

MCGRATH RENTCORP
Form 10-Q
November 01, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

Commission file number 0-13292

MCGRATH RENTCORP

(Exact name of registrant as specified in its Charter)

California 94-2579843
(State or other jurisdiction (I.R.S. Employer

of incorporation or organization) Identification No.)
5700 Las Positas Road, Livermore, CA 94551-7800

(Address of principal executive offices)

Registrant's telephone number: (925) 606-9200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of October 31, 2016, 23,913,704 shares of Registrant’s Common Stock were outstanding.

FORWARD LOOKING STATEMENTS

Statements contained in this Quarterly Report on Form 10-Q (this “Form 10-Q”) which are not historical facts are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical facts, regarding McGrath RentCorp’s (the “Company’s”) business strategy, future operations, financial position, estimated revenues or losses, projected costs, prospects, plans and objectives are forward-looking statements. These forward-looking statements appear in a number of places and can be identified by the use of forward-looking terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “future,” “intend,” “hopes” or “certain” or the negative of these terms or other variations or comparable terminology.

Management cautions that forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties that could cause our actual results to differ materially from those projected in such forward-looking statements. Further, our future business, financial condition and results of operations could differ materially from those anticipated by such forward-looking statements and are subject to risks and uncertainties as set forth under “Risk Factors” in this form 10-Q.

Forward-looking statements are made only as of the date of this Form 10-Q and are based on management’s reasonable assumptions, however these assumptions can be wrong or affected by known or unknown risks and uncertainties. No forward-looking statement can be guaranteed and subsequent facts or circumstances may contradict, obviate, undermine or otherwise fail to support or substantiate such statements. Readers should not place undue reliance on these forward-looking statements and are cautioned that any such forward-looking statements are not guarantees of future performance. Except as otherwise required by law, we are under no duty to update any of the forward-looking statements after the date of this Form 10-Q to conform such statements to actual results or to changes in our expectations.

Part I - Financial Information

Item 1. Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

McGrath RentCorp

We have reviewed the accompanying condensed consolidated balance sheet of McGrath RentCorp and subsidiaries (the "Company"), and the related condensed consolidated statements of income and comprehensive income, as of September 30, 2016 and for the three-month and nine-month periods ended September 30, 2016 and 2015, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2016 and 2015. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated interim financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of December 31, 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and we expressed an unqualified opinion on those consolidated financial statements in our report dated February 25, 2016. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2015, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ GRANT THORNTON LLP

San Jose, California

November 1, 2016

McGRATH RENTCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(in thousands, except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues				
Rental	\$ 67,757	\$ 70,195	\$ 201,036	\$ 203,002
Rental related services	20,122	21,862	57,028	54,456
Rental operations	87,879	92,057	258,064	257,458
Sales	33,486	20,426	58,916	40,181
Other	628	565	1,817	1,623
Total revenues	121,993	113,048	318,797	299,262
Costs and Expenses				
Direct costs of rental operations:				
Depreciation of rental equipment	17,819	18,809	54,590	56,507
Rental related services	15,240	15,802	42,404	40,602
Other	15,475	14,032	48,015	45,469
Total direct costs of rental operations	48,534	48,643	145,009	142,578
Costs of sales	23,026	14,259	38,944	26,533
Total costs of revenues	71,560	62,902	183,953	169,111
Gross profit	50,433	50,146	134,844	130,151
Selling and administrative expenses	26,201	24,996	78,281	74,661
Income from operations	24,232	25,150	56,563	55,490
Other income (expense):				
Interest expense	(2,940)	(2,444)	(9,486)	(7,182)
Foreign currency exchange gain (loss)	(15)	(201)	59	(454)
Income before provision for income taxes	21,277	22,505	47,136	47,854
Provision for income taxes	8,405	8,889	18,619	18,902
Net income	\$ 12,872	\$ 13,616	\$ 28,517	\$ 28,952
Earnings per share:				
Basic	\$ 0.54	\$ 0.54	\$ 1.19	\$ 1.12
Diluted	\$ 0.54	\$ 0.54	\$ 1.19	\$ 1.12
Shares used in per share calculation:				
Basic	23,911	25,334	23,891	25,853
Diluted	24,041	25,408	23,957	25,954
Cash dividends declared per share	\$ 0.255	\$ 0.250	\$ 0.765	\$ 0.750

The accompanying notes are an integral part of these condensed consolidated financial statements.

McGRATH RENTCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$ 12,872	\$ 13,616	\$ 28,517	\$ 28,952
Other comprehensive income (loss):				
Foreign currency translation adjustment	17	(31)	(69)	58
Tax benefit (provision)	(8)	7	24	(23)
Comprehensive income	\$ 12,881	\$ 13,592	\$ 28,472	\$ 28,987

The accompanying notes are an integral part of these condensed consolidated financial statements.

