RCM Technologies, Inc.

Third Quarter 2022 Earnings Call

November 10, 2022

CORPORATE PARTICIPANTS

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

Bradley S. Vizi, *Executive Chairman and President*

CONFERENCE CALL PARTICIPANTS

William Sutherland, *The Benchmark Company*

Alex Rygiel, *B. Riley Financial*

Frank Kelly, *Private Investor*

PRESENTATION

Kevin Miller

Good morning and thank you for joining us.

This is Kevin Miller, Chief Financial Officer for 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 third quarter.

Bradley Vizi

Thanks, Kevin.

Good morning everyone.

RCM delivered continued strong performance in our seasonally weak third quarter. I am proud of the team's execution. Our results demonstrate the leverageability of RCM's business model, driven by our unwavering commitment to delivering value for our world class client base.

During the quarter, strong performance was demonstrated across each division. Our Life Sciences and IT group bolstered its RPO offering with the addition of TalentHerder. I will speak more about the acquisition in a moment. Turning to our Engineering team, each of our business units delivered solid performance and I am excited about the traction we are gaining across several new business initiatives. Lastly, our HealthCare Services team continues to expand its presence across the K-12 end market with the addition of several strategic accounts.

Kevin will cover our financial performance in more detail but I want to share several financial and operational highlights from the quarter. RCM generated third quarter revenue of $58 million, a 28% increase year-over-year after adjusting to the Power Systems Canada sale. As for profitability, RCM generated Adjusted EBITDA of $4.8 million in Q3, representing growth of approximately $162% on a year-over-year basis.

On the operational front, there were several highlights worth calling out in more detail. First, as previously mentioned, our Life Sciences and IT group recently acquired TalentHerder, a leading talent services acquisition company. TalentHerder will bolster RCM's existing RPO capabilities by expanding candidate reach, extending alternative service models to our current base, and providing proven methods to new clients responding to a changing employment landscape at incredibly competitive rates.

TalentHerder's proven recruitment processes can help scale both in-person and remote working environments for companies across the globe. We are excited about the growth opportunities TalentHerder presents to our clients and staff. Over the near term, the focus remains on the seamless integration of the TalentHerder team. We are integrating the recruiting groups in addition to gaining leverage from our acquired offshore sourcing staff and we have already identified several new opportunities through our joint sales efforts. I look forward to sharing more updates on our progress in future calls.

On the engineering front, I am excited to announce the grand opening of our Innovation Center of Thermokinetics. The implementation of this state-of-the-art facility complements our team's existing equipment capabilities and enables our engineers to develop new processes alongside our customers. For many process applications, the ability to run a small-scale version of the system yields the required empirical data to design and derisk the process successfully.

This go-to-market approach will be essential as we scale up initiatives across select emerging technologies in which we have the necessary expertise, including sustainable aviation fuels. With an estimated $40 to $50 billion in SAF investment planned through 2025, and a further $1 trillion required by 2040, we believe there will be robust demand for identifying ways to scale supply cost effectively. Our test center has a strategic role to play and it will be a powerful tool as we position ourselves to become the go-to partner for clients looking to scale emerging process technologies in the future.

Pivoting to our Healthcare services group, the team continues to excel amidst the ever-changing healthcare landscape. The industry's issues are structural and will not be solved over the near term. COVID-19 has caused many healthcare professionals in the U.S. to reconsider their plans. For example, in a recent survey by Mackenzie, 29% of RNs in the U.S. said they were likely to leave their current role in direct patient care. Many respondents indicated they were considering leaving the workforce entirely.

The bottom line: the U.S. health sector is facing a substantial talent shortfall with several studies estimating that by 2025, there may be a supply demand imbalance of 200,000 to 450,000 nurses. We have the expertise to help close this gap for our clients as it will require a combination of innovation and robust execution that comes from decades of service committed to this end market. Thankfully, these are two of RCM Healthcare's greatest attributes. We believe RCM Healthcare will play an important role in addressing this structural deficiency, most prominently in our core education end market where our experience and scale is unrivaled. Our team is leveraging technology to take a more analytical, data-driven approach to resource allocation.

