Willdan Group, Inc.
Second Quarter 2023 Financial Results
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<u>Presenters</u>
Al Kaschalk, Investor Relations
Thomas Brisbin, Chair and CEO
Kim Early, CFO
Michael Bieber, President

<u>Q&A Participants</u>
Craig Irwin, ROTH MKM
Moshe Katri, Wedbush Securities

Operator
Good day, ladies and gentlemen, and welcome to Willdan Group's Second Quarter 2023 Financial Results Conference Call. Our host for today's call is Al Kaschalk. At this time, all participants are in a listen only mode. Later, we will conduct a question and answer session.

I would now like to turn the call over to your host. Mr. Kaschalk, you may begin.

Al Kaschalk, Investor Relations
Thank you, Martin. Good afternoon, everyone, and welcome to Willdan Group's Second Quarter 2023 Earnings Call. Joining our call today are Tom Brisbin, Chair and Chief Executive Officer; Kim Early, Chief Financial Officer; and Mike Bieber, President. The call today builds on our earnings release we issued after market closed today. You may find the earnings release and the Willdan investor report that accompanies today's call in the Press Release and Stock Information section of our Investor Relations website.

Management will review prepared remarks, and then we'll open the call up to your questions. Statements made in the course of today's conference call, including the answers to your questions, which are not purely historical, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The forward statements involve certain risks and uncertainties, and it's important to note that the company's future results could differ materially from those in any such forward-looking statements. Factors that could cause actual results to differ materially and other risk factors are listed from time to time in the company's SEC reports, including, but not limited to, the annual report on Form 10-K filed for the year ended December 30, 2022.

The company cautions investors not to place undue reliance on the forward-looking statements made during the course of this conference call. Willdan disclaims any obligation and does not undertake to update or revise any forward-looking statements made today. In addition to GAAP results, Willdan also provides non-GAAP financial measures that we believe enhance investors' ability to analyze the business trends and performance. Our non-GAAP measures include net revenue, adjusted EBITDA, and adjusted EPS.

I will now turn the call over to Tom Brisbin, Willdan's Chair and CEO.

Thomas Brisbin, Chair & CEO
Thanks, Al, and good afternoon, everyone. Our second quarter performance was strong. This continues the momentum we started last year. Net revenue grew 17% in the second quarter. For the first six months of this year, we grew net revenue by 20%. All of the growth was organic and across the entire company. The Willdan team is converting this net revenue growth to profit and cash flows. For the trailing 12 months ended June 30, EBITDA was $37.9 million, the highest level ever at Willdan.

Our backlog is solid, and we are seeing many new opportunities. These opportunities replace the annual reduction we saw from the SCE contract. These new opportunities include $40 million with NYPA, that's New York Power Authority, $120 million from one of the nation's largest school districts, $30 million plus from Southern California Edison, $20 million from PG&E in a program called CEDA, and $10 million from San Diego Gas & Electric.

Our Policy and Planning group, E3, remains very strong. They provide energy consulting to the entire country, helping develop the framework for the clean energy transition. In addition, E3's asset valuation and market price forecasting practices are growing rapidly. Large private infrastructure funds are pivoting their portfolios to clean energy investments. These investments support Willdan's other capabilities, such as city engineering, utility programs, grid distribution, data analytics, design, and construction management. Recently, we supported Blackstone Infrastructure Partners on their $2.15 billion equity investment in the Northern Indiana Public Service Company.

Cross-selling is working. We were recently selected by a major health care provider with over 1,200 facilities. The problem we are working on is how much of their capital budget is allocated to their decarbonization roles. To solve this problem, we are using our front-end consulting services, E3, along with our utility energy-efficiency programs and design/construction services. This decarbonization project is very similar to the LL 97 project for New York City. There we created a $4 billion budget to help decarbonize over 4,000 buildings.

Municipal engineering and financial services grew 16% year-over-year and continue to expand margins. Municipalities are an important customer for us, and we've served 90% of the cities and counties in California for nearly 60 years. We see cities starting to address decarbonization and exploring the use of IRA and infrastructure funds.

