STAFFING 360 SOLUTIONS

Transcript of
Staffing 360 Solutions, Inc.
Fiscal Second Quarter 2017Earnings Conference Call
August 16, 2017

Participants

Brendan Flood – Executive Chairman
Matt Briand – President and Chief Executive Officer
David Faiman – Chief Financial Officer

Analysts

Bill Relyea – Midtown Partners
Michael Shaw – Wells Fargo

Presentation

Operator
Greetings, ladies and gentlemen, and welcome to the Staffing 360 Solutions Fiscal Second Quarter 2017 Earnings Conference Call. 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 Brendan Flood, Executive Chairman of Staffing 360 Solutions. Mr. Flood, you may begin.

Brendan Flood – Executive Chairman
Thank you, Sherry, and thank you to everyone who has joined us for Staffing 360's Fiscal Second Quarter 2017 Earnings Conference Call. I'm joined today by Matt Briand, President and Chief Executive Officer; and by David Faiman, Chief Financial Officer. I want to bring to your attention that a webcast and a replay of this conference call is available by following the link contained on the bottom of the press release announcing this call and that this will also be available on Staffing 360's website, www.staffing360solutions.com.

Before we get started, I'll take a moment to read the Safe Harbor statement regarding today's call. This conference call will contain forward-looking statements within the meaning of U.S. federal securities laws concerning Staffing 360 Solutions, Inc. The forward-looking statements are subject to a number of significant risks and uncertainties, and our actual results may differ materially. Please refer to the company's filings with the SEC, which contain and identify important risks and other factors that may cause Staffing 360's actual results to differ from those contained in our forward-looking statements. All forward-looking statements are made as of today, August 16, 2017 and Staffing 360 Solutions expressly disclaims any obligation to revise or to update any forward-looking statement after the date of this conference call.

During these prepared comments, we may make reference to certain non-GAAP measures, such as adjusted EBITDA. Where applicable, we have provided reconciliations of these non-GAAP measures to the most directly comparable GAAP measures.

Now, with that, I'd like to take a bit of time to talk about our performance. When I have finished my introductory remarks, I'll hand the call over to Matt Briand for some additional detail on the performance of our operations and to David Faiman to explain our financial statements. At that point, I will discuss progress on our strategic aims before opening the call to Q&A.

Over the past 18 months, I have made much mention of our emphasis upon strengthening the financial and operational fundamentals of the business, in order to continue this work. While our revenue is down year-over-year by 9.1%, the largest parts of that were foreign currency translation of 2.5% and exiting low margin business in our PeopleSERVE operation of 2.3%. Outside of these our revenue was down about 4.3%.

Despite this drop in revenue, our gross profit saw a small uptick on a constant currency basis as a result of our margin improvement. We saw our margins improve from 17.3% in Q2 2016 to 18.8% in Q2 2017. For the six months to July 1, 2017, our gross margin improved to 18.4% against the comparative 17.0% in 2016. This improvement in margin has allowed us to continue to underpin our continuing adjusted EBITDA performance, delivering a solid $1.5 million in the second fiscal quarter and $2.6 million year-to-date with our stronger quarters still to come.

You'll hear from Matt about some of the wins, that our operations have made and also our progress on margin improvements. You will hear from Dave, how our balance sheet has improved, how our working capital continues to improve, and how our expense control continues to be a large initiative for us. After Dave has finished, I'll bring you up-to-date on the strategic initiatives that I mentioned on our last call and where we are in relation to these.

At this point, I'll hand the call over to Matt Briand, our President and CEO, for an update on our operational performance. Matt?

Matt Briand – President and Chief Executive Officer

Thank you, Brendan, and good day, everyone. Before Dave goes into the financials, I'll provide a few highlights of our operations as we continue to improve organic performance, strengthening our margins and reengage our acquisition practice. I'd like to start by mentioning how pleased we are with the latest results. Although we reported a dip in revenue, we have continued to drive improvements in both gross margin and cost savings.

I would first like to outline a few contributors to our continued gross margin growth. Through quarter two 2017, we have grown our gross margin 1.5% over 2016. As mentioned on prior calls, we have successfully managed our workers' compensation claims down, resulting in significant savings. This year, we've expanded our internal safety committee to include oversight of all US subsidiaries. Additionally, we have implemented new loss control programs within our largest clients, helping us better manage and close out clients. Our goal this year is to further reduce the overall cost structure of the program, resulting in additional cost savings moving forward.

In addition, our permanent placement divisions in the UK market continue to perform at some of the highest levels we've seen, positively impacting our margins. Both subsidiaries, The JM Group and Longbridge, have focused on generating more consistent monthly results for 2017. Our UK management team is directly involved in driving business development, improving our delivery model and maintaining a high level of employee engagement.

