Zacks Small-Cap Research

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Marla Backer
212-831-2417
mbacker@zacks.com

scr.zacks.com

111 North Canal Street, Chicago, IL 60606

Labor Smart Inc (LTNC-OTCBB)

LTNC: *Third Quarter 2013 Review*

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	05/22/2013
Current Price (11/21/13)	$0.26
Target Price	**$0.80**

OUTLOOK

Labor Smart, Inc. is an emerging growth company that serves the on-demand labor market, focusing primarily on filling blue-collar staffing positions on a temporary basis. In just two short years, the company has grown its footprint to 15 branches operating in nine states, up from only two in 2011, and annual revenue to an estimated $16.6 million in 2013, up from only $0.16 million in 2011. With a seasoned industry veteran at the helm, an experienced operating team, an ambitious growth strategy and the tailwind of favorable sector dynamics, we maintain our Outperform rating on Labor Smart shares.

SUMMARY DATA

52-Week High	**$0.82**
52-Week Low	**$0.10**
One-Year Return (%)	**N/A**
Beta	**N/A**
Average Daily Volume (sh)	**35,089**
Shares Outstanding (mil)	**20**
Market Capitalization ($mil)	**$5.3**
Short Interest Ratio (days)	**0.1**
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)
2011					0.16 A
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	4.685 E	16.571 E
2014					30.572 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011					$0.00 A
2012	$0.00 A	$0.00 A	-$0.01 A	-$0.02 A	-$0.03 A
2013	-$0.04 A	-$0.04 E	-$0.02 A	-$0.02 E	-$0.12 E
2014					-$0.11 E

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

2011 May- Dec **Disclosure Section begins on page 6**

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KEY POINTS

- Labor Smart (LTNC-OTC BB) reported 3Q13 results earlier this week. Revenue of $5.3 million – up 148% year-over-year – matched our forecast, while total operating expense of $1,076,595 came in under our $1,358,695 forecast.
- As a result, the company registered gross profit of $909,809 – beating our $857,892 estimate – and a gross margin of 17.0% compared to our 16.1% forecast. This was up 193 basis points sequentially from 15.1% registered in the second quarter of 2013.
- **We view this upward margin trend extremely positively.** We believe **revenue and margin growth are highly correlated to customer base expansion** and that the margin improvement illustrates the company's improving flexibility in managing gross margins as it expands and diversifies its customer base. The company targets a gross margin of 22% by year-end 2014.
- Labor Smart recently opened its 15th branch. The expanding branch network is a key factor fueling revenue growth, we believe.
- At the same time, **revenue per branch also continues to improve,** as well, as older branches mature. The six branches that were in operation for at least one year at September 30, 2013 registered an impressive 86% year-over-year revenue increase for the third quarter ended September 30, 2013. We believe this underscores the improving metrics in the company's business model.
- Moreover, post 3Q13, revenue momentum continues. Labor Smart reported last week that October 2013 revenue of $1.642 million was more than double the $788,912 October 2012 level.
- We also view positively that the company's cash balance improved to $237,736 at September 30, 2013, up from $63,959 at June 30, 2013. We believe Labor Smart strives to manage its cash balances even as it advances its growth objectives.
- We believe risks include that the company is highly dependent on its founder and CEO, is under capitalized and has significant funding needs for working capital and to support its growth, has not yet converted strong revenue expansion into positive EPS, competition could increase and customers could shift towards hiring permanent employees, among others.

REVENUE GROWTH IN-LINE WITH EXPECTATIONS

Revenue Trends Strong, as Expected Labor Smart (LTNC-OTC BB) reported 3Q13 results earlier this week. Not surprisingly, revenue of $5.3 million matched our recently revised forecast of $5.3 million. The company had pre-announced monthly revenue for the period. Specifically, July 2013 revenue of $1.586 million advanced 172% versus July 2012 and August 2013 revenue improved 176%. August also represented the company's first month above the $2.0 million mark. September revenue of $1.65 million exceeded $803,564 registered in September 2012 by 105%. Overall, $5.3 million revenue for the third quarter of 2013 was up 148% year-over-year.