In times of a recession, it's often cities that see the slowdown first and our work with cities does not show any signs of a recession. Our broader municipal capabilities, combined with a labor shortage at cities, is creating opportunities for growth. We're successfully expanding our municipal engineering and financial services into other states such as Arizona, Florida, Texas, to name a few.

Overall, our portfolio of utility programs is performing well. Our San Diego Gas & Electric outreach program is on schedule. We're receiving change orders to expand work under our small business program. Given our PG&E public program success, we saw a $2 million contract increase for 2023. PG&E extended the contract from '24 to '27, adding another $16.9 million to the contract. Our restructured SCE, Southern California Edison, contracts are delivering the modified SCE program goals. We are having encouraging implementation discussions and the program has improved operating results.

Our small business program for the Los Angeles Department of Water and Power, including our work for the Los Angeles Unified School District is doing well. And the same goes for our utility programs around the country such as Puget Sound Energy, Duke, and several New York utilities.

Our software business is having a great year. Their pipeline is robust, and they are positioned for their best year. Strategically, we see demand for electric vehicles, solar, battery, wind power, and electrification driving opportunities for both distribution grid planning and forecasting. Our software helps utilities plan and optimize their solutions. Further, we are collaborating across the organization by leveraging IA’s software with E3's consulting.

Our Performance Engineering Group is currently in their two strongest production quarters. They are beginning work for the sixth largest school district in the U.S. and advancing production on five new California-based performing engineering contracts. These wins were based on collaboration with our municipal engineering, utility engineering efficiency, and new construction software capabilities.

Our New York Energy Engineering business saw a contract revenue up 16% over the 2022 period with an improvement in profitability. Given our work with the Dormitory Authority of the State of New York, DASNY, the New York City Housing Authority, NYCHA, and the New York Power Authority, NYPA, this group is on track for 50% organic growth in 2023. They are electrifying NYCHA housing to decarbonize the grid and provide better living for the residents.

In closing, we expect to finish strong in 2023 and for these positive trends to continue next year. We are looking to resume acquisitions by late this year, early next year. With our earnings growth, strong backlog and acquisitions, we expect greater than 15% annual growth for the next three years. As Kim will discuss, we have increased our 2023 guidance for all financial metrics. I want to thank our employees, customers, and stockholders for your support.

I will now turn the call over to Kim, who will provide additional details on our financial results and our updated guidance. Kim?

Kim Early, Chief Financial Officer
Thanks, Tom. Good afternoon, everyone. As Tom mentioned, Q2 continued the string of strong performance driven by growth in our utility programs, additional software licenses, and strength from our Municipal Services segment as well as expanding revenue from our direct-to-customer construction management businesses. As a result, we generated $18.1 million in adjusted EBITDA and $18.9 million in cash flow from operations over the first half of 2023.

The improved earnings provided the fuel to continue to delever the balance sheet, bringing our leverage ratio to 2.4x adjusted EBITDA and putting us in a position to resume pursuit of strategic M&A opportunities. In fact, we recently closed on a small addition to our Municipal Engineering segment that broadens our service offering, and we're actively seeking additional acquisition opportunities.

Q2 gross revenue was up 16% and net revenue was up 17% versus Q2 in 2022. We saw double-digit growth in both of our segments with the revenue increases distributed widely across our service lines.

Q2 gross profit was 29% higher year-over-year as our gross margin improved to 34% in Q2 of 2023 versus 30.8% a year ago. The higher margins reflect the restructured California IOU contracts, strong growth in our municipal engineering revenue, and additional software licensing revenue.

Q2 G&A expenses were up modestly versus the same period a year ago, primarily due to higher employee incentive compensation resulting from the improvement in income from operations. Interest expense more than doubled to $2.2 million in Q2 of 2023 due to the unfavorable impact of higher SOFR interest rates.

