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

Jim Culligan. Thank you, Shaun and good morning, everyone. With me on today's call are Filip Gydé. CTG's President and Chief Executive Officer; and John Laubacker, Executive Vice President and Chief Financial Officer.

Before we begin, I want to remind listeners that statements made 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 today, Tuesday, July 21, 2020. The company assumes no obligation to update these statements based on information from and after the date of this conference call. Additional information concerning factors that could cause actual results to differ from those made in the forward-looking statements is contained in today's earnings press release, as well as in the company's SEC filing.

In addition, the company's press release and management statements during the call include discussions of certain adjusted non-GAAP measures and financial information. These financial measures and a reconciliation of GAAP to non-GAAP results are provided in both today's press release and the related Form 8-K. With that, I will now turn the call over to Filip for his opening remarks.

Filip Gydé. Thank you, Jim. Good morning, and thank you for joining us today. Acknowledging the broad and ongoing impact that COVID-19 has had on so many people, I hope that you and your families are all doing well. And we appreciate you taking the time to participate on today's call.

Over the past few months, CTG has continued to build on our solid start to the year. We delivered strong second quarter results, with both revenue and non-GAAP operating profit increasing sequentially, despite the unprecedented and challenging global business environment. These results are directly attributable to our team's success and disciplined execution, and collectively contributed to CTG achieving our highest first half operating margin and non-GAAP earnings per share in six years. We are pleased with these results and believe the consistent progress we have made in our transformation to a solution-centric organization and our favorable performance trends over the past year are proof that our strategy is working.

Our ongoing focus on accelerating our strategic shift towards solutions has served us extremely well in the first half of 2020. We are enhancing the resilience of our business by meeting a broader range of client needs while generating higher margins, and we are confident this will also allow us to emerge from the pandemic from a position of strength. We continue to take steps to build on this momentum and position CTG to capitalize on the significant long-term growth opportunities in our served end markets.

The transformation underway would not be possible without the unwavering commitment of our whole team. Since I was appointed CEO 18 months ago, I continue to be incredibly proud of the teamwork demonstrated across CTG. Over that time, our team has worked diligently to advance our strategy and support our clients with the end goal of generating added value for all stakeholders.

Our second quarter results are reflective of the team's determination, especially when considering the unprecedented environment we have all witnessed in recent months. As highlighted on last quarter's conference call, we took prompt and decisive action in response to COVID-19. This included rapidly transitioning 90% of billable staff to a work-from-home model, and implementing targeted cost containment efforts. We made these adjustments without loss of productivity and the team's effectiveness while working remotely resulted in both increased efficiencies, and higher utilization across our global operations. The transitions we have made have been highly successful and further demonstrate the resilience of our team and the ability to quickly adapt our capabilities to meet client needs in a dynamic market environment.

Also reflected in our second quarter operating results, there are certain non-recurring benefits, including a meaningful uptick in business from a large multinational oil and gas line, which subsequently sold its Alaska-based operations on June 30, as well as government reimbursements for unemployment in Europe associated with the pandemic, which largely offset the bench costs related to inactive employees.

Taken together, our second quarter was comprised of the following financial highlights: a continued and significant increase in higher quality revenue and margins driven by a higher mix of solutions business which generates higher margins and profits; sustained growth and performance in Europe despite a more challenging economic environment; and improved quality of staffing revenue as we continue to gradually disengage from lower margin business. Of note, the business most impacted by COVID-19 has largely been lower margin staffing. Together, this resulted in very strong performance across key metrics on a non-GAAP basis, including year-over-year improvement in operating income and earnings.

Our ability to deliver these solid results in the current environment reinforces the importance and timeliness of our solutions-centric strategy as work-from-home trends accelerate the need for CTG's solutions. The Solutions business grew sequentially to 38% of total revenue in the second quarter, as we continued to expand our services and offerings around relevant market opportunities while also driving a corresponding improvement in the margin profile of our business.

