RCM Technologies, Inc.

Second Quarter 2022 Earnings Call

August 11, 2022

CORPORATE PARTICIPANTS

Kevin Miller, *Chief Financial Officer*

Brad Vizi, *Executive Chairman and President*

CONFERENCE CALL PARTICIPANTS

Alex Rygiel, *B. Riley Financial*

Bill Sutherland, *The Benchmark Company*

PRESENTATION

Kevin Miller

Good morning and thank you for joining us. This is Kevin Miller, Chief Financial Officer at RCM Technologies. I am joined today by Brad Vizi, RCM's Executive Chairman.

Our presentation in this call will contain forward-looking statements. The information contained in the forward-looking statements is based on our beliefs, estimates and assumptions and information currently available to us, and these matters may materially change in the future. Many of these beliefs, estimates and assumptions are subject to rapid changes.

For more information on our forward-looking statements and the risks, uncertainties, and other factors to which they are subject, please see the periodic reports on Forms 10-K, 10-Q and 8-K that we file with the SEC as well as our press releases that we issue from time to time.

I will now turn the call over to Brad Vizi, Executive Chairman, to provide an overview of RCM's operating performance during the quarter.

Brad Vizi

Thanks, Kevin. Good morning, everyone.

I am pleased to announce a strong performance throughout the Company as we continue to execute against our long-term strategy. I have always believed that combining leading talent and technology with secular growth markets and excellent capital allocation would lead to superior long-term returns. Furthermore, I believe a virtuous cycle has emerged, where the success of RCM as a platform can be leveraged to attract top talent and investment opportunities in a talent and return-starved environment.

Specifically, many of the participants in the workforce today, especially those with highly specialized skill sets, are passive participants. Often these individuals are not looking for work, but if a particular firm or colleague calls that the candidate holds in high regard, the candidate will engage with alacrity and join the team. When the Company reaches a critical mass, comprising both tangible and intangible assets like the ones described above, economic benefits can increase at a compounding rate.

As we look to the rest of this year and beyond, we expect our performance to carry forward as we grow our share in existing markets and scale into new adjacencies.

Turning to our second quarter. Each unit demonstrated solid execution and performed well in our mostly recession-resistant end markets. Our Engineering team continued to gain traction on multiple fronts and exceeded our financial expectations for the quarter. Our Health Care Services team continues to expand its strategic footprint within the education market and deliver against the backdrop where decades of underinvestment have left the country's social infrastructure in disrepair. Finally, our Life Sciences and IT group have made demonstrable progress in its journey toward a managed service and solution-driven model.

In summary, while other companies are falling back to a defensive position, we continue to invest in the team and fill out our leadership ranks. Kevin will cover our financial performance in more detail, but I want to share several financial and operational highlights from the quarter.

Starting with our financial performance. RCM generated second quarter revenue of $74 million, a 59% increase year-over-year after adjusting for the Power Systems Canada sale. Regarding profitability, we also performed well, with RCM generating EBITDA of $8.4 million in Q2, representing growth of 281% on a year-over-year basis. Our finance team under Kevin's leadership continues to raise the bar, with RCM generating record cash flow from operations for the quarter of $18.3 million.

I remain enthusiastic about our future, and I'm excited about some of the industry developments we see across each of our end markets and the strategic pursuits within our organization.

First, I want to highlight my appreciation for the engine that ultimately drives our performance, which is our people. Our vision and demonstrated success is resonating with folks across the industries we operate in, but more importantly, good people, attractive people, again, a virtuous cycle, enabling us to attract top talent to RCM.

In particular, I'm excited to announce that Mark Francis has joined RCM as Senior Vice President of Engineering for our Aerospace Group. Mark brings a wealth of experience that will help us continue to build out our engineering and manufacturing engineering teams to successfully execute as well as support new client business pursuits and development. Mark has held leadership positions in operations, manufacturing, engineering and quality, most recently for Lockheed Martin. Mark has also held general manager roles for Tier 1 manufacturing companies in the aerospace industry. I'm excited to have Mark on board to help accelerate the increasing success of our Aerospace team.

Staying with the Engineering Group. Our P&I team is also working on several innovative projects within the biofuel space and is ideally positioned to take advantage of recent developments on the policy front. As many of you know, the path to realizing a more sustainable carbon footprint starts with smart legislation to provide the industry with the necessary incentives.

We believe the recent breakthrough in Washington regarding the Inflation Reduction Act is a great start, with investments totalling roughly $369 billion allocated to energy security and climate change, we believe our expertise in advanced biofuels, ethanol and carbon capture and conversion technologies affords us a strategic advantage in helping our clients decarbonize the economy.

Pivoting to our Healthcare Services group. The team is doing a tremendous job in profitably scaling the division even as the organization's size has grown considerably over the past year. Part of the success is attributable to the strategic investments the group has made in its technology systems. For example, the team is revamping its front-end and back-end systems with the new platform enabling the group to deliver solutions to our clients more efficiently and productively than ever before.

However, the team's success is also attributable to leveraging its strategic footprint in the primary and secondary education market to expand its solutions offering to clients across the U.S. In particular, I'm excited about the investments the team is making in behavioral health and special education.

