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Conference Call Transcript

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PRESENTATION

Operator

At this time, I would like to welcome everyone to the Hudson Highland Group's first quarter earnings call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question and answer [OPERATOR INSTRUCTIONS]. Mr. Kirby, you may now begin your conference.

David Kirby – *Hudson Highland Group – Director of Investor Relations*

Good morning, everyone and welcome to the Hudson Highland Group conference call for the first quarter of 2005. I am David Kirby, Director of Investor Relations for Hudson Highland Group. The call this morning will be led by Mr. Jon Chait, Chairman and Chief Executive Officer, and Mr. Richard Pehlke, Executive Vice President and Chief Financial Officer. Before we begin, I will read the safe harbor statement.

Please be advised that except for historical information the statements made during the presentation constitute forward-looking statements under applicable securities laws. Such forward-looking statements involve certain risks and uncertainties including statements regarding the company's strategic direction, prospects and future results. Certain factors including factors outside of our control may cause actual results to differ materially from those contained in the forward-looking statements including economic and other conditions in the markets in which we operate; risks associated with acquisitions, competition, seasonality; and the other risks discussed in our filings with the Securities and Exchange Commission. These forward-looking statements speak only as of today. The company assumes no obligation and expressly disclaims any obligation to review or confirm analysts' expectations or estimates to update any forward-looking statements whether as a result of new information, future events, or otherwise.

I will now turn the call over to Jon Chait.

Jon Chait – ***Hudson Highland Group – Chairman & CEO***

Thank you very much for joining us this morning. As we have done in the past, I am going to comment on the trends in the business as we saw them in the first quarter and then turn over to Richard Pehlke, our executive vice president and chief financial officer to talk about the financial results in more detail. The two themes in my remarks are going to focus on revenue growth and operating leverage, both of which came through in the first quarter. I am very proud of the contributions made by all of our regions to our results in the first quarter. In North America, we saw strong revenue growth and improving profitability. In Europe, we saw a very substantial turnaround and profitability as well as significant revenue growth. In Asia Pacific, we saw continued profitability and an improvement in profitability as a result of excellent expense management. In our smaller Asian countries, we have very strong revenue growth.

Turning to the individual regions for some additional detail. Hudson North America achieved the largest revenue growth with a revenue increase of 54% and a gross margin increase of 60% in Q1 compared to Q1 of the prior year. This was fueled by a strong growth in our core business lines of IT, legal, accounting and finance, and engineering, aerospace and defense. In Hudson Europe, we achieved an increase of 19% in revenue and 16% in gross margin in Q1 compared to the prior year. In constant currency, the revenue increase was 15% and the gross margin increase was 12%. We had constant currency gross margin growth in U.K. of 18% and in Belgium of 20% with strong growth in the smaller operations in Spain and in the Nordic region. Hudson Asia Pacific had an increase of 4% in revenue growth which was 1% in constant currency. It was led by very strong constant currency increases in our smaller Asian operations which are rapidly growing – particularly in China, which grew more than 100% in the quarter, Hong Kong which grew more than 50%, [and good growth in] Singapore and Japan. Constant currency growth in the New Zealand market and in Australia was weaker, but as we will see profitability was excellent.

Turning to EBITDA, as the measure that we have been talking about in terms of profitability in this quarter and for this year, we are talking about consolidated EBITDA rather than adjusted EBITDA. Our target in terms of EBITDA and improving our operating leverage has dropped between 25% and 50% of the increase in gross margin dollars to the EBITDA line. We think this is an ambitious target. We believe it is very comparable to our competitors. In fact, we think it compares very favorably to the operating leverage that our competitors are recording. We believe it is reasonable for our company at this stage of the economic cycle in most of our markets. Of the $18.5 million increase in consolidated gross margin in constant currency, $13.5 million dropped to EBITDA. Our constant currency expenses were very well managed. They were only up $5 million or 4%, and our expenses as a percent of the revenue dropped to 35.5% from 40.6% in the prior period. In Hudson North America, we achieved an EBITDA of $2.8 million compared to a loss in the prior year, which was an improvement of over $3 million.

