(TH) Target Hospitality Corp.
Q3 2023 Earnings Call
Wednesday, November 8, 2023, 9:00 AM ET

Officers and Speakers
Mark Schuck, Senior Vice President of Investor Relations & Financial Planning
Brad Archer, President and Chief Executive Officer
Eric Kalamaras, Executive Vice President and Chief Financial Officer

Analysts
Unknown Analyst, Oppenheimer
Stephen Gengaro, Stifel
Greg Gibas, Northland Securities

Presentation

Operator: Good day, and welcome to the Target Hospitality Third Quarter 2023 Earnings Conference Call. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Mark Schuck, Senior Vice President of Investor Relations. Please go ahead, sir.

Mark Schuck: Thank you. Good morning, everyone, and welcome to Target Hospitality's third quarter 2023 earnings call.

The press release we issued this morning outlining our third quarter results can be found in the Investors section of our website. In addition, a replay of this call will be archived on our website for a limited time.

Please note the cautionary language regarding forward-looking statements contained in the press release. This same language applies to statements made on today's conference call. This call will contain time-sensitive information as well as forward-looking statements which are only accurate as of today, November 8, 2023. Target Hospitality expressly disclaims any obligation to update or amend the information contained in this conference call to reflect events or circumstances that may arise after today's date, except as required by applicable law. For a complete list of risks and uncertainties that may affect future performance, please refer to Target Hospitality's periodic filings with the SEC.

We will discuss non-GAAP financial measures on today's call. Please refer to the tables in our earnings release posted in the Investors section of our website to find a reconciliation of non-GAAP financial measures referenced in today's call and their corresponding GAAP measures.

Leading the call today will be Brad Archer, President and Chief Executive Officer; followed by Eric T Kalamaras, Executive Vice President and Chief Financial Officer. After their prepared remarks, we will open the call for questions.

I'll now turn the call over to our Chief Executive Officer, Brad Archer.

Brad Archer: Thanks, Mark. Good morning, everyone, and thank you for joining us on the call today.

Our strong third quarter results are a continuation of the positive momentum we have sustained over the past several years. Our meaningful scale creates a highly efficient operating platform, allowing us to appropriately match changes in customer demand while continuing to generate strong financial results.

We continue to benefit from our materially expanded presence providing critical hospitality solutions to the U.S. government. This intentional focus has resulted in over 72% of third quarter revenue being derived from committed contracts by the United States government, with 73% of third quarter revenue having minimum revenue commitments. These elements continue to support impressive operating income and industry-leading cash conversion. This foundation has supported Target's ability to quickly respond to strategic growth opportunities while continuing to evaluate an expanding pipeline of value-enhancing growth initiatives.

In our HFS-South segment, we have remained focused on providing premium full-service hospitality solutions to our world-class customers, many of whom have been customers for over a decade. These premium service offerings have supported strong customer demand and a more fully optimized network over the past year, which has created a more normalized pricing environment. Coupled with continued operational efficiency gains, we anticipate additional positive momentum in the coming quarters.

In the government segment, our purpose-built portfolio of assets continue to serve the critical humanitarian aid mission they were designed to support while exceeding the expectation of our partners and the U.S. government for nearly a decade. As an example, during the quarter, our Pecos Children's Center community seamlessly responded, as designed, to an increase in demand for our critical hospitality solutions. This validated the influx care facility concept, illustrating the government's essential need for adequate capacity to properly respond to dynamic changes in the number of unaccompanied children arriving in the U.S., further exemplifying Target's role as a proven and trusted provider supporting critical humanity missions.

We are pleased to announce this week, our nonprofit partner was awarded a contract for the continuation of the ICF at our PCC immunity, solidifying its continued presence serving this critical humanitarian mission. The contract award is a continuation of the five-year indefinite delivery, indefinite quantity contract which was awarded to our nonprofit partner earlier this year. In total, this contract provides the government the ability to seamlessly ensure continuity of the service offerings at PCC through 2028.

This award solidifies PCC as one of the only influx care facilities in the United States and would represent eight years of continuous comprehensive humanitarian services. We look forward to continuing our long relationship supporting our partner's humanitarian mission at the longest running purpose-built ICF in the United States.

With this week's contract award, we are actively working to finalize Target's contract specifications with our nonprofit partner under our 11-year exclusivity agreement. We look forward to providing additional contract details, including specific economic terms, as they become available in the coming weeks.

