Mastech Digital Inc.
Q1 2021 Earnings
April 28, 2021

Operator:
Greetings, and welcome to the Mastech Digital Inc. quarter one 2021 conference 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.

Jennifer Ford Lacey:
Thank you, operator, and welcome to Mastech Digital's first quarter 2021 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, Paul Burton, Mastech InfoTrellis Chief Executive, 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 2020 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 regular meetings or calls.
I will now turn the call over to Jack for a review of our first quarter 2021 results.

Jack Cronin:
Thanks, Jen, and good morning, everyone.

The first quarter had some strong indications that the COVID-19 pandemic is dissipating with respect to its impact on a macro-economic environment. Activity levels generally increased during the quarter but the rate of increase varied materially from industry to industry and geography to geography. For instance, our IT Staffing Services segment had a significant uptick in activity from Q4 levels, while our Data and Analytic Services segment didn't see appreciable market improvement until the latter half of the quarter. As I review our Q1 2021 financial results, you will see this uneven recovery from the impact of the pandemic in our two business segments.

First quarter 2021 revenues totaled $49.8 million, compared to $50.4 million in the first quarter of 2020.

Our Data and Analytics Services segment contributed revenues of $8.8 million, essentially flat from the fourth quarter of 2020. Project delays continue to hurt revenues during the quarter. However, bookings rallied in the second half of the quarter to finish close to $16 million, which is quite strong and an indication of a solid revenue pipeline. Additionally, we saw activity improvement in Europe and parts of Asia, which are important growth markets for us. The uncertainty that still remains in the marketplace relates to when projects and pent up demand will be released in earnest, and we believe we are getting very close to this inflection point as we approach second quarter.

In our IT Staffing Services segment, activity levels increased from the fourth quarter of 2020 as we grew our global consultant-base by a record 9%. This performance essentially offset all of the billable headcount declines that we experienced during the pandemic impacted first half of 2020.

Gross profit in Q1 of 2021 totaled $12.8 million compared to $12.7 million in the first quarter of 2020. Gross margins, as a percentage of revenues increased by 50 basis-points over Q1 2020. During the quarter, we made additional investment in SG&A expense of approximately $1 million, largely in sales, operations, and leadership staff in efforts to capture anticipated future revenues as the COVID-19 recovery continues to gain traction globally.

Our decision to invest in front of an expected revenue growth curve reflects improving demand and early customer acceptance of our broadened D&A service offering, which Paul will touch on later in his prepared remarks.

GAAP net income for Q1 2021 was $1.2 million, or $0.10 per diluted share, compared to $1.9 billion, or $0.16 per diluted share, in Q1 2020.

Non-GAAP net income for Q1 of 2021 was $2.2 million, or $0.19 per diluted share, compared to $2.7 million, or $0.23 per diluted share in the first quarter of 2020.

SG&A expense items not included in non-GAAP financial measures, net of tax benefits, or the Amortization of Acquired Intangible Asset and Stock-Based Compensation and are detailed in our first quarter earnings release, which is available on our website.

Lastly, addressing our financial position at March 31, 2021, we had cash balances on hand of $7.2 million, no outstanding borrowings under our revolving credit facility, and cash availability of approximately $25 million. During the quarter, we reduced our term debt by $1.1 million to $16.4 million at quarter end. I should note that this debt balance includes the $10 million that we borrowed to finance the AmberLeaf acquisition in October of 2020.

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 the first quarter of 2021.

Clearly, project delays impacted revenues in our Data and Analytics Services segment this quarter, and hiring for projects that could ultimately be pushed out at the last minute took its toll on our profit margins. Nevertheless, we continue to invest for the future despite a bit of revenue lumpiness. Paul will have more to say about the Data and Analytics Segment performance and where we believe we are headed.

Now, let me share with you the good news with respect to our IT Staffing Services segment.

From the outset of Q1 2021, we saw a strong increase in demand in the segment. As a result of this demand uptick, we were able to increase our consultants-on billing by 99-consultants, or a record 9% as compared to our headcount entering the new year. Revenues increased sequentially by 3% during the first quarter, and the headcount and demand increases should have a more pronounced impact on Q2 revenue performance if these trends are sustained. On a year-over-year basis 2021 revenues were still down 5% from the first quarter of 2020. This performance represents a strong improvement over the 8% year-over-year decline in Q4 2020 as compared to Q4 of 2019.

Gross margins were in-line with last year's performance despite slightly higher benefit costs. I should reiterate that Q1 is historically a lower gross margin quarter in the staffing business due to a higher payroll tax load.

