Operator: Good morning and welcome to the CTG first quarter of fiscal year 2023 Financial Results Conference Call. All participants will be in listen only mode. [Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Craig Mychajluk, Investor Relations. Please go ahead.

Craig Mychajluk: Thank you and good morning, everyone. We certainly appreciate your time today and your interest in CTG. Joining me are Filip Gydé, our president and CEO; and John Laubacker, our chief financial officer. We released our first quarter 2023 financial results this morning before the markets opened. You can access the release at our website at ctg.com. After Filip and John's formal discussion this morning, we will open the line for Q&A.

Let me remind you that we may make some forward-looking statements during the formal discussions, as well as during the Q&A session. These statements apply to future events that are subject to risks and uncertainties, as well as other factors that could cause actual results to differ materially from what is stated on today's call. These risks and uncertainties and other factors are provided in the earnings release, as well as with other documents filed with the Securities and Exchange Commission. These documents can be found on our website or at sec.gov.

During today's call, we'll also discuss non-GAAP financial measures, which we believe are useful in evaluating our performance. You should not consider this additional information in isolation or as a substitute for results prepared in accordance with GAAP. We have provided reconciliation of non-GAAP measures with comparable GAAP measures in the tables in today's release and SEC filings.

I'll now turn the call over to Filip to begin Filip.

Filip Gydé: Thank you, Craig, and good morning, everyone. We appreciate you joining us today. During the first quarter, we continued to drive our transformation strategy as we work to make CTG a pure play IT Solutions business. Our digital solutions and services business now accounts for more than 80% of the total revenue mix. Despite the difficult macroeconomic environment. Our pipeline continues to be strong, and we achieved IT solutions and services bookings near $100 million in the quarter, including one project totaling $20 million in revenue, expected to be earned over two years. I thank our employees for their hard work in the quarter. We are pleased with our progress, and we remain focused on accelerating our efforts and delivering for our clients and shareholders.

We saw some additional encouraging signs in the quarter. For example, one area of focus is our software engineering services, which includes designing, testing, operating, and enhancing digital products and platforms. We generated more than $100 million in revenue from these services last year and are off to a strong start in 2023 with more than $30 million in revenue in the first quarter. Importantly, our change in business mix has led to a step change in our gross margin profile, which increased 430 basis points over the past two years on a consolidated basis, further highlighting the potential of our business model, whilst the performance in our North America IP Solutions and Services segment, which achieved gross margins of 38.7% in the quarter, up 510 basis points from a year ago and 610 basis points over a two year view.

We attribute this performance to our focus on driving digital solutions, including software engineering services, which yielded a gross margin of nearly 32% in the quarter as well as contributions from our recent acquisition, Eleviant. Overall, the Eleviant integration has gone exceptionally well, and this past quarter highlighted an excellent example of the sales synergy potential of the acquisition. We won a sophisticated digital IT solutions engagement for a North American client where the services will be primarily provided by the Eleviant team using our offshore model.

While we have been doing some work for this client previously under what we categorized as non-strategic staffing business, the new capabilities and talent of the Eleviant team helped us secure this new business.

Over time, we look forward to further driving sales synergies and delivering even greater value for our clients while leveraging lower delivery costs to improve profitability. We are approaching this year with conviction in our strategy. We made investments during the quarter to further expand our North America sales, solutions, and marketing teams. While these investments reduced our operating margin in the quarter, we continue to take a long-term approach to ensure we are positioned for accelerated growth and profitability in the future.

Looking ahead, we remain focused on what we can control around solution innovation, being a top tier place to work and cultivating relationships to improve our mix in an effort to drive our earnings power. Given the significant new projects and overall strong bookings level during the recent quarter, we now anticipate delivering more than 10% growth in the IT Solutions and Services segments during the upcoming second quarter when compared with last year's period. This performance is also driving the improved mix for the full year as John will discuss in more detail.

Before I turn the call over to John, I would like to reiterate that the board and management are always focused on enhancing shareholder value and regularly review our strategic plan, priorities, and capital allocation. To highlight our transformation strategy, we continue to deliver a higher mix of digital IT solutions and services focused on software engineering while thoughtfully disengaging from non-strategic staffing services to improve our financial profile.