As we previously announced, the government has outlined their desire to expand their ICF network to accommodate up to 10,000 individuals, requiring multiple new ICF communities. Target remains actively engaged and continues to build strategic partnerships to jointly pursue the creation of new ICF sites not currently in the government's portfolio.

As the government has continually stated, additional humanitarian housing capacity is urgently needed to manage the increasing number of unaccompanied children arriving in the U.S. We believe Target is well positioned to pursue these opportunities, and we look forward to continuing to support the U.S. government in their humanitarian missions.

In summary, we remain focused on sustaining the momentum we have created over the past several years. We have established a strong financial and operating platform to continue supporting our world-class customers while simultaneously pursuing the most robust growth pipeline we have seen in many years.

I'll now turn the call over to Eric to discuss our third quarter financial results, recent balance sheet initiatives and expanding strategic growth opportunities in more detail.

Eric Kalamaras: Thank you, Brad.

In the third quarter, we continued to benefit from our operational efficiency and scale, which allows us to seamlessly align with customer demand while consistently delivering strong financial results.

Third quarter 2023 total revenue was $146 million, and adjusted EBITDA was $95 million. Our government segment produced quarterly revenue of approximately $106 million. And as a reminder, this segment's revenue is centered around committed minimum revenue contracts. The sequential increase in revenue was driven by occupancy-based variable revenue at the PCC community.

Our HFS segments delivered quarterly revenue of $40 million, compared to $36 million in the same period last year. This increase was driven by sustained momentum in customer demand for Target's premium service offerings.

Recurring corporate expenses for the quarter were approximately $9 million. And we anticipate these will remain around $9 million to $10 million per quarter for the remainder of the year. Total capital spending for the quarter was approximately $13 million, with the majority related to enhancing assets focused on supporting the government's humanitarian aid mission. We anticipate minimal capital spending for the remainder of the year.

We ended the quarter with $105 million of cash and $23 million of liquidity, with zero borrowings under the company's revolving credit facility and a net leverage ratio of 0.3x. Excluding acquisitions, 2023 capital spending should approach more normal levels between $30 million and $35 million per year, predominantly focused on organic growth.

We continue to make meaningful progress in achieving a net debt-free balance sheet and anticipate over $315 million of total available liquidity by year-end 2023. Our 2023 outlook includes revenue between $550 million and $580 million and adjusted EBITDA between $346 million and $365 million.

Following the quarter, we took additional steps to create a more efficient capital structure and maximize flexibility as we continue to evaluate an expanding pipeline of growth initiatives. We significantly increased our liquidity profile for a $50 million expansion of our credit facility, which now has total available capacity of $175 million. Further, we prudently managed our maturity timeline with the completion of an exchange offer for 9 1/2% in new notes. The offer resulted in $181 million of new 10 3/4% in new notes due June 2025. We have subsequently announced a redemption notice for the remaining $29 million of 9 1/2% in new notes to be redeemed with cash in hand.

These prudent liability management initiatives are a continuation of our focused commitment to strengthen our balance sheet while optimizing financial flexibility. This focus provides the foundation to quickly react to strategic growth initiatives, which have supported a more than 150% increase in revenue and $550 million of cumulative discretionary cash flow within the past three years alone, all while reducing total indebtedness by 90% during that same time.

This materially strengthened balance sheet and optimized liquidity position creates the ideal scenario for Target to continue pursuing an expanded pipeline of strategic growth initiatives, including both organic and inorganic opportunities. These opportunities are designed to jointly leverage Target's operating expertise and existing core competencies to create a number of solutions across various U.S. government agencies and commercial applications for projects that support national defense, energy transition and humanitarian emissions.

These opportunities encompass Target's existing full turnkey hospitality solutions as well as select opportunities to broaden Target's value chain participation through individual elements of our existing core competencies. These solutions are focused on extending value chain participation to become a more fully integrated provider of these unique offerings, from immediate and urgent need to long duration and permanent solutions. We view these opportunities as a seamless extension of our existing service offerings and supporting a high consistent return on invested capital. As previously stated, Target is prepared to allocate over $500 million of net growth capital to these high-return opportunities over the next several years.

We are pleased with the progress and discussions for many of these large scale projects and look forward to providing additional updates in the coming quarters as the opportunities progress.

With that, I will turn the call back over to Brad for his closing comments.

Brad Archer: Thanks, Eric.