Q1 2021 operating expenses for the segment were lower than the first quarter of 2020 by approximately $600,000, which allowed us to slightly top last year's operating income for the segment despite the 5% decline in revenues. During the quarter, we did unwind some of the austerity measures implemented during the first half of 2020. Additionally, you will see prudently increased expenses for the segment in the coming quarters to support our anticipated growth.

I will now turn the call over to Paul for his comments on our Data and Analytics Services segment.

Paul Burton:
Thanks, Vivek.

Q1 represented a mixed performance for our Data and Analytics Segments. While revenue was basically flat from Q4 2020, we posted nearly $16 million in bookings in Q1 2021, which suggests to us that some of the pent up demand for Data and Analytic services is being released. Significantly, we signed one new multiyear Center of Excellence deal and received a verbal award on a second, which we expect to close in early Q2. This bodes well for the future, and we see it as a clear indication of the value we're able to deliver to our clients.

Revenue on the other hand, excluding AmberLeaf, compared unfavorably to Q1 2020, which was a very strong quarter for Data and Analytics. This sluggish performance was in no insignificant part the result of our reduced bookings performance during the second half of last year, when our clients were being substantially impacted by the pandemic. With strong bookings in Q1 2021 however, we now have reason to believe that revenue will recover and that we will re-establish the strong growth trajectory we were on prior to the onset of the pandemic.

For instance, as Jack has already mentioned, we're seeing deals close in Europe and Asia, which are accretive to our baseline revenue performance. Moreover, our pipeline in these geographies is very strong and growing. These trends, along with the expected release of demand in North America, are a positive sign for the coming quarters.

Notwithstanding all of the challenges we faced last year, we believe that we are extremely well positioned and, in many respects, stronger than we have ever been.

We have broadened our service offerings to encompass the cloud, and are in the process of delivering our first cloud engagements with more in the pipeline.

We have developed and managed services offering for our customer experience line of business and have closed our first deal with several more promising prospects in the pipeline.

We have also developed a managed services offering for data governance and have closed our first deal. Further, we recently received an RFP award for our second deal in this line of offerings. We expect this deal to close in Q2, as well.

Finally, we have initiated an offshore application development offering. And again, we have closed our first deal, which is set to yield at least $700k of revenue this year. This offering is particularly strategic for us as it is directly relevant to the application modernization imperative pandemic to commercial enterprises as they move their application portfolios to the cloud.

Overall, we believe we are seeing success in each offering area we've chosen to compete in. Over the last year, with limited business travel, we had the opportunity to focus on new offerings and the skills needed to deliver them. Additionally, our Data and Analytics pedigree continues to serve us well as we leverage these skills in the cloud and with our application modernization offering that I just alluded to.

We believe, we are well equipped and very well positioned to meet our client's needs as they modernize and migrate applications and infrastructure to the cloud. Data and Analytics especially—is especially germane to this outcome, because, in this age of digital, applications, as well as digital infrastructure, clients must be poised to move smartly with agility and speed. We differentiate ourselves with the capability to deliver smart, cloud enabled infrastructure and applications, and we're seeing the traction in the market for our operating—offerings and capabilities.

We are confident about the future. This concludes my prepared remarks, and I'll hand the call back to Vivek now. Vivek

Vivek Gupta:
Thanks, Paul. Operator, you can now open the session for questions.

Operator:
At this time, we will be conducting 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 that your question—that 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. One moment, please, while we pull for questions. Our first question is with Josh Vogel with Sidoti and Company.

Vivek Gupta
Hey, Josh.

Josh Vogel:
H everyone. Thanks for taking my questions. I got a couple here for you. The first one, I—hoping you could talk a little bit more about SG&A. You talked about where the investments were targeted. I'm curious, how much is planned in Q2 and over the balance of the year? And at what point do you feel that you have the cost structure and personnel in place that's align for these future growth opportunities?

Vivek Gupta:
Josh, this is Vivek. Let me let me try and answers into two parts. Let me talk about the IT staffing piece, and then I'm going to ask Paul to talk about the data analytics piece, because these two are slightly different. On the SG&A front, we did tighten our cost structure last year, as we were going through the pandemic. And as I've mentioned in my previous earnings calls, we didn't cut things so far that it would hurt when business starts picking up. And that served us very well, because this quarter Q1, we were able to capitalize on this demand, which came in a big way. We were able to do that because we had not cut ourselves down to the bone.

