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Stantec, Inc. (STN)

Q3 2018 Earnings Call

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Analyst, TD Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Stantec's Third Quarter 2018 Earnings Results Conference Call. Leading the call today are Gord Johnston, President and Chief Executive Officer; and Dan Lefaivre, Executive Vice President and Chief Financial Officer.

Today's call is webcast and those dialing in are invited to view the slideshow presentation, which is available in the Investors section of stantec.com. All information provided during the conference call is subject to forward-looking statement qualification set out on slide 2, detailed in Stantec's Management Discussion & Analysis and incorporated in full for the purpose of today's call.

With that, I'm pleased to turn the call over to Mr. Gord Johnston. Please go ahead.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

Thank you. And thanks to all of you for joining today's call. Just wanted to note that today we have Theresa Jang, our incoming CEO (sic) [CFO] (00:01:02) with us here. She's not going to be taking questions or responding, but we just wanted to let you know that, she is here with us and we're really glad that she's joining us.

Theresa will fill the CFO role as of January 1st of next year when Dan retires. I'll start with a quick overview of the quarter. Then Dan will walk us through the earnings and after that I'll go through some operational highlights. So we're now on slide 4 for those of you viewing the slide show.

Our results this quarter validate the hard work we've done over the past year to grow organically ramp up the pace of strategic acquisitions and improve our operational efficiencies. In Consulting Services this quarter, we have continued gross and net organic growth, a double-digit increase in adjusted net income and a CAD 0.10 increase in adjusted diluted earnings per share, which reached CAD 0.60. This improved performance in Consulting Services was offset by disappointing results in Construction Services, which reduced adjusted diluted earnings per share by CAD 0.16.

Last week, we closed the sale of our Construction Services group. The sale completes the strategic review we embarked on earlier this year. Our goal was to take a thorough look at Construction Services to optimize the value of the business and offer the best prospects for employees, clients and shareholders. With the divestiture of the Construction business, we look forward to focusing solely on our Consulting business. We'll provide more detail on the sale later on in the call, but for now I'll pass the call to Dan to take us through our Q3 results.

Daniel J. Lefaivre

Chief Financial Officer & Executive Vice President, Stantec, Inc.

Thank you, Gord and thank you Theresa for joining us today. I'm confident that investors can expect Theresa to be a solid steward of capital while providing transparent and insightful disclosures on our financial performance. Theresa is a well-known and seasoned CFO and brings significant experience in engaging with the investment community. She's a very strong addition to our Stantec team.

Now, let's start with Consulting Services on slide 6. We achieved solid results in Consulting Services this quarter as Gord alluded to earlier. Net revenue increased nearly 8% to approximately CAD 848 million when comparing to Q3 2017. We saw organic net revenue growth across all geographies. Looking at our business operating units, once again we had double-digit organic net revenue growth in Energy & Resources despite the continued oil pipeline project challenges we're seeing in Canada. We also had organic net revenue growth in our Environmental Services and Water business operating units though the net organic revenue was flat for Water. We saw net organic retraction in both Buildings and Infrastructure. For Buildings we can attribute this net revenue retraction in our Canadian buildings practice where we've basically wound down a few projects, which was partially offset by the growth in our U.S. and our global Buildings practices.

The retraction in Infrastructure is mainly due to an organic net revenue retraction in the transportation sector, which can be attributed to large projects wrapping up in the U.S. primarily in Texas and seasonality in some North American markets. This was partly offset by growth in community development.

Moving on to slide 7, gross margin for Consulting Services was at 53.7% of net revenue. This is slightly down from Q3 2017 mainly due to project mix, competitive pricing pressures, and increased revenues from our lower gross margin Energy & Resources business. We continue to perform within our annual targeted range of 53% to 55%. Administrative and marketing expenses for Consulting Services was up 40.5% of net revenue, which is below our annual targeted range. This speaks to higher utilization we typically see in Q3, our cost reduction efforts and our continued focus on operational efficiency.

As a reminder, we usually see lower utilization in Q4 and Q1 as we head into the holiday season and colder winter months in Canada and Northern U.S. So we do expect SG&A costs to be higher as we approach year-end.

Consulting Services adjusted EBITDA increased 13.6%, adjusted net income was up 21.3%and adjusted diluted earnings per share increased CAD 0.10 to CAD 0.60 as Gord noted when comparing Q3 2018 to Q3 2017. These increases are mainly due to our acquisition, organic revenue growth, higher utilization and lower administrative and marketing expenses.

I'll briefly touch on operating results from the Construction Services segment on slide 8 before digging into some of the details from the sale. During the quarter we recorded negative revenue cost adjustments totaling CAD 17.7 million, CAD 4.1 million of this comes from the legacy waste-to-energy projects in the UK where two of the three projects are now 100% complete and turns over to our clients.

On the third project we believe we've taken sufficient project provisions related to the delays in performance issues that we've experienced on that one project. The legacy hard-bid projects in the U.S. and incurred provisions of CAD 6.9 million due to production and productivity issues. We also recorded a CAD 6.7 million adjustment in our in our core UK water projects primarily due to one large project claims settlement with a client on a very old project and the other ones were really related to project inefficiencies.

