KFORCE

Q2 2020
CONFERENCE CALL

Prepared remarks from:
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SECOND QUARTER 2020 FINANCIAL RESULTS
CONFERENCE CALL, AUGUST 10, 2020
PREPARED REMARKS

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All statements, other than those of a historical nature, are forward-looking statements including, but not limited to, statements regarding the secular drivers of technology, the pace of digital transformation, the Firm's opportunity to continue investing in its future growth, returning capital to its shareholders including the intent and ability to declare and pay quarterly dividends, and maintaining sufficient flexibility to pursue acquisitions and make other strategic investments. Such forward-looking statements are within the meaning of that term in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Factors that could cause actual results to differ materially include the following: business conditions, growth rate in temporary staffing and the general economy; competitive factors; risks due to shifts in the market demand; a reduction in the supply of consultants and candidates or the Firm's ability to attract and retain such individuals; the success of the Firm in attracting and retaining its management team and key operating employees; the impacts (direct and indirect) of COVID-19 on our business, our consultants and employees, and the overall economy; changes in the service mix; ability of the Firm to repurchase shares; the occurrence of unanticipated expenses; the effect of adverse weather conditions; changes in our effective tax rate; changes in government regulations, laws and policies that are adverse to our businesses; risk of contract performance, delays or termination or the failure to obtain new assignments or contracts, or funding under contracts; changes in client demand and our ability to adapt to such changes; continued performance of and improvements to our enterprise information systems, ability to successfully manage outstanding litigation or other legal matters and the risk factors listed from time to time in the Firm's reports filed with the Securities and Exchange Commission, including the Firm's Form 10-K for the fiscal year ending December 31, 2019, as well as assumptions regarding the foregoing. In particular, the Firm makes no assurances that: we will successfully manage risks to our revenue stream; or we will successfully put into place the people and processes that will create future success. The terms "should," "believe," "estimate," "expect," "intend," "anticipate," "foresee," "plan" and similar expressions and variations thereof contained in this press release identify certain of such forward-looking statements, which speak only as of the date of this press release. As a result, such forward-looking statements are not guarantees of future performance and involve risks and uncertainties. Future events and actual results may differ materially from those indicated in the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements and the Firm undertakes no obligation to update any forward-looking statements.

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DAVID L. DUNKEL, CHAIRMAN AND CEO

Good afternoon. I would like to remind you that this call may contain certain statements that are forward-looking, including statements regarding the impact, opportunities and benefits from actions taken related to the COVID-19 economic and health crisis. These statements are based upon current assumptions and expectations and are subject to risks and uncertainties. Actual results may vary materially from the factors listed in Kforce's public filings and other reports and filings with the Securities and Exchange Commission. We cannot undertake any duty to update any forward-looking statements. 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.

Our focus on providing critical technology talent to world class companies as well as the ability of our FA business to support large-scale critical government-sponsored COVID-19 related initiatives, in addition to our core FA footprint, allowed us to grow revenues 1.2% on a year-over-year basis against the backdrop of an unprecedented macro-economic landscape resulting from the sudden and dramatic effects of the global pandemic.

Our strong performance in the second quarter is a testament to the longer-term strategic decisions we have made to position Kforce for success and significantly insulate the Firm from the consequences of the economic disruption. We have worked diligently over many years to shed non-strategic businesses, which has resulted in roughly 80% of our revenues being concentrated in high-end information technology staffing and solutions. This decision was supported by our belief that the technology staffing and solutions market would exhibit very strong and stable long-term demand that would have very limited economic sensitivity due to the critical need for ongoing technology investment, particularly in industry leading world class companies.

While nobody could have foreseen this severe of an event to be the proof positive of our long-standing secular thesis, we believe that the current crisis has only strengthened the secular drivers of demand in technology as companies accelerate investments in their digital transformation efforts. We will continue to place a priority on allocating capital to grow our technology business. While we remain cautious and continue to fortify our balance sheet in the near term, the strength in our performance and financial position allows us to be flexible in how we deploy capital in the future.

I am extremely proud of the tenacious focus and execution our leaders and associates have displayed during this difficult time. Our people have successfully tackled a sudden shift to working fully remotely, many schooling their children virtually in the spring and likely in the fall, without any decline in productivity levels. Our people have been nothing short of tremendous and they have proven to be one of the best teams in the industry.

As we look to the future, there is much that remains uncertain, but several things seem relatively clear to us. For instance, we will not be reoccupying our field and corporate offices any time soon and are assessing what our future real estate needs may be as we modify our business model and structurally reduce operating costs. Our investments in a cloud-based, technology-enabled operating model, primarily leveraging Microsoft as our platform of choice, has put our people in a position to excel in this virtual work environment and we are assessing areas to accelerate investments in technology that will drive much greater effectiveness and enhance service levels in what will likely be a more flexible future working environment.

