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TrueBlue, Inc. (TBI)

Q1 2016 Earnings Call

CORPORATE PARTICIPANTS

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

Steven C. Cooper
President, Chief Executive Officer & Director

OTHER PARTICIPANTS

Kevin McVeigh
Macquarie Capital (USA), Inc.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Sara Rebecca Gubins
Bank of America Merrill Lynch

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Randle Glenn Reece
Avondale Partners LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Connor and I will be your conference operator today. At this time, I'd like to welcome everyone to the First Quarter 2016 TrueBlue Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions]

Thank you. Derrek Gafford, TrueBlue's CFO, you may begin your conference.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

Good afternoon, everyone. Here with me is CEO Steve Cooper. Before we begin, I want to remind everyone that any forward-looking statements made by management during today's call are subject to the Safe Harbor statements found in TrueBlue's press release and SEC filings.

Any forward-looking statements in today's call speak only as of the date of which they are made and we assume no obligation to update or revise any forward-looking statements.

The company's first quarter earnings release and related financial information are available on TrueBlue's corporate website at www.trueblue.com under the Investor Relations section. This call is being recorded and a replay will be available on the company's website.

The discussion today contains non-GAAP terms including but not limited to EBITDA, adjusted EBITDA and adjusted earnings per share. Adjusted EBITDA excludes non-recurring integration and acquisition costs and processing fees related to the capture of the worker opportunity tax credit.

Adjusted earnings per share excludes non-recurring acquisition and integration costs, amortization of intangible assets WOTC processing fees and adjusted income tax expense to the ongoing expected rate of 32%. These are measurements used by management in assessing performance and in our opinion provide investors with additional insight on the underlying trends of the business. Please refer to the non-GAAP reconciliation on our Investor Relation's website for a full reconciliation of both current and historical periods.

I'll now turn the call over to Steve.

Steven C. Cooper

President, Chief Executive Officer & Director

Thank you, Derrek. Good afternoon, everyone. Today, we reported our 2016 first quarter results. First quarter revenue grew 13% to $646 million which included 4% organic growth and 9% from acquired businesses. Adjusted EBITDA and adjusted income per diluted share both grew 9% for the 13-week period.

Our results for the first quarter were disappointing compared to our expectations. I want to share five areas impacting our results and the outlook provided today. One, organic revenue has recently slowed; two, gross margin compression related to wage inflation; three, SG&A increases outpaced revenue growth; four, change in scope of services for our largest customer; and five, the recent acquisitions are performing better than expected.

First, organic revenue slowed in our Staffing Services during the quarter and in particular March resulting in less overall revenue than expected by $20 million. We missed our expectations regarding organic revenue growth. We had expected 7% organic growth during the first quarter and only produced 4%.

Our organic growth was over 8% in January. It reduced to 5% in February and for the month of March it was negative by almost 1%. There was surely a shift in demand as the quarter came to a close. The quarter – slowing through the quarter was across many geographies and industries that we serve. The slowing was especially pronounced for our large national customer base and the retail industry in particular.

On a more promising note, our services to construction clients grew at about 10% in Q1. And our services to our small and mid-sized clients also grew at about 10%. The outlook we have given today for revenue growth has been impacted by the mixed trends I've just discussed with you. Regarding our outlook, it remains promising that we've seen smaller accounts and our local accounts continue to increase their services with us.

The decline in larger accounts seems to be a pause in project based work such as remodels and resets inside retail stores rather than the general services related to ongoing support of retail sales, distribution and other ongoing positions in other areas of their businesses.

Second, gross margin compression related to wage inflation. Our gross margins improved overall by 70 basis points this quarter. The improvement was primarily due to the impact of certain acquisitions which produced higher gross margins in comparison to our blended company average. Also our construction services produced higher gross margins and those services are continuing to experience positive growth.

Offsetting these positive items that have improved our gross margins is negative pressure on the bill and pay rate spread. The current environment which combines slightly slowing demand with rising labor costs has created some sensitivity in pricing. That makes it more difficult to pass the full markup related to the higher wages along to customers. This is resulted in about 50 basis points of margin compression.

We will continue to work on reducing this compression and getting our full bill rate increases related to wage increases priced into the bill rates. We have not changed our process from prior years where we proved we can hold the margins even in the face of higher wages.

Third, selling, general and administrative costs had continued to rise at a faster pace than revenue. During 2015, we made significant investments by adding local sales and recruiting professionals in several markets which helped produce the organic revenue surge at the end of 2015 and here into the beginning of 2016.

In addition, we experienced increasing sourcing and screening costs overall related to a tightening labor market. About half of the $19 million of increase in SG&A is related to these investments along with the variable costs related to supporting higher organic revenue and half of the $19 million is related to the new acquisitions in the past year.

With the progressive slowdown in the growth during the current quarter, these investments have been curtailed and cost control programs commenced. We will selectively cut our costs this next quarter to ensure we generate operating leverage from our organic growth.

Fourth, change in scope of services with our largest customer. In April, we were notified by Amazon of their intent to shift our scope of services over the next year from serving many of their U.S. fulfillment centers to serving Canada's fulfillment centers along with being the key provider for their U.S. delivery stations which are the smaller package-sorting centers closer to their customers' final delivery location.

