RCM Technologies, Inc.

Year End 2021 Earnings Call

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CORPORATE PARTICIPANTS

Kevin Miller, *Chief Financial Officer*

Bradley 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 fourth quarter.

Bradley Vizi

Thanks, Kevin.

Our fourth quarter results serve as a nice bookend to 2021. As I reflect on our transformation plan, dating back prior to the pandemic, I am proud of the team's execution. The results speak for themselves: broad-based strength across each of our divisions.

Before we get into the numbers, I want to reflect on the year and why we're even more optimistic about the future. We entered 2021 with the foundational pillars in place to support RCM's next wave of growth. Twenty-twenty was clearly a year of recovery. We refined our processes and focus, upgraded our leadership ranks, and were opportunistic in deploying capital, driven by our improved balance sheet. As a result, we entered 2021 in a position to capitalize on the foundation we built and worked to fortify through the pandemic. It was time to leverage the infrastructure that we had put in place and to tangibly demonstrate all the progress we had made and how it translates into material bottom line results.

First, our refined focus and commitment to process led to numerous improvements across our business. Consistency and scalability are what we strive for, and over the course of 2021, we took the next steps in getting there. Our decision to sell Canadian Power Systems Unit was the direct result of our desire to streamline our focus on the right end markets, the right clients, and the right solutions. We believe simplifying our business will lead to greater consistency and focus.

We also took tangible steps to ensure we can scale our next wave of growth more productively and efficiently than before. We augmented our commitment to our processes with investments in new technology. Our teams are upgrading our front end and back end systems that will translate RCM into driving not only more business but doing so more profitably in the future.

Through the primary phase of our modernization effort, including upgrade of the Company's CRM, ERM, and marketing infrastructure will continue through 2022, we are already starting to see results. Furthermore, this process has provided further enhancement to our Company culture from one that was content being more of a fast follower to one that strives to be an industry leader. Constant innovation throughout the organization is essential to gain on the compass (audio interference) in today's dynamic environment.

Second, our right-sized balance sheet gave us the flexibility to play offense both operationally and financially. From an operational perspective, we leveraged this flexibility to reinvest in our people and upgrade our leadership ranks. I never felt more confident about the team we have assembled and believe we are positioned well to navigate the opportunities of the future.

Third, we are clearly taking share in many of our end markets. I do not remember a time where we were able to displace as many incumbents as this year. I believe the pandemic exposed the deficiencies of our competition, leaving us in position to capitalize as a result of significant investments made in enterprise, its talent, and fostering a culture with a maniacal focus on delivering first-class solutions for our clients. All of these efforts have translated into a step change in performance for RCM Technologies.

I will share more highlights before Kevin dives deeper into the numbers. As mentioned, our fourth quarter and 2021 results were strong across the board. Revenue contributions from Life Sciences and Information Technology, Health Care, and Engineering were all robust, with each division demonstrating growth both on a year-over-year basis and sequentially.

In total, RCM Technologies increased revenue to $203.9 million in 2021, a 36% increase above 2020 results. Profitability also increased materially in 2021, with the Company generating Adjusted EBITDA of $11.1 million compared to $1.1 million in 2020 and $8.2 million in 2019, representing an increase of 944% and 35% respectively.

As we look to 2022 and beyond, the future of RCM Technologies has never been brighter. Now, I will highlight just a few secular trends that bode well for our business in the future. We have the team, the infrastructure, and the strategic direction to assist our clients in solving some of the most difficult problems facing society today.

Starting with the great talent shortage many industries are experiencing as of late, this problem is one that cannot be solved overnight. To illustrate the scale of this dilemma, consider the following. First, core demographic trends are putting tremendous strain on our clients to source talent as the baby boomer generation drops out of the workforce. This dynamic is compounded by the multidecade decline in birth rates seen across many developed economies, and the reduction in both high skill and low skill immigration. These trends were all accelerated by the pandemic and exacerbating labor shortages facing many companies today. There just aren't many scalable solutions to backfill the declining working age population demographics facing the workforce today.

Adding it all up, here's the sobering math behind this new reality. Since the start of the pandemic, labor force participation rate of workers aged 55 and over has remained well below its pre-pandemic levels and has equated to approximately two million less workers today. The overwhelming majority of this age cohort are represented by baby boomers who are retiring from the workforce altogether.

