Mastech Digital, Inc.
Second Quarter 2023 Earnings Call
August 2, 2023

Operator
Greetings. Welcome to the Mastech Digital, Inc. Q2 2023 Earnings Call.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press “*”, “0 on your telephone keypad.

Please note this conference is being recorded.

It is now my pleasure to introduce your host, Jenifer 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 second quarter 2023 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; Jack Cronin, our Chief Financial Officer; and Michael Fleishman, our Chief Executive Officer of the company’s Data and Analytics Services business segment.

I would like to remind everyone that statements made during this call that are not historical facts are forward-looking statements. These are 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 2022 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 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 provide--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 second quarter 2023 results.

Jack Cronin

Thanks, Jen, and good morning, everyone. Second quarter 2023 was another challenging quarter for Mastech Digital. Revenues totaled $52.2 million, representing a 16% year-over-year revenue decline. Both of our business segments were impacted by customer concerns regarding slow economic growth, high inflation, and the possibility of a U.S. recession, which has lowered demand for our services in the near-term.

Our Data and Analytics Services segment contributed revenues of $8.8 million in the second quarter of 2023, compared to $11.2 million in the 2022 second quarter, as customers reduced resources on existing projects in light of continued economic uncertainty. Order bookings, however, increased to $10.1 million in the second quarter of 2023, compared to $8.4 million in the first quarter of this year. Additionally, our pipeline of opportunities continue to improve with the caveat that customers are taking a little longer to actually start new projects, once awarded.

Second quarter 2023 revenues in our IT Staffing Services segment totaled $43.4 million, compared to $50.9 million in the second quarter of 2022. Demand continued to be soft in the current quarter, particularly with respect to financial services clients.

Gross margins in the second quarter of 2023 was 26.1%, compared to 27% in the second quarter of 2022.

In our Data and Analytics Services segment, gross margins improved by 200 basis points compared to the second quarter of ‘22 gross margins. This favorable margin variance was largely due to higher utilization rates in the 2023 quarter, as we continued to drive better efficiency in our delivery processes.

In our IT Staffing Services segment, gross margins were down 110 basis points, compared to Q2 2022, due to reductions in direct hire revenues higher and usual medical claims related to our self-insured healthcare program.

In the second quarter of 2023, we recorded a pre-tax settlement reserve of $3.1 million on an outstanding employment related claim. No lawsuit has been filed to date, and we are currently in negotiations to settle this matter.

GAAP net loss for the second quarter of 2023 was ($2.2 million), or a loss of ($0.19) per diluted share, compared to a $2.4 million net income, or $0.20 per diluted share in the second quarter of 2022. The settlement reserve noted above had the effect of reducing GAAP diluted earnings per share, by $0.19 per share.

Non-GAAP net income for Q2 2023 was $1.3 million, or $0.11 per diluted share, compared to $3.6 million, or $0.30 per diluted share in the second quarter of 2022.

SG&A expense items not included in second quarter non-GAAP financial measures, net of tax benefits were: one, stock-based compensation; two, the amortization of acquired intangible assets; and three, the 2023 settlement reserve on an outstanding employment related claim.

A description of these items is included in our second quarter 2023 earnings release, which is available on our website. Also, it should be noted that both GAAP net income and non-GAAP net income in the second quarter of 2023, included $600,000 of professional service expense related to the outstanding employment claims.

Addressing our financial position on June 30, 2023, we had $18.6 million of cash balances on hand. We had no bank debt outstanding and borrowing availability of $23.9 million under our revolving credit facility.

Our day sales outstanding measurement was 56 days at quarter end, which is well below our target range of 60 to 65 days and are five days--and were five days better than our measurement at March 31, 2023.

During the second quarter of 2023, we executed on our share repurchase program purchasing approximately 62,000 shares of Mastech Digital common stock at an average price of $9.15 per share.

I'll now turn--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 Q2 2023.

The same macroeconomic headwinds that we experienced during the first quarter of 2023 continued to impact our clients' spending dynamics in the second quarter, resulting in lower demand for our services.

Our IT Staffing Services segment continued to see clients taking a more conservative approach with respect to spending on new assignments due to concerns around a potential recession on the horizon. Our Financial Services clients, in particular, were even more inclined to tighten their purse strings, given the recent regional bank failures and worries about a broader banking crisis. In recent weeks, however, we did see a modest improvement in demand from some of our clients in the Financial Services space, but I wouldn't call this a trend, just yet. Also, during the quarter, we expanded our portfolio of staffing offerings with an entry into Engineering Staffing Services, or ESS, as we call it for short.

ESS is an adjacency to IT Staffing and will be using the same recruitment engine that our customers depend upon and trust. Since its launch in late May, ESS is gaining traction with both our existing, as well as new customers, and we are hoping to see in the quarters ahead this new service offering make up some of the recent declines in IT Staffing.