McGrath RentCorp

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands)	September 30, 2016	December 31, 2015
Assets		
Cash	\$1,092	\$1,103
Accounts receivable, net of allowance for doubtful accounts of \$2,087 in 2016 and 2015	104,004	95,263
Income taxes receivable	—	11,000
Rental equipment, at cost:		
Relocatable modular buildings	763,777	736,875
Electronic test equipment	252,573	262,945
Liquid and solid containment tanks and boxes	308,852	310,263
	1,325,202	1,310,083
Less accumulated depreciation	(462,674)	(440,482)
Rental equipment, net	862,528	869,601
Property, plant and equipment, net	113,497	109,753
Prepaid expenses and other assets	27,182	28,556
Intangible assets, net	8,812	9,465
Goodwill	27,808	27,808
Total assets	\$1,144,923	\$1,152,549
Liabilities and Shareholders' Equity		
Liabilities:		
Notes payable	\$345,286	\$381,281
Accounts payable and accrued liabilities	72,397	71,942
Deferred income	41,479	36,288
Deferred income taxes, net	295,161	283,351
Total liabilities	754,323	772,862
Shareholders' equity:		
Common stock, no par value - Authorized 40,000 shares Issued and outstanding - 23,914 shares as of September 30, 2016 and 23,851 shares as of December 31, 2015	101,828	101,046
Retained earnings	288,884	278,708
Accumulated other comprehensive loss	(112)	(67)
Total shareholders' equity	390,600	379,687
Total liabilities and shareholders' equity	\$1,144,923	\$1,152,549

The accompanying notes are an integral part of these condensed consolidated financial statements.

McGrath RentCorp

CONDENSED Consolidated Statements of Cash Flows

(unaudited)

(in thousands)	Nine Months Ended September 30,	
	2016	2015
Cash Flows from Operating Activities:		
Net income	\$28,517	\$28,952
Adjustments to reconcile net income to net cash provided by		
operating activities:		
Depreciation and amortization	61,528	63,303
Provision for doubtful accounts	1,366	1,179
Share-based compensation	2,327	2,863
Gain on sale of used rental equipment	(10,798)	(9,066)
Foreign currency exchange loss (gain)	(59)	454
Change in:		
Accounts receivable	(10,107)	(7,445)
Income taxes receivable	11,000	—
Prepaid expenses and other assets	1,374	12,905
Accounts payable and accrued liabilities	4,082	(1,055)
Deferred income	5,191	11,033
Deferred income taxes	11,810	(2,519)
Net cash provided by operating activities	106,231	100,604
Cash Flows from Investing Activities:		
Purchase of rental equipment	(64,349)	(104,884)
Purchase of property, plant and equipment	(10,028)	(8,045)
Proceeds from sale of used rental equipment	24,037	19,681
Net cash used in investing activities	(50,340)	(93,248)
Cash Flows from Financing Activities:		
Net borrowing (repayments) under bank lines of credit	(16,034)	79,635
Principal payment on Series A senior notes	(20,000)	(20,000)
Amortization of debt issuance cost	39	39
Proceeds from the exercise of stock options	37	1,458
Excess tax benefit (shortfall) from exercise of stock awards	(993)	349
Taxes paid related to net share settlement of stock awards	(589)	(729)
Repurchase of common stock	—	(48,785)
Payment of dividends	(18,349)	(19,728)
Net cash used in financing activities	(55,889)	(7,761)
Effect of foreign currency exchange rate changes on cash	(13)	(5)
Net decrease in cash	(11)	(410)
Cash balance, beginning of period	1,103	1,167
Cash balance, end of period	\$1,092	\$757
Supplemental Disclosure of Cash Flow Information:		
Interest paid, during the period	\$9,042	\$7,224
Net income taxes paid, during the period	\$7,751	\$2,240

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Dividends accrued during the period, not yet paid	\$6,144	\$6,159
Rental equipment acquisitions, not yet paid	\$3,688	\$5,707

The accompanying notes are an integral part of these condensed consolidated financial statements.

7

McGRATH RENTCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2016

NOTE 1. CONDENSED CONSOLIDATED FINANCIAL INFORMATION

The condensed consolidated financial statements for the three and nine months ended September 30, 2016 and 2015 have not been audited, but in the opinion of management, all adjustments (consisting of normal recurring accruals, consolidating and eliminating entries) necessary for the fair presentation of the consolidated financial position, results of operations and cash flows of McGrath RentCorp (the “Company”) have been made. The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted pursuant to those rules and regulations. The consolidated results for the nine months ended September 30, 2016 should not be considered as necessarily indicative of the consolidated results for the entire fiscal year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s latest Annual Report on Form 10-K filed with the SEC on February 25, 2016 for the year ended December 31, 2015 (the “2015 Annual Report”).

NOTE 2. NEW ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers. The objective of this guidance is to establish the principles to report useful information to users of financial statements about the nature, timing and uncertainty of revenue from contracts with customers. In August 2015, the FASB issued an update to defer the effective date of this guidance by one year. The guidance in the update is effective for the interim and annual reporting periods beginning after December 15, 2017. The Company is evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Subtopic 842-10). Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) on the commencement date: a) lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and b) right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The Company is evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718). Under the new guidance, all excess tax benefits and tax deficiencies will be recognized in the income statement as they occur. This will replace the current guidance, which requires tax benefits that exceed compensation cost (windfalls) to be

recognized in equity, and tax deficiencies (shortfalls) to be recognized in equity to the extent of previously recognized windfalls. It will also eliminate the need to maintain a “windfall pool,” and will remove the requirement to delay recognizing a windfall until it reduces current taxes payable. The new guidance will also change the cash flow presentation of excess tax benefits, classifying them as operating inflows, consistent with other cash flows related to income taxes. The amendments in this guidance are effective for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. The adoption of this guidance is not expected to have a material impact on the Company’s financial position or results of operation.