As you know, by the end of 2023, we expect to deliver 7% adjusted EBITDA margins, completing what we considered the first phase of our transformation. Importantly, this is just the milestone and not the end destination. For the second phase, we expect to achieve 10% adjusted EBITDA margins by the end of 2025. With the support of the board, our management team embarked on this mission in 2018 because through this transformation, we expect to drive a rerating in our multiple and create significant shareholder value.

With that, let me turn it over to John to review our results in more detail. John.

John Laubacker:

Thank you, Filip. And again, good morning, everyone. We thank you for joining us on today's call. Consolidated revenue in the first quarter was $78.2 million. Change in revenue year over year reflects our continued shift to a mix of more solutions and services-based business and the intentional disengagement of $11.6 million from our lower margin, non-strategic technology services business during the quarter. Of note, the non-strategic Technology Services segment now represents less than 20% of our total revenue mix.

Looking specifically at our IT Solutions and services segments, North America revenue was up 13.5% as we were closing new customer engagements and benefiting from the contribution from the Eleviant acquisition. In Europe, revenue declined 5.6%. However, this was largely due to a change in foreign currency exchange rates. As Filip noted, we achieved IT solutions and services bookings of nearly $100 million in the second quarter, our second highest quarterly total in the last five years.

The consolidated gross margin was 25.7%, up 270 basis points over last year's first quarter and 430 basis points over two years ago, highlighting the success of our continued transformation to a digital IT solutions company. The combined North America and Europe IT Solutions and Services segments delivered a first quarter gross margin of 28.9%, up 130 basis points year over year and 220 basis points over two years.

Filip highlighted the strong margin performance with our North America IT Solutions and Services segment, which saw substantial expansion given the focus on digital solutions and contribution from Eleviant. Europe, which has faced greater macroeconomic headwinds, including labor constraints, saw some contraction in gross margin due to the timing associated with significant mandated salary adjustments in the European countries in which we operate. Within the European segment, we expect to see a gradual increase in margins as costs are passed along to our clients throughout the year and we benefit from improved utilization and a greater mix of digital solutions.

For the first quarter, GAAP operating income was $0.7 million with a margin of 0.9%. When excluding $600,000 of acquisition related expenses, $500,000 of ERP system implementation costs, and $300,000 of severance, non-GAAP operating income was $2.1 million or 2.7% of revenue. The change from last year largely reflects the increases in acquisition-related expenses, offset by additional investments made in support of the North America IT Solutions and Services segment Business Development Efforts. We recorded net income of $300,000 or $0.02 per diluted share, non-GAAP diluted EPS, excluding the previously noted cost, was $0.08. The effective tax rate was 34% compared with 23.9% in last year's first quarter, which benefited from windfalls in equity-based compensation transactions. We expect in the long term our tax rate to be approximately 35%.

We continue to maintain a strong and flexible balance sheet that can be leveraged to accelerate the pace of our growth in the future. Cash and cash equivalents were $23.3 million at the end of the quarter, and we had just $1.4 million outstanding on our revolving line of credit facility with no other long-term debt. Our revenue outlook range for 2023 was adjusted to an overall range of $310 million to $340 million.

We continue to maintain a midpoint of $325 million for the year. However, we did adjust the anticipated revenue mix by increasing our IT solutions and services revenue to a range of $265 million to $285 million. The outlook also now includes a reduction of $40 million to $45 million in revenue from the disengagement or non-strategic technology services business given the acceleration we saw during the recent quarter. Of note, the midpoint of our IT solutions and services revenue expectation is an 18% growth rate year over year, which includes a full year of revenue from Eleviant and well over 10% organic growth for the rest of the business.

We expect 2023 GAAP diluted earnings per share to range from $0.34 to $0.42 and non-GAAP diluted earnings per share to range from $0.56 to $0.64, a reduction of $0.02 at the midpoint of our range from last quarter. The GAAP EPS estimates reflect the previously announced ERP system implementation project. However, these costs are being backed out as part of the non-GAAP EPS disclosures. As a reminder, the total ERP project cost is estimated at $8 million to $10 million and will be largely spread over a two-year period with a completion date around the end of 2024.

As we indicated last quarter, we had expected a slower start to the year with results significantly improving in the second half of the year. We are committed to our plan, including reducing our overall cost structure and the continued disciplined execution of our digital IT solutions and services strategy to drive long-term shareholder value.

This completes our prepared remarks. Kate, could you please open the call for questions.