Labor Smart Third Quarter 2013 Monthly Revenue ($)

	2013	2012	Y/Y %Chg
July	1,586,351	583,228	172%
August	2,109,383	765,548	176%
September	1,649,390	803,564	105%

Source: Company reports

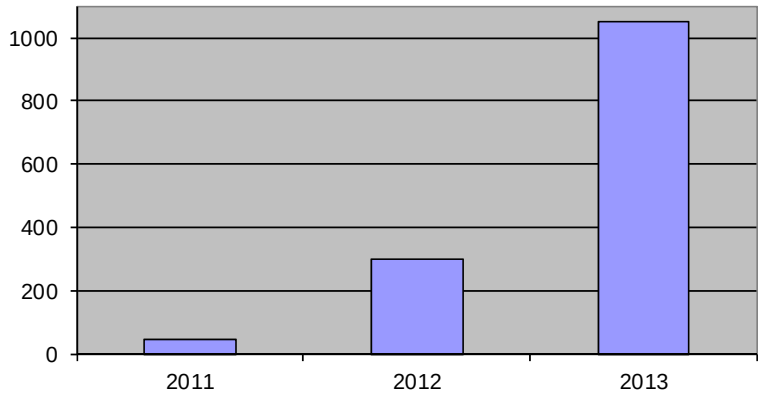
MARGINS IMPROVING AS BUSINESS DEVELOPS

Given the rapid growth and the infrastructure that Labor Smart has built to fuel this growth, including hiring experienced operating leaders, expenses were up, as well. However, at $1,076,595, total operating expense came in under our $1,358,695 forecast. As a result, the company registered gross profit of $909,809 – beating our $857,892 estimate – and a gross margin of 17.0% compared to our 16.1% forecast. This also represented a 193 basis points sequential improvement from 15.1% registered in the second quarter of 2013 and nearly 300 basis point advance from 14.0% registered in the first quarter of 2013. While we believe margins are likely to remain somewhat lumpy in the near-term, reflecting the seasonality of the on-demand temporary help business and the company's branch expansion, **we view this upward margin trend extremely positively.**

Revenue and margin growth are highly correlated to customer base expansion, in our opinion. We believe the above-noted margin improvement illustrates the company's improving flexibility in managing gross margins as it develops. Specifically, as branches mature, they can fill more competitive, higher margin assignments, according to management. The branch manager at a new location initially looks to the construction and janitorial industries for potential customers. This is because these industries have relatively short sales cycles and their staffing needs fluctuate considerably. As the branch matures, the manager can look to a more diverse industry group to fill more competitive assignments. Other industries that frequently turn to on demand staffing include: hospitality, warehousing, manufacturing, logistics and events, among others. Thus, as the customer base expands and becomes more diversified, it gives the company **greater flexibility in managing gross margins**, we believe. As Labor Smart's customer base expands and diversifies, we anticipate a positive impact on gross margins. The company targets a gross margin of 22% by year-end 2014.

We anticipate that as existing offices mature and grow the customer base, it will fuel further margin improvements. In 2011, Labor Smart had 47 customers. In November 2012, the company announced that its customer base exceeded 300. We estimate that it is well above the 1,000 customer level the company announced earlier this year.

Labor Smart's Growing Customer Base



Source: Company reports, Zacks estimates

The dramatic growth of its customer base also prompted Labor Smart to form a corporate accounts division earlier this year. By covering regional and national customers from a centralized division, the company can provide a single interface and faster service for the client, even though the orders may be filled at the branch level across multiple locations. This division is also expected to help Labor Smart address new verticals with existing customers. We believe it will also benefit Labor Smart's efforts to leverage its marketing efforts across geographic markets.