Our Data and Analytics Services segments performance was also impacted by clients reducing resources on existing projects, as they respond to economic uncertainty.

Michael will talk more about the state of affairs in the Data and Analytics Services business in a few minutes.

While we are encouraged by improvements in recent inflation data and some signs that the U.S. may dodge a recession, we have and will continue to take prudent actions to reduce our SG&A expenses in an effort to protect our operating profits.

I would like to reaffirm with 100% confidence our belief that our businesses remain fundamentally sound, that our financial clients are among the strongest in the industry, and that we have a solid balance sheet and access to ample capital to fund our current business needs and to support the share repurchase program that we announced, earlier this year.

Let me now turn the call over to Michael for his comments related to the Data and Analytics Services segment. Over to you, Michael.

Michael Fleishman
Thanks, Vivek, and good morning, everyone. As Vivek mentioned, uncertain economic conditions are clearly impacting our clients' spending behavior.

During the first half of 2023, we have seen clients reducing resources on existing projects as their way of mitigating concerns over economic conditions, and this posture has negatively impacted our revenues. However, beyond the revenue numbers, we believe we are making good progress in our efforts to reposition our organization from a master data management company to a much broader Data and Analytics Services firm that focuses on end-to-end data modernization services. Our progress in this transition can clearly be seen in our increased order bookings and pipeline building performance, year-to-date. In the second quarter of 2023, order bookings increased to $10.1 million, or $1.7 million higher than the first quarter of this year, 2023. Our first quarter bookings were also $1.6 million higher than the previous Q4 2022. Furthermore, during the second quarter, the number of our RFP submittals as well as our overall pipeline of opportunities, both increased. My expectation is that bookings will continue to expand over the second half of 2023, which should set us up nicely in 2024.

Also, in the second quarter of 2023, we made solid improvements in our gross margins. Our second quarter gross margins were 45.6% of revenues, which were 200 basis points higher than the corresponding quarter of 2022. This improvement reflected a higher utilization rate in the 2023 quarter versus the second quarter of 2022. From a strategic point of view, we aim to consistently have gross margins in the upper 40% gross margin range, irrespective of our revenue levels. Simply put, we need to quickly adjust our billable workforce to real time revenue streams. This ability to adjust is something that is a primary focus of our delivery team.

I'll now turn the call back over to Vivek.

Vivek Gupta
Thank you, Michael. Operator, this concludes our prepared remarks. We can take questions now.

Operator
At this time, we will 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 poll for questions.

Our first question comes from the line of Lisa Thompson with Zacks Investment Research. Please proceed with your question.

Lisa Thompson
Good morning.

Vivek Gupta
Hi, Lisa.

Lisa Thompson

Hi, there. You made your earnings even though we had lower revenues due to those great margins. So, that's very encouraging.

Vivek Gupta
Thank you.

Lisa Thompson
I have a few questions. First off, in staffing, you said you had a decline in Financial Services. Do you know what percent CGI was for the quarter?

Vivek Gupta
Yes, Jack, would you have the precise number? I think it was close to 24%. Is that right?

Jack Cronin
Right, it was 24%.

Lisa Thompson
Okay. So, was it across the board, not just them?

Vivek Gupta
Yes, actually. As I think we mentioned in the last earnings call, approximately 50% or just less than 50% of our business has been from Financial Services when we started the year. And we've seen that virtually across the board customers, direct customers that we work with as well as customers through partners like CGI.

Lisa Thompson
Okay. And what was the billable consultant number for the quarter?

Vivek Gupta
Jack, do you have that number in front of you?

Jack Cronin
Yes, I do. At the end of the quarter our quarter, our billable consultant base was 1,041.

Lisa Thompson
Oh, okay. So that's up, good. Let's see, could you go a little bit more into an example of this ESS offering? Can you give us maybe an example of a customer using it and what they do?

Vivek Gupta
Sure Lisa. So, this maybe I'll add a little bit of color on the ESS beyond what you just asked as well, which is we see ESS as an adjacency, as I mentioned, to the IT Staffing because we are able to use the same recruitment engine; we are able to use the same sales engine. And we find on the customer side, the buying centers are also fairly similar often the same, which is the

procurement processes that they have in place. Now, bill rates, gross margins, all seem to be in line with the IT Staffing. So, clearly, there is room to cross sell.

Now, to coming to your question, what kind of customers are we talking about? Actually, we found there is virtually 19 or 20 of our customers are already using engineering services. And by engineering services, the kind of people the kind of consultants they're looking for could be mechanical engineers, electrical engineers, test engineers, facilities engineers, industrial engineers, and so on and so forth. And it was easy for us, in some ways to cross sell this ESS to customers who have already been our customers for a very long time.

So, I hope that gives you a sense of what you're looking for, Lisa.

