Operator: Greetings and welcome to the CTG Inc. Third Quarter Fiscal Year 2022 Financial Results. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Craig Mychajluk, Investor Relations. Thank you, Craig. You may begin.

Craig Mychajluk: Yes, 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 third quarter 2022 financial results this morning before the market opened. You can access the release on our website at ctg.com. After Filip and John's formal discussion this morning, we will open the line for Q&A.

Let me first just remind you that you are likely aware 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 a 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. I would like to spend a few minutes on the progress against our strategy and then highlight the acquisition we completed at the end of the quarter.

Our third quarter results continue to validate the effectiveness of our strategy to evolve into a digital solutions and services business with solid margin expansion even against revenue headwinds. Our gross margin expanded 190 basis points to 24.3% year-over-year and was up 40 basis points sequentially. This improvement demonstrates the advancement of our strategy to drive a higher-level mix of digital solutions while reducing our exposure to lower-margin non-core business.

Our non-GAAP operating margin also expanded 70 basis points despite ongoing investments and inflationary pressures. We recorded net income of $1.1 million and adjusted EBITDA increased 2.0% to $3.8 million with a 100-basis points improvement in margin to 5.1%.

From a segment perspective, the gross margin for our North American and Europe IT Solutions and Services segment was a combined 29.1%, further highlighting our continued transformation to a digital solutions company.

We have also seen a strengthening of our Non-Strategic Technology Services segment margins as we have consistently been disengaging from the lowest margin business first. During the quarter, we disengaged from another $8.8 million of revenue within that segment. The labor environment remains competitive and our overall growth has been impeded by labor constraints, particularly in Europe.

We expect to combat this challenge by expanding our offshore delivery center's capacity. While we have had some success increasing our delivery headcount in both our Colombia and India centers, we look forward to leveraging our recent acquisition Eleviant, which we announced on September 29th. Eleviant was a privately owned digital transformation company headquartered in Dallas, Texas. During its 17-year history, they have built a reputation of exceeding expectations and, as a result, have enjoyed high client retention rates. This acquisition was driven in part by the strong alignment of our respective visions for accelerating our clients' digital transformation by leveraging emerging technologies and the commitment to deliver meaningful business results.

The rationale behind the transaction was quite competitive as they strengthened our digital offerings in AI, machine learning and intelligent automation. They expanded our capabilities in cloud migration, mobile application development and other technologies, such as blockchain and best-in-class SaaS platforms, which complement many of our existing solutions services and increase our global delivery center capacity and flexibility with the addition of established teams in Chennai and Coimbatore, India.

The purchase price was $18.6 million and was largely funded with cash and the small equity component. Our tight strategic and cultural alignment is expected to accelerate the integration and our combined ability to drive sales synergies and deliver even greater value for our clients. Eleviant is expected to add incremental annual revenue of approximately $10 million and, given its strong margin profile, is immediately accretive to our EBITDA margins.

We look forward to a bright future together and welcome the entire Eleviant team to the CTG family. John will speak to our specific guidance, but, generally speaking, we recognize that the global outlook has continued to soften and there are underlying pressures and uncertainties. We remain confident in our ability to navigate these challenges by continuing to focus our efforts on developing a stronger earnings profile to meet our long-term objectives.

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. Thank you for joining us on today's call.

Consolidated revenue in the third quarter was $75 million, which reflected an $8.8 million decrease related to the disengagement from lower-margin non-strategic business and a $5.7 million unfavorable impact to revenue due to changes in foreign currency exchange rates. Excluding these 2 items, revenue was down approximately 1%.

From a segment perspective, North America IT Solutions and Services revenue was down about 4%, largely the result of the macroeconomic climate, which has slowed clients' decision-making process for IT Solutions and Services. Also contributing to the change was the ramp-up in last year's third quarter of a significant project that was completed in the 2021 fourth quarter. Overall, our core business in North America has been solid and there's a steady pipeline of opportunities.

