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Q4 2019
CONFERENCE CALL

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

Great results through strategic partnerships and knowledge sharing.®

FOURTH QUARTER 2019 FINANCIAL RESULTS
CONFERENCE CALL, February 5, 2020
PREPARED REMARKS

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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. Unless otherwise indicated, our commentary relates to results from our continuing operations.

I'd like to begin by providing some commentary on 2019 and the activities completed to position our Firm for significant future success. Last year, with the successful divestitures of our KGS and Trauma FX businesses, we completed a multi-year effort to exit all non-core businesses and focus our offerings solely on the domestic technical and professional staffing and solutions markets. The completion of these efforts positions us to allocate our investments and dedicate our resources to growing our footprint and service offerings in technology and areas within finance and accounting which complement the massive data and digital transformation efforts taking place within all organizations. These combined segments make up one of the largest, and arguably, most strategic investments to the long-term success of organizations served by specialty staffing and solutions firms.

Technology now comprises nearly 80% of overall revenues. Clients looking to meet their talent needs in technology, are looking for partners that are able to provide resources at scale across a diverse range of skill sets and project management models, across multiple geographies and with a focus on compliance. We have built a business that is able to do just that without distraction and it is helping us increase client and market share.

Our shareholders gained immediate benefit from the 2019 divestitures through our repurchase of approximately 13% of outstanding shares, utilizing the approximately $102 million of net proceeds derived from the transactions. We were able to recapture all of the earnings per share lost from the KGS operations through the EPS accretion of the share repurchases by the end of the year resulting in a highly focused more profitable Firm going forward.

Additionally, in 2019 we continued to invest in technology and process improvements aimed at enhancing the experience of our clients and candidates and improving the productivity of our associates.

With respect to our financial performance during 2019, we were successful at once again driving significant above-market growth in our Tech Flex business, which increased 6.8% over 2018. Our compound annual growth rate in Tech Flex revenues over the last 10 years has been 8.5%. We also significantly improved our profitability in 2019 as demonstrated by a 13.4% increase in earnings per share and Return on Invested Capital for the year of approximately 25%.

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As we look ahead, demand for technology resources continues to be quite strong. Every organization across every industry is being confronted with the imperative to invest and rapidly adapt to ever-changing business models, new competitors and the changing preferences of their customers. Market leading companies understand the value of a flexible resource model to execute on the project work necessary to address this changing landscape where specialized skills, speed and flexibility are critical - without sacrificing quality. Discussions with many of these companies indicate leveraging flexible resources within their technology teams to meet these project-driven needs remains a vital element of their overall talent strategy.

These companies are also increasingly looking for their partners, such as Kforce, to both provide the resources necessary to execute on critical projects and to assume a greater role in more complex technical projects that require managed teams and solutions. Our clients have increasingly expressed a desire to engage with us to serve as an effective, more cost efficient alternative or complement to the larger scale integrators as evidenced by our success in recently winning several strategic engagements. This growing demand significantly expands our addressable market into the IT services market, which is significantly larger than the $30 billion domestic technology staffing market.

We believe the secular drivers of demand in technology have fundamentally changed the trajectory and persistence of technology investments and utilization of flexible labor to meet this demand. Given the strength in these secular drivers, we would expect the performance of the domestic technology market to perform well, relatively speaking, even during adverse macroeconomic environments.

Our confidence in the continued strength in our business and in our future operating cash flows is further demonstrated by our Board of Directors' approval of an 11% increase in our dividend to 80 cents per share annually, effective in the first quarter.

I also wanted to update you on our Board of Directors refreshment activities. Over the last five years, we have added three new members to our Board. Ann Dunwoody, Randall Mehl and John Simmons each bring unique and valuable experience to the Board. These additions have been made knowing three long-time Board Members would, at some point, choose to step down after long and distinguished tenures. Last week, John Allred, Richard Cocchiaro and Gordon Tunstall each informed the Board that they would not stand for re-election at the April 2020 Annual Shareholders' Meeting. These three outstanding individuals have been critical partners and advisors to our Firm from its entrance into the public markets through all stages of its growth. We have been very blessed by their service and they will be missed. However, the additions we have made results in a more diverse and independent Board that should serve shareholders well in the upcoming years.

We are looking forward to celebrating our 25th year as a public company. As a moment of reflection, our total shareholder return since going public has been approximately 1,200%, roughly 2.5 times greater than the Russell 2000 over the same period. Given that we are in the early innings of the massive digital transformation of the US economy, we believe the future of Kforce has never been brighter.

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, our intentions with use of cash proceeds and provide guidance on Q1.

JOSEPH LIBERATORE, PRESIDENT

Before I begin discussion of our fourth quarter results, I'd like to echo Dave's comments and specifically congratulate and thank our team on the progress we have made over the course of many years. We have built a platform, team and client portfolio that should allow us to consistently outperform our competitors in meeting client needs for technology and key finance and accounting talent across industries and skill sets. We believe that focus will win in a future where the war for top talent is intense and the demands of the client are growing significantly given the strong secular drivers.

