RCM Technologies, Inc.

Second Quarter 2023 Earnings Call

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CORPORATE PARTICIPANTS

Kevin Miller, *Chief Financial Officer, Secretary and Treasurer*

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CONFERENCE CALL PARTICIPANTS

Alex Rygiel, *B. Riley Financial*

Bill Sutherland, *The Benchmark Company*

Frank Kelly, *Scopia Capital Management LP*

PRESENTATION

Operator

Welcome to the RCM Technology Second Quarter Earnings Call.

I will now turn the call over to Kevin Miller. You may begin.

Kevin Miller

Good morning and thank you for joining us.

This is Kevin Miller, Chief Financial Officer of RCM Technologies. I'm 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, 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're subject, please see the periodic reports on Forms 10-K, 10-Q and 8-K that we filed with the SEC, as well as our press releases that we issue from time-to-time.

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

Brad Vizi

Thanks, Kevin. Good morning, everyone.

Consistent with our prior discussion, after starting the year off slow due to project timing, and a key client's unexpected program loss impacting the first half, we made the decision to maintain stride in building what we believe to be a highly differentiated platform in the professional service and marketplace. Our secular growth markets and strong portfolio of capabilities made the decision to ignore the perpetual drumbeat of economic prognostications an easy one.

In fact, as with any economic scare, we knew we would be in position to take advantage of opportunities to further strengthen the business and enhance long-term returns while others taking a more short-term approach tap the brakes. Since we last spoke, progress has been made across each of our divisions, and I am excited to discuss in more detail starting with our Health Care division.

RCM’s Health Care division continues to raise the bar in various aspects of the business. Our commitment to delivering best-in-class staffing services and solutions has led us to focus on several key areas. First and foremost, our steadfast dedication to improving the delivery of behavioral Health Care too has seen very positive outcomes and growth in new school districts nationwide. By implementing innovative and evidence-based approaches, we have made significant strides in addressing the behavioral and mental health challenges facing children and their ability to learn and succeed in schools.

Moreover, our effort to expand our school and Health Care facility clients have not only broadened our reach, but also strengthened our ties with local communities and providers. These initiatives have bolstered client penetration and allowed us to serve more students and patients in need, making a sustainable impact.

We have also invested significantly in technology to enhance the applicant user experience and optimize operational efficiency. This digital transformation, including the launch of our new app, has paved the way for expedited onboarding of service providers and an overall better candidate experience.

Furthermore, our reinvigorated branding strategy has solidified our position as a trusted and forward-thinking Health Care staffing provider, setting us apart from the competition and opening new avenues of growth.

As we look ahead, we remain committed to our pursuit of excellence and continuous improvement, embracing new technologies and staying attuned to emerging educational and behavioral Health Care trends will be pivotal in strengthening our continued success. With a strong foundation and a dedicated team, we are confident in our ability to navigate challenges and seize new opportunities, driving our business to new heights in the ever-evolving education and Health Care landscape.

On the Life Sciences and IT front, we believe the division has reached a tipping point as we continue to grow our project and managed solutions business. Just 30 months ago, the division has had less than 5% of its business in these areas. In 2023, the number has grown to more than 33% in Q1 and 43% in Q2. With a much-improved revenue stream comes a more robust margin profile. Again, when analyzing the same sequential quarterly periods in 2023, we improved gross margin by 500 basis points on top of over 10% revenue growth.

HCM continues to galvanize partnerships within its core clients, becoming the number one partner in its flagship offering and securing a long-term contract within the client's second key offering. Our HCM team continues to raise the bar and the rapid growth of our core clients has required increasing levels of support. We think the success of this group is in the early innings as we continue to grow our share within a fast-growing client base.

Our Life Sciences practice has introduced several new service offerings including commercial operations, a New Year key practice, and a series of target assessments to help clients quickly improve quality processes and data management. Our Life Sciences practice has also secured three new managed service clients and continues to strengthen its leadership and sales personnel. We continue to be optimistic for the remainder of 2023 and beyond. As mentioned earlier, I believe this group has reached a tipping point where it will serve as a strategic pillar within the RCM portfolio.

