressing our performance for the full year, most of my fourth quarter view can be applied to the entire year. We closed an exciting acquisition with plenty of potential. The market is still cooperating, and we have adequate demand for our services. We have a low cost operating model, which has proven to be effective. But, again, like the fourth quarter, we struggled to convert demand opportunities into new business at rates which were consistent with our performance from 2011 to 2014.

Let's talk a little bit about our focus for improvement in 2016. That focus is a back to basic strategy. Within our offshore recruiting organization, we have implemented smaller client centric teams, each with an experienced leader accountable for the performance of his or her team. The smaller teams have daily quality candidate submittal targets, and we simply do not go home until we hit our daily targets. If January is a measure, we're probably up about 25 or 30 percent on submittal rates, as compared to Q4, so, I'm very pleased with the initial action on there.

Number two, we've added resource managers to our onshore delivery organization, and those RM's are working with our clients to clarify job requisitions technically, to confirm those technical needs with the recruiting organization and to evaluate the candidates who are being submitted for both technical fit and client cultural fit.

Number three, within our sales organization, we have added additional experienced account executives, plus we are reestablishing relationships in several clients who changed MSPs-- that would be managed service providers--in the second half of 2015. As you know, in the MSP world, relationships with both the customer hiring manager and the MSP's sourcing coordinators or sourcing contacts are crucial.

Number four, we have several interesting growth opportunities in 2016, and I'd like to highlight just a couple of them today. We added a new client in 2015 who is a large user of contract IT resources. In the two quarters we have been servicing them, we've moved into their top tier of vendors, and we stand to grow with them in 2016, as well.

Two, we have one of our integrator partners, again, a top five customer of ours, who is challenging us to double our starts per month with them in the first half of 2016. We've added recruiting capability, and we've added sales and RM capability to service that account.

Three, we have one of our direct customers, again, a top five customer, who's offered us the opportunity to significantly grow our exclusive business with them beginning in January of 2016. Historically, this customer is an MSP customer with little hiring manager contact. So, we expect to leverage those new relationships that we are building there as well.

To summarize, for Mastech, 2016 will be all about organically increasing consultants on billing with our clients. Our how-to do that is a back to basic strategy focused on two things which are simple to say but much tougher to do - one, a much higher level of quality candidate submittal activity from our recruiting organization, and two, a much higher level of sales activity penetrating our existing clients, developing new or re-establishing existing relationships with contacts within both customers, and where applicable, the customer's MSP.

At this time, I’d like to open it up for your questions.

Operator: Thank you. We will 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 that 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. One moment please while we poll for questions.

Our first question comes from the line of Louis Mosher with Mayfax Investors. Please proceed with your question.

Mr. Louis Mosher: Yes, good morning. I did try to verify that the new acquisition is not a seasonal business. I know you included it for just part of the year. And I wondered if this business will continue to grow as it has apparently done during the time you've had the company?

Mr. Kevin Horner: Actually, we expect it to continue to grow and the customers of the business are somewhat seasonal in that many of our contracts in the business run through the end of the year. December 31, 2015, was a big ends time for that part of our business, as well. So, if there is any seasonality in the business - it's high growth in the first two to three quarters with some trailing in the fourth. Is that a fair way to describe the business, Jack? At least as much as we've seen so far and what the team can tell us about how the business has historically performed.

Mr. Jack Cronin: Yes, and that's been their historical trend.

Mr. Kevin Horner: Yes.

Mr. Louis Mosher: Thank you.

Operator: Our next question comes from the line of David Polonitza with AB Value Management. Please proceed with your question.

Mr. David Polonitza: Hi, Guys. Thank you very much for the call this morning. I just have two quick questions - one, if you could just comment about the sustainability going forward of the operating margin. Obviously, it's a good number compared to historical margins of the company and the second one is just a breakdown of the wholesale verse retail revenue, and if there was any permanent placements during the quarter?

Mr. Kevin Horner: Yes, I'll let Jack think through the perm question, and let me try the first one. Dave, we believe that the operating margin or that the relationship of our SG&A costs to our revenue at 13.8 percent is absolutely sustainable. Now, there'll be times where in a quarter where we will add salespeople or add some recruiters. Generally, the performance is trailing those additions. Generally speaking, I don't see any reason those ratios won't continue.

Jack, do you agree with that on the operating margin side? I don't see any reason that they won't--.

Mr. Jack Cronin: --From a gross margin perspective, I think they're sustainable.

Mr. Kevin Horner: Yes.

Mr. Jack Cronin: We had $100,000 favorable cost settlement because of good claim experience on our self-insured program. Is that going to happen each quarter? I would doubt that.

Mr. Kevin Horner: Yes.

Mr. Jack Cronin: Margins, again, our perm placement activity was down in Q4. So maybe those two offset a bit, but certainly gross margins in the low 20s, I believe is sustainable. So, the operating margins----if you look at the cost savings that we had in Q4 versus Q3, and both of those quarters have all of the SG&A expense associated with the Hudson acquisition, the Hudson operations, we had $800,000 of cost or expense improvements, some of which are, in a way, one-time like the sales commissions, the management incentives and the stock-based compensation. Hopefully--.

Mr. Kevin Horner: --But, one-time related to revenue.

Mr. Jack Cronin: One-time related cost.

Mr. Kevin Horner: No, but as revenue increases the ratio of SG&A to revenue will continue to stay where it is.

Mr. Jack Cronin: I think maybe in the long haul, those operating margins would hold.

Mr. Kevin Horner: Yes.

Mr. Jack Cronin: But, in the shorter-term, I would suspect they're going to decline a bit.

Mr. Kevin Horner: Oh. You mean like--.

Mr. Jack Cronin: --Q1--.

Mr. Kevin Horner: --Q4 to Q1?

Mr. Jack Cronin: Yes.

Mr. Kevin Horner: That's a fair statement, Jack. Yes, that's absolutely fair. So, I stand corrected. That is fair. Dave, did we catch you? Did we get what you were looking for?

Mr. David Polonitza: Yes, and do you have the numbers in front of you in terms of the wholesale versus retail breakdown on the revenue base?

Mr. Jack Cronin: Yes, I do. Give me a second.

Yes, for fourth quarter, we had approximately 19 million of wholesale and 13 million of retail. We're looking at retail of around 40 percent and wholesale around 60 percent and prior to the Hudson acquisition that number was dramatically different. The retail channel was more like 25 percent. One of the advantages that Hudson did was it moved up our revenue split in retail.

Mr. David Polonitza: Thanks, appreciate it.

Mr. Kevin Horner: Thanks, Dave.

Operator: Once again, if you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate that your line is in the question queue.

There are no further questions at this time. I would like to turn the floor back over to you, Mr. Horner, for closing comments.

Mr. Kevin Horner: Given there are no further questions, I'd like to thank you for joining our call today, and we look forward to sharing our first quarter 2016 results with you in late April. Thanks, all.

Operator: This does conclude today's teleconference. You may disconnect your lines at this time, and thank you for your participation.