KFORCE

Q4 2018
CONFERENCE CALL

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

Great People = Great Results®

KFORCE

FOURTH QUARTER 2018 FINANCIAL RESULTS
CONFERENCE CALL, FEBRUARY 6, 2019
PREPARED REMARKS

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.

As I reflect on 2018, in particular, the strong results we delivered in the fourth quarter, I am immensely proud of what our team has accomplished. During the course of the year we made significant progress in building our Tech Flex business. We have deepened client relationships, and, in many cases, we have become a trusted advisor in helping companies meet their ever-growing technology needs.

We have also continued to invest in tools that should further strengthen our capabilities and generate additional productivity from our associates. These investments included continued enhancements to our CRM and our Business Intelligence platform. A key technology initiative in 2019 will be the initial rollout of our Talent Relationship Management system which we expect to go live late in the year. We have also continued to incorporate other technologies into our processes which could further enhance our capabilities. We expect the pace of change from a business model and technology standpoint to continue and we believe that we, like virtually every organization, need to maintain high levels of technology investment for the foreseeable future.

In addition to accelerating revenue growth, we have also significantly improved profitability and generated significant cash for our shareholders. Total revenue of $1.42 billion in 2018 grew 4.0% year-over-year. We were also able to expand operating margins by 80-basis points and generate earnings per share of $2.30, which is a 46.5% improvement year-over-year. Our strong cash flows in the year and positive outlook allowed us to not only continue to return cash to our shareholders through stock repurchases, but to also increase our quarterly dividend midway through the year to 18 cents per share. All told, we returned $31 million to our shareholders through repurchases and dividends while also reducing debt by $45 million.

Fourth quarter revenues of $358.0 million meaningfully exceeded our expectations and earnings per share of 65 cents exceeded the mid-point of our guidance by 8 cents.

The demand environment continues to be very constructive and our outlook for 2019 is quite positive. As to the macro economic environment, significant market volatility and political uncertainty has persisted. Contrary to the concern that we might be late in the cycle however, the strength in recent employment reports point to the increasing need for skilled talent. Trends in our business as well as others in our space support the notion that secular drivers in technology will transcend traditional cyclical patterns as business models are transformed. Nontraditional competitors are entering new end markets; thus, putting increased pressure on companies to invest in innovation and evolve. 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 and non-traditional competitors enter the industry. At Kforce, our strategy is to embrace technologies that will enable our associates to focus on serving our customers with trusted relationships and, where appropriate, selectively invest in these technologies. We believe that technology will facilitate enhanced productivity and improved customer service in the sophisticated and complex world of professional and technical staffing.

In both the $30+ billion-dollar market for Technology staffing and the $100+ billion-dollar market for IT solutions, where staffing companies are increasingly gaining a foothold, there are limited providers with the infrastructure to not only provide quality and timely talent at scale, but to also meet increasingly stringent compliance requirements. These represent significant competitive advantages in today's war for talent. It is people serving people.

Before I turn the call over, I would like to share my deepest appreciation for the hard work done by all of our associates in the past year. I am proud and humbled to work side-by-side with these talented people who are dedicated to daily meeting the needs of our clients and consultants.

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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 add further color on fourth quarter results and provide guidance on Q1.

JOSEPH LIBERATORE, PRESIDENT

Our results in the fourth quarter, particularly in Tech Flex, reflect a continued strong demand environment and success from our efforts to optimize the alignment of our sales and delivery talent within our client portfolios. Overall revenues in the fourth quarter meaningfully exceeded the top end of our guidance driven primarily by Tech Flex, which grew 9.0% on a year-over-year basis. Our growth rate in Tech Flex continues to be more than double the industry average and is expected to continue or slightly accelerate into the first quarter. In Tech Flex, we experienced fewer assignment ends than anticipated and an increase of average hours worked, as clients are looking to hold onto and maximize the availability of these highly skilled scarce resources. An additional indicator of the strength of demand were the higher than normal levels of new assignment starts experienced later in the fourth quarter, which is typically a slow period for new activity. These trends provide us with good momentum going into the first quarter of 2019 and suggest that year-over-year growth rates may accelerate and may exceed 10%, despite increasingly difficult comps.