This segues into the sale as reflected on slide 9. As Gord mentioned we closed on November 2. Gross proceeds from the sale totaled CAD 102.6 million as estimated transaction costs and working capital adjustments of CAD 57 million based on values at September 30. The carrying amount of the disposal group exceeded the estimated net proceeds on sale and therefore, we've recorded a non-cash impairment charge – goodwill impairment charge of CAD 53 million against in Q3.

The tax implications of this sale are complex. But in the end the transaction results in a small taxable gain in the U.S. and therefore during the quarter, we recorded a deferred tax charge of CAD 8.7 million. We did not fully meet the accounting criteria of held for sale at September, 30 because negotiations were still ongoing. But with the divestiture finalized on November, 2, we will present Construction Services as discontinued operations starting in Q4.

As part of the sale, we will retain future obligations related to the single remaining UK waste-to-energy project, we'll also retain the defined benefit plan obligations related to the UK Construction Services business. This pension plan that has been closed to new participants for many years and however the remaining obligations will require cash resources into the future.

These pension plan obligations are currently in a small accounting surplus and are subject to regular valuations and are recorded on the balance sheet as a pension asset or liability with revaluations recorded to comprehensive income, other comprehensive income.

Overall, we believe the divestiture of Construction Services mitigates future construction risks and allows us to restore our focus as a design only firm. I expect that investors can look for to more consistency in our results going forward.

Moving on to slide 10, I'll quickly touch on our results compared to our 2018 annual targets. As you can see, we're meeting all targets in Consulting Services. As a result of the divestiture of the Construction business, we're withdrawing our targets for Construction Services and our consolidated results.

With that, now I'll turn it back over to Gord to look at our Q3 operational highlights.

Gordon Allan Johnston

President and Chief Executive Officer, Stantec, Inc.

Thank you, Dan. We'll now go to slide 12, where we'll have a look at Consulting Services in Canada. Gross revenue increased 4.5% and net revenue increased 4.8% in Q3 2018 compared to Q3 2017. We saw organic revenue growth or stability in all of our Canadian business operating units and sectors with the exception of Buildings, which was impacted by a number of major projects nearing completion.

In total gross organic revenue increased 1.9% and net organic revenue increased 1.7%. Demand for midstream work continues to increase in Canada and that's leading to growth in our oil and gas sector. It also contributed to improvements in our Environmental Services business operating unit. Our Canadian community development sector is seeing the benefits of increased urban development. The growth is partially offset by the soft housing market in Alberta.

Our Canadian Water business is benefiting from public spending for water projects and growth can be attributed to a large dam and reservoir project in Alberta and recent projects in British Columbia. For example, we're recently selected by Metro Vancouver to complete the design, construction management and commissioning, consulting engineering services for a section of the Coquitlam No. 4 water main. That project will provide seismic resistance and meet water demands until 2050.

Moving on to Consulting Services, the United States on slide 13 gross revenue increased 9.7% and net revenue increased 7.3% in Q3 2018 compared to Q3 2017. Organic gross revenue grew 4% and organic net revenue grew 1.8%. We grew organically in all business operating units and sectors with the strongest growth coming from Buildings, Environmental Services and Mining. We continue to see activity in airport, rail, highway, transit and bridge projects in the U.S. and in Power, transmission and distribution work remains steady. Our U.S. Buildings practice grew organically across the commercial, healthcare and science and technology sectors.

During the quarter, we were selected to provide a range of interior planning, architecture and engineering services for a new tower that Harrisburg University of Science and Technology is planning for downtown Harrisburg in Pennsylvania. Our Energy & Resources business in the U.S. had year-to-date growth in the Mining and WaterPower & Dams sectors, thanks to improving commodity prices. And then our U.S. Water practice continued improvements in the California market were driven by increased government spending and successful marketing campaigns.

We've posted strong results in our global Consulting Services business as you can see on slide 14. Gross revenue increased 12.6% and net revenue increased 15.8% in Q3 2018 compared to Q3 2017.

Organic gross revenue grew 4.4% and organic net revenue grew 6.1% in the quarter. Our global teams have been very successful winning new projects, growth in our Middle East Buildings business, project wins and WaterPower & Dams and a strong flow of work in Mining in Latin America drove organic net revenue growth.

The Latin American mining sector continues to improve for us and we're winning work as a result. During the quarter, our team was awarded the design services for a water treatment plant in Argentina that serves a lithium mine. We did however see organic net revenue retraction in our global Environmental Services and Water business. The retraction in water is partly due to the AMP6 cycle slowing down in the UK, although, we have recently been awarded two new AMP7 consulting roles. So, we are good future prospects in that sector.

Moving on to slide 15, our backlog held strong at CAD 5.3 billion in Q3, of course with the sale of Construction Services, we'll see a backlog decrease. The third quarter, CAD 4.1 billion of our CAD 5.3 billion in backlog is for Construction Services work, which represents about 12 months of committed work.

