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PRESENTATION

Operator

Welcome to the First Quarter 2023 ICF Earnings Conference Call. My name is Grace, and I will be your Operator for today's call. (Operator Instructions) I will now turn the call over to Lynn Morgen of AdvisIRy Partners. Lynn, you may begin.

Lynn Morgen *AdvisIRy Partners*

Thank you, Operator. Good afternoon, everyone, and thank you for joining us to review ICF's first quarter 2023 performance. With us today from ICF are John Wasson, Chair and CEO; and Barry Broadus, CFO. Joining them is James Morgan, Chief Operating Officer. During this conference call, we will make forward-looking statements to assist you in understanding ICF management's expectations about our future performance. These statements are subject to a number of risks that could cause actual events and results to differ materially, and I refer you to our May 9, 2023 press release and our SEC filings for discussions of those risks.

In addition, our statements during this call are based on our views as of today. We anticipate that future developments will cause our views to change. Please consider the information presented in that light. We may, at some point, elect to update the forward-looking statements made today, but specifically disclaim any obligation to do so.

I will now turn over the call to ICF's CEO, John Wasson, to discuss first quarter 2023 performance. John?

John M. Wasson *ICF International, Inc. - Chairman of the Board, President & CEO*

Well, thanks, Lynn, and good afternoon, everyone. Thank you for joining us to review ICF's first quarter results and discuss our outlook for 2023. Our strong first quarter results reflected ICF's expanded capabilities in the growth markets we have identified and have invested in, namely IT modernization, public health, disaster management, utility consulting, and climate, environment and infrastructure services. These areas have priority spending for our clients and in 2022 accounted for approximately 75% of revenue. Thanks to our deep domain expertise and increased scale, we expect these areas to continue to grow as a percentage of ICF's revenue in 2023 and beyond.

In terms of takeaways from our performance in the quarter: First, we reported over 15% growth in service revenue and total revenue increased close to 17%, of which organic growth was north of 8%.

Second, we achieved significant year-on-year margin expansion in the first quarter, primarily resulting from increased scale, higher utilization levels and reduced facility costs. This margin expansion is in line with our guidance of 15% adjusted EBITDA to service revenue margin for the full year.

Third, we made the decision to exit a small noncore commercial U.K. events service line that was not contributing to profitability. While immaterial from a revenue perspective, it is indicative of our strategy to focus our investment dollars and human capital in areas that are or have the potential to drive growth and are synergistic with the rest of our service offerings.

Fourth, this was another quarter of strong contract awards for ICF, up over 13% year-on-year and resulting in a trailing 12-month book-to-bill ratio of 1.3. Also, our business development pipeline increased 16% sequentially after more than $400 million in contract wins, which speaks to the high level of bid and proposal activity we are experiencing as well as the increased value of the contracts we're bidding on. Taken together, these accomplishments represented a strong start to the year and underscore our confidence in ICF's performance in 2023 and beyond.

Looking across our client categories, there are several highlights worth noting. Revenues from federal government clients increased over 22%, reflecting a combination of high single-digit organic growth and the contribution from the SemanticBits acquisition, which we closed in July of last year. Our IT modernization and public health markets were key drivers of first quarter growth in this client category, reflecting strong spending trends amongst our civilian agency clients. Both areas have seen robust funding and bipartisan support. A recent Bloomberg analysis cited IT contract spending at federal agencies is forecasted to be a record of $78 billion for 2023, with about 40% of that spend taking place in the fourth quarter.

Additionally, the analysis noted that civilian agency procurement is continuing a pattern of steady annual growth not seen since at least 2017. Federal agencies are prioritizing customer experience in digital services along with data access and use, which are directly in our sweet spots. The integration of SemanticBits is complete. In the first quarter, we continued to win additional business from existing clients. Additionally, we are working together on many potential revenue synergies, primarily at the Centers for Medicare and Medicaid Services, an agency that SemanticBits has served for many years.

As mentioned previously, this was a strong quarter for our public health work. In the first quarter, we continued to execute on a number of contracts supporting federal agency efforts to address mental health, substance abuse, and infectious disease and global health security. We also worked on issues related to health equity, social determinants of health and the future of the public health system. Adjacent to this work was the first quarter ramp-up of a new contract for the Administration for Children and Families, Office of Refugee Resettlement to assist arriving Afghan refugees in getting access to immigration and legal services.

Additionally, we continue to experience demand from federal clients for ICF services with respect to the Infrastructure [Investment] and Jobs Act. Under existing federal agency contracts, we've been tasked with more than 45 million in projects to support IIJA activities. ICF is providing a range of support to agencies, including digital modernization, technical assistance and communications and management support for IIJA programs. Also, ICF has seen considerable interest from states and other prospective IIJA funding recipients for a range of environmental support services, including planning and analytical services.

