22-Feb-2018

Stantec, Inc. (STN)

Q4 2017 Earnings Call

CORPORATE PARTICIPANTS

Sonia Kirby
Director-Investor Relations, Stantec, Inc.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

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

OTHER PARTICIPANTS

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Mona Nazir
Analyst, Laurentian Bank Securities

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Michael Tupholme
Analyst, TD Securities, Inc.

Chris Murray
Analyst, AltaCorp Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Stantec's Fourth Quarter and Year-End 2017 Earnings Results Conference Call. Today's conference is being recorded.

I would now like to turn the meeting over to Sonia Kirby, Director of Investor Relations. Please go ahead, Ms. Kirby.

Sonia Kirby
Director-Investor Relations, Stantec, Inc.

Thank you, April. Good morning, everyone, and thank you for joining us today for our Q4 and year-end call. With us today are Gord Johnston, President and Chief Executive Officer; and Dan Lefaivre, Executive Vice President and Chief Financial Officer.

The call today is webcast and we invite those dialing in to view the slideshow presentation, which is available in the Investors section at stantec.com. All information provided during this conference call is subject to the forward-looking statement qualification, which is [ph] settled (00:52) on slide two and detailed in our MD&A and incorporated in full for the purposes of today's call.

With that, I would like to turn the call over to Gord.

Gord Johnston

President & Chief Executive Officer, Stantec, Inc.

Thank you, Sonia. Good morning, everyone, and thank you for joining us today. For those of you following along in the slide show, we're on slide three. For this morning's call, we'll begin with my introductory overview of our performance and achievements in 2017, and after that, Dan will provide some commentary on our financial performance. When Dan concludes his remarks, I'll provide some operational highlights and our targets and outlook for 2018. And then finally to wrap up, I'll ask our operator to open the call for questions.

Let's move on to slide four. There were several company highlights in 2017 that were important milestones I would like to address. In 2017, we achieved our longstanding objective of becoming a top 10 global design firm, and we made significant progress towards fully integrating MWH and solidifying our strong global platform. We continue to win work together with MWH that we couldn't have won as separate organizations, and as of January 1 of this year, we rebranded Stantec globally.

Our core Consulting business continues to perform well, and we returned to year-over-year organic growth in 2017. Last month, we signed a letter of intent to acquire New Mexico based Occam Engineers, and earlier this month, we announced a signed letter of intent to acquire Traffic Design Group, one of the largest transportation planning and traffic engineering design brands in New Zealand.

Although I'm disappointed that we didn't meet our expectations in Q4, I'm confident in our strategic planning and our future. We believe that we are well positioned heading into 2018, and our outlook reflects that optimism. There were several items impacting our results including legacy project issues, additional administrative costs, and U.S. tax reform in the quarter. So, just looking at the headline numbers doesn't provide the full picture of our results from operations, and Dan is going to discuss that in a little more detail.

I'll now turn it over to Dan to provide additional detail on our fourth quarter and full-year financials. Dan?

Daniel J. Lefaivre

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

Thank you, Gord. Good morning. And I apologize for my voice this morning. I've got a bit of a cold apparently. For those following along with the presentation, we're moving to slide six. We've improved our disclosures around gross to net revenue and provided additional reportable segment detail for Consulting Services and Construction Services. Slide six reflects our overall performance in Q4 2017 as compared to Q4 2016.

As Gord mentioned, we had several discrete items that negatively impacted our results specific to the fourth quarter, and I'll begin by speaking to those items in more detail. Lower gross and net revenue in the quarter were due to a limited number of projects that experienced challenges. These issues also negatively impacted organic growth and gross margins. There were three main areas where we saw these impacts. In the Consulting Services US Water business, we recorded a CAD 5 million downward revenue adjustment on a major design build project due to additional costs, design issues, and project scope changes.

In the U.S. Construction Services business, we recorded a CAD 16.3 million impact in cost escalation increases against three legacy hard-bid projects. Site conditions, project management, and [indiscernible] (04:29) impacted the execution of these projects. These hard-bid projects are all near completion. These were awarded several years ago while Construction Services expanded to take on these hard-bid projects outside of their core regional areas of expertise. We have placed a hold on any further bidding on hard-bid projects outside of our established areas.

Finally, in the UK Construction business, we recorded a CAD 5 million increase in costs related to certain waste energy projects that are also nearing completion.

For all of the above noted construction projects, claims against parties believed to be responsible for these additional costs have been or will be asserted. As of the end of 2017, less than 30% of the asserted claims have been recognized in earnings. We expect that any recoveries obtained may benefit future quarters as these claims are resolved.

Now moving to slide 8, looking at impacts on administrative and marketing expenses as a percentage of net revenue, an increase from 44.3% to 44.9% was due mostly to a CAD 6.2 million increase in the provision for self-insurance and a CAD 3 million increase in marketing and administrative labor. These were partly offset by a CAD 5.3 million decrease in share-based compensation.

We incurred higher admin and labor costs in the fourth quarter mainly due to the holiday season and weather conditions in colder climates. As we have grown in the U.S., we see lower overall utilization also with the U.S. Thanksgiving holiday break. We've been very proactive in the management of our seasonal workforce. However, we still experience the impacts of lower utilization in Q4 and Q1 of each year.

EBITDA decreased in the quarter from CAD 83 million to CAD 69 million. Adjusted EBITDA decreased from CAD 84 million to CAD 63 million mainly due to the CAD 26 million in project impacts on revenue and gross margin and the CAD 4 million increase in admin and marketing expenses as I described earlier.

I would like to turn your attention to slide 9 and the impacts from U.S. tax reform. In Q4 2017, our reported tax rate was 64.8% primarily related to a CAD 31.2 million transition or repatriation tax, which was partly offset by the revaluation of deferred tax assets and liabilities, resulting in a net CAD 18.6 million increase in tax expense associated with U.S. tax reform. Without these impacts, our estimated annual effective tax rate decreased from 27% in Q3 2017 to 24% in Q4 2017, resulting in effective tax rate of only 7.6% in the fourth quarter of 2017.

