Q2 2018 Ecology and Environment Inc. Earnings Call
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P: Brett Reese; J&E; Analyst
P: Randy Mehl; Stewardship Capital; President
P: Charles Neuhauser; Mainwall Investments; Analyst

Operator: Good morning, and welcome to Ecology and Environment, Inc.'s second quarter 2018 investor conference call. Today's webcast is being recorded. The slide deck can be accessed on the investor relations page of E & E's corporate website at ene.com. At this time, I would like to turn the call over to Mr. Gerry Gallagher. Please proceed.

Gerry Gallagher: All right. Thank you. Good morning, everyone; and thank you for joining us to discuss Ecology and Environment's financial results for the second quarter of our fiscal year 2018. I'm Gerry Gallagher, E & E's President and CEO. Joining me on the call is our Chief Financial Officer, John Mye. After finishing our prepared remarks, we'll be happy to open up the call to take your questions.

Let's go to slide 1. Please note that certain statements made in the course of today's conference call may include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve certain risks and uncertainties, and it's important to note that the Company's actual future results could differ materially from such forward-looking statements. The Company cautions investors not to place undue reliance on any forward-looking statements made during the course of this conference call. Ecology and Environment, Inc. disclaims any obligations to update any forward-looking statements made today.

Let's go on to slide number 2. Although we're very pleased with the continuing improvement in the business climate in South America and the return of our operations there to profitability, the overall and consolidated results for Q2 are disappointing due to lagging revenue delivery in the U.S. side of our operations. We'll get into the details of that in just a moment.

A primary factor for our frustrations in U.S. revenue delivery in Q2, as was the case in our first quarter, has to do with delays both in client procurement processes and contract award, as well as in funding and obtaining authorization to proceed, in some cases even after we've been selected and assigned work by customers. I'll speak to this further a little later in the presentation, but let's first turn it over to John Mye, and he'll present our quarterly results.

John Mye: Thank you, Gerry; and good morning, everyone. My main objective this morning is to present the financial results for the Company for the second quarter and first half of fiscal year 2018. I will begin with the quarterly results.

On slide 2, you can see that our net loss for Q2 2018 was $768,000, or $0.18 per share, as compared with a net loss of $318,000, or $0.07 per share for the second quarter last year. Revenue less subcontract costs of $19.3 million in the second quarter of fiscal year 2018 was largely unchanged from the prior year.

Our year-to-date results are summarized on slide 3. Our year-to-date net loss was $235,000, or $0.05 per share as compared with income of $578,000, or $0.13 per share for the prior year. Revenue less subcontract costs of $40.7 million in the first half of fiscal year 2018 was relatively unchanged from the prior year.

In December 2017, the U.S. government enacted comprehensive tax legislation, referred to as the Tax Cut and Jobs Act, which significantly revised U.S. corporate income tax regulations, including, among other things, lowering U.S. corporate income tax rates and implementing a territorial tax system. Enactment of the new legislation resulted in net one-time adjustments that increased the Company's income tax provision by approximately $0.4 million, and effectively reduced earnings by $0.10 per share during the current quarter.

Revenue less subcontract costs is a key revenue metric for our business because this represents the revenue that we generate strictly from our consulting services. It is compared with pass-through revenue that we collect and pay out to subcontractors. A breakdown of revenue less subcontract costs and net income, and an explanation of those trends by geographic region is provided next in slides 4 and 5.

Slides 4 and 5 compare comparative quarterly and year-to-date results for our U.S. and South American operations. We report our geographic regions as business segments in our public filings which allows you to see the contributions from these business units.

First, I'll address our U.S. operations. We maintain an allowance and other accrued liabilities for potential settlements related to government contracts. Favorable settlements of longstanding contract liabilities maintained by the Company resulted in $0.5 million and $1.1 million of additional revenue during the first quarter and the first half of last year, respectively. The Company did not record any similar adjustments during the current year. Excluding the settlement adjustments, revenues from U.S. operations decreased 8% and 4% during the current quarter and the first half of the year compared with the same periods last year.

The decrease was primarily due to lower project activity resulting from three factors. First, we have experienced a trend of longer periods being required by various prospective commercial and federal clients to make contract award decisions. Second, we have also experienced a trend of longer periods being required by certain clients to fund projects, define project scopes and schedule project work. And lastly, weather related delays also impacted work delivery schedules for certain federal and state projects.

