KFORCE

Q2 2018
CONFERENCE CALL

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

Great People = Great Results®

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SECOND QUARTER 2018 FINANCIAL RESULTS
CONFERENCE CALL, AUGUST 1, 2018
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DAVID L. DUNKEL, CHAIRMAN AND CEO

Thank you, Michael.

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.
I will provide some high-level opening remarks on our second quarter results and operating environment and will then turn it over to Joe Liberatore, President, who will give greater detail into our operating results and trends and then Dave Kelly, CFO, who will add further color on second quarter results and provide guidance on Q3.

We are very pleased with our second quarter results. We have been on a journey over the past two years to enhance and improve our operating model through disciplined process, standardized messaging and through embracing technologies to improve productivity, accelerate revenue and improve operating margins. While we still have a long road ahead of us with significant opportunity to further improve, the investments we have made in our people and technology are having a meaningful impact on our operating metrics and financial results. Q2 revenue and earnings per share were near or at the high end of our expectations, and we reached our first profitability milestone, as operating margins were 6.4%. The most notable driver to our improving revenue trajectory was the growth of our Tech Flex business, which grew 11% year over year, when adjusted for the divestiture of our Manila business. Our diversification efforts within Tech Flex to better segment our client portfolios and more strategically align our sales and delivery talent within these portfolios are contributing to the acceleration in revenue growth and is also benefiting Flex margins. Cash flow was also particularly strong in Q2, with operating cash flows of $28 million. This strength should continue due to our expectation of continued profitability improvements as we grow.

Our internal metrics and conversations with our clients suggest that the demand environment continues to be very strong and we believe we are very well positioned to capitalize. Recent economic data suggest that growth in the US economy is strong and business spending is robust with many leading economists expecting this will continue. We have seen some increase in spending since the passage of the recent tax reform legislation but anticipate that this may accelerate going forward as confidence in the economy's growth prospects continue.

The strengthening economic environment only adds to the secular drivers of demand for our services. Companies across virtually all industries, and of all sizes are experiencing competitive dynamics requiring technology investments to enhance their customer experiences just to keep pace with the market leaders. These investments are not optional. Rather, they are necessary for survival in this increasingly tech driven world. Nontraditional competitors are also entering new end markets; thus, putting increased pressure on companies to invest in innovation and the evolution of their business models. We believe these secular drivers will transcend traditional cyclical patterns as these business models are transformed. Big data, artificial intelligence and machine learning continue to be in high demand, as well as cloud computing, cybersecurity, mobility and digital marketing.

As has been the case for this entire economic cycle, we expect that the need for increasing technology investments across all industries will drive companies to look to large firms such as Kforce to solve their human capital challenges. There are limited providers with the infrastructure to not only provide quality and timely talent, but to also meet increasingly stringent compliance requirements. These represent significant competitive advantages in today's war for talent.

Our confidence in the sustained strength of our business is demonstrated by our Board of Directors' approval of a 50% increase in our dividend, effective in the third quarter. As we look to Q3, we expect to further accelerate revenue growth and, consistent with our profitability objectives, continue to improve the operating leverage from our revenue growth. We also are continuing to invest in technology that equips our organization with improved capabilities to deliver exceptional service to our clients, candidates and consultants, while also increasing the productivity of our associates. We are also very proud to have recently launched our Kforce brand refresh. Kforce has always been, and will always be, in the business of personal relationships. That's why when the time came to realign our brand we started with our own people. Many of the words and sentiments you'll find in our brand update came directly from the employee perspective.

Our new tagline; We Love What We Do. We Love Who We Serve.® reflects my personal belief that we needed to convey that love and empathy are at the core of what we do. Kforce impacts the livelihoods of our people and those we serve; it's important to never forget that. This phrase has organically woven itself into Kforce's brand over the last several years and our people have really embraced it, so it's only natural that it has made its way into our official brand update."

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JOSEPH LIBERATORE, PRESIDENT

We believe the results for the second quarter of 2018 are reflective of the benefits being realized from the investments we have made and actions we have taken over the last few years.

Most notable is the continued acceleration in our Tech Flex business, which is now roughly 70% of overall revenues. The year-over-year growth rate in this business exceeded our expectations, accelerating to 11.0% year-over-year growth, when adjusted for the divestiture of our Manila business, and 9.8%, as reported, in the second quarter, up from 6.7%, as reported, last quarter. This growth rate is roughly three times the projected industry growth rate. During the quarter, our new assignment starts were strongest in the last month of the quarter and we also benefited during the second quarter from higher overall average bill rates, and this momentum has continued into the early third quarter. Our average bill rate of $73.60 per hour is up 3.5% year over year. This compares to a bill rate of $72.00 in Q1, which was a 3.1% improvement year over year.

