

Target Hospitality Corp.
Q1 2022 Earnings Call
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Officers and Speakers

Mark Schuck, Senior Vice President of Investor Relations and Financial Planning

Brad Archer, President and Chief Executive Officer

Eric T. Kalamaras, Chief Financial Officer

Troy Schrenk, Chief Commercial Officer

Analysts

Stephen Gengaro, Stifel

Greg Gibas, Northland Securities

Presentation

Operator: Good morning, and welcome to the Target Hospitality's First Quarter 2022 Earnings Conference Call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please note this event is being recorded.

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

Mark Schuck: Thank you, and good morning, everyone, and welcome to Target Hospitality's First Quarter 2022 Earnings Call. The press release we issued this morning outlining our first quarter results can be found in the Investor 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 this press release. The 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, May 10, 2022.

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 table 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 be joined by Troy Schrenk, Chief Commercial Officer, and open the call for questions.

I will 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. Target's first quarter results continue to exemplify the strength of Target's operating position, which continues to benefit from positive momentum and customer activity across Target's premier network of communities. Target's top-tier customers continue to find added value in the size and scale of our network, which provides premium hospitality solutions and unmatched logistical flexibility for their labor allocation requirements.

Our superior operating capabilities and world-class network has supported a 65% increase in customer demand since the first quarter of 2021. Additionally, the intrinsic value of Target's network has supported an over 90% customer renewal rate for more than 6 years. These strong demand fundamentals and superior operating capabilities allow Target to efficiently respond to increasing customer demand, while generating top-tier operating margins and strong financial results.

Target's HFS segment continues to benefit from its premium network and world-class service offering. These elements have supported continued strength in customer activity, resulting in 6 consecutive quarterly increases in HFS South customer demand.

Additionally, these strong demand fundamentals and Target's strategically-located communities supported the reopening of previously-idled assets during the first quarter of 2022. We anticipate consistent increases in customer activity throughout 2022, and are well positioned to benefit from this positive momentum across our network.

Additionally, Target continues to benefit from its increased concentration of critical humanitarian support services it provides to the United States government. Target's Government segment represented over 58% of first quarter 2022 revenue, supported by fully-committed minimum revenue contracts backed by the U.S. government. This is a clear illustration of our commitment to diversify and expand Target's end markets, while high-grading counterparty exposure and contract structure.

These accomplishments have allowed Target to materially enhance its financial strength, while simultaneously diversifying its business mix and establishing a foundation to continue pursuing strategic growth initiatives. These growth initiatives are focused on broadening Target's end markets, while significantly expanding our long-term growth opportunities. Target will pursue these initiatives while also remaining focused on expanding the critical support services it

provides to the United States government.

Target has intentionally established itself as the premier provider of permanent hospitality solutions for the U.S. government long-term domestic humanitarian aid missions. Target's premier and comprehensive service offering is viewed favorably by the U.S. government, and our scale and operational capabilities are unmatched in North America.

As it relates to our latest government service contract, which began in March of last year, we continue to have active discussions regarding the extension of this contract. These discussions include the potential for a meaningful increase in contract scope due to continued strong demand of Target's critical service offering.

Additionally, the U.S. government has recently outlined its intention to expand capacity and enhance capabilities to address its ongoing domestic humanitarian aid mission. As part of the U.S. government's plan, there has been a fiscal year 2022 annual appropriation of approximately \$8.8 billion. This annual appropriation illustrates the magnitude of the humanitarian aid mission and the volume of resources needed to appropriately respond.

We continue to work diligently with our customer on finalizing contract terms, and are highly confident in the successful outcome to these contract discussions. We are encouraged by the sustained momentum experienced in the first quarter of 2022, and believe we are well positioned to continue benefiting from our strategic position as North America's leading provider of comprehensive hospitality solutions and value-added services.

I will now turn the call over to Eric to discuss our first quarter financial results and ongoing growth initiatives in more detail.

Eric T. Kalamaras: Thank you, Brad. In the first quarter, we experienced continued strong demand fundamentals and positive momentum in customer activity. First quarter 2022 total revenue was \$80 million and adjusted EBITDA was approximately \$33

Our Government segment produced quarterly revenue of approximately \$47 million, compared to \$18 million in the same period last year. The significant increase was attributable to an additional U.S. government contract award executed in March of 2021, which contributed approximately \$33 million of revenue in the quarter. As a reminder, Target's Government segment is supported to minimum revenue contracts, which are fully backed by the U.S. government.