As we expand our footprint, it has become clear that a holistic solution is desperately needed to address the education industry's growing talent shortage.

According to the U.S. Center of Education Statistics, approximately 14% of all public school students received special education services during the 2019-2020 school year. Unfortunately, schools nationwide can't find enough special education teachers to fill the vacancies needed to serve this cohort of children. I am confident that the creative solutions we will be able to deliver for our clients will help address this growing pain point in school districts across the country.

Finally, our Life Sciences team continues to expand its managed service contract base. We have secured multiyear deals with select clients and have several contracts we are bidding on that we remain very excited about. In parallel with these efforts, the team continues to make strategic investments across its leadership ranks to ensure we have the bandwidth to take advantage of all opportunities in front of us.

I am also excited to share that the group is expanding the breadth of its offerings by bolstering our expertise in data analytics and other emerging technologies. I'm looking forward to sharing more updates related to these initiatives in the future.

In closing, our team executed well during the first half of 2022. Despite the macroeconomic headwinds we've been all reading about in the newspapers, we anticipate our progress to remain unabated due to our strong culture and robust secular growth tailwinds driving each of our end markets.

I want to thank all of RCM employees for a job well done. Your unwavering commitment to delivering value to our clients day in and day out has put all of RCM stakeholders firmly on offense. I'm excited about what the future holds for our organization, and I look forward to sharing more updates as the year progresses.

Now, I will turn the call back to Kevin to discuss the Q2 2022 financial results in more detail.

Kevin Miller

Thank you, Brad.

Regarding our consolidated results, revenue for the quarter was $74.3 million, growing over $25 million on a year-over-year basis. Adjusted EBITDA in Q2 2022 was $8.4 million, representing about a $6 million increase on a year-over-year basis. Gross profit came in at $21.6 million during the quarter, about a 77% year-over-year increase. Given robust cash flow generation from operations of $20.8 million during the first half of 2022, we were able to pay down the remaining balance on our revolving credit facility, and now we are debt-free.

Turning to our Health Care segment. The group generated revenue of $43.4 million in Q2 2022, which represents an 89% increase year-over-year. The performance was broad-based, and we remain excited regarding several growth initiatives the team is engaging in within the K-12 education end market.

Turning to our Life Sciences and Information Technology segment. The team continues to execute across each of its practice groups and demonstrated solid year-over-year growth in revenue and profitability. Regarding revenue, we generated about $10 million in Q2 2022 compared to $9.1 million in Q2 2021. We believe that as the group expands its managed service contract base in the future, the group's revenue base will continue to become stickier and more profitable.

And finally, turning to our Engineering segment. We continue to see vigorous activity across our client base and the respective end markets. After adjusting for the sale of our Canada Power Systems offices in Q3 of 2021, our Engineering Q2 2022 revenue of $20.9 million grew by 41% as compared to the adjusted Q2 2021 Engineering revenue of $14.9 million. Our engineering units performed well during the quarter, with our Aerospace and Process and Industrial groups leading the way.

As mentioned, we are very excited about what the future holds for our Process and Industrial group that continue to gain traction with a sustainable fuels market and are ideally suited to address the growing demand for decarbonization technologies.

Turning our attention to the second half of the year. I'll echo Brad's earlier comments that we remain confident in the demonstrable progress we've made and anticipate our strong operating performance will carry forward into the back half of the year.

This concludes our prepared remarks. At this time, we will open the call for questions.

Operator

Okay. Our first question is going to come from Alex Rygiel with B. Riley. Alex, your line is open.

Alex Rygiel

Thank you. Good morning, gentlemen, and very nice quarter.

Kevin Miller

Thank you.

Brad Vizi

Good morning.

Alex Rygiel

What stood most to me was that incredibly strong cash flow of $18 million. So, maybe if you could talk a little bit about the strength in that and your outlook for the next six months.

Kevin Miller

Yes. Obviously, we had a great quarter. I think it was—there's three factors there, right? Obviously, we had strong EBITDA. We had—our team, particularly our finance team, did a fantastic job of getting our invoices out quicker than ever and collecting on receivables faster than ever. We had our best DSOs that we've ever had. Then obviously, there's some seasonality there that's kicking into the cash flow in terms of—we have school closings in Q2, particularly towards the end of Q2. So, that gives a little bit of a benefit to the cash flow. So, Q2 was an extraordinary cash flow quarter.

Going forward, we expect to continue to do a nice job managing the balance sheet. Our DSOs were under 60 for the first time in the history of the Company. And frankly, that's our new standard, is keeping the DSOs under 60 days and continuing to manage the balance sheet, continuing to post strong EBITDA. Obviously, we have some seasonality in Q3, which helps from a cash flow standpoint. But we expect to continue to see nice cash flow.

Alex Rygiel

Okay. Then you mentioned the opportunity for a number of new awards in the Life Sciences segment. Can you expand on that a bit?

Brad Vizi

Yes. Now we just won a couple of, in particular, nice multiyear awards, (inaudible) seven-figure range primarily in our regulatory and compliance side, but also in our HCM. So naturally, as you pivot that portion of the business for more of a staffing orientation to more of a solution to manage service—service-orientation, it could result in higher margins and more predictability, ultimately freeing up our resources to focus on further growth in the business.