We continue to make necessary adjustments to the alignment of our sales and delivery talent within our client portfolio which is contributing to both improving 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 broader diversification efforts beyond our largest clients and deeper into other Fortune 1000 customers where we have established relationships. This focus on significant users of flexible staffing services has better enabled us to understand the technology issues and craft solutions for these sophisticated and substantial consumers of our services.

From an industry standpoint, we experienced growth in 9 of our top 10 industries. The growth was broad based, but strongest in Technology, Financial Services, Business Services and Manufacturing.

Our FA Flex business, which represents roughly 20% of overall revenues performed consistent with our expectations. Revenues improved sequentially and declined 11.7% year-over-year. The fourth quarter was inclusive of a project related to federal government disaster recovery, which does not carry into the first quarter of 2019. We have frankly struggled in this business over the past year and are early in working to reposition it to place greater emphasis on higher bill rate opportunities within the skill sets less susceptible to being disrupted by technology advancements. We are using the same disciplined methodology we applied to our technology segment. Bill rates within FA Flex have increased 5.3% on a year-over-year basis, which reflects our pursuit of a more balanced mix of higher skilled roles in FA as larger projects end. The market for higher bill rate FA staffing 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. We expect first quarter revenues to be down approximately 10%-12% on a year-over-year basis.

KGS services revenues declined 13.3% year-over-year due to a combination of award delays and refinement efforts to reduce the number of consultants on lower margin assignments as reflected in the year over year 50 basis point improvement within the services business. Despite the instability in the political environment, KGS' management team has done a nice job building a strong, qualified pipeline of new business pursuits and have positioned KGS for significant growth. It is clear the timeline of KGS' new business pursuits have been delayed as a result of the Federal government shutdown. Last quarter, we disclosed that KGS was awarded its largest contract in its history, with an estimated $150 million to $200 million value, which is expected to be recognized over a period of 5 years. This contract award is currently under protest and, while timing of resolution is a bit uncertain, we expect it to be resolved favorably over the next 30-60 days and make a meaningful contribution to revenue growth beginning in late Q2. We would expect it to contribute annualized revenues of approximately $30 to $40 million once fully ramped. Despite the impact of the shutdown on lost billable hours and award delays, we expect our KGS services business to be stable on a sequential basis.

KGS product revenues, which are inherently more volatile than its services business, increased approximately 29% year-over-year in Q4. Revenues annually ramp in this business with the strongest quarters typically in the second half of the year, to align with the buying patterns of the government fiscal year. For the first quarter, we expect KGS product revenues to decline to typical seasonal first quarter levels.

Overall KGS revenues in the first quarter will decline approximately 9% year over year.

Direct Hire revenues, which represent roughly 3% of overall revenues, increased 9.1% year-over-year. 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 have been selective in our investments in this line of business to meet this evolving model. We expect sequential and year-over-year growth rates to be down in the mid to high single digits in Q1, after a stronger than expected fourth quarter. Over the long term, we have built our model with the belief that Direct Hire will continue to decline as a percentage of our entire business.

The stabilization of our team after several years of significant change in combination with our technology and process investments have led to improved productivity of our revenue-generating talent, which has improved greater than 10% each of the past three years. Our associate population by design was flat sequentially and we expect headcount levels to remain relatively constant in the near term. As we refine our model, we continue to identify opportunities for improving productivity, and therefore 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.

I appreciate our team's efforts in driving our Firm forward in 2018 and look forward to 2019 and beyond. 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

Revenues of $358.0 million in the quarter grew 2.8% year-over-year and earnings per share of 65 cents improved 44% year-over-year, as adjusted for the $5.4 million impact in Q4 2017 of the revaluation of our deferred taxes stemming from the Tax Cuts and Jobs Act.

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Our gross profit percentage in the quarter of 29.8% declined 20 basis points year-over-year, as a result of a 30 basis point decline in our Flex gross profit percentage to 27.0%, which was partially offset by higher Direct Hire and KGS Product revenue mix.