Our pipeline of opportunities containing IIJA and Inflation Reduction Act or IRA-related work continues to grow and is currently at approximately $250 million, up from $150 million at the end of 2022. This includes a modest amount of work related to the IRA where we expect to see awards to support Federal agencies' responsibilities under the Act late in the second half of this year.

In the first quarter, our revenues from state and local government clients increased 13.3% year-on-year. Its 2 key business areas: disaster management and environment and infrastructure consulting that executed effectively on existing contracts and continued to win new work. In particular, we noted in our release, the award of a new contract with a value of $25.9 million with a U.S. territory to support implementation of its new energy program that will provide eligible households with renewable energy installations in case of an extended power outage.

Also, we continue to win smaller strategic resilience advisory work in new jurisdictions and with new clients in current geographies. We currently are doing mitigation advisory work for 30-plus clients across 17 states and 3 territories, which enables us to build relationships in key markets and to position for downstream implementation and new recovery work. There are significant synergies between our disaster recovery and mitigation work and the resilience and energy-related work we do for state and local and commercial clients.

In Q1, we continue to see these synergies pay off with good-sized wins with critical infrastructure clients in Oregon and California.

This is a good segue to our commercial energy business, where revenues increased almost 19% in the quarter, with each component of this business posting strong double-digit growth. Our commercial utility program revenue growth was driven by 2 large energy efficiency projects, the addition of several new marquee clients, as well as the expansion of the projects for existing utility clients. We saw particular strength coming from our innovative offerings related to electrification and grid modernization, behavioral efficiency programs, and dynamic pricing.

In Energy Advisory, we experienced strong demand for our services in the areas of decarbonizing energy markets, in particular, demand from renewable energy developers whose business is supported by the IIJA and IRA. We recently introduced EnergyInsite, ICF's technology-enabled service helping developers identify and analyze renewable project locations, and a new power price forecasting subscription service, and both have been met with favorable client response.

Our environment and planning work grew substantially in the first quarter, led by energy sector-related projects as well as the Blanton acquisition and the general ramping up of environmental projects. Growth in energy projects was strong both for developers seeking to permit new onshore and offshore projects and for utilities seeking environmental permits for large infrastructure, reliability and resilience projects, such as the undergrounding of power lines.

To sum up, the first quarter was a period of excellent execution for ICF in which we made significant progress in tiers that support our full year 2023 guidance as well as our longer-term financial targets. Now I'll turn the call over to our CFO, Barry Broadus, for a financial review. Barry?

Barry M. Broadus ***ICF International, Inc. - Senior VP & CFO***

Thank you, John. Good afternoon, everyone. In the first quarter of 2023, our total revenues were $483.3 million, up 16.9% as compared to the same period last year. This represented a balanced contribution from organic and acquisition growth. We benefited from broad-based revenue increases from our government clients, up 16.3% year-over-year and revenues from our commercial clients, which increased 18.8% as compared to the first quarter of last year. Service revenue grew 15.3% to $351.3 million.

Our first quarter total revenue benefited from a onetime media buy pass-through of approximately $6 million. Even after adjusting for this, our year-on-year growth in total revenue was firmly in the double-digit range at over 15%. Pass-through revenue for the first quarter accounted for 27.3% of total revenue as compared to 26.3% in the first quarter of 2022.

Gross margin was 35.3% of total revenue and 48.6% of service revenue as compared to 37.6% and 51% in last year's first quarter, respectively. The year-over-year variance mainly reflected a combination of factors, which included the timing of revenue recognition on fixed-price contracts and energy incentive fees. Also, the SemanticBits acquisition, similar to our Creative acquisition, generates a lower gross margin but higher EBITDA margin than we typically experience.

As a percentage of service revenue, our indirect and selling expenses on an adjusted basis declined to 33.9% of service revenue, 320 basis points below last year's levels as we continue to benefit from higher revenue, greater scale, and reduced facility-related expenses.

In absolute dollars, indirect and selling expenses increased 5.3% year-on-year, reflecting our ongoing investments in people and technology to support our long-term growth initiatives.

Interest expense was $9.5 million as a result of higher debt balances and higher interest rates as compared to last year. As I mentioned on our last call, we have implemented a number of initiatives as an offset to our higher interest expense, including reducing our facility costs, prioritizing high utilization, managing our other non-direct billable expenses and executing on our tax efficiency strategies, which will manifest in the second half of this year.