In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contract with Customers (Topic 606): Identifying Performance Obligations and Licensing. The amendments clarify the following two aspects of Topic 606: (a) identifying performance obligations; and (b) the licensing implementation guidance. The amendments do not change the core principles of the guidance in Topic 606. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company is evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contract with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedient. The amendments do not change the core revenue recognition principles in Topic 606. The amendments provide clarifying guidance in certain narrow areas and add some practical expedient. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company is evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts. This update addresses eight specific cash flow issues with the objective of reducing the existing diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in this guidance are effective

for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. The Company is evaluating the impact of the adoption of this guidance on its consolidated financial statements.

NOTE 3. EARNINGS PER SHARE

Basic earnings per share (“EPS”) is computed as net income divided by the weighted-average number of shares of common stock outstanding for the period. Diluted EPS is computed assuming conversion of all potentially dilutive securities including the dilutive effect of stock options, unvested restricted stock awards and other potentially dilutive securities. The table below presents the weighted-average number of shares of common stock used to calculate basic and diluted earnings per share:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2016	2015	September 30, 2016	2015
Weighted-average number of shares of common stock for				
calculating basic earnings per share	23,911	25,334	23,891	25,853
Effect of potentially dilutive securities from				
equity-based compensation	130	74	66	101
Weighted-average number of shares of common stock for				
calculating diluted earnings per share	24,041	25,408	23,957	25,954

The following securities were not included in the computation of diluted earnings per share as their effect would have been anti-dilutive:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2016	2015	September 30, 2016	2015
Options to purchase shares of common stock	636	1,326	998	746

In May 2008, the Company's Board of Directors authorized the Company to repurchase an aggregate of 2,000,000 shares of the Company's outstanding common stock. The Company has in the past made purchases of shares of its common stock from time to time in over-the-counter market (NASDAQ) transactions, through privately negotiated, large block transactions and through a share repurchase plan, in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934. In August 2015, the Company's Board of Directors authorized the Company to repurchase an additional 2,000,000 shares of the Company's outstanding common stock. The amount and time of the specific repurchases are subject to prevailing market conditions, applicable legal requirements and other factors, including management's discretion. All shares repurchased by the Company are canceled and returned to the status of authorized but unissued shares of common stock. There can be no assurance that any shares authorized for repurchase will be repurchased and the repurchase program may be modified, extended or terminated by the Board of Directors at any time. The following table presents share repurchase activities during the three and nine months ended September 30, 2016 and 2015.

	Three Months Ended	Nine Months Ended
(in thousands, except share and per share amounts)	September 30, 2016	September 30, 2015
Number of shares repurchased	— 1,754,636	— 1,856,289
Aggregate purchase price	\$—\$45,653	\$—\$48,784
Average price per repurchased shares	\$—\$26.02	\$—\$26.28

As of September 30, 2016, 1,592,026 shares remain authorized for repurchase.

NOTE 4. 2016 STOCK INCENTIVE PLAN

The Company adopted the 2016 Stock Incentive Plan (the "2016 Plan"), effective June 8, 2016, under which 2,000,000 shares of the common stock of the Company, plus the number of shares that remain available for grants of awards under the Company's 2007 Stock Option Plan (the "2007 Plan") and become available as a result of forfeiture, termination, or expiration of awards previously granted under the 2007 Plan, were reserved for the grant of equity awards to its employees, directors and consultants. The equity awards have a maximum term of 7 years at an exercise price of not less than 100% of the fair market value of the Company's common stock on the date the equity award is granted. The 2016 Plan replaces the 2007 Plan.

NOTE 5. INTANGIBLE ASSETS

Intangible assets consist of the following:

	Estimated	September 30,	December 31,
(dollar amounts in thousands)	useful life	2016	2015
Trade name	Indefinite	\$ 5,700	\$ 5,700
Customer relationships	11	9,611	9,611
		15,311	15,311
Less accumulated amortization		(6,499)	(5,846)
		\$ 8,812	\$ 9,465

The Company assesses potential impairment of its goodwill and intangible assets when there is evidence that events or circumstances have occurred that would indicate the recovery of an asset's carrying value is unlikely. The Company also assesses potential impairment of its goodwill and intangible assets on an annual basis regardless of whether there is evidence of impairment. If indicators of impairment were to be present in intangible assets used in operations and future discounted cash flows were not expected to be sufficient to recover the assets' carrying amount, an impairment loss would be charged to expense in the period identified. The amount of an impairment loss that would be recognized is the excess of the asset's carrying value over its fair value. Factors the Company considers important, which may cause impairment include, among others, significant changes in the manner of use of the acquired asset, negative industry or economic trends, and significant underperformance relative to historical or projected operating results.

The Company typically conducts its annual impairment analysis in the fourth quarter of its fiscal year. The impairment analysis did not result in an impairment charge for the fiscal year ended December 31, 2015. Determining the fair value of a reporting unit is judgmental and involves the use of significant estimates and assumptions. The Company bases its fair value estimates on assumptions that it believes are reasonable but are uncertain and subject to changes in market conditions.

Intangible assets with finite useful lives are amortized over their respective useful lives. Based on the carrying values at September 30, 2016 and assuming no subsequent impairment of the underlying assets, the amortization expense is expected to be \$0.2 million for the remainder of fiscal year 2016, \$0.9 million in each of the fiscal years 2017 through 2019 and \$0.2 million in 2020.