Our priority during economic downturns has always been to retain our great people and maintain important strategic investments in our business so that we are well positioned to take market share and accelerate growth rapidly as the situation improves. We have handled the current situation in much the same way. We are very well-positioned to navigate through the current period without having to take drastic actions to reduce costs, restrict or eliminate dividends or raise capital. Rather we will continue to manage our business in a disciplined manner as we always have based upon operating trends.

Through these difficult times we will continue to put the safety of our associates first. They are the key to our future success, and we know that their resilience and determination will drive increasing success as we move through and beyond the current situation.

I will now turn the call over to Joe Liberatore, President, who will give greater insights into our second quarter performance, recent operating trends, and other insights into our operating environment. Dave Kelly, CFO, will then give greater detail on our financial results, including cash flows and balance sheet position, as well as guidance for the third quarter.

JOSEPH LIBERATORE, PRESIDENT

The journey that Dave mentioned to narrow our focus by shedding non-strategic businesses to take greater advantage of the secular shift in technology demand and to limit our exposure to the highly cyclical direct hire business, is providing a significant level of resiliency to our revenues, as demonstrated by our second quarter results and early third quarter trends.

Our overall revenue growth in the second quarter on a year-over-year basis of 1.2% and the performance in each of our lines of business exceeded both internal and Wall Street expectations. Let me give you a little more color in each line of business.

With respect to our Technology business, flex revenues declined 3.0% year-over-year and 4.0% sequentially. As noted on last quarter's call, we didn't see notable impacts from the COVID-19 crisis until late March and into early April. After the April impact of declines from those businesses directly affected by the pandemic, our weekly trends were largely stable throughout the remainder of the second quarter. Since mid-June, we have seen modest growth in our billable headcount. For the month of July, on a year-over-year basis, technology flex revenues were down approximately 2% though these declines may increase slightly for the full quarter against a more difficult prior year comp.

Starts activity and job order flow have begun to increase over the last several weeks, though remain lower than pre-pandemic levels. While job orders are lower than pre-pandemic, the quality of the job orders is higher as clients seek to staff critical roles. Our internal metrics and revenue trends point to an improving environment. If trends continue, we will see third quarter sequential growth in Tech, as the higher skill set work, which is being done virtually 100% remotely, has been retained by our clients throughout the pandemic and is now being supplemented with new assignment growth.

The majority of the declines we experienced at the onset of the pandemic, as noted previously, were principally concentrated in the travel and leisure, retail and healthcare sectors. We found that many of our largest clients, where we have the greatest presence and most mature relationships, actually added additional resources in transformational roles as the quarter progressed.

We continue to experience the acceleration of technology driven, mission critical, strategic consumer direct initiatives within world-class companies. We have matured our capabilities to source and deliver diverse skill sets of qualified talent, at scale, to these large users that have priority needs for large-scale talent across the U.S. We are well positioned to further evolve our offerings to meet these client's changing needs, inclusive of the expanding demand for managed services and solutions that have historically been provided by large solution providers. Due to our longevity in the market and reputation for delivering quality services, we are seeing increasing demand supporting clients' needs in the managed teams, services and solutions areas. Revenues in this offering are accelerating at a significantly greater pace than our overall technology business. We feel extremely confident in the positioning of our technology business and the ability to expand our market share as competitive disruption in staffing companies emerges with those less capable or financially viable to navigate this economic downturn.

We expect flex revenues in our Technology business in the third quarter to be stable to slightly up sequentially. It is also notable that the stability we have seen in Tech is much more significant than that experienced during the 2008-2009 recession, which further supports the secular story. Should current trends continue for the remainder of the year, tech flex would experience a full year decline of less than 3%.

Moving to our FA business. Flex revenues were up nearly 29% year-over-year in the second quarter, primarily as a result of the contribution of approximately 35 million dollars of revenue from our support of government-sponsored initiatives tied to the COVID-19 pandemic. For this business, we have partnered with several companies to provide consultants in roles including customer service and call center agents as well as loan processing specialists. These opportunities have provided a level of support to our core FA Flex business as we navigate the revenue reductions brought on by this crisis. Our long-standing personal relationships, fortified by experience with these clients during prior natural disasters, and our ability to quickly source and deliver talent on a large scale, primarily due to our centralized delivery capability and innovative technology, uniquely positions us to support these critical initiatives. These engagements remain fluid, but we expect these opportunities should continue through the third quarter and at least into the fourth quarter. Due to the nature of the projects, we would expect declines in these revenues as the economy recovers, which would likely correspond with increasing demand for our core Tech and FA offerings. Due to the growth we experienced in the second quarter, revenues related to the COVID initiatives could be in a range of $45 million to $55 million in the third quarter.

