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**MASTECH**

**Q3 2015 Earnings Call**

**October-28-2015**

**Confirmation #13623381**

**Operator:** Greetings and welcome to Mastech Third Quarter 2015 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 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. Thank you.  
You may begin.

**Ms. Jennifer Ford Lacey:** Thank you, operator, and welcome to Mastech's Third 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](http://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](http://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, 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](http://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 third quarter 2015 results.

**Mr. Jack Cronin:** Thanks, Jen, and good morning. First off, I'm pleased to inform everyone that our integration of the Hudson IT acquisition has progressed nicely during the third quarter. Today, we're functioning as one cohesive business with all back office and support functions firmly in place across the entire organization.

Additionally, Q3 2015 reflects the first full quarter of Hudson IT's operating results, which have benefited our year-over-year comparables. With that said, Q3 2015 revenues totalled \$34.6 million compared to \$28.6 million during the third quarter of 2014. Our entire revenue increase reflected the consolidation of the Hudson IT acquisition.

Activity levels were also higher than the previous quarter and reflected working Hudson's client needs for the full quarter. Our average bill rate for the third quarter of 2015 was \$74.87, which was approximately 2.4 percent higher than in the third quarter of 2014.

Gross profits for the third quarter of 2015 totalled \$6.9 million, or 19.9 percent of revenues, compared to \$5.2 million, or 18.3 percent of revenues, during the same period last year. Our gross profit dollar improvement largely reflected the additional revenue volumes. Our third quarter 2015 gross margin percentage benefited from Hudson IT's strong retail client base, which generally carries higher margins than in the wholesale channel.

However, it's important to note that, when excluding the impact of Hudson IT's results on overall gross margins, we still had margin expansion of 40 basis points in Q3 2015 when compared to the corresponding quarter a year earlier. Higher margins on new assignments continued to drive this improvement in the current quarter.

GAAP net income for the third quarter of 2015 was \$887,000, or 20 cents per diluted share, compared to \$879,000, or 20 cents per diluted share, in the third quarter of 2014. Non-GAAP net income for the third quarter of 2015 was \$1.1 million, or 25 cents per diluted share, compared to \$956,000, or 21 cents per diluted share in the corresponding quarter of 2014.

Q3 SG&A expense items not included in the non-GAAP financial measures net of income tax benefits were, one, amortization of acquired intangible assets, two, acquisition transaction cost, and three, stock based compensation, all of which are detailed in our Q3 2015 earnings release.

Addressing our financial position at September 30, 2015, we had \$15.6 million of outstanding bank debt net of cash balances on hand. Our effective interest rate on borrowings during the quarter was just under 3 percent per annum. Our borrowing availability at quarter-end approximated \$8.5 million.

Bank debt net of cash increased during the quarter by \$2.2 million and reflected investments made in operating working capital of \$3.5 million. You may recall that our acquisition of Hudson IT came exclusive of its historical working capital. In other words, the seller retained the working capital of the business. Thus, our Q3 2015 investment in operating working capital was largely attributable to the Hudson IT operations.

Our largest asset, accounts receivable, at September 30, 2015 remained of top quality. During the quarter, we successfully worked through client contract assignment matters related to our asset purchase of Hudson IT.

Billing disruptions associated with these efforts had minor impact on our days sales outstanding measurement, which increased by one day during the quarter to 53 days.

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

**Mr. Kevin Horner:** Thanks, Jack, and good morning, all. As Jack mentioned, Q3 2015 is our first full quarter of Hudson IT's operating performance results consolidated into Mastech financials. I believe these consolidated results support the merits of our acquisition and clearly show the enhancements to our business in revenue, gross margin and profitability.

Also, I continue to be pleased with the result of our initiative to improve gross margins by being more disciplined with respect to profit content on new assignments. Gross margins in the third quarter of 2015, excluding the benefits of Hudson's higher gross margin retail business, continued to improve and are now 40 basis points higher than the corresponding period last year.

What I wasn't pleased with was the decline in consultants on billing during quarter. During the quarter, we experienced lower than expected starts and higher than expected ends, which combined to impact our billable consultant base.