Diluted EPS was down from CAD 0.26 to CAD 0.10 mostly due to project impacts on gross margin, leading to an after-tax EPS impact of CAD 0.17. U.S. tax reform was an impact of CAD 0.16 on EPS, and administrative and marketing cost increases was an after-tax EPS impact of CAD 0.03.

Slide 11 summarizes our full-year 2017 results. Gross and net revenue were up 19.5% and 10.3%, respectively, over the prior year. Organic gross to net revenue grew 3.6% and 0.1% as well as acquisition growth were partly offset by exchange impacts from foreign exchange – sorry – and the Consulting Services water project provision impact, as I previously noted, that occurred in the fourth quarter.

Gross margin in 2017 was slightly lower, 53.5% compared to 54.1% in the prior year, mostly due to the Construction Services projects impacting the fourth quarter as previously discussed. Without the CAD 14.5 million acquisition-related costs we incurred in 2016, administrative and marketing expenses increased in 2017 compared to 2016. This increase was due primarily to a CAD 12 million increase in IT costs related to the move to cloud-based software, developing our global platform, and our core network infrastructure; a CAD 13.3 million increase in the actuarial estimates associated with the provision for self-insurance with the addition of the MWH claims experience added to our insurance; a CAD 3.9 million increase in professional and audit fees related to items such as the first-year compliance for SOX for legacy MWH, U.S. tax reform, and out-from-under planning that we did in the third quarter.

MWH integration costs of CAD 3.5 million were incurred in 2017, and these higher costs were partly offset by CAD 11.3 decrease in occupancy and lease exit costs as we optimize our space and a CAD 3.5 million decrease in severance payments.

EBITDA increased to CAD 424 million, and adjusted EBITDA increased to CAD 363 million. Adjusted EBITDA as a percentage of net revenue remained consistent year-over-year for Consulting Services due to higher gross margins, offset by higher admin and marketing costs as previously discussed. Construction Services EBITDA was negatively impacted by the cost escalation adjustments on the projects I have discussed earlier.

Now moving on to our annual effective tax rate on slide 13 and the impacts we saw on 27 (sic) [2017] (10:45). On an annual basis, our reported tax rate was 63.2% and was impacted by three main areas in 2017: a CAD 94.5 million tax expense from Innovyze in Q2 2017, the CAD 3.2 million impact of the out-from-under reorganization we completed in the third quarter, and the net CAD 18.6 million tax expense from U.S. tax reform enacted in the fourth quarter of 2017. We anticipate our overall effective tax rate for 2018 will be approximately 27%. As many of the historical U.S. federal tax provisions we benefited from such as Section 199 and the deduction of interest expense and certain types of related party cross-border financing structures have been repealed under tax reform.

On slide 14, adjusted diluted EPS was of CAD 1.77 compared to CAD 1.69 in 2016. Adjusted diluted EPS for 2017 was lower mainly due to the gross margin project impacts, as I've talked about in the fourth quarter, having an EPS impact of CAD 0.17; increase of marketing and admin costs I discussed earlier having an EPS impact of CAD 0.12.

Moving to slide 15 and the targets we outlined last year, gross margin and admin and marketing and EBITDA as a percentage of net revenue were all within our expected ranges. Net income as a percentage of net revenue was 2.8% below our targeted range and was negatively impacted primarily by the tax on Innovyze sale, cost escalations on projects, U.S. tax reform as previously noted. Without these impacts, our net income as a percentage of net revenue would have met our targeted range.

I'll turn it back over to Gord now to discuss operational performance and our targets and outlook for 2018. Gord?

Gord Johnston

President & Chief Executive Officer, Stantec, Inc.

Thanks, Dan. Let's go to slide 17. I'd now like to summarize the performance of our core business in the fourth quarter and full year and will then look ahead to our outlook for 2018. We experienced overall organic gross revenue growth in the fourth quarter and the full year 2017. Stantec's Canadian Consulting Services business had organic gross and net revenue growth in the quarter and full year 2017. Growth in the quarter came from continued strong housing demand in Ontario, southern Alberta and Quebec, several larger pipeline projects, and a large mining project. We also continued work on large healthcare projects in Ontario, Alberta, and British Columbia.

If you move to slide 18, in United States, Consulting Services organic gross and net revenue retracted in the quarter and on a full-year basis. Organic retraction in the quarter was seen in our buildings, environmental services and Water business, and in our transportation sector. We completed significant design phases early in the year on several large projects in our buildings and Water business, operating units, and our transportation sector, resulting in lower revenues in the fourth quarter.

Water was also negatively impacted by the downward revenue adjustment on a major design build project we discussed in the beginning of the call. And that retraction was offset by growth in community development, mining, power, and our waterpower and dam sectors. Our Global Consulting business had a strong organic gross and net revenue growth in the quarter and for the full year due to strong project activity in the UK through the AMP6 cycle and improving market conditions in our Latin America Mining sector and our Middle East Water operating business units.

Construction Services had organic gross revenue growth in the fourth quarter and on a full-year basis. Organic gross revenue growth is a better indicator than net revenue for Construction Services as very little direct work is self-performed. Construction Services continued to win multiple project awards in 2017, contributing to the organic growth.

On slide 21, we have summarized organic gross and net revenue growth or retraction in the fourth quarter and the full-year 2017 by Consulting Services business operating unit. We also provided some additional color on what contributed to the results within these BOUs.

I'd now like to highlight some of our recent project wins as you'll see on slide 22. Our backlog stands at CAD 3.9 billion at December 31, representing roughly CAD 2.8 billion in Consulting Services and CAD 1.1 billion in Construction. While this is stable from the same period in 2016, we've seen backlog grow organically, however, this growth was offset by the impact of foreign exchange.

Earlier this month, we announced that we were chosen as the strategic partner for Yorkshire Water in a deal worth £50 million as they prepare supply change arrangements and contracts for the AMP7 period, which runs from 2020 through 2025. This major contract continues until 2025 with the potential to extend by an additional five years. And just last week, we announced that Stantec will serve as the lead engineer for the recent award of the CAD 1.9 billion design build commuter rail expansion for the Long Island Rail Road in Nassau County, New York.