As you can see on the next slide, we won many significant projects across the world in Q3. I spoke to a few of them earlier and on the slide, you'll see more of the many projects we've recently won that illustrates the diversity of our experience, our ability to capitalize on improving macro environments and our expanded geographic reach.

On slide 16, taking a look at our acquisitions. We announced and closed the acquisition of Peter Brett Associates or PBA in the UK during the third quarter. PBA is a multi-discipline firm based in Reading, England with regional offices across the UK and Central Europe. Their team of approximately 700 engineers, planners, scientists and economists deliver projects in a variety of sectors and will significantly diversify our service offering in the UK. And shortly after the quarter, on October 5, we acquired True Grit Engineering. True Grit is a 55 person infrastructure engineering project management Environmental Services firm based in Thunder Bay, Ontario.

And then on October 9, we signed a letter of intent to acquire Wood Grieve Engineers (sic) [Wood & Grieve Engineers] (00:15:30) based in Perth, Australia. Wood & Grieve is an award winning engineering focused consulting company with a team of more than 600. Subject to due diligence, we expect to close the acquisition in Q1 2019.

Regarding our outlook on slide 17, our position remains steady. We believe we'll benefit from increased infrastructure spending in North America. We're focused on expanding our global footprint and we're committed to our overall growth targets. With year-end fast approaching, we've made significant strides towards achieving the priorities we set out early in the year.

We're achieving organic and acquisition growth, deepening in our expertise and are on a pace with our plans for our fiscal and operational excellence. And now, with the divestiture of Construction Services business, our management team and our people can continue their focus on growing our Consulting Services business and delivering good returns on investment for our shareholders. That concludes our remarks for the quarter.

But before we open the call for questions, I'd like to take a moment to acknowledge that this is Dan's last earnings call with us. Dan has been our CFO since 2009, but he's been a guiding force at Stantec for nearly 30 years. He's been part of the – part of some of the most transformative initiatives at Stantec and has played a pivotal role in executing our strategy, strengthening our finances, improving value for shareholders and building relationships in the investment community. He's also an active member of our local community and a well-respected leader who has been a mentor to many.

So Dan, thank you for your countless contributions to our success, and I wish you all the best in retirement.

Daniel J. Lefaivre

Chief Financial Officer & Executive Vice President, Stantec, Inc.

Thanks, Gord. I appreciate the kind words. We all know though that we can't do this alone, and I'd like to recognize our strong leadership team, and importantly, all of the outstanding Stantec teams that make my job so much easier. There's no doubt that we've seen significant changes over the years, and I've been very fortunate to be part of the team of dedicated and committed professionals who have continually adapted and evolved to ensure that we have a strong – have strong control processes, where we can provide exceptional disclosures to our – to assist our shareholders and really and gaining a better understanding of our business. And I'd also like to thank our business partners and the entire investment community, both the buy side and the sell side, who continually challenge us to be better.

So with that, we'll turn it over to Brittany, our operator to start the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll take our first question from Jacob Bout with CIBC. Please go ahead, Jacob.

Jacob Bout
Analyst, CIBC World Markets, Inc. Q

Good morning.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc. A

Good morning, Jacob.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc. A

Good morning, Jacob.

Jacob Bout
Analyst, CIBC World Markets, Inc. Q

So, with the sale of the Construction business behind you, can you talk a bit about your – what's your acquisition strategy is going to be and in what areas you're going to focus on?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc. A

Great question. Yeah. We've been pretty transparent with the markets for this year that we're going to continue with acquisitions in North America, but then we really want to build out our footprint that that we got from MWH primarily in the UK, Australia and New Zealand for now. Those were locations were Stantec wasn't present in a meaningful way before MWH joined us. As part of our strategic planning process, we really see that as areas that we're going to continue to focus.

We do see that Peter Brett Associates in the UK provides a strong footprint there, and diversifies our service offering from just being in the Water space where we were previously. And in Australia, based on customary conditions and the closing of Wood Grieve Engineers (sic) [Wood & Grieve Engineers] (00:19:59) in the first quarter of next year, that will really give us a strong footprint to build upon in Australia.

Jacob Bout
Analyst, CIBC World Markets, Inc. Q

And then maybe next question here just on EBITDA margins going forward, how should we be thinking about that, we can revert back to kind of a 13% to 14% range or...?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc. A

Yeah. I'll answer that one, Jacob. The EBITDA margins, I don't expect we'll get back to that 14% range. I think as we've noted many times over the past quarters is that the mix of our business has changed, when we were up

14%, 60% of our revenues were coming out of Canada. Today only about 30% about our revenues are coming from Canada with lower margin businesses, primarily due to geography in some certain sectors like transportation in the U.S. or lower margin business.

So that 11% to 13% that we're targeting for this year of Consulting Services, I expect to be fairly consistent into 2019. Having said that, we haven't quite completed our budgets [indiscernible] (00:21:09) board meeting this week and we'll be reviewing our budget with the board, and providing guidance with our Annual Report as we report in February. But I don't expect it to be materially different from what we're seeing this year, but certainly not 14%.

