Operator. Ladies and gentlemen, thank you for standing by and welcome to the CTG Quarterly Conference Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time. As a reminder, this call is being recorded. I'd now like to turn the call over to Jim Culligan. Please go ahead.

Jim Culligan. Thank you, Amy, and good morning, everyone. With me on today's call are Bud Crumlish, CTG's Chief Executive Officer, and Brendan Harrington, Chief Financial Officer. Bud will begin the call with some opening remarks and an overview of the quarter followed by Brendan, who will provide an overview of our financial results. We will then open the call for questions. If you don't have a copy of the earnings results press release distributed early this morning, you can access it in the IR section of the company's website at ctg.com.

Before we begin, I want to mention that statements during the course of this conference call that state the company's or management's intentions, hopes, beliefs, expectations, and predictions for the future are forward-looking statements. It's important to note that the company's actual results could differ materially from those projected. These forward-looking statements are based on information as of this date. The company assumes no obligation to update these statements based on information from and after the date of this call. Additional information concerning factors that could cause actual results to differ from those in the forward-looking statements are contained in our earnings release as well as in the company's SEC filings. You can find these at our website or the SEC's website at SEC.gov. Please review our forward-looking statements in conjunction with these cautionary factors.

It's now my pleasure to turn the call over to Bud for his opening remarks.

Bud Crumlish. Thanks, Jim. Good morning to everyone on today's call. Revenue for the third quarter was $78.1 million, primarily reflecting recurring weakness at our largest staffing clients and also lower than anticipated demand in our healthcare solutions business. During the quarter, we proactively responded to this weakness by implementing cost reductions. This enabled us to deliver non-GAAP earnings of $0.04, at the high end of our guidance range.

The company-specific challenges facing several of our largest staffing clients continued to result in significant headwinds for our business during the quarter. As indicated in our press release earlier this morning, our largest staffing client also informed us they were reducing a portion of the service that we provide beginning in the fourth quarter. We expect the size of the reduction to be approximately 20% of our historical annualized revenue with this client and another portion of the remaining business to be slightly less profitable due to lower pricing. This was a result of the consolidation of service providers and in absolutely no way a reflection of the quality of service that CTG provides to the client.

In fact, we've been working very closely with this longstanding client, have had recent meetings in regards the remaining business that we'll continue to provide to them. Based on these discussions, I feel we have a solid position as it relates the remaining scope of business. CTG continues to provide a high level of valuable service to this client, and we expect them to be a meaningful account for years to come. So while we're certainly disappointed by this recent development, we are focused on leveraging our strengthened sales team to drive a more diversified client base consisting of higher gross margin revenue.

Now I will turn over to an overview of the actionable steps we've taken over the past quarter beginning with a few comments on my assessment of the company since being appointed CEO in late July.

Together with management, I've completed a comprehensive review of CTG's capabilities, objectives and strategies across the organization. Following this assessment, I am convinced that our strategy is fundamentally sound and does not require significant shift in direction; rather, it's imperative that we as a company remain focused on execution.

My first area of focus over these past 90 days was the leadership team, I've taken steps to emphasize the importance of accountability as we continue to broaden our sales, recruiting and delivery capabilities across the company. I've also expanded the profile of new accounts we're targeting to include medium-sized businesses in addition to the Fortune 1000 we've historically targeted. During the third quarter, we successfully added a series of new accounts in our staffing, healthcare and European lines of business. As is typical with new accounts we expect them to increase in size over time with several offering meaningful growth potential.

Additionally, I want to mention a company-wide initiative that I plan to formally roll out later in the fourth quarter called ONE CTG. The mission of this new initiative is to expand all of our staffing and solutions offerings through a pervasive collaboration across the organization. This initiative is designed to literally touch every area of our business and increase the total value we provide to clients. We created a new team specifically to identify opportunities to leverage solution offerings more widely throughout the company, ultimately increasing the profitability of our business. We're currently in a process of establishing clearly defined goals, rules of engagement, as well as compensation incentives that will encourage collaboration and support of our larger objectives. I look forward in providing additional updates on this initiative in the coming quarters.

Now I'd like to provide a few brief comments specific to each of our four lines of business: staffing, healthcare solutions, diversified industrials and Europe.