NOTE 6. SEGMENT REPORTING

The Company's four reportable segments are (1) its modular building and portable storage segment ("Mobile Modular"); (2) its electronic test equipment segment ("TRS-RenTelco"); (3) its containment solutions for the storage of hazardous and non-hazardous liquids and solids segment ("Adler Tanks"); and (4) its classroom manufacturing segment selling modular buildings used primarily as classrooms in California ("Enviroplex"). The operations of each of these segments are described in Part I – Item 1, "Business," and the accounting policies of the segments are described in "Note 2 – Significant Accounting Policies" in the Company's annual report on Form 10-K for the year ended December 31, 2015. Management focuses on several key measures to evaluate and assess each segment's performance, including rental revenue growth, gross profit, income from operations and income before provision for income taxes. Excluding interest expense, allocations of revenue and expense not directly associated with one of these segments are generally allocated to Mobile Modular, TRS-RenTelco and Adler Tanks based on their pro-rata share of direct revenues. Interest expense is allocated among Mobile Modular, TRS-RenTelco and Adler Tanks based on their pro-rata share of average rental equipment at cost, intangible assets, accounts receivable, deferred income and customer security deposits. The Company does not report total assets by business segment. Summarized financial information for the nine months ended September 30, 2016 and 2015 for the Company's reportable segments is shown in the following table:

	Mobile Modular	TRS- RenTelco	Adler Tanks	Enviroplex ¹	Consolidated
(dollar amounts in thousands)					
Nine Months Ended September 30,					
2016					
Rental revenues	\$96,002	\$61,562	\$43,472	\$ —	\$ 201,036
Rental related services revenues	37,034	2,156	17,838	—	57,028
Sales and other revenues	25,416	18,491	1,039	15,787	60,733
Total revenues	158,452	82,209	62,349	15,787	318,797
Depreciation of rental equipment	15,642	26,939	12,009	—	54,590
Gross profit	67,329	34,033	28,362	5,120	134,844
Selling and administrative expenses	38,162	16,444	20,786	2,889	78,281
Income from operations	29,167	17,589	7,576	2,231	56,563
Interest (expense) income allocation	(5,264)	(1,921)	(2,487)	186	(9,486)
Income before provision for income taxes	23,903	15,727	5,089	2,417	47,136
Rental equipment acquisitions	35,363	24,991	404	—	60,758
Accounts receivable, net (period end)	63,752	20,267	15,922	4,063	104,004
Rental equipment, at cost (period end)	763,777	252,573	308,852	—	1,325,202
Rental equipment, net book value (period end)	543,141	93,894	225,493	—	862,528
Utilization (period end) ²	77.6 %	62.4 %	52.1 %		
Average utilization ²	76.3 %	60.1 %	49.9 %		
2015					
Rental revenues	\$84,242	\$66,612	\$52,148	\$ —	\$ 203,002
Rental related services revenues	33,904	2,271	18,281	—	54,456
Sales and other revenues	15,971	16,385	1,082	8,366	41,804
Total revenues	134,117	85,268	71,511	8,366	299,262
Depreciation of rental equipment	14,218	30,335	11,954	—	56,507
Gross profit	56,263	35,293	36,383	2,212	130,151
Selling and administrative expenses	34,436	17,059	20,755	2,411	74,661
Income (loss) from operations	21,827	18,234	15,628	(199)	55,490
Interest (expense) income allocation	(3,790)	(1,580)	(1,953)	141	(7,182)
Income (loss) before provision for income taxes	18,037	16,200	13,675	(58)	47,854

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Rental equipment acquisitions	59,501	37,822	8,328	—	105,651	
Accounts receivable, net (period end)	60,132	23,649	20,312	3,467	107,560	
Rental equipment, at cost (period end)	717,892	266,034	309,779	—	1,293,705	
Rental equipment, net book value (period end)	515,207	107,801	241,269	—	864,277	
Utilization (period end) ²	77.9	%	60.5	%	57.0	%
Average utilization ²	75.3	%	60.2	%	59.9	%

1. Gross Enviroplex sales revenues were \$15,872 and \$9,077 for the nine months ended September 30, 2016 and 2015, respectively, which include inter-segment sales to Mobile Modular of \$85 and \$711, respectively, which have been eliminated in consolidation.

2. Utilization is calculated each month by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding accessory equipment and for Mobile Modular and Adler Tanks excluding new equipment inventory. The Average Utilization for the period is calculated using the average costs of rental equipment.

11

No single customer accounted for more than 10% of total revenues for the nine months ended September 30, 2016 and 2015. Revenues from foreign country customers accounted for 5% of the Company's total revenues in each of the same periods.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Form 10-Q, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), contains forward-looking statements under federal securities laws. Forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties. Our actual results could differ materially from those indicated by forward-looking statements as a result of various factors. These factors include, but are not limited to, those set forth under this Item, those discussed in Part II—Item 1A, "Risk Factors" and elsewhere in this Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC on February 25, 2016 (the "2015 Annual Report") and those that may be identified from time to time in our reports and registration statements filed with the SEC.

This discussion should be read in conjunction with the Condensed Consolidated Financial Statements and related Notes included in Part I—Item 1 of this Form 10-Q and the Consolidated Financial Statements and related Notes and the Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2015 Annual Report. In preparing the following MD&A, we presume that readers have access to and have read the MD&A in our 2015 Annual Report, pursuant to Instruction 2 to paragraph (b) of Item 303 of Regulation S-K. We undertake no duty to update any of these forward-looking statements after the date of filing of this Form 10-Q to conform such forward-looking statements to actual results or revised expectations, except as otherwise required by law.