Historically, we haven't routinely publicized project wins. We are highly diversified with tens of thousands of projects, so [ph] aren't (16:31) reliant on any one project for a significant portion of our revenue, however, we're modifying this approach to provide a bit more transparency regarding significant project wins as we expand globally.

Looking ahead to 2018, we refined our targets to provide better visibility into the differences between the Consulting Services and Construction Services businesses. For Consulting Services, our targets remain the same as our overall targets in 2017. We've now broken out specific targets for Construction Services, and you can see those on the slide as well as the consolidated numbers. In addition to those targets, we also outlined in the MD&A the expected gross to net revenue ratios for Consulting and Construction Services, which we expect to be in line with what we saw in 2017. Additional assumptions around capital expenditures, amortization of intangibles, and software additions in 2018 are also reflected on this slide.

In our annual report, which we released this morning, we outlined our outlook for 2018 as shown on slide 24. Overall, we continue to target a long-term average compound gross revenue growth rate of 15% through a combination of organic and acquisition growth, a number that we've achieved over the past 5 and 10-year periods. In 2018, we expect overall organic gross revenue growth in the low- to mid-single digits, supported by continued economic growth in United States, increased infrastructure spending in both Canada and the U.S., modest improvement in the Energy & Resources sector, global economic growth, and our ability to continue to expand our global footprint. And just before I open it up to questions, this morning, we announced a 10% increase in our quarterly dividend over last year.

We're also pleased to announce that Richard Bradeen has joined Stantec Board of Directors. Richard is a former Senior Vice President of Strategy, Mergers & Acquisitions, Pension Investments, Corporate Audit Services and Risk Assessment from Bombardier. Before that, Mr. Bradeen worked at Ernst & Young for about 19 years, holding increasingly senior roles including Partner and President of the Corporate Finance Group in Toronto. Mr. Bradeen will serve on our board's audit and risk committee.

That concludes this morning's presentation. Thank you for joining us. Operator, let's start the Q&A portion for today's call.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Benoit Poirier from Desjardins Capital Markets. Please go ahead.

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Q

Yeah. Good morning, gentlemen. Could you provide a little bit more color around the provision for the legacy project on the Water business? And also, could you talk historically about the provision that business has taken over the last five years? I'm just trying to get a better understanding of the Construction leg going forward.

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

A

Sure. I'll give you a bit more color on that, Benoit. It's really in two different areas, so it's the waste-to-energy projects in the UK where we took some additional provisions. Those are outside of the historical core Water business that MWH had done on the construction side previously. When we look at the AMP programs in the UK, those are all operating very well both on the consultancy and on the construction side.

So, these are legacy projects that were really based on incentives from the UK government that have now more or less been taken away as a result of Brexit, really working for one developer, three projects, and those are all nearing completion. We're working through the final tail end of those projects. So, that's the UK Water business where we had the impacts there.

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Q

Okay. And now, when we look at your consolidated EBITDA margin, you ended with 12.4%. So, you are guiding for 10% to 12% on a consolidated basis, so lower than what you were guiding back in 2017. Could you provide some color around what drives the decline in the EBITDA margin, whether it's only the full contribution from MWH or slightly weaker margin pressure overall or more competition?

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

A

Sure. I think what we've tried to do for everybody is to show you the consolidated business broken out between Construction and Consulting Services. So, on the Consulting Services business, we're confident that we'll still be able to achieve the margins that we have historically as laid out in our disclosures.

The Construction Services frankly is a slightly lower margin business, and I think that's where providing that additional color to the investment community allows you to understand what the consolidated margin should look like. And so, that's why we've broken it out this way. We're not suggesting that the Consulting business by any stretch, which is 80% of our business, is retracting or seeing additional price pressures or anything like you mentioned there, Benoit.

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Q

Okay. And given what happened with the Construction business in Q4, does it change your view about whether Construction is core or not, Dan?

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

A

I'll let Gord take that one.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Sure. We see still a lot of synergy between the Consulting and the Construction businesses. In the UK, from the AMP programs, there's a lot of synergy with those groups working together. And in the U.S., we worked together on a number of design build jobs, and we're continuing to look for additional synergies there. So, we still feel pretty good about the Construction business going forward.

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

A

They've got a lot of backlog in what we would call their core water business in the U.S., significant backlog and a lot of good project wins around the type of projects that are not those hard-bid projects. Progressive design build and CMAR-type projects were much more within their wheelhouse.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

And as Dan mentioned, the projects in the U.S. where we're experiencing some issues in Q4 were projects that they took on outside hard-bid jobs that they took on outside of their geographic area of comfort back three or four years ago. Those are all wrapping up now. They're in the 95%-97% range.

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

A

Oh, with the exception of one.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

With the exception of one.

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

A

Yeah.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

So, we're looking forward to wrapping those up and then moving forward.

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Q

Okay. And last one for me, you ended the year with a strong balance sheet. You mentioned in the past that you expect to be very active on the M&A front in 2018. You already announced two recently. So, I was just wondering if you could provide more color about the dry powder you have, whether it's tuck-in mostly or what is the bidding pipeline if you are looking at any transformational deal and if you have seen some change in the valuation recently. Thank you.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

In terms of the pipeline of potential acquisition, it probably is full now as it's ever been. The last half of 2017, we really focused on meeting with a number of prospective firms that we think would be a great addition to Stantec both in the UK, Australia, New Zealand, and throughout North America. So, we've announced two so far this year, and we're confident that there'll be a number of additional ones coming forward.

As to the financial metrics, Dan, maybe you could speak to that.

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

A

Financial metrics have stayed relatively consistent in that six to eight times EBITDA, generally the range that we're looking at, and nothing has really fallen outside of that range. I think it's always a question of what the forward forecasts are and the projections from these entities looking not only historically but into the future of what the right price to pay. That is only one factor that we consider though when we do an acquisition.

Benoit Poirier
Analyst, Desjardins Securities, Inc.

Q

Good. Thank you very much for the time.

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

A

Thanks, Benoit.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thanks, Benoit.