Our impressive third quarter results are a testament to the operational efficiencies and scale we have created, enabling us to appropriately match customer demand while simultaneously generating strong financial results. Since 2021, we have taken intentional steps to diversify the business while simultaneously high-grading contract structure and revenue visibility. This week's contract award for PCC is a continuation of these strategic initiatives, further supporting the enhanced operating platform we have established.

We are well positioned to optimize financial flexibility and the strongest pipeline of growth opportunities we have seen in many years. We are excited to continue pursuing these value-enhancing initiatives, focused on accelerating value creation for our shareholders.

I appreciate everyone joining us on the call today. And thank you again for your interest in Target Hospitality.

Questions and Answers

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Scott Schneeberger with Oppenheimer.

Unknown Analyst: It's Danny on for Scott. Could you please address the potential duration of the contract, how it could look if we're talking about one-year extensions, five-year extensions? Please elaborate on that, please.

Brad Archer: Daniel, this is Brad. It's a five-year agreement with four option periods on top of the base period, is how it's structured. If you look at this, there are some annual appropriations. This is no different than our contract on the South Texas Family Residential Center, which is in its ninth year. So very typical in what we see in these contracts.

I think the positive thing here is when you look at the government, they've taken three years to really design the system, if you will, this ICF program. Then they came out with the IDIQ. And the biggest reason is this is going to become part of their long-term solution. It's their new program. It's the ICF. As we know there are still bids out there for more. So they're still building out this program under this IDIQ platform.

Unknown Analyst: Got it. Thank you. I recognize you're still discussing the economics. But how should we think about the potential structure here? Could it be something similar to what you have currently with the fixed component and a variable component? Any thoughts there of the potential structure would be helpful.

Eric Kalamaras: It's Eric Kalamaras. A couple of things on the structure of the contract. So it will have generally the same look and feel as the existing contract that PCC has. So there will be a minimum revenue component. There will be the variable revenue component. There can be slight shifts in mix between those and what we have today. So there will be some slight

modifications in that, but I think there is also the opportunity for it to be even more economically attractive in some ways than on the existing contract.

So look, stay tuned on that. We're still in the process of finalizing our portion of this. But I think, generally speaking, what you know regarding PCC as it relates to the contract structure, I don't think you'll find anything materially different as it relates to that. So it's got all the same elements, the same look and feel. But there will be some slight modifications in index.

Scott Schneeberger: Got it. Thank you. Final one for me, please. How do you think about the potential for incremental contracts at this point?

Brad Archer: Yes. Look, as I said first, they're still building out this program. If you look at their weekly report that I think most people look at now, they continually say they don't have enough beds. Well, we know there's a third ICF out there that should be awarded sometime first half of next year. We're definitely bidding that. We're working on that. So we look for this program to continue to grow, and again, continue on as one of their long-term solutions for the unaccompanied children.

Operator: [Operator Instructions] Our next question comes from Stephen Gengaro with Stifel.

Stephen Gengaro: Congrats on this award. I guess a couple of things for me. But first, when you guys internally think about allocating capital to growth opportunities, from our seat, we think about the government business having a lot of visibility, which gives you the flexibility to invest growth capital with known free cash flow coming. Does the terms of this deal, one-year versus five-year, impact the way you think about the visibility of that free cash flow and investment in other opportunities?

Eric Kalamaras: Stephen, look, I think anytime you have a business that generates a such a large percent of the cash flow, you always have to take these sort of things into consideration. But here's the other thing that we all would ask you to think about, too, is this is wrapped up in a five-year IDIQ, which is basically the multiyear funding vehicle for it. So look, so that in and of itself provides a much greater degree of confidence.

But look, we look at this long term. And I think fortunately, we're in an envious position where our cash generation is really very strong. And so when we look at opportunities for projects, we're always going to look at this through the life cycle. And we're going to look at whether that is a project on the HFS side or whether it's a long-term project, it needs to meet the hurdles of not only the return, but also the minimum revenue commitment that's tied to it. And so that's how we're going to think about any additional capital deployed. And that has not been different, frankly, from the way the company has operated for over a decade.

Brad Archer: Yes. And just specifically on this government contract, we can get into all the five-year agreement and the base period, the option. That's very typical, the annual appropriations or how we're set up in Dilley. It's been a nine-year contract. Internally, when we assess these, this is not one we look short term. Yes, it has yearly funding. But that's been typical on every

government contract we have done. So we're not sitting in here looking at this as short term. We're looking at these as a long-term solution for the government.