And now, I'll address our South America operations. During fiscal years 2016 and 2017, the Company's South American operations were adversely affected by unstable economic conditions and depressed energy and mining sectors. Improvement in economic conditions that began during fiscal year 2017 has continued in the current year, particularly in Brazil and Peru. In addition, management in South America and the U.S. collaborated on new or improved business development and cost management initiatives resulting in stronger operating platform in South America.

During the first half of fiscal year 2018, these initiatives resulted in additional business opportunities, a growing backlog, and significant improvement in revenue and earnings. As you can see on slide 5, our South American operations experienced significant improvement in revenue and earnings through the first half of this year compared to last year.

Slide 6 shows operating cash activity for the first half of 2018 compared with 2017, as well as cash balances at the end of those periods. During the first half of this year, our cash position again improved continuing the positive trend from the last three fiscal years. This accumulated cash balance is an important resource for funding potential acquisitions and other strategic investments to meet our growth objectives. And now, I'll turn it back over to Gerry to finish our presentation.

Gerry Gallagher: OK. Thanks, John. We'll go to slide 7. As we've seen over the last couple of quarters, market drivers and challenges for our business continue to evolve. Leadership and funding of government environmental programs is shifting from the federal level to states and local governments. E & E has offices in states such as New York, California, Florida and Texas where there's a continued emphasis on requirements for addressing natural resources and environment issues.

We do expect ongoing federal and state cleanup of legacy pollution and funding of those efforts to continue; and, therefore, expect that the prospects for our projects to continue in this area are good. In the second quarter, E & E was awarded new contracts with the states of Minnesota, Texas, and Washington for providing services such as environmental planning, public engagement, site assessment and restoration services. The addition of these and other state government and tribal relationships will be important for us going forward.

The federal regulatory roll back is continuing, and the potential effects on our business in both the public and private sectors remains in flux. A part of the slow progress by some our energy development customers to authorize work is related to uncertainty regarding agency consultation and approval processes, and an unclear path on how and when necessary permits for their projects can be obtained.

Given the current political climate, federal and state agencies, and sometimes tribes, each have increasingly divergent agendas regarding process, reviews and acceptance of proposed large energy development projects. In this current climate of uncertainty, our customers and their investors hesitate; and this translates into delays and intermittent commitments for authorizing project activities, such as E & E's environmental planning services that we provide.

In the energy sector, we do see investment in liquefied natural gas export terminals, renewable energy development, and electric transmission infrastructure continuing. We expect our work in these areas to continue; however, delays in funding of project startups and more spend-gate decisions still cause some frustration, including as we experienced in our first quarter.

We're encouraged that some of the LNG export terminal licensing projects that we're involved with are now beginning to move forward, and as well as in the increasing interest in offshore wind development, particularly on the east coast U.S.

The damaging results of last year's hurricanes is expected to lead to more resilience planning and restoration opportunities similar to what we saw after hurricanes Sandy and Irene. In the second quarter, E & E was awarded a contract with the state of Texas that can be used by those state agencies to serve as recovery phase requirements.

Simple infrastructure opportunities in the U.S. are expected to increase, and E & E is pursuing opportunities in those areas. The South American economy and business climate continues to recover; and we are experiencing an increase of business opportunities in both the energy and civil infrastructure sectors in those countries.

Let's go over to slide 8. Slide 8 shows our backlog at the end of Q2 2018 compared with the end of fiscal year 2017 and the end of Q2 in fiscal year 2017. As you can see, firm backlog has grown modestly over the past year; and the portion that we expect to deliver within the next 12 months reduced somewhat at the end of Q2.

Let's go to slide 9. We continue to work toward our strategic objectives with a forward view for alignment with marketplace opportunities we see being important for our future within the next three to five years, and for achieving both organic and acquisitive growth. In addition to focus on the sectors and service areas shown on the slide, we've been working to secure new avenues for work at the regional and local level within the U.S. with a focus on specific communities and the opportunities they contain. As I described last quarter, in addition to exploring opportunities for M&A, we are putting emphasis on recruiting new talent into E & E for doubling down on making progress in areas of strategic interest.