But as we go forward, we will have to keep increasing our SG&A costs in terms of having the right amount of capacity for the producers, salespeople and the recruiters to keep pace with the demand, which is there, which we are hoping will sustain. I think we are already in a fairly good position, and we are not talking about a very large increase. But there will be some incremental increase as the quarter's progress, and we will obviously keep pace with the demand. If the demand keeps increasing, we will rev up the engine a little bit more. If it slows down, we will slow down as we have been doing prudently and as we've done pretty successfully last year. Now, as regards the data analytics part, I'm going to ask Paul to take that question. Paul.

Paul Burton
Thanks, Vivek - as Jack mentioned, we invested about $1 million in SG&A. And as I mentioned in my prepared remarks, we saw the closure of one significant Center of Excellence deal with another award forthcoming hopefully imminently. We expect to close that soon. What we're seeing in our installed base is a significant number of multiyear deals that are requiring SG&A and salespeople and operations capability in order to meet the demand. So, we felt comfortable investing forward seeing the demand in the pipeline, and we anticipate and more of these deals coming along. So, specifically with respect to SG&A, we added seven people in the Data and Analytic to meet this demand and hopefully capture it going forward. I hope that answers your question.

Josh Vogel:
Yes. I appreciate the insights there. I was just looking a little bit higher level when we think about SG&A on a full year basis, when you go back to 2018 and '19, you were about 16% to 17% of revenue last year just under 20. Understanding that you do need to invest certainly on the D&A side when ahead of certain projects. How should we think about an annual run rate for the cost side of the equation going forward or for the term? Should it still be sub 20%? Should it be

closer to 2020 or maybe closer to like an 18% range? Any sort of insights that would be helpful. Thank you.

Vivek Gupta:
Josh, I think it should be below the 20% mark, but I'm going to ask Jack if he has a feel for what the rest of the year SG&A. Jack?

Jack Cronin:
Josh, I would say that it's clearly going to be higher than our historical trend, because, as Paul said, we continue to develop new service offerings, etc. And we always seem to be staffing ahead of the curve, which is a good thing, obviously if you projected the revenue growth curve properly. So, I would say, for 2021, we'd likely be a little bit plus or minus of the 20% range.

Josh Vogel:
Great. That's helpful. Thank you.

Jack Cronin:
Did that answer your question?

Josh Vogel:
Yes, it did. Thank you. Sorry. My mute button wasn't unmuting. A question, I guess, for Paul. With easing headwinds around COVID, I guess it's still a little surprising that project delays were still impacting D&A. You did talk about a strong pipeline in the latter half and some pressure letting up there. But I was curious, is there—are you seeing any of the projects that were delayed last year? Are any off the table or not going to materialize? Just what's the thoughts in your confidence level around that?

Paul Burton:
Yes, I can look at the business across two dimensions. With respect to our core business, the clients that we have significant relationships with and that we've been building over time, we are seeing the project come back, and they're coming back as we would expect without a terrible amount of delay. So, that piece of the business is performing as expected. There is, however, a transactional aspect to the business of deals that come to us, shall we say, transactionally or ad hoc perhaps. And those deals are just now starting to come back. Project delays, I think for the most part are coming to an end, and we're starting to see demand return to a pattern that we saw before COVID and before the pandemic. There still is a little bit of uncertainty out there in certain geographies. For example, as we know, India is suffering from the pandemic terribly right now, and that is a bit of a wild card going forward. But in terms of the overall demand, our core business, our core accounts are coming back exactly as expected and I think strongly, and the transactional demand that is a little bit more volatile, quarter-over-quarter is starting to return to a normal pattern, as well. I am seeing things come back the way we would expect.

Josh Vogel:
That's great to hear. You gave good commentary around new offerings like cloud engagement, data governance, application development. Curious when those types of newer service offerings that you're getting into, can you talk about the sales cycle, there in terms of engagement signings starting to ramp and ultimately be fully ramped up and how that compared to pre pandemic projects?

Paul Burton:
There continues to be a significant move to the cloud. Clients are realizing—all businesses are realizing that, if they want to move with any type of agility or speed, they can't stand up infrastructure by servers, stand up networks and do the typical things that they would have done years ago. So, moving to the cloud offers a significant speed advantage in terms of bringing technology capabilities online and that's why we're seeing the move to the cloud.