Our strong service revenue growth, together with the initiatives I just mentioned and economies of scale drove a 24.1% increase in EBITDA to $46.4 million and a 21.8% increase in adjusted EBITDA to $51 million. We're also pleased to report our adjusted EBITDA margin on service revenue of 14.5%, representing an 80-basis point improvement over the 13.7% reported in the year ago quarter.

Net income totaled $16.4 million and diluted EPS was $0.87 per share in the first quarter inclusive of $3.5 million or $0.18 of tax-affected special charges. Of this, approximately $0.09 represented charges associated with the company's decision to discontinue its small noncore commercial U.K. events service line. The remainder represented severance, acquisition-related expenses, and facility consolidation costs.

While we may have other opportunities on the horizon to further reduce our facility costs, they would be substantially less than what we incurred in 2022. Our first quarter net income compared to the $17.9 million and $0.94 per share in the first quarter last year inclusive of $0.17 of tax-affected special charges. Non-GAAP EPS increased 8.4% to $1.42 per share from the $1.31 per share reported in the first quarter of 2022.

Moving to cash flow statement and balance sheet. We used $17 million of operating cash for working capital needs in the first quarter of this year, which is in line with our historical trends and our increased scale. Capital expenditures totaled $6.4 million essentially the same as the period a year ago. Days sales outstanding for the quarter improved to 71 days compared to 79 days in last year's first quarter as a result of our cash management initiatives.

Our debt at the end of March was $598 million as compared to $556 million of debt at the end of 2022. This increase was driven by the cash seasonally required in the first quarter for year-end bonuses, stock repurchases as well as the timing of an extra payroll cycle this quarter. Our adjusted leverage ratio was 2.98 at quarter end compared to 2.86 at year-end. Approximately 50% of our total debt is at a fixed rate.

Consistent with our capital allocation strategy, we plan to focus on debt reduction as well as paying dividends, repurchasing shares to offset the impact of employee incentive programs, and making smaller opportunistic acquisitions. In the first quarter, the company used $18.1 million to repurchase 180,000 shares, which is sufficient to entirely offset the forecasted 2023 dilution. We still have $93.7 million remaining under the current authorization plan. We also announced today a quarterly cash dividend of $0.14 per share payable on July 14, 2023, to shareholders of record on June 9, 2023.

Now to help you with your financial models, there are a few important metrics that are unchanged from our guidance in early March. Our depreciation and amortization expense is expected to range from $23 million to $25 million. Amortization of intangibles should be approximately $36 million. Interest expense will range from $32 million to $34 million. Our full year tax rate will be approximately 23.5%. Our operating cash flow is projected to be $150 million. We expect our fully diluted weighted average share count to be approximately $19.1 million, and our capital expenditures are anticipated to be between $26 million and $28 million.

You may have also noticed that we have streamlined our total revenue breakout by market, aggregating smaller end markets under the category of Security and Other Civilian and Commercial Markets. And with that, I will turn the call back over to John for his closing remarks.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Thank you, Barry. We are very pleased with our first quarter results. The strong award and pipeline growth we continue to achieve is a clear demonstration of how well aligned ICF's capabilities are with client spending priorities. Similarly, we are pleased to reaffirm our guidance for 2023, which represents substantial year-on-year growth across key financial metrics. ICF has the capabilities and the scale to capture the considerable growth opportunities on the horizon, and we will continue to make the requisite investments in people and technology to build upon our competitive advantages and expand our addressable market. While doing so, we'll remain mindful of maintaining the collaborative culture we are known for and continue to advance the positive impact that our work has on society.

Operator, I'd like to now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Joe Vafi at Canaccord Genuity.

Joseph Anthony Vafi ***Canaccord Genuity Corp., Research Division - Analyst***

Nice results. I thought maybe we just kind of first go back to your comments, John, on the IIJA and the IRA pipeline growing. But it sounds like it's mostly IIJA in the pipeline growth at this point and not IRA. Do you expect to see that the IRA contribute more to that kind of combined pipeline over the next few quarters? And then I have a couple of follow-ups.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

So certainly, your comment is correct that IIJA represents, we discussed both the sales -- the vast majority of the sales and a significant portion of the pipeline. And I would expect that IIJA will remain certainly the majority, not the significant majority for this year. I think as we've talked about, Joe, I think the IRA really is, I think we'll expect to see the pipeline begin to ramp up late in the second half of the year and how that'll be much more 2024 and 2025 play. I do think the IRA does provide significant upside for us, it's just it will be in the outer years. Certainly, for this year, we'll see more opportunity from the IIJA, given the fundings further along. And so it's coming -- contributing to the pipeline more in the short run.

