Q2 2023 Earnings Call

Company Participants

- David Noble, Chief Financial Officer
- Jeffrey Eberwein, Executive Chairman of the Board
- Richard Coleman, Chief Executive Officer & Director

Other Participants

- Tate Sullivan, Managing Director & Senior Industrials Analyst
- Theodore O'Neill, Chief Executive Officer & Research Analyst
- Unidentified Participant, Analyst

Presentation

Richard Coleman {BIO 1497461 <GO>}

Thank you, operator. Good morning, everyone. Thanks for joining us for our second quarter 2023 results conference call. On the call with me today are Executive Chairman, Jeff Eberwein; and our Chief Financial Officer, Dave Noble.

It's a pleasure to be with you today and update you on our second quarter performance. It's especially gratifying to report on the previously announced sale of our Healthcare division and its dramatic positive impact on our. We completed the divestiture of our Healthcare division, which operated as Digirad Health for $40 million on May 4. This was a truly transformative transaction, which created immediate shareholder value significantly strengthened our balance sheet.

We ended the second quarter with a cash balance of $21.4 million and 0 debt, leaving us in a much stronger position to execute on our next stage of growth, including bolt-on and new business acquisitions, and the ability to thoughtfully explore new opportunities within our Investments division.

In addition to having $21.4 million of cash and no debt, we also have a $6 million equity position in TTG Imaging Solutions, the successor company to Digirad, $8.5 million in notes receivable, a $4.8 million public equity portfolio and $5 million of real estate. All of this is in addition to our valuable and growing Construction businesses.

second quarter of 2023, revenue decreased 47% to $8.9 million versus $16.8 million in the second quarter of 2022, while gross margin percentage increased to 29.3% versus 14.4% in the same period last year. The primary driver for the revenue shortfall was project timing, which, in addition to normal variability was impacted by interest rates and macroeconomic uncertainty.

Despite lower in the period, the division's gross margin percentage more than doubled versus same period last year, due to quality execution and management's ability to maintain pricing levels, while controlling input costs. We remain confident in the division's ability to continue delivering good results based on a healthy sales pipeline as well as a significant project backlog.

As with any construction-related business, revenue and expense recognition can vary greatly from project to project and quarter-to-quarter, and we caution investors to not read too much into single period results. Year-to-date, gross profit increased by 75.8% versus the first six months of the year, and we maintain our mid-20s or higher gross margin percentage target for our Construction division.

Despite the economic headwinds across the Construction space at large, our reputation as a reliable and high-quality tier in select markets gives us a unique and sustainable position. Our reputation is strong and growing in the geographies we serve and we're continuing to target expanding opportunities in workforce and affordable housing, educational dormitories and school buildings and environmentally sustainable housing.

Heading into the second half of the year, we expect to maintain or grow our backlog. In addition, our management teams continue to improve our manufacturing processes and strengthen our relationships with all of our clients and partnerships.

Now I'll turn the call over to Dave Noble, our CFO to provide additional second quarter consolidated financial highlights. Dave, please go ahead.

David Noble {BIO 2268081 <GO>}

Thank you, Rick. Good morning. Let's now turn to Star Equity's consolidated financial results. I would like to note that due to the sale of our Healthcare business on May 4, as Rick mentioned, all results and historical comparisons relate only to continuing operations, which include Construction and Investments.

Digirad Health is now reported as part of our discontinued operations. In Q2 2023, SG&A were 31.7% versus Q2 2022. This was due to transaction-related costs related to the sale of Digirad Health as well as increased activity at our Investments division.

Moving on to bottom line results for Star Equity. We generated a net loss from continuing operations of $1.4 million in Q2 compared to a net loss from continuing operations of $1.3 million in Q2 of 2022. Non-GAAP adjusted net loss from continuing operations in Q2 was a $0.9 million compared to an adjusted net loss of $0.8 million in Q2 of 2022.

Non-GAAP adjusted EBITDA from continuing operations decreased to a negative $0.8 million in Q2 of 2023 from a negative $0.4 million in Q2 of 2022. Construction generated non-GAAP adjusted EBITDA of positive $0.7 million in Q2 this year, down from $1.3 million in Q2 of 2022. For the year-to-date period, non-GAAP adjusted EBITDA from continuing operations improved to a loss of $36,000 from a loss of $1.5 million in the first half of 2022.

