Q1 2018
CONFERENCE CALL

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

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FIRST QUARTER 2018 FINANCIAL RESULTS
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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.

I will provide some high-level opening remarks on our first 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 first quarter results and provide guidance on Q2.

We are very pleased with our first quarter results, especially with the continued acceleration of growth in our Tech Flex business and the significant progress we are making towards meeting our previously stated profitability objectives. The actions to focus the efforts of our sales and delivery talent more broadly across our portfolio of clients is benefiting both revenue growth and margin stability more rapidly than we had anticipated, which contributed positively to our first quarter results.

Flex gross profit margins in both Tech Flex and FA Flex improved on a year-over-year basis, which along with lower SG&A costs, resulted in a year over year improvement of 80 basis points in operating margin. Also, when combined with the lower effective tax rate, earnings per share increased 60% year-over-year.

The demand environment continues to be very strong and we believe we are very well positioned to capitalize on this growth. Though the recent headline for GDP was slightly lower than anticipated, business spending is robust and many leading economists expect continued strong growth. We have seen some increase in spending since the passage of the recent tax reform legislation, but anticipate that this may accelerate going forward. Companies across virtually all industries, and of all sizes are experiencing competitive dynamics requiring technology investments to enhance their customer experiences in this rapidly changing marketplace. We believe these secular drivers will transcend traditional cyclical patterns as 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.

Again, we expect that the need for increasing technology investments across all industries will continue for the foreseeable future. To meet this demand, companies are continuing to look to flexible solutions and partners that have the infrastructure to provide quality and timely talent and are also able to meet increasingly stringent compliance requirements.

As we look to Q2, we look forward to achieving the first milestone in our objective of significantly improved profitability and accelerating revenue growth. We also expect to continue to invest in technology that equips our organization with improved capabilities to deliver exceptional service to our clients, candidates and consultants while increasing the productivity of our associates.

JOSEPH LIBERATORE, PRESIDENT

The results for the first quarter of 2018 reflect our continued efforts to bring consistency to our operating model and align our activities to the places of greatest value to our clients and consultants.

We have made significant progress in our Tech Flex business, which is roughly two-thirds of overall revenues. The year-over-year growth rate in this business accelerated to 6.7% in the first quarter from 5.4% last quarter. After considering the loss of revenue from the divestiture of our Global business in the third quarter of 2017, our core Tech Flex business grew 8.1%, which is roughly twice the projected industry growth rate. This is due to an increase in starts activity that allowed us to rebound from year-end assignment ends at the fastest rate in this economic cycle. This momentum has been carried into the early second quarter.

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We have been working diligently on better segmenting and diversifying our client portfolio and optimizing the alignment of our sales and delivery talent within our client portfolio. 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 few largest clients and deeper into other Fortune 1000 customers where we have established relationships. This focus on clients with whom we have established relationships better enable us to understand the technology issues they are facing and to craft solutions. As a result, engagements structured under statements of work continue to be a key focus area within our portfolio. From an industry standpoint, we experienced growth in virtually all of our industries, so growth was broad-based.

This strategy 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, and 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 additional capacity exists.

For the second quarter of 2018, we expect Tech Flex revenues to grow sequentially and for year-over-year growth rates to accelerate from Q1 levels.

Our FA Flex business, which represents 22% of overall revenues, declined 7.9% year-over-year. While we anticipated certain larger project ends to present headwinds in the first quarter, these ends were greater than we anticipated. New assignment starts in FA Flex also were lower than anticipated.

We believe the market for F&A Flex remains strong and we are focused on accelerating activity levels that should result in improving trends. We have already seen improvements due to this focus and expect second quarter revenues to be stable to slightly down and year-over-year declines to approximate first quarter levels.

KGS services revenues grew 24.5% year-over-year, which was primarily driven by the increase in revenues from the two strategic prime contracts that were awarded in the third quarter of 2017. KGS product revenues, which are inherently more volatile than its services business, declined 34.0% year-over-year.

We referenced in our last call that a significant re-compete, representing 18% of our revenue base, was scheduled for award in the first quarter. We were successful in winning this re-compete as a subcontractor; however, as is common in this business, it is currently being protested and we expect the protest to be resolved in the second quarter of 2018. KGS continues to operate in a cost competitive environment and this recompete is expected to put pressure on KGS' margins going forward. For the second quarter, we expect KGS revenues to grow double digits on a year-over-year basis and at a growth rate that exceeds the first quarter primarily as a result of an increase in product revenues, which are expected to roughly double the low Q1 levels.

Direct Hire revenues, which represents roughly 3.0% of overall revenues, declined 1.0% year-over-year. Our Direct Hire business is an important capability in ensuring that we can meet the talent needs of our clients through whatever means they prefer. We expect a seasonal increase in the second quarter, but expect a decline on a year-over-year basis.

