

Mastech Digital Inc. Q2 2017 Earnings Call

July 26, 2017

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Operator: Greetings, and welcome to the Mastech Digital, Inc. Second Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

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

Ms. Jennifer Ford Lacey: Thank you, operator, and welcome to Mastech Digital's second quarter 2017 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, 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 beliefs, 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 2016 Annual Report on Form 10-K filed with the Securities and Exchange Commission and available on their website at www.sec.gov. Additionally, management has elected to provide non-GAAP financial measures to supplement our financial results presented on a GAAP basis. Specifically, we will provide non-GAAP net income and non-GAAP diluted earnings per share data, which we believe will provide greater transparency with respect to the key metrics used by management in operating our business. Reconciliations of these non-GAAP

financial measures to their comparable GAAP measures are included in our earnings announcement, which can be obtained from our website at www.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 2017 results.

Mr. Jack Cronin: Thanks, Jen, and good morning, everyone. Revenues for the second quarter of 2017 totaled \$35.1 million and represented a 4.3 percent improvement over revenues of \$33.6 million in the second quarter of 2016. On a sequential basis, revenues improved by 6 percent over first quarter 2017's top-line results.

Our activity levels were solid and showed some improvement over the previous quarter. And accordingly, we were able to materially increase our billable consultant base. Actually, the increase of 75 COBs during the quarter was our best performance since Q3 2010.

Gross profit for the second quarter of 2017 totaled \$7.1 million compared to \$6.9 million in the same period last year. Our gross margins for the second quarter of 2017 improved to 20.2 percent from 18.8 percent in the previous quarter but were still slightly shy of gross margins of 20.5 percent achieved in the second quarter a year ago.

The year-over-year gross margin percentage drop was due to two factors - one, lower direct higher fees, and two, some margin reductions in a couple of client accounts in our retail sales channel.

SG&A expenses were \$6.1 million in the second quarter of 2017 and represented 17.4 percent of total revenues compared to 5.2 million or 15.5 percent of revenues in the second quarter of 2016. It should be noted that the SG&A expenses in the 2017 period, included approximately \$300,000 of transaction expenses related to our recent acquisition of InfoTrellis. Excluding these expenses in the 2017 period, SG&A expenses would have increased by approximately \$600,000, when compared to the previous year. This increase was entirely related to investments made in our sales and recruitment organizations to support growth and improve our practice capabilities.

GAAP net income for the second quarter of 2017 was \$696,000 or 15 cents per diluted share compared to \$945,000 or 21 cents per diluted share in the second quarter of 2016.

Non-GAAP net income for Q2 2017 was \$1.1 million or 23 cents per diluted share compared to \$1.1 million or 25 cents per diluted share in the corresponding quarter of 2016.

Second quarter SG&A expense items not included in non-GAAP financial measures net of income tax benefits were, one, the amortization of the acquired intangible assets, two, stock based compensation, and in the 2017 period, acquisition transaction expenses and are detailed in our second quarter earnings release, which is available on our website.

Briefly addressing our financial position at June 30, 2017, we had \$9 million of outstanding bank debt net of cash balances on hand. Our accounts receivable balance at quarter-end remained of top quality, and our days sales outstanding measurement improved by three days from last quarter to a healthy 55 days.

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

Mr. Vivek Gupta: Good morning, everyone. Thank you, Jack, for the detailed financial review of our operating results. Let me supplement that narrative with a few observations about our financial and operational performance in Q2, and after that, I will comment on our recent acquisition of InfoTrellis.

Simply put, Q2 was an outstanding quarter for Mastech Digital. We are clearly seeing tangible results from the deliberate increase in our investments in the sales and recruitment organizations over the last several quarters. Our billable consultant base grew by almost 8 percent during the quarter, and we achieved sequential revenue growth of 6 percent. Our gross margins also improved from the previous quarter by 140 basis points.

With the executive leadership spending considerable time and energies on the InfoTrellis acquisition during the quarter, our management team stepped up and delivered an outstanding performance. Let me take a moment to acknowledge, Mike Bryan, Senior Vice President of Direct Sales, Sameer Srivastava, Senior Vice President of Alliance Sales, and Shipra Sharma, our Vice President of Offshore Recruitment - a sincere thank you to them and their teams, well done.