The shift in our scope of services is to assist them with the highest growth segment of their delivery system as they ramp up many of these locations over the next few years. The result of this shift in our scope of services will be approximately $180 million less in revenue and $10 million less in EBITDA during 2016.

The shift first takes our services out of certain U.S. fulfillment centers here in the second quarter and then it will take a few quarters to balance out the additional work we are starting up, which is what creates the drop in revenue and EBITDA in 2016.

Based on the information provided to us from our customer, we don't expect to further drop in revenue and EBITDA from the 2016 outlook we have provided here. And we do expect significant growth in connection with the delivery station ramp up over the next few years.

Fifth, our newest acquisition of SIMOS and Aon's RPO business are performing better than previously provided expectations. Effective December 1, 2015, we acquired SIMOS Insourcing Solutions, a leading provider of on-premise workforce management solutions. They specialize in helping clients streamline warehouse and distribution operations to meet the growing demand for online commerce and supply chain solutions. This has been a strategic move for our on-premise teams as we see many new opportunities to infuse our current operations with these special services.

Effective January 4, 2016, we acquired Aon Hewitt's RPO services. These acquired operations expand and complement our PeopleScout services and have quickly been fully integrated with our PeopleScout services line here in early 2016.

Although we were disappointed by our first quarter results, and the changes to our 2016 outlook that these items resulted in. Our top priority remains to produce strong organic revenue growth and leverage our cost structure to generate increasing EBITDA margins.

We have worked through several soft patches over the years and once again we will work through this one by staying focused on those most important activities that drive organic growth.

We will continue to stay focused one transaction at a time to move the gross margin results back to where we expect them and close this 50 basis point gap that existed in the first quarter against our expectations.

We will be diligent on our cost structure to curtail certain costs and reduce others in order to drive the right results and drive the operating leverage we expect. We have had and continue to have a strong relationship with Amazon by being accountable to the results we deliver against their expectations.

We have met those in the past, as we assisted them in quickly ramping up their U.S. fulfillment centers and we will do the same for them as they ramp up their Canadian fulfillment centers and their U.S. delivery stations.

Acquisitions are a key element of our growth strategy, improving shareholder returns through ramping up the most current acquisitions, along with sourcing, acquiring and integrating additional companies will remain a focus for our team.

In addition, we're committed to technology innovation that makes it easier for our customers to do business and easier to connect people and work. We are making significant investments in online and mobile applications to improve access, speed, and ease of connecting our customers and workers.

We have the beta applications working in about 30 of our offices with fantastic results in reducing the labor hours needed on our support teams to fill assignments, as about 30% of the current assignments in those early beta offices are being filled without any interaction of our support staff. This will reduce the cost of fulfillment quickly.

We are also working on being able to attract and source new workers with the mobile apps, without the need for the high number of recruiting branches in large markets. And we are working on the apps that customers use to place orders and communicate their needs with us without interaction of our support staff.

All these innovations will increase the reliability of our services, improve access around the clock, as no staff will be necessary to take orders and fill orders. We are excited to continue on our testing this spring and complete a rollout later this year.

From our outlook today, you can see our adjusted EBITDA margins for 2016 are anticipated to be higher than 2015. Even in the face of operating disappointments in the first quarter and the annual impact they have on our results, we remain committed to expanding our adjusted EBITDA margins.

Innovations within our company, along with the additional acquisitions, combine well with our existing business to put us in a strong position for the future, to be the leader of talent solutions. We believe the RPO market has tremendous potential on a worldwide scale, which is why we are so pleased we could bring the Aon Hewitt RPO operations into our PeopleScout brand here early in 2016.

I will now turn the call over to CFO Derrek Gafford for further analysis, and to provide details on our results and outlook. Derrek?

Derrek L. Gafford

Executive Vice President & Chief Financial Officer

Thanks Steve. Total revenue grew by 13%, with four percentage points from organic growth, and nine percentage points from previously announced acquisitions. Total revenue growth for the quarter was – or total revenue dollars for the quarter was $646 million, or about $20 million less than our midpoint expectation, as a result of slowing growth during the quarter.

The revenue shortfall was concentrated in the Staffing Services segment, with roughly half the shortfall coming from the branch-based operations, and half from on-premise operations.

From an industry perspective, overall growth in retail was flat, but down 10% within the branch-based business. On an overall basis, manufacturing grew by 5%, aided by new customers in the on-premise business. Excluding the success in on-premise, manufacturing declined by 10% across the larger customer base of the branch-based operations.

Transportation and logistics-related industries were down roughly 5%, while construction continued to show promise for the year ahead, with growth of 10%. On a segment basis, revenue for the Staffing Services segment was up 10%, or 3% on an organic basis. Results were generally mixed for the quarter in this segment. Large customer growth was flat for the quarter, versus an expectation of mid-single-digit growth.

We saw some movements towards a leaner workforce strategy within parts of our national customer base, and these trends continue to show softness entering the second quarter. Less demand from the company's largest customer contributed to the shortfall in the on-premise business.

Small to medium-size customers showed signs of strength, growth accelerated to nearly 10%, in comparison with 5% growth in Q4 2015.

Revenue for Managed Services was up 84%, or 17% on an organic basis. Organic growth was driven by strong growth in the MSP business.

