Mastech Digital, Inc.
Second Quarter 2022 Earnings Call
August 3, 2022

Operator
Greetings. Welcome to Mastech Digital, Inc. Second Quarter 2022 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, Jennifer Ford Lacey, Manager of Legal Affairs for Mastech Digital. Thank you, Ms. Ford Lacey. You may begin.

Jennifer Ford Lacey
Thank you, operator and welcome to Mastech Digital's Second Quarter 2022 Conference Call. If you have not yet received a copy of our earnings announcement, it can be obtained from our website at www.mastechdigital.com.

With me on the call today are Vivek Gupta, Mastech Digital's Chief Executive Officer. Jack Cronin, our Chief Financial Officer, and Ganeshan Venkateshwaran our new Chief Executive Officer of the Data and Analytics Services segment.

I would like to remind everyone that statements made during this call that are not historical facts are forward-looking statements.

These forward-looking statements include our financial growth and liquidity projections, as well as statements about our plans, strategies, intentions, and beliefs concerning the business, cash flows, costs, and the markets in which we operate. Without limiting the foregoing, the words believes, anticipates, plans, expects, and similar expressions are intended to identify certain forward-looking statements.

These statements are based on information currently available to us, and we assume no obligation to update these statements, as circumstances change. There are risks and uncertainties that could cause actual events to differ, materially, from these forward-looking statements, including those listed in the company's 2021 annual report on Form 10-K, filed with the Securities and Exchange Commission and available on its website at www.sec.gov.

Additionally, management has elected to provide certain non-GAAP financial measures to supplement our financial results presented on a GAAP basis.

Specifically, we will provide non-GAAP net income and non-GAAP diluted earnings per share data, which we believe will provide greater transparency with respect to the key metrics used by management in operating the business. Reconciliations of these non-GAAP financial measures to their comparable GAAP measures are included in our earnings announcement, which can be obtained from our website at www.mastechdigital.com.

As a reminder, we will not be providing guidance during this call, nor will we provide guidance in any subsequent one-on-one meetings or calls.

I will now turn the call over to Jack for a review of our second quarter 2022 results.

Jack Cronin
Thanks, Jenny, good morning, everyone. Revenues for the second quarter of 2022, totaled $62.1 million, representing an organic increase of 16% over Q2, 2021 revenue. This revenue performance was a new record for our Company, as both business segments showed sequential revenue improvement during the quarter.

Our Data and Analytics Services segment contributed revenues of $11.3 million, which represented organic growth of 26%, over last quarter's Q2 revenues. Sequentially, revenues increased 11% from the previous quarter.

In our IT Staffing Services segment, revenues totaled $50.9 million and represented a year-over-year increase of 14%, compared to Q2 of 2021. Activity levels continued to remain elevated, during the second quarter, as we increased our durable consultant headcount by 4%, during the current quarter.

Gross profits in the second quarter of 2022 totaled $16.7 million, or 17% higher than in the corresponding quarter of 2021. Gross profit, as a percent of revenue in Q2, 2022, was 27%, compared to 26.7% in the 2021 second quarter.

GAAP net income for Q2, 2022 was $2.4 million, or $.20 per diluted share, compared to $3.7 million, or $.31 per diluted share in Q2, 2021. It should be noted that a favorable "revaluation of a contingent consideration" liability was responsible for a $1.4 million benefit in net income and a $.12 benefit in diluted earnings per share in the 2021 second quarter.

Non-GAAP net income for Q2, 2022, was $3.6 million or 30% per diluted share, compared to $3.4 million or $.29 per diluted share in Q2, 2021.

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

Note that net income in the second quarter of 2022 was impacted by several conscious decisions that we made for the benefit of the second half of 2022, and beyond.

Specifically, we increased durable staff by 22%, during the quarter in our Data and Analytics Services segment in anticipation of higher revenues, during the second half of 2022.

We invested in the cloud-services space, within our Data in Analytics Services segment, and we invested in “offshore staffing” within our IT Staffing Services segment.

While these actions mitigated our net income during the second quarter of 2022, we believe that all of these actions will have a favorable impact in the second half of 2022 and beyond.