Our Core FA Flex business declined approximately 25%. As we stated last quarter, we felt the negative impacts from the current crisis earlier and more deeply in this line of business. After the initial impacts were felt, we saw signs of stabilization during the majority of the second quarter and have experienced modest growth in billable headcount since the end of June. For the month of July, revenues in our Core FA business were down roughly 26% and we could see a sequential decline for the third quarter in the mid-single digits. When combined with the mid-point of the range of COVID revenue, total FA Flex may be up approximately 17% sequentially and nearly 50% YoY.

Direct Hire revenue in the second quarter decreased approximately 50% year-over-year. We experienced a significant impact at the end of Q1 and generally held at those lower revenue levels throughout the second quarter. Direct Hire revenues are inherently less predictable. Year-over-year revenue declines have decelerated in the month of July and we may see revenue levels for the third quarter at approximately second quarter levels. As in most recessionary cycles, this service offering tends to be most impacted by economic uncertainty and we have consistently reduced our concentration of Direct Hire revenues over the years. At the peak of the economic expansion prior to the dot.com bust, Direct Hire revenues were 22.5% of revenues and now constitute less than 2% of revenues in the second quarter. While Direct Hire remains an important part of our service offering to clients over the longer term, we have not allocated significant investment here in part due to the sensitivity of the revenue stream to economic cycles and the disruptive technologies that have continued to evolve in this space. Additionally, we are able to provide Direct Hire capability in our technology practice through the same channel utilized in our technology flex business as the skillsets we service are similar.

As Dave stated, we have continued to invest in strategic initiatives to better position our Firm for the long term, including investments in our most critical technology initiatives. Several years ago, we made a strategic decision to leverage Microsoft's suite of product offerings for our cloud-based technologies. This includes our customer relationship management system, which we implemented in 2017, and our talent relationship management system, which we are in the process of implementing in 2020. This combined with the seamless integration of these technologies with other Microsoft Office 365 products such as Outlook and Teams has provided us significant efficiencies with a fully integrated platform, especially as we shifted our associates to a work-remote environment in mid-March.

We are continuing to manage the productivity of our associates as we typically do, with an elevated focus on retaining our most productive associates so we are best positioned to take advantage of the market subsequent to this crisis. We experienced a decline in overall performer headcount levels due to natural performance managed attrition, but we did not and do not expect to undertake any large-scale reductions. We will continue to monitor the business environment and our operating trends and manage our performer headcount accordingly. As conditions begin to improve, we believe we can take advantage of the capacity that exists in our existing talent, along with improving productivity gained through our technology investments and greater enablement of our current communication tools that have been so successful for us during this transition to remote work.

Our experience has been that recessionary cycles result in a shift in the competitive environment and we believe we are ideally situated to take advantage of the market as conditions recover in what we believe could be an accelerated digitally led expansion.

I greatly appreciate the trust our clients, consultants and candidates have placed in Kforce and I couldn't be prouder of our teams' efforts executing in a fully remote capacity while managing through these remarkable times. We are well underway in assessing any adjustments to our future operating model brought to the forefront by this pandemic; including, but not limited to, our future real estate footprint, internal talent acquisition strategies, technology investments, among others. I will now turn the call over to Dave Kelly, Kforce's Chief Financial Officer.

DAVID M. KELLY, CHIEF FINANCIAL OFFICER

Revenues of $343.0 million in the quarter grew 1.2% year-over-year and earnings per share of 47 cents declined 28.8%, largely due to a decline in gross margin and higher SGA costs related to retention of critical infrastructure and resources.

Our gross profit percentage in the quarter of 28.4% decreased 140 basis points year-over-year primarily as a result of a lower Direct Hire revenue mix.

Our flex gross profit percentage of 27.0% improved 10 basis points year-over-year despite the negative impact from the higher mix of revenues from the COVID-19 business, which carries a lower overall margin profile. Flex margins in our technology business increased 70 basis points year-over-year primarily as a result of lower payroll taxes and consultant travel costs. Spreads in our technology business remained flat year-over-year and sequentially as improved spread from new managed services business has offset any pricing concessions provided to certain strategic clients during the pandemic. Flex margins in our FA business declined 240 basis points year-over-year, though approximately 120 basis points of this was driven by the lower margin COVID-19 business. Spreads in our core FA business were down slightly sequentially.