In our Europe segment, on a constant currency basis, revenue was relatively flat compared with the prior year period. Strong execution helped to offset some of the challenges that are present in that part of the world, particularly around labor constraints, as Filip discussed. We are currently looking to leverage our global resource pool with the improved capacity that Eleviant brings to our offshore delivery centers.

As we highlighted today, our margin profile improved during the quarter as we continue to optimize our revenue mix. Consolidated gross margin was 24.3%, up 190 basis points over last year's third quarter and 220 basis points higher over a 2-year period.

For IT Solutions and Services, the North America gross margin expanded 370 basis points, despite lower revenue given the improved mix of digital solutions. Europe's gross margin was down about 60 basis points, a solid result given the labor and inflationary pressures.

While we continue to disengage from the lowest margin projects in the Non-Strategic Technology Services, that segment has seen a steady improvement in margins. SG&A expense declined 9% to $16 million, though as a percentage of revenue increased 190 basis points, largely due to the loss of operating leverage. GAAP operating income was $2.3 million for an operating margin of 3%, which was flat with last year. Non-GAAP operating margin, which excludes $744,000 of acquisition-related expenses, was $3 million, or 4% of revenue, up 70 basis points.

We recorded net income of $1.1 million, or $0.07 per diluted share, in the quarter. Non-GAAP EPS, again, excluding the acquisition-related costs, was $0.11 compared with $0.13 in the year ago quarter. Of note, the effective tax rate was elevated in the quarter at 40.8% due to a reversal of deductions previously taken in a foreign jurisdiction.

Lastly, our adjusted EBITDA margin also improved to 5.1% in the quarter, which was up 100 basis points. CTG's total headcount at the end of the quarter was 3,250, of which approximately 88% was billable. This compares with 90% billable during the prior year period.

Turning to our balance sheet and cash flow, cash and cash equivalents were $26.8 million, down from $35.6 million at year end 2021, reflecting the cash usage to acquire Eleviant. We generated strong cash from operations during the quarter of $9.7 million, for a year-to-date total of $12.5 million. There is no debt outstanding at quarter end. We still maintain a strong and flexible balance sheet that can continue to be leveraged to accelerate our pace of growth in the future.

For our outlook, we are adjusting our revenue for 2022 to range from $320 million to $330 million - which reflects a reduction of approximately $30 million, as a result of the intentional disengagement from the lowest margin business in our Non-Strategic Technology Services segment, $20 million from foreign currency exchange impacts and a significant expected reduction in the fourth quarter compared with the prior year due to the completion of a large project last year in our North America segment. Eleviant is expected to add approximately $2.5 million in revenue in the fourth quarter.

Despite the top line decrease in challenging macroeconomic headwinds, we expect our operating margin for the year to improve over the prior year, given the positive ongoing changes to our business mix. We now expect 2022 GAAP diluted earnings per share to range from $0.42 to $0.48 and non-GAAP diluted earnings per share to range from $0.52 to $0.58.

As we continue to execute our plan, we believe we have further earnings power to unleash and our long-range goal remains unchanged as we drive our adjusted EBITDA margins to approximately 7% by the end of 2023.

That completes our prepared remarks. Operator, could you please open the call for questions?

Question And Answer

Operator: [Operator instructions] Our first question is from Kevin Liu with K. Liu & Company.

Kevin Liu: Good morning. Maybe just starting with some questions on the acquisition of Eleviant. How much headcount did that add in terms of the quarter-end number? And then, how should we think about the gross margin and incremental OpEx you would expect on an annualized basis?

Filip Gydé: Well, Kevin, the headcount is around 300 employees. Most of them, obviously, are software engineers and the vast majority are in the two delivery centers in India. As to their gross margin, that's significantly higher than our IT Solutions and Services margin, even than the one in the States. So, we're talking about above 50% and we see a very strong financial profile. John, is there anything you would like to add on that?

John Laubacker: Not really, Filip. That was perfect. Regarding the operating expense, you asked about, Kevin, our operating margins also will be well above where we have been in the past, even with our solutions business, so a really nice and profitable business.