Now let me talk a little bit about our recent acquisition of InfoTrellis, and then I'll open the session for your questions.

InfoTrellis is a Canada-based consulting services company with specialized capabilities in data management and analytics. These capabilities are right in the center of the digital transformation revolution and an IT services area that I believe has tremendous potential ahead of it. Specifically, InfoTrellis provides project-based consulting services around master data management, data integration, big data and data analytics. The company is headquartered in Toronto and has offices in Austin, Texas and a global delivery center in Chennai in India. The two founders who both joined Mastech Digital in connection with the acquisition are highly recognized and well respected in the industry and are a welcome addition to our executive leadership team.

The headline purchase price of the acquisition was \$55 million with \$35.7 million paid in cash at closing, subject to working capital adjustments, and \$19.3 million deferred over the next two years. The deferred purchase price is contingent upon the acquired business generating specific EBIT targets during the two years following closing.

The funding for the transaction consisted of a combination of debt and equity, which came in the form of a new and expanded credit facility with PNC Bank, and a \$6 million private placement of newly issued shares of the company's common stock to Mastech Digital's founders and majority shareholders, Ashok Trivedi and Sunil Wadhvani.

More detailed information relating--related to the terms and conditions of the transaction and its financing have been filed with the Securities and Exchange Commission in two separate current reports on Form-8K, one filed on July 13, 2017 and the other filed on July 19, 2017. Each of these filings is available on our website at www.mastechdigital.com.

I will now open the session for your questions.

Operator: Thank you. We will now 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 your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Once again, if you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Our first question comes from the line of Howard Rosecrans with Value Advisory. Please proceed with your question.

Mr. Howard Rosecrans: Hi, thank you. I'm trying to just get a better understanding of the changes in your business at a very high level without too much depth into the tech as to sort of the, legacy staffing business and what you did with Hudson and what this acquisition does for you and sort of to get a sense of the synergies that you perceive between - will they be expense synergies or what do you perceive?

I saw you projected or made a statement that deferred payments were dependent on something like \$10 million in EBIT being generated I guess by InfoTrellis, and I'm just curious should we expect synergies beyond that or--that's the gist of my question. Thank you.

Mr. Vivek Gupta: Thank you, Howard for your question. Let me try and answer that by going back a little bit.

I came on board on March 1, 2016, and immediately after coming on board, we built a strategy to take the company from a pure staffing company towards a digital transformation services company. And a bunch of changes were introduced in the organization, new capabilities were introduced in the digital staffing area.

And September 12th to be precise, we actually changed the name of the company from Mastech to Mastech Digital. And at that point in time, we launched, some digital transformation services in addition to the staffing services that we were already providing. And that was sort of the first major step in our transformation from a pure staffing company into a digital transformation services company. And the services that we added were in the area of cloud or Salesforce.com, SAP Hana capability and digital learning capability.

Now, InfoTrellis acquisition is actually the second significant step in the same transformation. We have a significant anchor investment which becomes sort of the foundation for the digital transformation services to kind of grow the digital transformation services fees. And it

brings the most significant digital technologies focus that we were wanting to introduce on the digital transformation side.

So, now we have a company with the combined entity which is providing the digital transformation services and it is also providing IT staffing services. And, it gets us to--from what I think I've used that expression in the past, from Mastech 1.0 to Mastech Digital 2.0. We think there is tremendous synergy between the two businesses, although there'll be other business units under the larger Mastech Digital umbrella.

There is a great opportunity for us to cross-sell services of one business into the other. There are marquee customers that we already have on the Mastech Digital side, and InfoTrellis brings with it relationships with really good Fortune 100 customers, as well. The opportunity for us to be able to cross-sell across the two will be tremendous. So, that is the sort of the thinking behind this.

Now, when it comes to how this is going to pan out, clearly, there are EBIT targets which are part of the deferred payment criteria, and we are quite hopeful and optimistic that those numbers will be achieved and that will be accretive for Mastech Digital.

Mr. Jack Cronin: --Yes--.

Mr. Vivek Gupta: --If you like to add some.

