Q1 2019
CONFERENCE CALL

Prepared remarks from:
David L. Dunkel, Chairman and CEO
Joseph J. Liberatore, President
David M. Kelly, CFO

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DAVID L. DUNKEL, CHAIRMAN AND CEO

You can find additional information about this quarter's results in our Earnings Release and our SEC filings. In addition, we have published our prepared remarks within the Investor Relations portion of our website. We have provided an additional table in our press release to reconcile our GAAP results with adjusted results, which is provided to give you greater clarity into the underlying trends in the business.

As previously announced, we successfully closed on the divestiture of KGS, our prime federal government contracting business, on April 1st and are making good progress pursuing strategic alternatives for our TraumaFX business. Finalizing the sale of KGS is the culmination of a journey we began years ago to concentrate our business in the areas within commercial staffing that are focused on the most critical talent needs in our information and technology driven society. We have executed this plan in a patient and disciplined manner allowing us to maximize our return on these assets and unlock the capital of our Firm and the focus of our team.

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As we look to the future, we are excited to have completed this important strategic shift and are even more excited about our future prospects. Kforce is now exclusively US focused and nearly 80% of our revenues are derived from technology. As the technology talent market has evolved, every industry and organization is confronted with the imperative to invest and rapidly adapt to changing business models and new competitors. Our focused domestic technical and professional staffing platform provides an excellent foundation to meet our clients' needs for flexible talent and will continue to be the driver to our near-term growth. However, these same clients are looking to firms such as Kforce to assume a greater role in more complex engagements that require managed services and solutions. Our clients have increasingly expressed their desire to engage with us to serve as a viable alternative or complement to the larger scale integrators. This leverages our delivery capabilities to identify qualified, highly-skilled talent, quickly, at attractive rates and also manage the stringent and complex compliance requirements. We believe that significant opportunity exists to invest and expand our capabilities in this space to not only serve existing clients but enhance our ability to grow our client portfolio. This will allow us to expand our reach and capture a sizable share of not only the $30+ billion-dollar domestic market for Technology staffing, but also a portion of the $100+ billion-dollar market for IT solutions. We have been working on and will continue to evolve this strategy and consider investments that will help better shape the future of our Firm and lead to enhanced prospects for long-term success. I can envision twenty percent of our technology revenues being derived from this segment in 5 years. The pace of technological change, in particular, suggests that regardless of the economic backdrop, companies will need to continue to access technology resources, which should sustain demand for our services in all economic climates.

In anticipation of and subsequent to the close of the KGS divestiture, we have aggressively been repurchasing our stock. At these levels, we believe the repurchase of our stock with the sale proceeds best serves our shareholders and we expect to continue our repurchase activities until the cash proceeds from the sale are exhausted. We are able to comfortably undertake these actions without reducing our flexibility to make other strategic investments due to our very strong operating cash flows.

First quarter revenues and earnings per share from continuing operations were within the range of our expectations. We continued to make meaningful progress in improving our profitability levels as the Firm grows, while also investing in technology to better enable our associates and improve service capabilities to our clients, consultants and candidates. Given the acute labor shortages, our technology investments have been and continue to be focused in areas including candidate sourcing and attraction, advanced screening and matching algorithms, engagement and retention platforms.

The demand environment continues to be very constructive and our outlook for the remainder of 2019 is positive. Big data, artificial intelligence and machine learning continue to be in high demand, as well as cloud computing, cybersecurity, mobility and digital marketing.

These rapidly changing technologies are also impacting staffing as new tools become available. At Kforce, our strategy is to embrace technologies that will enable our associates to focus on serving our customers with trusted relationships. We believe that technology will facilitate enhanced productivity and improved customer service in the sophisticated and complex world of professional and technical staffing.

I will now turn the call over to Joe Liberatore, President, who will give greater detail into our operating results and trends and then Dave Kelly, CFO, will provide further details on impacts of the KGS transaction and share repurchase activities as well as add further color on first quarter results and provide guidance on Q2.

JOSEPH LIBERATORE, PRESIDENT

Overall revenue from continuing operations in the first quarter met our expectations.

We were pleased with the 9.8% year-over-year billing day growth in our largest business, Tech Flex, which now represents approximately 77% of overall revenues. We believe the growth we are experiencing in Tech Flex, which continues to significantly exceed published market growth averages, is reflective of a continued strong demand environment as well as success from our efforts to optimize the alignment of our sales and delivery talent within our client portfolios.