Jacob Bout
Analyst, CIBC World Markets, Inc.
Q

Last question here, that [ph] CAD 31 billion (00:21:28) Texas plan to protect its shoreline, how big of a deal is that for Stantec?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

You know we see a lot of the large projects coming up at the Texas line, I think you're referring to it. We're very well known in the space. Certainly whether it from shoreline protection, dams, levees with our Mid-Breton project that we're doing in Louisiana which is a short-line sediment diversion project and replenishment. But we're very active in the type of work. So we've been tracking it. We're familiar with it and we think we're well positioned for it.

Jacob Bout
Analyst, CIBC World Markets, Inc.
Q

I'll leave it there. Thank you.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

Thank you. Thanks, Jacob.

Operator: Our next question comes from Devin Dodge with BMO Capital Markets. Please go ahead Devin.

Devin Dodge
Analyst, BMO Capital Markets (Canada)
Q

Thank you. Good morning.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.
A

Good morning.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

Good morning, Devin.

Devin Dodge
Analyst, BMO Capital Markets (Canada)

Q

Yeah, in your prepared remarks, you talked about AMP6 activities starting to slow there. I guess, how should we be thinking about activities under that program over the next 6 to 12 months. And do you think ramp up in AMP7 is enough to offset any kind of softness you'd see? I know you mentioned a couple of opportunities that you were awarded recently. Just kind of any color you can provide there would be helpful.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Yeah. No, that's great. The AMP7 awards for the strategic consulting are only two have been – have come up so far to my knowledge and we've been successful in both of them. One thing that a lot of our clients have been trying to do in between the various AMP cycle is, as one AMP cycle begins to enter year three or four, historically things have slowed down a little bit as people began to position to get ready for the next AMP cycle.

Several of our clients that were in the process where they can just roll it over, we have to renegotiate rates, but if they're acceptable – if our performance has been acceptable, they can roll that over. So we're at the point where some of our clients are making those decisions here in the near future. We believe that we're well-positioned for those. So, we don't see a big hiccup in the AMP6, we're going forward in the next 6 months to 12 months, but those renegotiations or those sort of transitioning to the next AMP cycles are just beginning to start now.

Devin Dodge
Analyst, BMO Capital Markets (Canada)

Q

Okay. Okay. That makes sense. It's helpful. Thank you. Just on the Construction Services sale, can you provide some color on your decision to retain the closing out of one of the waste-to-energy projects in the UK? Just trying to get a sense of how much work is remaining, and do you expect to have any recoveries on the project before closing them?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

So there were three of those projects, two of which are closed out, completely buttoned up and we're done. This last one, we're still just working through the plant operations with regards the one piece of equipment in particular. So the vendor of that equipment is engaged in helping us rectify that situation. We've – the plant has been up, it's been producing well, we're fine-tuning some things now. Our plan at this point we believe that by mid-January, that is where we're thinking that we'll have achieved a 30-day testing. That could go a little bit further, but certainly it's our and our partners' best expectations at this time that they will be ramping up this project certainly within Q1.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

And then with respect to...

Devin Dodge
Analyst, BMO Capital Markets (Canada)

Q

Okay.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

[indiscernible] (00:25:07) certainly we are continuing to pursue any mitigation that we may have on this project. There may be some upside, but certainly we are not going to guarantee anything at this point. If any if we do get any upsides as a result of closing of this project, then we'll certainly be transparent [indiscernible] (00:25:29).

Devin Dodge
Analyst, BMO Capital Markets (Canada)
Q

Okay. Okay. And then one last one from me, but when you look out to 2019, I know you're not providing guidance today, but I guess which lines of business or geographies do you think are best positioned to do well for Stantec?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

We feel pretty good about the overall Infrastructure, Water, Buildings segment in North America. Certainly we've seen following the midterm elections this week, a lot of discussion of Infrastructure as a bipartisan effort that could be moved forward. So we feel good about that.

We see continued growth in our Latin America, that seems to be very strong for us and certainly with the – now that we've acquired Peter Brett Associates, we're already beginning to see a lot of synergies between their clients and the legacy MWH Water clients of services go back and forth. So I think we should see some good growth in the UK and certainly, we're very excited about – should we close on Wood Grieve Engineers (sic) [Wood & Grieve Engineers] (00:26:33) and building our Australia market. So we feel in general positive about 2019.

Devin Dodge
Analyst, BMO Capital Markets (Canada)
Q

Okay. Okay, great. Thanks guys.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

Great, thank you.

Operator: Our next question comes from Yuri Lynk with Canaccord Genuity. Please go ahead, Yuri.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.
Q

Hey, good morning guys.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.
A

Good morning, Yuri.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.
A

Hi, Yuri.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.
Q

Hey. Dan, congratulations. I don't have to tell you this, but enjoy your time off. I'll start with you Dan. In your prepared remarks, you talked about the seasonal decline in utilization in Q4. That happens every year. So I just want to make sure that there's nothing special this quarter that you were calling out and I might have missed.