Now let's discuss the company's profitability for the quarter. Total adjusted EBITDA grew by 9%, lower than expected gross profit was offset by lower than expected SG&A expense, delivering adjusted EBITDA of $21 million, in line with expectation. Adjusted EBITDA margin of 3.3% was roughly in line with Q1 last year.

Gross margin was up 70 basis points in Q1, aided by 120 basis points of favorable acquisition and revenue mix. The acquired businesses carry a higher gross margin than the company average and a higher rate of growth in small to medium-size customers, which carry a higher gross margin than large customers, created a positive lift from a revenue mix perspective.

Higher wage costs for contingent workers and challenges in passing through the company's traditional markup resulted in 50 basis points of negative impact. Pay rate inflation topped 5% during the quarter, in comparison with our historical average of 2% to 4%, driven by a combination of higher wages to attract candidates in a tight labor market and state minimum wage increases.

While we are largely able to pass-through the higher wages, passing through our standard markup on these costs has been more challenging than in prior years. While it's not uncommon to experience some challenge on this front during the first six weeks of the quarter with an improvement thereafter, we did not see a meaningful improvement in the back half of the quarter, as we have seen in other years.

SG&A expense of $131 million was $3 million less than expected, as a result of cost reduction actions. SG&A expense was up $19 million compared to Q1 last year, from $9 million of ongoing operating costs associated with acquired businesses and $10 million of higher costs in the organic business. The SG&A increase within the organic business is related to investments made in 2015, which start to anniversary this year in Q3 and Q4.

Staffing Services' adjusted EBITDA decreased 2% and related margin was down 120 basis points, as a result of lower gross margin and higher SG&A expenses, offset by the SIMOS acquisition. The SIMOS business acquired in December 2015 is performing well and meeting expectation.

Managed Services' adjusted EBITDA increased 150%, and related margin was up 560 basis points, largely due to the RPO acquisition. The acquired RPO business is performing better than expected and the integration is on track to be substantially complete in Q2 this year.

The effective tax rate of 8% was lower than expected as a result of higher than expected yields of prior year tax credits associated with the Worker Opportunity Tax Credit (sic) [Work Opportunity Tax Credit] (19:25). Looking forward, we still continue to expect an annual effective tax rate of 32%.

Turning to the balance sheet, Q1 finished with $166 million of total debt, $80 million less than Q4 2015, due to the seasonal deleveraging of working capital from [ph] our peak (19:47) in Q4. Cash flow from operations, less capital expenditures, less cash used in the RPO acquisition was $85 million. Total liquidity defined as cash plus borrowing availability on the revolving credit facility was $115 million.

Looking ahead to Q2 2016, we expect total revenue growth of about 9% or organic growth of 4% excluding our largest customer, or flat on an all-in organic basis. On a segment basis, Staffing Services revenue is expected to be up 7% or 4% on an organic basis, excluding our largest customer or flat on an all-in basis. Managed Services revenue is expected to be up about 60% or 5% to 10% on an organic basis.

Adjusted EPS is expected to be $0.42 to $0.47 and adjusted EBITDA is expected to be $33 million to $36 million or a decline of roughly 5%.

We have updated the full year outlook today. While visibility of future demand is admittedly low in our business, we believe providing an annual outlook will help investors better understand our business in light of changes in our operating trends and the blended impact of our most recent acquisitions. We encourage investors to use our outlook for this purpose, and not as an indication of increased visibility or certainty regarding future results.

I will speak to this outlook on a mid-point basis for simplicity, but investors should thoroughly review the materials provided in the 8-K filing today, to ensure a holistic understanding of the assumptions and risks associated with this outlook.

We expect total 2016 revenue to be in the vicinity of $2.85 billion, producing growth of roughly 6% or 4% on an organic basis excluding our largest customer or a decline of 2% on an all-in organic basis.

This represents a decrease from our previous expectation of roughly $260 million, comprised of $180 million decrease from our largest customer, and $80 million less revenue from the remaining organic staffing business. We expect adjusted EBITDA in 2016 of roughly $165 million or a growth of about 12%. This constitutes a drop of $25 million in comparison with the prior outlook.

I'll now provide a rough breakdown of this change. A drop of about $10 million associated with less revenue from our largest customer, net of cost reduction actions. A drop of about $20 million associated with the rest of our organic business, approximately half of the drop from less revenue net of cost reduction actions and about half from lower gross margin. And lastly, an increase of about $5 million from better performance in the acquired SIMOS and RPO business acquisitions.

There continue to be multiple opportunities for growth in today's environment, particularly among small to medium-size customers and the construction industry, which are key focus areas within our business plan this year. Improving our gross margin trends is a significant priority as is reducing our operating costs.

The 2016 outlook shared today includes $25 million of executable cost reductions, and we believe there are more cost efficiency opportunities ahead. While the recent change in operating trends is disappointing, our excitement remains high about the future for several reasons.

First, the strong secular trends driving long-term growth in the human capital space remain unchanged, rapidly changing demographics, a shrinking pipeline of skilled trades candidates, and an aging workforce will continue to drive businesses to increase their reliance with strategic partners.

Second, our industrial staffing and RPO businesses are market leaders in their spaces, built on specialization that will continue to differentiate us from the competition.

Third, a historical track record of achieving above market growth in revenue and profits. And last, a tenured management team with experience in successfully managing the business across various economic cycles.