General

The Company, incorporated in 1979, is a leading rental provider of relocatable modular buildings for classroom and office space, electronic test equipment for general purpose and communications needs, and liquid and solid containment tanks and boxes. The Company's primary emphasis is on equipment rentals. The Company is comprised of four reportable business segments: (1) its modular building and portable storage container rental segment ("Mobile Modular"); (2) its electronic test equipment segment ("TRS-RenTelco"); (3) its containment solutions for the storage of hazardous and non-hazardous liquids and solids segment ("Adler Tanks"); and (4) its classroom manufacturing segment selling modular buildings used primarily as classrooms in California ("Enviroplex").

The Mobile Modular business segment includes the results of operations of our Mobile Modular Portable Storage division, which represented approximately 7% of the Company's total revenues in the nine months ended September 30, 2016. Mobile Modular Portable Storage offers portable storage units and high security portable office units for rent, lease and purchase.

In the nine months ended September 30, 2016, Mobile Modular, TRS-RenTelco, Adler Tanks and Enviroplex contributed 51%, 33%, 11% and 5% of the Company's income before provision for taxes (the equivalent of "pretax income"), respectively, compared to 38%, 34%, 29% and negative 1% for the same period in 2015. Although managed as a separate business unit, Enviroplex's revenues, pretax income contribution and total assets are not significant relative to the Company's consolidated financial position. Accordingly, we have not presented a separate discussion of Enviroplex's results of operations in this MD&A.

The Company generates its revenues primarily from the rental of its equipment on operating leases and from sales of equipment occurring in the normal course of business. The Company requires significant capital outlay to purchase its rental inventory and recovers its investment through rental and sales revenues. Rental revenues and certain other service revenues negotiated as part of lease agreements with customers and related costs are recognized on a straight-line basis over the terms of the leases. Sales revenues and related costs are recognized upon delivery and installation of the equipment to customers. Sales revenues are less predictable and can fluctuate from quarter to quarter and year to year depending on customer demands and requirements. Generally, rental revenues less cash operating costs recover the equipment's capitalized cost in a shorter period of time relative to the equipment's potential rental life and when sold, sale proceeds are usually above its net book value.

The Company's modular revenues (consisting of revenues from Mobile Modular, Mobile Modular Portable Storage and Enviroplex) are derived from rentals and sales to education and commercial customers, with a majority of revenues generated by education customers. Modular revenues are primarily affected by demand for classrooms, which in turn is affected by shifting and fluctuating school populations, the levels of state funding to public schools, the need for temporary classroom space during reconstruction of older schools and changes in policies regarding class size. As a result of any reduced funding, lower expenditures by these schools may result in certain planned programs to increase the number of classrooms, such as those that the Company provides, to be postponed or terminated. However, reduced expenditures may also result in schools reducing their long-term facility construction projects in favor of using the Company's modular classroom solutions. At this time, the Company can provide no assurances as to whether public schools will either reduce or increase their demand for the Company's modular classrooms as a result of fluctuations in state funding of public schools. Looking forward, the Company believes that any interruption in the passage of facility bonds or contraction of class size reduction programs by public schools may have a material adverse effect on both rental and sales revenues of the Company. (For more information, see "Item 1. Business – Relocatable Modular Buildings – Classroom Rentals and Sales to Public Schools (K-12)" in the Company's 2015 Annual Report and "Item 1A. Risk Factors – Significant reductions of, or delays in, funding to public schools have

caused the demand and pricing for our modular classroom units to decline, which has in the past caused, and may cause in the future, a reduction in our revenues and profitability” in Part II – Other Information of this Form 10-Q.)

Revenues of TRS-RenTelco are derived from the rental and sale of general purpose and communications test equipment to a broad range of companies, from Fortune 500 to middle and smaller market companies primarily in the aerospace, defense, communications, manufacturing and semiconductor industries. Electronic test equipment revenues are primarily affected by the business activity within these industries related to research and development, manufacturing, and communication infrastructure installation and maintenance.

Revenues of Adler Tanks are derived from the rental and sale of fixed axle tanks (“tanks”) and vacuum containers, dewatering containers and roll-off containers (collectively referred to as “boxes”). These tanks and boxes are rented to a broad range of industries and applications including oil and gas exploration and field services, refinery, chemical and industrial plant maintenance, environmental remediation and field services, infrastructure building construction, marine services, pipeline construction and maintenance, tank terminals services, wastewater treatment, and waste management and landfill services for the containment of hazardous and non-hazardous liquids and solids. The liquid and solid containment tanks and boxes rental business was acquired through the acquisition of Adler Tank Rentals, LLC on December 11, 2008.

The Company’s rental operations include rental and rental related service revenues which comprised approximately 81% and 86% of consolidated revenues in the nine months ended September 30, 2016 and 2015, respectively. Of the total rental operations revenues for the nine months ended September 30, 2016, Mobile Modular, TRS-RenTelco and Adler Tanks comprised 51%, 25% and 24%, respectively, compared to 46%, 27% and 27%, respectively, in the same period of 2015. The Company’s direct costs of rental operations include depreciation of rental equipment, rental related service costs, impairment of rental equipment (if any), and other direct costs of rental operations (which include direct labor, supplies, repairs, insurance, property taxes, license fees, cost of sub-rentals and amortization of certain lease costs).