BRANCH EXPANSION FUELS GROWTH AND MARGINS

Labor Smart recently opened its 15th branch, located in Raleigh, North Carolina. The company has expanded its branch network from only two locations in 2011, which were in Marietta, Georgia and Nashville, Tennessee. Initially, expansion efforts were concentrated on the southeast. Labor Smart has subsequently expanded into Kentucky, Florida, Indiana, Alabama, Missouri, South Carolina and North Carolina and ultimately plans to have a national footprint. This would provide a competitive advantage, we believe, over more regionally focused competitors.

The expanding branch network is a key factor fueling revenue growth, we believe. As well, **revenue per branch also continues to improve** as older branches mature. For example, the six branches that were in operation for at least one year at September 30, 2013 registered an impressive 86% year-over-year revenue increase for the third quarter ended September 30, 2013. We believe this underscores the improving metrics in the company's business model.

Moreover, post 3Q13, revenue momentum continues. For example, Labor Smart reported last week that October 2013 revenue of $1.642 million was more than double the $788,912 October 2012 level. The fourth quarter can be seasonally slow for the temporary staffing industry overall, reflecting the interruptions of the holidays and as companies focus on end of year activities. Moreover, in many parts of the country, construction and other projects wind down temporarily due to weather, as well. Nevertheless, with one month already announced at levels double the year ago timeframe, we anticipate significant growth for 4Q13. The company has also indicated that it expects to exceed its 2013 revenue guidance of $16.0 million.

MANAGING BALANCE SHEET

We also view positively that the company's cash balance improved to $237,736 at September 30, 2013, up from $63,959 at June 30, 2013. We believe Labor Smart strives to manage its cash balances even as it advances its growth objectives. In addition to financing new branch openings, Labor Smart must maintain working capital to pay its temporary workers. It then gets reimbursed when it collects from the client, but the billing cycle can take up to three months. We expect the company to continue to engage in short term financings during this early period of rapid growth. Labor Smart recently retired two convertible promissory notes with combined principle of $243,500 early. This eliminated the overhang of their potential conversion into common shares, in our opinion. Labor Smart had $63,959 in cash as of June 2013. We anticipate further branch expansion in 2014, as Labor Smart intends to open another 15 to 25 locations next year, including in additional southeastern states.

RECENT NEWS

Subsequent to the third quarter ended September 2013, one of the directors on the company's board, Shannan Manix, tendered her resignation, although we understand that she continues to provide consulting to the company on an as needed basis. We believe Labor Smart will move quickly to replace her on its board and also to expand its board over time.

RISKS

- The company is highly dependent on founder and CEO Ryan Schadel.
- Labor Smart is under capitalized and has significant funding needs for working capital and to support its growth. To-date, the company has engaged in short term financings but the cost or supply of capital could make it difficult for Labor Smart to fulfill its planned expansion.
- Given the rapid growth and the infrastructure that Labor Smart has built to fuel this growth, including hiring experienced operating leaders, 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.
- Customers could shift towards hiring permanent employees instead of using temporary workers.
- Economic factors could constrain industry growth.
- A worker could get hurt when on assignment, although the company maintains workers' compensation insurance for its on demand workers to mitigate risk.