Importantly, our team has done an outstanding job of sustaining new business development efforts, even though the pace of new requests for proposals and contract wins have slowed due to the heightened uncertainty associated with the pandemic. During the quarter, we continued to submit a number of proposal responses that we believe will help contribute to future growth when we emerge from the current environment. This includes a multimillion dollar contract secured in the quarter to manage the go-live implementation of an Epic-based electronic health records for a prominent healthcare system in the Northeastern U.S. This win represents a meaningful milestone, with our team successfully converting an existing engagement with this client for application management and support, to CTG being selected to manage the client's go-live implementation.

As another example of the growing traction within our Solutions business, we have seen a rapid increase in our business pipeline for testing solutions following our launch of these offerings in North America earlier this year. We are also making solid progress on the integration of StarDust, the full service testing company that we acquired in March. The addition of StarDust's unique cloud testing capabilities expanded our portfolio of solutions offerings, enabling CTG to provide a more complete coverage of the full IT lifecycle.

As we continue to build out our core global solutions offerings of Application Advantage, EIM Advantage, and Testing Solutions, we are increasingly better positioned to address a wider scope of client needs, resulting in enhanced opportunities to sell multiple solutions to a single client. Fundamental to both our solutions and the introduction of new expanded offerings is that our solutions are scalable and they can easily be replicated across multiple clients and end markets.

Consistent with these objectives, in the third quarter we will formally launch our newest solutions offering, Microsoft 365 Services. This collaborative service is specifically targeted at helping clients maximize the value of their Microsoft 365 investment, from initial implementation and migration planning to deployment, optimization, and maintenance.

In support of our ongoing focus on expansion of the new solutions business, we are also consistently taking steps to enhance the skills and capabilities of our people. In June, we announced that Brett Hunt, a seasoned IT solutions and services executive, joined CTG as Managing Director of Solutions in North America. In his new role, Brett will help drive accelerated growth of the company's Solutions business through the deployment of key partnerships, while also supporting the rapid adoption of CTG's Delivery Center model. We are pleased to have Brett on board and look forward to his contributions to the team.

Further complementing our growing Solutions business, we recently expanded our strategic delivery platform with the opening of a delivery center in Bogotá, Colombia. This new delivery center leverages our centralized approach and enhances our capabilities to deliver high quality, cost effective IT services and solutions for clients in both the Americas and Europe.

We believe the second quarter was an indication of the strength and durability of CTG's business, evidence that our strategy is working and the planned execution of our entire team. We remain very enthusiastic about CTG's prospects for future growth and success, and we expect to benefit from continued traction as we convert our solid pipeline higher margin Solutions business into revenue generating engagements.

As we look ahead to the third quarter and the second half of 2020, we anticipate a softening in our overall performance. This is primarily related to the expected increased seasonality and lower utilization in the near term as stay-at-home restrictions are lifted and employees take paid time off, particularly in the coming summer months. We also expect a gradual roll-off of the non-recurring governmental benefits we realized in the second quarter. We additionally believe we will realize a slower ramp-up of new business due to ongoing uncertainty on clients' decision making processes.

With that said, we strongly believe in the long-term view of our strategy and we remain fully committed to our transformation to a higher-margin, solutions-centric organization. We are confident that our prudent investment in business development and expanded solutions offerings during the second half of the year will advance our future growth opportunities and accelerate the achievement of our longer term objectives while generating substantial long-term value for CTG shareholders.

I will now turn the call over to John for a detailed review of our second quarter results, as well as trends that we expect to play out in the second half of 2020.

John Laubacker. Thank you, Filip, and good morning, everyone. Thank you for joining us today.

As reported in our press release earlier this morning, consolidated revenue in the second quarter was $89.1 million, compared with $86.9 million in the first quarter of 2020 and $100.4 million in the second quarter of 2019. Currency translation had a negative $800,000 impact on revenue in the second quarter of 2020 compared with the negative $2.4 million impact in the same period of 2019. Total billable days in the second quarter were 64, compared with 62 days in the first quarter of 2020 and 64 days in the year ago second quarter.