The Company’s Mobile Modular, TRS-RenTelco and Adler Tanks business segments sell modular units, electronic test equipment and liquid and solid containment tanks and boxes, respectively, which are either new or previously rented. In addition, Enviroplex sells new modular buildings used primarily as classrooms in California. For the nine months ended September 30, 2016 and 2015, sales and other revenues of modular, electronic test equipment and liquid and solid containment tanks and boxes comprised approximately 19% and 14%, respectively, of the Company’s consolidated revenues. Of the total sales and other revenues for the nine months ended September 30, 2016 and 2015, Mobile Modular and Enviroplex together comprised 68% and 58%, respectively, and TRS-RenTelco comprised 30% and 39%, respectively. Adler Tanks sales and other revenues for the nine months ended September 30, 2016 and 2015 were 2% and 3%, respectively, of the Company’s total sales and other revenues. The Company’s cost of sales includes the carrying value of the equipment sold and the direct costs associated with the equipment sold, such as delivery, installation, modifications and related site work.

Selling and administrative expenses primarily include personnel and benefit costs, which include share-based compensation, depreciation and amortization, bad debt expense, advertising costs, and professional service fees. The Company believes that sharing of common facilities, financing, senior management, and operating and accounting systems by all of the Company’s operations results in an efficient use of overhead. Historically, the Company’s operating margins have been impacted favorably to the extent its costs and expenses are leveraged over a large installed customer base. However, there can be no assurance as to the Company’s ability to maintain a large installed customer base or ability to sustain its historical operating margins.

Adjusted EBITDA

To supplement the Company’s financial data presented on a basis consistent with accounting principles generally accepted in the United States of America (“GAAP”), the Company presents “Adjusted EBITDA”, which is defined by the

Company as net income before interest expense, provision for income taxes, depreciation, amortization, and share-based compensation. The Company presents Adjusted EBITDA as a financial measure as management believes it provides useful information to investors regarding the Company's liquidity and financial condition and because management, as well as the Company's lenders, use this measure in evaluating the performance of the Company.

Management uses Adjusted EBITDA as a supplement to GAAP measures to further evaluate period-to-period operating performance, compliance with financial covenants in the Company's revolving lines of credit and senior notes and the Company's ability to meet future capital expenditure and working capital requirements. Management believes the exclusion of non-cash charges, including share-based compensation, is useful in measuring the Company's cash available for operations and performance of the Company. Because management finds Adjusted EBITDA useful, the Company believes its investors will also find Adjusted EBITDA useful in evaluating the Company's performance.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Adjusted EBITDA should not be considered in isolation or as a substitute for net income, cash flows, or other consolidated income or cash flow data prepared in accordance with GAAP or as a measure of the Company's profitability or liquidity. Adjusted EBITDA is not in accordance with or an alternative for GAAP, and may be different from non-GAAP measures used by other companies. Unlike EBITDA, which may be used by other companies or investors, Adjusted EBITDA does not include share-based compensation charges. The Company believes that Adjusted EBITDA is of limited use in that it does not reflect all of the amounts associated with the Company's results of operations as determined in accordance with GAAP and does not accurately reflect real cash flow. In addition, other companies may not use Adjusted EBITDA or may use other non-GAAP measures, limiting the usefulness of Adjusted EBITDA for purposes of comparison. The Company's presentation of Adjusted EBITDA should not be construed as an inference that the Company will not incur expenses that are the same as or similar to the adjustments in this presentation. Therefore, Adjusted EBITDA should only be used to evaluate the Company's results of operations in conjunction with the corresponding GAAP measures. The Company compensates for the limitations of Adjusted EBITDA by relying upon GAAP results to gain a complete picture of the Company's performance. Because Adjusted EBITDA is a non-GAAP financial measure, as defined by the SEC, the Company includes in the tables below reconciliations of Adjusted EBITDA to the most directly comparable financial measures calculated and presented in accordance with GAAP.

Reconciliation of Net Income to Adjusted EBITDA

	Three Months Ended		Nine Months Ended		Twelve Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
(dollar amounts in thousands)						
Net income	\$12,872	\$13,616	\$28,517	\$28,952	\$40,035	\$42,839
Provision for income taxes	8,405	8,889	18,619	18,902	25,624	29,237
Interest	2,940	2,444	9,486	7,182	12,396	9,538
Depreciation and amortization	20,111	21,132	61,528	63,303	82,505	84,045
EBITDA	44,328	46,081	118,150	118,339	160,560	165,659
Share-based compensation	741	910	2,327	2,863	2,863	3,707
Adjusted EBITDA ¹	\$45,069	\$46,991	\$120,477	\$121,202	\$163,423	\$169,366
Adjusted EBITDA margin ²	37 %	42 %	38 %	41 %	39 %	41 %

Reconciliation of Adjusted EBITDA to Net Cash Provided by Operating Activities

	Three Months Ended		Nine Months Ended		Twelve Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
(dollar amounts in thousands)						
Adjusted EBITDA ¹	\$45,069	\$46,991	\$120,477	\$121,202	\$163,423	\$169,366
Interest paid	(2,396)	(2,328)	(9,042)	(7,224)	(11,859)	(9,982)
Net income taxes paid	(2,072)	(750)	(7,751)	(2,240)	(8,009)	(8,821)
Gain on sale of used rental equipment	(4,516)	(3,501)	(10,798)	(9,066)	(13,634)	(13,657)
Foreign currency exchange loss (gain)	15	201	(59)	454	(25)	672