Daniel J. Lefaivre A
Chief Financial Officer & Executive Vice President, Stantec, Inc.

Yeah, no, thanks Yuri. There's nothing special that was being called out here, it's just a reminder to the market that we do generally see lower utilization in the fourth quarter and therefore, on revenue and so on. But I don't want to expect it to be materially different from prior years.

Yuri Jonathan Peter Lynk Q
Analyst, Canaccord Genuity Corp.

Okay. I just want to turn to M&A and you mentioned the UK as a target market and I found it interesting when you moved on the PBA acquisition ahead of Brexit's in March. So I know you guys haven't seen much impact from Brexit, but I'd argue that it hasn't happened yet, and it looks like the negotiations are pretty contentious. So what's so attractive about buying in the UK that you would move on an acquisition like PBA now rather than wait and see what might happen in March when the actual exit from EU happens?

Gordon Allan Johnston A
President and Chief Executive Officer, Stantec, Inc.

Great. Good question, Yuri. As we've been looking at opportunities to grow through M&A in the UK, we've specifically been looking for firms that we believe would be less susceptible to a hard Brexit and an economic downturn. So we're not looking at firms that are – would be engaged in manufacturing or that overall supply chain. Not firms that are heavily engaged in retail.

PBA is a fundamentally an infrastructure firm, have some involvement with High Speed rail, some involvement with Crossrail. These sorts of things. Certainly involvement in the – with – there's a huge plan going there with regard to hospitals and care centers and so on. So we see PBA as a play really investing in our core Infrastructure roots which are complementary to Water. And not really getting us into some of those areas where which we could be more susceptible to a hard Brexit.

Yuri Jonathan Peter Lynk Q
Analyst, Canaccord Genuity Corp.

Okay. Lastly from me, just another good quarter of bookings in the Consulting Services, calculating close to a 1.2x book-to-bill. So you think you can maintain a book-to-bill in excess of 1x in 2019 on an organic basis?

Gordon Allan Johnston A
President and Chief Executive Officer, Stantec, Inc.

As we've – we have a pretty comprehensive opportunity pipeline that we use all our staff use it as they put in opportunity as they see the timing where they think they might become available and we factor them in. So we do see the opportunity pipeline for projects coming up in 2019 to still be pretty robust. So we still feel positive about going forward into 2019.

Yuri Jonathan Peter Lynk Q
Analyst, Canaccord Genuity Corp.

Okay. I'll leave it there guys. Thanks.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Thanks, Yuri.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Thanks, Yuri.

Operator: [Operator Instructions] We'll take our next question from Derek Spronck with RBC. Please go ahead, Derek.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Thank you very much for taking my questions. I know you touched on this before but just wanted to get an updated view. Is there any percentage of revenue from the Consultancy business that is tied currently to the Construction business? And with that , how should we think about organic growth rates in 2019?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Sure. I'll talk about first about the percentage of work in Consulting types of the Construction business and primarily that would be in our Water Consulting group and I'll break it into two components. The first would be in the United States where our Consulting group does partner with our Construction group on design-build jobs or do those sorts of things periodically. But it's not an exclusive relationship in either direction.

So as we've talk with our Water leadership in the United States about the potential impacts from the divestiture of Construction, we don't see that to be significant or mature at all in the United States. The projects that we have been working on together, the design-build jobs are nearing or at completion and there were really were no new ones in the hopper to carry it into 2019.

In the UK there are some opportunities where our Consulting business sub-contracts to our Construction business. And so the discussions that we've had going forward are that the Construction business still requires to have the – those Engineering Services provided, the Construction group there as part of a joint venture. So we see over time could there be some impacts there, but certainly as we were looking for a potential suitor to acquire the business, we specifically were not looking for an acquirer that would be part of a large engineering firm that would very quickly want to transition our engineers out.

So with this buyer with Oaktree, GFI, we don't see that as an issue. So could there be some impact there going forward? Perhaps, but for now the work still needs to be done and so we can't guarantee what will happen in the future, but we couldn't guarantee that before either. Because we were just part of a joint venture, so we don't see any big material hit there Derek.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. That was a good color. Thanks, Gord. Just moving on acquisitions, it seems like you've been picking up the activity levels on acquisitions, in particular, in the back half of the year as well with a couple of sizable ones. And I think you mentioned one that you find last night that seems to be fairly sizable as well.

If I add up all the acquisition growth from an employee perspective, including the one that you mentioned on the call, it looks like you've added 1,000 to 1,500 employees in 2018 on an acquisition basis. Is that about right and how should we be modeling acquisition growth for 2019?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

So just to start, we did not announce anything that we signed last night, so maybe I misspoke or it was misinterpreted. The one I was talking about was WGE or Wood Grieve Engineers (sic) [Wood & Grieve Engineers] (00:34:34) that we signed some time ago, but we're just in the due diligence process now, and we anticipate that closing in Q1 of next year to really build out our Australian business. But you are right, we are – we have certainly cranked up the M&A activity after taking an intentional hiatus slowdown following the MWH acquisition, we needed some time just to digest that one and work through the integration.