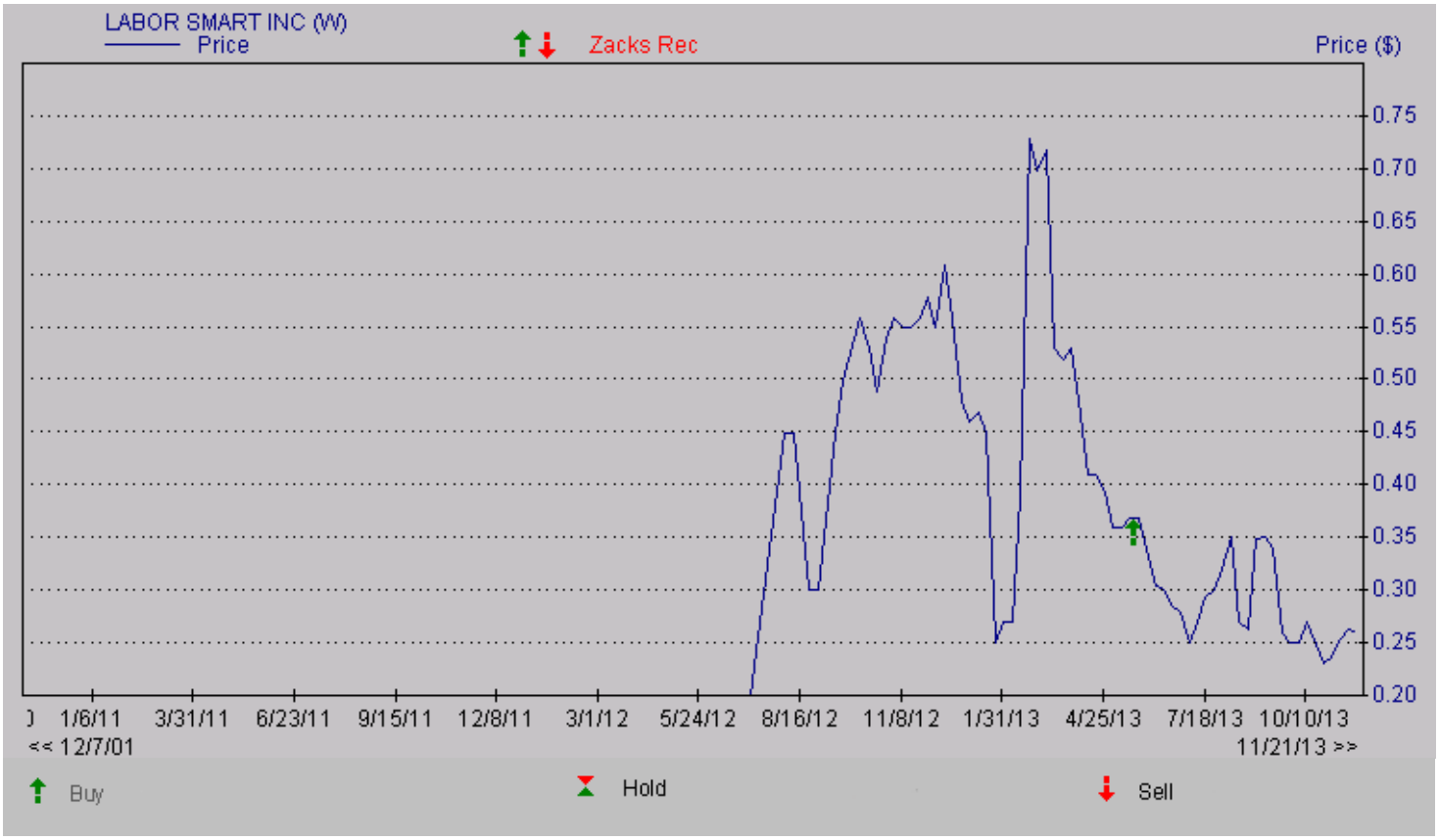
PROJECTED INCOME STATEMENT

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

	1Q12	2Q12	3Q12		4Q12	2012	1Q13A	2Q13A	3Q13A	4Q13E	2013E	2014E
Revenues	**$1,183,716**	**$1,710,324**	**$2,152,243**		**$2,129,563**	**$7,175,846**	**$2,503,872**	**$4,037,040**	**$5,345,172**	**$4,685,039**	**$16,571,123**	**$30,571,795**
Cost of services	986,484	1,431,248	1,776,081		1,761,866	5,955,679	2,152,476	3,427,674	4,435,363	3,886,240	13,901,753	25,374,590
Gross Profit	**197,232**	**279,076**	**376,162**		**367,697**	**1,220,167**	**351,396**	**609,366**	**909,809**	**798,799**	**2,669,370**	**5,197,205**
Professional fees	9,650	4,210	25,000	E	2,271	41,131	62,500	297,056	57,045	60,644	477,245	361,092
Stock based compensation					210,600	210,600	250,616	23,954	69,483	243,172	587,225	1,190,859
Payroll expenses	68,565	93,061	184,081		203,664	549,371	160,076	300,519	388,385	374,803	1,223,783	2,338,742
Bad debt expense			62,104	E	2,214	64,318					-	
General and administrative	71,577	142,408	169,326		144,646	527,957	249,167	496,738	529,440	468,504	1,743,849	2,506,887
Loss on sale of receivables	7,147	40,222	51,751		27,201	126,321	35,522	57,838	32,242	36,598	162,200	167,856
Total operating expenses	156,939	279,901	492,262		590,596	1,519,698	757,881	1,176,105	1,076,595	1,183,721	4,194,302	6,565,437
Operating income/(loss)	40,293	(825)	(116,100)		(222,899)	(299,531)	(406,485)	(566,739)	(166,786)	(384,922)	(1,524,932)	(1,368,232)
Interest expense	(5,525)	(7,427)	(15,963)		(116,258)	(145,173)	(7,630)	(194,854)	(272,437)	(7,653)	(482,574)	(283,117)
Interest income					-		73			75	148	223