As we indicated on the call last month regarding the sale of KGS, our starts activity in the quarter was trending slightly below expectations due to the lingering effects of the shutdown in combination with weather impacts experienced during Q1. Activity has begun to normalize across the business, though government clearances still are taking longer than usual, which affects our staffing efforts with government integrators. However, lower attrition rates of consultants has slightly lengthened assignments and allowed us to achieve billable headcount levels at quarter end consistent with our expectations. We believe these lower attrition rates and a continuation of bill rate increases at rates higher than inflation are indications of our clients' desires to retain the highly-skilled and scarce talent as well as the evolution of technology initiatives towards an agile, continuous improvement environment.

We continue to make the necessary adjustments to the alignment of our sales and delivery talent within our client portfolios, which is contributing to above market revenue growth rates and associate productivity. Fortune 1000 companies continue to be the largest consumers of flexible technology talent. Our revenue growth over the last several quarters has been largely a result of our diversification efforts beyond our largest clients and deeper into other Fortune 1000 customers where we have established relationships. We have been very successful in growing these accounts, which remain among our 25 largest relationships, through a deep understanding of their needs and our ability to craft solutions through both traditional staff augmentation, and also by providing a greater level of managed service and solution offerings. While we have seen this growth, no single client constitutes more than 5.5% of tech flex revenue.

We have experienced growth across virtually every industry vertical in which we do business. Top growth industries for us were financial services, business and professional services, as well as new growth in health services.

We expect continued above market growth in our Tech Flex business in the second quarter. Year-over-year growth rates should remain in the high single digits despite more difficult year-over-year comps.

Our FA Flex business, which represents roughly 20% of overall revenues, declined 11.7% year-over-year. We continue to make progress repositioning this business in more highly skilled positions that are less susceptible to being disrupted by technology advancements. We are beginning to see progress as average bill rates within FA Flex have increased 7.5% on a year-over-year basis. The market for our FA business continues to be strong and we believe our efforts in this area should lead to improving performance as we enter the second half of the year. While the realization of results from this strategic shift has taken longer than anticipated, our internal trends suggest that our FA Flex business may turn slightly positive sequentially in the second quarter and; year over year declines will recede to the high single digits.

Direct Hire revenue, which represents roughly 3% of overall revenues, increased 4.8% year-over-year. The market for permanent talent, particularly in Tech continues to be quite strong and our Direct Hire business continues to be an important capability in ensuring that we can meet the talent needs of our clients through whatever means they prefer. We continue to be selective in our investments in this line of business. We expect a seasonal sequential increase in the second quarter and for growth rates in this business to be stable year-over-year. Over the long term, we have built our model with the belief that Direct Hire will continue to decline as a percentage of overall revenue due to the growth expectations in our other lines of business.

With respect to our revenue-generating talent, we continue to make significant technology and process investments in order to improve associate productivity, which has now improved greater than 10% each of the past three years. Improving productivity has also had a positive impact on associate retention, which should continue to drive additional productivity improvements. We have not made material additions to associate headcount beyond those areas where productivity levels warrant additions as we believe significant capacity exists to continue to grow revenue at our targeted levels.

Our simplified business model has us well positioned for long- term growth. I appreciate our team's efforts in driving our Firm forward. I will now turn the call over to Dave Kelly, Kforce's Chief Financial Officer, who will provide additional insights on operating trends and expectations.

DAVID M. KELLY, CHIEF FINANCIAL OFFICER

The results of KGS and our TraumaFX business have been reflected as discontinued operations and as assets held for sale in our first quarter 2019 consolidated financial statements. The total gain on the sale of KGS is approximately $72 million. The income tax benefit of $18.5 million, or 74 cents per share, was required to be recognized in the first quarter. Given the April 1st closing of the transaction, the remaining portion of the gain, $53.5 million, will be recognized in the second quarter. Net cash proceeds from the sale will be approximately $93 million.

Revenues from continuing operations of $326.7 million in the quarter grew 4.6% year-over-year on a billing day basis. GAAP earnings per share from continuing operations of 32 cents were negatively impacted by 6 cents from severance and other costs recognized as a result of actions to simplify the support structure for our business in anticipation of the KGS divestiture. Excluding these costs, earnings per share were 38 cents in the first quarter of 2019, which improved nearly 19% on a year-over-year basis.

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Our gross profit percentage in the quarter of 28.5% declined 70 basis points year-over-year primarily as a result of a decline in our Flex gross profit percentage.