Energy Services closed Q2 with strong results, seeing continuous growth through the first half of 2023. The team added a significant amount of backlog in Q2 for major contract wins and was selected to be the engineering firm for a large new substation project in the northeastern United States. This win was made possible by delivering results as promised, and being a trusted partner to our major utility client's year-after-year.

Across the globe, the energy transition is driving investment in new projects to strengthen the grid for the future and RCM is proud to expand its services to support our clients and communities' evolving electricity demands. Our European footprint has been developing well through Q2 and the team is building a strong foundation to serve our growing list of utility clients. Focus on developing a sturdy foundation across all engineering and project management disciplines has enabled energy services to take on more large, complex projects to provide our clients with complete turnkey solutions.

The second half of 2023 is expected to be consistently strong as the team continues to convert opportunities into backlog and expand our client list. Second quarter results in our process and industrial business were again in line with the plan. Focus over the past three months was on project execution, growing and strengthening our relationships. One important increase to the backlog came in the form of additional engineering for critical elements of an advanced ethanol facility to produce sustainable aviation fuel.

We had a noticeable acceleration in pipeline throughout the quarter, stemming from projects with both new and established customers. Aside from the significant revenue potential expected in 2024, this expansion of the sales funnel is strong evidence that our growth and market diversification plans are being realized and strengthening RCM's presence in the global energy transition.

RCM Thermal Kinetics, a key unit within process industrial continues to advance projects while performing engineering and lab testing for future demonstration and production scale facilities. It was rewarding to see the impact the RCM team is making to the community through the open house of our new 10,000 square foot office and lab held in July. Many members of local universities, vendors, clients, friends and families joined us to learn from a variety of educational demonstrations.

These demonstrations in our state-of-the-art lab highlight how our approach can provide clients with higher quality output, saving time and money while de risking projects across the many markets that we serve. The team and Company history was also featured by the local business journal *Buffalo Business First*.

Aerospace and Defense is seeing a market recovery in the third quarter. After a key client experienced an unexpected program loss at the end of last year, the aerospace and defense team rose to the occasion, accelerating business development activity with new clients and deepening relationships with existing clients. Thus far in 2023 the division has already added eight new clients, well on the way to achieving our goal of 12 by the end of 2023.

Also of note, we have almost tripled the number of hires across our client base in the second quarter compared to the first quarter 2023. This expansion includes new clients in defense, specifically sea vessels, new vertical lift (phon) customers, as well as new customers and aerospace component part manufacturers, assisting them on the production floor and within the aftermarket domain. The expansion of existing clients and new clients with our core expertise and new arenas provides much desired depth and breadth to the organization and strongly positions us for 2024.

We have also begun to see traction on one of our largest awards from our strongest OEM clients across the entire spectrum of engineering resources with potential opportunity spanning into 2026. In addition, we have been awarded a sole source contract for one of our space clients, where we are providing support from conceptual design through aftermarket services in hybrid and flexible scenarios. We now have a proven track record with our digital conversion expertise and methodology with an aftermarket, as well as our model-based definition prowess, which now expands across multiple clients throughout the United States.

With the addition of our new Senior Vice President, our aftermarket group is now touting the S factor which broadens our reach beyond S1000D publications into S2000M, material management, S3000L, logistic support analysis, S4000P, maintenance, and S5000F, in-service data feedback. Once the realization of the support we have provided to our customers was apparent, we decided it was time to market the full solution in an offering that we believe is differentiated in the marketplace.

I believe when we look back on 2023, RCM aerospace and defense will serve as a shining example of our culture at work, one of continuous improvement, even in the face of adversity, day in and day out, and incessant focus on upgrading the quality of our business through value-accretive growth.

Before turning the call to Kevin, who will cover our financial results in more detail, I will take a moment to touch on our progress on the capital allocation front. During the second quarter, we repurchased over 939,000 shares to bring our year-to-date share repurchase to nearly 1.6 million shares. Our clean balance sheet and high cash generating business model and dedicated culture committed to continuous improvement of our business have allowed us to repurchase approximately 40% of the Company over the last three years at an average price of $7.50 per share.