We have commented on prior calls on our efforts to better segment and diversify our client portfolio, optimizing the alignment of our sales and delivery talent within our client portfolio and tailoring incentives to the growth that we expect to occur. 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 they are facing and to craft solutions. From an industry standpoint, we experienced growth in virtually all our industries, so growth was very much broad-based. The increasing bill rates that I previously mentioned, coupled with this more broad-based growth, has again allowed us to sequentially increase bill/pay spread for the fourth time in the past five quarters.

Our focus on large users of flexible staffing is well supported by our mature centralized delivery platform, which allows us to deliver consultants at scale across the United States. This capability, combined with improved execution and focus in our field offices, our enhanced candidate attraction and sourcing capability leveraging the application of technology has also allowed us to increase productivity levels again this quarter. While we are certainly pleased with the productivity gains, we believe significant additional capacity exists. We also believe that our continued investments in technology will yield additional efficiencies and productivity.

For the third quarter of 2018, we expect Tech Flex revenues to grow sequentially and for year-over-year growth rates to accelerate and again exceed 10%.

Our FA Flex business, which represents roughly 20% of overall revenues, declined 9.4% year-over-year. Similar to what was accomplished in our technology business, we are focused on diversification, better aligning our sales and delivery talent with a more strategic client portfolio in mind. In addition, as larger projects end, we are actively pursuing a more balanced mix of higher skilled roles in FA. We are seeing some early positive indicators to this focus in the form of increasing bill rates, which have increased 4.4% year-over-year. However, as we work through this transition, new assignment starts have been lower than anticipated, which is driving the revenue declines.

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We are positioning this business for future growth against a demand environment that we believe is solid. We expect third quarter revenues to be flat to down slightly sequentially, as activity levels begin to improve in the second half of 2018, and year-over-year declines to approximate second quarter levels. In addition, we expect this business to turn sequentially positive during the fourth quarter of 2018.

KGS services revenues grew 18.2% year-over-year as this business continues to benefit from the two strategic prime contracts that were awarded in the third quarter of 2017. We referenced in our last call that we were successful in winning a significant re-compete that represented approximately 18% of our revenue base but that, as is common, the award was being protested. This protest was favorably resolved in the second quarter. We believe there is insignificant recompete risk for the remainder of 2018 and 2019 for KGS. KGS continues to operate in a cost competitive environment and the secured recompete is expected to put pressure on KGS' margins going forward. With that said, we are strategically focused on improving the profitability of KGS, especially in certain existing contracts and expect margins in the services business to improve sequentially in Q3.

KGS product revenues, which are inherently more volatile than its services business, accelerated 63.2% year-over-year. For the third quarter, we expect KGS total revenues to increase sequentially by high single digits and for growth to be in double digits on a year-over-year basis, though the rate of growth will decline compared to the second quarter.

Direct Hire revenues, which represents roughly 3.5% of overall revenues, declined 9.5% 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. Given the volatility in this business, sensitivity to cyclical economic cycles, and necessary ramp cycles for talent, we have been selectively investing in this line of business as we have in past economic cycles. We expect a typical seasonal decrease in the third quarter, and year-over-year to be down slightly.

We continue to make targeted investments in training, technology, business intelligence and other tools that are directed towards improving the experience of our clients and consultants as well as significantly improving the productivity of our people. These tools and technologies include our customer relationship management system, a new consultant time and expense management system, talent management system with greater capabilities for candidate sourcing and matching, among others.

We have improved the productivity of our revenue-generating talent by approximately 13.6% year-over-year. As we refine our model, we continue to identify opportunities for improving productivity, and therefore have not made additions to associate headcount as we believe significant capacity exists to continue to grow revenue at our targeted levels.

Our success is tied to our ability to consistently improve associate productivity by ensuring they are engaging with the right customers and arming them with the best tools and leadership.

Our team has executed well, and I appreciate everyone's efforts as we continue to move our Firm forward.

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DAVID M. KELLY, CHIEF FINANCIAL OFFICER

Revenues of $358.6 million in the quarter represents 5.4% year-over-year growth, which accelerated from 3.7% last quarter, and earnings per share of 65 cents improved 48% year-over-year.
Our gross profit percentage in the quarter of 30.0% declined 50 basis points year-over-year, primarily related to a decline in the mix of Direct Hire and a 30 basis point year-over-year decline in our Flex gross profit percentage to 27.1%. The Flex margin decline is due to continued pricing pressures in our KGS services business.