As it relates to our fourth quarter performance, total revenues of $336.2 million were within our range of guidance but certainly below our expectations due to a number of factors that I will enumerate throughout these remarks.

Let me begin the quarterly discussion by providing some details about the performance in each of our business lines.

Our Technology business continues to be our growth driver and has now exceeded the market growth rate for the ninth consecutive quarter. In the fourth quarter, our Technology Flex business grew 4.8% year-over-year. The operating trends in this business sustained the strong trends we experienced in Q3 through October and the majority of November. However, as we entered the holiday season, we saw a significant increase in year-end planning activities by some of our large clients both to minimize fourth quarter expense and also secure crucial talent for the upcoming year. Specifically, we saw more significant furlough activity than we had anticipated coupled with a spike in conversions, which were almost 50% greater than the already elevated level experienced in the fourth quarter of 2018. We also experienced some client specific consultant ends at levels we hadn't anticipated, particularly in the financial services industry vertical. These factors negatively impacted Tech Flex performance in the quarter and also reduced the base of billable consultants on assignment coming into the new year, which consequently will negatively impact first quarter revenues.

As it relates to our portfolio management strategy, we believe our continued focus on diversifying our activities beyond our largest clients, but within our existing client base, which includes relationships with roughly 70 percent of the Fortune 500, is the right path. These companies continue to be the largest consumers of technology talent and have been driving our growth. The growth in these clients during 2019 has allowed us to continue to generate above market growth rates, even while some of our largest clients have experienced declines.

With respect to the industries we serve, we are well diversified within our portfolio. We experienced year-over-year growth in 8 out of our Top 10 industries with particular strength in business and professional services, insurance, manufacturing products and healthcare. However, we experienced broad weakness in our financial services vertical, which was down approximately 5% year over year.

Overall, average bill rates in technology increased 3.5% year-over-year but were stable sequentially.

Our strong relationships, the nature and quality of the skilled technology talent we provide our clients and the way in which technology projects are executed is contributing to a higher average duration of client assignments, which is nearly 10 months. We believe this trend may remain at historic high levels due to a scarcity of supply and the growth we are experiencing in higher-value-add managed teams and solutions projects which continued to grow faster than our core Tech Flex business.

Given the trends we experienced later in the quarter, we expect that the year-over-year growth rate in our Tech Flex business may decelerate slightly from fourth quarter 2019 levels as we continue repositioning resources to clients demonstrating ongoing high levels of demand.

Our FA Flex business declined 7.6% year-over-year. Trends in this business were stable from Q3 to Q4 as revenues grew sequentially on a billing day basis for the second consecutive quarter. However, a discrete project in the fourth quarter last year to support hurricane relief efforts, which distorts year-over-year trends and drove a higher year-over-year decline, did not reoccur this year. The market for our FA Flex business continues to be stable and we expect year-over-year declines to decelerate into the low single digits in the first quarter of 2020.

Direct Hire revenue decreased 6.6% year-over-year, primarily as a result of seasonal declines. 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 typically experienced a sequential improvement in Direct Hire revenue in the first quarter; however, initial trends to start the quarter have been softer than expected. We believe this is partly due to the timing of the Holiday but also due to the continued tightness in the labor market where highly skilled professionals have many options and are receiving multiple offers and heightened levels of counteroffers.

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We continue to make significant technology and process investments in order to drive further improvements in associate productivity. We are particularly focused on our new Talent Relationship Management system, which we expect will be available to our associates midway through 2020. We also continue to make technology investments focused in areas that improve the interactions with and experience of our candidates with the goal of more effectively and efficiently sourcing, qualifying, matching, deploying and retaining talent.

We continue to drive productivity improvements and a reduced level of turnover in our Technology business which has allowed us to accelerate revenue growth while maintaining a relatively stable level of sales and delivery associates. We expect this trend to continue and believe we have significant capacity available to drive further growth. We don't expect to make material additions to headcount beyond specific areas where productivity levels are extremely high and building further capacity is warranted.

Our simplified business model, client portfolio and focused service offerings has us well positioned for long-term growth. Our focus on the relationships with our clients and candidates is well recognized as we continue to carry a world class Net Promoter score from our Clients and Glassdoor's highest rating within our industry.

I appreciate the trust our clients and candidates have placed in Kforce and our team's efforts in driving our Firm forward. 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 $336.2 million in the quarter grew 1.8% year-over-year and earnings per share from continuing operations of 66 cents grew 22.2% year-over-year.

Our gross profit percentage in the quarter of 29.2% decreased 40 basis points year-over-year as a result of a lower Direct Hire revenue mix and a decline in our Flex gross profit percentage.

