Zacks Small-Cap Research

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Marla Backer
312-265-9211
mbacker@zacks.com

scr.zacks.com

10 S. Riverside Plaza, Chicago, IL 60606

Labor Smart Inc (LTNC-OTCBB)

LTNC: *Strategy to Drive Margin Improvements, Strengthen Balance Sheet and Pursue Opportunistic M&A*

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	05/22/2013
Current Price (8/18/14)	$0.18
Target Price	**$0.80**

OUTLOOK

Labor Smart reported 2Q14 results last week, with revenue of $6.43 million up 59.5% y/y and the operating loss narrowing to ($136,000) from ($566,739) in 2Q13. Same-store revenue growth at branches that had been in operation for at least one year was 35.8%. Labor Smart's footprint has doubled in 2014 year to 30 locations. Going forward, the company plans to emphasize growth through opportunistic acquisitions, drive further gross margin improvement and strengthen its balance sheet. We maintain our Outperform rating on Labor Smart shares.

SUMMARY DATA

52-Week High	**$0.50**
52-Week Low	**$0.17**
One-Year Return (%)	**-36**
Beta	**-2.70**
Average Daily Volume (sh)	**100,118**
Shares Outstanding (mil)	**22.9**
Market Capitalization ($mil)	**$4.12**
Short Interest Ratio (days)	**0.0**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**78**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2013 Estimate	**N/A**
P/E using 2014 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**Above Average**
Type of Stock	**Small-Growth**
Industry	**Staffing**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	1.184 A	1.710 A	2.152 A	2.129 A	7.176 A
2013	2.503 A	4.037 A	5.345 A	4.672 A	16.558 A
2014	4.793 A	6.438 A	6.467 E	8.343 E	26.042 E
2015					48.439 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.00 A	$0.00 A	-$0.01 A	-$0.02 A	-$0.03 A
2013	-$0.04 A	-$0.04 A	-$0.02 A	-$0.05 A	-$0.14 A
2014	-$0.05 A	-$0.04 A	-$0.04 E	-$0.04 E	-$0.17 E
2015					-$0.11 E

Quarters may not sum to total due to rounding.

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

Disclosures begins on page 7

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KEY POINTS

- Last week, Labor Smart (LTNC-OTC BB) reported 2Q14 results, with revenue of $6.43 million up 59.5% y/y and operating loss of ($136,000) versus ($566,739) in 2Q13. At branches that had been in operation for at least one year, **same-store revenue growth was 35.8%**.
- The gross margin came expanded by over 600 basis points to in at 21.2% and the company reported **positive adjusted EBITDA of $401,455,** excluding non-recurring costs of $341,730**.**
- Management's strategy is to further expand its client base and drive opportunities with existing clients across multiple branches and markets.
- The company's goal is to continue to **drive gross margin improvements.** Labor Smart's recent transition to self-insuring in 14 states, better product mix and continued focus on cost containment efforts are expected to contribute to gross margin expansion.
- The company is also focused on **strengthening its balance sheet** and hopes to lower its reliance on short-term financing by putting a more traditional revolving line of credit in place.
- Labor Smart's footprint has doubled this year to 30 locations. The company plans to emphasize **growth through opportunistic acquisitions** going forward.

2Q14 HIGHLIGHTS

Higher Revenue, Cost Controls Create Operating Leverage

Last week, Labor Smart (LTNC-OTC BB) announced results for 2Q 2014, with revenue of $6.43 million up 59.5% year-over-year. This growth reflects the company's expanding footprint, combined with rising revenue at existing branches. Branches that had been in operation for over one year registered same-store revenue growth of 35.8%, according to management. The company was able to achieve operating leverage against the above-noted revenue increase. Cost of services came in at 78.8% of revenue, down from 84.9% in the second quarter of 2013 and up only 48.0% year-over-year compared to the above-noted 59.5% revenue increase. As a result, Labor Smart's 2Q 2014 gross margin came in at 21.2%. This was significantly ahead of our 17.0% forecast and up over 600 basis points from 15.1% registered in 2Q 2013.