Tech Flex margins of 25.3% declined 80 basis points year-over-year. As noted last quarter, we have experienced spread compression in Tech Flex as a result of the mix of growth in some of our larger clients, which have a slightly lower margin profile. As we look to the future, we expect to continue to more deeply penetrate our existing clients. This may create slight margin pressure as our pricing structures typically include tiered discounts for greater volume at our largest clients. However, our continued efforts in overall portfolio management should mitigate much of this impact. As importantly, greater scale at individual clients allows our associates and support infrastructure to be more efficient and drive profitability from these clients that is accretive to our operating margin targets even at slightly lower gross margins.

SG&A expenses, adjusted for the $2 million of severance and other costs resulting from the divestiture of KGS, declined as a percent of revenue by 100 basis points year-over-year. We continue to make progress in generating SG&A leverage as revenues expand. This leverage has been achieved while also significantly increasing our technology investments. We are also aggressively pursuing opportunities to partner with leading technology firms to embrace applications that enhance our customer experience and further improve productivity and strengthen client and consultant relationships.

Our first quarter operating margin, excluding severance and other costs, was 4.2%, which has improved 40 basis points year-over-year, and met our expectations. During this economic cycle, our gross margin percentage has declined by approximately 200 basis points. Despite this compression, operating margins have improved by more than 400 basis points.

Our effective tax rate in the first quarter from continuing operations was 26.1%.

Operating cash flows in the first quarter, which is typically our lowest quarter of the year, were $11.8 million. Based upon current trends, operating cash flows in 2019 could reach approximately $85 million, excluding any proceeds from the sale of our KGS and TraumaFX businesses. We repurchased 430 thousand shares of stock at a total cost of $14.6 million during the quarter and have continued to be active in repurchasing our shares subsequent to the end of the quarter. We expect to continue these activities until the net proceeds from the divestiture of KGS have been exhausted. As of yesterday, the remaining net proceeds yet to be deployed were $78 million.
Long term debt under our Credit Facility was $82.5 million as of March 31, 2019. We expect to maintain debt levels for the remainder of 2019 at $65 million, which is the notional amount of our attractive interest rate hedge. Depending on the extent of our operating cash flows and pace of stock repurchases, we expect to be in a net cash position for the remainder of 2019.

Our healthy cash flows, minimal capex requirements, low debt levels and $300 million Credit Facility collectively provide us maximum flexibility to execute quickly on strategic or tuck-in acquisitions or other ventures and strategic partnerships even while aggressively repurchasing stock.

I wanted to provide you a sense of how our weighted average shares outstanding could trend for the remainder of 2019 given current repurchase trends. Based upon Q1 activity, we forecast being able to deploy between $20 and $25 million in cash per quarter. This would result in weighted average diluted share outstanding of approximately 24.5 million in Q2, 23.9 million in Q3 and 23.3 million in Q4. Actual results of course could vary significantly depending upon stock price and volume.

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Our billing days are 64 days in the second quarter, which is equal to the second quarter of 2018. With respect to guidance for continuing operations, we expect Q2 revenues to be in the range of $338 million to $343 million and for earnings per share to be between 64 and 66 cents. Gross margins are expected to be between 29.7% and 29.9%, while Flex margins are expected to be between 27.0% and 27.2%. This includes an expected sequential improvement from seasonal payroll taxes of 100 basis points. SG&A as a percent of revenue is expected to be between 22.8% and 23.0% and operating margins should be between 6.3% and 6.5%. Guidance assumes an effective tax rate of 26.0%. Weighted average diluted shares outstanding, as I mentioned, are expected to be approximately 24.5 million for Q2.

This guidance does not consider the effect, if any, of charges related any one-time costs, costs or charges related to any pending tax or legal matters, the impact on revenues of any disruption in government funding, or the Firm's response towards regulatory, legal or future tax law changes.

We are pleased with the continued above-market performance in our Tech Flex business and are focused on repositioning our FA Flex business as we previously discussed. Subsequent to the sale of KGS, we now expect operating margins to be 6.5% or better in a quarter without seasonality effects where revenues are $350 million, which could occur as early as the third quarter. We expect profitability levels to continue to improve to 7.7% in a $400 million quarter. This is a 20-basis point improvement from 6.3% and 7.5% at the same revenue levels in models provided prior to the divestiture of KGS. Costs related to seasonality impact our first and fourth quarters each year by approximately 180 basis points and 40 basis points, respectively. We continue to be excited about our prospects as the market for our services remains quite strong and we remain confident that we have built a solid foundation for sustained revenue growth and continued improvements in profitability.