Tech Flex margins of 26.6% declined 60 basis points year-over-year and FA Flex margins of 28.7% increased 20 basis points year-over-year. Overall spreads in our Tech Flex business have been relatively stable over the course of 2018, but we experienced slight compression in the second half of the year as a result of strong growth in two of our largest clients that have a slightly lower margin profile. As we look into 2019, we expect growth to be strongest in clients outside of those where we already have very significant relationships. This should result in reasonably stable Tech Flex spreads since those very significant clients have a slightly lower margin profile than the rest of the portfolio. As is the case every year, overall Flex margins will be negatively impacted sequentially by annual payroll tax resets which occur in the first quarter.

SG&A expenses as a percent of revenue declined 100 basis points year-over-year to 23.0% in the fourth quarter of 2018. We continue to make significant progress in generating SG&A leverage by improving the productivity of our associates and exercising solid control over discretionary expenses. These actions have allowed us to increase our investments in technology while also improving operating margins. We expect to continue to reduce SG&A expense as a percentage of revenue as revenues grow. As a reflection of this trend, looking forward to Q1, we expect SG&A dollars to actually be down year-over-year despite higher levels of revenue and incremental investments in technology.

Fourth quarter 2018 operating margins of 6.2% improved 80 basis points year-over-year and were consistent with expectations at these revenue levels. During this economic cycle, our gross margin percentage has declined by 190 basis points. Despite this compression, operating margins have improved by 430 basis points.

Our effective tax rate in the fourth quarter was 23.7%, which was lower than anticipated as a result of excess tax benefits from the vesting of restricted stock and higher income tax credits.

With respect to our balance sheet and cash flows, operating cash flows in the fourth quarter of $23.0 million were quite strong. We ended 2018 with outstanding borrowings under our Credit Facility of $71.8 million, which equates to leverage of approximately 0.8 times trailing twelve-months EBITDA. Cash flows in 2019 could reach approximately $100 million based upon current trends.

Our healthy cash flows, minimal capex requirements, low debt levels and $300 million Credit Facility collectively provide flexibility to execute quickly on strategic or tuck-in acquisitions or other ventures and strategic partnerships and also continue to return significant capital to our shareholders through both a healthy dividend and share repurchases.

Billing days are 63 days in the first quarter, one less than the first quarter of 2018. Billing days for the rest of the year will be 64 days in the second quarter, 64 days in the third quarter and 62 days in the fourth quarter. Revenue per billing day in the fourth quarter of 2018 was $5.8 million. With respect to guidance, we expect Q1 revenues to be in the range of $351 million to $356 million and for earnings per share to be between 40 and 42 cents. Revenues in the first quarter will be impacted by the government shutdown which created delays in new contract awards and lost billable hours primarily in KGS but also our Tech Flex business, which provides staff on a subcontract basis to many government integrators. The total impact of the shutdown in Q1 is expected to be approximately $3 million in revenues. Gross margins are expected to be between 28.2% and 28.4%, while Flex margins are expected to be between 25.7% and 25.9%. This includes an expected sequential impact from seasonal payroll taxes of 90 basis points. SG&A as a percent of revenue is expected to be between 23.4% and 23.6% and operating margins should be between 4.1% and 4.3%. Guidance assumes an effective tax rate of 25.5%. Weighted average diluted shares outstanding are expected to be approximately 25.1 million for Q1.

This guidance does not consider the effect, if any, of charges related to the impairment of intangible assets, 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 firmly on track to reach our next milestone of 7.5% operating margins when quarterly revenues reach $400 million. We expect the progression in profitability improvements to be relatively linear absent seasonality impacts in the first and fourth quarters. For the first quarter, the range of operating margins contemplated in our guidance of 4.1% to 4.3% includes a 220 basis point impact in cost of sales and SG&A combined from seasonality and payroll tax resets. Payroll taxes impact EPS by 15 cents. Thus, our profitability in the first quarter against our operating margin commitments is very much on track.

We are very pleased with our performance in the fourth quarter, especially with the continued above-market performance in our Tech Flex business. In 2018, we were successful in accelerating revenue growth in our Tech Flex business, continuing to improve associate productivity, generating higher levels of profitability and significantly improving cash flows. We are excited about our prospects in 2019 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.