Question And Answer

Operator: [Operator instructions] At this time we will pause momentarily to assemble our roster. The first question is from Kevin Liu of Kevin Liu & Company. Please go ahead.

Kevin Liu: Hey, good morning, guys, and nice job on the bookings this quarter. First question I'd like to ask about was just the large deal that you signed. Could you provide a little bit more color just in terms of what verticals this may have been in, kind of, the time you expect it to ramp to full contribution. And should we expect revenue on a quarterly basis to be relatively consistent once fully ramped?

Filip Gydé: Sure, Kevin. And this large deal is in the healthcare vertical. As was said, it's spread over two years. It started with the planning at the end of last quarter and is ramping up as we speak. We believe once it's ramped up, it's probably going to stay relatively stable over the period of two years.

Kevin Liu: Got it. That's helpful. And one thing I wanted to clarify was this large deal the one you guys are also referencing in context of Eleviant delivering those services, or are those two separate opportunities?

Filip Gydé: That is a separate opportunity. The Eleviant opportunity is a very interesting one because it really goes to the core of why Eleviant made so much sense to CTG. It's the digital capabilities they have, it's the offshore delivery where we can have the standard model of 80% offshore, 20% onshore. It's actually a SaaS platform, development deal in a company that has been a client for CTG in the non-strategic business, which is very encouraging that we're now selling high value, high margin digital business in the clients where previously we were only doing low margin SaaS.

Kevin Liu: Understood. That's good to hear. And just regarding the European business, you guys talked last quarter and kind of referenced it again this quarter the wage increases that have happened there. You know, how have those impacted kind of conversion of your pipeline as you move through Q1 and into Q2 here, and maybe talk about how those discussions with your customers are going about being able to pass along those wage increases.

Filip Gydé: Sure. The wage increases were abnormally high due to the extreme inflation last year. And we are able to adjust for this, in part, through higher bill rates at the beginning of the year. Roughly half of our contracts have some provisions built in for inflation adjustments, but it's very different from contract to contract. So, we are adjusting it in part, but we expect that it will take the entire year to pass through most of the costs.

On the other side, where you were asking about the throughput in our in our pipeline and our closing deals. The European pipeline, as the total pipeline, of course, is strong. Though in Europe, we have been experiencing more of a high level of labor constraints. It's not easy to fill client demands. The right resources are scarce, difficult to recruit, difficult to grow. The reason why that's harder in Europe than in the States is simply a function that there are more IT professionals retiring than joining the workforce out of our universities in Belgium and Luxembourg.

Kevin Liu: Appreciate that. And then just lastly for me, just on the guidance, obviously, the revenue number is unchanged at the midpoint. But it does have a higher mix of solutions revenue. So just wanted to get a better understanding of why then the midpoint of your earnings guidance is down slightly. Are you planning to just make higher levels of investment on the sales front, or is there other some other dynamic we should be aware of?

Filip Gydé: John, do you want to take this question?

John Laubacker: Sure, Filip. Thank you. Hey, Kevin. Really the dynamics of the guidance is we're excited about increasing the solutions guidance in North America and Europe overall, the total. And again, I think I mentioned during the call that the comparison of the midpoint of this year to our actual from last year would be an 18.8% increase. Dramatic increase from where we were.

As far as the earnings guidance, we did lower that by $0.02 to the midpoint to $0.60, from $0.62. And that's reflective of two or three items. One is the pace at which we're passing through those wage rate increases to bill rate increases to our European clients. The macroeconomic headwinds that we see in Europe are a little bit stronger now than we had seen at the beginning of the year.

But lastly, we made investments in Q1. We saw an opportunity to do that. Some great people came along to add to the team and the business, at the moment, whether that be sales, solutions, delivery, marketing. So, we added those people, we firmly believe that you’ve got to add the right resources to drive business to long term growth. We're excited about, talking about attaining 10% growth in the second quarter for the Solutions business. That's something that we've been working hard towards. So, we made those investments and I think when you put all those pieces together that came out to the slight change, the slight decrease in the midpoint of the earnings guidance.

Kevin Liu: Understood. Thanks for taking the questions and good luck here in Q2.

Operator: The next question is from Marc Riddick of Sidoti. Please go ahead.

Marc Riddick: Good morning. So, I was wondering if you could talk a little bit about the new engagements and new orders, and wonder if you sort of characterize a little bit, are you beginning to see some of those new engagements from clients that are targeting cost savings efforts? Or are you getting a sense that they're kind of growth driven? Is there any particular concentration? It seems as though cost savings would make sense at this moment, because when if that's what you're seeing.