Both our starts and ends results have been influenced by a tightening in the supply of talented IT professionals. Just to put some context around the marketplace for the call, TechServ Alliance reported earlier this month that there are now 4.99 million IT jobs in the United States. That's a high point for IT jobs in the history of IT jobs in the US. It's also a year-over-year increase of 195,000 IT jobs against a backdrop of less than 80,000 new IT graduates from colleges and universities in the same period.

Additionally, that 5 million IT job number is roughly a million more IT jobs in the United States since the economic downturn in 2008 to 2010. The bottom line to the market is there's virtually a full employment condition in the IT sector of the US economy, and this full employment condition has hit our business fairly hard this year, particularly in Q3.

We have seen a higher than normal number of client hires of our consultants in 2015 as well as a higher than normal number of resignations where the employee is converting to a full time hire somewhere else in the market.

We're continuing to adjust and train our recruiting workforce; including broadening the places that recruiters are searching for candidates and adding some US based resource managers to assist our recruiting organization in quality candidate delivery. While we have not directly seen the payback from the investments that we have made in our recruiting organization over the past several quarters, I'm confident that our recent actions, coupled with the larger scale recruiting organization, will provide the necessary skills and pools to be successful in the business longer term.

Entering Q4, our focus will be squarely on improvement our recruitment performance on the front side and addressing market driven ends issues with adjusted to client contracts and employee employment agreements where possible.

Additionally, I'm getting closer to filling our vacant Chief Revenue Officer position, which should occur in Q4 and which I believe will have a positive influence on our prospects moving forward.

With acquisition integration largely complete in Q3, we'll put all of our organizational efforts and energy to getting back to an organic growth focus for the combined business.

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



**Operator:** Thank you. The floor is now open for questions. If you would like to ask a question, please press star, one on your telephone keypad at this time. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. Once again, that is star, one to register your questions at this time. One moment please while we poll for questions.

Once again, ladies and gentlemen, that is star, one to register your questions at this time.

Once again, that is star, one to register your questions at this time.

Thank you. Our first question is coming from David Polonitza of AB Value Management. Please proceed with your question.

**Mr. David Polonitza:** Hi, guys, good morning. Kevin, if you could just go over and provide a little color with the merger and how the integration process went and your expectations versus reality now that you're about four months into a combined company?

**Mr. Kevin Horner:** Actually, that's a good question, Dave. Thanks for asking. I was concerned that we had a problem with the phone. So, thanks for asking.

I'll let Jack weigh in, as well. I actually think we were prepared for the process to go, if these are reasonable words, less well than what it did. I think our consultant population moved over reasonably well. I think we ran into some unexpected ends in the quarter, but that happened in both the legacy Mastech population as well as the Hudson population. So, I don't believe there was anything abnormal there.

I think we've done a really good job of servicing the client base. We had to my knowledge, to date; no client issues as a result of the acquisition. I believe our employee population, our sales and recruiting population has transitioned reasonably well.

Dave, I would say, the transition really pretty well met our expectations. And I think you have already read through the financials of the acquisition, I'm sure. We didn't over-leverage the company in order to make the acquisition. At least that's my view. I think it was a fairly conservative leverage point for the business.

When I look at the acquisition through the P&L, I'm very, very pleased. And when I look at the acquisition through the balance sheet, I'm very, very pleased. So, I think it pretty well went the way we expected it to go.

We're in the middle of doing some of the basic logistics things that happen after an acquisition. So, we've had to move some folks around from where our offices are located. We're in a new space in Chicago, which is fundamentally a block from our old space. We're now into some new space in Tampa, which is a couple of blocks from our old space. And our folks in Orlando and Boston are in their existing spaces.

I don't think we impacted folks dramatically that way, either. Dave, I don't know if this is what you're looking for, but I'm pretty pleased. I think the acquisition integration process that we followed at least at four months; I would say the process is repeatable.

**Mr. David Polonitza:** Okay, thanks. One more question here - you had mentioned that there was a decline in consultants on billing in the quarter. Looking at your two business segments, wholesale versus retail and really kind of the legacy Mastech versus what you acquired with Hudson, is there an area where the consultants on billing decline --was it more wholesale focused, retail , just curious about that?