Then let's go to slide 10. In summary, despite continuing challenges for our U.S. operations, our fundamentals remain stable. Results from our South American operations are improving. We've seen modest improvements in our backlog despite challenging marketplace conditions. Our liquidity continues to improve. We have approximately $17.7 million of available cash as of the end of Q2. We have $40.1 million in total lines of credit, of which $37.8 million is available. We've paid 61 consecutive dividends since 1987; and the current dividend yield is around 3.5%.

This concludes our presentation, and we'll now open up the call for your questions.

Operator: Thank you. Ladies and gentlemen, at this time, if you do have a question, please press the star and the number 1 key on your touchtone telephone. If your question has been answered or you wish to remove yourself from the queue, please press the pound key. Just one moment for any questions. And again, if you have a question, please press the star and the number 1 key on your touchtone telephone. Our first question comes from the line Bret Reese of J&E. Your line is open.

Bret Reese: Yes. Good morning, and thanks for the call. Is there a share buyback authorization in place? And, if not, is that something the board would consider?

Gerry Gallagher: There is not. That is not in play right now. John, you want to comment?

John Mye: Right. That would be considered at any point in time by our board of directors; but, as Gerry said, that has not been considered right now. We view, as Gerry said and the board has supported, on this continuing growth path that we're going forward on, as Gerry outlined in our strategic initiatives which will consume and require our cash resources. But that's not to preclude the fact that that could happen in the future.

Bret Reese: Right. Right. Can you give us some more color in, you know, the M&A activity that you're looking at? Where might that head toward?

Gerry Gallagher: Well, we've talked about this on the previous call. We're interested in areas in the energy development area, water resources, coastal restoration. There's a number of different service areas where we believe there's opportunity for us over the next years.

There's some geographic interests. I'm not going to talk about specific locations for competitive reasons. But within the U.S. primarily there are areas where we see improving our location, our concentration of resources in those areas and focusing on the opportunities within certain communities, metro regions where, particularly with infrastructure, we believe we could get more opportunities going forward over
the next few years.

So in terms of M&A and as well as hiring on new folks, new talent into the Company, we have an eye toward those areas as being promising for us going forward.

Bret Reese: In your area of interest, are you seeing multiple candidates of interest? I mean, do you have a lot of potential projects on the plate?

Gerry Gallagher: We have a lot of opportunities that we are pursuing; yes. And they're across a number of different sectors in energy development, both conventional and renewables. Renewables has been a very active area for E & E, and it will continue to be. Water resources, civil infrastructure is an area where we're focusing a lot of our attention. Coastal restoration, water resources, emergency management planning, and in the DOD area for facilities planning and environmental planning.
These are all areas where we're exploring heavily and we're pursuing opportunities.

Bret Reese: Anything that you potentially will buy in the future will it be accretive immediately? Is that one of the litmus tests before you'd make an acquisition?

Gerry Gallagher: Companies that are of interest to us is where we see a strong potential for synergy where the two companies coming together, it opens doors for both of us to go into new areas and provide new services - where the combined entities can both get some synergy effect and opportunities - you know, lay some ground work for organic growth that would come as a result.

Bret Reese: Great. Thanks for taking my questions. Good luck.

Gerry Gallagher: Thank you.

Operator: Thank you. Our next question is from the line of Randy Mehl of Stewardship Capital. Your line is open.

Randy Mehl: Good morning, Gerry and John. Just following up on the U.S. business. What needs to happen for the U.S. regulatory environment to be more constructive; and what's your best guess on timing?

Gerry Gallagher: Not sure about timing. I mean, things continue to evolve. But more secure sources of government - sources of government work coming on line. The continued trend toward state and local funding of projects. And we need to see - and I think our customers need to see more certainty regarding federal policy as far as the process for obtaining approvals for their projects so that they can have some confidence in their investments and move forward.

Randy Mehl: So it's more - I'm just trying to figure out if you need regulatory moves, is this strictly a staffing problem inside the government? Is this a sentiment issue, you know, with the states? What needs to happen?

Gerry Gallagher: Well, on the federal side I think it is partly staffing in terms of their procurement processes and the slowdown. We have, for example, an EPA procurement where we were selected a year ago and it's been a year and we're still slowly moving through the process of coming under contract to provide services. I think to some degree that's staffing related.

In other areas it's policy oriented, and it's the different agendas of federal and some states as far as process for reviewing and approving projects. That continues to change and evolve, and we've seen a little bit of pickup in these areas; but I think our customers need to see a clearer path to the finish line in terms of getting through the reviews and approval processes for their projects in order to make those investments and put us to work.