Our HFS segments delivered first quarter revenue of \$33 million, compared to \$26 million in the same period last year. This increase was driven by sustained momentum in customer demand for Target's premium service offerings, supported by strengthening economic fundamentals.

While Target has significantly grown its revenue and adjusted EBITDA over the past year, we have remained diligent in appropriately managing cost components. We take an active approach to managing our input costs and benefit from our service offering flexibility, which allows us to

adjust primary cost components to mitigate pricing pressure. As a matter of practice, Target maintains a disciplined approach to managing costs across the organization, and this provides significant flexibility which has allowed Target to preserve margins through a variety of operating environments.

Recurring corporate expenses for the quarter were approximately \$7 million. As a result of this scalable business model, we anticipate recurring corporate expenses to remain around \$7 million to \$8 million per quarter through 2022.

Total capital expenditures for the quarter were approximately \$4 million. Target continues to benefit from an efficient operating structure and scalable business model, which has allowed the company to match increasing customer demand with little incremental capital requirements.

We ended the quarter with \$6 million of cash and total available liquidity of \$115 million, including \$109 million available under the company's \$125 million revolving credit facility. The company has remained focused on preserving financial strength is achieved over the last few years, and has a leverage ratio of 2.6x which represents a 60% improvement from the first quarter of 2021.

We are excited about the continued strength in customer activity we experienced during the first quarter, and anticipate the cadence of customer demand to continue as we progress through 2022. Additionally, we are pleased we are pleased with the progress made in contract discussions regarding the extension and expansion of our 2021 humanitarian aid contract award. These discussions have evolved to include the potential for a significant increase in contract scope, for the expansion of existing facility amenities through the strong, continued demand for this critical service offering.

The United States government has recently published a detailed summary outlining the capacity and facility requirements for its domestic humanitarian aid program, which encompasses the services Target has continued to provide as part of the 2021 contract. This summary outlines the anticipated increases in scope needed to support the existing program. The U.S. government has allocated a meaningful amount of resources to addressing this ongoing humanitarian crisis, including the appropriation of approximately \$8.8 billion for unaccompanied children in fiscal 2022 alone, highlighting the critical nature of the humanitarian support services Target is providing.

As a result, Target has executed short-term contract extensions to ensure the continuity of our critical services while contract terms are being finalized. The economics of these short-term contract extensions reasonably mirror the terms of the original contract award, and will remain in place until final contract execution.

As a reminder, the government's direct prime counterparty to this contract is a leading national nonprofit organization. Target is the subcontractor to this agreement, providing comprehensive hospitality solutions to our nonprofit customer through a fully committed contract backed by the

U.S. government. As a result of Target's and our customers' past performance, we are pleased with the direction of contract renewal and extension discussions, and look forward to providing additional information in the foreseeable future.

As a result, we have reiterated our preliminary 2022 financial outlook, which consists of revenue between \$325 million and \$335 million, and adjusted EBITDA between \$125 million and \$135 million, with \$12 million to \$17 million of capital spending. Our preliminary outlook is representative of Target's current business operations only. We intend to provide an updated 2022 financial outlook to appropriately reflect the outcome of the contract renewal and extension discussions.

Target has strategically positioned itself as North America's leader in premier modular accommodations and hospitality solutions. Our superior network and capabilities create a highly scalable and efficient operating structure. These attributes support robust operating margins and strong cash flow generation, creating an ideal scenario to simultaneously pursue strategic growth aspirations, focused on expanding Target's long-term growth opportunities. Our strategic growth initiatives are centered around the strength in Target's existing core service offerings, which offer the opportunity to unlock value through unique elements of our core competencies.

Our established presence within the government services end market creates a platform to expand our unique offering to other agencies and geographies. Additionally, our unique capabilities offer opportunities to enter adjacent commercial end markets. The elements of Target's holistic hospitality solutions naturally translate across a wide range of commercial and industrial applications, including disciplines such as construction and facilities management, modular solutions, hospitality services and logistics.