Hudson North America achieved EBITDA equal to approximately 2.5% of revenue in a historically week quarter and returned 37% of increase in gross margin dollars to the EBITDA line. Hudson North America increased its temporary gross margin to 20.8% of revenue from 19.5% in the prior year. Hudson Europe achieved the largest turnaround in the company in the first quarter. It achieved an EBITDA of $3.3 million compared to a loss of $2.7 million in the prior year for an improvement of $6 million. Hudson Europe achieved an EBITDA equal to 2.7% of revenue and returned 84% of increase in gross margin dollars to EBITDA line. Profits were achieved in the U.K., Belgium, Netherlands, Central Europe, France, Spain, and the Nordic region.

Hudson Asia Pacific achieved 6.8 million compared to 2.1 million in the prior year reaching an EBITDA of 6.6% in the quarter. This region was the largest in terms of sheer profitability within the company and featured excellent expense management in Australia and New Zealand, and strong revenue growth and profitability growth in the smaller Asian operations in Singapore, Japan, Hong Kong, and China. Our Highland Partners operation also experienced a significant turnaround improving to $0.4 million EBITDA from a loss in quarter 1 of 2004 on flat revenues. In the North American market, we achieved revenue growth of 22% which is by far our largest business. Consolidated net income was a loss of $4.1 million for the quarter, including depreciation of $4.9 million in tax and $1.4 million. Our depreciation charges are running at approximately $18 million a year (it will be approximately $18 million for 2005) although our capital expenditures are running at a lower level that would imply a lower depreciation charge over a period of time.

Rich will comment in more detail on the reason for the income tax charge notwithstanding the negative net income.

I want to make mention in closing of our guidance for the remainder of 2005. Our guidance is raised in terms of constant currency, and assumes comparable revenue and gross margin percentages for the rest of the year. We currently believe that assumption of 12% to 15% revenue growth for 2005 is reasonable, resulting in a full year EBITDA range of $22 to $29 million. If you look at what we announced in our press release, as to our assumptions of revenue growth and our major regional markets, we mentioned 30% to 35% in the Hudson North American market and 10 to 15% in Hudson Europe and 0% to 5% in Hudson Asia Pacific and Highland Partners. In the last 3 regions, those estimates are comparable to our current run rates. In the North American market our estimate is below the run rate in the first quarter of 2005, but we are looking out at a comparison in the second half of the year against a very strong period in 2004. You might remember that was a period in which Sarbanes-Oxley fueled accounting and finance and there was very significant growth in the IT business in the North American market. As a result, we think 30%

to 35% annual growth rate for the Hudson North American business is a reasonable assumption at this point in time. With that I will turn over to Rich to look at the financial statements in more detail.

Richard Pehlke – ***Hudson Highland Group – EVP & CFO***

Good morning everyone. I will touch briefly on the couple of topics relative to the financials and then we will move on to the Q&A. I just want to reemphasize a couple of points about the currency impact on the quarter. When you look at the quarter year over year, currency boosted both revenue and gross margin, contributing to 6% to the percentage gain in revenue and 3% to the percentage increase in gross margin, and about a $0.5 million impact on the EBITDA. On a sequential quarter basis, it had virtually no impact on EBITDA, and a very minor impact on both revenue and gross margin. So, as has been the case all long, it has been almost a natural hedge with revenue and expenses relative to the currency fluctuations in our region. Most of the larger fluctuations came in the Asia Pacific region.

Another comment about the reported revenue gross margin results, in our Hudson business globally, we did benefit from additional billing days in the first quarter which contributed approximately $1.7 million in gross margin and about $300,000 contribution in EBITDA, of which two-thirds of both these totals roughly happened in North America. Jon touched on the expense growth, which again we are very proud of our people, and their response in diminishing expenses worldwide. In particular, the net salary related expenses decreased year over year to 2%, and 4% in constant currency. Our salary and related expenses which we would expect to increase 9%, 7% in constant currency, which reflects purely the growth in our business and the salary benefits related and growth commission related to the growth and gross margin. When we look at the sequential movement of expenses, the G&A expenses actually grew a bit over quarter 4 by 9%, 7% in constant currency. But before you get alarmed at those percentages, there is about a $2 million increase on the size of our business, so it is really a very small amount. I think again it is more support-related cost to the growth in our business. Salary expenses for the same period sequentially actually declined, so again we are very proud of the run rates that our people are dealing in terms of holding the line on expenses and delivering operating leverage as Jon touched on.