That ends our prepared comments today. We can now open the call for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] . Your first question comes from the line of Kevin McVeigh with Macquarie. Your line is open. Kevin McVeigh, your line is open.

Kevin McVeigh
Macquarie Capital (USA), Inc.
Q

Steve, Derrek, can you hear me?

Steven C. Cooper
President, Chief Executive Officer & Director
A

Yeah. Yes.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer
A

Yeah. We can hear you now.

Kevin McVeigh
Macquarie Capital (USA), Inc.
Q

Okay, great.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

We're getting a lot of feedback there for a minute.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Oh! Sorry about that. Hey, thank you so much for the detail, very, very helpful. My question is, Steve, if I heard you right, it sounds like this is more of a soft patch as opposed to meaningful change in fundamentals, maybe just the Amazon change in scope weighing on the results a little bit. Can you help us understand that we're thinking about that right? Number one. And number two, how much – and I could do the math, I just – unfortunately I don't have my model in front of me, how much of the business is Amazon today? And how should we model that over the next couple of quarters as that scope runs off?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah, thanks. Thanks, Kevin. I will take the first part of that question, while Derrek would grab those numbers on that account. We've been here before, where the first quarter is a bit soft and organic revenue falls off a bit, and really in the last couple of years we haven't had strong organic growth in the first quarters, and where the year turns out as a whole okay, and last year we had a booming second half.

This is a bit different. The strong economic growth and especially in temporary staffing has been driven by large accounts in the last five years, where in our branch-based delivery system we've moved our large accounts from 7% up to 25% plus. And now we're seeing that at the front end of 2016 that some of these larger accounts are – they have reduced their orders. And a lot of its project based work, where we were helping them with remodels or resets or very large projects, even our energy business is very project driven, and some of these larger projects with larger customers have become soft. That's the downside of what we're seeing Kevin, here in Q1.

The upside is these small and mid-size accounts, and the investments that we've made in our business during 2015 are really paying off, because that other 75% of our business is growing. And so we believe the things and the strategies we put in place are working, but when a large account changes its strategy to not do any remodels in the first quarter, there's not much we can do about it. So that's the first part of that question.

I think I walked through our largest account with Amazon and the reasons why they made a shift, and what that means for us, and it's a little bit of a slowdown here in 2016, but we [indiscernible] (28:08) back on the high growth engine with them as soon as we stabilize and help transition the business around, and as they do it a different way, so we can reallocate our resources to their highest growth.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

[indiscernible] (28:21) some of the outlook.

[indiscernible] (28:22)

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

That business represented about $350 million of revenue in 2015, and we are talking about a revenue base this year of approximately $200 million.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Okay. And is that – is it fair to say, Derrek, [Technical Difficulty] (28:41-28-47)?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Try repeating that one more time, Kevin. You cut out.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Sorry about that. The margins associated with that business, are they below the corporate average in line or how should we think about it from a margin perspective?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah, they're a little bit south of the company average.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Okay. And then just my final question. How long would it be before you would start to see some of that come back in terms of change of scope to services with Amazon? Is that two quarters or three quarters or how does that typically play out?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yes. These are new conversations we're having and they're sharing their plans with us in where they need us. And so it's going to take us a couple of quarters to ramp down some of the sites, and we're not going to help them in certain fulfillment centers in the U.S. during the busy season, and we're going to start reallocating some of those services to the delivery stations.

That ramp up, some of it will take place in 2016, and that's built into our outlook that we've provided today what the net effect is, and then we kind of draw a line there, and 2017 might not show a lot of growth from the numbers that we provided today, as we still have a little bit of takeout here in the next couple of quarters, replaced by these fulfillment centers – or these delivery stations, but what they've shared with us, and the growth of – as they bring those on, it's pretty exciting. And we reestablished that growth, and it's going to take us four quarters, Kevin, to work through this and start seeing the growth again.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

It's helpful. But again if I – my kind of key takeaway feels like it's more one-off-ish as opposed to macro specific?

Steven C. Cooper
President, Chief Executive Officer & Director

A

I think so, on this one. This is an account that has rapid growth in them, and they have had at the last five years, and this is a new form of business trying to get the delivery station closer to the customer, so they can deliver faster, and they're basically sorting centers, where the fulfillment is done in a bigger center, and now they're trying to get the package sorting on more timely delivery to the customer. So it's a growth part of the business for them, and we're excited about it.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Understood. Thanks, guys.

Operator: Your next question comes from the line of Jeff Silber with BMO Capital Markets. Your line is open.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Thank you so much. Just a focus again on the business with Amazon. Can you break out the business between the Staffing Services and the Managed Services? You mentioned its $350 million in revenues last year. What was the breakdown for that?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah. This – hi, Jeff, it's Derrek here. The revenue that I talked with you about its – this is really all Staffing Services. There's a very immaterial amount that we do outside of the staffing space. So this is a staffing conversation.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Okay. Great. That leads to my next question. I'm just curious why we're looking for such a sizable decline in organic growth in the Managed Services business, if Amazon doesn't really have much to do with that?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

From an organic perspective you're talking, Jeff?

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Correct. You did 17%, I think, in the first quarter?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yes, of organic growth?

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Yes.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

And you're saying, why wasn't that...