Addressing our financial position, on June 30, 2022, we had outstanding bank debt, net of cash balances on hand, of $4.2 million. We had no borrowings under our revolving credit facility, and we had cash availability of $36.8 million, in addition to term loan capacity of $20 million under our credit facility accordion feature. Given today’s increasing interest rate environment and our elevated revolver availability, you’ll likely see us “early pay” some of our term debt with that said cash during the balance of 2022.

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 second quarter of 2022.

Let me start by saying that I’m very pleased with our Q2, 2022, revenue performance in both of our business segments, despite some impact on our earnings on account of investments made for the second half of 2022, and beyond. As I’ve stated more than once in the past calls, our main goal is to manage our businesses and our strategic objectives for the long term.

I will now provide you with my comments related to our IT Staffing Services segment’s performance and outlook and then pass the mic over to Ganeshan for his remarks on our Data Analytics business segment.

As you are all aware, there are a number of headwinds facing the U.S. and global economies. Inflation has skyrocketed, interest rates are increasing, as central banks take actions aimed to reduce inflation. The labor market is continuing to be tight, and the Ukraine Russia conflict has added another element of uncertainty that the markets need to absolve. While many pundits and seasoned executives are predicting recessionary conditions in the immediate near term, so far, we have not seen any material signs of such in our clients' businesses.

The IT Staffing Services segment delivered record revenues and record gross margins, over the first two quarters of 2022. Revenues were strong in the second quarter of 2022 in both digital and mainstream technologies and also for both contract staffing as well as permanent placements. Additionally, we're very encouraged with our offshore staffing service offering, which has gained good traction and is one of the areas we have invested in to accelerate the pace of future growth.

Gross margins continue to expand in the second quarter of 2022, to 23.3% in the IT Staffing segment. This is the second consecutive quarter of gross margin expansion, and the first time that we have exceeded the 23% threshold, since going public in 2008.

Our operating profits also continue to grow, despite our investments in offshore staffing and delivering compensation increases necessary to retain our talented workforce.

Let me now turn the mic over to Ganeshan for his remarks on our Data and Analytics Services segment.

Ganeshan Venkateshwaran
Thank you, Vivek. And good morning, everyone. It's a pleasure to be here today talking to you on my second Mastech Digital earnings call.

I'm actually taking this call today from our delivery center in Chennai, India. So, good evening to all of our Indian friends on the call.

As I near my fifth month with the Company, I'm pleased to share that we are making progress on a number of fronts. 1), formulating a new future state go to market strategy, leveraging on our current strengths. 2), addressing the gaps in our technology and talent capabilities. And 3), a robust execution methodology to support the go to market strategy.

Let me start off by addressing our Q2 financial highlights, and I will come back to the progress being made on the strategy side.

In Q2 of 2022, we generated record revenues, which were 26% higher than in Q2 of last year and 11% better than the previous quarter. Our bookings during the second quarter of 2022 approximated $10 million with one large deal closure slipping into Q3. Most of the others secured in Q2 were "close to the money" bookings, which means that they will be booked, within the next 12-month period. As a result of the foregoing, we expect that the second half of the year revenues to exceed our first half revenue performance.

Coming to the strategic improvements that I mentioned earlier, we made progress on three fronts. The first, formulating a new future state go to market strategy. What do we do today? We have very strong implementation capabilities built around Data and Analytics and customer experience. While this expertise positions the Company well with the stakeholders at the implementation level, it limits the opportunity to engage with the senior decision-makers responsible for driving large data transmissions.

So, what is new? A), we have extended our core capabilities to offer advisory services around data modernization, which includes current state assessment and a roadmap for transformation. This positions us at the higher end of the decision-making team. B), we are building automations and improvised frameworks to accelerate our implementations and migrations, as they are repeatable in nature. C, our post-implementation managed service offerings are designed to drive big cost optimization, which will result in repeatable revenues for us.

All of this will also improve our gross margins.

The second area of focus, identifying and addressing the gaps in our technology and current talent. To support the advisory solutions software, go to market strategy, we introduced new roles at the leadership level and made a few changes to the existing leadership.

We're also strengthening our solution architecture teams and building out cloud native capabilities.

We are strengthening our business development team and expanding on our technical process capabilities.

While we bring in this new talent, we will also be rationalizing our SG&A costs in the next couple of quarters.

