KFORCE

Q1 2016
CONFERENCE CALL

Prepared remarks from:
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Joseph J. Liberatore, President
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FIRST QUARTER 2016 FINANCIAL RESULTS
CONFERENCE CALL, MAY 3, 2016
PREPARED REMARKS

DAVID L. DUNKEL, CHAIRMAN AND CEO

Over the past two quarters we have been aggressively taking action, particularly in our Tech Flex business, to reduce reliance on a few large customers by strengthening our position more deeply in our client portfolio and adding sales talent at an accelerated level. Though we are seeing signs of recent improvement from these efforts, first quarter results of $322.2 million in revenue were below our expectations, while earnings per share of 24 cents, adjusted for certain non-recurring charges, fell within guidance.

The overall demand environment remains strong. We have begun to see a gradual reacceleration of activity in those few large clients that have slowed their usage of flexible staffing due to transactions, and conversations with client representatives at these clients suggest a strong pipeline of projects. Additionally, as we further deepen relationships more broadly in our portfolio, we continue to identify new opportunities, though building significant presence within these large customers will happen gradually and take some time.

We believe the secular drivers of Technology such as mobility, cloud computing, cyber security, e-commerce and the desire of companies to leverage technology for efficiency gains within their organizations are still intact. Continued high levels of key performance indicators point to a strong market. We are confident that the steps we have taken will result in sequential growth in Q2 and ultimately to a reacceleration of year-over-year growth rates in our Tech Flex business in the second half of 2016.

FA Flex experienced its ninth consecutive quarter of year-over-year double digit growth rates, though our current pipeline of project activity and difficult year-over-year comparisons suggest near term growth rates may be in the mid to upper single digits. The market here also continues to be strong across various skill sets and industries as we continue to invest in this business.

The U.S. economy continues to be sluggish, with modest GDP growth levels in recent quarters, including a recent downward adjustment in Q1 GDP estimates. Despite the slow moving progress in the economy, we are seeing continued stability and areas of strength in the skilled labor markets and a low unemployment rate for college educated professionals, particularly in the Tech and FA specialties that we serve. The BLS temp penetration number remains near record highs as the secular shift towards temporary staffing is continuing. We believe the ever expanding regulatory requirements, particularly around employee classification, have created a higher risk employment environment for clients. This trend should continue to benefit the staffing industry, and in particular, larger staffing firms with greater capacity and infrastructure around areas of compliance.

Now, I would like to discuss some exciting developments in our KGS business. The vision we had when we built our KGS government business was to capitalize on Kforce's core competency of being able to quickly identify and provide, at scale, talent to the world's largest user of technology resources. We felt this capability would be a differentiator as it has always represented a significant challenge for government contractors. We have been patiently working on and investing in this business over the past several years, even as many questioned why.

We are pleased that Rear Admiral Patrick Moneymaker (Ret), CEO of KGS is here with us today. Welcome Pat. Pat and his team have diligently positioned KGS for long-term success by building a first-class leadership team and focusing KGS' business development efforts on prime solutions in our areas of competencies. These efforts were rewarded during the first quarter of 2016, with the selection of KGS as one of 9 large businesses and 12 small businesses to be awarded a prime contract by the United States Department of Veterans Affairs on its T4 Next Generation contracting vehicle. To quote Pat: "this is a game changer for KGS." T4 Next Gen, as it is referred to, will be focused on procuring services for the VA in areas that include information technology infrastructure improvements, cyber security, and operations and network management. The contract vehicle has an overall program ceiling of approximately $22 Billion, which is expected to be released over a period of 10 years.

As a point of reference, the VA procured over $7.47 billion of services from 15 prime contractors over its 5-year term on the original T4 contract, with the smallest total awards to any one prime contractor being $83 million and the largest single contractor, which was a small business, receiving over $1.4 billion in awards.

The fact that KGS has been supporting the VA for over 20 years, most recently as a subcontractor under the original T4 vehicle, leads us to be very optimistic about our prospects to capture a meaningful share of this significant opportunity in a prime role. KGS has had successful past performance in providing solutions to the VA, supported by the backing of Kforce's centralized delivery capabilities, which we believe were key elements in KGS receiving this award. The T4 Next Gen contract vehicle could provide KGS with an opportunity to experience exponential growth over the next several years beginning in Q4 of 2016.

We are focused on making the necessary investments in KGS to capture the significant future business potential this contract provides. A couple of important points for our investors who are not familiar with the government contracting environment. Our prime award on this contract is expected to yield higher gross profit and operating margins than we are currently experiencing. Additionally, this provides a stable and more predictable revenue stream over the 10-year life of the contract vehicle. It also raises KGS's visibility within the government services contracting space, which we expect will afford us opportunities to propose on future prime opportunities in other areas within the government. We are very proud of our KGS team's accomplishments and will provide updates on a quarterly basis as to the anticipated timing and scale of revenue capture opportunities around T4 Next Gen, as well as other developments within KGS.