In terms of the sales cycle, it's different - we're seeing three to six months sales cycles for cloud offerings. And significantly, with respect to the cloud, as clients move to the cloud, they actually have to move something to the cloud. And so, we're seeing a significant number of application modernization offerings coming along, which bodes well for the future. And when I say application modernization offerings, you know, as application portfolios are picked up off of premise, shall we say, and move to the cloud, there's a certain amount of work that has to go into it to make it cloud ready. And that work, for the most part, is really beginning to spike as we come out of the pandemic and clients return to something resembling a normal posture. So, I would say a three to six month sales cycle for cloud engagements and application modernization engagements, which can be quite large, can take longer, but they're broken into pieces and we're starting to see those come as well.

Josh Vogel:
That's really helpful. Thank you. And just one more, and I'll hop in the queue. Maybe for Jack, just wanted to make sure I was doing the math right. Thinking about billable consultants are we now sitting somewhere closer to the second half ‘19 levels, which is like just north of, you know, 1,150. And then, also, could you just—quick comments around how bill rates are tracking. Are they still in the in the mid-70s around 76 to 77?

Jack Cronin:
Yes, you're thinking about the billable consultants correctly. We are in that range 1,150, a little bit above and the average bill rate is still in the mid-70s. It came down a little bit in Q1, but we're still in the, mid-70 range.

Josh Vogel:
Sounds great. I’ll get back in the queue. Thanks for taking my questions, everyone.

Jack Cronin:
Sure.

Operator:
Our next question is with Lisa Thompson from Zacks Investment Research. Please proceed with your question.

Lisa Thompson:
Good morning.

Jack Cronin:
Good morning

Lisa Thompson:
So, I'm using my highly scientific algorithm. If you increase staffing consultants 9%, does that mean sequentially revenue should be up 9%?

Vivek Gupta:
Lisa, the revenue 9%. I don't think I want to make a statement like that, because there is still quite a lot of things that need to happen in terms of how this quarter pans out. I would just like to leave it and say, yes, this quarter, the revenue should definitely be up in comparison with Q1.

Lisa Thompson:
Okay. And since it's already April 28th, is this quarter tracking the same amount of ads?

Vivek Gupta;
Actually, we haven't quite reached the end of the month yet. So, that's when we really do the pluses and minuses, and a lot of contracts actually end on the last day of the month, because that's how the customers often signed the contracts for. So, we have to wait for the end of April to happen before we can say what happened in this. But it is looking positive. I don't know what the final will eventually look like.

Lisa Thompson:
Okay. Could you possibly tell us what AmberLeaf contributed in the quarter? Or you're not talking anymore?

Vivek Gupta:
I'm actually going to pass this question over to Paul.

Paul Burton:
Hi, AmberLeaf was fully integrated into the business effective January 1st, are not running separate P&Ls on them anymore. What I can tell you is that the AmberLeaf as a channel certainly opened up eight new logos in first quarter, and we continue to see opportunities as a result of that acquisition. But we're not tracking the P&L separately.

Lisa Thompson:
Okay. And going back to your bookings of almost $16 million, is that a record number?

Paul Burton:
No, that's not a record number. It may be a second best number, but it's not a record number. A record number was Q4 of 2019.

Lisa Thompson:
Okay. You quickly went through all the new things that you were working on. I was wondering if you could talk a little bit more about what you meant when you said about the first cloud engagement. And then also the managed services data governance piece, can you talk a little bit what that means?

Paul Burton:
What we're seeing is as clients move to the cloud, they don't necessarily have the skills on staff in order to manage and sustain their cloud environment, to migrate (technical difficulties) data into the cloud, etc. And so, there is a managed services opportunity to stand up a team off-shore and to essentially run this business for them—run the project, if you will, for them over an extended period of time. So, when we talk about managed services, we're talking about standing up a team and sustaining and maintaining their cloud infrastructure environment and doing certain tasks around (technical difficulties) and data migration into the cloud over time. That's what we're talking about when we see managed services in the cloud. With respect to data governance, again, as clients are moving to the cloud and their applications are moving to the cloud what we're finding is all of their data, of course, has to follow it, but there are certain standards that their data has to meet in terms of, shall we say, hygiene and cleanliness. So, there's a tremendous amount of work that's available to straighten out, and help clients straighten out their data as it gets moved to the cloud, so it's appropriate for applications. And so, there's an offering that we've taken on around that. And we have closed one deal and expect to close the second deal around that soon.

Lisa Thompson:
Okay. Great. And so, I also assume, in your business, gross margins will continue to improve as you get AmberLeaf figured out?

Paul Burton:
Yes. Yes. I expect gross margins to hold and improve throughout the balance of the year.

Lisa Thompson:
Okay. Great. Thank you. That's all my questions.

Vivek Gupta:
Thank you, Lisa.