Our Flex gross profit percentage decreased 20 basis points year-over-year. As it relates specifically to our Tech Flex business, the year-over-year 20 basis point decline is the result of slightly higher healthcare costs. Bill/pay spreads in this business have been stable over the last year, due primarily to diversifying and expanding relationships outside of our very largest clients. This next tier of clients typically has a more attractive margin profile. Additionally, revenue from managed services projects, which also have a more attractive margin profile, is increasing. The 20-basis point decline in FA Flex margins is being driven by slightly lower spreads.

Looking forward, we expect continued success in both our portfolio management activities and the growth in revenue from managed services projects. We expect these efforts to result in stable tech margins prospectively, exclusive of seasonality impacts.

Specifically, in the first quarter, we expect that overall Flex margins will be negatively impacted by approximately 110 basis points relative to Q4 due to seasonal payroll tax resets.

We have been able to maintain a consistent level of SG&A dollars spent year-over-year and drive operating leverage despite the growth in revenues and a significant increase in technology investments. This is the result of continuing to drive operating efficiencies and improving the productivity of our associates. SG&A as a percentage of revenue declined 50 basis points year-over-year.

Our fourth quarter operating margin of 5.8% was on track with our operating margin objectives. During this economic cycle, our gross margins have declined by approximately 200 basis points due to a decline in both the percentage of Direct Hire business and compression in our Flex spreads. Despite this compression, operating margins have improved nearly 400 basis points, which reflects our success in deepening relationships in our existing client base while aligning our infrastructure to optimize efficiency in serving these large complex clients.

Our effective tax rate in the fourth quarter was 20.0%, which was consistent with our expectations. The fourth quarter included a tax benefit related to the vesting of restricted stock of approximately $1.1 million which reduced the rate in the quarter by approximately 600 basis points. The incremental benefit on a year-over-year basis was driven by the 31% increase in Kforce's stock during 2019. Due to the vesting schedules of our long-term incentive grants, the impact of this discrete adjustment is reflected almost entirely in the fourth quarter of each year.

Our business continues to generate significant operating cash flows, which were $20.1 million in the fourth quarter. We repurchased 700,000 shares of Kforce stock in the quarter for $26.5 million. This repurchase completed the deployment of the $102 million in net proceeds from the KGS divestiture more quickly than we had anticipated. As a result, as we look forward, we have been able to fully replace the EPS generated from KGS operating performance with EPS accretion from the repurchases.

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For the full year in 2019, our operating cash flows, coupled with the cash proceeds from our divestitures, allowed us to return nearly $135 million in capital to our shareholders through share repurchases and cash dividends and reduce net debt by $26.6 million.

Our net debt at the end of the fourth quarter was approximately $45 million, or approximately 0.5 times trailing twelve-month EBITDA. The strength of our balance sheet, healthy operating cash flows, low capital requirements and $300 million Credit Facility provide us maximum flexibility to both pursue strategic acquisitions that enhance our service offerings and also return capital to our shareholders.

There are 64 billing days in the first quarter, which is two days more than Q4 and is one day more than the first quarter of 2019. A single billing day equates to roughly $5.4 million in revenue. With respect to guidance, we expect Q1 revenues to be in the range of $333 million to $339 million and for earnings per share to be between 43 and 47 cents. Gross margins are expected to be between 27.7% and 27.9%, while Flex margins are expected to be between 25.6% and 25.8%. SG&A as a percent of revenue is expected to be between 22.9% and 23.1% and operating margins should be between 4.3% and 4.5%. Weighted average diluted shares outstanding, are expected to be approximately 22.2 million. Our anticipated effective tax rate is 26.5% in the first quarter.

As a reminder, first quarter operating margins are typically impacted by approximately 150 basis points due to seasonal impacts of annual payroll tax resets. This also impacts earnings per share by approximately 17 cents. As we've mentioned on prior calls, we anticipate an approximately two cent impact related to our share of quarterly losses from the WorkLLama joint venture we established in June 2019. We anticipate that our share of the losses in this joint venture should approximate these levels over the next several quarters. These costs are reflected in Other Expense on the Income Statement.

Our guidance does not consider the effect, if any, of charges related 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.

During the last decade, we have grown revenues in our continuing operations at a compound annual rate of 8.0% and grown earnings per share at a compound annual rate exceeding 20%. Over this same time period, we repurchased a total of $467 million in stock, at an average cost of $19.10, and returned $120 million to shareholders through our dividend program. As Dave mentioned, our Board approved an 11% increase to our quarterly dividend effective in the first quarter, which will return anticipated quarterly cash outlays for dividends to levels approximating those experienced prior to our share repurchases this year and bring the dividend yield to approximately 2%.

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While we weren't particularly pleased with fourth quarter operating results, we understand that unexpected volatility will periodically occur in client spending and talent acquisition patterns. We remain confident, however, in the overall strength of the market, our strategic direction, and our ability to sustain above-market growth rates and continue to improve profitability. We expect 2020 to be another strong year for Kforce and for growth to accelerate as the year progresses. We are poised to take advantage of our competitive differentiators and focused footprint. Our future prospects have never been brighter.