We remain confident in our prospects and therefore are maintaining an investment posture as it relates to revenue generating talent additions, technology investments to enable our associates and the necessary investments in KGS to maximize the opportunities that exist under T4 Next Gen. With that said, we remain committed to our profitability target of 7.5% when annualized revenue of $1.6 billion is achieved.

I will now turn the call over to Joe Liberatore, President, who will provide further details on our Q1 operating results. Dave Kelly, Chief Financial Officer, will then add further color on our Q1 operating trends and financial results as well as provide guidance on Q2.

JOSEPH LIBERATORE, PRESIDENT

Thank you Dave and thanks to all of you for your interest in Kforce.

Our top line performance in Q1 was slightly below guidance. Tech Flex, our largest business unit, which accounts for 66% of total revenues performed as we expected with Tech Flex revenues growing 1.3% on a year-over-year basis.

As Dave mentioned, the disproportionate declines in a few of our largest clients has abated in the first quarter of 2016. It is worth pointing out that these clients, along with many of our largest clients, have provided significant growth over the last several years and we continue to believe that our longstanding relationships with these clients provide longer term strength to our overall revenue base within these clients.

Demand remains strong and broad-based across the industries we serve and the skill sets we provide. The ability to access and retain talent continues to be the most significant constraint in Tech Flex, as exhibited by the continued high level of conversions which have disproportionately impacted our largest clients over the last several quarters.

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We believe we are having success as we diversify our resources within the existing client portfolio and our activity levels have increased significantly year-over-year. We have not yet seen an acceleration in starts activity, however, as it typically takes time to turn activity into starts at larger clients.

We expect Tech Flex revenues to increase sequentially in the second quarter, however year-over-year growth will likely decelerate slightly due to a challenging comp versus last year.

Finance and Accounting Flex, which represents 23% of our total revenues, grew 13.8% year over year. We did experience unexpected ends within some relatively significant projects midway through the quarter. These were primarily concentrated in the healthcare industry as several clients converted a high percentage of consultants to full time employees.

This business continues to experience high demand and KPI levels. However, as we have seen in our Tech Flex business, conversion activity remains elevated due to a shortage of available talent. The end of these significant projects in Q1 will moderate year-over-year growth in the near term for this business unit though still outpace industry levels. We expect Q2 Flex revenues to increase mid to high single digits year-over-year.

Revenues for Kforce Government Solutions decreased as expected by 10.7% year-over-year. We expect KGS revenues to improve in Q2 from Q1 levels and to improve slightly year over year. We are focused on building a solid foundation to capture the significant opportunity that we believe exists under the T4 Next Generation award that Dave spoke to earlier.

Direct Hire revenues from placements and conversions increased 4.0% year over year, and remains approximately 4% of total Firm revenues. Following a relatively strong start to the quarter, Direct Hire revenue plateaued a bit in March and continued into early April. Our objective is to meet the talent needs of our clients through whatever means they prefer, and providing the highly skilled capability to deliver resources through Direct Hire remains important in meeting those needs. We expect Direct Hire revenues to be consistent to slightly up with first quarter revenues.

We continue to add to our associate population with a focus on Tech Flex sales and as a result, revenue generating talent has increased 10.6% year-over-year in Q1. The focus of our hiring has been, and continues, to be to add resources at some of our largest clients and diversify within our current portfolio within Tech Flex and F&A Flex clients.

We believe our shift in revenue generating investment and expansion of our focus to a greater number of larger clients that began in Q4 of 2015 will result in greater client penetration, market share and better execution of delivery. We believe we are taking the appropriate actions to take advantage of our platform, infrastructure and client base to put our Great People in an environment where they can be successful accelerating revenue growth while delighting our clients and consultants.

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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

Thank you Joe.

Total revenues for the quarter were $322.2 million, which represents a 3.1% increase year-over-year. Our Flexible staffing revenues collectively grew 4.3% year-over-year, while our government business declined 10.7% year-over-year. Direct Hire revenues of $12.6 million increased 4.0% year-over-year.

GAAP earnings per share were 14 cents in the first quarter, which includes non-recurring charges which impacted EPS by 10 cents. The non-recurring charges included $1.7 million, or $1.0 million after tax, in severance charges related to our recent reorganization and a $1.7 million charge to income tax expense for certain non-cash true-ups related to prior periods. Further commentary around our first quarter results will exclude the effect of these charges to focus on our core operating results.

First quarter net income and earnings per share were $6.4 million and 24 cents, respectively, which represent increases of 10% and 20% on a year-over-year basis.

