KFORCE

Q3 2020
CONFERENCE CALL

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

KFORCE®

THIRD QUARTER 2020 FINANCIAL RESULTS
CONFERENCE CALL, NOVEMBER 2, 2020
PREPARED REMARKS

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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.

It is becoming clearer each day that the COVID-19 pandemic has triggered a generational change in the shape and conduct of business and personal lives. Prior to the pandemic, our society, and the business community at large, were rapidly transforming and embracing digital models and technology investment. The pandemic has exponentially accelerated the pace of this technological revolution. Companies that previously conducted their customer engagement largely in person or through more traditional bricks and mortar have been forced to convert that engagement online, oftentimes through self-service digital platforms. Education and learning companies and institutions and their students are adapting to virtual learning; healthcare companies are working aggressively to address consumer desires for telehealth; retailers across industries have been forced to invest more heavily in online engagement and delivery platforms and FinTech continues to disrupt elements of the financial services industry. These are just a few examples of businesses and industries being redefined. It is not optional to make these investments as organizations and entire industries are rapidly transforming.

We believe these macro and secular trends play to the heart of the position of Kforce as a 100% domestic professional services and solutions firm principally focused on providing critical technology talent and solutions to world class companies. The demand for our services and the resilience of our revenue stream during the pandemic are a testament to the longer-term strategic decisions we made to focus on addressing client needs driven by these trends. We observed these changes beginning to unfold during the Financial Crisis as mobility began to take hold during the early stage of personal devices with the release of the first iPhone in June of 2007.

Our results confirm our strategy as we experienced sequential revenue growth in all lines of business in the third quarter and significantly improved our profitability levels. Most encouragingly, we experienced sequential growth of nearly 2% in our technology business, which is roughly 80% of overall revenues. We have also experienced a return close to pre-COVID-19 start levels in Technology over the past 4 weeks. We continue to perform exceptionally well and capture market share against the backdrop of an unprecedented macro-economic landscape resulting from the sudden and dramatic effects of the global pandemic. Our business footprint has and should continue to insulate the Firm from the consequences of economic disruption and position us to significantly outperform our competitors as conditions improve.

I continue to be amazed by the incredible focus, execution and dedication our leaders and associates have displayed during these difficult times. Our people have successfully tackled a sudden shift to working fully remotely, many juggling family responsibilities during the school year in the spring and now here in the fall, while still driving success for our firm. Our investments in a cloud-based, technology-enabled operating model and the flexibility and support we have provided to our people have allowed them to excel in this virtual work environment. 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, 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. We have exercised caution as we have fortified our strong balance sheet in the near term, ending the third quarter with net cash on our balance sheet. The strength of our performance and financial position allows us to be flexible in how we deploy capital in the future.

We are taking the opportunity during this pandemic to build on our success and assess areas of our business model where we might gain additional advantage by exploring new tools and approaches that could increase the effectiveness of our people and improve the engagement experience with our clients and candidates. Over the last two quarters, we have also initiated activities to streamline our field office layout and geographic footprint by leveraging existing tools which will generate additional longer-term efficiencies. We expect to reinvest some of these savings, as we have been doing, in new technologies and tools to meaningfully improve our flexibility and capability in providing exceptional service in a more virtualized work environment and in onboarding new associates that will position us to capture greater share in the eventual economic recovery.

We expect to continue to manage our business in a disciplined manner, as we always have, based upon operating trends. Through these uncertain and trying 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 third 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 fourth quarter.

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JOSEPH LIBERATORE, PRESIDENT

Our results for the third quarter and our expectations of fourth quarter performance continue to demonstrate a remarkable level of resilience and represent further confirmation of our strategic decisions to focus our business to take advantage of the secular shift in technology demand. The higher-end technology skillsets that we support have demonstrated a greater ability to work effectively remotely during this pandemic. Our strategic journey has included shedding a number of non-strategic businesses and also limiting our exposure to the highly cyclical direct hire business.

Overall revenues grew 5.7% in the third quarter on a year-over-year basis and, importantly, all of our lines of business grew on a sequential basis and exceeded our expectations. Let me give you a little more color in each line of business.

With respect to our Technology business, flex revenues grew 1.7% sequentially and declined 4.2% year-over-year due to more difficult prior year comps. As noted on last quarter's call, we began to see mild growth in billable headcount beginning in early June and this growth continued throughout the third quarter and through October, which we believe reflects our clients growing confidence in restarting projects and seeking resources for key initiatives. Technology billable headcount is now 8% larger than the low point in early June.

Job order flow and new assignment activity have continued to increase over the last several weeks. While job orders certainly remain at levels significantly lower than pre-pandemic, we are finding that the quality of job orders is higher as clients are executing against an overall higher mix of critical technology initiatives. Average new assignment starts in the most recent four weeks is at 95% of levels a year ago and the average bill rate has increased 4.6% from Q3 last year. This is encouraging as we progress through the fourth quarter that still has an air of uncertainty around rising COVID cases, election outcomes and potential pent up demand of paid-time-off and furlough activity around the holidays. Our internal metrics and revenue trends continue to point to an improving environment.