[indiscernible] (32:03)

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

I'm sorry. Your second quarter guidance looks for a really steep decline in that number. What's impacting that?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah. Sure. Sure. Well, let's talk about what boosted the performance in Managed Services. A portion of that was our MSP business, which – what we're talking about here is, in Managed Services, is roughly a – let's call it a $150 million to $175 million business. We have an MSP business that makes up [ph] $20 million to $25 million (32:35) of that, and they had a very strong quarter this quarter.

[ph] Brought on (32:39) some nice accounts, it was growing well last year, and those accounts picked up pace. That's been offset by some softness, though, in the legacy RPO space. As we finish the fourth quarter and entered the first quarter, we were – we had some pushback from customers, just as far as our larger customers, their feelings about the economy and some hiring freezes, and that's really incorporated into our outlook.

That did tend to loosen up a bit here towards the end of the quarter, as far as feedback we were getting with clients, but our largest customers in our RPO space here domestically have been very cautious with their hiring outlook, and that's the main thing.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Okay. Let me play devil's advocate a bit here. I do appreciate the fact that you guys do give annual guidance, most staffing companies do not. But considering the relative lack of visibility in the business, why continue to stick your neck out by giving 2016 guidance?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah. I appreciate that. We did it in the first quarter, because the two new acquisitions did come on, and there was a bit of noise, even in our own numbers, so just to bring clarity around our cost structure and what we felt margins would be. Now here we are in the second quarter, and there's been a change with a large account, the new acquisitions are still coming on. So this is really about, if you take Q2's revenue, which we feel we have some sense of what it will be, and then build in a cost structure and a margin structure around that, so it's just giving you our best [ph] hand (34:18), Jeff.

As Derrek mentioned a couple of times, it's not us trying to make a guess on the long-term economy, it's just what we see today. So we can better give you what's on our minds, because we have a bit more information than you have, but not trying to reach out and us understand any better today than we knew last year, when we didn't.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

And let me add just a little bit of...

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Okay.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Color to that, Jeff. I appreciate the question. Steve's right on the mark here. We can't really say it enough times, not to take this as a sign of visibility or precision that we have, but given the fact that we've given an EBITDA outlook and revenue outlook as we started off the year, and clearly things have changed. Two reasons for that, to add on to Steve's comments. One is, clearly conditions have changed, and if we didn't go out with that, we feel like we'll be doing everybody a disservice.

And secondly, as you would imagine with some change in operating trends, there [ph] become (35:13) questions about how we're going to run the business outside of the second quarter? And if we're not out there with some form of annual guidance, it – from a Regulation FD perspective, it really limits what we can say, and we wanted to be able to talk openly and freely about how we see the year, how we're going to make adjustments, and hit it from a big picture perspective outside of just our normal guidance that we provide for the most upcoming – next quarter.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Okay. I appreciate that. It sounds like you put a lot of thought into that. And just a quick numbers question, I'll let somebody else jump on. The Q2 adjusted EBITDA guidance, what's embedded from a gross margin and an SG&A perspective? Thanks.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

From an overall gross margin perspective, we're talking about, you know, in the neighborhood of about 24.5% on a gross margin basis. And we're talking about an SG&A increase over the same quarter a year ago of roughly what we had in Q1, call it 16%, 17%. That would put you in the neighborhood of, on an SG&A basis, between $135 million to $140 million of SG&A. Included in that number that I just provided is about $3 million of integration-related costs that will be excluded from adjusted EBITDA.

Jeffrey Marc Silber
BMO Capital Markets (United States)

Q

Okay. That's really helpful. I appreciate it. Thanks so much.

Operator: Your next question comes from the line of Sara Gubins with Bank of America Merrill Lynch. Your line is now open.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Hi. Thank you. I wanted to follow-up on a couple of things. First, just going back to Amazon, were there any service issues or other issues that came up that might explain why they're pulling back in one area and growing in another, as opposed to just growing with you as they grow?

Steven C. Cooper
President, Chief Executive Officer & Director

A

No. We have really tight metrics with them, and we have really hit those service metrics well. This is a shift in how they want to grow, and as certain lines of business mature, they're showing their hand, that they can do some of this themselves. And some other lines of business that mature, they're going to figure out a little bit different way to do it.

So now, in these new delivery stations, it's new and there's more of them, they're smaller staff and they're going to need more help, because it's more spread out, but in some of these larger centers, they're – the growth is stabilizing on how many they need in the United States, and now it's time for them to focus on something else, so.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Okay. So you're not being replaced by a competitor in this case, it's just that they're bringing it in-house?

Steven C. Cooper
President, Chief Executive Officer & Director

A

I think there's a mix of what they're doing. We don't have all of their exact plans, but there's a couple different strategy shifts that they put in play, and some of it is – learning how to do some of it in-house, some of it's switching it to the other partner they have, so we could be freed up to work on some other things.

So, they do like to have more than one partner doing things. So for us [ph] to continue to (38:28) grow, take on more and when they reduce scope for all partners, then they did consolidate some of the services to the other partner.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Okay. And given the $175 million cut this year on the base of $350 million of revenue, can we think of that $175 million as being like $240 million on an annualized basis, just given the time of the year that they're doing the cutting?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

There's two important numbers here when it comes to this client, Sara. So compared to last year, we're talking about roughly $150 million less of revenue. In our earnings release deck, we are bridging between our last guidance that we provided, and the updated guidance from a revenue perspective, and that is where you're picking up the $175 million of revenue.