Consolidated cash flow from continuing operations for Q2 was a negative $3.3 million versus a positive $3.6 million in Q2 of 2022. This was driven by transactions related costs for the sale of Digirad, increased investments-related expenses as well as working capital-related changes. For the year-to-date period, consolidated cash flow from continuing operations was a positive $1.9 million compared to a positive $2.9 million in the prior year period.

As of June 30, 2023, our consolidated balance sheet and liquidity were strong. As a result of the sale of our Healthcare business, as was mentioned on May 4, we had 0 interest-bearing debt remaining and a cash -- our cash balance stood at $21.4 million at the end of Q2. Now I'd like to turn the call back to Rick to add some additional remarks.

Richard Coleman {BIO 1497461 <GO>}

Thanks, Dave. The Digirad sale was a monumental change to our business. The team worked diligently on this for several months with an impressive result for our shareholders.

However I don't want to overlook the exceptional work that's being done in both of our Construction businesses. Strong leadership, along with disciplined planning and execution, gives us confidence in the potential for continued strong performance and growth.

The Star Equity Board and management team are fully focused on creating additional shareholder value through our targeted business development initiatives. We'll continue to assess and prioritize the next steps of our growth strategy. We look forward to sharing more details with shareholders as our plans evolve. I'll turn the call over to the operator now for questions.

Questions And Answers

Operator

(Operator Instructions) Our first question comes from Tate Sullivan with Maxim Group.

Q - Tate Sullivan {BIO 16100420 <GO>}

I mean just looking where the stock is. I mean and your book value per share less the preferred with an equity are at a little above $3. I mean can you give more detail on the value you realized in your Healthcare business? I mean $27 million in the quarter from income from discontinued operations, was that all the gain on the sale of Digirad or was some of that a loss on operations or income from operations since you sold it in the quarter, please start there?

A - David Noble {BIO 2268081 <GO>}

Yes. Thanks, Tate. The actual gain from the sale was $26 million for the sale of Digirad. In terms of value realized, we -- the cash portion of that, we also have $6 million in equity in the entity that we sold Digirad too, and $7 million of Seller's now. So we believe that we realize a tremendous amount of value. It may not be completely reflected in our stock price, but we cleaned up the balance sheet, we really set up a platform for growth with no debt and a lot of cash.

A - Richard Coleman {BIO 1497461 <GO>}

Yes. Tate, this is Rick. I would add that we really hard for the equity. We believe in the strategic plan that TTG has going forward, and we're excited to be a shareholder.

Q - Tate Sullivan {BIO 16100420 <GO>}

You have a slide in your presentation this morning on the -- I mean that you realized roughly around $63 million of value through the Healthcare division through going back to 2018. Internally, do you look at it as a multiple of invested capital on the cash that you've outlaid in that business? Or do you have that figure available?

A - David Noble {BIO 2268081 <GO>}

We don't. We can certainly try to put that together for you, Tate, but we don't have that available.

Q - Tate Sullivan {BIO 16100420 <GO>}

But suffice to say I mean you grow up to the $60 million, $50 million, okay I can figure out the cash, I'll let it through that. Then what is your current investment portfolio value or not current as of 6/30, is it -- I'm scanning through? And how many -- have you disclosed how many unrealized gains or profits are in that portfolio?

A - Jeffrey Eberwein {BIO 15257673 <GO>}

Tate, this is Jeff. So on the investment -- yes, on the investment portfolio under GAAP, we mark that to market every quarter. So the value that's in the investor deck that we published this morning will match what's in the 10-Q that's going to be filed soon as well as what's on our balance sheet at the end of June, and that's just all based on the marketplace for those securities. So it's a -- in the footnote, it's all kind of Level 1 assets.

Q - Tate Sullivan {BIO 16100420 <GO>}

Okay. I'll look for that. Then you talked about some available real estate before to potentially expand the KBS footprint. Are you -- do you have any real estate available for sale? Because I think you've given us a figure before that the real estate appraised value is much higher than on your books, and I'm just looking for it now as well?