Consistent with our prior commentary, taking into account normal Q3 seasonality, the business continues to strengthen as we move through the year, setting up a healthy double-digit earnings increase in the fourth quarter, a trajectory consistent with our long-term objectives.

Now I will return the call over to Kevin to discuss the Q2 2023 financial results in more detail.

Kevin Miller

Thank you, Brad.

Regarding our consolidated results, revenue for the second quarter was $67.0 million, flat with the first quarter of 2023. As we expected, the second quarter decline in Health Care was offset by sequential increases by Engineering and our Life Sciences and Information Technology segments.

The second quarter seasonal decline in Health Care revenue was entirely due to several of our significant school clients closing in May and all of our school clients closing by late June. We will still see greater seasonal declines in Q3, while we gear up for the 2023/2024 school year that starts in August and September for various school clients. We're incredibly excited about this upcoming school year. I want to give some limited information on our non-COVID related school business.

In fiscal 2022, we had about 60 active school clients with 22 exceeding $100,000 in revenue. That compares to fiscal 2019 when we had only six clients over $100,000 in revenue. For fiscal 2023, we expect at least 75 school clients with 30 over $100,000 in revenue. We saw a nice sequential uptick in engineering revenue in Q2 '23 driven mainly by the increase in energy services contract wins. We expect our engineering group to see sequential increases throughout the rest of 2023. As Brad discussed, our Life Sciences and Information Technology segment had a nice sequential increase as our managed service offerings continue to drive our growth.

Gross margin in the second quarter was 28.0%, also flat with the first quarter. We saw outstanding gross margin performance from our Life Sciences and IT segment at 39.4%. While this may be a high watermark, we do expect to see gross margins in the upper 30s going forward. Engineering gross margin saw a small sequential uptick as revenue increased. However, we expect better gross margin performance going forward. We are targeting the upper 20s. Health Care gross margin performance was off in the second quarter due primarily to June school closings, a mix shift and several discrete adjustments. We also expect better gross margins in Health Care going forward and target the upper 20s as well.

As we look to the second half of 2023, we expect Health Care to continue to experience its underlying sequential growth trend. However, due to seasonal school closings, we will see a sequential top line decline in the third quarter as we do every year. We expect the fourth quarter to be our best quarter for 2023. With so many recently awarded school contracts, we are very excited to see the results. We expect both our Engineering and Life Sciences and Information Technology segments to see sequential increases in the third and fourth quarters. While there is always the risk of large projects sliding to the right, we expect a substantial uptick in the fourth quarter for all three of our engineering groups.

In summary, we believe that Q3 2023 EBITDA will be similar to Q3 2022, and we are lining up for an impressive fourth quarter and a nice run rate heading into 2024. In 2024, we expect to see at least double-digit growth in EBITDA as compared to fiscal 2023. This concludes our prepared remarks.

At this time, we will open the call for questions.

Operator

(Operator Instructions)

It looks like our first question is going to come from Alex Rygiel with B. Riley. Your line is open.

Alex Rygiel

Good morning, gentlemen. Very nice quarter.

Kevin Miller

Thank you. Good morning.

Brad Vizi

Thanks, Alex.

Alex Rygiel

First on the—in the Health Care business. As it relates to the third quarter, can you help us refine what normal seasonality, what you mean by that? Obviously, a little bit difficult to look at that over the last two, three years, given COVID.

Kevin Miller

Yes. We typically see a pretty big decline, Q2 to Q3. An exact projection is difficult, especially with all the new schools that we have coming on, and some of them coming on in August when they—typically, most of our schools started—in the past started in September.

Alex Rygiel

Okay.

Kevin Miller

But just to give you a little finer point, certainly, we'll be under $30 million in Q3. It's tough to give an exact number, but maybe $25 million to $29 million, $25 million to $28 million, in that range. We'll see where it comes in.