**Mr. Kevin Horner:** Yes, that's a really fair question, as well. The decline was predominately in the wholesale space.

**Mr. David Polonitza:** Sure. Do you have the overall revenue breakdown between those two segments?

**Mr. Kevin Horner:** I do not. Jack, can you help me with that one?

**Mr. Jack Cronin:** I do, I do have it. Give me a second.

Yes, for third quarter, the wholesale channel revenue was 21 million, and the retail channel revenue was 13.4 million. We had a couple hundred thousand of perms to make up the 34.6.

**Mr. David Polonitza:** Okay. No, that's a good number. I guess that helped contribute in some fashion to your gross margin number.

**Mr. Kevin Horner:** Yes, the perm revenue always does.

**Mr. Jack Cronin:** --Yes--.

**Mr. Kevin Horner:** --That's not higher than abnormal perm revenue for even the Mastech legacy business.

**Mr. David Polonitza:** I meant the higher retail number as a percentage--.

**Mr. Kevin Horner:** -- No, absolutely.

**Mr. Jack Cronin:** Absolutely.

**Mr. Kevin Horner:** Without a doubt.

**Mr. Jack Cronin:** Yes.

**Mr. David Polonitza:** One final thing, I don't know if there are other questions here, but what's the role of your footprint in India in the retail business today or where you hope it will be at some point?

**Mr. Kevin Horner:** I can talk a bit about it today. I would say that was part of the alignment that we did in the third quarter was to immediately work some MSP accounts that the Hudson business brought with it in the third quarter. So, we turned that business on to the India based recruiting model almost immediately after the acquisition.

There were several MSP VMS clients that Hudson was really unable to work in their old model other than maybe to cherry pick a req here or there. And we were able to turn that on immediately.

Secondly, we were able to use our Indian based recruiting team to cross submit to Hudson requirements, on the retail end of their business with their direct clients. What I mean by that, I think those of you who know the industry will understand that pretty readily, when we find a candidate for a req in the legacy Mastech business, it seems to fit skills, experience and know how required for the job.

Step two is to actually look if there are any other potential job requisitions in the company that might fit those same skills and submit that candidate to those, as well, which we were able to do. And that netted us several placements in the Hudson retail business, as well.

**Mr. Jack Cronin:** Yes, one other thing, when we formulated our purchase price of Hudson, our expectations were that we were going to get a company with 30 million of revenue, approximately 3 million of incremental EBITDA and 200 global consultants. And that's pretty much what we got.

**Mr. Kevin Horner:** That's almost exactly what we got.

**Mr. Jack Cronin:** Moving forward, we're not going to break out, what were Hudson revenues, what were legacy Mastech. We're just not going to do that. We got what we expected in the acquisition, and we're going to win or lose as one company. It's not going to be one, Hudson's doing well or they're doing poorly and Mastech's doing better. Moving forward, it's one company, and one company only.

**Mr. David Polonitza:** All right, great. Thanks, guys, pretty good numbers, and appreciate it.

**Mr. Kevin Horner:** Yes, we think so. We're pretty pleased with both the top line and with the GM and with the profitability numbers. Thank you.

**Operator:** Thank you. Our next question is coming from Howard Rosencrans of Value Advisory. Please proceed with your question.

**Mr. Howard Rosencrans:** Good morning, guys.

**Mr. Kevin Horner:** Hi, Howard.

**Mr. Howard Rosencrans:** I didn't have a full chance to get on for all of the call. Did you mention specifically the COB, where it was at the beginning of the quarter and the end of the quarter?

**Mr. Kevin Horner:** No, we didn't. I will tell you that we were down in the quarter about 4.5 percent.

**Mr. Howard Rosencrans:** Okay. And that just speaks to the environment of just not enough availability of reasonably priced talent out there for you to work with to earn a decent margin? Does that capture it, or please, help me with that?

**Mr. Kevin Horner:** Yes, I actually think it speaks to a number of things. First, we had an abnormally high number of ends in the quarter --where consultants were actually hired full time, either by the existing client or where consultants went and took a full time job. So that was probably the single biggest driver.

The second driver for us was the Fourth of July week appeared to us like our customers didn't work. July was not only a very high ends month for us, it was also a very low starts month for us, as well. We've been, kind of beating the ground, getting our customers back from that process.