The majority of the assignment ends we experienced at the onset of the pandemic, as noted previously, were principally concentrated in the travel and leisure, retail and healthcare sectors. We experienced growth sequentially in the retail space though travel and leisure and healthcare experienced some weakness sequentially and remain well below pre-pandemic levels. Financial Services, Insurance and Telecom have shown relative resilience throughout the pandemic and grew on a sequential basis.

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, further supported by the backdrop of the evolving trends breaking down geographic constraints to source top talent for 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, through our recruiting core competency and 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.

We expect the level of fourth quarter sequential growth in Tech to accelerate slightly from third quarter levels on a billing day basis. Though current expectations are for US GDP to decline by approximately 4% for the full year, we expect full year flexible revenues in our technology business to decline between only one and two percent. Our performance compares extremely favorably to overall economic trends and is notably better than that experienced during the 2008-2009 recession, which further supports the secular story.

Moving to our FA business. Flex revenues were up nearly 52% year-over-year in the third quarter, primarily as a result of the contribution of approximately 51 million dollars of revenue from our support of government-sponsored initiatives tied to the COVID-19 pandemic. These opportunities have provided an important level of support to our core FA Flex business as we have navigated the revenue reductions brought on by this crisis with many of the roles within FA Flex not being as remote work friendly. Towards the end of the third quarter, we began to see declines in these lower-level, predominantly customer service and call center roles, as government-sponsored customer needs are declining with improvement in economic and employment trends. This revenue stream remains fluid and we expect that revenues related to the COVID initiatives could be in a range of $25 million to $30 million in the fourth quarter. The expected run rate of revenues supporting the COVID initiatives as we exit the fourth quarter of 2020 suggests that we could see up to $10 million in revenues in the first quarter of 2021.

Our Core FA Flex business grew slightly on a sequential basis and declined approximately 25% year-over-year, exceeding our expectations. As we have discussed, we felt the negative impacts from the current crisis earlier and more deeply in this line of business. Since the middle of June, we have experienced modest growth in our billable headcount throughout the third quarter and into October. Given our progress in growing this business from its low point late in the second quarter, we expect that we could see sequential growth in the fourth quarter in the mid-to-high single digits on a billing day basis. When combined with the mid-point of the range of COVID revenue, total FA Flex may be down approximately 18% sequentially and up nearly 21% YoY.

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Direct Hire revenues in the third quarter increased approximately 32% sequentially and declined nearly 27% year-over-year. Direct Hire revenues are inherently less predictable and as in most recessionary cycles, this service offering tends to be most impacted by economic uncertainty. We have also by design reduced our concentration of Direct Hire revenues from 22.5% of revenues at the peak of the economic expansion prior to the dot.com bust to approximately 2% of revenues in the third 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. We expect Direct Hire revenues in the fourth quarter may be stable to slightly down versus Q3 levels given the traditional seasonality in this business.

We have continued to invest in strategic initiatives to better position our Firm for the long term. 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, with the last phase slated for early 2021. This combined with the seamless integration of these technologies with other Microsoft Office 365 products such as Outlook, Teams and Power BI has provided us significant efficiencies with a fully integrated platform, especially as we shifted our associates to a work-remote environment in mid-March. Our team has also significantly advanced efforts in the evolution of a fully integrated hybrid operating model to enhance the online experience of our internal team and with our clients, candidates and consultants in part leveraging our KFORCEconnect from a sourcing, referral and engagement standpoint in a boundaryless environment. These and many other efforts underway will position us with maximum flexibility regardless of what lies ahead during these uncertain times.

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, by design, experienced a decline in overall performer headcount in the third quarter due to natural performance managed attrition, though as we continue to experience improving trends, particularly in our technology business, and gain confidence in a strong tech market in 2021, we have begun efforts to increase associate levels at a measured pace to assist in sustaining our above-market growth rates. These actions will add to the existing capacity of our current associates. Overall capacity should continue to be positively impacted by the improving productivity generated by our technology investments and greater enablement of our current communication tools and processes that have been so successful for us during this transition to remote work.

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

We have retained our best people, taken cost out of the system and are refining a more leverageable model which will result in positive leverage as growth accelerates as we reimagine the future that lies ahead.

I greatly appreciate the trust our clients, consultants and candidates have placed in Kforce and I couldn't be prouder of our teams' attitude and efforts executing in a fully remote capacity while managing through these remarkable times. I will now turn the call over to Dave Kelly, Kforce's Chief Financial Officer.

DAVID M. KELLY, CHIEF FINANCIAL OFFICER

Revenues of $365.4 million in the quarter grew 6.5% sequentially and 5.7% year-over-year. Earnings per share of 89 cents grew 30.9% year over year, as we generated solid leverage from our top line growth and continued SG&A discipline.

Our gross profit percentage in the quarter of 28.4% was stable sequentially and decreased 140 basis points year-over-year primarily as a result of a lower Direct Hire revenue mix and a decrease in overall Flex gross profit margins.