Lisa Thompson
Yes. So it's basically kind of like a job shop, where you sign up for a 6-month project or something as an engineer, is that right?

Vivek Gupta
Yes. it's not very different from IT Staffing, which is the customers have requirements. They reach out to us either directly or through VMS or portals. And we look at those requirements and find appropriate consultants and go through the same process of putting them in front of the customers and, you know, they get them interviewed, and customers could be signing up for whatever duration they're looking for. But it does average six to nine months. What we have seen is their requirements tend to be in that range.

Lisa Thompson
All right. Great. Sounds good. So, I just have one last question about this employment issue. So, on the balance sheet, you have $6 million for a liability and then $2.2 million for insurance recovery. Could you explain the mechanics of that?

Vivek Gupta
Jack, will you go through the numbers?

Jack Cronin
Yes, sure. Again, these are estimates and we're in the process of negotiating the settlement.

Lisa Thompson
Right.

Jack Cronin
So, I mean, our estimate is that we're going to have a gross claim before insurance and other offsets of $6 million. Our estimate on insurance claim would be $1 or $2.2 million. And then, we have some other recoveries that I don't want to say right now, because we're still in negotiations, but would bring down the net claim to $3.1 million.

Lisa Thompson
Okay. And why isn't it the $6 million include the lawyers and all that sort of stuff?

Jack Cronin
It does not.

Lisa Thompson
Okay. All right. And that you said that was $600,000 in the quarter for consultants or whatever?

Jack Cronin
Right.

Lisa Thompson
All right. Great. Okay. Well, so should we expect revenues for both businesses to be sequentially up in Q3 and for expenses to be down a little? That's the general thought.

Vivek Gupta
Lisa, I would not want to make a projection there but I mean, clearly, we are not out of the economic uncertainties at this point in time. So, we need to go through this quarter and see how it pans out.

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

Vivek Gupta
Thank you.

Operator
Our next question comes from the line of Tim Call with The Capital Management Corporation. Please proceed with your question.

Timothy Call
Good morning.

Vivek Gupta
Hi, Tim.

Timothy Call
With a clean balance sheet and no debt and your share repurchase pace, leaving you with $18 million on the balance sheet, is there a way to make it so that earns interest if you put it in a 3- or 6-month U.S. Treasury bill? You might be making over 5% or--or $1 million a year on that $18 million cash. Are you able to invest any of that or earn interest on any of that cash balance on your balance sheet?

Vivek Gupta
Jack?

Jack Cronin
Yes, we are. And, the interest income that we earned in the second quarter and, of course, we didn't have all $18 million on day one of the quarter. We had interest income of, I would bet, about $120,000 in Q2. And we have flexibility. We have an arrangement with our bank, PNC, where, you know, as soon as they sweep the funds, we're earning interest income.

And, you know, the day that we need the funds, to fund working capital, and just day to day accounts payable and payroll, you know, it comes out. But it's efficient with the monies that we have. Some of our monies are in foreign subsidiaries. We invest there, as well. But, to lock something up for, a substantial period of time, we haven't really looked at that yet, but we will. As our cash balances grow, we will take that approach to invest in multiple months rather than on a day to day basis.

Timothy Call
Well, knowing your successful history and, having Michael lead DNA and expanding into ESS, it's a very bright outlook. Hopefully, that cash can be put to use with accretive acquisitions, but also the share buybacks. So, as you move out of this slower period, having those share buybacks, continue or accelerate will have very positive long-term results. So, congratulations on repurchasing some, already. Thank you.

Vivek Gupta
Thanks, Tim.

Operator
And our next question comes from the line of Marc Riddick with Sidoti & Company. Please proceed with your question.

Marc Riddick
Hey, good morning, everyone.

Vivek Gupta
Hi, Marc.

Marc Riddick
So, I wanted to scope a couple of things. One of the things that you've mentioned in your press release and prepared remarks were some of the expense reduction efforts. I was wondering if you could dig a little bit into--to that a bit more, and sort of how we should think about what those benefits are with, both within the quarter and going forward.

Vivek Gupta
I didn't quite catch. Are you talking about the reduction in the SG&A expenses?

Marc Riddick
Sorry, I think it was within the press releases, just some of the cost control efforts that took place during the during the quarter and how that plays out going forward?

Vivek Gupta
So, Marc, the good thing in a way is that we've been through this just a couple of years ago in 2020, when COVID hit us and we took all the prudent cost control steps at that time. So, we were able to sort of revisit the same playbook. And what we have done is basically pushed out or deferred out or canceled all discretionary expenditures. So, things like, you know, if you're having conferences, the internal conferences, we are doing it more virtually rather than in person. We are looking at every single, you know, that are kind of relationships that we have with our vendors and seeing how we can improve upon it. We are looking at low performing, staff and seeing if we can reduce our headcount and not have them. We're looking at other expenses, which can be brought down. We've deferred compensation increases by a couple of quarters.