We had a small adjustment in the restructuring lines as we said before that we are not adding to the restructuring lines in any way. However, we are required by accounting rules that if we had an estimate or a charge related to say real estate restructuring that we record the path that we need to true up and follow the accounting treatments that we recorded earlier. That is the case in the first quarter. We recorded about $0.5 million of expense as we finally exited a property that we had made a provision for, and that property is now gone off our books.

I have continually updated you on our outlook for depreciation. We currently think depreciation will run in the $17 million to $18 million range for the full year, and that the run rate that you see in the first quarter will continue to move its way down as we hit the second half of the year as we have commented on that previously. There is no change in our CapEx expectations for the year which still remain in the $10 million to $12 million range. Jon touched on it earlier that we did have tax expense in the quarter. I think it is important to understand why this looks from a book perspective a bit of an anomaly. We do record income tax expense in our Australia and New Zealand operation, where we no longer have tax loss carry forwards. And that has been historically our most profitable region so we do record income tax expense. We still have significant tax loss carry forwards in both U.S. and Europe. The total gross value is just over $288 million with an estimated benefit of about $86 million dollars, but as we continue to record profit in U.S. and Europe we should be able to utilize those tax loss carry forwards and over time minimize our book tax expense, and certainly turn those operating profits into cash.

The last thing I will touch on is the cash. We finished the quarter with $12 million in cash. You may note that we have had a dramatic growth in our accounts receivable – $25 million. The quality of our accounts receivable remains excellent, but I think it is important to note here that we are experiencing strong growth. We certainly had a strong March relative to our operation and we have even seen that trend start to continue at least from the revenue and accounts receivable perspective into the start of the second quarter. Bad debt is not a factor in our business. We have cleaned up that issue and as you see in our financials that it is virtually not a factor in our turnover. We have experienced slippage in working capital ratios in both North America and Europe, where a lot of the growth has been and where we expect a lot of the growth for the balance of the year as Jon outlined. Our growth is stretching our resources because basically we invest in working capital. When we are in a growth mode, as we add receivables to our balance sheet, we pay out the accruals and these related expenses to the growth faster that we collect from our customers. It is just the nature in the business model that we run. So, as a result we are experiencing a faster rate of growth in our balance sheet. It is a quality growth rate. We are working with our lender currently to look at ways that we can adjust the flexibility of our credit facility, so that we can manage the movement in our working capital as effectively as possible. We negotiated this week a $4 million extension to our credit facility to increase the capacity now from $50 to $54 million, and that is now in effect. The reality is that as we grow, we will continue to grow our asset base. The important thing to note here is that this is a quality asset base. I think this is a good problem to have because basically our ability to borrow money to support our working capital is still incumbent upon the quality and the size of our asset base. We are in a different position than we were 3 years ago, both financially, as well as, in size of the business. So, we are working diligently to make sure that our capacity to borrow and manage our working capital is appropriate to our business, and that will be a challenge for the rest of the year. We will

record some additional interest expenses obviously as the year goes on as we continue to grow the business because we will need to continue to dip in and manage that working capital. I will also call your attention to the fact that we still believe that between what we think we can do with our credit facility and the available shelf registrations that we have in effect with the SEC that we believe we have the adequate tools to manage our working capital needs, our funding needs, and our liquidity. With that, I think we are ready to take the questions.

QUESTION AND ANSWER

Operator

[OPERATOR INSTRUCTIONS]. Your first question comes from Matthew Litfin with William Blair & Co.