Our flex gross profit percentage of 26.7% declined 30 basis points sequentially and 50 basis points year-over-year primarily due to 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 decreased 60 basis points sequentially and 30 basis points year-over-year primarily as a result of slight spread compression. Approximately 30-40 basis points of the sequential decline was due to unique circumstances in the third quarter relating to client furlough activities and rebate adjustments.

Flex margins in our FA business declined 170 basis points year-over-year driven by the lower margin COVID-19 business.

Average bill rates in technology of roughly $80 per hour were stable sequentially and up roughly 4.6% year-over-year. We believe this year-over-year increase was driven, in part, by business mix as our clients have generally retained the more highly skilled consultants given the scarcity of talent. The majority of the assignments that were ended at the onset of the pandemic were on average in lower skill, lower bill rate areas. New starts during the pandemic have typically been at or near our current average bill rate of $80. We expect Tech bill rates should remain elevated, but we may see some return of assignments with rates closer to our prior averages. Average bill rates in our Core FA business of approximately $37 per hour are close to pre-pandemic levels due to shift in the mix of assignments.

As we look forward to the fourth quarter, we would expect general stability in our bill/pay spreads in our overall technology business as we continue to benefit from a greater mix of more profitable managed services revenues that have higher than average margins. This greater mix would be expected to offset any slight spread compression in the remainder of our technology staffing business. Overall FA Flex gross profit margins are expected to be stable to slightly down sequentially.

Our strong results, the improvements we have made in associate productivity and continued strong cost discipline have allowed us to sustain or accelerate expenditures on strategic activities such as technology investments while also retaining critical resources through the pandemic. We also have been able to accelerate our efforts to reposition our FA business and have begun streamlining our physical office footprint, which has resulted in a reduction in future real estate spend. We believe all of these activities will position us well to continue to outperform the market as the crisis subsides.

Overall SG&A expenses declined in terms of absolute dollars sequentially and declined approximately 270 basis points as a percentage of revenue. Roughly 80% of our SG&A expenses are variable in nature, which allows us significant flexibility to manage our cost structure.

We expect SG&A expense to decline further in Q4 in terms of dollars given lower revenues from the COVID initiatives and to increase slightly from Q3 levels as a percentage of revenue.

Our third quarter operating margin was 7.3%, which significantly exceeds our operating margin target at these revenue levels.

Our effective tax rate in the third quarter was 27.2%, which was slightly higher than we anticipated.

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

Operating cash flows were $55 million in the third quarter. Our profitable revenue growth sequentially of more than $20 million and the performance of our high-quality accounts' receivable portfolio, which saw a decrease in days' sales outstanding of 6 days sequentially, were critical drivers to our strong cash flow. We also continued to benefit from the deferral of approximately $12 million in payroll taxes under the CARES Act in the third quarter, bringing the total deferral on a year-to-date basis to $25 million. The strong operating cash flows in the third quarter resulted in us finishing the quarter with $1.3 million of net cash on hand, a quarter sooner than we anticipated being debt free.

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 September 30th, net of cash on hand, was approximately $110 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 September 30, 2020 was roughly $92 million, which currently provides incremental borrowing capacity, should we need it, of roughly $150 million. This capacity, in addition to the $101.3 million cash on hand and future expected positive free cash flow, 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.

The continued macro-economic uncertainty and the unpredictability of our current COVID-19 revenue stream necessitates continuing to provide a broader range in our guidance. Our billing days are 62 days in the fourth quarter, which is two fewer days as Q3 2020 and the same as Q4 2019. We expect Q4 revenues to be in the range of $337 million to $347 million and earnings per share to be between 70 and 78 cents. The lower end of our Revenue and EPS guidance contemplates the COVID-19 projects slowing at a greater pace than anticipated and the potential impact of the recent flare-up in COVID cases. Gross margins are expected to be between 28.1% and 28.3%, while Flex margins are expected to be between 26.5% and 26.7%. SG&A as a percent of revenue is expected to be between 21.4% and 21.6% and operating margins should be between 6.2% and 6.6%. Weighted average diluted shares outstanding are expected to be approximately 21.2 million for Q4, and the anticipated effective tax rate is 23.5%. This lower rate is the result of tax benefits expected to be realized upon vesting of our long-term incentive awards, which happens annually in the fourth quarter.

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.

Kforce outperformed the market during the Great Recession and we have delivered superior results again in the third quarter against a very challenging global and U.S. economic backdrop. Our balance sheet is very strong, our strategic position and client portfolio is in the ideal position and our performance continues to be encouraging. Lastly, I'd like to extend a sincere thank you to all of our teams for their efforts over the last several quarters to ensure that we are living up to our brand promise of providing great results through strategic partnership and knowledge sharing.

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DAVID L. DUNKEL, CHAIRMAN AND CEO

Thank you for your interest in and support of Kforce. As we forge ahead through these unprecedented times, I would like to say thank you to each and every member of our field and corporate teams for the incredible 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 delivered another quarter of exceptional results and are excited about the foundation we are setting for 2021 and look forward to talking with you again in the new year.