Hypothetically, natural population growth and immigration would be able to backfill and offset these lost workers, but in reality, both are actually contributing to the shortage. In 2021, the U.S. population grew just 0.1%, its slowest rate since the nation's founding, with the working age population actually declining. As it relates to immigration, there are about two million fewer working age immigrants than there would have been if pre-pandemic trends continued.

The takeaway is clear. As the labor market swings from abundance to scarcity, the process of sourcing, securing, and retaining talent for organizations is becoming a strategic asset of the highest priority. That is where we come in. At RCM, we have the expertise and know-how to help our clients excel in all three facets.

One example can be found on our Life Sciences and Information Technology group. Our scalable talent solutions in helping clients in mission critical industries to meet the demands of this quickly changing and dynamic labor market. Our teams are innovating in the delivery of these services in an RPO model that is resonating with our client base. We handle the talent sourcing the recruitment efforts for our clients so they can focus on providing value-add products and services to their end customers.

The wide scale adoption of the RPO model represents a $5.5 billion plus market opportunity and is quickly gaining steam within a fast-changing labor market where demand for talent is outstripping supply. This model is a win-win for RCM and our partners as it represents a more holistic solution for the client and has enabled us to establish longer duration contracts with blue chip customers across healthcare, pharma, and life sciences.

Not only are we helping our clients address the talent shortages of today, but we are also remaining focused on cultivating the next generation of talent tomorrow. This process starts and ends with assisting our clients to address the unique problems facing our youth today. As we are all aware, the country's social infrastructure was already under stress leading up to the pandemic, but that stress has only exacerbated as our country exits from that.

The stress has been particularly acute for our youth. From learning loss to declines in social-emotional development, the direct and indirect impact the pandemic has had on children across the country is now becoming clear. Here are a few statistics that highlight the overall magnitude of the problem. From a learning loss perspective, the average child in Grades 1-6 are five months behind in math and four months behind in reading. If unaddressed, these learning gaps will compound through time as many parents in schools are reluctant to hold back an entire cohort of children.

As children struggle in the classroom, it is no surprise this has an impact on kids’ social and emotional wellbeing. Parents across the country are concerned for their child's mental health as they are seeing increased rates of anxiety and depression. According to surveys, 35% of parents said they were very or extremely concerned about their child's mental health. Unfortunately, we are also seeing an absolute uptick from pre-pandemic rates in children's anxiety, depression, social withdrawal, and self isolation, to the tune of 5%, 6%, 8%, and 7% respectively. Meanwhile, the capacity to assess and test children for issues related to mental and behavioral health have declined by approximately 6% compared to 2019.

These trends are clearly not sustainable. That's why our healthcare team is leveraging their 40 plus years of experience and leading position in the education end market to help solve what I believe might be one of the least talked about crisis our country faces today, the persistent development gap our youth faces as we recover from the pandemic. We are helping parents in schools across the country on a variety of fronts to address the problems facing our youth today.

First, our team has done an excellent job of keeping kids in school by scaling up their testing business by partnering with several of the largest testing companies in the country.

Second, our therapy and behavioral health programs are thriving as we ensure schools and students have the necessary skilled support to help reverse the social-emotional fallout that resulted from the pandemic.

Lastly, we are helping teachers in the classroom address the learning gaps by providing enhanced instructional and supplemental support through the expansion of our PAR educators and RBTs into the classroom.

Given the diversity of our solutions and capabilities, we are quickly becoming the strategic partner of choice for school districts across the country. We facilitate students being in the classroom, aid teachers in having the resources to improve students' educational outcomes, and make certain districts have the necessary behavioral and supplemental support to ensure their student population thrive in the future.

Dovetailing the discussion about providing sustainable and scalable solutions to our schools, I also want to touch upon the role we are playing providing sustainable and scalable solutions regarding our nation's infrastructure and overall carbon footprint.

Within our Engineering group, we are taking great strides to incorporate innovative solutions that can help our clients address both of these areas. Our Energy Services group is playing its part as the U.S. embarks on a multidecade investment cycle upgrading and expanding the nation's electrical infrastructure. Time is of the essence as the effects of this aging infrastructure are becoming more pronounced. Meanwhile, many of our clients are also making the transition to renewable sources of power at the same time, which also require their own interconnection to the grid.