Our income tax rate was 38% in the second quarter compared to a credit of 28% in the second quarter of 2022.

So for the second quarter, net income was $397,000 or $0.03 per share versus a loss of $4.3 million or a loss of $0.33 per share a year ago. Adjusted EBITDA in Q2 of this year was $8.2 million compared to $1.2 million in 2022 and adjusted earnings per share was $0.26 versus a net loss of $0.06 per share a year ago, a welcome turnaround thanks to the growing revenues and improved utility contract terms.

In terms of the six months ended June 30, 2023, versus the prior year, gross revenue was up 14% and net revenue was up 20%. All of that growth was organic and led by construction management, planning and analysis services, and expanding services for our municipal client base.

Gross profit increased 30% as gross margin improved to 37% in 2023 compared to 32% a year ago, driven by the higher level of software revenue, improved productivity, and a favorable service mix.

We realized significant operating leverage in the period. SG&A expenses increased only 2.1% versus the same period a year ago, while net revenue was growing 20%.

Higher employee incentive compensation due to the improvements in income from operations was partially offset by lower stock-based compensation. Interest expense increased $2.9 million to $4.7 million for the six months ended June 30, 2023, compared to the same period a year ago due to the impact of the higher SOFR rates. Income tax expense was $1.0 million, a 43% effective tax rate compared to an income tax benefit of $4.1 million on the loss in 2022. The high effective tax rate is a result of the timing of certain tax adjustments and will moderate toward the high 20s for the full year as the year progresses.

The year-to-date net income was $1.3 million or $0.10 per share compared to a loss of $8.1 million or $0.63 per share in 2022. The restructured California IOU contracts, higher software licensing revenue, and improved results throughout the company enabled the significant turnaround. Our balance sheet also reflects the benefits of our improved earnings and the higher cash flows. At the end of June 2023, our leverage ratio improved significantly to 2.4x the trailing 12-month adjusted EBITDA and net debt was $89 million.

We feel good about our first half performance as we move into our busiest production period. We have a strong backlog of projects in our Energy segment and our Engineering and Consulting segment continues to enjoy strong growth and improving profitability. This gives us confidence to raise our 2023 financial guidance. For 2023, we now expect net revenue growth of 9% to 10%. Adjusted EBITDA is now expected to be in the range of $38 million to $40 million and adjusted diluted EPS in the range of $1.30 to $1.35. We're assuming a 27.5% full year tax rate and a diluted share count of 13.7 million. Our capital expenditures are expected to be in the range of $10 million to $12 million.

We also want to note that we are in the process of refinancing our bank credit facilities, which expire in June 2024. We plan to have a new three-year credit agreement in place by the time of our next quarterly call to facilitate our expected growth.

Operator, we're now prepared to answer questions.

Operator
At this time, we will conduct the question and answer session. If you would like to ask a question, please press star, then the number one on your telephone keypad now and you will be placed in the queue in the order received. Once again, to ask a question, please press star, then the number one on your telephone keypad now.

Your first question comes from Craig Irwin with ROTH MKM. Your line is open.

Craig Irwin, ROTH MKM
Evening, guys. Congratulations on a really solid quarter here.

Thomas Brisbin, **Chair & CEO**
Thank you.

Craig Irwin, ROTH MKM
So my first question is really about gross margins. You mentioned a few differences in there that are working for you. Can you maybe sort of list them in order of priority as far as margins? And any color you could share as far as whether or not those factors are likely to sustain over the next couple of quarters or maybe even build from here?

Thomas Brisbin, **Chair & CEO**
Well, I would say in order of magnitude of the impact on the improving margins, of course, the software revenue is a big factor in that, had strong first half, and that's a strong contributor to the higher gross margins that we realized. And we do have a strong backlog of opportunities in that business. So we expect continued revenue growth in that area. I think the second impact was the restructuring of some of the California IOU contracts compared to a year ago provide that additional gross margin that we're able to achieve and that's probably the second biggest factor.