Beginning with our staffing business, although we continue to face headwinds at multiple legacy accounts that I just discussed, the team remains focused on expanding our client base. We added a number of new staffing clients in the quarter, increasing our pipeline of future opportunities. We've recently added several business development executives and have plans for additional hires in the coming quarters. They each will support the objective of diversifying our portfolio of clients in key geographies pursuing new accounts. Going forward, our highest priority will continue to be on increasing our business development success through expansion of existing clients and aggressively pursuing new clients.

Also during the quarter, we completed the implementation staffing of our recently launched offshore recruiting and sourcing center in Hyderabad, India. This fully staff fulfillment center consisting of approximately 50% recruiters and 50% sourcers, significantly increases our available recruiting capacity for both the U.S. and Europe. Today, the team in India is actively providing 24/7 support and improving our response time to clients. As we increase our business development capability, we can utilize this expanded capacity while continuing to increase efficiency and cost.

Our healthcare solutions business continued to be impacted by the trail-off in EMR implementations as we transition to other healthcare offerings in response to the market. For a number of years, we've benefited from being a leading provider of EMR implementations; however, healthcare organizations have evolved, creating both new and different areas of opportunity.

Despite the continued headwinds we have faced in this line of business, I remain absolutely committed to pursue the healthcare industry, realizing the future growth it represents for CTG. In fact, reestablishing growth in this business is one of my top priorities.

In order to capitalize in the future opportunities, it's critical we strengthen the capabilities and offerings of our healthcare solutions business to better align with evolving trends and market demand. In support of this objective, we are now actively expanding our optimization and performance improvement solutions, as well as our application management and service desk offerings. Each of these areas represents a growing segment of the market with favorable margins, and we are optimistic about the ability to introduce expanded offerings to successfully capitalize on these attractive opportunities over time.

Shifting to Europe, our offerings target a number of different market verticals including staffing, financial services, healthcare, life sciences, industrials, telecommunications, and government. Our European business performed in line with expectations during the quarter with modest year-over-year revenue and profit growth on a constant currency basis. This is especially notable considering typical seasonality, as well as the current macro and geopolitical environment in the region. More specifically, our prior investments in business development continue to more than offset the softer business climate in Belgium and Luxembourg where we have a higher concentration of our business.

As further evidence of the team's success in expanding our client base, we added a number of new clients in Europe for the third consecutive quarter, highlighted by newly-secured contracts with two prominent telecom service providers. Our pipeline of perspective new accounts also increased despite what continues to be a relatively soft environment in the region.

Turning to diversified industrials, where we have dedicated offerings across energy, logistics, mining, telecommunications, and government, revenue in the quarter continued to be constrained by the relatively low price of oil and reduced budgets throughout the energy sector. We continue to believe that this business unit represents a strong and differentiated platform with the opportunity to scale a unique pool of skilled IT professionals across a diversified client based over time. In support of this goal, during the quarter we hired a new business development executive with existing relationships across multiple industries, including the energy sector.

In summary, as the challenges faced by a number of our clients translate into potential ongoing headwinds for CTG in the coming quarters, we continue to carefully manage costs in order to protect earnings while prudently investing in future growth. Although disappointing, the lower future sales at our largest client represents an opportunity to replace that revenue with higher margin business as we continue to win new accounts and further diversify our client portfolio across a larger number of clients. I am confident that we have the right strategy and foundation in place; now it's about execution. Although, it will take some time for our recent initiatives to show results, I strongly believe we're taking appropriate steps to ultimately return CTG to a path of growth in the future.

I'll now turn the call over to Brendan for a brief discussion of our financial results.

Brendan Harrington. Thanks Bud. Good morning, everyone. As we indicated in this morning's news release, revenue in the third quarter was $78.1 million, compared with $83.5 million in the second quarter and $93.1 million in the third quarter of last year. The sequential decrease in revenue primarily reflects recurring weakness at our largest staffing clients and lower demand in our healthcare solutions business. Unfavorable currency translation reduced revenue in the third quarter by approximately $100,000. There were 63 billing days in the third quarter versus 64 in both the second quarter of 2016 and the year-ago quarter.

Staffing revenue decreased by $2.9 million from the second quarter, or 4.9%, and declined by $6.8 million, or 10.8%, year-over-year. Revenue from our solutions business declined by $2.5 million, or 10.3%, sequentially and by $8.2 million, or 27.1%, year-over-year.