Joseph Anthony Vafi ***Canaccord Genuity Corp., Research Division - Analyst***

Sure. And then in the commercial area, especially in energy, maybe you could kind of give us a more detailed breakdown. I know historically, you've done a lot with the utilities themselves, but the business is diversifying. It sounds like you're doing a lot more with alternative and green power producers. Is there -- can we get a feel for how big the overall businesses outside of the core utilities and how you see that market shaping up for these kind of newer entrants?

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Sure Joe. I think I'd say a couple of things. I mean we talked about it at our Investor Day a year ago, I think it's still true. Certainly, the vast majority of the business is focused on energy efficiency, 75%, 80% of the business, which, as I mentioned in my remarks, we've had some good wins here in the last quarter. We continue to see growth there in kind of the mid- to high single-digit range. But having said that, some of the newer opportunities around decarbonization, electrification, flexible load management, equity-related things, that 15%, 20% of the business I think provides in the long run much higher potential growth areas, double-digit growth areas.

We are seeing some signs of that, certainly in the decarbonization electrification front. You mentioned we're seeing a lot of opportunity working with developers on renewable solar and wind resources. We're seeing opportunities around decarbonization. And so while that portion of our business is smaller, it's growing more rapidly. And I would expect in the long run that we'll see a larger portion of the business in those new areas. And we'll continue to accelerate the growth rate for our energy business.

I would also say that we've been -- we had quite a nice first quarter with our environment and planning business, which does do some of the environmental work for -- on solar and wind, but it's also working on broader infrastructure projects. We've had nice growth there. And so to be honest with you we're quite pleased that basically every quarter of our energy business grew double digits in the first quarter, and it gives us a very positive and bullish outlook on that business.

Operator

Our next question comes from the line of Tobey Sommer with Truist Securities.

Jack Wilson ***Truist Securities***

This is Jack Wilson on for Toby. I just want to ask a quick one. So can you speak to headcount growth and hiring in 1Q?

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

I think that as we've discussed on prior calls I mean, the highest-level we are a professional services firm. And so if we're going to be growing, as I said, 8% organically in the quarter then on an annualized basis, we need to be adding 6% to 7% head count. To deliver that growth, we always look to squeeze a little more efficiency, a little more utilization out of our existing staff. But we're certainly in a mode where we're adding headcount. And as I say, I would expect it to be in the 7% to 8% -- 6% to 7% range with our 8% organic growth. Obviously, we also did the SemanticBits acquisition last year, which brought all headcount from a nonorganic perspective. But I think that's how we think about the head count. We are -- as I said before, we're investing quite significantly in recruiting and generally have been successful in attracting the talent and adding to headcount. And so feel generally good that we'll be able to add the staff and have the capabilities to achieve our growth goals.

Jack Wilson ***Truist Securities***

Okay. And then shifting gears a little bit. Is there an opportunity for ICFI in the (inaudible) mitigation space?

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

I'm sorry, you said mitigation what space? I'm sorry, I missed that.

Jack Wilson ***Truist Securities***

I meant the (inaudible) mitigation space.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

I'm not sure I know what PSAG is. I mean, we do a significant amount of mitigation work on disaster recovery and mitigation work on climate change. And so for all of our clients across from federal state of local to commercial, we do both mitigation and resilience work. We have significant deep expertise on that. But the specific reference you're making, I'm not sure I'm familiar with.

Jack Wilson ***Truist Securities***

Yes, I'm truly referencing (inaudible) substances so EPA. I know it's making sort of, putting emphasis on that.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Yes. I mean we do significant work for EPA, but I'm just not familiar with it. It's something we can certainly get back to you on but Jack, I don't know the details of what ICF may be doing there.

Operator

(Operator Instructions) our next question comes from Kevin Steinke with Barrington Research Associates.

Kevin Mark Steinke ***Barrington Research Associates, Inc., Research Division - MD***

I just wanted to ask about your state and local government business. It had a nice sequential pickup in revenue there. Just wondering the sort of opportunities you're seeing both on the disaster recovery side, what more could be in the pipeline as well as on the mitigation side of things.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Sure. I think, as you know, I mean, we had quite nice growth in our state and local businesses. I would say, as you know, Kevin, those are made up of 2 key components, our disaster recovery business and then our environment and planning business that does environmental work for large infrastructure projects for state and local governments.