The difference between the two is the amount of growth that we expected to have in that account this year. So put another way, we did about $350 million last year in revenue, and we were expecting to do approximately $380 million this year. We are now saying we will do approximately $200 million this year.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Got it. Okay. Okay. And that will kind of bleed into 2017 as we think about it, because it will take time for the new business to start to ramp up?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

There will be some bleed into 2017, from an EBITDA perspective though, what we have now, and some discussions about the potential for some future business, which has been discussed with us, we think we're at a relatively stable EBITDA base at this point.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Great. Okay. And then just turning back to gross margins and the challenge of passing on the wage increases, are you finding that your competitors are willing to give up something on pricing in order to get business? I'm wondering if these are competitive issues where your clients are saying that they wouldn't take the markup, or is it more just negotiation and not wanting to lose the client perhaps to them hiring on their own? I'm wondering what the competitive dynamics look like?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yes. It's a tough questions, because we have 130,000 customers, and it's hard for me to represent all 130,000 of those conversations. So a lot of mine has to go off of trends and conversations I have with broader sales teams of what's going on. But in the phase of a little bit slowing demand and as Derrek said we made some pretty good headwind in the first six weeks, but we didn't move the number on that compression in the last six weeks. That was the exact same time that we were feeling a little bit of fall-off in demand.

So when you're not replacing new work and there's not growth in your demand, historically we have had a bit more struggle getting pass-throughs done. So it's more of an environmental issue than a competitor taking us out or competitor getting it done. But there's been some pretty stiff minimum wage increases around the country, and we've had those conversations and as Derrek mentioned, we get the wage pass-through, but it takes a bit of time to gets the extra markup pass-through. We still work for it.

As we take on new accounts or we re-price business, it's easier. But when you're working with an account that's not growing or account that's not changed in their volume, it's a little bit tougher to move those bill rates as fast, so it's kind of a mix bag right now.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

One additional challenge that we've had here, Sara, and I don't want to make a light of the challenge here in front of us, because it is something that we still have to work on, and we're seeing some movement on this gross profit – gross margin side, but one dynamic that's a bit unique is, the minimum wage in California this year – at the beginning of this year moved up by $1.

It's a big increase. And along with that there's some new sick pay regulation in the State of California along with that. That's our single biggest challenge. And so it's not uncommon when we come out of the gates, particularly in a region like that with that size of increase to not be getting – it's not that we don't generally get the costs pass-through, it's getting our markup on top of that, that's the primary challenge.

Now, getting that with existing customers is more challenging than it is in pricing in new business. We saw elements of this in the – about a year and a half ago when we had a similar increase in the State of California. So we're still optimistic that we'll work out of this like we did before, but it is a tighter overall labor market out there and so it is the challenge that we're talking about does extend some beyond the State of California.

Sara Rebecca Gubins
Bank of America Merrill Lynch

Q

Got it. Okay. Thanks so much.

Operator: [Operator Instructions] Your next question comes from the line of Mark Marcon with R. W. Baird. Your line is now open.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

HI, Good afternoon, Steve and Derrek. Can you talk a little bit about what you can do on the SG&A front in terms of making adjustments? You've alluded to making some changes, but wondering if you can give a little bit more clarity with regards to the scope and extent and when those would start hitting.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Certainly. You certainly can, Mark. I think it would help to frame this discussion into two categories. The first, I'll call it the blocking and tackling area. This includes things that would fall into talking a look at head count that's been added, is a productive, also looking at our productivity levels internally compared with the economic dynamics that are going on in a certain metro market, we want to be look at from an internal perspective as well as what the opportunity is in a market. And so a lot of that has to do with some basic blocking and tackling there.

We've been working on and still believe that we have some additional synergies from a vendor perspective that are out there. Somewhat related to the consolidation or the – and the integration of bringing Seaton on and some volume discounts and such. So let's [indiscernible] (45:00) first category.

The second is our more fundamental changes and sustainable changes and how we do business. And so, Steve talked about one example here and that's our use of technology to automate – further automate the matching of jobs within our branch network.

So, what we're talking about here are our more algorithm matchings that will we believe drive – can drive a sizable amount of efficiency from an operating expense perspective as well as capture some more wallet share.

Other things that would be on that [ph] list and (45:34) as far as changing the game from a cost center perspective. We're excited about some of the India operation that came with the RPO acquisition that we did from Aon Hewitt earlier this year, both in not just leaning down the cost structure and how we deliver our RPO services, but leveraging that model and that environment to lower our overall cost structure and how we're doing some services at TrueBlue holistically.

And there were some other things in there as far as centralized recruiting and technologies that we can use to attract candidates. All of those would fit into Category B to further lower our operating costs.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

And so those operating efficiencies are built into your full year guidance, is that correct?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer
A

Now, really what's built into the guidance, there is about $25 million of cost reductions built-in right now and so of the revenue decline that we talked about, those are – and this has come on relatively fast by the way both the drop off in the broader business as well as this news from our largest customers.

So what has incorporated in there now is really the costs to size the SG&A base related to those specific revenue drops or put another way, take the variable costs associated out of that and exit some on-sites and such.