A - David Noble {BIO 2268081 <GO>}

Yes. Yes. So we I think the recent appraisals, the most recent appraisals of the real estate are around $5 million, but these are old appraisals and that's just for the two factories that we retained. We did sell a third factory during the quarter that we really didn't see any useful and that was the smallest of the three. But we believe the market value of those two remaining facilities is significantly above where we have it booked, that's point one.

Point two is we have significant upside in that business. We're operational in one of those two factors. We believe that the other factory would have a similar throughput to what we're able to do in the first one. So we have significant upside potential with the factories that we own.

A - Jeffrey Eberwein {BIO 15257673 <GO>}

Tate, this is Jeff, that's may or may not be helpful, but there's kind of three different numbers to think about. One is what's the market value, which you don't know until you actually go to sell real estate. Then you have the appraised value, which was done by a third party, and that was for our credit lines, and that was done in 2019, and that's what's in our investor deck. Then you have our actual book value.

And so if this is helpful, the third factory that Dave was just talking about, we sold it for approximately $1.2 million. That was its appraised value. Then if you look at financials or like the adjusted EBITDA table, you'll see a gain of $424,000, so that gives you a sense of what the book value was.

And so the appraised value is higher than the book value, and we're saying we think the market value of those assets is at least the appraised value (inaudible) higher.

Q - Tate Sullivan {BIO 16100420 <GO>}

Then last for me is on the Construction gross profit margin consistently well above 20% for the last four quarters. It sounds like you have a good backlog in that business based on the visibility of the projects. Is that still -- it seems like that -- can you maintain this type level of gross profit margin recently? I think what historically, you said a target of greater than 20%. Is that still the case?

A - Richard Coleman {BIO 1497461 <GO>}

Yes. Our target remains mid-20s or higher.

Operator

Our next question comes from Theodore O'Neill with Litchfield Hills Research.

Q - Theodore O'Neill {BIO 1522888 <GO>}

Rick, probably I'll use a little guidance on the revenue going out. Is it going to be a variable around the current quarter's level? Or does it vary between the current quarter and the year ago quarter. If you could give us any kind of sense for that?

A - Richard Coleman {BIO 1497461 <GO>}

Yes, that's one of the challenges of the Construction business. Every quarter is different. If you think of a quarter as being a portfolio of projects, we can have one quarter with a smaller number of very large projects. That impacts our financials much differently than a quarter that had a large number of smaller projects. So sometimes the -- our revenues and our profits don't fall into the quarter that they may have if we had a different project portfolio.

A - Jeffrey Eberwein {BIO 15257673 <GO>}

And Theo, this is Jeff. I would just add, the production flow is typically fairly steady by revenue recognition has gotten a lot of scrutiny in recent years, and there's a lot of different rules around when we recognize revenue on projects. It just causes the revenue recognition to be lumpier than our actual production. In a way if you look at a rolling four-quarter average or you look at last year's results, I mean we think we have a business that should do $50 million to $60 million of revenue a year. It's kind of nice growth trajectory to it.

Of course it can be a cyclical business, but we think we're in a growthy part of construction with a lot of the themes that we've talked about. Factory built, we think is going to take share, and there's a lot of emphasis on workforce housing, environmentally friendly housing and we have great products for that.

So we think there's some secular growth characteristics in what can be a cyclical business. We would just caution people to not read too much into any one quarter's revenue. If you took any one quarter and multiply it x4, you get a lot more volatility than you would if you just look at like a four-quarter average.

Q - Theodore O'Neill {BIO 1522888 <GO>}

Okay. Fair enough. And are you disclosing what the backlog is?

A - Richard Coleman {BIO 1497461 <GO>}

No. We haven't really disclosed the details in the backlog.

Q - Theodore O'Neill {BIO 1522888 <GO>}

Does it get disclosed annually? Is that what it is, not just not quarterly?

A - Richard Coleman {BIO 1497461 <GO>}

Well we have some information in our investor deck that we filed this morning. Fairly consistently, we've had a sales pipeline of $50 million or greater. That's been pretty consistent for a year or two now. That doesn't mean we're going to win every one of those projects, but that's kind of a leading indicator to our backlog.

And I guess just the point we're trying to make on that is that our sales pipeline has been pretty consistent. Our backlog has been pretty consistent. What's not consistent is the quarterly revenues just because of the revenue recognition rules. So our businesses isn't nearly as lumpy as the quarterly revenue ups and downs would imply.