Operator: And we'll take our next question from Jacob Bout with CIBC. Please go ahead.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

Hi. Good morning.

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

A

Good morning, Jacob.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Good morning, Jacob.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

So, the issues that you have in the fourth quarter, maybe comment on do you expect much of a bleed into the first quarter of 2018.

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

A

We don't expect that to continue to bleed in 2018. The cost adjustments that we took in the fourth quarter are really based on the information that we have at the time. So, it's the best information that we had. When you look at the cost adjustments that we made, as I indicated, there is a whole bunch of claims outstanding associated with these cost escalations, and we've only recognized less than 30% of the revenue associated with that.

So, hopefully and hope isn't a strategy, but we've got the teams working on the recovery of these claims, and hopefully, there'll be a pickup in 2018, but there's no assurance of that. So, you have to look at it from the perspective of the revenue recognition standards where the hope of recovery or the likelihood of recovery is based on three primary criteria. One is that there is a highly probable condition of collectability. So, that's really over 80% or 70% certainty of collectability that we have a legal basis for our claims and that we are in a negotiable or a good position with our client to get this resolved. And that's why we've only recognized a very small portion of the overall claim. So, we do expect to continue to work through these in the first half of 2018.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

Turning to the Water segment, if you think about organic growth in the water industry, what do you think that's growing out and how do you expect to perform in 2018?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

We see the Water business line for us performing very well into 2018. We've won a number of solid projects over the last couple months in fact, a large design build in the U.S. Northeast, and in fact, just yesterday, we were awarded the Mid-Breton Sediment Diversion project down in Louisiana, which is a very large project for us. It was very actively competed. We see that strengthening going forward. The provision that we took in Q4 was for a legacy project that MWH, the water group had been working on with the MWH construction group. And so, as Dan mentioned, as we're negotiating the claims for that project, the overall hopeful recovery will be inclusive of recoveries for either the water consulting side or the water construction side, and that will come collectively together.

So, we feel good for water going forward. We see some of the projects or some of the big programs that we're working on moving forward. Of course, we announced that we were successful on the Yorkshire Water AMP7 project. So, there's really a lot of good things happening on the water space, and we're comfortable with the growth in that segment going forward into 2018.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

Is this like a GDP-type growth business for you or something better than that?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

It'll be better than GDP growth for us.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

And maybe just lastly, just on your EBITDA guidance of 10% to 12%. Maybe just help us out what gets us to the bottom top end and the risk on the downside. Is that primarily in the Construction Services?

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

A

I think the guidance, the risk is really when you consider on the Consulting side – I'll break it down between the two. On Consulting, the risk is really our ability to keep our utilization up and perform well on our projects. Obviously, it flows all the way down from getting the appropriate pricing, understand the scope on a project to our project execution, and then having our staff fully utilized. So, that's what's going to drive EBITDA on the Consulting side. If we have better utilization in 2018, that will push us to the higher end of that range.

In Construction Services side, the EBITDA is more of a function of gross revenue than net revenue because we don't self-perform. We perhaps should look at changing the metric here for Construction Services, but it's really a function of gross revenue because of that self-performance, but we expect them to improve their performance over what we saw in the latter part of 2017. And that's really the expectations that we're getting from that business.

Jacob Bout
Analyst, CIBC World Markets, Inc.

Q

Thank you.

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

A

Thanks, Jacob.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thanks, Jacob.

Operator: And we'll take our next question from Sean Eastman with KeyBanc Capital Markets. Please go ahead.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

Thanks, guys. So, first off, Gord, just want to say congrats on your new role. It sounds like you got a busy year ahead.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

It'll be an exciting year for us.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

I just wanted to continue trying to break down the revenue growth outlook for this year. You guys highlighted a low- to mid-single digit type expectation for 2018. I'm just curious in particular what you guys are assuming in there around the energy and mining spaces in particular. It seems like we've seen an inflection here recently. I'm just wondering, is a continuation there reflected in this outlook.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Yeah, we are feeling pretty good about our Energy & Resources segment. In the mining space, with the increases in copper prices, we're seeing more activity particularly in our South America operations. We're seeing some strength in additional proposal activity and some more positive momentum there.

In the oil and gas space, certainly, we're on some of the large pipeline jobs we're working on in Canada. Even though there seems to be some inter-provincial conflict and so our work hasn't slowed on those jobs in both our environmental services space and in our Energy & Resources group, our oil and gas group. So, we are seeing some positive movement there as well.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

Both of those end markets will be up in 2018.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

We believe so. When you look at the momentum, our net revenue growth in our Energy & Resources space starting negative early in the year, in Q4, we had almost 35% organic growth in that space.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

We're feeling very bullish about that.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. And then secondly, I just wanted to ask about the AMP program in the UK. You guys secured a contract this quarter. I have been hearing that just around Brexit and just economic woes in the UK that that AMP program could be smaller. So, if you could just walk me through when the bidding starts to commence for this next phase and whether you guys are seeing the next phase as being equal or larger than the previous one?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

The Yorkshire Water was the very first AMP7 that had been recompete, and so we are glad to be successful on that one. As we're talking to our clients about the next phase of the AMP project, which is about two years out, will be the rebidding. We're not seeing talk of retraction in the size of those projects currently. There always is some uncertainty with Brexit and [ph] uncertainty (34:14) with some of the elections there with the various parties having different opinions on the ownership of the utilities. So, there's a little uncertainty there. But certainly at this point, we haven't seen any of our clients coming to us saying that the projects might be certainly put on hold or talking about reductions in the size of the projects at this point.

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

A

Yeah, I think one of the risks that we've – we just met with our UK lead just last week, and one of the risks with Brexit is [ph] a favored (34:48) party gets in on their platform. They're talking about nationalization of the water utilities. That would take a very long time and very difficult to do. These are all private entities that are operating all the about 12 different water utilities across the UK.

Sean D. Eastman
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. I appreciate the responses, guys.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thanks, Sean.

Operator: And we'll take our next question from Yuri Lynk with Canaccord Genuity. Please go ahead.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Hey. Good morning.