The third area of our focus, robust execution methodology to support the go to market. For each of the go to market solutions that I conduct a year, we have established a set of differentiators that include a 4-to-8-week assessment framework to develop roadmaps, reusable solutions to accelerate deployments and migrations, a differentiated product oriented dilutive model to drive speed and execution predictability.

We are seeing early-stage positive validation to our new value proposition from several Fortune Enterprises in the U.S. and in Canada with needed conversations with the clients have pivoted from-I need you to implement this versus how can you help us solve this data problem for me.

This has also positioned us to expand our footprint into other partner ecosystems with similar offerings, such as IBM data solutions without having to agreeing to one that we read.

All of the above, I believe, will have a very positive impact on our market brand positioning, deal sizes and the tenure of all of these in future.

With that summary, I thank we for your attention and turn the mic back to you, Vivek.

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

Operator
Thank you. 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. And for participants using speaker equipment, it may be necessary to pick up the handset, before pressing the star keys.

Our first question is from Lisa Thompson with Zacks Investor Research. Please proceed.

Lisa Thompson
Hi, good morning. I was wondering if you could expand a little about what you did, as far as training? Is this something that people got trained for three hours or three days or three weeks? And how much revenue would they have generated, had they been billable consultants?

Vivek Gupta
Hi Lisa, this is Vivek here. I think this question is probably best answered by Ganeshan because it pertains to the Data and Analytics side. Ganeshan, will you take that?

Ganesh Venkateshwaran
Sure. Hi, Lisa. Good morning.

Lisa Thompson
Good morning.

Ganeshan Venkateshwaran
As part of looking out into the second half, we hired people and we hired people both from lateral hires, as well as freshers who were put through training, so, as a part of the supporting the growth for the second half.

So, we have a plan for billing them, but they have to first go through the training for the first couple of months and then they will become productive and start to bill on projects.

Lisa Thompson
Okay, so, there's going to be more—more of that in Q3?

Ganeshan Venkateshwaran
More of training,?

Lisa Thompson
Yes, more new people and more training.

Ganeshan Venkateshwaran
Well, no, we inducted quite a few people to support the requirement for second half because when we are inducting freshers, they have to go through a training for at least, two to three months and then they can be deployed into projects.

So, at this point of time, we don't expect to onboard any more freshers for the remainder of the year. But who we have had will be deployed into billable engagements, during the course of the couple of quarters.

Jack Cronin
Hey, Lisa, Jack.

Lisa Thomson
--Hey.

Jack Cronin
Let me answer the second half of the question. You said how much revenue was sort of missing or would have been increased, if they would have been on, if they were able to be on projects.

Lisa Thompson
Right.

Jack Cronin
The estimate of the extra costs, the higher bench utilization was approximately $600,000. So, if you assume a 50% margin when they're on projects, that would have been about $1.2 million in revenue.

Lisa Thompson
Alright. So, is that going to be the same sort of number for Q3?

Jack Cronin
Well, I mean, I think they're going to be on projects in Q3. So, depending on how many are still in training programs or on bench versus how many of went into a project status will depend on the additional revenue.

Lisa Thompson
Okay, so, it's probably not as big. So, does any of that cost go into cost of revenue once they shift to billables?

Jack Cronin
Yes, it's in cost of revenue, while they're on training. It's in cost of revenue when they're on projects. They're kind of relegated to.

Lisa Thompson
--Okay.

Lisa Thompson
So, the increase in SG&A was other stuff.

Jack Cronin
Yes.

Lisa Thompson
And that should continue to - was there anything unusual in this quarter, or does that just continue to go up?

Jack Cronin
Well, in D&A, there are SG&A cost increase about $500,000. We said in our prepared remarks that we invested in plus services that investment was as people. And for the quarter, that was about $200,000.

Ganeshan came on board in April and, in the first quarter we had no, CEO cost. So, that increased our SG&A and second quarter, by another $200,000. And then, we had travel and event cost, which is more of a onetime hit of $100,000.

So, that sort of makes up, at a high level, the increase in SG&A costs in Q2 versus Q1.

Lisa Thompson
Okay. So, I guess it won't increase as much in Q3 and Q4 then.

Jack Cronin
'll let Ganeshan answer that. But I can tell you this. We are rationalizing our SG&A expense in--in both of our segments. And, you know, I know for certain that we found some savings in the D&A, SG&A expense.