We continue to make targeted investments in training, technology and other business intelligence tools that are directed towards improving the experience of our clients and consultants as well as improving the productivity of our people. To that end, we have improved the productivity of our revenue-generating talent by approximately 11% year-over-year and we believe significant capacity exists to continue growing revenue. Associate headcount in the quarter grew slightly sequentially, but has declined 7.2% year-over-year. We expect associate headcount levels to be stable in the second quarter with first quarter levels as we further accelerate revenue growth.

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.

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 $346.3 million grew 3.7% year-over-year and earnings per share of 37 cents improved 60% year-over-year.

Our gross profit percentage in the quarter of 28.9% declined 20 basis points year-over-year, though staffing flex margins have improved. The decline in gross profit margins was driven by a lower percentage of Direct Hire and KGS product revenues versus Q1 last year.

Our Flex gross profit percentage of 26.3% improved 10 basis points year-over-year, which was driven by a 30 basis point improvement in both Tech and FA Flex margins, which offset a 50 basis point decline in our KGS service business. We have now seen a sequential improvement in bill/pay spreads in three of the last four quarters in our staffing business, which reflects both strong demand and our success in pricing discipline and further penetrating higher margin accounts.

As a footnote, shared initially last quarter, the sale of our low bill rate Global operations in second half of 2017 has resulted in a substantial improvement in our Tech Flex average bill rate, which has increased from $67 to $72. Not only is our core Tech Flex business growing at a faster rate excluding the Global operations, as Joe mentioned, but the resulting higher rates will help drive more gross margin dollars as we grow. Technology bill rates, normalized for the Global divesture, have grown approximately 3% year-over-year.

Gross margins will benefit sequentially from higher levels of direct hire and product revenues, which will offset slightly lower flex margins in KGS. Second quarter Flex margins are expected to be stable in our Tech and FA Flex businesses after taking into account the improvement in Q2 from Q1 of seasonal payroll taxes. Flex margins in our Government services business will see further compression as a result of a full quarter of revenues under the recent recompete.

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SG&A expenses as a percent of revenue declined 100 basis points year-over-year to 24.4% in the first quarter of 2018. We continue to make progress in generating SG&A leverage by significantly improving productivity and controlling expenses. This has allowed us to significantly increase our investments in technology while continuing to improve operating margins. Looking forward into Q2, SG&A dollars spent should be essentially flat year-over-year on significantly greater revenues. We will continue to make additional investments in technology, with a focus on improving the candidate and consultant experience and further expanding our business intelligence capabilities. While these investments will have up-front costs, they are directly linked to generating additional productivity improvements. We are also aggressively pursuing opportunities to partner with leading technology firms to embrace applications that enhance our customer experience and improve productivity and relationships.

First quarter 2018 operating margins of 3.9% improved 80 basis points year-over-year.

Our effective tax rate in the first quarter of 25.1% was slightly lower than we had anticipated as a result of higher anticipated tax credits and the vesting of share-based compensation awards. As it relates to our effective income tax rate on a go-forward basis, we expect this will track closer to 26% for the remainder of 2018.

With respect to our balance sheet and cash flows, operating cash flows in the first quarter, which is typically our lowest cash flow quarter, were $10.3 million. Long Term debt under our Credit Facility at the end of March was $123.2 million.

Capital Expenditures in the first quarter were $1.5 million. We repurchased roughly 318 thousand shares for $8.7 million during the quarter and paid approximately $3 million in dividends.

We will continue to balance the utilization of this cash and other available capital between investing in the long-term growth of our business through technology investments, potential tuck-in and strategic acquisitions, investments in strategic partnerships, reducing debt levels and returning capital to our shareholders.

The second quarter of 2018 has 64 billing days, which is equal to Q1 2018 and equal to Q2 2017. With respect to guidance, we expect Q2 revenues to be in the range of $355 million to $360 million and for earnings per share to be between 62 and 65 cents. Gross margins are expected to be between 30.0% and 30.2%, while flex margins are expected to be between 27.0% and 27.2%. SG&A as a percent of revenue is expected to be between 23.0% and 23.2%. As Dave noted in his opening remarks, our guidance for the second quarter reflects our expectation to achieve the first milestone in our commitment to improve our profitability. In the second quarter, we expect to exceed $350 million in revenues and operating margins are forecasted to be between 6.3% and 6.5%. Guidance assumes an effective tax rate of 26.0%. The high end of guidance also contemplates Tech Flex year-over-year growth rates that are approaching 10%. Weighted average diluted shares outstanding are expected to be approximately 25 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 towards regulatory, legal or future tax law changes.

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We are 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, greater levels of more profitable Direct Hire and KGS Product revenues, lower seasonal payroll taxes, 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.