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

A

Good morning, Yuri.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Good morning, Yuri.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Guys, I'd like to go back to the question, I think it was Benoit asking about just the difference in the consolidated EBITDA margin guidance this year is down about 100 bps on both the top and bottom and compared to last year. I understand the new disclosure, and it's much appreciated, but I'm assuming when you gave that guidance last year, you guys had looked at the two businesses in their totality. So, I guess, my question is the 100 basis point reduction in EBITDA margin guidance, is that due to the Consulting business or the Construction business? I'm guessing it's the latter and just some color on what's changed there.

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

A

I think as I indicated earlier, Yuri, it's really based on the Construction business. As I said, the Consulting business is very similar to what our expectations were last year. I think as we learn more about construction and we break down the business, we're able to get more clarity around Construction and thus, the additional disclosures. And with that, we're perhaps being a little conservative overall given that Construction is only 20% of overall revenues, but that's more reflective of what we expect the Construction business to be this year.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

And how does the potential recovery of claims play into your guidance?

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

A

We have not factored those into our guidance.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Okay. And maybe one for Gord. Gord, just high level, I mean, your growth target is 15% compounded revenue growth, long term. I mean, is the revenue growth target really appropriate especially in light of some of the execution problems you've had with MWH and how, I think, difficult it is to do M&A sometimes? I mean, shouldn't it be more of a sum per share metric, either adjusted earnings per share, free cash flow per share, whatever you want to look at it? Is revenue the right thing to be thinking about?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Revenue growth is just an overall proxy for the success of our overall, both organic and acquisition growth program. We will continue to focus on our acquisition, really filling out our global profile. But your point is a good one, and we are spending a lot of time looking back on the cost control side of the house in improving some of our cost control structures, spending a lot of time focusing on project execution. And all of those things will certainly have a positive impact on earnings and earnings per share. We expect long term that our top line and bottom line growth will match. And that's really where we're focusing on. We're certainly focusing on growing the top line, but we're spending a lot of focus on improving our bottom line growth as well to match top line.

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

A

And I think if you look historically, we've accomplished that when you absorb an acquisition the size of MWH and you invest in building that platform out, which is really what we've done throughout 2017. It sets us up well for the future. You see some of the additional costs we incurred in 2017. Those are largely behind us. The bulk of the integration is complete, at least the heavy lifting of it. We still have the global operations to integrate into our larger ERP system, but that's going to be a much less of an impact than what we've seen in 2017 with getting the North American operations up to speed on Oracle.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Okay. When will all of these projects be completed, the problem projects? I know you're 90%, 95%.

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

A

Yeah.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

But just if you can get more specific on the three buckets and when those projects will wrap up, and that'll be it for me. Thanks.

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

A

I don't know that we have an exact date, Yuri. [ph] You're (39:58) working through the final commissioning on these projects are all in production with the exception of one, as I said, and that's about 80% complete. The other ones are all at that 97%, so in the wrap-up phases. And then obviously, we're working to the claims on these things. So, they will take some time. Speaking with our President of our Construction business yesterday, he was confident that some of these will be wrapped up in the first half of the year.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Okay. And then there is a warranty period, I would assume.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

That includes the warranty period.

Yuri Jonathan Peter Lynk
Analyst, Canaccord Genuity Corp.

Q

Okay, guys. I'll turn it over.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thank you.

Operator: [Operator Instructions] We will take our next question from Mona Nazir from Laurentian Bank. Please go ahead.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Good morning and thank you for taking my questions.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Good morning, Mona.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Hi. So, I just want to keep going a little bit on Yuri's question. Of those CAD 26 million in provisions that you [ph] talked (41:05), just wanted to clarify that about CAD 20 million were related to water projects. So, would it be safe to say that those stem from MWH?

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

A

All of the CAD 26 million were related to Water, and all of them were related to legacy MWH projects.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Okay. And do you know what year – I know we just talked about when they could end, but do you know what years they were signed?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

It was that 2013-2014 range.

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

A

For the bulk of them. One was more recent, probably in 2016, the large manufacturing project.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Right.

Mona Nazir
Analyst, Laurentian Bank Securities

Q

Okay. That's helpful. Thank you. Okay. So, that was it on the provisions. And just turning to M&A, you said that the pipeline was as full as it's ever been. But just given the targeted kind of EBITDA multiple of 6 to 8 times, is it safe to assume that they're kind of smaller in size or the tuck-ins, as we like to call it, or could they be larger?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.
A

There is a number of different size of firms that we're looking at right now, ranging from the smaller ones. We don't see anything as big and transformational as an MWH in the pipeline right now, but certainly, in that small to midsize range.

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

[indiscernible] (42:29) active pursuits there are – and we've always said that if there is a larger one that comes along, generally these are going to be brokered processes, we'll participate. But we aren't seeing anything in the pipeline today.

Mona Nazir
Analyst, Laurentian Bank Securities
Q

That's helpful. And then just turning to the integration of MWH, and I know that North America is now behind us. We're moving into UK, the rest of the world. I'm just wondering if you could quantify those onetime integration costs for 2017 and what a normalized margin would have been and what kind of stepdown could we expect in 2018?

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

There were two areas where we identified additional costs. One was on the IT side of things, Mona, where we mentioned about CAD 12 million of additional costs. Not all of that was integration related, but probably about a – I would suggest about – I don't have the exact number but probably about CAD 3 million of that would have been related to MWH getting all of our collaboration tools, our global networks, putting everyone on to the same network would have been part of that. And then we identified about CAD 3.5 million of pure integration costs, and that's usually related to labor being not billable to clients as we're working through the integration and people are getting used to the new systems and learning the new revenue recognition approach and so on. So, I think there was probably about CAD 6 million to CAD 7 million there in the impact of MWH integration in 2017. Going into 2018, I don't think it will be as high. Certainly, we don't expect that amount next year.

I think the other thing that impacted our results was the additional insurance costs and the actuarial estimates with the addition of MWH, and that will be normalized going forward. And so, we don't expect that to be a year-over-year increase in 2018 that we saw in 2017. So, it will be more embedded into our actuarial estimates of our claims outstanding in 2018. So, you take those three items, those would the impact that we saw this year that certainly, we don't expect to see that level of impact in 2018.