Flex margins in our core commercial staffing businesses continue to improve, however. Tech Flex margins, which are now 27.2%, have increased 30 basis points year-over-year due to improvement in bill/pay spreads and FA Flex margins of 29.1% have also increased 30 basis points year-over-year. We have now seen a sequential improvement in bill/pay spreads in four of the last five quarters in our staffing businesses, which reflects increasing bill rates due to strong demand and success in pricing discipline and further penetrating higher margin accounts.

As shared previously, the sale of our low bill rate Global operations in the second half of 2017 has also contributed to the improvement in our Tech Flex average bill rate. Overall bill rates, normalized for the Global divesture, have grown approximately 3.5% year-over-year in our Tech Flex business and 4.4% in our FA Flex business. This represents a slight acceleration from the 3.1% and 3.5% bill rate increase last quarter for Tech Flex and FA Flex, respectively.

Third quarter Flex margins are expected to be relatively stable in our Tech and FA Flex businesses, while Flex margins in our Government services business are expected to improve sequentially.

SG&A expenses as a percent of revenue declined 120 basis points year-over-year to 23.0% in the second quarter of 2018, which is a historic low for our Firm. We continue to make progress in generating SG&A leverage by significantly improving productivity and controlling expenses. This has allowed us to increase our investments in technology while continuing to improve operating margins. Looking forward to Q3, SG&A dollar expense should be essentially flat sequentially on greater revenues, providing further leverage and improved margins. SG&A expenses in Q3 contemplate continued investments in technology, with a focus on improving the candidate and consultant experience and further expanding our business intelligence capabilities. We are also aggressively pursuing opportunities to partner with leading firms to embrace technology that enhances our customer experience and improves productivity and relationships.

Second quarter 2018 operating margins of 6.4% improved 70 basis points year-over-year, exceeding the milestone we set when quarterly revenues were to exceed $350 million. During this economic cycle, we have now improved operating margins by more than 400 basis points despite the divestiture of two non-core businesses that were more profitable than overall Firm averages, and overall compression of our Flex gross profit margins. We are very pleased with the progress we have made and are firmly on track to reach our next milestone of 7.5% operating margins when quarterly revenues exceed $400 million.

Our effective tax rate in the second quarter was 25.5%. As it relates to our effective income tax rate for the remainder of 2018, we expect this will track close to Q2 levels, excluding the impact of any excess tax benefits that may be recorded, which would likely reduce our tax rate.

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With respect to our balance sheet and cash flows, operating cash flows in the second quarter of $28.0 million were very strong. We used this cash flow to decrease debt by $22.6 million. Long term debt under our Credit Facility at the end of June was $100.6 million and approximately one times trailing twelve-month EBITDA. Our strong balance sheet and cash flows allows us to continue returning cash to our shareholders while maintaining the flexibility to take action if there are dislocations between our stock price and performance or if we were to identify strategic or tuck-in acquisitions or partnerships.

Capital expenditures in the second quarter were $1.6 million.

As Dave mentioned, our Board approved a 50% increase to our quarterly dividend, bringing the payout to 18 cents per share effective with our 3rd quarter dividend. This increase brings the dividend level to approximately 25% of earnings, and the dividend yield to approximately 2%. Our strong performance and cash flows make us quite comfortable with a dividend at these levels and the Board will plan to evaluate dividend levels annually.

The third quarter of 2018 has 63 billing days, which is one day less than Q2 2018 and the same as Q3 2017. Revenue per billing day in the second quarter of 2018 was $5.6 million. With respect to guidance, we expect Q3 revenues to be in the range of $359 million to $364 million and for earnings per share to be between 65 and 67 cents. Gross margins are expected to be between 29.7% and 29.9%, 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 22.7% and 22.9%. Our guidance for the third quarter reflects continued progress towards our next operating margin milestone and operating margins should be between 6.4% and 6.6%. Guidance assumes an effective tax rate of 25.7%. The high end of guidance also contemplates Tech Flex year-over-year growth rates exceeding 10% on an as reported basis. Weighted average diluted shares outstanding are expected to be approximately 25.4 million for Q3.

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 very pleased with the continued acceleration in our Tech Flex business and believe we have a solid foundation for sustained revenue growth and continued improvements in profitability. Sequentially, our operating margin is expected to benefit from the leverage gained from revenue growth, stable flex margins, improved associate productivity and continued SG&A expense discipline. We expect to make continued incremental improvements in meeting our next milestone of 7.5% in a quarter, without seasonality impacts, where revenues reach $400 million. We continue to believe we are in businesses that will remain in significant demand and are excited about our future prospects.