I also think that the macroeconomic situation, as you've been hearing and seeing from, the general economy is also beginning to show itself. Whereas the IT industry is in all respects, I would call it a full employment condition in the IT space. You're seeing a whole bunch of people miss on the top line, and we just aren't seeing the growth in the general economy through the first three weeks of Q3 earnings announcements.

I think there are some general economic things that are going on, as well; the staffing industry analysts revised their forecasts for the IT segment growth for 2015. At the beginning of the year, growth was expected in our segment to be about 7 percent. We're looking now at, ---they are looking now--I shouldn't say we are--they are looking now at something that's probably closer to 5, possibly 6.

**Mr. Howard Rosencrans:** That's 5 or 6 for '15, is that what you're saying?

**Mr. Kevin Horner:** Yes, for '15.

**Mr. Howard Rosencrans:** So, with all of the slowdown [unintelligible--.]

**Mr. Kevin Horner:** --The slowdown is coming in the back end. That's correct, Howard.

**Mr. Howard Rosencrans:** Right. So, effectively, the back end has got to be growing 3 or 4 to bring the average for the full year.

**Mr. Kevin Horner:** --At a much lower pace, that's correct.

**Mr. Howard Rosencrans:** So, in essence, then-I guess the pure ITers, or the guys who need bodies on an around the clock basis have retained either your employee or somebody else's on a full time basis, and the increment overload that would generally entail the temporary worker is diminished, and that's what you're seeing across yourselves and across the industry?

**Mr. Kevin Horner:** Well, I hesitate to speak for the entire industry. We definitely saw it and have seen it in 2015 in total that we've had a much higher, full time hire rate of our consultants. In fact, I think our full time hires for our consultants year-to-date in 2015 is higher through nine months than the entire year of 2014 or 2013. It's indicative of the strengthening of the IT market and our customers not being able to get the talent they want, and so locking in some people on a full time basis is obviously part of their talent strategy.

**Mr. Howard Rosencrans:** I guess in part my question speaks to the bidding process. You guys were, I won't say the forerunner, but a very significant player at least for your scale in pursuing a different model predicated on shooting for a lower gross margin and doing it from a more

automated process as the customers got more automated and just trying to work that model. Are you finding more of your competitors are now employing the same model and your win rate is diminished?

**Mr. Kevin Horner:** I don't know I would go that far. I can tell you, we compete for recruiting talent in our centralized recruiting model at a much higher rate today than what we have ever seen. So, maybe said a little differently, the offshore India based recruiting model is beginning to mature, and we compete for talent like crazy in that world.

We are making some investments in the U.S. with some U.S. based recruiting as well as some U.S. based resource managers who can assist the offshore recruiters in making sure that they have real clarity around the job requisition and the skills the clients are looking for and then making sure that we lock down candidates, once we get agreement with a client that they want the candidate, we lock the candidate into that job.

I've seen--in 2015, I would venture to guess that the majority of our billing consultants that we are putting on new assignments have multiple job offers.

**Mr. Howard Rosencrans:** All right. I believe--let me try to parse that question a little more because--or your answer, per se. That sort of addresses in my mind, and please correct me if

I'm mistaken, the sort of buy side of the equation because you're buying, per se, your employee, and then you're selling them to the shop that has IT demand. Just take me through the other side of the equation as to what's happening on the sell side. Are more of your customers reaching a sort of automation level, are more of your competitors going through the same automated cell of bodies all adding up to a more challenged sale of your employees, or is it really just an issue of an inadequate amount of bodies that you're able to capture on what I'll term the buys side?

**Mr. Kevin Horner:** Yes, I can't speak to the entire \$28 billion marketplace around how much more automated that market is on the customer side today as compared to 24 months ago. Listen, I do believe that the marketplace has continued to grow on the MSP VMS side, that automation side. So, from that perspective, is there more automation out there? Yes, I think there is.

I think either SIA or TechServ could probably help us with some of the specific data around that. The last data that I saw was really about a year ago, and it would suggest that over 80 percent of the Fortune 1,000, were participating in MSP VMS style hiring systems and practices for talent acquisition. Do I believe that number continues to grow? Yes, I do. I don't--I wouldn't suggest that it's now 90, though but I do believe it continues to grow.