Mona Nazir
Analyst, Laurentian Bank Securities
Q

Okay. Thanks so much. I'll step back.

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

Thanks, Mona.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thanks, Mona.

Operator: And we'll take our next question from Derek Spronck from RBC Capital Markets. Please go ahead.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Yeah, it kind of sounds like [indiscernible] (45:31). Thanks for taking my questions. Just on the acquisition front, the change in the U.S. tax regime, does that change your focus at all in terms of regional acquisition focus and/or does that kind of spur potential sellers into selling in that region?

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

A

It certainly doesn't impact us from a U.S. tax reform perspective. It really doesn't have an impact on us from that perspective. I don't think it has a material impact on sellers. I don't know honestly in tax reform whether there's a change in the capital gains rules or any of those types of things. And I don't think there were. It's more related to the lower tax rate and the repatriation tax. So, I don't think there's been a material impact there, certainly doesn't impact us from doing the acquisition. Where it does have an impact for Stantec is the elimination of the deductibility of interest expense above a certain level on EBITDA. We're looking closely at that, and that's why our effective tax rate does not take into consideration any potential changes or optimization. The rules are still changing. The IRS is still issuing guidance every day, multiple guidance every day. So, as we get further through 2018, we'll be looking at what alternatives we have to optimize our effective tax rate in the U.S. going forward.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Presumably, it will be an improvement though, all else equal. Is that the right assumption?

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

A

Yes, we don't expect it to be any higher. If anything, hopefully it gets a few basis points lower in the effective rate in the U.S.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. Great. Thanks. And just on the accounting front, IFRS 15, does your guidance take that into consideration? And I know due to the nature of your contracts, it's probably going to be less impactful, but any color around the potential impact of IFRS 15 and IFRS 9?

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

A

Yeah, Derek. I can give you a bit of additional color. We didn't touch on it in our script. IFRS 15 is required to be implemented in Q1 of 2018. We will be implementing it on a modified retrospective basis. We are currently completing our contract reviews, and the impacts of those have not yet been formally determined. If there are any impacts, it will impact our opening retained earnings. There will be adjustments there.

We are looking closely at the performance obligations under IFRS 15, and it really is about the segregation and consolidation of contracts and the services that we provide under those contracts. We don't have, as I said, the numbers related to those. In addition, we're reviewing any contract modifications, claims. I mentioned, the highly probable legally enforceable and client history impacts. We're looking at those under IFRS 15. We won't be discounting holdbacks any longer under the new standard, and we will be adding a number of additional disclosures in Q1.

So, we don't have the exact numbers yet. We've certainly been working through it. It's been a very long and arduous process getting to this standard. Where the impacts are going to occur, I expect to your question is going to be more on the Construction side than on the Consulting side.

The other big change that we will see is in backlog. Historically, as you know, we've only represented backlog about the next 12 to 18 months on a contract. In the future, we'll be recognizing all of the backlog that we have contracted, which, I think, you'll see a significant bump in backlog once we report that in Q1.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. That makes sense. And so, lowered retained earnings, higher backlog, and maybe some timing-related revenue recognition by and large.

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

A

Exactly. Yeah.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. And just quickly, one last question, you won two very significant projects, are part of the consortium that won the projects, the Montreal LRT and the Long Island Rail Road project. Any way to quantify your proportion of those contracts and when we should start seeing the positive financial implications of those two projects flowing through the financials?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Well, the Long Island Rail Road project kicks off right away. We have people working on those already. In Q4, we saw a little bit of net revenue retraction in transportation because a lot of the bidding work that we are working on. We wrapped up a number of projects in Texas, doing a lot of bidding work on the REM certainly in Montreal and on Long Island Rail Road, so two that we have been successful on and we're looking to get people engaged on them right way. But we're seeing some good momentum going into Q1 in the transportation space.

Derek Spronck
Analyst, RBC Dominion Securities, Inc.

Q

Okay. Great. Thanks.

Operator: We'll take our next question from Maxim Sytchev with National Bank Financial. Please go ahead.

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.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Good morning, Max.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Dan, I don't know if you're going to have these numbers on hand. But what percentage of work in Construction is fixed price in nature? Because my understanding [ph] it would have been (51:46) probably the bulk of it now.

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

A

No. In fact, we're seeing a big swing. Once we get through these legacy projects that are all causing the issues, bulk of them are fixed price contracts. I think we're estimating it's between 20% and 30% of the legacy or of the MWH construction group, actually now Stantec Construction Group are fixed price. So, in order to be able to be a contractor, you do have to self-perform some of these, and you do have to have some of that are hard-bid. So, it's about that 20% to 30%. It's certainly a smaller portion of the work than we've seen historically with that group.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

All right. But I mean, correct me if I am wrong, a lot of the water projects are done on a sort of full EPC basis. So, I mean, the ability to ramp down that percentage, is that conceivable? I'm just trying to see how you're going to be able to approach the business development on a going forward basis.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Right. And so, to your point, Max, as Dan said, 20% to 30% would be that hard-bid type number. But we have a lot that are construction management at risk. The big job we're doing right now in San Francisco is construction management work. And a lot of the other work that we do is actually progressive design build where you iterate through the design of what the structure will look like with the client until you get to a high level of certainty. So, it's less risky, less hard-bid type work. So, that hard-bid work is really the minority of the work in the U.S. and really in the UK. A lot of it is progressive design build, not a lot of hard-bid work there.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay. [indiscernible] (53:37).

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

And we're seeing that risk profile change from those projects that we – in the 2013-2014 period of time where MWH Constructors kind of moved as part of a growth strategy out of their area of core competence and in geographic areas where they were comfortable and were sort of just ramping up those projects now. And certainly, we will not be repeating that going forward.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

All right. Okay. No, that's helpful. And then in terms of, Dan, kind of the numbers, I assume that the goodwill in relation to MWH was tested for impairment given what transpired in Q4. But how should we think about that that part of – from an accounting perspective on a going forward basis?