IT Solutions revenue in the second quarter of 2020 was $33.8 million, expanding to 38% of total revenue, compared with $29.1 million representing $33.4% of total revenue in the previous quarter, and $35.6 million representing 35.5% of total revenue in the second quarter of 2019. In addition to Solutions' revenue continuing to become a growing portion of our overall business, the direct profit from solutions in the second quarter improved 290 basis points over 2019 to 28.5%. Revenue from IT Staffing in the second quarter of 2020 was $55.3 million, or 62% of total revenue, compared with revenue of $57.9 million or 66.6% of total revenue in the previous quarter and $64.8 million or 64.5% of total revenue in the second quarter of 2019. The decrease in Staffing revenue reflects the combined effects of our disengagement from select lower margin staffing business in recent quarters and lower demand from clients impacted by the COVID-19 pandemic during the second quarter. Additionally, we also improved the direct profit from Staffing in the second quarter, as it increased 220 basis points over 2019, to 16.5%.

Revenue from IBM in the second quarter was $18.9 million, or 21.2% of total revenue, compared with $19.9 million, or 22.9% of total revenue in the first quarter of 2020 and $21.1 million, or 21.1% of total revenue in last year's second quarter. Our master services agreement with IBM has been extended for one quarter to September 30, 2020 as we continue to discuss general business terms and conditions of an extended agreement. No other client represented more than 10% of revenue during the second quarter of 2020 or in recent comparable periods.

Direct costs as a percentage of revenue were 79% in the second quarter of 2020, compared with 80.4% of revenue in the first quarter of 2020 and 81.7% of revenue in the year ago second quarter. The reduction in direct costs as a percentage of revenue is due to the increasing percentage of solutions in our overall business mix.

GAAP operating margin in the second quarter of 2020 was 2.1%, compared with 2.4% in the first quarter of 2020 and 1.8% in the year-ago quarter. Non-GAAP operating margin in the second quarter of 2020, which includes severance and acquisition-related expenses totaling $1 million, was 3.2%, compared with 2.9% in the first quarter of 2020 and 2.4% in the year ago quarter. As part of our continuing evaluation of the impact of the COVID-19 pandemic on our business, we adjusted our resources, which caused us to incur severance costs during the quarter totaling approximately $600,000.

The second quarter GAAP operating margin increased by 30 basis points and the non-GAAP operating margin increased by 83 basis points year-over-year, with both measures reflecting a high utilization of billable resources across the business during the quarter and our continued focus on cost management. The effective income tax rate in the second quarter of 2020 was 43.7% compared with 39% in the first quarter of 2020 and 36.6% in the year ago second quarter. A higher effective tax rate in the second quarter of 2020 was primarily due to certain nondeductible expenses incurred in the U.S.

GAAP net income in the second quarter of 2020 was $1.8 million, or $0.12 per diluted share, which includes a net $400,000 of income, or $0.02 per diluted share, comprised of gains from life insurance proceeds and the sale of real estate, offset by severance and acquisition-related expenses. This compared with net income in the first quarter of 2020 of $1.1 million or $0.08 per diluted share, which included $0.02 per diluted share in acquisition-related expenses. GAAP net income in the year ago second quarter was $900,000 or $0.07 per diluted share, and included $0.02 per diluted share in acquisition-related expenses.

Non-GAAP net income for the second quarter of 2020 was $1.4 million or $0.10 per diluted share, compared with $1.4 million or $0.10 per diluted share in the previous quarter, and $1.3 million or $0.09 per diluted share in the second quarter of 2019. GAAP net income for the first half of 2020 was $2.9 million, or $0.20 per diluted share, compared with $1.6 million, or $0.11 per diluted share, in the first half of 2019. Non-GAAP net income for the first half of 2020, excluding severance and acquisition-related expenses as well as the gains from life insurance proceeds and the sale of real estate, was $2.9 million, or $0.20 per diluted share, compared with $2.2 million or $0.16 per diluted share in the first half of 2019.

CTG's total head count at the end of the second quarter was approximately 3,700, compared with 4,000 at the end of the first quarter of 2020 and 4,350 at the end of the year ago second quarter. The decrease in headcount compared with the prior periods primarily reflects a reduction in IT Staffing personnel as we continue to gradually transition away from select lower margin staffing business. Additionally, the employees we had furloughed during the pandemic as a result of a reduction in client demand have primarily delivered staffing services to our clients. Approximately 90% of our second quarter 2020 headcount is billable.