Matthew Litfin – *William Blair & Co – Analyst*

Good morning. Congratulations on the quarter. You sort of stressed on this just now when you prepared comments but how do you actually feel about your current capital structure - meaning ratios of debt to equity? And based on the cash flow outlook how do you expect that to change as the year rolls down?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Well, how I feel about it and I think we kind of said this in the past Matt is that basically we never had the ability to truly design our capital structure with this business. And one of the challenges we have always faced is that as we improve the business and continue to tweak the portfolio, at some point of time we knew that if we ever hit a very strong growth path we would be challenged with our resources particularly in a year where we still have some hangover from our restructuring payments of charges we took in the first two year of our operations since the spin. I would call everyone's attention to the fact that we also because of our balance sheet over time have had to use about 40% of our current credit facility just in support of letters of credit for our leases because of the quality of the financial condition of the company. Obviously, it is one of our objectives. As this facility rolls of at the end of this year and as we negotiate a new credit facility that we want more flexibility, greater size and certainly something that is more adapt to the current shape of our business and reflects the status of our business 2-3 years ago. So, I would like to have more flexibility in the short-term. I think we are going to get there. I think as I said in my remarks, there is only short-term challenges, but I think over time we are going to have the adequate tools. We certainly have had good responsiveness from our lender and they are working with us, as they have grown to trust us to learn our business better, and we will manage this. But Jon outlined in his remarks that you know some of the areas that we are experiencing strong revenue growth. The only way you grow this business is to invest in asset base because the plain truth of the matter is if you don't invest in a receivable and you go put quality receivables in your books, you don't grow.

Matthew Litfin – *William Blair & Co – Analyst*

Sure. One follow-up, it is more related to the income statement. You guided for revenue growth for the year at a slower yearly rate than you showed in the first quarter. I understand the comparisons get more difficult as the year rolls out, given that there is some debate out there about an economic soft patch recently in North America. Have you seen any slow down in April related to Q1 run rate? I know you touched on receivables in April but then maybe you could talk about just general income statement trends in April.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Well, we are certainly early into the game in the second quarter, but I can tell you that as evidenced by the fact that we have negotiated the additional facility and receivables follow revenue that we have not seen any material change in the movements that was outlined. I think with the guidance that Jon touched on, what we have formally issued reflects kind of our expectations what we thought would happen this year.

Operator

Next question comes from Mark Marcon with Robert W. Baird.

Mark Marcon – ***Robert W. Baird – Analyst***

I was wondering if you could talk a little bit about the dynamics that led to the good sequential growth in North America during this last quarter? As I am sure you are aware that it is in stark contrast to some other players in the industry and I was wondering along those lines, if you could talk a little bit about the monthly trend that you saw as the quarter progressed going into April?

Jon Chait – ***Hudson Highland Group – Chairman & CEO***

I will give you some general comments and I will turn it over to Rich to make sure that the facts are right. I think we ended up the fourth quarter very strongly. So looking at our North American business, we are operating in four big categories, accounting & finance, legal, IT, and engineering. Accounting & finance ended up the year as we all know very strongly because of Sarbanes. We have gone through the first quarter and continuing in the second quarter, essentially flat compared to the fourth quarter. We view that as very positive because I think if you look at my remarks at the end of the year, but I wouldn't say concerned, we were conscious of the fact that Sarbanes could roll off and we could have a short-term impact. We had guided people to say it wasn't a huge part of our business, but it has. It was meaningful. In fact, we have maintained our business which we think is very positive and again we are maintaining the business in the first part of the second quarter. Our outlook for the year is again positive, although we have realized we are coming against a very strong comparison in the second half of that part of our business.

Our legal business is our star for the quarter in North America in terms of sequential growth. It has been a business that has confounded me in that it has yielded continuous strong growth and had a real fantastic quarter. We did have a big project that we landed in the first quarter, although we only have about 3 weeks worth of revenue from the first quarter. These are some very good positions for the second quarter. We had excellent sequential growth in Legal. Engineering, aerospace and defense has been a very steady grower and very steady sequential growth continuing in the first quarter as well. So those three have been the strong points. IT is a business that was sequentially flat in the first quarter, again against a very strong fourth quarter. And I would say as again essentially flat so far in the second quarter. So you have a 35% growth, the 30% or 35% which was our guidance growth for the year that annualized – It is not really a number that we can be too shy about, yet not as good as the first quarter standing by itself but we had an easy comparison, particularly in the accounting business, quarter 1 to quarter 1.

Mark Marcon – ***Robert W. Baird – Analyst***

In terms of the financial accounting and in terms of it staying flat Jon, why were you able to stay flat when so many others weren't?