And finally, throughout 2017, all subsidiaries have been focused on shedding client arrangements with low margin return. Although this has negatively impacted revenue growth in the short term, it has repositioned us to grow smarter revenue in the long term. Our leadership has been focused on either renegotiating existing agreements or driving our business development teams through value-based selling to win business at higher margins.

Moving away from margin, I'd like to share a couple of operational points, updating everyone on a few of our new initiatives. On the last call, I spoke about our large subsidiary, Monroe Staffing, enhancing our workforce management solution program, which manages large contingent workforces, upwards of 100 temporary associates within specific clients. This quarter, we executed two new partnership agreements in the northeast. Each program will consist of managing over 150 temporary associates and we're very excited about the opportunities this program is offering us and I look forward to providing further updates.

Across all subsidiaries, we are bolstering our business developing teams, specifically focusing in our Massachusetts market, selling IT and engineering staffing solutions. Our PeopleSERVE and Lighthouse brands have successfully expanded and teamed the two sale forces together, sharing best practices, implementing cost-selling initiatives and driving employee engagement through training and development.

And finally, to support current and future growth needs, we'll be entering two new lease agreements in our Massachusetts and UK markets. Lighthouse, The JM Group and Longbridge will be entering new space over the course of the next few months.

In summary, we are pleased with the synergies we have achieved in our continued focus on improvements in gross margin and adjusted EBITDA. Our employees have done a fantastic job improving metrics, and we thank them for their strong work ethic and dedication.

I would now hand the call over to David Faiman, our Chief Financial Officer, for the financials. Dave?

<u>David Faiman – Chief Financial Officer</u>

Thank you, Matt, and good morning, everyone. For the second quarter of 2017, revenue of $42.1 million was down 9.1% against the prior year second quarter of $46.3 million, but was an increase sequentially by $1.4 million over our first quarter revenue of $40.7 million. The decline included $875,000 from foreign currency translation, or 2.5% of our revenue, with the remainder driven by the strategic decision to exit low margin government business in our PeopleSERVE subsidiary, as well as the timing of new client starts.

Gross profit for the second quarter of $7.9 million was essentially flat with the prior year despite the lower revenue as more revenue came from higher margin business, and lower workers' compensation insurance. This has heavily contributed driving gross margin to 18.8% versus 17.3% over the prior year, a 150 basis point improvement.

Operating expenses of $7.1 million was down significantly from $9.3 million or 23.4%, as we manage cost to a lower revenue base and continue to reduce nonrecurring costs, such as legal expenses. This performance translated into positive operating income of $826,000, our largest ever, versus an operating loss of $1.3 million in the prior year quarter.

Other expenses, which are primarily interest expense and financing costs, were $1.4 million versus $908,000 in the prior year, mainly due to a gain on the conversion of warrants in the second quarter of 2016. This translated into a net loss for the quarter of only $539,000 versus $2.5 million in the prior year, an improvement of almost 80%, and adjusted EBITDA of $1.5 million, a 3.6% margin. I'd also like to point out that our underlying pure EBITDA also was $1.5 million, signifying the continued reduction in nonrecurring transactions.

For year-to-date, revenue of $82.9 million was down 7.4% versus prior year of $89.5 million. Of that decline, $1.9 million or 2.1% was due to foreign currency translation, with the remainder due to pure working days in the first quarter, due to weather-related stoppages, exiting lower margin business and timing of new client starts.

Gross profit of $15.3 million was up slightly over the prior year, despite the lower revenue, again, driven by higher margin business and lower workers' compensation insurance, resulting in gross margin of 18.4% versus 17% in the prior year, a 140 basis point improvement.

Operating expenses of $15.5 million were down significantly by $2.1 million from $17.6 million year-to-date last year, as we closely manage our cost structure to lower revenue base and continue to reduce nonrecurring costs. Other expenses of $3.8 million were up from $2.2 million in the prior year by $1.6 million, of which $1.4 million was a loss on a debt extinguishment in the first quarter, driven by our balance sheet refinancing efforts, and a gain of conversion of warrants in the prior year. Excluding these items, other expenses would actually have declined as our overall cost of capital continues to improve.

This performance translated into net loss of $4 million year-to-date, against $5.2 million for the prior year. Excluding the loss on debt extinguishment this year and the gain on warrants conversion in the prior year, the improvement would have been $3.1 million year-over-year.

Finally, our trailing 12-months adjusted EBITDA is now $5.3 million versus $4.5 million, an improvement of $800,000 or 18.7%. It should also be noted that our trailing 12-month pure EBITDA was also positive.

Turning now to the balance sheet, days sales outstanding is 41.7 at the end of the second quarter of 2017 versus 43.3 days as of December 31, 2016, an improvement of 1.6 days. Our working capital deficit has improved by $2.4 million and we successfully redeemed the Series B preferred stock using proceeds received from Jackson Investment Group.