Turning to our balance sheet, cash and cash equivalents at the end of the second quarter were $34.3 million, which included net cash proceeds of approximately $2.4 million from the completed sale of CTG's corporate headquarters during the second quarter. The net value of the building had previously been recorded at the end of the first quarter as other current assets, as it had been held for sale. The company's outstanding long-term debt was $12 million at quarter-end, resulting in net cash of $22.3 million at the end of the second quarter.

Capital expenditures in the second quarter of 2020 were approximately $500,000, compared with $700,000 in the first quarter of 2020 and $380,000 in the second quarter 2019.

Looking forward, given the continued impact of the COVID-19 pandemic on CTG's end markets, we're not providing updated guidance for full year 2020. We anticipate seasonality in the fiscal third quarter will be higher than normal as employees take vacations that have been previously delayed resulting in lower utilization of our billable resources. We also expect a reduction in government subsidies in Europe for technical unemployment, the sale of a customer's business unit in Alaska to another company and our continued investment in business development and solutions experts to impact earnings in the second half of the year.

Despite these near-term challenges, we are very encouraged by the progress of our IT solutions-centric strategy, which has resulted in the highest non-GAAP operating margin and diluted earnings per share we have reported for the first half period in the past six years. We remain committed to our strategic transformation and will continue to take the necessary steps to enhance the long-term value of CTG.

As a reminder before we move to the Q&A session, the purpose of today's call is to discuss the financial and operational results for the quarter. We will not address the previous unsolicited offers to acquire the company. As in the past, our Board – in consultation with its advisors – will continue to review and evaluate any such proposal to determine the course of action that we believe is in the best interest of the company and all stakeholders.

Shaun, can you please initiate and manage our question-and-answer session?

Operator. Our first question will come from the line of Kevin Liu from K. Liu & Company

Kevin Liu. Good morning. I hope you're all doing well. Can you talk a little bit about RFP activity throughout the quarter, mainly focused on how trends have been through the quarter, and then subsequent to quarter-end. Has there been any shifts in the types of projects that clients are focused on, both from pre-COVID to current date?

Filip Gydé. The RFP activity, or the business development activity in the broader sense, has continued. That is also why in the beginning of the pandemic we did not implement the 20% furlough for non-billable employees on business development and on our global solutions teams because we were, and are, still reviewing and evaluating opportunities for growth across our business.

What has changed in that second quarter is the speed of converting opportunities into real business, into contracts, and at the same time, I have to say that some areas of our business have seen more workload and more traction. As you can imagine, some help desk operations have had additional work in response to demands from our clients, like patient access to their online medical records or like supporting our client staff to work from home. We have helped some clients with their remote work capabilities, and we also saw pockets of our business where consultants were turning commuting time into billable hours as they were staying at home.

So from all of that you can deduce the areas where we see traction going forward is everything that has to do with remote solutions offerings, work from home, support from work from home or helping the clients to install infrastructure so their employees can work from home in an easier way, and then I'm thinking around cloud services. Fortunately, if you look to CTG's solutions portfolio, all of our global solutions are perfectly applicable in a work-from-home environment. So I think our move to solutions, our strategy to more solutions-centric organization is helping us keep a very healthy pace in our business development.

Kevin Liu. Longer term, some of the efficiencies and increases in productivity that you're seeing as clients allow you guys to work offsite, are you expecting that to persist even beyond the pandemic, and does that provide a longer term benefit to your gross margin?

Filip Gydé. We do believe parts of that will continue. Obviously, meeting face-to-face with people, with clients, especially in a sales environment or also in an early-stages project or environment makes a lot more sense, when that's possible to do that in a safe environment while protecting our clients and our own employees. I think that will come back.

But frankly, I think everybody has seen in their own lives that there are some areas where I would say the routine meetings, the project follow-ups, maybe the third or the fourth conversation when you're in a proposal review, all those things can easily be done with the collaboration platforms we already had for a while but were not really using that much. And that's also, frankly, the reason why we're going to launch our services around Office 365 and collaboration platform, cloud, security, how to work. And it's not only about Teams and video call, it's about implementing more productivity in the collaboration, and I think that's definitely an area where we will see still more evolution coming up.