**Mr. Howard Rosencrans:** --Let me try to make this the last one then, at least in the forum.

What was your trend in the quarter sort of on a month by month basis on the COB's? You mentioned July 4th was particularly weak. Can you tell us where you ended on a year to year basis, what sort of--ballpark, what sort of basis--where you were at the end of July, the end of August, for those two months?

My last question is the accretion that you saw or the year to year increase that you saw on a non-GAAP basis in your diluted earnings, does that reflect simply the accretion from the acquired business?

**Mr. Kevin Horner:** I'm going to let Jack try that second one. And while he's thinking through that, let me hit the first one.

Yes, without tearing into an incredible amount of detail, what I can tell you is we've had net growth in the business of consultants on billing, in the months of July and August--excuse me--August and September, right? For August and September, the sum total of those two months was a positive net growth. And we had some fairly dramatic negative net growth in the month of July. That's a fair and accurate statement, correct, Jack?

**Mr. Jack Cronin:** That's fair and accurate.

**Mr. Howard Rosencrans:** So, August and September were, I don't know, how did he characterize it - meaningful net growth?

**Mr. Jack Cronin:** Yes, modest increases.

**Mr. Kevin Horner:** Yes, exactly.

**Mr. Howard Rosencrans:** Modest increases in COB.

**Mr. Kevin Horner:** Yes. Yes.

**Mr. Jack Cronin:** Yes.

**Mr. Howard Rosencrans:** And the accretion that you saw in the quarter, it sounds like it came from the acquisition. I know you're not going to talk about it that much in the future on a broken out basis, but it seems pretty clear that it came from the acquisition.

**Mr. Jack Cronin:** Yes. And again, all I can say is, we when we acquired Hudson, we expected a \$30 million, increase in revenues from the Hudson acquisition and about a \$3 million EBITDA,

incremental EBITDA increase and 200 consultants. And that's what we got. So, you buff that down by quarter, and you can certainly do the math.

**Mr. Howard Rosencrans:** Right. Right. Is that--remind me quickly, that was a \$30 million--what--how much was the acquisition?

**Mr. Jack Cronin:** We paid, \$17 million and then plus working capital. All of our financial valuations were based on getting a company that brought \$30 million of revenue to the table and about \$3 million of incremental EBITDA.

**Mr. Kevin Horner:** And 200 billing consultants.

**Mr. Jack Cronin:** And 200 billing consultants. We're a little bit plus and a little bit minus in those three measurements, but just a hair plus and a hair minus in, you know in the difference.

**Mr. Howard Rosencrans:** Okay. Do you get sort of a full benefit from that? The first quarter that they were on board- did you feel like you got the full benefit - you said they tracked exactly as you thought they would, I know, but maybe there was some transition going on and did you feel like you got the full lift associated with that acquisition?

**Mr. Jack Cronin:** Yes, we saw it. We got the full lift in Q3.

**Mr. Howard Rosencrans:** Okay. Is there a lot of seasonality that we're going to experience? I know we've talked about it in the past, but other factors have impacted the sort of top of the bottom line for the past year or so. What do you see; I guess the combined businesses from a seasonal perspective, what's going to be the best and what's going to be the weakest quarters?

**Mr. Kevin Horner:** Yes, all I'll say moving forward is, in this business, December is always a tough month, right - just nature of the business, contracts are ending and so on and so forth. Q1 is generally speaking, a tough month on the cost side because all of taxes, insurance, etc.

**Mr. Jack Cronin:** That's exactly right. I mean, for the P&L is a downer in Q1. Consultant net growth is generally a downer in Q4.

**Mr. Kevin Horner:** Yes.

**Mr. Howard Rosencrans:** Great. Thank you for all your time.

**Operator:** Once again, if you do have a question, please press star, one on your telephone keypad at this time. One moment please while we poll for any additional questions.



Thank you. At this time, I'd like to turn the floor back over to management for any additional or closing comments.

**Mr. Kevin Horner:** Just simply, given there are no further questions, I'd like to thank you for joining the call today, and we look forward to sharing our fourth quarter 2015 results with you in the early February timeframe. So, thanks very much, folks, and everyone have a great day.

**Operator:** Ladies and gentlemen, thank you for your participation. This concludes today's teleconference. You may disconnect your lines at this time, and have a wonderful day.