Revenue from IBM was $24.4 million, or 31.3%, of revenue compared with $26.3 million, or 28.3%, of revenue in last year's third quarter. Revenue from Lenovo was $8.6 million, or 11%, of revenue compared with $10.5 million, or 11.3%, of revenue in the year-ago quarter. On a sequential basis, revenue from Lenovo increased by approximately $300,000 or 3.6%.

Direct costs as a percentage of revenue were 82.2% in the third quarter compared with 80.9% in the second quarter of 2016 and 81.2% of revenue in the third quarter of 2015. Second quarter of 2016 direct cost benefited by approximately $700,000 from payroll tax refunds received in our European operations.

Non-GAAP SG&A expense, excluding severance charges, was $13.1 million, or 16.8%, of revenue in the third quarter compared with $14 million, or 16.8%, of revenue in the second quarter and $13.9 million, or 14.9%, in the third quarter of 2015. SG&A declined $900,000 sequentially in part due to the proactive cost reduction initiatives we implemented during the quarter as indicated previously by Bud.

Subsequent to quarter end, we have taken further actions to reduce costs in response to the lower revenue and profit expected from our largest staffing client beginning in the fourth quarter. These additional measures included rationalizing resources and account management, recruiting and administrative support resources. I'd like to emphasize that although these actions were necessary to offset the lower revenue and profits, we are not pulling back on our investments in sales and business development as we believe these investments are essential to support our future growth objectives.

As described in our press release, we recorded a non-cash impairment charge in the third quarter of $15.8 million, or $1.01 per diluted share, for the write-down of goodwill related to our healthcare business under generally accepted accounting principles.

CTG's balance sheet after the impairment charge includes no goodwill related to any of its business units. In addition, CTG recorded charges of $1.5 million, or $1 million net of tax, or $0.06 per diluted share, related to severance expenses for two former executives.

Non-GAAP operating income excluding the goodwill impairment and the severance charges in the third quarter was $0.8 million, or 1% of revenue, compared with $1.9 million, or 2.3%, of revenue in the second quarter of 2016. Operating margin in third quarter of 2015 was 3.8% of revenue.

The effective tax rate in third quarter was 1.3%, compared with 29.6% in the second quarter and 41.5% in last year's third quarter. The non-GAAP income tax rate in the third quarter of 2016 was 32.2%.

GAAP net loss in the third quarter of 2016 was $16.2 million, or $1.03 per share. Excluding the non-cash goodwill impairment of $1.01 per share and severance charges of $0.06 per share, adjusted net income in the third quarter was $600,000, or $0.04 per diluted share. This compares with GAAP net income of $1.3 million, or 0.08 per diluted share, last quarter and GAAP net income of $2.1 million, or $0.13 per diluted share, in the year-ago quarter. Second quarter 2016 EPS included the benefit of $0.03 per diluted share related to foreign payroll tax credits.

Our headcount at the end of the third quarter of 2016 was 3,500, compared with 3,500 at the end of the prior quarter and 3,700 at the end of the third quarter of 2015. Approximately 90% of our third quarter employees were billable resources.

Cash at quarter end was $9.8 million and long-term debt was $500,000. Days sales outstanding were 86 days in the third quarter of 2016 compared with 73 days in the year-ago third quarter, primarily reflecting longer contractual payment terms with larger clients. The cash surrender value of life insurance is $29.3 million at quarter end.

The CTG corporate headquarters building, which has a net book value of $1.2 million, continues to be on the market with an asking price of $3.3 million. We have engaged a new brokerage firm to market the headquarters building as well as the other office building the company owns and occupies. The second property has a book value of $1.8 million and an asking price of $3.2 million. Our intention is to consolidate our Buffalo-based workforce into one building in the Buffalo area.

Turning to our guidance, we anticipate total revenue for the fourth quarter of 2016 in the range between $73 million and $75 million. The lower revenue guidance is primarily due to less demand than initially anticipated from our largest staffing customers, lowered revenue from our healthcare unit and the expected reductions in headcount at our largest customer. Net income is expected to be between $0.04 and $0.06 per diluted share. Operating margin is expected to be approximately 1.7% of revenue. There are 63 billing days in the fourth quarter of 2016, compared to 62 days in the prior year fourth quarter.

