Mastech Digital Inc.
Q4-2019 Earnings Call
February 5, 2020

Presenters
Jennifer Lacey - Manager of Legal Affairs
John Cronin - CFO & Corporate Secretary
Vivek Gupta - President, CEO & Director

Q&A Participants
Joshua Vogel - Sidoti & Company
Timothy Call - Capital Management Corporation

Operator
Greetings. Welcome to the Mastech Digital Fourth Quarter 2019 Earnings Conference Call. At this time, all participants are in listen only mode. A brief question-and-answer session will follow the formal presentation. If anyone today should require operator assistance during the conference, please press star zero from your telephone keypad. Please note that this conference is being recorded. I'll now turn the conference over to your host, Jennifer Ford Lacey, Manager of Legal Affairs for Mastech Digital. Ms. Ford Lacey, you may now begin.

Jennifer Lacey
Thank you, operator, and welcome to Mastech Digital's Fourth Quarter 2019 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 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 2018 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 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 fourth quarter and full year 2019 results.

Jack Cronin
Thanks, Jen, and good morning, everyone. 2019 was an exceptional year for Mastech Digital in terms of improving overall financial performance, deleveraging our balance sheet, and enhancing capabilities in both of our business segments. Vivek will touch on many of these operational enhancements in his prepared remarks, but first, let me summarize our financial results for Q4 and the full year of 2019.

Addressing fourth quarter, revenues for the fourth quarter of 2019 totaled $50.4 million and represented a 13% increase compared to $44.6 million reported in the fourth quarter of 2018.

Our Data and Analytics segment contributed $7.2 million of revenue during Q4 2019 compared to $5.4 million in the fourth quarter of 2018. This represented a 34% year-over-year improvement. Activity levels increased materially in the fourth quarter of 2019, and the resulting outcome was a number of significant assignment wins and a very strong pipeline of opportunities as we enter 2020.

Year-over-year revenue growth from our IT Staffing Services segment was 10% in Q4 as our billable consultant-base and our average bill rate both increased during the year. Demand for our IT Staffing Services remained positive during the fourth quarter, despite the high level of seasonal assignment ends that the industry experiences in December. Our focus on digital—our focus on digital technologies has proven to be a key driver of our revenue growth in 2019.

Gross profit for the fourth quarter of 2019 totaled $12.8 million compared to $10.7 million in the same period last year.

Our gross margins for Q4 2019 were 25.3% of revenues, compared to 23.9% in the fourth quarter of 2018 and it was our first time breaking the 25% gross margin barrier.

Our Data and Analytics Services segment had gross margins of 49.1% in Q4 2019, an increase of close to 400 basis points from a year earlier. Our IT Staffing Services segment had Q4 gross margins of 21.4%, an increase of 40 basis points from the 2018 fourth quarter. Higher margins on new assignments in both segments helped drive these GM percentage improvements.

SG&A expenses were $9.3 million in fourth quarter 2019 compared to $8.4 million in the fourth quarter of 2018. This $900,000 increase in SG&A expenses represented investments of $700,000 in our Data and Analytics Services segment, principally in the areas of sales and delivery and $200,000 in our IT Staffing segment for system upgrades and other volume-driven variable costs.

GAAP net income for Q4 2019 was $2.3 million, or $0.20 per diluted share, compared to $874,000, or $0.08 per diluted share, in the fourth quarter of 2018.

Non-GAAP net income for Q4 2019 was $2.9 million, or $0.26 per diluted share, compared to $1.8 million, or $0.16 per diluted share, in the corresponding quarter of 2018.

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

Briefly addressing our full-year results, 2019 revenues totaled $193.6 million and represented a 9% increase over 2018 revenues of $177.2 million. Gross profits for 2019 were $48 million compared to $42.5 million in 2018. Our gross margins as a percentage of revenues were 24.8% in 2019 compared to 24% in 2018. And both of our business segments had gross margin improvements during the full-year.

GAAP net income for the full-year 2019 totaled $11.1 million, or $0.99 per diluted share, compared to $6.7 million, or $0.60 per diluted share, in 2018.

Non-GAAP net income for 2019 totaled $9.3 million, or $0.82 per diluted share, compared to $8.2 million, or $0.74 per diluted share, in 2018.

Again, a detailed reconciliation of our non-GAAP financial measures compared to their comparable GAAP measures is included on our earnings release, which is available on our website.

Addressing our financial position, at December 31, 2019, we had $22.5 million of outstanding bank debt, net of cash balances on hand, and our borrowing capacity approximated $13 million under our existing revolving credit line. For the full year 2019, we reduced debt levels by over $13 million, including a $5 million early payment on our outstanding term loan balance in Q4 of 2019. Bank debt now represents 36% of our total capital structure compared to 53% a year ago.