Change in certain assets and liabilities:

Accounts receivable, net	(8,144)	(13,586)	(8,741)	(6,266)	3,556	(3,990)
Income taxes receivable	—	—	11,000	—	—	—
Prepaid expenses and other assets	4,237	4,924	1,374	12,905	1,125	1,533
Accounts payable and other liabilities	(2,323)	(7,031)	4,580	(20,195)	14,243	(3,905)
Deferred income	3,130	10,447	5,191	11,034	1,306	7,398
Net cash provided by operating activities	\$33,000	\$35,367	\$106,231	\$100,604	\$150,126	\$138,614

1. Adjusted EBITDA is defined as net income before interest expense, provision for income taxes, depreciation, amortization, and share-based compensation.

2. Adjusted EBITDA margin is calculated as Adjusted EBITDA divided by total revenues for the period.

Adjusted EBITDA is a component of two restrictive financial covenants for the Company's unsecured Credit Facility, and Series A Senior Notes, Series B Senior Notes and Series C Senior Notes (as defined and more fully described under the heading "Liquidity and Capital Resources" in this MD&A). These instruments contain financial covenants requiring the Company to not:

• Permit the Consolidated Fixed Charge Coverage Ratio (as defined in the Credit Facility and the Note Purchase Agreement (as defined and more fully described under the heading "Liquidity and Capital Resources" in this MD&A)) of Adjusted

15

EBITDA (as defined in the Credit Facility and the Note Purchase Agreement) to fixed charges as of the end of any fiscal quarter to be less than 2.50 to 1. At September 30, 2016, the actual ratio was 3.75 to 1.

Permit the Consolidated Leverage Ratio of funded debt (as defined in the Credit Facility and the Note Purchase Agreement) to Adjusted EBITDA at any time during any period of four consecutive quarters to be greater than 2.75 to 1. At September 30, 2016, the actual ratio was 2.11 to 1.

At September 30, 2016, the Company was in compliance with each of the aforementioned covenants. There are no anticipated trends that the Company is aware of that would indicate non-compliance with these covenants, although, significant deterioration in our financial performance could impact the Company's ability to comply with these covenants.

Recent Developments

On September 21, 2016, the Company announced that the Board of Directors declared a quarterly cash dividend of \$0.255 per common share for the quarter ended September 30, 2016, an increase of 2% over the prior year's comparable quarter.

Results of Operations

Three Months Ended September 30, 2016 Compared to

Three Months Ended September 30, 2015

Overview

Consolidated revenues for the three months ended September 30, 2016 increased 8% to \$122.0 million from \$113.0 million in the same period in 2015. Consolidated net income for the three months ended September 30, 2016 decreased 5% to \$12.9 million from \$13.6 million for the same period in 2015. Earnings per diluted share for the three months ended September 30, 2016 was flat at \$0.54 compared to the same period in 2015.

For the three months ended September 30, 2016, on a consolidated basis:

• Gross profit increased \$0.3 million, or 1%, to \$50.4 million in 2016. Mobile Modular's gross profit increased \$2.0 million, or 9%, due to higher gross profit on sales and rental revenues, partly offset by lower gross profit on rental related services revenues. Enviroplex's gross profit increased \$2.0 million, or 126%, primarily due to higher sales revenues. TRS-RenTelco's gross profit decreased \$1.1 million, or 9%, primarily due to lower gross profit on rental and rental related services revenues. Adler Tanks' gross profit decreased \$2.7 million, or 23%, primarily due to lower gross profit on rental and rental related services revenues.

• Selling and administrative expenses increased \$1.2 million, or 5%, to \$26.2 million, primarily due to increased employee headcount, salaries and employee benefit costs.

• Interest expense increased \$0.5 million, or 20%, to \$2.9 million in 2016 compared to the same period in 2015, due to 22% higher net average interest rates of 3.25% in 2016 compared to 2.67% in 2015, partly offset by 1% lower average debt levels of the Company.

• Pre-tax income contribution by Mobile Modular, TRS-RenTelco and Adler Tanks was 52%, 27% and 9%, respectively, compared to 48%, 28% and 20%, respectively, for the comparable 2015 period. These results are discussed on a segment basis below. Enviroplex pre-tax income contribution was 12% in 2016 compared to 4% in 2015.

• Adjusted EBITDA decreased \$1.9 million, or 4%, to \$45.1 million in 2016.

Mobile Modular

For the three months ended September 30, 2016, Mobile Modular's total revenues increased \$10.6 million, or 20%, to \$63.7 million compared to the same period in 2015, primarily due to higher sales and rental revenues, partly offset by lower rental related services. The revenue increase, partly offset by lower gross margin on rental and rental related services, and higher selling and administrative expenses, resulted in a 1% increase in pre-tax income to \$11.0 million for the three months ended September 30, 2016, from \$10.9 million for the same period in 2015.

The following table summarizes quarterly results for each revenue and gross profit category, income from operations, pre-tax income and other selected information.