The foundation of our existing network and broad-reaching capabilities creates a platform to pursue these opportunities with limited capital requirements, create impressive return on invested capital, while simultaneously preserving the financial flexibility we have created. These characteristics of our growth strategy meaningfully increase revenue visibility and strengthen economic returns, while enhancing Target's unique value proposition. We believe these attributes significantly increase Target's long-term growth pipeline and creates opportunity to accelerate value creation for our shareholders.

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

Brad Archer: Thanks, Eric. Our strong first quarter results illustrate Target's ability to efficiently meet our varying customers' needs, while positioning the company to continue pursuing value-enhancing growth opportunities. We are excited about the sustained momentum experienced during the first quarter, and believe we are well positioned to continue benefiting from strong customer demand throughout 2022.

We remain committed to pursuing strategic initiatives focused on expanding our long-term growth initiatives, which we believe creates the greatest opportunity to accelerate value creation

for our shareholders.

Before we wrap up, I want to comment on the leadership transition we announced earlier this year. The transition has continued in a normal business course. And the Board of Directors has commenced an executive search process. As this process continues, I will continue to lead the company in my current role until December 31, 2022. We will provide additional information on the transition and executive search as they become available.

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). Stephen Gengaro with Stifel.

Stephen Gengaro: A couple of things for me, if you don't mind, and start with the HFS-South business. Everything we've seen has been positive from an activity perspective and the outlook seems pretty bright. I'm just trying to reconcile sort of the sequential utilized room-change. I know it's minor, but just curious what's going on there. I know there were some weather disruptions early in the quarter. I'm just trying to sort of triangulate what happened there, and how we should think about kind of room demand in HFS-South as we go forward here.

Eric T. Kalamaras: Good morning, take care, hope you're doing well. Look, a couple of things. Let me just give some kind of high-level overview just to level-set a little bit. I'd say that the performance this quarter is right on plan, where we expected, no surprises there at all. We came into the year with the expectation kind of from Q4 to Q4, that is Q4 2021 to Q4 2022, we were expecting somewhere in the very low-teens sort of revenue growth. So that's coming in about where we expected. And look, I think as you're seeing, sequential quarter, we have fewer days in the quarter; that does make a difference as to how much revenue comes in there. We are seeing, bear in mind --

Stephen Gengaro: (Inaudible) positive, but is there any lag between what we see in room demand and what actually is happening in the spot level (inaudible)?

Eric T. Kalamaras: We'll typically see a lag of a few months to maybe a quarter or two, depending on just how things shift there. But as commodity prices come up, as development happens, there is a little bit of a lag there. So you have to bear that in mind. That said, we are seeing really steady improvement across the -- really, across all areas there in the HFS South side particularly. But you have to remember too that the companies (inaudible) the capital spending discipline. And our large customers, which are the big boys out there, they have maintained capital discipline and that being --

But look, that being said, we expect to see margin expansion through the rest of the year of hopefully a couple hundred basis points as we go through the year there. So seeing good positive trends there (inaudible) timing and so optimistic in how that looks. But I do think it's probably more back-half weighted than front-half weighted as a function of some of the lags that we talked about.

Stephen Gengaro: Okay. Thank you. And the occupancy, can you just remind us, a relative split between kind of E&P personnel and service personnel?

Eric T. Kalamaras: It's going to be primarily more service-integrated. I'd be reluctant to use E&P specifically to suggest its independence. It's going to be large integrated and then large, very large services.

Stephen Gengaro: Okay. Thank you. And then when you -- I'm curious on the government side, and I know you probably can't add a whole lot more color. But when you think about this extension that you're talking about, and you're obviously pretty confident that you're in a good spot, who -- I'm just trying to think about this, and this may just be my lack of knowledge on the government side. But who else could do it? Like when you think about the competitive landscape, it seems like you're pretty well positioned. But are there really any other options?

Brad Archer: Hey, Stephen, this is Brad. Look, I'm sure there are some options out there. I'd just point you back to how long we've serviced the government and we're in place today. This is not a question, if you will, on signing a new contract on the facility we have; it's more about how big is the expansion going to be, taking it from an emergency influx care facility to a more permanent care facility, which adds a lot of things. And you've probably seen some of the public memos out there, it's education, it's medical.

So I'd tell you, we sit in a very good position to continue to move forward with this and get a contract signed fairly quickly. So we're very confident in a successful outcome there. I don't know that I could point you to anybody that could do exactly what we do out there. We are one of those companies, we have the buildings, we have the construction, we have the land, we have the permits. We have a great name and a successful track record, which is huge, especially when you're taking care of children. And on top of that, we have a great nonprofit customer that has a great track record as well.