Operator:
Our next question is with Brian Kinstlinger with Alliance Global Partners. Please proceed with your question.

Brian Kinstlinger:
Hi. Good morning, guys. Thanks for taking my question. When you talk about delays, is it delays in getting new contracts signed, meaning longer sales cycles, or is it delays in getting signed contracts to begin? Or is it both?

Vivek Gupta:
It's the former Brian. Its delays in getting the contract signed. Typically once the contracts are signed, we start execution as soon as possible after that - the contract in hand, and at the last minute, the customer may say, can you delay the start date of this by a certain period. But that's less frequent.

Brian Kinstlinger:
So, with that said, there was discussion about winning a large Center of Excellence contract, I think in late 1Q. I may be assuming those with the timing. Has that program started? Or, if not, when do you expect that will start?

Vivek Gupta:
I'm going to now ask Paul to answer that question.

Paul Burton:
That contract signed, and its effective April 1st. Billing did start on April 1st.

Brian Kinstlinger:
Great. And then, finally, can talk about the competitive landscape and data analytics business. I mean, it's obviously a buzzword. It's a popular target market right now. So, talk about the competitive landscape. And is pricing higher or lower or even with last year?

Paul Burton:
Pricing's improving. Thanks, Vivek. Pricing is improving, there continues to be a shortage of skills in the market for Data and Analytics, especially Data and Analytics as it relates to the cloud and to applications. What we're seeing is, as applications are ported or migrated or modernized into the cloud, is that they're being infused with analytics and with intelligence or business intelligence, as they're migrated into the cloud. So, there is a big opportunity for this to happen. The skills in this area are relatively scarce compared to other areas. And so, I would expect pricing to hold and improve depending on the skill and the project we're talking about. I don't see any dilution or erosion in pricing or gross margin this year in this business. I expect things actually to get better.

Brian Kinstlinger:
Great. Thank you.

Operator:
As a reminder, if you would like to ask a question, please press star one on your telephone keypad. Okay. Our next question is with Josh Vogel with Sidoti and Company. Please proceed with your question.

Josh Vogel:
Thank you. Just a quick one around, MAS-REMOTE. We're about a year in now. When we think about your staffing business longer term and the delivery model, how much business do you think are targeting to be run through MAS-REMOTE. Can you remind me if the margin profiler bill rates are any different there? And, any sort of commentary. Thank you.

Vivek Gupta:
Sure, Josh. The MAS-REMOTE offering was really well timed. We launched it in June, and since then, almost two thirds of our placements that we have been doing have been in remote locations. Even last quarter, 65% of our placements were remote. But when the customers are signing up, there is an expectation from half of them. So, roughly, when I say two thirds, one third out of the whole are expected to come back in some shape or form to the office locations. Once the customer is comfortable, that the pandemic is under control and they can do that. And it may not be a full, all five days kind of thing. But the interesting thing is, the remaining one third will always remain remote because they are so far removed the consultants are actually living in a very different location completely different cities altogether, often different states. So, that will continue to be. And we see this kind of trend going forward that, from this—even today the requirement—the demand that I'm talking about, which is coming to us there is a majority of them are okay for remote locations.

To answer your other question about gross margins, etc. Gross margins still tend to be in the same range. It's just that the price point changes depending on where the candidates are. If they are in lower cost locations, then you're able to attract them and the clients get the benefit of that lower cost, as well. And they are willing to make the compromise of not having the candidates come over at any point in time to their locations, if they are able to get better quality candidates and better pricing, as well. So, I don't know if this answers your question.

Josh Vogel:
No, that definitely does. Thank you. And just one last one for Jack. Can you remind me the contingent consideration math that could be paid this year in future years if AmberLeaf hits its targets?

Jack Cronin:
Yes. They total, the fair value that we have on our balance sheet is about $2.9 million. And that's a statistical value based on a probability model. That's on the balance sheet. But that's

what we believe the fair value is likely to be. But the contract earned out is $4.5 million. And that splits in two years. The first year is fiscal year 2021, and the second, of course, is fiscal year 2022. So, if they make earn out their payments would probably happen in April of 2022 and April of 2023, if you're trying to assess the cash flow indication.

Josh Vogel:
Yes, perfect. Thanks again, guys.

Jack Cronin:
Sure, Josh.

Operator:
Ladies and gentlemen, we have reached the end of our question-and-answer session, and I would like to turn the call back to Vivek Gupta for closing remarks.

Vivek Gupta:
Thank you, operator. So, 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 second quarter 2021 results with you in late July. Thank you.

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