And then third, overall, I think is just the expanded volume and kind of a productivity increase across a lot of our municipal engineering and the planning and analysis work. Those are -- that's probably third in order of rank of the impact on that higher margin.

Craig Irwin, ROTH MKM
Okay. And then as a follow-up --

Thomas Brisbin, **Chair & CEO**
Yes. Yes. Just to answer the question about whether or not that's sustainable. I believe that it is all sustainable. In fact, some of that volume may increase. As we mentioned, this is going to be -- the second half of the year is going to be our busiest time. We expect on that T&M service-oriented business, those margins to continue to improve.

Craig Irwin, ROTH MKM
Okay. Excellent. So then just to continue on the line of software, right, as being the largest impact in the first half, SMUD and the LoadSEER contract was the only press release contract in the second quarter for Integral Analytics. Can you maybe give us an idea on the materiality of this contract? Is this sort of a small fish or big fish? Just something incremental? How would you --

Thomas Brisbin, **Chair & CEO**
The small contract, you mean? Yes, Mike.

Michael Bieber, President
That was a small fish, Craig. We had a big fish in the first quarter that we press released. We didn't announce the name of it because that was confidential, but we announced that in the first quarter. So the big fish was in the first quarter, the small fish was in the second quarter, and we have a very good pipeline of software opportunities in the back half of the year and going into '24.

Craig Irwin, ROTH MKM
Excellent. That's really good to hear. So then a follow-up question. Investor perception out there seems to look at Willdan as largely benefiting from utility spending on energy efficiency. Your comments on the call and some of the meetings we've done give me the impression that that is not the case, that utilities are actually a minority of your drivers right now, but yes, those are great contracts to have and great customers. But you're finding a lot of activity in other markets. Could you maybe update us on mix and markets that are maybe working for you in a big way versus markets that are sort of incrementally improving?

Michael Bieber, President
Sure. State and local is actually a little larger percentage of work for Willdan overall than even utility contracts. Those are similar in size and then a very small part, about 8% to 10%, is commercial. So in order of the state and local work where we do a policy analysis, a lot of data analytics, a lot of our software is sold there, we also do different types of energy upgrades for infrastructure is very strong. State and local business is very good right now, and that's the largest customer segment. Utilities are also good. That's kind of a steady Eddy business. So that's the size. But we're really being driven by spending at the state and local level, which those customers have a lot of confidence right now.

Craig Irwin, ROTH MKM
Thank you. So you also mentioned in your comments that some of this work preparing for the IRA money is benefiting you at the moment as different state and muni entities look to plan and position themselves to participate in those programs. Can you maybe describe for us whether or

not there's a follow-on opportunity after the consulting engineering is done as far as addressing the pinch points in the grid or the other needs in a local geography?

Michael Bieber, President
Yes. To be clear, the IRA money does not really hit our marketplace. A lot of customers are paying us to explore how to receive those funds though and what to do with them, how to prioritize projects that will help decarbonize and help with the energy transition for that particular customer. So that study work is the work that we're seeing right now. It's not the actual work funded by IRA. Later on, there is a follow-on opportunity though. This work will lead to infrastructure projects later on, which positions us well for that type of follow-on work, which might occur over the next several years.

Operator
Once again, to ask a question, please press star then the number one on your telephone keypad.

Your next question comes from Moshe Katri with Wedbush Securities. Your line is open.

Thomas Brisbin, **Chair & CEO**
Moshe, if you're talking, we cannot hear you.

Operator
Your line is open.

Moshe Katri, Wedbush Securities
Sorry about that. I said, let me add my congrats on the results. You started by providing color on some new emerging opportunities that you love. Is there any way to quantify the bid and proposal pipeline that you're kind of looking at at this point? And I think you've done this in the past. And in that context, you also suggested that the software business also has a very, very solid pipeline. Is there any way to quantify that as well? That's my first. Thanks.