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 2019.

Let me start by saying how delighted I am with both the Q4 results, as well as the full year 2019 financial performance of Mastech Digital. All of our financial parameters were soundly positive with strong revenue growth, gross margin expansion, and higher operating profits, all while we made significant investments to fuel our future growth. We also materially improved our financial position by reducing debt levels from cash generated by operating cash flows.

With $50+ million of revenue delivered in Q4, I'm happy to say, that on an annualized basis, we are now a $200 million revenue company, a great milestone for Mastech Digital, which was only $123 million in revenue less than four years ago when I took over as CEO.

Both of our business units contributed to this strong performance in 2019.

Our Data and Analytics Services segment had a truly transformational year beyond its improved operating results in 2019. Spearheaded by our new leadership team, led by Paul Burton, we materially enhanced our portfolio of service offerings, implemented an effective go-to-market strategy, and built a highly talented sales organization. The results of this progress can be seen in all aspects of our Data and Analytics business from higher client satisfaction, stronger operating results to a vastly improved win ratio and a strong pipeline of exciting opportunities.
Another key improvement in the business is the size and type of deals that we are winning. Many are multiyear, multimillion-dollar engagements, having annuity-based revenue streams. I'm extremely excited about the opportunity we have for further growth as we continue to aggressively execute on our plans for this segment.

Our IT Staffing Services segment also had an excellent year. The business continued its focus on digital technologies, and, with a 9% annual growth in revenue in 2019, we beat the average industry growth rate of 3% by approximately three times. In addition, during 2019, we also expanded gross margins and increased our average bill rate. Operationally, our recruitment engine continues to strengthen in terms of capacity and capabilities, which gives me great satisfaction as this was my first key area of focus in moving the IT Staffing business segment towards digital technologies upon my joining Mastech Digital in early 2016.

Now, let me share with you my general expectations for our business segments in 2020, noting in advance that we do not give financial guidance.

First, our Data and Analytics Services segment. As I said before, this segment has huge potential. Currently, we are seeing excellent traction for our expanded service offerings globally. In 2020, we will endeavor to broaden our geographical reach beyond North America into Asia, Europe, and the Middle East. You will also see us continue to make additional investments to expand the size of our sales organization and enlarge our delivery centers in both India and North America.

With respect to our IT Staffing Services segment, I fully expect this segment to once again beat the average industry growth rate in 2020. Continued efficiency gains at our offshore recruitment center and successes in capitalizing on digital technology staffing services will again be key drivers for us this year.

While we plan on continuing to invest ahead of our growth curve, our focus will be on further improving operational efficiencies and, as a result, dropping more profits to the bottom line.

And lastly, as we enter the New Year, I'm happy to tell you that both morale and confidence levels are extremely high across the entire organization. Collectively, we are looking forward to and anticipating a prosperous and successful 2020.

I will now open the session for your questions.

Operator
Thank you. At this time, we'll now be conducting a question-and-answer session. If you'd like to ask a question, please press star one from your telephone keypad, and 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. One moment, please, while we pull for questions. Thank you. And our first question is from the line of Josh Vogel with Sidoti & Company. Please proceed with your questions.

Joshua Vogel
Thank you, good morning, Vivek and Jack. Thanks for taking my questions. My first, I guess, for Vivek. Can you give us a little bit more color on those multiyear, multimillion-dollar contract signings? I guess, when we think about how much, how long, and when these will contribute?

Vivek Gupta
Hi, Joshua. Thank you for your question. Yes, actually, the fourth quarter, we really had a fantastic order booking during the quarter. And particularly, I can talk about December. In December alone, we booked $23 million of orders. And considering that this segment—the Data and Analytics business, only a year ago in 2018, delivered a revenue of about $24 million, picking up that kind of quantum of orders in just one month alone is very satisfying and rewarding for all the hard work that has been put in during the year. And the majority of the revenue from this $23 million order is coming from two large multiyear, multimillion-dollar deals.

We call them centers of excellence engagements with customers, and these would run typically three to five years, and they have an annuity revenue stream coming out of that. And this is something which is new for us, because in the past, we would have this issue of projects coming to an end at different points in time and that would lead to lumpiness in the revenues coming from this segment. But now that we are getting these kind of annuity-based engagements, and there are many more in the pipeline, which we are hoping to close over the next few quarters, that will not only help us scale, but it will also help us mitigate the lumpiness in the revenue stream. The deal that I'm talking about would definitely add more stability and, of course, scale to what Data Analytics business is trying to do.

Joshua Vogel
That's helpful. Thank you. When we think about the D&A contracts especially these new multiyear, multimillion dollar ones - what's the typical ramp period? And are there upfront costs, too? Or, in other words, are these profitable right out of the gate, or is it take several months?