We saw robust growth in both those businesses. And I would say the pipelines remain quite good on the disaster recovery side. We continue to see opportunities, certainly on the mitigation front, across multiple geographies. We're doing -- we have a nice pipeline in Puerto Rico. We're -- we certainly are busy in Texas. As I mentioned, we're working with over 30 states on the kind of mitigation advisory work. And so I think that's an area that we see strong funding, and we continue to build the pipeline there. In addition to continuing to do our traditional disaster recovery work book. Again, I think we have opportunities in Puerto Rico. We have opportunities in the Gulf Coast area, we see opportunities in Texas. And so the business in the pipeline there is quite strong.

On the environment and planning side, I think, again, given the focus on investment in infrastructure around the IIJA and in clean energy technologies and energy technologies generally, pipelines, power lines. And again, I think the pipeline has been building quite nicely there. And so we're quite positive on the trends in the pipeline in those areas and the future opportunities for us.

Kevin Mark Steinke ***Barrington Research Associates, Inc., Research Division - MD***

Okay. Just in terms of the international government business, I think you had been cautiously optimistic about the pipeline there and perhaps that business picking up as we move forward? I mean what's -- any update on just trends in international government?

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

I think we've generally indicated that we thought that for 2023, that international government business should return to growth. I think we're thinking kind of low to mid-single-digit growth there. I think for the last year, we've obviously had some difficult (inaudible). We were rolling off a large implementation project we did in 2020, 2021 and early 2022. But we'll -- we rolled off of that at the end of this first quarter. And so I think as we go forward, we're -- we believe that business should return to growth in the low to mid-single-digit range as we look forward.

Kevin Mark Steinke ***Barrington Research Associates, Inc., Research Division - MD***

Okay. And then obviously, you spoke to the IT modernization opportunity and a lot of momentum there. And I believe you've mentioned before that you have, I think, the capabilities in place to address that opportunity, but just wondering if there, as this opportunity continues to grow and evolve, if there are any other pieces that you need to add to the mix in terms of your service capabilities, specifically when thinking about M&A.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Yes, sure. I think it's what we've discussed in recent quarters, I think we feel like we have a core of what we need to address, generally address the IT modernization market in the federal arena. As you know, we've made 3 significant acquisitions in the last 2 or 3 years that have given us kind of a full range of low-code capabilities and then with the SemanticBits acquisition gave us the open-source capabilities to address that market. And so I think we have the core of what we need.

But Kevin having said that, as you know, that market is constantly evolving, and there's constantly new entrants and new platforms and new capabilities. And so -- so as you know, we're always out looking at potential acquisitions. I would think we would do more, to the extent that we do acquisitions in the IT modernization world, there'll probably be more small to medium-sized acquisitions that bring either new platforms that are coming on the market where we feel we need skills or add capabilities around things like artificial intelligence or data and analytics or machine learning, which are important and in our news a lot.

And so -- but I would think of it more as tuck-in acquisition as opposed to kind of large significant acquisitions just to give us critical scale or critical mass in that market. I feel like we have the critical mass and the key capabilities we need to address that market effectively.

Kevin Mark Steinke ***Barrington Research Associates, Inc., Research Division - MD***

Okay. And just lastly, I don't know if this is outside of your control obviously, but just any thoughts on the negotiations going on around the debt ceiling and if that's something investors should even have in mind, I mean, these things typically get resolved, but just wondering if you could offer up any thoughts on that?

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Yes, Kevin, I'm not sure I have any great insights into how the debt ceiling and how will resolve. I mean it's not the first time we've had this issue. I mean, obviously, we're watching it carefully. I think if history is any guide, there could be some bumpiness or turbulence here the next month as that issue gets worked through. But I would ultimately expect it to be resolved. And generally, the headlines and the risk you read in the headlines tends to be much greater than the risk ultimately when they work out the deal. And so we're watching it carefully. But ultimately, I would expect it to get worked out.

And ultimately for us, I do think that -- depending on where that lands in terms of impact on the budget, to the extent that the budget is impacted, I just would note that really the areas we're really focused on in federal markets, public health and health issues, IT modernization, you know kind of have been very high priorities across both Republican and Democratic administration. And so I would expect that in terms of our key growth markets, many of those will be -- remain high priorities and wouldn't be the first place that cuts would occur. And so I would -- I think that's how we're looking at it. Obviously, we're watching it carefully. I think the good news is, obviously, the last 2 years, 22 million, 23 million to civilian budgets for us. Materially, we have very good momentum. We have a very good backlog. And so we feel good about that, but we're certainly watching it very carefully.

Operator

I would now like to turn it back to John for closing remarks.

John M. Wasson ***ICF International, Inc. - Chairman of the Board, President & CEO***

Thank you all for participating in today's call. We look forward to connecting at upcoming conferences and events. Thanks for participating today. Take care.

Operator

Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.