With these financing transactions and our continued growth in adjusted EBITDA, our leverage ratio now stands at 2.6 times versus 3.1 times at the same point last year. Subsequent to the balance sheet date, we received a further $1.6 million from Jackson Investment Group, which was used to settle the longstanding arbitration dispute that was previously accrued. This matter is now officially closed.

Finally, turning to the statement of cash flows, net cash provided by operating activities was $2.1 million year-to-date versus $1.7 million for the same period last year, primarily from lower accounts receivable, but does include approximately $1 million of outflows for payables that was funded by the initial proceeds from Jackson Investment Group's investment.

Net draws from our accounts receivable financing line were $2.7 million versus $1.6 million for the prior year, resulting in net cash used of $605,000 versus net cash received of $161,000 in the prior year. However, as I mentioned earlier, excluding the $1 million of outflows for payables, the year-to-date net outflows would have been positive inflow of $400,000 in the current year versus the $160,000 in the prior year.

I'd like to wrap up my discussion by saying that despite some of the topline noise, the fundamentals of the business continue to improve, which we believe, over time will continue to unfold positively.

At this point, I'll hand the call back to Brendan before we open the call for Q&A.

Brendan Flood – Executive Chairman

Thank you, Dave. On January 25, 2017, we received a notification from NASDAQ that our share price did not meet its minimum bid price requirement and that we had 180 days in which to correct it. On July 24, 2017, we received a further letter from NASDAQ outlining that while we still failed to meet the minimum bid price, we met all of the other requirements for retaining our listing on NASDAQ, and therefore we were given a further 180-day extension to January 22, 2018, by which time we would have to fall back into compliance. We are comfortable that we will resolve the issue before then.

On our last call, I mentioned that we were moving back into M&A mode and reinvigorating the part of strategy, that we have continuously outlined, which involves Staffing 360 Solutions becoming a $300 million annualized revenue international staffing business. While our pipeline of acquisitions continues to be strong, there are three transactions that we are now under signed letter of intent with, due diligence is proceeding and the exercise of raising the finances to fund them is continuing.

While there is never any certainty that any transaction will actually close, all of the businesses that we are working with are firmly within our strategic model and fit within what we call our five strategic pillars of accounting and finance, information technology, administration, engineering, and light industrial. We hope and expect to provide more information on this in the near term.

In conclusion, we've continued to strengthen our business and we are looking to continue this trend in the coming quarters. Operator, at this point, I would like to hand the call over to a Q&A session.

Operator
Thank you. [Operator instructions]. Our first question is from Bill Relyea with Midtown Partners. Please state your question.

Q: Good morning. Nice performance. Just wondering if in your potential acquisitions you're looking at some of the new territories that you've already started offices in, such as North Carolina or other places that would be new geographically?

Brendan Flood – Executive Chairman
Thanks, Bill. So without giving away the entire game, I have mentioned a couple of times that our geographic reach will only be in the United States and the United Kingdom.

Q: Right.

Brendan Flood – Executive Chairman
We have also mentioned once or twice, and also Dave mentioned in his commentary, that we have historically been somewhat open to harsh winters in New England. So I can tell you that one of the three acquisitions is in a warmer environment than Massachusetts in January.

Q: Good. Thank you.

Operator
Our next question is from Michael Shaw from Wells Fargo. Please state your question.

Q: Hi, guys. I actually have a bunch of questions. I don't know if there are other people who are going to be in the queue. So I was hoping to kind of get a little bit more information about the company; I'm kind of a newer shareholder. About the acquisitions that you guys are looking at, in particular, I know you guys have a couple criteria for it. And I guess my first question then is going to be, in terms of these acquisitions, should shareholders assume that these things are going to be immediately accretive?

Brendan Flood – Executive Chairman
Yes, so this is Brendan. So just to reiterate as you are new, the criteria that we follow, we don't acquire anything that needs to be fixed. Therefore, we expect that every single acquisition that we will ever make is immediately accretive. It has to be within one of the five areas in which we specialize, so accounting and finance, IT, engineering, administration and light industrial. It has to have a strong management team. It has to have recurring revenues and a strong client base.

So what I can confirm to you is that we won't do any acquisition unless it ticks each and every one of those boxes and therefore, all three of these acquisitions ticks each and every one of these boxes.

Q: Got it. Okay, so I guess, my next question kind of to lead on into this, when I look at our balance sheet, there's not a tremendous amount of cash on it. There's maybe, as of July 1st, there's about $0.5 million worth of cash, which obviously doesn't seem like enough to finance some of these purchases. So as you discussed, as you're looking at funding, and I assume that it's mostly going to be in the form of debt. My question and one of my concerns is for something like this is, in terms of your funding options, do you look beyond Jackson Investment Group?