But certainly when I was named to take this role that was something that I wanted to do, was really get M&A going again. So you know what, we still – our M&A pipeline is probably as full or fuller than it's ever been because not only are we continuing to look at M&A activity in North America, but now we're still looking in Australia, New Zealand and the UK. So I would anticipate continued good M&A activity going into next year.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Would you think as it stands right now, we're looking at like a 2% to 3% lift in net revenue from acquisitions in 2019 or any way to frame it?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

I think with the addition of 3,900 people in both the UK and Australia, that will certainly help the acquisition growth. When you look at all the transactions we did in the first half of 2018, that will also have a bit of a lift, but we are actually working through our budget, so once again in the first quarter where we will want to release our annual results, so we'll have a much better view of how much revenue that's going to add. So I think it's probably best to just leave it at that for now and provide a bit more color next quarter on that.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. Fair enough. Thanks. I'll leave it there and turn it over. Thank you.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Thanks, Derek.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Thanks, Derek.

Operator: Our next question comes from Mona Nazir with Laurentian Bank. Please go ahead, Mona.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Good morning, and thank you for taking my questions. I just wanted to...

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Good morning, Mona.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Hi. I just wanted to turn back to the Consulting and the Construction kind of overlap. I know you said that there would not be much overlap or impact on the U.S. side, but there could potentially be some on the UK side. And I'm just trying to get a sense of the potential magnitude. And I – if we're just looking at the Construction, once fully divested, we expect net revenue to kind of trend down in the – just over [ph] CAD 200 million, CAD 220 million (00:37:16) range. Would that be – or could that turn into an overall, if we expect some flow through to Consultancy? [ph] CAD 300 million, CAD 400 million (00:37:26), I'm just – or is that...

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Not at all, Mona. I think, the impact will be immaterial that we would see on the elimination of the Construction net revenues. We don't expect to see any material impact. And if anything, it'll be a blip on the radar certainly, but with any decline in our Water Consulting business as a result of divesting Construction.

As Gord said, it's not mutually exclusive and we certainly weren't dependent on Construction projects to drive our Consulting business either in the UK or in the U.S. We don't expect any material impact. And maybe going back to Derek's question a little bit on revenue growth from acquisitions, I think, we will expect to see a good portion of that net revenue that is going away from Construction replaced by acquisitions into 2019.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Okay. Perfect. Because if we add up the Peter Brett and then, the Wood & Grieve, I believe the majority of Construction net revenue decline should be offset. Would that be true?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Yeah. That's correct. That's what we're thinking. It'll be – the majority of it. I don't think it will replace all of it, but certainly will replace a substantial portion of it.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Okay. Perfect. And then, secondly from me, I'm just wondering once Construction is fully divested, is there any liabilities or guarantees that are required from your site to Oaktree in regard to current projects or projects that were kind of under your scope and potential overruns in the future.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

No. The only thing that we have to resolve is the closing balance sheet with Oaktree and that will be done over the next 120 days. So, that's subject to obviously anything that comes up in the last month here from September – from our September financials to October. But no there is no trailing liability to Oaktree. What we have disclosed is that we will be retaining that one waste energy project as well as the UK pension obligations. But those are the only things remaining.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Okay. Very helpful. And just lastly I just want to confirm that the recent acquisitions and targets that you're looking at have no construction exposure, if that's correct? And then on that, has the due diligence process shifted at all over the last three years?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Yeah. So, to answer your question Mona, that is correct that none of the acquisitions that we've made nor the ones that we're looking at going forward have a Construction component to them. And in terms of our due diligence process, over the last number of years, we have significantly continued to process – it's a process of continued evolution and enhancement, but we have continued to strengthen our due diligence process. We've hired more people, added to our M&A and due diligence team with not just engineers and architects, but also with additional financial and HR people as well. So I believe that we continue to strengthen our due diligence process.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Thank you. That's it for me. And Dan I just wanted to say, all the best as you start this next chapter and it's been a pleasure. Thank you.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Thank you, Mona.

Operator: Our next question comes from Maxim Sytchev with National Bank Financial. Please go ahead, Maxim.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Hi good morning.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Good morning, Max.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Good morning, Max.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

And Dan, obviously all the best in retirement. In terms of the couple of questions I had, how should we think about it, the fact that organic growth is kind of matching GDP right now, certainly in North America? And I mean, typically at this point of the cycle, we would have much strong organic growth because I mean it's later stage, things are getting tighter. I'm just wondering if there is anything structurally has changed from your perspective in the business that, that is leading to that slowdown versus the prior economic cycles?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

No, I don't see that Max. In fact, as we noted earlier, our book-to-bill is above 1x. So, we're getting – we're strengthening where the backlogs are feeling good. We just have to continue to work hard to get that work out the door. And in some cases, we have to add staff in order to continue to bill by the hour and get the work out the doors, so we are in an active recruiting stage in many of our geographies. Labor markets are tight.