Average bill rates in our technology business of $80 per hour increased 4.6% sequentially and 6.2% year-over-year. We believe this increase was driven, in part, by business mix as our clients are retaining the more highly skilled consultants given the scarcity of talent and the assignments that were ended at the onset of this pandemic were lower skilled areas which were less capable of working remotely. New assignment adds in the quarter, inclusive of the increasing mix of higher bill rate managed services business, were concentrated, as well, in higher bill rate skill sets. We saw a similar story in our core FA business, where average bill rates of $40 grew 4.6% sequentially and 9.5% year-over-year.

As we look forward to the third quarter, we would expect continued stability in our bill/pay spreads in our technology and core FA business versus second quarter levels and for overall margins to be stable.

Our strong results and the improvements we have made in associate productivity are allowing us to sustain or accelerate expenditures on strategic activities such as technology investments, acceleration of efforts to reposition our FA business and retaining critical resources through the pandemic. These actions, as well as other discrete costs related to the pandemic, led to an increase in SG&A as a percent of revenue in the second quarter of 50 basis points year-over-year. We expect SG&A expense to decline in Q3, which, in addition to increased revenue, will have a significant positive impact to earnings per share.

Roughly 80% of our SG&A expenses are variable in nature, which allows us significant flexibility to manage our cost structure. We have also gained significant operating leverage over the last several years. This leverage along with recent cost containment actions and our quality revenue stream has put us in a position to navigate the current crisis without taking drastic action. We have continued to make investments in our business that we believe will position us well to continue to outperform the market as the crisis subsides.

Our second quarter operating margin was 4.5%. Our effective tax rate in the second quarter was 29.4%, which was slightly higher than we anticipated as a result of certain true ups.

Next, I'll spend a few minutes discussing our operating cash flows and liquidity position.

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Operating cash flows in the second quarter were $36 million, an increase of $25.4 million year-over-year, due to continued profitable growth. We also benefited from the deferral of approximately $12 million in payroll taxes under the CARES Act in the second quarter. Our accounts receivable portfolio continues to perform well as days sales outstanding was flat with Q1 2020 levels.

We have a very strong balance sheet which provides ample liquidity to operate the business, even in extreme conditions, and flexibility to opportunistically allocate resources. Our working capital balance as of June 30th, net of cash on hand, was approximately $140 million, which serves as a reliable source of liquidity if revenues were to contract.

We have a $300 million revolving credit facility that matures in May 2022. Our trailing twelve months EBITDA as of June 30, 2020 was roughly $87 million, which currently provides incremental borrowing capacity, should we need it, of roughly $140 million. We had approximately $52.4 million cash on hand at the end of the quarter and net debt as of June 30, 2020 was approximately $48 million, or roughly 0.5 times trailing twelve months EBITDA. Looking forward into Q3, we expect to continue to generate positive cash flow, which we plan to utilize to further reduce net debt levels. Our current cash flow expectations suggest that we could be effectively net debt free by the end of 2020.

We believe we are in an enviable position due to our low debt levels, healthy cash flows, high-quality accounts receivable portfolio and resilient revenue stream. The strength in our financial position allows us to be flexible in making continued investments in our business, deploying capital in other areas such as acquisitions and returning capital to our shareholders.

We are resuming guidance this quarter, but with wider ranges given the continued unknowns and the unpredictability of our current COVID-19 revenue stream. Our billing days are 64 days in the third quarter, which is the same as Q2 2020 and the third quarter of 2019. We expect Q3 revenues to be in the range of $352 million to $362 million and for earnings per share to be between $0.72 and $0.80 cents. Gross margins are expected to be between 28.2% and 28.4%, while Flex margins are expected to be between 26.9% and 27.1%. SG&A as a percent of revenue is expected to be between 21.3% and 21.5% and operating margins should be between 6.3% and 6.7%. Weighted average diluted shares outstanding are expected to be approximately 21.0 million for Q3, and the anticipated effective tax rate is 26.8%.

This guidance does not consider the potential negative impact on the demand environment from a significant increase in COVID-19 cases, the effect, if any, of charges related to 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.

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Kforce outperformed the market during the Great Recession and our results thus far during this pandemic have been encouraging. At that time, technology only comprised 50% of total revenues versus approximately 80% today. We believe we are in an even better position to outperform as we navigate the current economic and health crisis. Lastly, I'd like to extend a sincere thank you to all of our teams for their efforts over the last five months to ensure that we are living up to our brand promise of providing great results through strategic partnership and knowledge sharing.

DAVID L. DUNKEL, CHAIRMAN AND CEO

Thank you for your interest in and support of Kforce. As we continue to navigate these unprecedented times, I would like to say thank you to each and every member of our field and corporate teams for the tremendous efforts, and to our consultants and our clients, for your trust in Kforce in partnering with you and allowing us the privilege of serving you. We are excited about our future and look forward to talking with you again next quarter.