This focus has enabled us to engage with our clients more strategically by providing tailored holistic solutions according to their needs as opposed to the non-scalable practices of yesteryear that focused on placing individuals on an ad-hoc basis. We are confident this model will lead to a more sustained value creation for our customers and a more defensible economic moat for RCM.

Finally, I would like to take a minute to express appreciation to our shareholders on behalf of RCM and its employees. I have spent nearly my entire career helping publically traded companies realize their potential. I cannot recall a more supportive, constructively engaged group. I know a substantial portion of you are long-term shareholders, more than one-third of which are current and prior RCM employees.

Your support is one of many latent assets at RCM. Your commitment has allowed us to retire over 25% of the Company shares outstanding since the summer of 2020 while investing heavily in the Company's future. We are committed to further rewarding your support with a scalable platform and clean balance sheet to compound value to all stakeholders for years to come.

In closing, as our clients grapple with the realities of scaling their businesses in a talent-starved increasingly technology-driven world, our expanding suite of cross-functional capabilities and technical expertise have positioned RCM as the de facto platform of choice when searching for solutions. I remain optimistic about the Company's future as we have many exciting initiatives under way.

I will now turn the call back to Kevin to discuss the Q3 2022 financial results in more detail.

Kevin Miller

Thank you, Brad.

Regarding our consolidated results, revenue for the third quarter was $58.2 million, growing by $12.7 million on a year-over-year basis. Adjusted EBITDA in Q3 2022 was $4.8 million representing an approximately $3 million increase on a year-over-year basis. RCM generated gross profit of $17.4 million during the quarter, a 42% year-over-year increase.

Turning to our Healthcare segment, the group generated revenue of $28 million in Q3 2022 which represents a 43% increase year-over-year. The team continues to make great progress within the K-12 market and has expanded its footprint with the onboarding of several new accounts. The opportunities across behavioral health and special education remain robust and the team is positioned to take advantage.

Turning to our Life Sciences and Information Technology segment, as Brad mentioned, the team's integration efforts regarding the TalentHerder acquisition are going very well, and the execution across each of the remaining practice groups has not missed a beat.

In terms of revenue, we generated $9.2 million in Q2 2022 which is essentially flat with Q3 2021. From a profitability standpoint, the group's gross margin profile increased by 200 basis points as the team transitioned the business model to a more leverageable managed service contract profile.

Finally, regarding our Engineering segment, after adjusting for the sale of our Canada Power Systems office in Q3 2021, our Engineering Q3 2022 revenues of $20.9 million grew by 31% as compared to adjusted Q3 2021 Engineering revenue of $16 million. The performance was broad-based across each of the divisions, and the team is doing an excellent job of expanding into adjacent service offerings that leverage each unit's diverse skillsets. As we migrate through the fourth quarter, we remain confident that we will finish the year strong and enter 2023 in stride. We are in a strong position financially to be opportunistic across each of our segments and we are excited about 2023 as our teams continue to execute throughout the organization.

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

Operator

First up, it looks like we have Bill Sutherland of Benchmark Company. Your line is now open.

Kevin Miller

Hello Bill.

William Sutherland

Thank you. Good morning guys. A couple of questions on healthcare.

Kevin, what was the mix between education and non-education?

Kevin Miller

Let's see. I should have that in front of me but I don't and so let me get it for you as you…

William Sutherland

While you're looking, for Brad, I was thinking about your comment about healthcare and leveraging technology for the clients. Can you give us a little color on what's involved there?