Randy Mehl: OK. Just a follow-up to that. Do you feel like, based on the trends in the environment, you're, sort of, scraping along the bottom right now? Or is there still deterioration in the business? In other words, should we continue to expect declines in the business in the U.S.?

Gerry Gallagher: We still see a lot of opportunity, and we're adjusting our focus over into other areas, new areas where we believe there is opportunity going forward. challenging over the last couple of years with the changes, politically and so forth, and what's evolved in the energy sector, particularly for us. But I think we have targets to shoot at. And as we go forward, we're working toward securing some of these opportunities and working our way to a prosperous future.

Randy Mehl: OK. Just one more question as it relates to South America. There's strong revenue trend in the quarter, but the contribution was fairly modest, just given the strong revenue growth. Is there anything specific that contributed to that; or is that, sort of, a level we should expect out of South America?

Gerry Gallagher: John, you want to take that one?

John Mye: Sure; I'll be glad to. Yes. In South America, with the uptick in our business and backlog in revenue, as I alluded to there, we spending more. We've consciously implemented and want to spend more on business development activity down there. And so our expenses during the quarter - and if you looked at our marketing and business development expenses in the Q as listed, I think they're up about $600, $500, $600,000. That is all in South America. And that's primarily due to the increase in business activity down there. Our quotation activity and so forth is very important because of long lead time projects.

Randy Mehl: OK. Thank you. I appreciate it.

Operator: Thank you. And just as a reminder, if you have a question, please press the star and the number 1 key on your touchtone telephone. Our next question is from the line of Charles Neuhauser of Mainwall Investments. Your line is open.

Charles Neuhauser: Yes. Hi. Maybe I missed this, but if I'm looking at slide 5 where you break out the financial results by region for the six months, at least the South American operations seem to be earning what you would call at least an acceptable profit margin; and the U.S. business is three times the size. Is there a bunch of corporate overhead thrown into the United States side of things that causes the lack of profitability - number one?

And number two is I assume with a $30 million for six months, and let's just assume twice that for a full year, that you ought to be able to earn money of some description on that. I mean, if you were a distributor of roofing nails, you could earn a few percent after tax. What is the prospect for bringing some of that revenue money in the United States down to the bottom line?

Gerry Gallagher: Well, as we discussed and as emoted on slide 5 there in the presentation, net income results for the first six-month period, of course, booked in the second quarter was that $0.4 million for the tax adjustment related to the Tax Reform and Jobs Act. In the six-month period for the prior year we did, as noted there, we recorded $1.1 million of additional revenue during the first half of the year, which also flowed through to the bottom line after, of course, tax adjusted. So you'd have to go through and normalize those.

But that being said, we agree with you 100%. This is all - this business is revenue generated. We have a high fixed operating leverage in this business. And when the revenue turns around and up ticks, there's a great deal of fall through to the bottom line with our contribution margin.

Charles Neuhauser: Right. And it sounded like, from your description - when I first read the press release, it sounded like maybe new business opportunities in the United States were simply being delayed because of people being slow to commit themselves. But your description now makes it sound more like it's a structural issue that because of changes in the regulatory environment and/or the general macro environment people are tending to drag their feet, and that there's no particular reason to expect that to turn around or improve markedly any time soon, I guess is more the correct way of looking at it. Does that sound fair to you?

Gerry Gallagher: Well, we have - important for us is to keep our staff at a high utilization. And when projects delay, those staff are not utilized and they become an overhead cost. So if we move forward a couple of months of delay, that's a cost. We don't have - we can't adjust real time to these changes. We have to take that cost going forward, just to clarify.

Charles Neuhauser: Right. But, again, when you use the word delay, I mean, it sounds like it's just being postponed and, therefore, a month or two months, or however many months from the end of the second quarter, these projects should get up and running; and that problem you were just talking about should go away.

Gerry Gallagher: That's right.

Charles Neuhauser: Well, that sounds positive. Thank you very much.

Operator: Thank you. I'm showing no further questions at this time. I'd like to turn the conference back over to Mr. Gerry Gallagher for closing remarks.

Gerry Gallagher: OK. Well, thank you, everyone, for joining us on our quarterly conference call today.

The transcript for the call will be available on our website, I believe, on Monday. And thanks again for attending, and look forward to speaking with you again next quarter.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.