Mr. Jack Cronin: Sure, Howard, the targets are pretty much void of any cross-selling opportunities and/or cross rationalization, which isn't gonna be much. So, any cross-selling successes that we have should lay on top of those targets.

Mr. Howard Rosencrans: Although the cross-selling you said is not going to be much.

Mr. Jack Cronin: No, I said the cross rationalization isn't going to be much.

Mr. Howard Rosencrans: Oh. Okay.

Mr. Jack Cronin: Yes.

Mr. Howard Rosencrans: Sorry.

Operator: Thank you. Once again, as a final reminder, if you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for question.

Our next question is a follow-up from Howard Rosencrans with Value Advisory. Please proceed with your question.

Mr. Howard Rosencrans: Hi. I wanted to understand in terms of gross margin progression - you had this nice jump Q-to-Q, although you're still down year-to-year. Is that a comment that the sort of traditional staffing business, the margins are getting squeezed, while at the same time the digital service--I guess you have consultants that do digital and you have consultants that do more traditional work. The consultants that are doing traditional are getting squeezed whereas you're able to garner a better margin on the digital?

Mr. Jack Cronin: I think that's exactly right, Howard. I think the margins on the digital staffing resources come at a higher level and offset some of the margin squeezed on the mainstream technology side. So, I think you got it right on.

Mr. Howard Rosencrans: But, it's always different guys. Is that right? Your consultant that you're putting on for the digital is a different guy than the consultant you're putting on for the sort of legacy staffing business, right?

Mr. Jack Cronin: Absolutely, different skill sets, absolutely.

Mr. Howard Rosencrans: And, increase in SG&A, which is certainly very pronounced given the slim margins in your business, it's tough to recapture really much in a way of at least to date, we're not capturing much from that investment, - is the vision that we can at some point back off the huge incremental SG&A investment or simply that we'll have to drive the top-line-- again, this will be in the non InfoTrellis business?

Mr. Jack Cronin: The investments are the investments that we made, the extra roughly \$600,000 are all in investments in increasing production. Our SG&A expense is 100 percent flat. The question is are we going to recover, are we going to get payback on that investment. And I think the answer is yes, and I think we see that in our Q2 growth rates. Our target isn't to be running SG&A at 17 percent or high 16s. I mean, our target is to get that number down to around 15, 15.5 percent. And we think that's very achievable.

Mr. Howard Rosencrans: Is the mix of--does the income statement of the acquired company, look somewhat the same in terms of the gross margin and the SG&A ratios?

Mr. Jack Cronin: No, they're different, Howard. And we'll have more color on that in Q3, but clearly different. They're a much higher margin, gross margin business. And frankly, their SG&A cost as a percentage is actually lower than ours right now. So, you'll get some color when you--.

Mr. Howard Rosencrans: --Are you going to report the businesses separately?

Mr. Jack Cronin: Yes, I believe it's going to be a separate segment. We're assuming that it's going to be a separate operating segment, and in our financial filings with the SEC, we'll probably operate under two segments.

Mr. Howard Rosencrans: Okay. And if you were to break down the two businesses, not InfoTrellis-- well, actually, I have a question on InfoTrellis, but we'll get back to that in a second. But, if I was to break down your two businesses, your sort of legacy staffing business and the digital side of what you're doing now, could you tell us what sort of the growth rate is on the digital side and how much digital represents of the mix?

Mr. Vivek Gupta: Yes, actually, we have been tracking that for the last four quarters or so. So, around the same time, around Q1 of last year, 2016, the total amount of business which was coming from digital technologies was around 18 percent. And, today, this quarter, we've achieved a little over 25, 25.4 percent. So, that's growing much faster than the mainstream. In fact, mainstream technologies type, revenue are probably shrinking marginally, but this one is growing much, much faster.

As you can see, the 7 percent increase has happened in five quarters. And we expect this trend to continue. And now with the addition of Info Trellis, the number will get into the mid-30s to probably late-30s, and we think that's a good place to be. So, if we are calling ourselves a digital company, and Mastech Digital itself has that digital name in it then, you know, 35 to 40 percent of our revenues coming from digital is actually a good place to be.

Mr. Howard Rosencrans: Okay. The margins I guess on the digital side would be--I guess on the sort of historical staffing side, the margins are pretty much razor, razor, razor thin. I mean, on a blended basis, you're only making a few points on a blended basis, on an EBIT basis.