Stephen Gengaro: Okay. Thank you. That's very helpful. And then just one final one for me. The

cash flow in the quarter, there was a big working capital (inaudible) imagine it's timing-related. But can you just maybe comment on that, and comment on how working capital likely plays out for the remainder of the year?

Eric T. Kalamaras: Sure, good question, good catch. Look, I think the way to think about working capital, give you a little bit of context. And this is when we had structured the large government last year, we had a large upfront payment on that. So you did see in the quarter about a \$25 million shift in deferred revenue, right? So you can see that shift in the balance sheet and then flowing through, of course, the cash flow statement. And that's largely a function of just having the upfront payments there, and then seeing deferred revenue associated with that. Essentially, right, you had 4 months of payment without the work happening in 2021. So we're catching up for that now.

Look, as we see things moving forward as it stands today, bear in mind in the outlook that we provided, it's business as usual, right? So you'll see another month of kind of that effective working capital shift that I just described. And then from there, things will normalize from more of a normal working capital trend that you would have previously expected.

Brad Archer: More timing than anything.

Eric T. Kalamaras: Yes, it's more just complete timing.

Stephen Gengaro: Okay, great. Thank you for the color, gentlemen.

Operator: Greg Gibas with Northland Securities.

Greg Gibas: Congrats on the strong quarter. Wanted to ask on the government humanitarian aid contract, when that's finalized, do you expect your existing capacity to be sufficient to fulfill the increase in scope that they're kind of looking for?

Brad Archer: Yes, we do. We should be able to address especially where we're at today with them. It is a sizeable increase in bed capacity, but with what some of the idle equipment we have that we can move around, we should be able to take care of that for them.

Greg Gibas: Okay, great. And I guess just wanted to confirm that you're saying it's rolling over month-to-month, the existing contract that is. Safe to assume that was extended through the end of May?

Eric T. Kalamaras: Yes, hi, Greg. It's not quite through the end of May, but you're in the right zip code and that's in Evergreen. So it'll just continue to roll over. Technically, from a contractual perspective, it's month-to-month. We've done things a little bit shorter than that for the last generation or two. But look, we hope that's a signal that there's an announcement hopefully soon.

Brad Archer: Greg, just a little bit more color. So we started off with the 30, and as you get closer to finalizing the contract, maybe they're a little shorter, right, which is a good thing for us. We

thought we were finished with the final design just late as last week. Give you a little color. They came back, they increased the scope, so we had to add some buildings, give them a price increase on some things just because we're adding square footage. But still on track to get this done fairly quickly, we believe.

But this is a -- while it's a very large project for us and the government, I think all of us got to remember it's a small piece of the puzzle in relationship to everything else the government is working on for immigration. Remember, we're just handling the unaccompanied minors; there's many other issue on the immigration front that they're dealing with. So while it is big, we're pressing, you can only push these guys so fast. And then with them continuing to make changes as well, it just kind of extends those dates. But we think it happens again pretty quickly.

Greg Gibas: Great, very helpful. That is exactly what I was trying to figure out. So I appreciate the color there. If I could just turn over to your strategic initiatives, talking about kind of translating your existing capabilities, the new applications or end markets, how are you kind of weighing or thinking about doing so via M&A versus organically?

Brad Archer: Well, look, I think your first step is definitely organic when you start to talk about the government piece, even the HFS. So your initial growth is going to continue to come from that organic -- the first thing we always concentrate every morning we wake up, is to try to fill the rooms that we already own, right? At the same time, with the cash this business continues to generate, we're also looking at inorganic growth. So Eric continues to build that pipeline on inorganic growth, looking at some acquisitions that fit within the company. So we're going to prosecute both of those avenues at the same time at this point.

Brad Archer: Yes, I think, Greg, the other thing I'd point out -- and Brad hit on this. As we think about the core competencies of Target, there are a number of things we can do. And I think it's a thought process of taking the organic activity and operations we have today, and how can we perhaps disintermediate some of that over time, and be more [focused] on the customers, right? So from facilities management, construction management, modular solutions, hospitality services, all those things, we currently do as an integrated platform today.