Alex Rygiel

Helpful. Then your margin commentary in that segment would suggest high-20s. Last year, you were in the low-30s in the second half of the year. Is the variance just mix? Or is it something …

Kevin Miller

Yes. We had a confluence of factors in Q2 that I think created a gross margin for Health Care that is not indicative of the actual margin. But I think the way that you should think about the gross margin in Health Care is, we did 28.8% year-to-date. I think that's a pretty good number on a go-forward basis. We're always looking to improve the margin. The thing that—there's a fair amount of uncertainty around Health Care just because we have a lot of new contracts and we never know exactly how they're going to really start with a lot of these new schools. But certainly, I think that 28.8% indicates a pretty good range. I would be surprised if our margins in Q3 and Q4 aren't in the 28% to 29% area, and hopefully, we're pushing up towards the top of that.

Alex Rygiel

That's good. Thank you very much.

Operator

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

Bill Sutherland

Thank you. Hey, guys. Great work. Two things on Specialty Health Care. Kevin, can you just tell me, or tell us, I'm sorry, the revenue in the quarter from school clients?

Kevin Miller

Bill, hold on. I need to grab that. I actually don't have that open. You have another question?

Bill Sutherland

Yes. When you were running through the clients this year, last year, and those over $100,000, I didn't quite get last year with 60 clients and how many over $100,000?

Kevin Miller

We had over—we had about 22—we had 22 over $100,000 (multiple speakers) when we only had about six.

Bill Sutherland

In 2019, okay.

Kevin Miller

Yes. Obviously, pick 2019 as that's a pre-COVID year. The business has changed quite a bit since 2019 as we've added so many new school clients.

Bill Sutherland

Are you finding that the deals that you're winning in schools are broader in terms of the roles and just the—it sounds like it, given the sizes.

Kevin Miller

Yes. Every school is different, Bill. Frankly, sometimes when we win a school, it's just nursing. Sometimes when we win a school, it's just behavioral health. Usually, we're entering with one service, but oftentimes in the next school year we get to introduce a second. It's different from—there's so many nuances to the different school systems, and it's hard to give you a blanket answer. But usually when we enter into a school, it's one service and we often get to expand the following year to another service.

Bill Sutherland

Got it. In Life Science, when you're seeing this nice expansion in gross margin, and I assume it's tied to the expansion of Life Sci, is that just pricing? Or is that something about how you can optimally run those pieces of business?

Brad Vizi

Yes. That was a good question, Bill. Not pricing at all. Actually, in fact, it's primarily mix driven. These wheels were set in motion about three years ago. When you looked at the Life Sciences and IT business, it was primarily a staffing business, and we made the strategic decision to move more towards a solutions and managed service-based model. Naturally, that comes with a higher margin profile and can be stickier as well as you continue to deliver more value to clients.

As part of that progression, naturally, your team evolves, right? We saw this throughout different parts of the portfolio, obviously, outside of Life Sciences and IT. I think this is the point in the life cycle where they're at, where the business has kind of hit a tipping point. I personally think that a lot of that is talent-driven, naturally. You wouldn't necessarily have the same set of folks focused on staffing that you would on solutions and managed services. What gives me further confidence in the dynamic and the drivers there is as we continue to fortify the team and build it out. That's one area and one part of the portfolio that we expect exciting things going forward.

Bill Sutherland

Roughly where are you—go ahead, Kev.

Kevin Miller

I was just going to give you the school stuff. But if you have some more questions on Life Sciences, go ahead.

Bill Sutherland

Well, just I was curious where you've gotten managed services as a percent of revenue, ballpark?

Brad Vizi

Yes. When you look at solutions and managed services, a little under half at this point.

Bill Sutherland

Over half? Okay.

Brad Vizi

A little under half, up from roughly 5%.

Bill Sutherland

Okay.

Kevin Miller

Yes. The school revenue in Q2 of 2023 was $26.5 million, and we were just a shade over $9 million for non-school.

Bill Sutherland

You said ‘22, you meant this year, didn't you?

Kevin Miller

I meant this year, Q2 of '23. Sorry about that. Yes.

Bill Sutherland

Yes, certainly, 26.5 …

Kevin Miller

Roughly 75% of our business in Q2 was school. It's pretty consistent with Q1.