To give our investors and listeners a better sense of the scale required to fix our nation's electric grid, let's first focus on issues hampering our existing infrastructure and the level of investment needed to fix it.

First, our electrical grid is less dependable than what it once was. Large, sustained outages are becoming more common for utilities across the country. For reference, the average utility customer experienced over eight hours of power interruption in 2020, more than double the amount in 2013 when the government began tracking this data.

The second factor is the overall age of the grid itself. According to the American Society of Civil Engineers, roughly 70% of transmission and distribution lines are well into the second half of their expected 50-year lifespans. This factor also compounds the first. Aging infrastructure also becomes less reliable over time.

However, this is only one part of the electrical grid story. In parallel is the ongoing transformation of our existing generation capacity from carbon heavy to carbon light renewables. As utilities accelerate this transition to renewable sources of energy, it also drives a massive spending effort for T&D interconnection investments to the existing grid.

Given the location of these renewable projects, it isn't as simple as shutting down a coal-fired plant and building a utility scale solar project around existing T&D infrastructure. Most often, utilities also have to build out entirely new T&D interconnect infrastructure to connect this new generation capacity to the existing grid.

Given the combination of the nation's aging electrical infrastructure, the under-investment in maintaining our existing grid, and the shifting of generation capacity to meeting renewable generation targets, our clients are embarking on a massive multidecade investment cycle to meet their objectives.

For context, although our clients have been spending approximately $50 billion per year on T&D maintenance and upgrades through the years, it is still not enough. The Society of Civil Engineers estimate that utilities across the country will face a cumulative investment gap of $208 billion by 2029 based on current spending projections; 35% of this spending gap, or $73 billion, is comprised of T&D spending.

Ensuring the nation's electrical grid can scale sustainably and make the seamless transition to renewables is an area where our Energy Services group can deliver tremendous value. Our world class utility clients have come to expect it and they know our team can deliver. We look forward to helping them perform this mission critical work in the years to come.

Related to the topic of renewables, it is also worth mentioning that our Engineering group’s diverse capabilities are also expanding to help clients in other industries reduce their carbon footprint more proactively. Our process and industrials carbon capture initiatives are in pilot programs with customers that aim to repurpose our existing patented technology and process expertise to assist our innovative partners in addressing one of the most pressing problems of the 21st century: climate change.

Carbon capture alone is a $2 trillion market opportunity, and we are at the forefront as we deploy our scalable distillation and evaporation processes to help capture and recycle carbon in a more sustainable way. I look forward to sharing more of these developments in the future.

Finally, I would like to touch upon the strides we have made within our Aerospace team. The group has done a complete 180 over a very short period of time, and I believe this team is capable of growing materially and in strategic significance to RCM.

First, now more than ever, aerospace and defense, in particular the need for national defense spending, is coming into focus given recent world events. Our clients are responding to changing geopolitical landscapes accordingly, and our team is here to help them scale as national defense budgets increase throughout the world.

For instance, Germany recently pledged to increase its defense spending budget to over 2% of GDP in the coming years, or an annual increase of €20 billion per annum. To translate this policy shift into actual defense spending, Germany in its first publicly confirmed major arms purchase since the announcement stated the country plans to purchase 35 F-35 fighter jets from the U.S. to aid in its military modernization effort over the next several years.

This is just one example of what we believe is a wholesale shift in national defense spending from nations across the world, given the recent tragic events unfolding in Eastern Europe. I am confident our Aerospace team can assist our clients in meeting the challenges of tomorrow. Whether it is through our engineering solutions or our aftermarket business, our Aerospace team is aligned to the right end markets and has well-established relationships with many of the U.S. defense prime contractors. In particular, our Tech Publications team has been doing a tremendous job in helping one of our largest clients modernize its suite of technical documentation manuals across much of its fleet that remains in service.

We have also been creative in assisting our clients in scaling up their sustainment and aftermarket businesses. Our vendor on-premise program has been a tremendous success in helping the largest prime contractors meet today's labor challenges in a holistic and sustainable way.

Lastly, I am also excited to share the inroads we have made into the nation space ecosystem. We have landed several new client logos over the past three quarters, and we expect big things from this practice. As a reminder, we believe the space ecosystem, both commercial and defense, will grow into a $1 trillion annual market opportunity over the next 10 to 15 years. Our mission is to be the partner of choice in providing value-add solutions across our engineering aftermarket service groups. I will share more details regarding our recent successes within the space industry on future calls.