Operating expense rose 27.7% year-over-year to $1.5 million. However, as a percentage of revenue, it fell to 23.3% from 29.1% in last year's second quarter. With the higher revenue combined with lower relative costs, Labor Smart was able to narrow its operating loss to ($136,000) from ($566,739) registered in last year's second quarter. Moreover, the company reported **positive adjusted EBITDA of $401,455,** excluding non-recurring acquisition and expansion costs of $341,730**.** The loss per share came in at ($0.04), which is equal to last year's level and about $0.01 better than our projected ($0.05).

Same-Store Sales

As noted, management indicated that branches that had been in operation for over one year registered same-store revenue growth of 35.8% in 2Q 2014. Subsequent to the second quarter, the July same-store sales metric was impacted by management's decision to discontinue lower margin, higher risk business. Following the completion of this process, management is optimistic about same-store sales going forward and noted that it generally takes a new store some 6-9 months for to ramp up revenue in order to be profitable at the store level.

Expanding Client Base

Management's strategy is to further expand its client base. The company expects to add customers that are active during periods during which it currently experiences slower demand, in order to smooth out the seasonality of its business. For example, peak demand for temporary labor from the hospitality industry generally does not coincide with peak demand from the construction industry. Management also expects to expand its opportunities with existing clients across multiple branches and markets.

In March 2014, Labor Smart appointed a Director of Business Development. We believe this is consistent with management's strategy to forge relationships with multi-regional companies in order to drive revenue from its existing customer base across multiple stores, drive recurring revenue and grow its overall customer base. The company's client base continues to grow. In the second quarter of fiscal 2014, Labor Smart added 289 new clients.

Gross Margins

Another company goal is to continue to improve gross margins. As noted, the company's 2Q 2014 gross margin of 21.2% expanded by over 600 basis points year-over-year. The company plans to further expand margins by its recent transition to self-insuring in 14 states, a better product mix and continued focus on cost containment efforts.

The company expects the product mix to improve, following the elimination of certain lower margin business. The monthly revenue impact of this process is roughly $320,000. As a result, management reduced its 2014 revenue guidance from $30 million to the $25 million to $27 million range.

However, the elimination of this business is also expected to boost 2014 gross profit margins. Therefore, the company simultaneously increased its guidance for 2014 gross margins to 23.5% for the full year and 25% in 4Q 2014. This compares to management's original gross margin target of 22% by 4Q 2014. We have adjusted our model to reflect the updated guidance.

FOCUS ON STRENGTHENING BALANCE SHEET

Similar to many other small companies at the early stages of their development, Labor Smart has financed much of its growth through a combination of equity, debt and convertible debt offerings, as well as by factoring its receivables. In order to avoid the dilution from conversions, management has attempted to repay the convertible notes, whenever possible. The company believes that it can repay a significant portion of convertible debt during the slower winter months, as it collects on accounts receivables in late 2014-early 2015.

Going forward, management's strategy is to reduce its reliance on this type of short-term financing vehicle. The company hopes to put a traditional revolving line of credit in place and thereby dramatically reduce its need for short-term financing. We would view it positively if Labor Smart were able to obtain a revolving credit line at reasonable terms. Management indicated that it is in advanced discussions with two potential sources for an expanded financing instrument.

Earlier this year, the company also negotiated better terms with Transfac Capital for funding against its accounts receivable. Labor Smart has been able to expand the agreement with Transfac to fund against 85% of receivables, up from the 70% earlier. Management believes this improvement reflects the growth of its business. Moreover, by funding against a larger portion of its receivables, the company will also strive to reduce its reliance on short-term financing.