Financing costs			(2,526)		2,526		(233,746)		4,297	(23,421)	(252,870)	(280,846)
Realized loss on trading securities					(38)	(38)	(185)	(26)			(211)	
Other	-	-	-		(4,723)	(4,723)	(1,170)	-	15,912	(1,000)	13,742	(1,000)
Total other income (expenses)	(5,525)	(7,427)	(18,489)		(118,493)	(149,934)	(242,658)	(194,880)	(252,228)	(31,999)	(721,765)	(564,740)
Net income (loss) before taxes	34,768	(8,252)	(134,589)		(341,392)	(449,465)	(649,143)	(761,619)	(419,014)	(416,922)	(2,246,698)	(1,932,971)
Income tax expense	5,172	-	-		-	-	-	-	-	-	-	-
Net income (loss) after taxes	29,596	(8,252)	(134,589)		(341,392)	(449,465)	(649,143)	(761,619)	(419,014)	(416,922)	(2,246,698)	(1,932,971)
Unrealized gain on marketable securities		2,278	2,989		985	6,252	2,381	(7,152)	1,399	2,381	(991)	(9)
Comprehensive income (loss)	29,596	(5,974)	(131,600)		(340,407)	(443,213)	(646,762)	(768,771)	(417,615)	(414,541)	(2,247,689)	(1,932,980)
EPS or loss per share	**$0.00**	**($0.00)**	**($0.01)**		**($0.02)**	**($0.03)**	**($0.04)**	**($0.04)**	**($0.02)**	**($0.02)**	**($0.12)**	**($0.11)**
Average shares outstanding	16,045,000	16,045,000	16,328,424		16,756,244	16,293,667	18,029,377	19,373,074	19,436,806	18,029,380	18,717,159	18,365,303
Y/Y revenue growth (%)							112%	136%	148%	120%	131%	84%
Gross margin	16.7%	16.3%	17.5%		17.3%	17.0%	14.0%	15.1%	17.0%	17.1%	16.1%	17.0%
Payroll expenses % revenue	5.8%	5.4%	8.6%		9.6%	7.7%	6.4%	7.4%	7.3%	8.0%	7.4%	7.7%
G&A % revenue	6.0%	8.3%	7.9%		6.8%	7.4%	10.0%	12.3%	9.9%	10.0%	10.5%	8.2%

Source: Company reports, Zacks estimates

HISTORICAL ZACKS RECOMMENDATIONS



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