Kevin Liu. Related to that, you mentioned the partnership or the effort to work on Office 365 services. Is that primarily an organic initiative or would you expect to acquire Microsoft partners in order to build up the scale as you move forward on that path?

Filip Gydé. At this moment, Kevin, it's an organic initiative and it's not something new for CTG. It's an area where we already have a lot of experience in Europe and in the States. We're a Microsoft Gold partner everywhere. We have the global expertise, the references on both continents. So it's not something new. It's something that in the current environment is getting more traction and more value.

When you talk about acquisitions, we always are looking for, or evaluating potential investments in the stronger parts of our business, and potential acquisitions will always have to meet our disciplined investment criteria and have to be complementary to CTG's business. But we do believe at this moment in the current environment, it would be difficult to complete an acquisition, so it's not our immediate focus.

Kevin Liu. Understood. Regarding the new service delivery center in Colombia, what exactly drove the need to open that center, especially at this particular time? And then what sort of implications are there for how you'll scale the headcount in the coming quarters as well as any sort of impacts on the overall utilization rate?

Filip Gydé. Good question. We have been working with a partner in Bogotá, Colombia, for over a year now, so we have been building experience in how to work with people in Colombia, how to set up an organization over there. We already have clients working with us through that Colombia team. Now, we have taken the next step to establish a delivery center which can leverage our centralized approach, which can add something to our delivery center network.

Bogotá, Colombia has a favorable economic environment, it's in a U.S. time zone, our India delivery center wasn't, nor our European delivery centers. We also are meeting a demand from clients for a

Spanish-speaking alternative for delivery center activities, and we find in Bogotá a strong technical infrastructure, so we can have reliable connections and competitive labor costs and access to a lot of high quality, Spanish-speaking IT talent. So, we were present already and obviously now we make the next step and we count on that delivery center to help us expand our business.

Kevin Liu. Lastly, I was wondering if you could quantify the impact of the reduced government subsidies in Europe, and then also what's the revenue impacts from the Alaska business unit that was sold?

John Laubacker. On the government subsidies, what we have done in the past is, when we look out into the out quarters and the out years, we've only included the information that we know at this point in time, so primarily in the countries that we do business, in Belgium, Lux and France. In Belgium and in France, officially those programs have only been approved through August at this point in time as far as the technical unemployment reimbursements that have come to companies like CTG.

So we don't know if they will be extended beyond August at this point in time, but we have not assumed that they will be, and so where we had a full quarter in Q2, we expect those countries to not have a full quarter in Q3. Luxembourg has been approved, primarily I believe through the end of the year but at a reducing rate, and so there is a diminishing return on the Luxembourg reimbursement at this point in time. And so when we make that statement, we just are focused on what we know at this point in time as far as what's been approved full quarter in Q2 and diminishing amount of benefits in Q3 and Q4, and that's why we made that comment.

We haven't disclosed the revenue relative to the business unit in Alaska that we had dealt with. We have publicly talked about the sale of BP Alaska to another company. That is an organization that over the years we've done an awful lot of business with, have a great relationship with. We're working hard to forge and continue that relationship with the buyer of that organization. But again, we're not making any assumptions that it will be sort of a one-for-one extension from old client to new client there. We're taking a very conservative approach on the relationship, understanding how they work, working with them, helping the transition from old to new, and have made some, I think, reasonable estimates there that would be more conservative maybe than just assuming that it's just going to continue.

Operator. Thank you. And at this time we have no further questions in queue.

Filip Gydé. Thank you, Shaun. In closing, we have done an excellent job navigating the challenges associated with COVID-19 while continuing to make progress on our transformation, and delivered another very solid quarter. We believe the second quarter clearly demonstrates the strength and durability of CTG's business, our strategy and the team's disciplined execution of our plan. As with any plan, there's likely to be some variation in our growth and reported results from quarter-to-quarter, especially in light of the uncertain market conditions driven by the pandemic. However, we remain excited about CTG's prospects for future growth and success, and we expect to benefit from continued traction with our solutions offerings and high margin business over time. I am confident we will emerge from the current environment stronger than ever and that we are executing on a strategy that will succeed in maximizing value for shareholders.

Thank you for your continued interest and participation on today's conference call. Shaun, you may now disconnect the call.