There's also applications to do that on a separate basis as well. And so that's certainly something to look at. Look, we're highly disciplined in how we look at return objectives. When we look at transactions, there are many number of things we look at, and frankly, that we have passed on just because the risk and the return just, look, it just wasn't there. And so we're looking for opportunities that fit really well with us commercially and operationally. And we'll continue to look at those.

But we're also disciplined and so we'll just -- we'll keep you posted. And we'll -- I think we've got some exciting things that we're looking at, and hopefully we can push those across the finish line.

Greg Gibas: Great. Yes, I'll look forward to updates. I guess last one for me, and sorry if you

already addressed this. But kind of implicit in your guidance, wondering if you could discuss kind of cadence on how you're thinking about the remainder of the year. Are you expecting maybe typical seasonality there?

Eric T. Kalamaras: Sure. So from an outlook perspective level-set, there's no additional upside we assumed obviously, from any modifications to the government contracts, right? So I think in the HFS side of the business, as I mentioned, we're probably looking at about 10% year-over-year growth on that kind of Q4 to Q4 exit. Look, I do think there's going to be additional margin expansion there on the HFS side.

On the Government side, because there was a pretty significant ramp-up period for the government occupancy last year, you'll probably see on a relative basis, that margin come down a little bit. However, I think corporate-wide, you'll continue to see the margin increase in the neighborhood of kind of 50 to 100, 150 basis points through to the course of the year.

So I think we're seeing really -- as you look at the performance this quarter, we continue to see that getting better as we move through the year. And then of course, hopefully, we have some other things that we can announce that will obviously propel that.

Greg Gibas: Sounds good. Thanks, guys.

Operator: (Operator Instructions). Stephen Gengaro with Stifel.

Stephen Gengaro: Just curious, based on Brad's comments, it seems like you're in pretty deep discussions on this contract. Is it a reasonable assumption that the ADRs and the margins will be very similar to [what it is] right now?

Eric T. Kalamaras: Yes, that's the assumption that they'll be very similar to what it is today.

Stephen Gengaro: Thank you. And then if I flip back to HFS South, I think, as I sort of think about this, there's a difference in rate between sort of committed rooms and any kind of call-out rooms. And I'm curious how we should be thinking about rooms under contract that are in your guidance versus potentially call-out rooms and maybe the impact that might have on ADRs.

Eric T. Kalamaras: Sure. So look, there is a pretty big spread between -- think about spot rates versus what we're seeing first of all, for contractual rates, right? That's the first thing. And maybe the second thing to bear in mind here is that to be a little bit careful on the ADR because the ADR, in certain contracts, particularly for some of these large contracts, is really just a function of the number of rooms that have come through the system based upon the revenue based in the contract.

So if we have a fixed revenue amount that's coming from the contract, and you bring more rooms to us, right, your effective ADR actually comes down slightly. And that can have a weighting on the ADR, all the while our revenue actually continued to go up, which is why I was saying before I think we continue the margin expansion there. So to be a little bit careful on the ADR and

focusing that too much as a metric going forward, albeit it is important but --

And the other thing that's happening too is the market, it is tightening, right? So some of the pricing pressures that we were seeing a year or so ago, or even 6 months ago, we are starting to see that as the market tightens, particularly on the spot side. And that'll help run the ADR up as well.

Stephen Gengaro: Okay, great, thanks. And then just one final one that just came to mind. When you think about particularly on the pressure-pumping side, Liberty and [OneStim] got together and you got a ProFrac buying FTSI, and few of the other things that have been out there, has that consolidation impacted you either positively or negatively?

Troy Schrenk: Stephen, good morning, this is Troy, great question. As we've talked about in the past related to consolidation, because of the size of our network and the nature of our agreements as a preferred provider for the largest publicly-traded oilfield service companies operating in the Permian Basin consolidation, we absolutely benefit from some of those names that you've mentioned. Clearly, we'll continue to support in the Permian today on a consolidated basis, or on an individual basis. So absolutely, we look forward to that and welcome more consolidation as it makes sense.

Stephen Gengaro: Okay, great. Well, thank you for the color, gentlemen.

Operator: (Operator Instructions). This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Brad Archer for any closing remarks. Please go ahead, sir.

Brad Archer: Thank you, everyone, for joining the call today, and your interest in Target Hospitality. We look forward to speaking with you again on our second quarter earnings call.

Operator, that concludes our call for today.

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