Thomas Brisbin, **Chair & CEO**
I don’t know if you want to go to number or quantifying -- still work strongly. So the decarbonization studies or municipal or the private sector are just getting going. And we've landed on what we believe are two very important contracts in the country, that was New York City and a large health care system. Every Fortune 500 Company is looking at the same thing, how do I meet goals for decarbonization between now and 2050.

That's just getting started, Moshe. And we've landed the early contracts that were very significant. So we are putting an effort into that. Utilities are growing at your typical pace, we're adding some services, but we don't believe that's where the future is. The utility work for us has been a great way to get to know their customers, a great way to put measures into their facilities, a great way that they -- when we walk back in on bigger projects, they know who we are. So going from there to software, which I'll let Mike address, we've consolidated software across the company. They're all working together. And you want to finish that one, Mike?

Michael Bieber, President
They're set for a record year. Our best year ever was about $12 million in revenue from software sales external to external customers, and we're looking to significantly beat that this year. But we've got another six months to go, Moshe.

Thomas Brisbin, **Chair & CEO**
Yes. The other thing, Moshe, is the utilities are looking more at electrification, that's also getting started versus energy efficiency. And they're kind of going parallel where energy efficiency, I would say, is more mature with the utilities and their customers where electrification is in a very early stage with utilities, probably, you know, first inning of a nine inning game, it's faster than that, maybe opening inning. So that's a market that we have dipped our toes into in both California and New York, just like we did with energy efficiency back some 14 years ago. So does that help you at all?

Moshe Katri, Wedbush Securities
Yes. And just a follow-up on this one. Are there any renewals coming up here that we should be aware of?

Thomas Brisbin, **Chair & CEO**
Yes, Con Ed, our proposal then is under evaluation, that's for the end of the year. LADWP, there'll be a recompete by the end of the year, or it may be extended, we don't know. If you're just selling energy, it's being recompeted. Do you have anything, Mike?

Michael Bieber, President
Just for the large. Every year, we have 25% of our contracts that get recompeted or so and that's true this year. Tom just mentioned the big ones.

Thomas Brisbin, **Chair & CEO**
Yes. Just so you know, we've had Con Ed since about 2009. We've gone through four recompetes. We've had LADWP for about 11 years. There's been two recompetes. Puget Sound there's been three recompetes. And that's also a 10- or 11-year history, and also the big ones for us. We had no other significant recompetes. We have a few new opportunities that were down to -- we have not been selected yet, but we're in, what we call, best and final or we've submitted all our paperwork, we have not heard the decision, which we've never worked for before. So we're waiting on those.

Michael Bieber, President
In the first half of the year, we also had Mid-America recompete. They -- our contract was due to expire, and they elected because of our technical qualifications and internally developed software that they could procure that service no place else, and they extended our contract with a new contract without bidding that work, so.

Moshe Katri, Wedbush Securities
And following on your -- any kind of -- any guidance on how we should look at Q3 versus Q4? I appreciate the annual guidance, but just in general, how should we think about Q3 on the revenue side, net revenue side, and some of the other metrics?

Thomas Brisbin, **Chair & CEO**
Yes. Well, we're expecting it to be better than Q2. And for that kind of -- it's probably kind of a straight line from the first half results to the guidance for the full year. If you take them in a straight line Q3 to Q4, you would probably get a pretty good ramp there. Q3 will be better than Q2. Q4 should be a little better than Q3.

Moshe Katri, Wedbush Securities
Understood. All right. Thanks.

Operator
Once again, to ask a question, please press star, then the number one on your telephone keypad.

At this time, it appears there are no further questions. I'd like to turn the call back over to Tom Brisbin for any closing remarks.

Thomas Brisbin, **Chair & CEO**
Just thank you all for participating on the call. I hope the good news makes you as happy as it makes us. We feel like we're out of the woods a little bit or out of the dark and it's getting much brighter. So thank you all for sticking with us and being patient. Take care.

Operator
That does conclude today's Willdan Group's Second Quarter 2023 Financial Results Conference Call. Thank you everyone for attending. Have a wonderful rest of your day.