Mobile Modular – Three Months Ended 9/30/16 compared to Three Months Ended 9/30/15 (Unaudited)

(dollar amounts in thousands)	Three Months Ended		Increase	
	September 30, 2016	2015	(Decrease) \$	%
Revenues				
Rental	\$33,210	\$30,154	\$3,056	10 %
Rental related services	13,697	14,313	(616)	-4 %
Rental operations	46,907	44,467	2,440	5 %
Sales	16,700	8,539	8,161	96 %
Other	82	107	(25)	-23 %
Total revenues	63,689	53,113	10,576	20 %
Costs and Expenses				
Direct costs of rental operations:				
Depreciation of rental equipment	5,295	4,938	357	7 %
Rental related services	10,025	10,124	(99)	-1 %
Other	9,735	7,485	2,250	30 %
Total direct costs of rental operations	25,055	22,547	2,508	11 %
Costs of sales	12,592	6,569	6,023	92 %
Total costs of revenues	37,647	29,116	8,531	29 %
Gross Profit				
Rental	18,180	17,731	449	3 %
Rental related services	3,672	4,189	(517)	-12 %
Rental operations	21,852	21,920	(68)	0 %
Sales	4,108	1,970	2,138	109 %
Other	82	107	(25)	-23 %
Total gross profit	26,042	23,997	2,045	9 %
Selling and administrative expenses	13,364	11,794	1,570	13 %
Income from operations	12,678	12,203	475	4 %
Interest expense allocation	(1,662)	(1,309)	353	27 %
Pre-tax income	\$11,016	\$10,894	\$122	1 %
Other Information				
Average rental equipment ¹	\$729,943	\$678,274	\$51,669	8 %
Average rental equipment on rent	\$559,584	\$520,036	\$39,548	8 %
Average monthly total yield ²	1.52 %	1.48 %		3 %
Average utilization ³	76.7 %	76.7 %		0 %
Average monthly rental rate ⁴	1.98 %	1.93 %		3 %

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Period end rental equipment ¹	\$734,639	\$686,582	\$48,057	7	%
Period end utilization ³	77.6	%	77.9	%	0

1. Average and Period end rental equipment represents the cost of rental equipment excluding new equipment inventory and accessory equipment.
2. Average monthly total yield is calculated by dividing the averages of monthly rental revenues by the cost of rental equipment, for the period.
3. Period end utilization is calculated by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding new equipment inventory and accessory equipment. Average utilization for the period is calculated using the average month end costs of rental equipment.
4. Average monthly rental rate is calculated by dividing the averages of monthly rental revenues by the cost of rental equipment on rent, for the period.

18

Mobile Modular's gross profit for the three months ended September 30, 2016 increased \$2.0 million, or 9%, to \$26.0 million. For the three months ended September 30, 2016 compared to the same period in 2015:

• **Gross Profit on Rental Revenues** – Rental revenues increased \$3.1 million, or 10%, primarily due to 8% higher average rental equipment on rent and 3% higher average monthly rental rates in 2016. As a percentage of rental revenues, depreciation was 16% in 2016 and 2015, and other direct costs were 29% in 2016 compared to 25% in 2015, which resulted in gross margin percentages of 55% in 2016 compared to 59% in 2015. The higher rental revenues, partly offset by lower rental margins resulted in gross profit on rental revenues increasing \$0.4 million, or 3%, to \$18.2 million in 2016.

• **Gross Profit on Rental Related Services** – Rental related services revenues decreased \$0.6 million, or 4%, compared to 2015. Most of these service revenues are negotiated with the initial modular building lease and are recognized on a straight-line basis with the associated costs over the initial term of the lease. The decrease in rental related services revenues was primarily attributable to lower services provided during the lease. The lower revenues, together with lower gross margin percentage of 27% in 2016 compared to 29% in 2015, resulted in rental related services gross profit decreasing \$0.5 million, or 12%, to \$3.7 million in 2016.

• **Gross Profit on Sales** – Sales revenues increased \$8.2 million, or 96%, compared to 2015, due to higher new and used equipment sales. Higher sales revenues, together with higher gross margin percentage of 25% in 2016 compared with 23% in 2015, resulted in gross profit on sales increasing \$2.1 million, or 109%, to \$4.1 million. Sales occur routinely as a normal part of Mobile Modular's rental business; however, these sales and related gross margins can fluctuate from quarter to quarter and year to year depending on customer requirements, equipment availability and funding.

For the three months ended September 30, 2016, selling and administrative expenses increased \$1.6 million, or 13%, to \$13.4 million, primarily due to increased employee headcount, salaries and benefit costs and higher allocated corporate expenses.

TRS-RenTelco

For the three months ended September 30, 2016, TRS-RenTelco's total revenues decreased \$3.0 million, or 10%, to \$26.3 million compared to the same period in 2015, primarily due to lower rental, sales and rental related services revenues. Pre-tax income decreased \$0.6 million, or 9%, to \$5.8 million for the three months ended September 30, 2016 compared to the same period in 2015, primarily due to lower gross profit on rental and rental related services, partly offset by lower selling and administrative expenses.

The following table summarizes quarterly results for each revenue and gross profit category, income from operations, pre-tax income and other selected information.

TRS-RenTelco – Three Months Ended 9/30/16 compared to Three Months Ended 9/30/15 (Unaudited)

(dollar amounts in thousands)	Three Months Ended		Increase (Decrease)	
	September 30, 2016	2015	\$	%
Revenues				
Rental	\$20,365	\$22,612	\$(2,247)	-10%
Rental related services	655	821	(166)	-20