Stephen Gengaro: Great. And on a similar -- along similar lines, it would -- therefore, it doesn't change the way you think about how much cash you may be willing to return to shareholders as well?

Eric Kalamaras: Well, I think that question really goes in concert with how you look at deploying capital writ large, whether it's shareholders or whether it's to enhance the business for the growth profile. Look, all that has to work in concert. And so I don't look at those as, really, a mutually exclusive decision, Stephen. I mean, those all have to go together.

As Brad mentioned, we have the most active -- not only organic pipeline, we have the most active inorganic pipeline we've had in years as well. And I'll tell you that there are a lot of strategic decisions that will be made coming up on that. And so stay tuned. But look, this all has to go together and all has to go in concert with the growth of the business.

Brad Archer: Well, let's be clear. The first one is to get the five-year contract.

Eric Kalamaras: That's first step.

Brad Archer: And that's done. So we can move forward.

Stephen Gengaro: Got it. Okay. Is it a reasonable -- I think us and others we talk to have thought about '24 as contained similar economic contribution from Pecos as '23, excluding the CapEx reimbursement. Is that a reasonable starting point still?

Eric Kalamaras: Yes. Look, I think, again, there will be a shift in mix. So we do have to bear that mind. And we're a little too early to be talking about that specifically. I think the other thing we have to think about is the variable revenue contribution has to be considered as well as to what that looks like. But again, the concept is not going to be drastically different.

And so look, at this point, I wouldn't look to change things meaningfully because, again, the construct is roughly the same. And it's going to have the same mechanisms and the same components to it. But again, it's a little too early for us to get too specific as to what that looks like going forward.

Stephen Gengaro: Excellent. Thanks. And then just one final one on the HFS side. When we see what's going on with activity levels in the oil patch, and we've had a lull here. We've gotten mixed comments about seasonality, et cetera. But there seems to be a consensus that '24, you're going to start to get at least some level of recovery in activity, particularly in the Permian. Do you see that in your conversations with your customers? Or any color on what you're seeing on that front?

Brad Archer: Yes. In some of the conversations, Stephen, that I've been involved with on the sales side, I agree. '24, they're saying that they should see an uptick in some of the work. And

what we would hope is we get a portion of that. I think it's going to be minimal. I think we're pretty well maximized at our locations. But look, I think it will be -- as good as a year as it was this year, it may be a little better.

Operator: The next question comes from Greg Gibas with Northland Securities.

Greg Gibas: I think a few of mine have been answered. But just wanted to -- you mentioned that it could be more favorable. And obviously, we can't get into the specifics. But is that in the relation to the mix of minimum revenue components versus variable revenue, are you saying? It's just going to be possibly more favorable mix?

Eric Kalamaras: Sure. No, that's a great way to describe it. I wouldn't change anything that you said. Again, it comes down to the mix. So it comes down to putting surety in place for the minimum revenue portion. And then you've got the [verba] piece, which offers even greater upside potential. So that's how I would describe it.

Greg Gibas: Sure. That's fair. And as we think about it being finalized, those specifications, is there risk to just carrying forward the existing economics? Because I know the existing contract is up in about a week here. So until everything is finalized, would we just assume that existing economics roll forward?

Eric Kalamaras: Correct. So from a technical perspective, nothing changes economically until the contract is under the new terms. So that's a process we have to go through. So right now, don't change anything as it relates to the existing contracts.

Greg Gibas: Okay. Perfect. And then just lastly, assumptions into Q4 guidance or for the year. Just assuming similar occupancy levels seen today through the rest of the quarter? Or any notable changes in your assumptions there?

Eric Kalamaras: No. Look, I don't think so. I think I would offer -- I think I feel like I do this every year about this time. I always offer the gentle reminder that the HFS does get a little bit of seasonality towards the tail end of the Q4 period. It's not a lot, but it's a couple of hundred basis points in margin. So it's something at least to be aware of. Look, beyond that, I don't think there's anything meaningful to be expected out of Q4 that we really didn't see in Q3.

Operator: As we have no further questions, this concludes our question-and-answer session. I would now like to turn the conference back over to Brad Archer for any closing remarks.

Brad Archer: Thanks again for joining us on the call today. And we look forward to speaking again after the first of the year. Have a good day.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may all now --