Bradley Vizi

Yes. The first wave of our investment is going to be focused upon driving productivity of our recruitment resources. As you've probably read, Bill, I know you follow the industry pretty closely, there's no shortage of needs out there. Really, it's just a matter of making sure you're able to really connect the dots between the resources that are out there and the needs that exist. Inevitably, we think that driving productivity of our recruitment resources could potentially unlock quite a bit of upside for us.

Kevin Miller

Bill, just to answer your first question, our school revenue was $16.6 million and our non-school revenue was $10.4 million.

William Sutherland

The seasonality played out about as you expected, Kevin?

Kevin Miller

Pretty much, yes.

William Sutherland

Okay. The gross margin, was that a mix benefit? It was strong in healthcare.

Kevin Miller

Yes, it's a combination of things. It's mix. It's a robust market, robust demand. If you sort of look out to the future, I would tell you that Q3 is probably a little bit on the high side compared to what we probably expect to see in the near term but not substantially higher than what we'd expect to see.

William Sutherland

Okay. I guess last, Brad, as you look at your opportunities for capital deployment, do you rank order or is it—tell me how you are thinking about that. Thanks.

Bradley Vizi

Well, I would normally refer to our stock response but when you look at the earnings power of the business and where the stock is trading, you could probably guess what is towards the top of the rank order. We've been pretty judicious in our approach so far and we will continue to do so. The good news is we have multiple teams that we have a very high level of confidence in and are (inaudible) to put capital behind, so we're at a point where there isn't a shortage of opportunities for us to benchmark returns against to deploy capital.

Where it ultimately ends up, whether it be in the form of organic investment, bolt-on acquisitions, or share buybacks, again, and this is something that we review regularly and can change very quickly, but we're in a good spot with what we believe is a healthy earnings power, a clean balance sheet and again, a very talented group of individuals to get behind.

William Sutherland

Actually I meant to ask, did you guys provide any detail on TalentHerder in terms of the financial impact?

Kevin Miller

We have not, but there is an AK filing on it.

William Sutherland

Yes. All right. Thanks guys. Appreciate it.

Operator

Next up, we have Alex Rygiel of B. Riley. Your line is now open.

Kevin Miller

Hi Alex.

Alex Rygiel

Good morning, guys. Very nice quarter.

Following up on the TalentHerder question, I did notice in the AK that you paid I think around $4 million in cash for that acquisition. Can you talk a little bit about maybe what the revenue contribution could be? If not, maybe talk about what your traditional acquisition purchase multiples generally are targeted in a range of.

Kevin Miller

If you want to talk about multiples, I would say somewhere between 4x and 8x is a typical range for us. When we do deals, if someone is getting to 8x, it's probably because they're performing really well during the earnout period. We're happy to pay 8x if we can because that just means that they've delivered outstanding performance. We focus on companies that we think have sort of a low floor in terms of performance, post-closing, but also potentially have some good synergies and we can really drive a lot of growth.

In the case of TalentHerder, it's a really good fit for us in terms of what we're seeing in the market and mapping that against the outstanding team that we acquired.

Alex Rygiel

When you think about TalentHerder, can you talk a little bit about sort of their revenue growth expectations that you—or opportunity that you see over the next couple years and what the margin profile of that business is compared to yours?

Kevin Miller

Well, the margin profile is quite high. You're probably looking at like a 30% operating margin on that business, which is pretty typical in the RPO space, so it certainly will be accretive to our margins. This is something—we're small players in the RPO business today but we have tremendous aspirations in terms of being a major player in that space. We think the team that we brought on has the capability to really—combined with RCM resources and our sales team and everything that we bring to the table, we believe we can become a fairly prominent player in that space over time.

Alex Rygiel

That's great.

Then Brad, you mentioned in the healthcare space you had several new strategic accounts. Can you expand upon that a bit?

Bradley Vizi

Yes. So I would think of them as being in our core education end market now, really as we continue to diversify that base and, most importantly, is they're accounts that we think that in aggregate are certainly accretive over the near term but have opportunity to grow materially from where they are today. So, really our K-12 initiative is really starting to gain its footing and we're really starting to build our presence throughout the country.