FOCUS ON M&A

In April 2014, Labor Smart opened three new offices located in Savannah, Georgia, Knoxville, Tennessee and Denver, Colorado. In May 2014, the company added new offices in Florida, Louisiana, Mississippi, South Carolina and Alabama. In total, Labor Smart has doubled its office network thus far in 2014, bringing the footprint to 30 locations compared to 15 offices in operation at the end of 2013.

The company also continues to grow revenue through acquisitions. If acquisition terms are attractive – for example, in April 2014, Labor Smart acquired Oklahoma based Shirley's Employment Service for roughly 2x projected EBITDA -- this could enhance revenue growth, in our opinion, particularly as it generally takes a new-build store 6-9 months to become profitable at the store level, as noted.

Management noted that organic footprint expansion can be more costly than expansion through M&A. Therefore, the company intends to accelerate its growth through acquisitions going forward. The company believes it can integrate $20 million to $40 million in acquisitions in 2015. Given how fragmented the staffing industry is, management indicated that it is presented with frequent M&A opportunities but often does not find the candidate to be a good fit. A key criterion Labor Smart uses when evaluating a potential acquisition is that a corporate culture is as dedicated to providing customer service. The company would like to add branches that are within about four hours of existing branches, in order to leverage its existing senior management team and particularly would seek acquisitions in Florida and Texas. Complementing its opportunistic M&A strategy, the company anticipates launching up to 12 new sites organically in 2015. Management's strategy is to primarily add new locations in markets where existing regional and national clients have operations and can generate new assignments for on-demand labor.

RECENT NEWS

Labor Smart announced that July 2014 revenue reached a record $2.068 million, which represents a 30.4% year-over-year advance. Same-store revenue at the 14 branches that were in operation for one year or longer was essentially flat compared to July 2013, as they were negatively impacted by the afore noted elimination of certain lower margin, higher risk business. The company views July 2014 as a transitional month. The company also believes that this elimination has reduced its risk exposure from a work environment safety and credit perspective.

RISKS

- It may take longer than management expects to put a revolving line of credit in place, which implies that management would be forced to continue to pursue short-term unattractive financing.
- The company has not yet converted strong revenue expansion into positive EPS at this early stage.
- Competition could increase. The temporary staffing industry is one with few barriers to entry, we believe. Thus, just as Labor Smart has entered as a new player, another company could also launch and complete with Labor Smart.
- Economic factors could constrain industry growth.
- A worker could get hurt when on assignment.