So, the question is, you know, what is Ganeshan's hiring patter to fulfill some of these gaps that he mentioned. And you know, what's the timing of that.

But, so, I'll just defer to Ganeshan on that one.

Ganeshan Venkateshwaran
Thank you, Jack. So, Jack mentioned, we are rationalizing our SG&A cost. And which will have its impact in the next couple of quarters. But the SG&A cost, as a percentage of revenue, okay, will, you will begin to see It drop as we begin to take our rationalization activities.

Lisa Thompson
Okay, that helps. I guess the last question is just a big picture question. Do you see signs of recession and all these things? And I did see that job hiring listings are down, you know, sequentially, all around. But I assume that has nothing to do with IT.

Are you having just as much time, just as much trouble hiring IT people, as before?

Vivek Gupta
Lisa. Right now, the demand continues to be pretty high for IT. And, we haven't really seen much of a drop. I mean, there is a little bit of seasonality, which comes in around this time, and people are on vacation. Customers are on vacation.

We haven't seen that, which doesn't mean that it's not coming or is not going to happen. As I mentioned in my prepared remarks that when we are looking at each of our customer accounts closely, there is a lot of caution concern about these impending inflationary conditions. But mine hasn't come down. So, that's why we were able to increase our billable headcount on staffing side, by as much as 4%, during the quarter.

Lisa Thompson
Okay, great. Thank you. That's all my questions.

Vivek Gupta
Thanks, Lisa.

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

Our next question is from Tim Call with the Capital Management Corporation. Please proceed.

Tim Call
Congratulations on another strong quarter growth. Your tax rate increased greatly to around 32.5%. What should we expect as a tax rate, going forward?

Vivek Gupta
Jack, will you take that?

Jack Cronin
Yes, a good question. The increase in tax rate in Q2 was for two reasons. We looked at NOLs in our foreign subsidiary, and we made valuation allowances for those, and you make valuation allowances when it's more probable than not that you're not going to utilize those benefits.

So, that cost us about $100,000 of additional tax expense. And then, we had another circumstance with respect to the exercise of stock options. We had a couple individuals that left the company, and they didn't exercise.

So, I don't want to, detail you in accounting. But we had an extra tax expense because we got no gain, tax gain for those options. And so, there was about a $75,000 additional hit on taxes, because of that event. I can't say it is a one-time shot, but I would be surprised if our tax rate for the second half of the year didn't return to what we call normal, which is about 27%-27.5%.

Tim Call
Thank you. Your cash or cash equivalents or-- now exceeds your long-term debt on the balance sheet. And so while you might pay that off early have you given any thought that these price levels to offset stock option dilution by repurchasing some shares being opportunistic there?

Jack Cronin
Vivek, do you want me to answer that, the best I can?

Vivek Gupta
Actually, I don't think we are considering that at this point in time. That's the best answer I can give you.

Tim Call
Well, it would certainly be opportunistic and accretive to earnings per share. And you have such a stellar balance sheet. So, congratulations on returning growth and having such a clean balance sheet. You've done a great job managing the firm. Thank you.

Vivek Gupta
Thank you, Tim.

Operator
Our nest question is from Marc Riddick with Sidoti. Please proceed.

Marc Riddick
Hey, good morning.

Vivek Gupta
Hi, Marc.

Marc Riddick
So, I just realized I just said good morning, but that's not appropriate for everyone, is it. So, hello to everyone. I wanted to and forgive me, I think I lost connection with you for a couple minutes there, during Lisa's question. So, forgive me if I repeat one or two. But I did want to double check to see if you could bring us up to date, as for as cash flow from operations and CapEx, year to date and maybe a couple of housekeeping items around where headcount ended the quarter.

Vivek Gupta
Okay, I'll pass these questions to Jack, first. Jack, you may be on mute.

Jack Cronin
I'm trying to look up the headcount. Our total headcount, I think, was, at least in the Staffing and Data Analytics segment, it's about—Vivek, correct me, if I'm wrong-- but I think it's about 2,400.

Vivek Gupta
Yes, that number.