Gross Margins of 30.2% declined 10 basis points year-over-year as a result of a slight decline in Flex Margins. Our Flex gross profit percentage of 27.3% in the first quarter declined 20 basis points year-over-year. The decrease was primarily due to higher than anticipated health insurance expenses in our FA Flex and Government businesses. Larger than anticipated enrollment in our FA Flex health plans drove increased costs as consultants have been increasingly willing to utilize the Firm's health plans rather than pay the Individual Mandate penalty under the Affordable Care Act. We have continued to educate our clients and have been successful passing through these costs. Year-over-year spread has improved 60 basis points in FA Flex. The increase in healthcare costs in our Government business was the result of several large claims, which we don't expect to persist at these levels in future quarters. Tech Flex Margins improved 30 basis points year-over-year primarily as a result of a 50 basis point improvement in bill/pay spreads.

As we look forward, after taking into account the sequential improvement in Q2 from the impact in Q1 of seasonal payroll tax increases, we expect Tech Flex and FA Flex Margins to continue to be relatively stable at these levels. Though it won't impact Q2 margins, our government business should benefit from the T4 Next Gen prime contract award as it begins to contribute to the top line later this year, since prime contracting arrangements typically carry 3-5% higher gross margins than sub-contracts. The current mix of subcontract to prime contract revenue at KGS is approximately 60% subcontract and 40% prime, and we expect that mix to reverse over time.

SG&A as a percentage of revenue declined 30 basis points year-over-year to 26.0% in Q1 2016 versus 26.3% in Q1 2015. We expect SG&A as a percent of revenue to improve into Q2 with the decline in payroll taxes and to remain in the low to mid 25% range in the short-term, as we absorb the costs of increased associate levels and investments in KGS that we believe are necessary to generate long-term shareholder value. We also expect to see some increased costs for technology investments later in the year as we consider replacement of our existing front office tools. The aggregation of these costs has an impact of two cents in Q2 and may increase slightly in the second half of 2016.

Q1 2016 operating margins of 3.4% improved 20 basis points from 3.2% in Q1 2015.

With respect to our balance sheet and cash flows, our accounts receivable portfolio continues to perform well. Operating cash flows in the first quarter were $3.1 million. Capital expenditures for Q1 were approximately $1.3 million.

We continue to maintain significant borrowing capacity under our $170 million Credit Facility. Long-term debt at the end of the quarter was $107.0 million, compared to $83.8 million at the end of Q4, an increase of $23.2 million.

We returned approximately $23 million to our shareholders during the first quarter through the repurchase of 1.1 million shares at a total cost of $19.8 million and a $3.1 million outlay for the payment of our 12 cent per share quarterly dividend. In the seven quarters since the divestiture of our HIM business, we have continued to provide liquidity in our stock and return cash to our shareholders through share repurchases and dividends. Approximately $160 million has been returned and outstanding shares have been reduced by approximately 20%. There is approximately $33 million available for repurchases under current board authorization. We expect to continue balancing the allocation of our capital, after capital expenditures and dividends, between stock repurchases and debt retirement as conditions warrant.

With respect to guidance, the second quarter of 2016 has 64 billing days, which is the same as the first quarter of 2016 and the second quarter of 2015. We expect Q2 revenue to be in the $332 million to $337 million range, and for Earnings per Share to be between 39 and 42 cents. The combined seasonal improvement to Flex Margins and SGA due to annual payroll tax decreases in Q2 relative to Q1 is expected to be approximately 11 cents per share.

Following two consecutive quarters of sequential revenue decline and significant efforts to refocus our activities, our revenue guidance for Q2 implies sequential growth in the range of 3.0% to 4.6%. Gross margins are expected to be between 31.4% and 31.6%. SG&A as a percent of revenue is expected to be between 25.3% and 25.5%. Operating margins are expected to be between 5.2% and 5.5%. Our effective tax rate in Q2 is expected to be 39.3%. This guidance assumes weighted average diluted shares outstanding of approximately 26.3 million for Q2.

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

We continue to remain very focused on the actions necessary to reaccelerate revenue growth, in particular in our Tech Flex business, as well as making the necessary investments in KGS to position us for success in capturing the significant opportunities that we expect to present themselves beginning in the second half of 2016 under the recently awarded T4 Next Gen prime contract. We believe these investments, as well as increases in technology spend, are in the best long term interests of our shareholders. Our client relationships remain strong and our sales metrics are trending positively. We remain very confident in the demand environment within the markets and clients that we serve and still expect to meet or exceed our 7.5% operating margin target when $1.6 billion in annualized revenue is reached.

Operator, we would now like to open up the call for questions.

DAVID L. DUNKEL, CHAIRMAN AND CEO

Thank you for your interest in and support of Kforce. I would like to say thanks to each and every member of our field and corporate teams, and to our consultants and our clients, for allowing us the privilege of serving you.