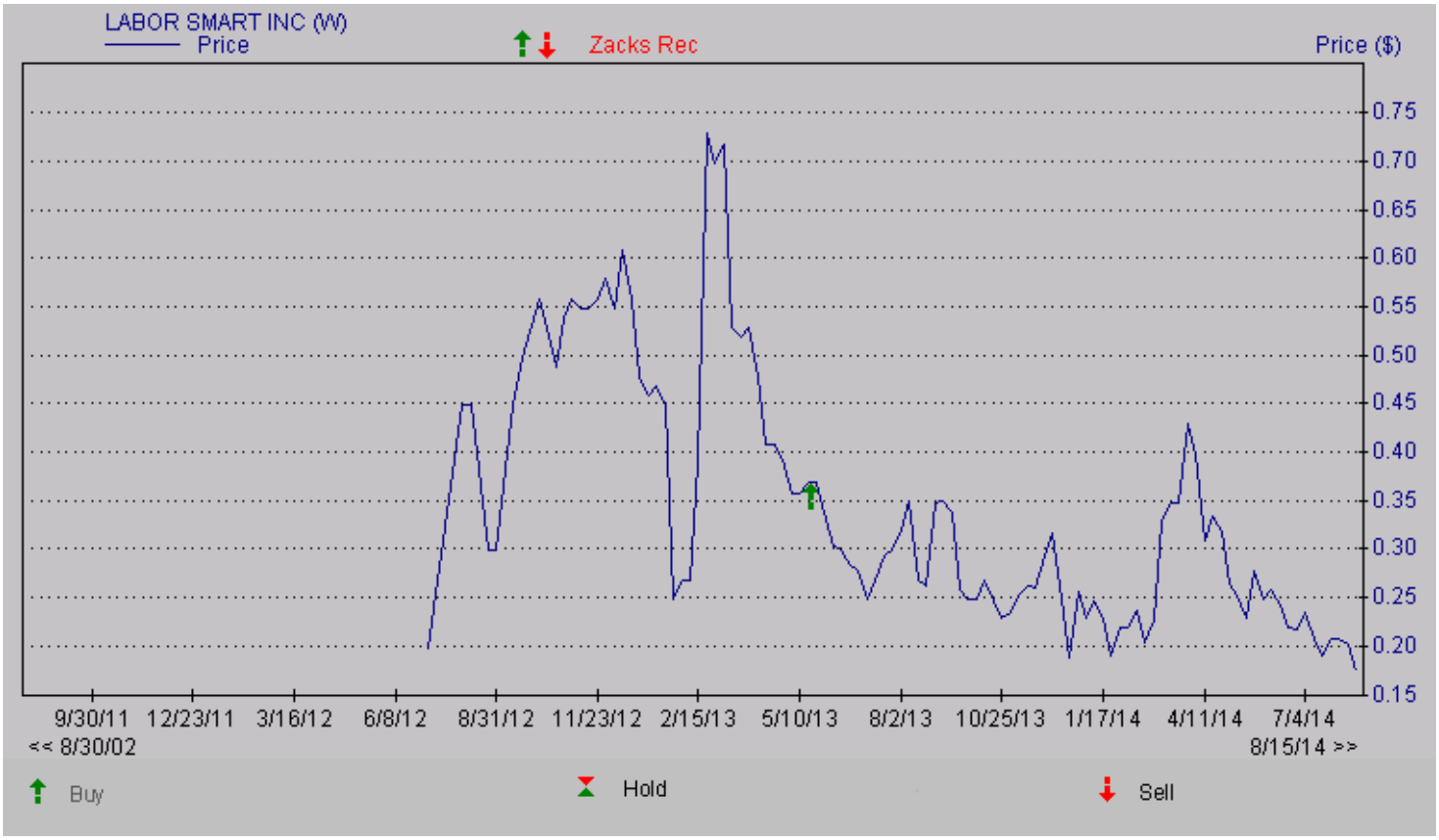
PROJECTED INCOME STATEMENT

Labor Smart, Inc.
Income Statement and Projections ($ Millions except per share data)