For the full year 2016, we expect the revenue to range between $320 and $322 million. Full year adjusted non-GAAP net income, excluding the impairment and severance charges, is expected to be between $0.20 and $0.22 per diluted share, and non-GAAP operating margin is expected to be approximately 1.6% of revenue.

With that, we'd like to open the call for questions. Operator, can you please manage our Q&A session?

Operator. Our first question will come from Bill Sutherland with Emerging Growth Equities.

Bill Sutherland. Thanks, operator. Good morning. I was a little surprised on the IBM information in the sense that vendor consolidation would maybe yield more business for the surviving vendors. I'm just trying to understand that. Thanks.

Bud Crumlish. That portion of our business is being dispersed amongst the other suppliers as opposed to us. So that's really what it amounts to. There's a significant portion of our business we've always had and expect to continue that in the future. So essentially a portion of what we had originally [is affected].

Bill Sutherland. What's the dimension of the price reduction on the other business?

Brendan Harrington. It's just on a portion of the business that's remaining, Bill. There's approximately 20% that we lost. Obviously that goes away and then for another probably 10% or so of the remaining business, there's a slight reduction in terms of the markups that we're able to charge. We're not going to give out what that amounts to, but ultimately we were able to offset that impact through cost reductions.

Bill Sutherland. So it's on a pretty small fraction of the business. And Brendan, what got you directionally higher on DSO is it—we were kind of in a range here of low 80s?

Brendan Harrington. I think it was 86 at end of the quarter. That was impacted a little bit by how payments came in toward end of the quarter. I would expect that low 80s as you mentioned to be about where we'd be going forward. The 86 was maybe a little bit higher than what we typically expect.

Bill Sutherland. Bud, on the healthcare investments that you're making, maybe a little color on each of those business lines that you're targeting.

Bud Crumlish. On the optimization performance improvement, as the EMR implementations really started taking off in 2000 to 2008 range, it turns out that when systems were put in, hospitals hadn't included some affiliates and things like that. The other thing is they're not making total effective use of what the applications can do for them on the whole. For example, similar to Y2K, you put the system in and you have it about 75% or 80% efficient. Now we're talking about optimization of that to make it run more efficiently, include more people, as well as improving performance.

We do clinical and financial system optimization, and clinical document improvement. So that's one area, the application management outsourcing, that's something we've been in for a long time, and we're seeing more and more interest in the marketplace not only to take over legacy systems as they're finishing off the implementations of their EMR [software], but we're actually getting some new business to manage their existing applications, for version upgrades, and things like that.

Some of the hospital organizations have determined it's a bit of a challenge from a support perspective. So we're expanding our help desk particularly in a clinical role in call it Level 2. It's not very basic things. It's more dealing with people like a physician calling in or someone like that. So we've expanded that, and we see that to be a strong opportunity for us as well.

Those are just a few examples. There are many other things, especially related to some of the changes in Medicaid, Medicare, MACRA, PCMH and some of the quality reporting strategies that are ongoing as the whole movement changes from a fee for service to value based care.

Bill Sutherland. On that last opportunity, would that be more as a service side of an application initiative? In other words, would you be going into that opportunity with a software partner?

Bud Crumlish. Yes, it would be more some of the methodologies and tools that we have as opposed to a specific application. It's not like a product that we would have and utilize, it would be more systems and methodologies.

Operator. Our next question comes from Kevin Liu at B. Riley.

Kevin Liu. I missed the headcount numbers at the end of Q3, so I was wondering if you could update me on that, and with the changes in the IBM relationship, where would you expect headcount to end up at yearend?

Brendan Harrington. The headcount at end of Q3 was 3,500, Kevin. And we're going through some transition so during the fourth quarter, there's going to be an impact at IBM between 100 and 200 people.

So we would expect the headcount to drop somewhat, certainly at IBM between 100 and 200, but for some of that to be offset by some growth in other areas.

Kevin Liu. Bud, you mentioned earlier that with the remainder of that IBM business, you do expect them to remain a client for some time. Can you give us a sense of the scope of work that you'll continue to do for them, how stable that book of business has been over the years, and why you're confident that it stays a meaningful portion of your business going forward?

Bud Crumlish. We've dealt with several lines of business within IBM, and one in particular is called the IBM systems group, formerly known as the systems and technology group. And we became the predominant supplier in 2005, meaning that we were the sole source for that group. They're the ones that are making all the servers, the large ones, the Z-series and that. We've worked intimately with them. As you can imagine, being more of a sole source to them, we got ingrained in their management and all of their initiatives that were going on, so we understand the business exceptionally well. That enables us to provide very talented technical resources to IBM for that particular group.