Look, we had a few more on the horizon that we're getting close on. So hopefully, we'll have—for the positive update on that front going forward.

Alex Rygiel

Then if you could lastly talk a little bit about the seasonality of Specialty Healthcare segment. Obviously, revenues came in a little bit in 2Q partly because of seasonality. I suspect there's probably some roll-off of opportunistic healthcare opportunities you had kind of during the COVID period. Have we gotten to a stable point where maybe that's going to lessen to some degree, that downside, and therefore, we're getting closer to sort of a more stabilized sort of run rate level?

Kevin Miller

Frankly, I think we're pretty much already there. I mean, we'll see what happens in Q3 and Q4. We expect Health Care to post very good results in Q3 and Q4. Obviously, we have significant seasonality in Q3 for Health Care with July—and July, basically, almost every school work with is closed. Then August, Chicago is closed. New York is closed. A lot of our other secondary schools are closed. Hawaii is open in August. A lot of the California schools open sort of in the middle of August to the end of August. So, we'll see some seasonality there.

But as we're sitting here today and having discussions with our school clients, we expect Q4 to be really good. We don't expect any significant falloff because as some of the COVID revenue is falling off, we're also adding a lot of schools. We've added several new schools for this new school year. So, we expect real good results in Q3 and Q4.

To give you a little bit more color in terms of like Q2, just to give you an example, like in Q1 for Hawaii, there's 55 school days. In Q2, there's 38. For Chicago, there's 62 school days. In Q2, there's 45. Then New York goes from 56 to 51. So, when you talk about a little bit of a revenue falloff, yes, there was a falloff from Q1 to Q2, but it's almost entirely related to school days, frankly. When I go back and look at revenue per day—per school day, Q2 versus Q1, they compare very favorably.

Alex Rygiel

Then just to kind of follow up on that answer. Traditionally, in the third quarter, revenue seems to kind of fall off sequentially 20% to 30%. Given the shift in sort of contract mix, do you still anticipate sort of that sequential falloff from 2Q to 3Q of 20% to 30%?

Kevin Miller

Yes. That sounds probably in the right ballpark, probably more towards the higher end, I would say. But we'll see how things shake out in terms of how the school year starts off.

Alex Rygiel

Thank you very much. Nice quarter.

Operator

Our next question is going to come from Bill Sutherland with Benchmark. Bill, your line is open.

Bill Sutherland

Thank you. Hey, Brad. Hey, Kevin.

Kevin, could you give us just a little more detail on the Healthcare segment in terms of revenue from education clients and then all other clients?

Kevin Miller

Sure. Let me just—do you have another question while I put my fingertips…

Bill Sutherland

Yes, yes, yes. Sure, sure. Then I kind of—I'm very interested—since Life Science really is coming on strong in the IT group, I'm kind of wondering just rough order of magnitude, what that is as a percent of that line, also maybe as you would define it as managed services as a percent of the IT? Just a rough view for that.

Kevin Miller

Well, Life Sciences in general runs about—runs around 60% of our total revenue for IT, roughly. It fluctuates from quarter-to-quarter, obviously. But that's a rough number.

Bill Sutherland

Okay. What was I going to ask you? The margins are—in Health Care, do they fluctuate much with the seasonality, the direct margin?

Kevin Miller

They have in the past, but I think that we're seeing pretty robust pricing across all of our healthcare lines, frankly. So I don't expect—they can always fluctuate a little bit from quarter-to-quarter based on a variety of factors, but we don't expect significant fluctuation in Q3 from maybe a blend of Q1 and Q2. We may see a little bit of a downturn in Q4 because we do have some new school contracts coming in at some bill rates that are a little bit lower than what we've seen in the first half of this year. But I certainly don't expect to see any significant erosion in gross margin in Q3 or Q4.

So getting back to your school question in Q2, our school revenues were $32.3 million. Our non-school revenue in Q2 was $11.2 million.

Bill Sutherland

Do you happen to have the comp?

Kevin Miller

I do. In Q2, we're looking at $15.1 million for school revenue and $7.9 in Q2 of '21.

Bill Sutherland

Okay. That's helpful. And then last—I don't know. Maybe Brad, maybe Kevin. Capital allocation, now that your net cash—you're in a net cash position now, any new thinking on what you may want to do?

Brad Vizi

Yes. Fair question, Bill. Well, (inaudible) our framework hasn't changed when it comes to capital allocation. We have a substantive track record, as you know, you followed us for a while. Whether it be in the form of share buybacks and dividends or acquisitions, internal investment. We have a pretty strong ROIC. I think we're pushing 50% at this point. It kind of serves as our North Star. So, we look to continue to do more of the same on basically the agnostic approach to the capital allocation with—between those four vectors.

Bill Sutherland

Okay. Thank you, both.

Operator

Okay. It doesn't look like there are any more questions in the queue.

Brad Vizi

Thank you, everyone, for attending RCM's second quarter conference call. We look forward to our next update in November.

Operator

Okay. This concludes your call. You may now disconnect.