Operator

Our next question comes from Mark Ross [ph] with Aegis.

Q - Unidentified Participant

Yes. I'm just a little perplexed as to being where the stock price is, you guys wouldn't be buying back some stock.

A - Jeffrey Eberwein {BIO 15257673 <GO>}

Yes. This is Jeff. We think the stock is dramatically undervalued relative to NAV. The window isn't open as often as you might think it is. It all depends on what we have going on. But there has been significant insider buying if you look at last quarter's activity. That's a tool in the toolkit. We have bought back stock historically. And as a microcap, we also need to focus on just having more critical mass as a company.

So the Board thinks about those things all the time and talk about those things and our focus is growing value per share and stock repurchases, we agree is one way to do that.

Operator

Our next question comes from Kevin Excell [ph] with North First [ph].

Q - Unidentified Participant

I just kind of to follow-up with that last question. How do you guys look at your internal hurdle rate or IRR compared to some of your potential microcap investments versus buying back shares?

Then as I understand it, some of the stories you need to get to scale and maybe make your currency -- your equity attractive as a currency for a roll up. Is that kind of your view on how this might work and how maybe some thought on how you get there?

A - Jeffrey Eberwein {BIO 15257673 <GO>}

Yes. A lot of things in there. This is Jeff again. The primary focus is growing value per share and everything else as it means to that end. So when we make investments, whether it's a CapEx investment in our Construction division, or in any other investment is definitely going to have a high -- higher return.

We think buying back stock has a high return. We think getting more scale adds value. You definitely see in the private market a strong correlation between multiples of businesses and size. Multiples tend to go up as you get to size.

So for example, not that we're trying to get bigger just for the sake of getting bigger. But if -- in theory, we could double our Construction business and the revenue was more like $100 million instead of $50 million. The multiple at which we could sell that business at would be higher than for what it is today which is a $50 million revenue business.

And that was one of the reasons why we've made the decision to sell the Healthcare business. We were doing about $50 million to $60 million in revenue. We didn't see a path to get to $100 million unless we were willing to aggressively make acquisitions. We just didn't think that was an attractive return on capital.

So we made the decision to merge it with another business, got cash, got sellers note and also got equity in that new entity. So I think over the long-term, you don't see us buy things and sell things, and it's all driven by our expectation for internal rate of return with the goal of maximizing value per share over the long-term.

Operator

(Operator Instructions) Our next question is a follow-up from Tate Sullivan with Maxim Group.

Q - Tate Sullivan {BIO 16100420 <GO>}

I think you've talked about the revenue capacity in Construction before it does not include opening the other facility. Is it just a matter of flexing up the labor? Or have you mentioned a revenue capacity number or unit capacity before, please?

A - Richard Coleman {BIO 1497461 <GO>}

Yes. Tate, so as we continue our growth, our first step, I think in the existing factory would be to add another shift to extend the work hours and be able to get additional production that way. But as we expand into other related businesses, it could be expressed manufacturing or cabinetry or related things that we currently do associated with building modules, then we would expand into the other factory.

On top of that, we're looking at a number of different alternatives to partner with other companies and potentially get that factory open and producing additional revenue.

A - David Noble {BIO 2268081 <GO>}

Yes. The only thing I would add is we believe we have the facilities to more than double that modular revenue, which is about half of our total Construction revenue today.

A - Richard Coleman {BIO 1497461 <GO>}

We've probably got 25% to 30% additional capacity in our current plan.

Q - Tate Sullivan {BIO 16100420 <GO>}

Okay.

A - Richard Coleman {BIO 1497461 <GO>}

Without having to expand them today into the other factory.

Operator

That concludes today's question-and-answer session. I will now turn the call back over to Rick Coleman for closing remarks.

A - Richard Coleman {BIO 1497461 <GO>}

Thank you, Operator. Before concluding the call, I want to note that we're always available to take your call and discuss any additional questions you might have. So please don't hesitate to contact us. We'll continue to share our story with existing and potential investors in the coming weeks and months. And as always, we appreciate all of our shareholders and your continued feedback and support. Thank you.

Operator

Thank you for joining the Star Equity Holdings second quarter conference call. Today's call has been recorded and will be available on the Investors section of our website www.starequity.com.