Because one thing I've noticed is that funding in general has been—the funding before was expensive, but the funding afterwards, when you used Jackson Investment Group, also seems very expensive. And that seems to be highly dilutive, whether it's either a lot of warrants attached or especially there's a lot stock attached to it as well. And I was wondering, what is the criteria that you guys are looking for when you're looking for funding, and how many different sources do you go to for it?

Brendan Flood – Executive Chairman
So that's a long lead into what was a relatively short question at the end. We've spoken to a number of sources. And what we're looking at without either giving the game away or trying to negotiate with potential parties through an earnings call, we have and we'll continue to be in discussions with Jackson Investment Group as our largest shareholder. It's a natural basis. Our expectation is that we'll raise some mezzanine debt, which will fund the majority of it. But the leverage ratio that Dave spoke about in his commentary is something that is becoming incredibly dear to our hearts, as we've improved it materially over the last two years. Our expectation is that, whatever way in which we fund these acquisitions, we will continue to see improvements on the leverage ratio over the next two years.

Q: Okay. And I guess I have one last question though. Specifically on Jackson Investment Group, they offered $1.10 a share, margin, it wasn't necessarily a firm offer. I mean, the board rejected it, but the shareholders didn't necessarily vote on it. I was curious as to why that was or if there was—that would kind of solve the financing issue, right? And it will also solve the $1 a share issue. I was wondering if you could speak to that a little bit in terms of why it was rejected or if there was any opportunity or any chance that they were going to firm it up at all.

Brendan Flood – Executive Chairman
I mean it's always very pleasing when somebody values a company at a higher price than the market is currently at. We did an internal valuation, the board reviewed the internal valuation as to what we believed on the basis of comparable staffing companies of our size the stock price was really worth. And given where many of our shareholders actually got into us, the price they got into us at, we believe that it would be unfair and below value for us to accept an offer of $1.10 per share.

Q: So was there any discussion or negotiation with them at all in terms of where the board felt was a fair valuation?

Brendan Flood – Executive Chairman
Yes, there was.

Q: And what was the conclusion of that? Did they decide that was just too high?

Brendan Flood – Executive Chairman
Sorry, that $1.10 was too high?

Q: No.

Brendan Flood – Executive Chairman
You mean the conversation with the Jackson Investment Group as to whether it would match the board's view of the valuation?

Q: Yes, exactly.

Brendan Flood – Executive Chairman
No there wasn't.

Q: So I guess, then the question then is, why not? I mean it would seem to me that they might be interested in owning the company outright. But it would seem to me that as a subsidiary of Jackson Investment Group that that actually might be a better solution in terms of looking for financing, in terms of dealing with the NASDAQ issue, why wouldn't that be pursued more aggressively?

Brendan Flood – Executive Chairman
So, okay. So it's a fair point. Our view internally as a board of directors was that the valuation offered wasn't sufficient. Our continuing view as we do our best to espouse on all of these calls every quarter is that we believe that our business is comfortably undervalued, but given that the exercise that the management team has been going through in terms of driving improvements to the financial statements and improvements to the operational performance, in addition to reinvigorating our M&A program, that we could make a better return to our shareholders than just giving them $1.10 a share.

Q: I guess my concern isn't necessary—I don't know if you see what I'm getting at here. Right? My point though is that while I agree that the stock price does seem very low relative to kind of what the promise of a company like this might be, the concern for something like this is that every time there's some type of financing, there's a bunch of warrants. And so with a bunch of warrants, there's a bunch of dilution as the stock price goes up—as the company improves that shareholders may not necessarily be sufficiently rewarded for it. It may actually be a better return on capital to just sell the company out to essentially your largest shareholder, who's going to get most of the upside anyway.

Brendan Flood – Executive Chairman
I understand what you're saying. So the offer from Jackson Investment Group, which was made public was an all-cash offer. So $1.10 would have been the maximum that anybody was going to recover. Our beliefs as a board of directors was that we could deliver more than $1.10 back to our shareholders. Despite occasionally having to further dilute in order to make these finance raises, we still believe that we can deliver significantly more than $1.10 back to our shareholders.

Q: All right. Thank you.

Operator
[Operator instructions]. Ladies and gentlemen, that marks the end of our question-and-answer session today. Does anyone on the team have any closing remarks?

Brendan Flood – Executive Chairman
Sure, thank you, Sherry. So as we continue to improve our balance sheet, improve in our operational milestones, and to get closer to our stated aim of achieving a $300 million revenue run rate, we believe our full potential will begin to be realized. As a management team, we remain committed to growth in revenue, to growth in earnings and to growth in shareholder value.

Operator, that is the end of our call. Thank you all again and have a very pleasant day.