Kevin Liu: That's great to hear. And then, just focusing on the North American IT Solutions segment for a bit, obviously, the gross margin expansion there was impressive to see on relatively flattish revenues quarter-to-quarter. I was just wondering if you could talk a little bit about the mix of work you're getting there in this current environment and whether the type of margins we saw in Q3 are sustainable moving forward.

Filip Gydé: I didn't understand the very last sentence you've said, could you repeat that?

Kevin Liu: I was just wondering if the 38% gross margin we saw for the North America segment in Q3 is going to be sustainable going forward.

Filip Gydé: Okay, thanks. So, the mix of business we see in North America is really strong as it's been specified by margin. We see a good pipeline, good level of digital opportunities in the pipeline and, of course, you know about the significant projects we had last year in the second half and, primarily, in the fourth quarter, so that's going to make comparisons between years difficult.

But, on your question about the 38% margin, most of that business at this moment is delivered onshore. As you know, we already had offshore capabilities. We had them before Eleviant in Colombia and in Hyderabad, India. But still, most of the business in North America was a little bit onshore So, that means, with the leverage of Eleviant and with the cost difference between India and North America and the margins that Eleviant is able to create in their delivery system, we believe that 38% is not the end. We're aiming higher.

Kevin Liu: Great. And then, maybe if I could just wrap up with some questions on the Europe IT Solutions segment. Can you talk about this quarter-over-quarter? Have you seen any improvement at all in the labor constraints you've talked about? And then, as we move forward from here, how do you feel about your ability to increase margins there, either through pricing actions or continuing to win new business that could potentially push that margin up?

Filip Gydé: Quarter-over-quarter, the labor constraints still remain at the same level, so it's still very hard to fill client demand in the areas that we want to focus on - in the digital skill set space. In other areas, we see it becoming less stringent, but still, this is in the areas we want to grow. It's a difficult situation. We bare combating that in two ways, Kevin, mostly two ways.

First, again the offshore component, we're looking forward to delivering at lower cost and higher margins. If our mix is moving in that direction, that will definitely impact our profitability. Second, if you go back to the Eleviant acquisition, we also acquired some best-in-class SaaS platforms with that acquisition and a number of those are very well positioned to automate parts of our existing solutions and services.

By the way, that's not only in Europe; that's in Europe and North America. So, we can look at existing assignments, existing projects, and automating part of that work with vBots or vChat, two of their platforms in their V-suite and increasing margins. So those are the two areas. Obviously, moving the legacy solutions business we still have in Europe towards digital model is the main driver of profit improvement.

Operator: Our next question is from Marc Riddick with Sidoti & Company.

Marc Riddick: So, a couple of things I wanted to start on. Maybe you could touch a little bit on the elevated tax rate that was mentioned in the press release. I was wondering if you could touch a little bit on that and whether we should expect that to also be elevated in the fourth quarter and that being part of your guidance there as well.

Filip Gydé: John, would you like to comment on that?

John Laubacker: Sure, relative to the tax rate in the quarter, just over 40%, it was due to some revisions on deductions that we had previously taken. We have a very conservative approach around tax across the company worldwide, but you're always going to face a situation where authorities take a look and do some audits to prior years. A multi-year audit was done and there were some things that were disallowed that raised the rate in the quarter.

So, I don't expect that to continue in the quarter. It might be a little bit higher in Q4, but I don't think it pervasively goes from where it was hanging out around 28% to 30% to 40%, 41%, unless statutory rates change, of course.

Marc Riddick: Okay, I just wanted to get that covered. Moving on to one of the things that was kind of interesting, certainly, you've been working on winding down the Non-Strategic. The winddown that you've done so far has actually led to an increase in the margins, better margins than we thought we would see, but also, year-over-year, an increase in Non-Strategic, so could you talk a little bit about that?. Is there some business in there that you might revisit, or how should we think about that overall picture; and then, how that reduction rolls off next year?

Filip Gydé: Sure, Marc, and yes, it's very obvious that we are moving away from the lowest margin business first. So, of the whole list of contracts, we're looking at where the margins are lowest. Obviously, that's our first area of focus to go and talk with the clients to see if there's another way we can provide the same services, if we can get out of the Non-Strategic part and then move it to solutions. If not, then we're not going to renew or only want to renew at a significantly higher margin, which so far has resulted in the average margin of the remaining Non-Strategic business increasing.