Filip Gydé: Sure. We do have opportunities and deals closed for clients that are looking at cost savings, like what you're saying. And it makes sense at this moment in time, but that's not all what is happening. We still see in the digital transformation area a lot of companies needing to implement their strategic projects, changing their business model, shortening the time to market, changing the customer experience.

All those areas in the current macroeconomic environment are even more important than in other times, and that is, for instance, when together with Eleviant, is exactly what that is. It's like I said, the SaaS platform development of a point-of-sale app in the manufacturing company. So not related to cost savings but related to strategy implementation. We can't say there's a more of one or the other. We see both in the market at this moment.

Marc Riddick: Okay. And then I was wondering if you're seeing much of a difference in the length of the sales cycle more recently with these orders? Or is it similar to historical pattern?

Filip Gydé: Well, we definitely have more detailed discussions with clients and somewhat slower decisions. It has everything to do with global inflation, the recessionary pressures. But we do have part of the wins, and we're actually encouraged by that high number of bookings, our second highest in the past five years. So, we're winning a lot of new deals. We anticipate delivering more than 10% growth in the second quarter compared to the previous year. And so, we see a very healthy pipeline. But yes, more details and slower discussions.

Marc Riddick: Okay. And then switching to a different pipeline. I was wondering if you could talk a little bit, Eleviant was in September of last year. I was wondering if there are any thoughts as to maybe what the acquisition pipeline currently looks like and your current appetite; and maybe what you're seeing from valuation perspective.

Filip Gydé: Well, we're continuously evaluating potential acquisitions, Marc, based on our, I would say almost rigorous investment criteria. There really has to be an added value to CTG, like I said before, there must be seeds for growth, established, profitable companies, the skill set that we need, or a customer base we need access to. In short, very synergistic. We do have a good pipeline, very filtered, and we will remain prudent in our disciplined capital allocation framework.

Marc Riddick: Great. And then you were talking about the investment in adding personnel during the quarter. And I was wondering if there is room for that to continue or do you get the sense that you kind of got to where you want to be there, at least in the near-term?

Filip Gydé: Well, we saw, like John said, we saw opportunities. Finding some great people looking at our approach has always been a long-term approach, looking at where we can bring the business, transform our business to a digital place. We have added significant sales solutions and marketing resources. I think at this time the gravity center is now moving into integrating those people, bringing them up to speed and making sure we get the returns. We're always going to see the pipeline for sales solutions, marketing, people; but at this moment, we're implementing and bringing those new forces up to speed to accelerate that growth that we're talking about.

Marc Riddick: Great. And then the last one for me: it seems as though there was a little bit of a shift in revenue mix. I mean, you certainly have a lot of verticals that fit the marketplace, but there seems to be a little bit of a shift in the industry vertical mix, I guess a little bit away from technology. I was wondering if you could talk a bit about maybe what you're seeing in that overall business mix or and maybe some of the things that you might be some areas that you might be more encouraged about than others perhaps in the near-term. Thanks.

Filip Gydé: The shift away from the technology sector has everything to do, Marc, with the shift away from our non-strategic business because that's where a lot of that was centralized. So that's an easy answer. Looking at the other verticals, we see growth in the financial industry; government in Europe is positive but not great. Healthcare in the States is under a lot of pressure generally. And that's why we're so encouraged and pleased with the large contracts that we have signed in the healthcare segment. So, our healthcare business isn't under pressure.

Marc Riddick: Thank you very much.

Filip Gydé: You're welcome, Marc.

John Laubacker: Thanks, Marc.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

Filip Gydé: Thank you for participating in our teleconference today. And as always, please feel free to reach out to us at any time. We look forward to talking with all of you again after our second quarter 2023 results. We hope you have a great day. Kate, you may now disconnect the call.

Note: This transcript has been edited slightly to make it more readable. It is not intended to be a verbatim recreation of the Computer Task Group, Inc. (CTG) financial results teleconference and webcast that occurred on the date noted. Please refer to the webcast version of the call, which is available on the Company's website (www.ctg.com), as well as to information available on the SEC's website (www.sec.gov) before making an investment decision. Please also refer to the opening remarks of this call for CTG's announcement concerning forward-looking statements that were made during this call.