Kevin Miller

Yes, I would say Alex, if you compared our school business to say three or four years ago, we have triple the number of clients easily today. We feel like we have just a lot of momentum to add a lot more. In addition to the bricks-and mortar-schools, we're also making some pretty good in-roads with some large virtual school systems as well which is really exciting because we can service those schools from anywhere in the country. We're not restricted to finding regional talent where the schools are. We can have somebody in Idaho providing services for the virtual school system.

Alex Rygiel

Sure.

Kevin Miller

Yes, so we're really excited about expanding that. We think that portion of the business is still a little small today, but from our perspective, it has huge potential to grow really fast.

Alex Rygiel

Then lastly, the revenue in the healthcare business was up 42% year-over-year. What dynamics are at play that would either increase or decrease that number in the fourth quarter?

Kevin Miller

In terms of the fourth quarter versus the third quarter?

Alex Rygiel

Fourth quarter of this year versus fourth quarter of last year.

Kevin Miller

Sure. Well, the major dynamic is the demand is still off the charts. The demand for our services is fantastic. We have a lot more school clients this year than we did last year. We have deeper penetration into some of our non-school clients. We've added some new school clients. Obviously, the transition of COVID from pandemic to endemic will have a little bit of a headwind for the fourth quarter compared to the fourth quarter of last year, but everything else is going fantastic. We're crushing just about every area in healthcare.

I would say the only impediment to continuing to grow the healthcare—and obviously we're not just focused on the fourth quarter, we're focused on 2023 and 2024—I would say the biggest headwind is obviously getting the people. It's an incredibly competitive market to find the people but our healthcare group is just performing exceptionally well with regard to finding people for our clients. We'll probably never be able to find enough because we can pretty much place every quality provider that we find but they're doing a great job.

Alex Rygiel

Very helpful. Thank you very much.

Operator

Next up in queue, we have Frank Kelly, a private investor. Your line is now open.

Frank Kelly

Good morning, gentlemen. What a great quarter and compliments to the entire team that pulled that together. I have a couple of questions.

One, Brad, I will actually start out with a thank you for Brad for acknowledging the long-term significant shareholders that are out there that are kind of hanging on and growing with the Company, and being patient at that.

The second, I know Brad, you had discussed a little bit about capital expenditures and whatnot, the capital program. You talked about organic investment. We talked about buybacks, but what was obviously missing was the addressing of rewarding those shareholders with some sort of return. Is that in the mix? It was noted as missing in your response earlier.

Bradley Vizi

Yes. No, fair question, Frank. Look, having bought back 25% of the Company at this point, I think to the extent that we do introduce a dividend one day, it's reoccurring, and we're able to grow EBITDA and shrink share count, the good news is the dividend is likely to be much bigger when you get it. So as long as we continue to see opportunities with the return profile that we see and we continue to generate extraordinary returns on capital, I think I mentioned earlier, I think we're in the 50% range at this point.

Frank, historically in my investment career, any time I found teams that were able to put up numbers like that, I wanted them to keep the capital and potentially add to it. So though we are pretty active with respect to retiring shares, a dividend in the very near future isn't really on the dashboard but look, that could always change. Again, we'll talk about it regularly.

Frank Kelly

Great. Yes, I just noticed I guess, come December, it's been five years since there's been actually any direct return. Obviously, buybacks do affect the price for an actual return to the shareholder, and so if we could just in future keep that in mind, that would be great and it sounds like you're doing that.

Kevin, I guess on the financial side, looking at SG&A Q-over-Q, and it's not much different for year-over-year. I see a 21% increase in SG&A versus a revenue increase of 27%. At least in the Q and, to some degree in the year-over-year, the SG&A seems to be growing significantly higher as a percentage than would be expected for that kind of revenue growth. Could you shed some light on that?