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

A

Good question, Max. Yes, we evaluated goodwill. October 1 is the valuation date. And all of that is in the disclosures, in the notes for the financial statements and to some extent, in the MD&A, but in essence, both Canada and U.S. have significant clearance in terms of goodwill. So, any change in assumptions should not impact goodwill or cause impairment. Where we are close is on the Construction business and on our global operations. And you would expect goodwill, the fair value or the carrying value to be fairly close given that we've only had a very short history, so it's all about the change in assumptions going forward, the discount rates, the operating performance expected, so we go through a very thorough valuation effort to compare the results historically and the forecast assumptions. We are close on those two as you would expect. But given our expectations around the global economy improving, certainly, we expect that our global goodwill on the Consulting business will be fine.

Construction, we have to get through this rough spot and continue to perform. With the backlog that we see in Construction right now, we're optimistic that that business is growing. And frankly, the only way to avoid a goodwill impairment is growth. And if you're continuing to grow and you've got that projection into the future, that's what's going to prevent any goodwill. So, that's where we are today. I don't expect any material change from what we saw in the quarter. It's only one quarter, and it certainly doesn't impact [indiscernible] (56:23).

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Right. And what is the next impairment test timeline?

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

A

There is a quarterly indicators of impairment that we have to go through every quarter. And if there is an indicator of impairment, then you have to go through the full test. So, we look at it every quarter, but the full test is on an annual basis as a minimum.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Can you maybe also comment please on U.S. organic growth retraction? When we look at most of your peers, everybody is in that sort of 4% to 5% range growth in the local market. Just trying to see why there is that discrepancy? Is it timing? Are you losing market share? Any color there, please?

Gord Johnston A
President & Chief Executive Officer, Stantec, Inc.

So, we actually feel good about our go-forward there, Max. In the water space, we did see some retraction in Q4. That was primarily related to that construction provision that we took as we discussed earlier. We're feeling positive going forward with our recent project awards.

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

Dam and water would have actually been positive without that CAD 5 million impact on the one consulting project.

Maxim Sytchev Q
Analyst, National Bank Financial, Inc.

Right.

Gord Johnston A
President & Chief Executive Officer, Stantec, Inc.

Infrastructure, we're feeling very strong. Again, you saw the recent awards there in the Northeast and the Long Island Rail Road. So, infrastructure feels good from both the transportation perspective as well as community development. Our land development business, we're seeing some strengthening there in Florida and some of the southern states. So, you're right that 2017 was a bit of a blip in those areas. We see Energy & Resources coming back up. I think, Max, going in through to 2018, we'll see some more positive numbers for us there.

We have the overall lower organic growth the first couple quarters of 2017. We'd always messaged that we're going to return to positive organic growth by the end of the year. And we got there just by a little bit, but we did get there, and we see the momentum going in the right direction through 2018.

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

And I think to add to that, Max, we saw in the U.S. – we talked about it a bit in the third quarter where the water projects were in between the cycles on the programs, so those have come back. They'll add to our revenues in 2018 as well as the large transportation projects in Texas that we completed largely in the last quarter. You saw a bit of that impact in Q4. So, as Gord mentioned, that's some of the new wins that will pick us back up again.

Maxim Sytchev Q
Analyst, National Bank Financial, Inc.

Right. And last question on M&A, I know that you've highlighted certain geographical areas of interest, but in terms of the verticals that you're going after right now, where is the focus? Because I mean, it's been a bit of sort of a painful dynamic. A lot of capital is deployed in oil and gas. Now, Water having some issues, and that was a growth market couple years ago. So, where do you see the opportunity to deploy [ph] critically (59:47) capital now?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Certainly, if we look at some of the different geographies in the UK, we're already the number one water firm. So, we're not looking to acquire additional water firm strength there. There, we're looking at environmental services, buildings, transportation, some of our other core strengths. Australia and New Zealand, again, looking at strength in transportation, environmental services, buildings, and so on there. So, those are really our areas of focus for in those geographies and looking for tuck-ins where it makes the most sense in North America as well.

Maxim Sytchev
Analyst, National Bank Financial, Inc.

Q

Okay. All right. Well, thank you very much. That's it for me.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Thanks, Max.

Operator: And we'll take our next question from Michael Tupholme with TD Securities. Please go ahead.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Thanks. Good morning. Just back on the CAD 26 million of provisions in the quarter, I know you mentioned that all of that is related to water projects and all of it is related to MWH work. Is it all on the Construction side or did any of that actually affect the Consulting business?

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

A

Yes, CAD 5 million impacted the Consulting business, and that was a revenue adjustment where, as I stated in the opening comments, that relates to revenue estimates on that project. All the other ones were cost escalation estimates, so earned value on our estimates to complete on those projects. But CAD 5 million on Consulting, and the remainder were on the Construction business.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. Sorry. I apologize if you did already mention that. I mean, I think everybody sort of understands how you can find yourselves in these kinds of situations on the construction side with fixed price projects. But on the Consulting – and I apologize if you already gone through this, but what was the nature of the situation that triggered this CAD 5 million impact on the Consulting side?

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

In fact, that one was on a design build job with our construction firm as well. So, it was due to some scope change issues. And as we worked it through – so again, that one was related to Construction and just how the client responded there. So, as we're negotiating the overall claim with that client, we're looking at negotiating holistically the best recovery that we can and whether in the end that's gets quoted to the recoveries – assuming we achieve recoveries, gets quoted to Consulting or Construction. Our optimum solution is just to get the best that we can for Stantec.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. That makes sense. And then just the second question for me, with respect to the remaining work to do on the MWH integration and I think you touched on this to some extent, if I understand correctly, it's really the global operations where there is still some work to do. But can you just be a little more clear about what exactly is left and does this take all year long? Just trying to get a bit better sense as to what remains to be done there.