In closing, whether it is addressing the talent shortages driven by the great resignation, reinvesting in our education sector, upgrading our country's critical infrastructure, or helping tackle one of the most pressing problems of our time in climate change, RCM's broad and robust solution set enable us to play a critical role in ensuring our partners are positioned well for the years ahead. I look forward to sharing more updates on our progress in the future.

Now I will turn the call back to Kevin to discuss the Q4 2021 financial results in more detail.

Kevin Miller

Thanks, Brad.

Regarding our consolidated results, revenue grew $19.4 million sequentially over Q3 2021 and $23.8 million on a year-over-year basis compared to Q4 2020. After removing the impact from our now exited Canada Power Systems Group, we grew by $27 million, or 71%, as compared to Q4 2020. It is worth reiterating the broad-based strength in revenue contributions we saw from each segment as they all meaningfully grew, both sales and contribution operating profit sequentially and year-over-year.

Gross profit expanded to $17.8 million, a 46% increase from Q3 2021 and a 66% increase from Q4 2020.

Adjusted EBITDA in Q4 '21 was $5.3 million, representing a sequential increase of 192%, and $4.6 million or a 400% increase over Q4 2020 Adjusted EBITDA.

Our profitability metrics all demonstrated material improvement and illustrated the significant operating leverage we have in our model, despite the €2.5 million year-over-year increase in SG&A expense driven by the hiring of new staff and rewarding our employees for strong operational performance in 2021.

Turning to our Health Care segment, the group generated revenue of $34.8 million in Q4 2021, which represents an 87% increase on a year-over-year basis, and a 77% increase sequentially. Performance within the Health Care segment was broad-based.

Our Life Sciences and Information Technology segment also performed well, with revenue and profitability both up sequentially and year-over-year. On revenue, we generated $11.9 million in Q4 2021 compared to $8.2 million in Q4 2020, and $9.3 million in Q3 2021, growing 46% versus prior-year's performance and 27% sequentially. The level of client interest in our managed service solutions remains robust as the group's leadership team continues to execute well on their transition to a stickier revenue model.

Lastly, turning to our Engineering segment, we generated revenue of $18.3 million in Q4 2021, growing both sequentially and year-over-year. After removing the impact of our Canada Power Systems Group, our revenue in Q3 2021 and Q4 2020 was $16.0 million and $11.2 million respectively, growing 14% sequentially and by 63% year-over-year. The division also generated material improvement in its profitability metrics, demonstrating a sizeable increase in contribution operating income, both sequentially and on a year-over-year basis.

At the unit level, the new additions to our Aerospace team have hit the ground running and have made significant inroads transforming the business. In 2021, we established commercial relationship with multiple new OEM clients, including making strong inroads into the burgeoning space ecosystem. We look forward to sharing more about their progress with you as we move through 2022.

Our Energy Services team also performed well. The unit's investments in its leadership team and systems are paying dividends as the group's business pipeline and overall client activity levels continued to develop.

Lastly, our Process and Industrial unit performed well in 2021, and we are very encouraged by the level of business activity that we've seen thus far in 2022.

Collectively, as strong as our performance was in Q4 2021, we're equally optimistic about the future of our Company. We truly believe we are building something unique and special that is set to capitalize on the long-term secular growth markets of tomorrow.

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

Operator

Our first question is coming from Alex Rygiel from B. Riley. Alex, your line is now open.

Alex Rygiel

Thank you. Congratulations on a really strong quarter and year, gentlemen. Couple of quick questions here. First, can you quantify the share gain in some way within the specialty Health Care segment?

Bradley Vizi

Hi Alex, though we can't specifically quantify the share gain, what I will say is just generally speaking is we believe we've taken share in all three businesses with very specific displacement of incumbents. Health Care is certainly a bright spot but I wouldn’t necessarily limit the statement to Health Care.

Alex Rygiel

Just to help us to sort of think about and model the Health Care segment sort of going forward 12 months, can we use the fourth quarter as a good baseline for let's just say sort of like 100% of activity level, everybody's back at work, everybody's back at school, and that's a kind of a normalized quarter and then layer on seasonality over the next four quarters, and layer on kind of future growth or gains? Is that how we should think about this most recent fourth quarter? Is that a good baseline?