And so as you know with – we're a pretty diligent and disciplined company along the way. So we're trying our best to not participate in some of the frothiness that we're seeing some of our competition pay people just to get them in the door, because we see – we believe that would lead to margin erosion in the future. So, we're trying to be very disciplined about it.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

I think the other thing that we've mentioned Max and called out is, we did have as I mentioned in the opening comments, a couple of very large transportation projects in the U.S. and you don't replace those projects every day. You've got to work hard to get these big projects. So a couple of those came from the KBR acquisition and those have all been completed and successfully wound up. We also had a couple of large hospital projects in Canada in our Buildings practice at primarily in the Toronto area that have more or less being completed as well.

So, is that organic growth on quarter-to-quarter basis? Can be a little lumpy. I wouldn't suggest that because it's slightly lower this quarter that that's a trend. It's just the timing of projects coming in and out of the pipeline.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay fair enough. And then I had a question in terms of the non-cash working capital relative to last year. Is there some noise in relation to Construction that maybe you can call out? Because there is a pretty significant decline versus last year.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Sure. There's no question that our cash generated from operations and free cash flows are down compared to last year. Two primary issues there, one is certainly Construction that probably contributed to about CAD 70 million in reduced cash flow. As you see it's come through our operating results, it's also impacted cash flows because we're incurring costs there's essentially no revenues to complete these problem projects.

Secondly in the Consulting Services, our day sales outstanding, has increased from year-end of last year. So management is very focused on improving not only getting invoices out the door, but collecting on those invoices. So, certainly an area of focus, we saw our DSOs go down a little bit in the third quarter and we're still focusing on getting those further reduced and bringing more cash in the door in Q4 and certainly into Q1.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay. And sorry, the CAD 70 million is that year-to-date or that LTM?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

That's year-to-date.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

That might be – I think it's TTM.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay, okay. That's helpful. And then in terms of – sorry, the pension obligation that you will have in the UK, can you quantify it in terms of the contribution on a per annum basis?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Sure. The – and I – just going back to your last question that CAD 70 million is really year-to-date, not a TTM. So it'd be a little higher on a TTM basis...

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

...given we had some traction in Q4 of last year.

Sure. The pension contribution is about £4 million on an annual basis from the treatment for the Construction business that we've looked at our cash flows for the UK business and we certainly will be able to absorb those additional costs going forward. The overall pension obligation is around £40 million, that's payable over the next 20 years.

So [ph] it's also valuations and (00:46:04) revaluations. So as soon as that – I don't think that the company will actually have to pay the full £40 million because once the investments actually start gaining traction and they reach a level of self-sufficiency, then the obligation will be much less.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Right. Okay now that's helpful. And then last question just in terms of interest on Australian M&A. I mean like that market was kind of depressed maybe four years or five years ago. Right now it's really kind of brought back and so your view is that that momentum will continue. Just mindful of the end markets that are kind of up on a [indiscernible] (00:46:43) and then sort of cooled down post the transaction closing potentially. So just maybe any thoughts there, please.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Yeah. We still see a lot of Infrastructure works in the area, certainly as we continue to look at potential acquisition targets in some states, very large transportation plans. Still we see opportunities there, additional opportunity in the Buildings space as we still see some development, certainly the land development in and around some of the major cities, particularly in the southeast, very significant, very robust. So, we do see some positive tailwinds there for the next number of years, Max.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

And what about the transaction multiples because it has been such a hot market?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Transaction multiples have been fairly consistent with what we've seen in North America. They wouldn't have been anywhere outside of the norm that we've seen historically.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay. Thank you very much. That's it for me.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Thanks, Max.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Thanks, Max.

Operator: [Operator Instructions] We'll take our next question from Michael Tupholme with TD Securities. Please go ahead, Michael.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Thanks, good morning. You were asked earlier about the areas you feel good about for 2019 and you went through a list of a number of end markets and sectors. I don't know if you mentioned Energy & Resources unless I missed it, but I'm just wondering how you feel about that area. Going forward I mean obviously the growth has been very strong there for the last number of quarters, but at some point you're going to start to face tougher comps. So any comment on how we can be thinking about that area going forward?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Yeah. Certainly – and you're right. In Energy & Resources, the type of net revenue growth that we've been seeing, 25%, almost 26% in this quarter up a little over 26% year-to-date. That's not going to continue. I mean it just is – it can, and you're right, I mean we maybe have – you know as we even start to get into Q4 of 2018, we're coming off a higher comp in Q4 2017.

So, we still see a lot of work there coming up. We're engaged on a number of – pieces of work related to the LNG Canada Export Terminal, our Environmental Services groups are involved there, that Coastal Gas Link pipeline, we're involved in both the environmental and oil and gas engineering support, we've been doing that for several years. And a lot of the big pipelines jobs we're engaged in, so we do see that continuing. But in terms of organic growth in the 20%-plus range, I think we'll see that tapering off in 2019...