So are the digital-- are you doing at least, I don't know, 5, 6, 7 percent on the digital side and like 1 or 2 on the staffing side, because you're blending at about 3?

Mr. Jack Cronin: Yes, right now, I mean, the platform digital and the margin compression from mainstream, overall margins, we're just jogging in place right now. There's going to be a little bit of expansion on the mainstream side or a little greater growth on the digital side to bump up those margins in the staffing business materially.

On the InfoTrellis side, it's a whole different margin play. And again, you'll see that when we announce Q3, we'll give some segment information on that, as well.

Mr. Howard Rosencrans: So, not talking about InfoTrellis, but is the digital business--if you could separate it out just in terms of broad general color, is that like a 5 or 6, 7 percent business in terms of margin? And the core, the legacy staffing business is, I don't know, a 2? Is that some sort of ballpark? I guess that would sort of mold to 3 if one is 25 percent of your business and one is 75.

Mr. Vivek Gupta: Actually, this is where I'm not being able to connect with that, because our gross margins are in the range of 20 percent or so. The difference between what we are getting for digital and what we are getting for mainstream is actually a plus, minus 2 percent, 3 percent kind of thing, right, maybe a little bit more. But, because of the size of digital being much smaller, the upside from that and then the mainstream being much larger, the downside

because of the pressure on that sort of becomes a wash in a way or gives us a small bit of upside but not a huge one. So, I'm not fully understanding this 2 percent and this 5, 6 percent that you're mentioning.

Mr. Howard Rosencrans: Okay. I was netting out the SG&A, so I guess just looking at it from a--which I guess in, you know, includes a lot of the embedded G&A, but just to look at it from a gross margin standpoint, so the gross margins on the digital business would for the sake of conversation, would run let's say, 23, 24 percent, whereas the gross margins on the historical staffing business would run, I don't know what, would that imply--they'd run , 17, 18?

Mr. Vivek Gupta: Well, I don't have the figures in front me, but the difference may not be that significant, but, yes, it is broadly like that. It's like, 20 percent and they could be a plus, 10 percent on this side, and there could be 10 percent lower on the other side.

Mr. Howard Rosencrans: Okay. Okay. And what do you think the growth rate is on the InfoTrellis business?

Mr. Vivek Gupta: The historical growth rate that we have seen over the last few years is actually pretty healthy. And, the last five years would be upwards of 20 percent.

Mr. Jack Cronin: I believe that's about right.

Mr. Vivek Gupta: Yes. And we are hoping with this kind of EBIT targets, which are there would be an expectation that the business will continue to grow over the next two years.

Mr. Howard Rosencrans: Okay. So, historically, they've grown--I guess I missed it in the filings, I apologize. Historically, the business has been about a 20 percent grower?

Mr. Vivek Gupta: Sorry, Howard, could you repeat the last question.

Mr. Howard Rosencrans: Sure. The InfoTrellis business has historically been about 20 percent grower?

Mr. Vivek Gupta: Yes.

Mr. Howard Rosencrans: All right. That's it for now. Thank you so much for your time. What is the rate--I guess one more question--what is the rate on the PNC? I probably missed in the filing--what is the rate of the money you borrow from PNC?

Mr. Jack Cronin: Our effective interest rate now is just a tad under 4.5 percent. We have a \$30.5 million term loan and we swapped--we, put a fixed rate on that. We did a swap for about half of that. And, you know, the fixed rate is more like 5 percent, and the variable term is about roughly 4.25. And then our revolver which we're into by probably around \$9 million today, is at about 100-basis points lower.

So, if you take those three interest rate numbers and you blend them to the outstandings that we have right now, it's about 4.5 percent, a tad under.

Mr. Howard Rosencrans: Okay, great. Thank you, guys. Appreciate all the color.

Mr. Jack Cronin: Thanks, Howard.

Operator: Thank you. Once again, if you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for more questions.

There are no further questions at this time. I would like to turn the call back over to the Vivek Gupta for closing remarks.

Mr. Vivek Gupta: Thank you. 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 2017 results with you in late October. Thank you.

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