Kevin Miller

You left out the EBITDA growth. Don't we have to throw that into the mix?

Frank Kelly

No. I think we're just looking at pure SG&A. I know there's a lot buried in there, and not only that but in the older Q, there were some higher interest numbers for interest payments which run through there as well that are not necessarily at the same number that are in the current Q.

Kevin Miller

Sure. Well, the interest is down because the debt is down but interest is not included in SG&A. But anyway, I was just needling you a little bit. I think I can do that.

At any rate, no, look, the bottom line for us, Frank, is and you know us well, is we're incredibly mindful of every dollar that we spend on SG&A. However, I will say this. When we look across our businesses, all of them, we see incredible opportunities. Every single business is in a market that is exploding. We are happy to continue to wisely invest SG&A because we know that—and every decision that we make obviously on the SG&A front is not going to turn out the way we expect it to, but most of them do and most of them have.

We need to continue to invest in SG&A frankly to keep growing the Company. We're not interested in being a $30 million EBITDA Company for very long. Brad and I want to get this to $100 million in EBITDA. We're not going to do that without increasing SG&A. Simply, we have to increase SG&A to make more money and to drive more EBITDA and to drive the stock price. Now, we have to do it wisely but we absolutely have to invest in SG&A to grow the Company. I think if you look at this Company historically, that's an area where we've made some mistakes, where we've been hesitant to make investments, and part of our performance in the past is a result of not investing in SG&A.

We're going to—just to give you a really easy example to understand, and you know this Company really well but obviously other people are listening, we will hire every single recruiter, qualified recruiter that we can find, period. If you came to me with 50 recruiters that I could hire tomorrow, I'd hire them, period. I'm not going to worry about the SG&A increase because I know that if I hire 50 recruiters, 40 of them are going to work out really, really well and we're going to get an outstanding return on those 40 recruiters.

When you look out to the investment front, we're continually looking about how we can drive efficiencies in the business through technology. Well, you know, that's going to take short-term investment to get a long-term return and that's something we are going to continue to do, but be aware that we are very mindful of every dollar that we spend.

Frank Kelly

Yes, well that's certainly encouraging to hear. I guess one of the concerns I had was the growth rate of SG&A in this past quarter versus the revenue growth rate because there, you'd like to think, yes, we're investing but at 21% versus 27% revenue, maybe close to 28% revenue increase in the SG&A at 21%...

Kevin Miller

Sure, but you really ought to be looking at it on a year-to-date basis because Q3 SG&A has a lot of fixed cost in it and we have a lot of seasonal variability in the revenue and gross profit in Q3, as you know. If you're going to go through that exercise and look at the growth of SG&A compared to the growth in revenue, you've got to do it on a year-over-year basis.

Bradley Vizi

I might disagree with both of you. Kevin, what was the operating margin increase year-over-year, 600 basis points, 700 basis points?

Kevin Miller

Yes.

Bradley Vizi

Frank, as long as we can increase operating margin at a clip anywhere near that, like we are going to pour on SG&A, and I think you're going to like the outcome.

Frank Kelly

Okay. Yes, because we do see to Kevin's point, a 54% increase year-over-year on revenue and a 33% increase in the SG&A. Sometimes, obviously, you have to drill down into specifics of the SG&A and what's in there but it's something certainly that as long as it's being monitored historically, we need to do that.

Bradley Vizi

Definitely appreciate the feedback and you've always been a great thought partner on a couple of topics, this being one of them, Frank. Thank you.

Frank Kelly

Great. Thank you, gentlemen. Again, great quarter and certainly without the seasonality anomaly in the third quarter, we're hopefully looking at an absolutely outstanding fourth Q.

Operator

At this time, I am seeing no further questions in queue.

Bradley Vizi

Thank you for attending RCM's third quarter conference call. We look forward to our next update in 2023.

Operator

All right, ladies and gentlemen, that concludes your call. You may now disconnect your lines. Thank you again for joining us today.