Now there was a strategy change a few year ago, so there's not a predominant supplier anymore, but we still maintain a very, very healthy portion of that business. We've built strong relationships with some of the other areas outside of that to support some of IBM's large clients, and we're very critical. It's the same type of thing, one of our differentiators is that we have a lot of account managers throughout the organization, and they become ingrained and are serving IBM's clients as well as internal IBM processes. So I feel very confident; we've had this relationship for many, many years, well before 2005, and we expect them to be a very strong account for us in the future.

Kevin Liu. With new staffing customers that you've won year-to-date, can you give us a sense for how some of the ones secured earlier in the year have started to ramp and then perhaps how much of the lost IBM business you feel you can replace with these new customers, say, over the next 12 months?

Bud Crumlish. We have a number of new clients, more than double digits. We were going to do this anyways, but in terms of adding business development executives, especially for our staffing organization, we have a solid infrastructure. With them being able to add accounts, I feel very strongly. They're going to start off small, as they do. We have to compete with other suppliers. It's a relationship business, we have to prove ourselves. One thing about this that's key to what we do is our recruiting capability and capacity. To go into a new account, we have to bring forth a lot of talent—exceptional talent—that differentiates us from the others. That's how we'll get in.

It's going to take time. I don't have specific numbers of exactly how much we anticipate of this business over the next 12 months, but we added business development executives in the quarter and we plan to add the same in future quarters as well and continue to drive that.

As you can imagine, there are accounts that buy very large volumes and obviously get very, very significant price reductions, and those that not so large, where it's a medium-sized businesses. We expect that the margin on some of these medium-sized businesses to assist in our direct profit margin numbers.

Kevin Liu. As you look at the company today and you kind of see the need to invest alongside all these growth initiatives, can you just update us on your thoughts on priorities for cash flow? Do you guys still see the dividend as important to maintain, or do you believe things like investing in the business as well as acquisitions should start to take higher priority?

Bud Crumlish. Well, the board frequently evaluates the dividend to determine a prudent use of capital. And when the board meets, all the potential ways to allocate capital including dividends, stock buybacks, acquisitions and organic investments are considered. It's a high priority for them.

Brendan Harrington. Yes, it's something that gets looked at on a regular basis, Kevin, and that's something that will continue. The board will continue to evaluate the best use of the capital.

Operator. Our next question comes from Vincent Colicchio at Barrington Research.

Vince Colicchio. Bud, your predecessor made some investments on the healthcare side. I'm just curious, we haven't really seen a return from that. Do you think they were after the wrong type of business? What are your thoughts there?

Bud Crumlish. Vince, honestly, I think sometimes that you try and go after really, really large deals, and it's great if you win those, and I think there was some of that going on. We're also in the process of very diligently evaluating these new individuals that came on board, and we expect to add some more horsepower to business development.

So I think that as you look at the opportunities, we can redirect them into some other that are more closable opportunities that may be smaller and still go after the big ones as well. So I think it's a refocused effort, and we're working with them. And that's one of my initiatives, I want to get out with all of them, see our clients, talk to them, remove any kind of potential barriers there are so that they can be successful.

Vince Colicchio. My understanding is the European Union has been a good customer in Belgium. Just wondering if any of that investment has tailed off or is likely to tail off given the uncertainty around the union.

Bud Crumlish. As a matter of fact, no, we haven't seen any tail-off. In fact, we actually won—we announced that last earnings release—we won a new engagement with the European Union. There are certainly some challenges over in Europe, but we've been doing well, so we're really pleased about that. The team over there's been doing a great job and are very aggressive in going after new business. We added new development individuals last year, and it's paying off for us.

Operator. There are no further questions in queue.

Bud Crumlish. Thank you, Amy. I would now like to take this opportunity to thank all of CTG's 3,500 employees for what they do every day, contributing to the company's exceptional track record, providing clients with the reliable IT services and solutions so they can succeed in this global economy. I'd also like to thank our shareholders for their patience and continued support as we execute on our business plans to drive future growth and shareholder value. We appreciate your time today and look forward to reporting on our continued progress in the upcoming quarters.