	1Q13A	2Q13A	3Q13A	4Q13A	2013A	1Q14A	2Q14A	3Q14E	4Q14E	2014E	2015E
Revenues	**$2,503,872**	**$4,037,040**	**$5,345,172**	**$4,765,801**	**$16,651,885**	**$4,792,941**	**$6,437,976**	**$6,467,486**	**$8,343,978**	**$26,042,381**	**$48,438,828**
Cost of services	2,152,476	3,427,674	4,435,363	3,937,609	13,953,122	3,685,229	5,072,227	4,979,964	6,257,983	19,995,404	35,844,733
Gross Profit	**351,396**	**609,366**	**909,809**	**828,192**	**2,698,763**	**1,107,712**	**1,365,749**	**1,487,522**	**2,085,994**	**6,046,977**	**12,594,095**
Professional fees	62,500	297,056	57,045	(108,086)	308,515	92,597	59,545	95,058	93,000	340,199	391,229
Stock based compensation	250,616	23,954	69,483	457,862	801,915	57,156	12,841	14,382	16,108	100,487	115,560
Payroll expenses	160,076	300,519	388,385	771,879	1,620,859	443,654	590,933	614,411	792,678	2,441,676	4,601,689
Bad debt expense				215,255	215,255	11,982	84,064	20,000	20,000	136,046	140,000
General and administrative	249,167	496,738	529,440	123,532	1,398,877	778,598	754,366	756,696	976,245	3,265,905	5,667,343
Loss on sale of receivables	35,522	57,838	32,242	(34,776)	90,826	-	-	40,487	85,752	126,239	189,358
Total operating expenses	757,881	1,176,105	1,076,595	1,425,666	4,436,247	1,383,987	1,501,749	1,541,033	1,983,783	6,410,552	11,105,179
Operating income/(loss)	(406,485)	(566,739)	(166,786)	(597,474)	(1,737,484)	(276,275)	(136,000)	(53,512)	102,212	(363,575)	1,488,917
Interest expense	(7,630)	(194,854)	(272,437)	(560,110)	(1,035,031)	(798,446)	(949,865)	(959,364)	(968,957)	(3,676,632)	(3,860,464)
Interest income	73			-	73	-		-	-	-	-
Financing costs	(233,746)		4,297	229,449		-		-	-	-	-
Realized loss on trading securit	(185)	(26)		4,451	4,240	(443)	(2,975)	(3,005)	(4,400)	(10,823)	(1,500)
Other	(1,170)	-	15,912	30,480	45,222	10,656	155,994	157,554	10,000	334,204	40,000
Total other income (expenses)	(242,658)	(194,880)	(252,228)	(295,730)	(985,496)	(788,233)	(796,846)	(804,814)	(963,357)	(3,353,251)	(3,821,964)
Net income (loss) before taxes	(649,143)	(761,619)	(419,014)	(893,204)	(2,722,980)	(1,064,508)	(932,846)	(858,326)	(861,146)	(3,716,826)	(2,333,047)
Income tax expense	-	-	-			-		-	-	-	-
Net income (loss) after taxes	(649,143)	(761,619)	(419,014)	(893,204)	(2,722,980)	(1,064,508)	(932,846)	(858,326)	(861,146)	(3,716,826)	(2,333,047)
Unrealized gain on marketable s	2,381	(7,152)	1,399	(3,566)	(6,938)	2,151	(6,882)	(2,000)	(2,000)	(8,731)	(9,604)
Comprehensive income (loss)	(646,762)	(768,771)	(417,615)	(896,770)	(2,729,918)	(1,062,357)	(939,728)	(860,326)	(863,146)	(3,725,557)	(2,342,651)
EPS or loss per share	**($0.04)**	**($0.04)**	**($0.02)**	**($0.05)**	**($0.14)**	**($0.05)**	**($0.04)**	**($0.04)**	**($0.04)**	**($0.17)**	**($0.11)**
Average shares outstanding	18,029,377	19,373,074	19,436,806	18,029,380	19,337,142	21,454,557	22,863,325	21,454,557	21,454,557	21,454,557	21,454,557
Y/Y revenue growth (%)	112%	136%	148%	124%	312%	91%	59%	21%	75%	56%	86%
Gross margin	14.0%	15.1%	17.0%	17.4%	16.2%	23.1%	21.2%	23.0%	25.0%	23.2%	26.0%
Payroll expenses % revenue	6.4%	7.4%	7.3%	8.0%	9.7%	9.3%	9.2%	9.5%	9.5%	9.4%	9.5%
G&A % revenue	10.0%	12.3%	9.9%	10.0%	8.4%	16.2%	11.7%	11.7%	11.7%	12.5%	11.7%
Cost of services % revenue	86.0%	84.9%	83.0%	82.6%	83.8%	76.9%	78.8%	77.0%	75.0%	76.8%	74.0%

Source: Company reports, Zacks estimates

HISTORICAL ZACKS RECOMMENDATIONS



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Hold/Neutral: The analyst expects that the company will perform in line with the broader U.S. equity market over the next one to two quarters.
Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

The current distribution is as follows: Buy/Outperform- 17.0%, Hold/Neutral- 76.3%, Sell/Underperform – 5.8%. Data is as of midnight on the business day immediately prior to this publication.