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

A

Well, I'll try to add a bit more color, Michael. The global integration consists of many [indiscernible] (01:03:17), so I think it's important to understand that much of it has been completed. So, the integration of our leadership, of our branding, of our marketing systems, all of that kind of effort has been completed. What's remaining is really the financial migration. Moving them on to Oracle or in the smaller global operations on to a smaller system, we have [indiscernible] (01:03:44) system that we use because Oracle is just way too much overhead for a smaller operation. So, that's what's left.

So, we're in the middle of doing the detailed planning for those. When you implement a business financial system in any jurisdiction outside of our legacy jurisdictions, think of it as a brand-new implementation because you have to deal with the localizations, the tax, the payroll, the legal side of how you set up your accounts, et cetera. And we're going through that detailed work.

This is all with internal staff that do this on an ongoing basis all the time. So, it's not an additional cost. Where the additional costs will come in is once we start flipping the switch and moving all of the projects that we have into Oracle at that time or the other system, and that's where there will be some training and some downtime related to the operations staff getting used to or being trained up on the new system.

So, it's not anywhere near significant as what we've seen historically. So, we're talking about 1,000 people or so in the UK that have to move over and less than that in Australia and New Zealand. But every jurisdiction is a new implementation. So, we talk about Australia and New Zealand that's really implementing Oracle in two different countries. All the basis is there. All the framework, if you will, [ph] the chart (01:05:21) accounts, et cetera is all there. It's just a matter of rolling it into place once we're completely ready.

Michael Tupholme
Analyst, TD Securities, Inc.

Q

Okay. That's great color. Thank you, Dan.

Operator: And we'll take our next question from Chris Murray from AltaCorp Capital. Please go ahead.

Chris Murray
Analyst, AltaCorp Capital, Inc.

Q

Thanks, guys. Good morning. Turning back to the Construction segment, so if we think about your comments about some of these projects were out of scope but they're in a run-off position now, I guess, a couple things. How should we be thinking about the Construction business if, as you say, it's going to be part of the core? What do we think the margin impact to call these out-of-scope projects are going to be through 2018? Maybe what's a more normalized margin on a longer-term basis? And I guess, the other piece of this question is, how do you have the confidence that you actually have the systems in place to manage the Construction business so you don't get into these problems again?

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

A

Start with the margins [indiscernible] (01:06:25).

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Yeah, I'll start with the margins. I think what we've guided to, Chris, on the margins in Construction Services is exactly what our expectations are. So, we aren't expecting any further major hits. It's not to say it can't happen. It's based on what we know today and the evidence that we have in front of us and the claims, as I mentioned, that we have outstanding. So, the guidance that we provided is really, really the margin guidance that we're expecting. Now on the second part for you.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

A

Sure. In terms of overall governance, we've done a number of things. We have set up an overall risk committee that our COO and Chief Practice Officer sit on in addition to the Construction group. We've looked at shutting down hard-bit projects that pursuit outside of the geographies and sort of our core competencies. So, we don't see that reaching a little bit from several years ago that's causing us some heartburn now. So, we feel that we've got the new projects that we're looking to acquire. We feel that we've got the risk profile back under control.

Chris Murray
Analyst, AltaCorp Capital, Inc.

Q

Okay. I guess, my question though is was more – we appreciate that your guidance take into account some of these out-of-scope projects. I guess, what I'm trying to get my head around is, with those out-of-scope and run-off projects in the numbers, is it fair to think that if you get back into scope into 2019 or into 2020 that that margin should improve?

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

A

I think it can improve. We're always looking at trying to improve our margins. I think as we remove some of the risk associated with these hard-bid projects, we can get improved margin.

Chris Murray
Analyst, AltaCorp Capital, Inc.

Q

Okay. I'll leave it there. And then, Dan, just going through your outlook, one of the items that was a little bit surprising, just your capital spending will be a lot different, I think, this year, kind of some onetime items. Can you just walk us through some of the puts and takes on – I guess, there are some lease changes and some other onetime costs and then CapEx. Can you just walk us through all those moving parts and maybe some of the timing that we should be aware of?

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

A

Sure. Absolutely, Chris. Good question because that wasn't necessarily highlighted in our outlooks, but it was all in the materials. So, for everyone, it's worthwhile having looked at that. So, our capital expenditures in total, I think, are going to be about CAD 150 million. I don't have the exact number in front of me. But that includes a couple of things, one, primarily the move to the Stantec Tower in Edmonton, the new tower. It's a combination of leasehold improvements and office furniture and equipment.

That CapEx is going to be offset by tenant improvement under the lease, which gets amortized over the life. So, we'll have the pure cost incurred in 2018. With that offset, I think it's about CAD 50 million. So, we have CAD 79 million, if my numbers are correct, in additional costs associated with moving to the new tower, offset by about CAD 50 million in TI. So, that's the impact on that. And then the remainder of our CapEx is really normal course of business, which is very consistent with what our spend was in 2017.

Chris Murray
Analyst, AltaCorp Capital, Inc.

Q

Okay. Great. That's helpful. Thank you.

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

A

So, there was just one other element, and it has to do with lease exit liabilities. We're expecting that we will have to take, for accounting purposes, a lease exit liability in the fourth quarter. We mentioned that in our materials. So, expect that in the results in Q4, it's a noncash item because what happens is when you terminate a lease, you automatically have to record the lease exit liability. However, our new landlord is paying for any of the remaining lease costs that we have as part of our new lease agreement. So, there is zero cash impact. It's an accounting impact. And the benefit that we get from the new lease is amortized again over the life of the new lease. So, it's a bit of an accounting nuance that really doesn't necessarily reflect the business reality or the economic reality. It's an accounting thing that we'll be adjusting for in the fourth quarter, so expect that.

Chris Murray
Analyst, AltaCorp Capital, Inc.

Q

Okay. Thanks.

Operator: It appears there are no further questions at this time. I'd like to turn the conference back to you, Gord Johnston, for any additional or closing remarks.

Gord Johnston
President & Chief Executive Officer, Stantec, Inc.

Okay. Well, just to say thanks, everyone, for joining Stantec's earning call and for your questions. And both Dan and I look forward to speaking with you in the coming quarters. Thanks very much.

Operator: This concludes today's presentation. We thank you for your participation. You may now disconnect.