Bradley Vizi

Yes, so though we don't give guidance, what I will say is, we certainly intend on growing the Health Care business. There are a number of initiatives and programs in place that not only show promise, but frankly they're crystallizing as we speak. I wouldn't necessarily point to this past quarter as being a static run rate, if that answers your question without giving guidance.

Alex Rygiel

No, that is helpful for sure, and then is there any chance you could update us on backlog, or sort of maybe talk about how bid opportunities or some sort of backlog measure that you look at internally has maybe changed over the next 12 months and how that gives you good visibility into 2022?

Bradley Vizi

Yes. Backlog is very strong. Activity has picked up markedly as we referenced in prior calls in all three of our Engineering businesses and that is converting to backlog and again, the pipeline continues to refill. So ultimately, we expect good things going forward from our Engineering businesses.

Alex Rygiel

Thank you very much.

Operator

Our next question is coming from Bill Sutherland with The Benchmark Company. Bill, your line is now open.

Bill Sutherland

Thanks. Good morning, guys. Tremendous job.

Bradley Vizi

Good morning.

Bill Sutherland

Curious about what you're seeing in terms of pricing across your three segments, and maybe I'm thinking particularly about Health Care and realizing your focus is not like the guys with the big travel nurse businesses, but whether as you look forward there's any rate normalization that you think could be occurring this year.

Bradley Vizi

Yes. No, that's a good question, Bill. I think you've been tracking the space and I think there's a perception that some of the elevated (inaudible) rates of late have been directly the result of COVID. We think about a little bit differently. We simply respond to the environment and that environment continues to be tight. Now rates have been resilient; we anticipate them continuing to be resilient. That being said, we will react to the market, but we have not seen any material changes.

Bill Sutherland

Okay, and then with all the opportunities on your plate, how are you thinking about your capital deployment strategy for this year?

Bradley Vizi

Yes. You’ve followed us for a while, Bill. We tend to be pretty balanced in our approach as you know, whether it's returning capital to shareholders via share buyback and dividend or opportunistically pursuing acquisitions. I'll say we're getting to a point where our balance sheet gives us a great deal of flexibility moving forward, particularly in light of our EBITDA trajectory.

What I'll say is we take a lot of pride in our capital allocation discipline and our track record. We're going to continue to do that. Frankly, we look forward to being in a very enviable position with respect to our ability to react to opportunities that we frankly haven't been in the recent past. We're agnostic. We are going to allocate capital. We think the returns are so—while rewarding shareholders along the way, of course.

Bill Sutherland

So growth will not diminish the recent return strategy you've had for shareholders?

Bradley Vizi

We are comfortable with our capital structure and again, we will balance flexibility of it with returning capital to shareholders as we've done historically.

Bill Sutherland

Okay, good. Kevin, just a couple of number questions. I notice the very strong gross margins in Engineering and IT in the quarter. Should we think about those as sustainable? Are there any special factors?

Kevin Miller

Yes. No, I think you definitely should look at them as sustainable. As you know, we're going to have variability from quarter to quarter. That's not going to change, but I think when you look at the range, like a range of where we were in the fourth quarter, I think that's a pretty good range.

Bill Sutherland

Okay. All right.

Kevin Miller

If you sort of look at that compared to some other quarters, but there's nothing going on in the fourth quarter margin that is unsustainable or a onetime event

Bill Sutherland

And then last...

Kevin Miller

In our view.

Bill Sutherland

Okay. And then the effective tax rate was much lower than that had been. Was there something in the quarter?

Kevin Miller

Yes. there's a few things going on there, but we had some decent contribution from Serbia. We had a few adjustments in there as well. When you see the K, you'll see the rate rec, but the tax rate is probably a little bit low in 2021 compared to where we're going to see it, going forward. I think if you assume—like maybe 28% to 28.5% is a safe number. Hopefully we can beat that through tax planning and whatnot, but that's probably a decent assumption for your model.

Bill Sutherland

Okay. I'll follow up with you later, a few details. Thanks, gentlemen. Great job.

Operator

There are no more questions in the queue.

Bradley Vizi

Thank you for attending RCM’s fourth quarter conference call. We look forward to our next update in May.

Operator

Ladies and gentlemen, this concludes the call. You may now disconnect.