Vivek Gupta
Well in most cases, there is a ramp-up cost involved and our clients are happy to pay a start-up fee to pay for the investments that are being made. So, with that in place, these contracts become profitable right from the very first month. And, most of the billing is on a monthly basis. So, yes, it's not that you end up having a breakeven further down into the life of the contract. You will start virtually from the beginning itself.

Joshua Vogel
Great. Okay. So, looking at 2019, put up very strong results. We saw progressive revenue improvement from quarter to quarter. Today, we're seeing your IT Staffing segment is growing at about triple the industry average. Data and Analytics clearly putting up strong results and benefited from those initiatives you've undertaken for the sales and delivery capabilities. And thank you for your commentary about 2020. I was just curious, maybe this one more for Jack. given the outsized growth in Data and Analytics, how should we think about gross margin trends? Any directional commentary, 2020 versus 2019?

Jack Cronin
Yes. Well, our fourth quarter, we were at 19.1% in D&A for gross margins, which is a record for us.

Vivek Gupta
49.1%.

Jack Cronin
49.1%, which is a record for us, since we acquired the company. Are we going to be at 49.1%, for the entire year 2020? I wouldn't suggest that - but I do think when we compare ourselves to the full year of 2019, 2020 should be an improving gross margin year for us.

Joshua Vogel
Great. Jack, why did you decide to early pay a portion of that term loan last quarter? Would that not hurt your cash availability under the revolver?

Jack Cronin

We paid on $5 million. And the reason we did it is it did lower our cash availability by $5 million under our revolver, but we have more than enough cash availability. And the savings that we got--or that we will get from paying down the term loan would be about $80,000. And that's because the interest on the term loan is about 150 basis points higher than the interest on the revolver. We felt that we had more than enough availability to satisfy our cash needs in 2020. We had an opportunity for some cost savings, and we capitalized on that. Frankly, I wouldn't be surprised if we made some early payments on the term - some additional ones in 2020.

Joshua Vogel
That's helpful. Thank you. And if I could sneak in one more. How should we think about your capital allocation strategy today? Maybe--obviously, paying down the term loan, but Vivek, you mentioned, looking to broaden geographically, Asia, Europe, and Middle East. I'm curious if that's something that you will do completely organically, or is there an appetite for an acquisition, assuming it would be more data and analytics focused? But if you could talk to how you plan to expand geographically, and what's your appetite for acquisitions, and would it be more specialty related, geographic, or a mix of both? Thank you.

Vivek Gupta
Let's pick the first one first. The geographical expansion that is going to be done entirely organically. And we have already started the process. We brought on board salespeople who are experienced and who have been in that business for a long time, and they are tried and tested. We brought them on board and already a lot of pipeline building is happening in that space. So, there won't be any acquisitions in that area.

But coming to the acquisitions piece, we feel that we have reached that stage, in the life of the Data Analytics business within Mastech Digital that we could be looking at the next step--the next acquisition. But the focus won't be on the geographical spread. The focus will be more on capabilities specifically in the analytics area. And, there's a couple of other focus areas that we have identified. And, we will be looking at that over the next few quarters.

Joshua Vogel
Great. Well, thank you for taking my questions.

Vivek Gupta
Thank you.

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

Timothy Call
Congratulations on a great quarter. I was wondering with the accounts receivable falling when revenues are rising, is that because of your use of the new ERP system and efficiencies?

Jack Cronin
Maybe it was because of inefficiencies related to the new ERP system, and we transitioned out of that in the last half of 2019.

Timothy Call
And then--.

Jack Cronin
When we did our implementation, we definitely had some challenges on the cash conversion aspect of the business, and we worked our way through that. And right now, our receivable levels have returned to prior implementation levels.

Timothy Call
And interest expense is falling rather fast. Should we expect that to continue until you find your next acquisition?

Jack Cronin
We do. We do. And, if we go down the acquisition route and find something that's attractive to us, there's probably going to be an overhaul in our debt facility. So, one can look at us and say, “Well, gee, you're early paying the term. Why are you doing that if you're going to look for an acquisition?” And the answer to that is, if we do, do an acquisition, it's highly likely that we're going to essentially redo our credit facility.

Timothy Call
Great. Thank you. And congratulations again.

Vivek Gupta
Thank you.

Operator
Thank you. As a reminder, to ask a question today, you may press star one from your telephone keypad. Thank you. There are no additional questions at this time. I'll hand the floor back to management for further comments.

Vivek Gupta
Okay. If there are no further questions, I'd like to thank you for joining our call today, and we look forward to sharing our first quarter 2020 results with you in late April. Thank you.

Operator
This will conclude today's conference. Thank you for your participation. You may now disconnect your lines at this time.