So, is there part of this business that we might revisit? It's our policy to always go and talk with the client and find ways to increase our added value, to look at the profitability we have and make it more acceptable to us.

If the client sees the value for them, and thinking in the same direction with us, yes. As we look at the business, how this is being positioned right now, I think that this is all business we want to move away from, except if we're able to change the parameters that we're working on. For next year, Marc, our plan is to continue at the same rates of this engaging business. This year is a little more than last year. I think for next year, we're looking at somewhere in between the two numbers. Maybe, John, you could expand on that.

John Laubacker: Sure, we were at about low $20 million last year, in 2021, of which we disengage from, and, this year, it's a little bit over $30 million, so we have averaged $25 million over the last couple of years. I think that's sort of our run rate going forward, so a little bit higher in 2022 but gravitate back down into the mid-20s as far as what we think we'll disengage from.

Marc Riddick: Okay, great. That leads me into the next part as there seems to be continued comfort as far as the goal of reaching your adjusted EBITDA margin level of 7% by the end of '23. I was wondering if you could talk a little bit about that, because it seems as though, between the disengagement from Non-Strategic, the acquisition, the overall progress that you're making and maybe the pricing dynamics that you're seeing as well, it would be reasonable from the outside looking in to view that goal as more attainable today or maybe more confidence in attaining that goal today than maybe 6 to 9 months ago. Does that make sense? Can you share some thoughts on that?

Filip Gydé: Sure, well, we're moving in the right direction on all of the elements that we're trying to influence. First of all, we're focusing on investing in sales, solutions, partnerships, marketing to drive the organic growth or getting the right talent in the company to grow that digital business, because the digital business, with higher-value and higher-margin, is going to help us increase that margin.

Second, we're reducing our exposure to lower-margin Non-Strategic technology. Third, we're focusing on lowering our delivery costs through the offshore delivery centers. With the leveraging of Eleviant that we started; we're going to make significant progress on that. Lastly is our focus on acquisitions that grow and expand our digital solutions business.

Again, Eleviant is a significant step forward and we're looking for additional prudent investments, still using our disciplined capital allocation approach. To continue, with all four of the leaders that help us increase that margin, we have made significant progress. That's why we're confident to maintain that goal for end of '23.

Marc Riddick: Okay, and then, the last one from me – and I appreciate all the feedback and color. I just wanted to talk a little bit about some of the demand dynamics that you're seeing. Your customer base is fairly broad and you certainly touched on all of the key industry areas, so could you touch a little bit on what you're seeing from your customers, given recessionary concerns, global pressures and the like. Are there any callouts that might be helpful for us?

Filip Gydé: Sure, the simple answer, Marc, is that we are seeing the same kind of effect in almost all industry sectors. It's a difficult economic environment in Europe, as we said. There, the only industry that isn't affected that much and that still is going strong is the government, both national governments and European governments. All of the others are the same as the discussions we have in the United States.

It's not that our pipeline is shrinking. It is very healthy, but the discussions are more detailed and definitely slower. Global inflation causes everybody to pause, rethink the priorities, and only focus on the absolute top priorities. Looking at Europe, we have more of a labor-constrained problem there than in the States. In the States, that's not the case at this moment, but the global inflation is slowing down things everywhere.

Operator: There are no further questions at this time. I'd like to turn the floor back over to management for any closing comments.

Filip Gydé: Thanks, Paul. In closing, the third quarter marks another quarter of continued progress and execution on CTG's digital solutions strategy. We are realizing some improvements in the company's operating margins and, with the acquisition of Eleviant, we expect this to continue as we work towards our long-term goals and the ongoing commitment to building value for all CTG shareholders.

Thank you for participating in our teleconference today. As always, please feel free to reach out to us at any time, and we look forward to talking with all of you again after our fourth quarter 2022 results. We hope you have a great day. Paul, you may now disconnect the call.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.