Bill Sutherland

Okay. You saw in your non-school business the same trend that the pure plays in that side were reporting?

Kevin Miller

Yes. I think it pretty much lines up. We expect to see growth there going forward though. We had a little bit of a sequential decline, but that was really almost entirely driven by one client that was scaling back some of their expenses. We've got plenty of room to grow our non-school business.

Bill Sutherland

Okay. Last one on deployment. You're just going to continue with this very successful path you've had as opposed to anything related to a dividend, special dividend or tender or anything that might be outside of that tap to bid on?

Kevin Miller

All avenues are open, Bill, all avenues. But we think the stock is trading at a very attractive price. Let me see if we—look at my screen real fast here, yes, $16.49. That makes the decision pretty easy.

Bill Sutherland

Okay, guys. Thanks a lot. Appreciate it.

Operator

(Operator Instructions)

Our next question is going to come from Frank Kelly. Your line is now open.

Kevin Miller

Hello, Frank.

Frank Kelly

Hi, Kevin. Hi, Brad. How are you guys?

Kevin Miller

Good.

Brad Vizi

Hi, Frank.

Frank Kelly

Good, good Life Science and IT Q, striking almost 40%. I think that has to go—that has to go marked pretty hard. That's great. Hopefully, the other sectors will come in the line as well as we add value. One question, if we can shift over to the balance sheet. Looking at gross AR, can you shed some light as to why we had a 32% increase in AR over the Q? Obviously, cash is king, and it also drives over to the P&L on the interest costs? Can you help us—help me understand or help us understand what is and obviously what's not happening in AR?

Kevin Miller

Sure, sure. Well, to be really frank with you, Frank, the AR is just too high in Q2. There's a whole—as I'm sure you can appreciate, there's not one reason for it. There's a couple. We look at DSOs as opposed to the dollar amount. But you get to the same conclusion, which is the DSOs in Q2 were just high. We'll bring them down. I expect the DSOs to come down. As you know, Q3 is a seasonally low quarter for us. We should see a pretty nice decline in Q3 in the receivable dollars. I expect DSOs to be much better in Q4 as well. Obviously, depending on where revenues come in, in Q4, we may or may not see a decrease in AR, but I'm confident we'll see a decrease in the DSOs in Q4.

I'm glad you asked about cash flow because obviously, we're pretty—despite the poor performance in our trade (inaudible) in Q4, we did see really good cash flow in Q2. For the year, we're at $16.5 million for cash flow from operating activities. We're pretty happy with the overall cash flow, but we can do better with the receivables and we will.

Frank Kelly

Great. Yes. We're looking at borrowings and then translates down interest and things like that. It just seems like an opportunity that we're not really capitalizing, but I'm sure you guys are—where are we at DSOs in Q1 versus Q2?

Kevin Miller

I don't have the exact numbers in front of me, Frank, but they're too high. They need to come down, but—and they will, as I said. I think the more important takeaway is that, as I mentioned in the press release, we expect to see really nice cash flow in the second half of this year, particularly in Q3.

Just to be to—obviously, we're always looking to drive our debt down, right, and drive interest costs down. But we're pretty proud of and happy with where our debt is right now relative to all the shares that we've purchased. But we can do a better job with the receivables and if our debt goes up and our balance sheet looks good, and if our debt is going up because we're buying shares, we're happy to pay the interest.

Brad Vizi

Two other data points I'd just throw in there, Frank, because obviously after the close of the quarter, collections have been good so far. But also, in addition to that, setting our capital allocation decisions aside, particularly on the share repurchase front, fast forward the next couple of quarters, I would anticipate debt levels being relatively modest if we have debt at all as we move into the fourth. We feel pretty good about where the balance sheet is at. But on the point you highlight is very relevant and is well taken.

Frank Kelly

Great. No, I appreciate it. Understood. I see where we're heading and that sounds like a very good direction. That's all I had.

Brad Vizi

Thank you, Frank.

Operator

(Operator Instructions)

Okay. It doesn't look like there are any more questions in queue. I will turn it back over to you for any closing remarks.

Brad Vizi

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

Operator

This concludes your call. You may now disconnect.