So, it's basically looking at every element of the SG&A cost and seeing if there is a way, we could either reduce or defer it. And, that has been something we've done now for a couple of quarters. And we will continue to look at things as we go forward, until things start opening up once again. So that's the plan.

Marc Riddick
Okay.

Jack Cronin
And then, Marc--

Marc Riddick
I'm sorry. Go ahead.

Jack Cronin
This is Jack. The only other thing that I want to point out is some of our expenses are, you know, self-correcting, if you will. I mean, they come down on their own, such as commissions and bonuses, where, you know, if we're in a recessionary type environment or a low growth environment, you know, we have lower commissions, we have lower bonuses, and we have lower background checks. So, we're going to get the benefit of, and we have gotten the benefit of those types of expenses in addition to what Vivek said.

Marc Riddick
Okay, that's helpful. Thank you. And then, where do we finish? Can you give us an update as far as where bill rates were during the quarter and maybe some of, you know, any thoughts around what you're seeing there?

Vivek Gupta
So, Jack, you have the

Jack Cronin
Our bill rates are trending down a bit, but it's not like our gross margin content for most of our projects is trending down. It's more of the types of resources that we're using on a project. I mean, if we have resources that are $80 an hour resources and we make 20%, 25%, you know, now, I think we're using resources that are a little lower but still have the same or close to the same margin content, but we're down a few bucks with respect to the average bill rate.

Marc Riddick
Okay. And then I think you said that the, I just want to make sure I heard you correctly, the headcount was 1,041?

Jack Cronin
Yes. and I think Lisa said that's good, it's higher. But it's not higher, it's lower.

Marc Riddick
Okay, I was just double checking on that. And where was I going with this? Oh, yes. so, there was a commentary in prepared remarks around utilization within DNA. And I was wondering if Michael sort of talk about where those benefits occurred and, sort of how they materialize there.

Vivek Gupta
Michael?

Michael Fleishman
Sure. Vivek, okay, So the utilization was predominantly increased through a couple of different avenues. One, tighter controls and processes over our existing project delivery so that we have greater visibility into our ramp times. So that when projects were starting to ramp down in resources, we've got, right now, controls in place to have a 4-month notification on that.

So, then we have four months to ensure that those resources are either renewed within the existing client or placed in net new opportunities within the existing client or placed in net new opportunities within other clients, such that when they ramp down, they immediately ramp up into another project, either again within same customer or another customer.

This is the primary contributor to driving great utilizations, in addition to driving net new bookings which, of course, require resources to be leveraged and utilized. We never want to have a 0% bench, because we always want people training and cross certifying.

But our goal, internally, is an 80% utilization rate and we've been really, really good in consistent at hitting that level of utilization internally, which then drives, greater levels of gross margin which you've seen in our numbers consistently increasing over the past two quarters.

Marc Riddick
Okay, no, that's very helpful. Thank you. And then, I guess, just a little--last two questions for me. One, I know you've talked about some of the struggles within Financial Services. Wonder if you'll talk a little bit about maybe some of the other customer, vertical industries, whether, you know, what you're seeing, whether it's in retail or healthcare and the like.

And then the second question is around the new engineering staffing services kind of maybe the type of revenue contribution that maybe we're seeing initially and what you believe that can grow to? Thanks.

Vivek Gupta
Sure, Marc, we've been seeing that cost control from the customer side across the board in all industries. And, before the regional bank failures happened it was evenly balanced, maybe to a lesser extent on the Financial Services side, and then suddenly that started picking up steam.

So, I wouldn't want to single out any specific industry, but at this point in time we are seeing it across the board. So that's the first question.

And the second one on the engineering services side, candidly, we just started this; we launched it on May 31. So, we've just had a few weeks there. And right now, at this point in time, we're seeing a lot of interest, a lot of traction. We are seeing some reps coming through and we've only had a handful of placements.

So, we really don't have enough data at this point in time to tell you how that is going to impact the overall numbers in terms of bill rates or gross margins. But our research has shown that we, the bill rates and gross margins should be comparable to what we are able to get on the IT Staffing side.

Marc Riddick
Okay, that's helpful. Thank you very much.

Vivek Gupta
Thank you, Marc.

Operator

And just as a reminder, if anyone has any questions, you may press "*", "1" on your telephone keypad to join the question-and-answer queue.

And we have reached the end of the question-and-answer session. I'll now turn the call back over to Vivek Gupta for closing remarks.

Vivek Gupta
Well, thank you, Operator. If there are no further questions, I would like to thank you for joining our call today. And we look forward to sharing our third quarter 2023 results with you in early November. Thank you.

Operator
And this concludes today's conference. And you may disconnect your line at this time. Thank you for your participation.