So this other area category – the second category I talked about more sustainable ongoing changes to our – the approach that we take in delivering our sources, our services, there's really nothing built-in for that right now.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)
Q

And I mean you – we've been talking about technology improvements for a while and you've been executing against those. I mean how attainable would some material change be relative to what you've already captured and particularly in terms of putting it in place this year or in the next 18 months?

Steven C. Cooper
President, Chief Executive Officer & Director
A

Yeah. It's been an initiative of ours for quite some time and we're making good progress. I kind of broke it down into three categories when we first started this over a couple years ago, reducing the dependency on our local branches and we could bring a number of them down.

As Derrek talked about the largest cost that we have is head count and so that's about half of our SG&A. And then the next largest is facilities. And so, ensuring that that we have those right-sized at all time is something that's really important. The initiative to say, well, how do we reduce the dependency on that local branch for its recruiting and operational needs is, we first started in the morning, over three years ago that we started texting out the job assignments, so the workers didn't need to come to the offices in the morning, about the same time we started paying them on pay cards, so they didn't need to come into the offices [ph] in the night and pay them (48:42)

And over the last couple years, we've been working on, well how can we reduce the dependency on the day-time operations of what takes place in these branches, so we can take one more large swipe at right-sizing the organizational facilities, which is the key to right-sizing the head count. Because once you have a facility, you need at least a minimum of three to four people to run it and our goal is in larger markets is to work in teams and reduce the facilities and then we can right-size the head count faster.

So this last day-time push is all around recruiting the candidate and interacting with the customer. And so how does that work? How do they submit orders? And how do they know what's available? So this last bit of work is still underway, but we're getting closer on it.

The rollout of what we're working on this year, reduces the fulfillment which happens – replaces the texting, if you will. It makes it stronger. So we'll take the texting system out as we put this mobile app in and it's just a stronger, more sticky way to ensure we have the workers and have them ready to go.

So I think it's going to help us with our long-term worker pools and management of our workers. It makes it more enjoyable for the workers to work with this. It's easier for them to check-in on the app, see what jobs are available, how far they are away, what the assignments are, what the requirement is, what the pay is and accept the assignment. And they can do it when no one is in the office.

So we're well on our way to improving fulfillment, but we still need to improve filling the pipeline of candidates and giving the customer a tool to place an order and interact and pay their bill, work with us on problem solving during the day. And when we get that fixed, then in these large markets, 300 markets where we probably could take out another 150 branches fairly quickly.

So later this year is when we'll give you that signal, but we were on a pretty good pace to closing offices and increasing productivity per head by reducing overall head count and that's been slowed a bit the last 12 months to 15 months as we were shifting some of that labor into more sales positions and recruiting positions to ensure we keep the pipeline full.

Now, the good news, Mark, is that local selling and that local recruiting is getting really good results even in the midst of our bad news today, we have strong results in our local recruiting and selling and that's fueled by these initiatives that we're working on. And now we just need to take a step further in the next six months and reduce further dependency on these recruiting branches and get another 150 branches [ph] have been closed (51:33) and the head count cleaned up, which was what was to pay for these new recruiting and sales people that we added last fall. So we're in the midst of crossing a bridge here that we're not all the way across.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

And of the 150 branches, how many are closed?

Steven C. Cooper
President, Chief Executive Officer & Director

A

No, they're all open. I'm just saying we could take another 150 branches out when all of these initiatives are done.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

So, over the next two years?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah. Probably not start again for another six months, to ensure that we have some of these things in play and then [ph] we add then (52:05) over a 12 month, 18 month window from there, take another 150 branches out. So, your timeline is about right.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

Okay. Great. And then, with regards – you mentioned the SMB portion of the business is doing well. How – when you talk about that portion of the business, how big of your Staffing Services is that?

Steven C. Cooper
President, Chief Executive Officer & Director

A

It's about 75% of our business.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

75% of the staffing business, exclusive of the largest client?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah.

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

Okay.

Steven C. Cooper
President, Chief Executive Officer & Director

A

In the branch-based business...

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

Okay.

Steven C. Cooper
President, Chief Executive Officer & Director

A

...of staffing, so.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

And this with regards to what you ended up seeing between February and March, was that consistent across the country, or was it really just some of those really large accounts that – where that really was pronounced?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah. No, it's where those large accounts existed, and it's spotty. We have some strong states that are showing strong revenue growth, and so it's – really it's where those large accounts were. So, for instance, Walmart, we didn't serve them heavily in the West and – but California is growing through that, even though, as Derrek mentioned, we're having some margin compression that we're fighting there, but at least the top-line is growing through that, and we're working through that. That's what gives us hope that that's going to bounce here. But things like that, it's around where these large accounts were being served, it's very spotty.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

So it's not necessarily a reflection of the macro environment per se?

Steven C. Cooper
President, Chief Executive Officer & Director

A

It doesn't feel like it, except related to those large accounts and you'd have to know what they're feeling and whether that's macro or not, but it's hard for us to give you a state-by-state rundown and say that's macro driven. It's really being led by these relationships with these largest accounts.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

And then the last question, and I'll jump off and follow-up offline. But with regards to Amazon just, as you think about what the prospects are beyond this year, when they talk to you about those smaller delivery centers, how are they – what sort of opportunity does that look like in a year or two years from now?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Yeah. They've shared with us what their outlook is, and that's not for us to share for them, but it looks good for us and we have great relationships there. I mean we were asked a question earlier, is this service related? And it's absolutely not. They have put us on one of their toughest problems to solve, based on our track record with them.