Jack Cronin
That includes subcontractors. But our cash flow as far as our capital expenditures, etc., we had for the first six months of 2022, we had operating cash flows of close to $2 million. Our capital expenditures were about $790,000 in CapEx. And the lion's share of that was, we did an oracle implementation on the Data and Analytics Services segment. That went live July 1. So, those costs are pretty much completed. We're going to have some continued support, but that's what to be an SG&A expense item that you'll see in the second half of the year that our capital expenditures go down pretty dramatically.

Marc Riddick
Okay, so, I just want to make sure I got that right. So, the oracle implementation was completed, during the second quarter, and you said went live, July 1.

Jack Cronin
True.

Marc Riddick
Okay, great. And then, I wanted to touch a little bit the timing, as far as maybe what you're seeing from customers. Particularly, it sounds as though, certainly, the the activity continues to be solid, up to this point, given, despite recessionary concerns and fears. I was wondering if you see any particular pockets of strength either by industry, vertical, geography or if there's anything, in particular, amongst your customers that- stands out, either positively or negatively.

Vivek Gupta
I think there's a little bit of heightened concern among the financial services organizations. That's one. Healthcare seems to be the least impacted. Retail, the concern seems to be that a lot more, over there.

Marc Riddick
Right.

Vivek Gupta
And, I would say somewhere in the middle is manufacturing. But it's one continuum. It's not that one is extremely on this side or that side. So, it's there and all of us are reading the same newspapers, every day, and we are having conversations with customers. They're keeping their powder dry, but they really are not firing the gun as yet. And demand continues to be in pretty good shape for us. So, we are making the most of demand being more than supply, right now.

Marc Riddick
Okay. And then, are you seeing much in the way of change in revenue mix that would be a callout, as far as gross margins or any thoughts around maybe shifts of client demands that might have a other benefit or impact on margins, besides the, obviously, kind of some of the training conversation that we've had, up to this point.

Vivek Gupta
So, I can say about IT Staffing, and I'll let Ganeshan add on the Data, Analytics side. But on the IT Staffing side, what should we say, the costs are going up. I mean, what we paid to our consultants. But then the gross margins are kind, of keeping pace with that. One positive thing happened is the offshore staffing, which seems to be gaining a lot of traction. And, a lot of customers are realizing that because of the cost arbitrage, they're able to do more for less.

And, as everybody has tightened their belts, that's a good strategy to do offshore staffing. Customers are already comfortable with remote staffing, which is having people in other parts of United States. And this just seems to be the natural next step of doing people, having their staffing people in-in India, rather than over here at a price point. But it also gives opportunity to have better gross margins. And that has partly contributed to the record gross margins that we've been able to achieve in this quarter. And, I'll let Ganeshan say something about the Analytics side.

Ganeshan Venkateshwaran
Sure, Vivek. Again, I think on the Data and Analytics side, we are seeing a strong momentum. In fact, even while we see that there is a market trend from a recession standpoint with some industries, we have been working with the fortune hundred banking company and want to pick up latest change in the country. And, the spend that we see with them, when it comes to investing on their data transformation, is significant.

As I speak about the shift in how we are going into the market, we are seeing clients beginning to talk to us about, hey, how can you help with our data transformation strategy. Now, what that does is it positions us on the upstream of decision making. But when the conversion happens from a revenue standpoint, the downstream revenue becomes much more of the mix is much higher in quality of revenue, and from a pricing standpoint, again, it helps us get to premium pricing, which will have a positive influence on the gross margins aspect. So, even though we are likely to see a shift, in terms of what the margin implements, as well as in terms of the quality of revenue that would be coming, as we pivot towards the advisory services and, the managed resource type engagements.

Marc Riddick
Excellent. Thank you very much.

Vivek Gupta
Thank you, Marc.

Ganeshan Venkateshwaran
Thank you.

Operator
As a reminder, it is “*”, “1” on your telephone keypad, if you would like to ask a question. We will pause for just a brief moment to pull for any final questions.

There are no more questions, at this time. I would like to turn the conference back over to management for closing comments.

Vivek Gupta
Thank you, Operator. So, if there are no further questions, I’d like to thank you all for joining our call, today, and we look forward to sharing our third quarter, 2022, results with you in early November. Thank you.

Ganeshan Venkateshwaran
Thank you.

Operator
Thank you. This does conclude today’s conference. You may disconnect your lines at this time and thank you for your participation.