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

...to a more normalized.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

More normalized, yeah, yeah.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. And then just sort of follow up on the LNG Canada, recognizing that typically Stantec would get involved on sort of the front-end of these kinds of projects. Now with that project moving towards the actual commencement of construction, is your work actually ramping up still there or is it more steady state or actually tapering off?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Yeah, we see that opportunities going forward there. From an engineering perspective, we see good opportunities in geotechnical work, our ports and terminal groups, water resources, transportation, certainly community development is going to be new neighborhood and the new infrastructure put in place to house these people. In Environmental and – you know we see a lot of work going forward, whether it's for roads or transmission mains or collector pipelines or any of those things, there's certainly, we see a lot of opportunity going forward there. So...

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. And then I apologize if you'd mentioned this earlier, but with respect to Infrastructure and Buildings, we saw a negative organic growth on a net basis this quarter. I think that's been the case for at least a couple of quarters now, but you sounded quite positive certainly about Infrastructure. Just – are you expecting sort of an imminent turn in terms of the organic growth turning back into positive territory in those areas?

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

For Buildings, starting with Buildings, I think Dan, in the U.S., we did have positive organic growth in Buildings...

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

That's right.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

...in the quarter. It was really just in Canada where we came off a number of big hospitals that we – while we're working on Calgary Cancer in those locations, it's just – wasn't enough to offset the big projects that turned down.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

That's correct.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

And there is a number of, still some good opportunities in Canada. So we feel okay, about Canada going forward. We're still a bit reserved. On the Infrastructure side though a lot of opportunity out there, light rail, public transit, roadways. So I think, in Infrastructure which is our Infrastructure group is still primarily dominated by transportation. We're still seeing to be turned down in a number of the big Texas projects that we finished up at this time next year. We have some good new projects that are on the rail. We talked about the Long Island Rail Road and others. So I think that we will see a turn in the Infrastructure as well going into the Q4, but certainly into next year.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

And maybe just to add one other thing on that. In projects like Long Island, there are requirements where we have to hire other consultants, women disadvantaged businesses and so on. So that's why you're seeing good organic growth on the gross revenue line, but net revenue, we have to sub out some of that works by contract, so on the large transportation projects. So that has a bit of an impact that certainly we can do all the work, but it's a requirement that we sub some of this out.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. You've been asked a couple of questions about the sale of the Construction business and what that might mean in terms of once you separate that and I think, some of those questions were more getting at the revenue opportunity that may be sort of be lost or people wondering about that and I think you addressed that.

But I guess what I'm wondering is, are there any dis-synergies from a margin perspective for your Consulting operations once you – or now that you've closed the sale of the Construction piece. So I'm specifically thinking about MWH's Consulting business any linkage to the Construction business and any kind of dis-synergies on the margin within the Consulting business that you will now have going forward?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

We've had a good look at that, Michael, and I think there is maybe CAD 1 million or so of potential moving from having the costs being done internally versus as a sub consultant. But it's not going to be material on certain projects. These are really construction management type projects that we're seeing. So that's over the life of the project, so it's not going to be reflective in any given quarter. But other than that, I'm not really aware of anything that would create that kind of dis-synergy that you're – you would think would be material.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

Right. And one thing just to clarify again that – as we've talked a little bit about some of the acquisitions we've brought on or planning to bring on, the net revenue that we're generating through these new acquisitions is as Dan said are both the same as what we're losing in construction not quite as much, but certainly from a gross revenue perspective, there'll be a big change...

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Yeah.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

A

...because Construction has certainly generated significant gross revenue. So I think you'll see the as a company that overall gross to net is going to take note.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

And we will see an improved margin, but obviously with the Consulting Services acquisitions from the poor margins that we've seen in Construction to date, so that too will help. So, the revenue replacement has added much better margin – EBITDA margin than what we're replacing, so.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. That's a good point. Maybe just to tie all of that together then, your guidance for the Consulting Services business for EBITDA margin has been 11% to 13%. As we move forward, is there anything that would cause that to change things we just talked about, but other things I mean, you're going to have maybe some additional integration next year with a lot of the M&A you've done, you've mentioned some competitor pressures in the gross margin. Just as we tie it altogether, is a 11% to 13% still kind of the range or is there a different range we should be thinking about?

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

I think as I kind of commented earlier as that is right now, I think that makes sense that we don't see anything that's really driving those margins significantly lower if we get significantly higher revenue and opportunities in the oil and gas sector that's lower margin business, so that could drive down the overall EBITDA margin a little bit. But I don't know that I can give you a specific answer today until we get to our budget and our forecasting for 2019 which again will be provided in the Annual Report, but I don't think it's going to be materially different, Michael.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. Thanks for that, and all the best for your retirement, Dan.

Daniel J. Lefaivre
Chief Financial Officer & Executive Vice President, Stantec, Inc.

A

Thank you, sir.

Operator: And it appears there are no further questions at this time.

Gordon Allan Johnston
President and Chief Executive Officer, Stantec, Inc.

Great. Well, thank you, and I'd just like to thank everyone for joining. We'll see several of you I'm sure over the next quarter and look forward to chatting with you no later than our Q4 call, which will be in February. Thanks very much everyone.

Operator: Thank you all for your attention. This concludes today's conference call. All participants may now disconnect.