The unfortunate part is, the business matures and they figure out how to do it in-house and they figure out how to do it for a lower cost and they come up with a new formula, that is one of the challenges have been in our business. That's why people – customers use us is – and that's what we sell, is that flexibility and then, when that flexibility happens, it's hard to talk to our investors the day that it happens with these very large accounts.

We've had to do it a couple times over the years, but it's nice to ramp up with them and, on a day they have a bit of a scope change, makes it a little bit more difficult. But what we do know is, their business moves rapidly and they are a leader out there in the online commerce and they've given us news over the past at times from here to there, and sometimes it can change in a few months, based on their own volumes and their own business.

So we've kept a great relationship with them. We're working through these transitions on a great partnership level with them and keeping our head up and moving forward with them, because that's the best way to be a great partner with that account.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

I mean, would you expect that that account would return to its prior size within a couple of years, or is that too hard to say?

Steven C. Cooper
President, Chief Executive Officer & Director

A

Well, [ph] they're certainly (56:06) forecast for that. We're having a hard time just getting through 2016 and forecasting out what that looks like. But we're – yeah, as everything balances, it's not a overall disappointing place for us. We've just got to work through the balance in a 12 month to 18 month window.

Mark S. Marcon
Robert W. Baird & Co., Inc. (Broker)

Q

Great. Thank you.

Operator: Your next question comes from the line of Randy Reece with Avondale Partners. Your line is open.

Randle Glenn Reece
Avondale Partners LLC

Q

Good afternoon. First question, where did you expect staffing – or let's just say, how much different were the staffing gross margins versus your expectations in the first quarter, and how much did they change for the year?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Hi. Good afternoon, Randy. The staffing gross margins are about 50 basis points to 60 basis points, actually for the year, the gross margins are probably looking up about 50 basis points to 60 basis points lower than what we had originally expected and that's incorporated in our guidance here. For the first quarter, it's maybe 60 basis points to 70 basis points disappointment.

Randle Glenn Reece
Avondale Partners LLC

Q

It's kind of hard to peel off because of the effect of the acquisitions. The SG&A margin was elevated, I would think that would be primarily just the deleveraging effect, but you had indicated that there were some inefficiencies in the Managed Services business that you were hoping to take care of. Did you make progress on that front?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah. Our team has done a really nice job in the Managed Services side of the house as far as restructuring the – what the head count looks like there. I mean we've been really pleased with some of the movement that's been made there.

From a consolidated perspective, you're right. I mean SG&A, and I'm taking out any differences in one-time costs that we had planned. Let's call it on an adjusted SG&A basis, the costs actually came in $3 million less than what we had expected. And so the difference in the SG&A as a percentage of revenue is really all about the deleveraging.

Randle Glenn Reece
Avondale Partners LLC

Q

When I look at the construction business, I'm wondering if that is coming in in line with your expectations, or is – that has continued to be a little soft at the beginning of the year?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Well, the overall – construction was up 10% for us. So, certainly above the organic trends that we've been talking about here. So we're really pleased with that. The first quarter is a seasonally – our seasonally lowest from a total revenue perspective in the quarter, so it's lower in our mix. So we're still quite optimistic about the season ahead as we get into some warmer weather months. So 10% growth we'll take that.

We continue to get good feedback from our sales teams about what pipelines look like. I think we'll have a much better indication about if that holds its ground or possibly even accelerates once we close out the second quarter with some of the more traditional warm weather work that we do in that area.

Randle Glenn Reece
Avondale Partners LLC

Q

All right. Thank you very much.

Operator: Your next question comes from the line of Kevin McVeigh with Macquarie. Your line is now open.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Hey guys. Could you just give us a sense of how the trend in April has been relative to March?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah. It's a little tough because [indiscernible] (1:00:06) we had this Easter holiday moving around, but – Kevin you might need to put yourself on [indiscernible] (1:00:11) coming back in there.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Okay. Sorry about that. Can you hear me?

Derrek L. Gafford
Executive Vice President & Chief Financial Officer

A

Yeah. I can hear you. Okay, that's great right there. So going into April, the trends are generally right in line with our guidance, small to medium-sized businesses still looks – the growth looks good there. The larger customer trends, our national account trends as Steve mentioned continue to be soft.

From a gross margin perspective, early on, it looks like we're getting a little bit more movement on this. So that looks like it has some opportunities as we go into the second quarter. And that's probably about as much as I can give you until we – April is a tough one to give exact percentage in the way that Easter holiday moves around. But it looks right on target with what we're talking about from a guidance perspective.

Kevin McVeigh
Macquarie Capital (USA), Inc.

Q

Got it. Thank you.

Operator: There are no further questions at this time. I will turn the call back over to Steve Cooper for closing remarks.

Steven C. Cooper
President, Chief Executive Officer & Director

Yeah. Thank you. We sure appreciate your questions today and the interest in being on the call and we'll update guidance as we go through the next quarter. Thanks.

Operator: This concludes today's conference call. You may now disconnect.