Jon Chait – ***Hudson Highland Group – Chairman & CEO***

Well I think we have to be honest and say we are a smaller base. And what the advantage of being a smaller base, first of all, is we are more nimble than larger companies. Secondly, to be honest, a few extra orders makes the difference to us whereas say one of the big companies a few extra orders does not cut it. So a few extra orders makes the difference and our team has been I think very nimble in terms of moving in to a couple of different areas that have allowed them to replace the business that we have lost from a Sarbanes perspective. And like everybody we have had a few clients where the projects ended - happy clients that were very satisfied with the work but with Sarbanes the projects ended. So I think we have been little nimble because we are little smaller.

Mark Marcon – ***Robert W. Baird – Analyst***

Okay, how would you expect the kind of trend sequentially as the year progresses in North America? Because the bottom-end of your guidance would imply quarterly run rates below what you did during the first quarter.

Jon Chait – ***Hudson Highland Group – Chairman & CEO***

Well in terms of year and year growth as we look out, we think we will be in a pretty good shape. I'll let Rich comment on what he thinks the magic number is year and year. As we look out to the second half, we had a very strong second half in North America and it is the law of bigger numbers. Our North American company is getting to be a bigger company but again looking at 30% or 35%, I do not think there are too many companies in the industry that are looking at the world in those terms right now in North America.

Mark Marcon – ***Robert W. Baird – Analyst***

If it was 30% and our model is right, it would imply in the last 3 quarters an average run rate in terms of absolute revenues of approximately $108 million which would be below the first quarter performance. So I was wondering, in terms of that middle end of the guidance, would you expect things to just basically run flat on or trend down slightly in terms of an absolute level in the final 3 quarters of this year in North America?

Richard Pehlke – ***Hudson Highland Group – EVP & CFO***

Well, Mark I will jump in a little bit. I think a couple of things, but still the one thing is that our business is never really a pure sequential run rate business. As you know, we tend to have spikes in a couple of quarters. I think we certainly would expect a bigger spike in the second quarter, and I also think quite frankly that one of the risk factors that we have always factor in which Jon touched on earlier is that our legal business is off to a very strong start. That is a project-oriented business that is being fueled by a lot of litigation and M&A activity. Some of those deals may run 18 months, some of them may run 6 months, some of them may run years. I can assure you that we are going to try and make sure that we keep that pipeline full, but the reality is we have to be somewhat cognizant of the fact that the business spikes a lot relative to the type of business it is.

Mark Marcon – ***Robert W. Baird – Analyst***

In terms of the EBITDA guidance, in terms of the margins for 2006, would you need to get significant revenue growth in order to achieve that or are there opportunities as you continue to fine tune the business to kind of get there without having a huge jump in revenues?

Richard Pehlke – ***Hudson Highland Group – EVP & CFO***

I think we have to keep growing the business is the quick answer. As we said many times and I think we have demonstrated it, we keep tweaking the expense base. And I think our people have done an outstanding job and by the same token, the pressure is always on, but the reality is as the numbers get bigger here, our non-salary expenses just are not big enough to drive the EBITDA even if you make them all go away. I mean the reality is you have got to grow the business. You have got to invest in the assets. You have got to drive the productivity. That is why we are looking for the operating leverage that Jon commented on, and we have commented on before. The reality is we have to drive the growth and invest in the growth in the business. Having said that we have always said in terms of how we have tried to guide people about the future is we are not going to let this horse just run away on its own. We have to manage the growth in some respects because of our resources, and because there are places where we could grow the business that would not drive the right operating margin. So, it is a balancing act, because we are not totally where we want to be, but we believe we are all on the path to getting there.

Operator

Your next question comes from Avi Fisher with Harris Nesbitt.

Avi Fisher ***- Harris Nesbitt - Analyst***

This is Avi Fisher. I am on for Jeff. Congrats on the great quarter. Can you give a little more detail on the 2Q 2005 metrics or guidance in terms of revenue growth or margins?

Richard Pehlke – ***Hudson Highland Group – EVP & CFO***

I think you got as much guidance as you are going to get in Q2.

Avi Fisher – ***Harris Nesbitt – Analyst***

But, in terms of revenue growth, it will be obvious that there will be spike in Q2?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

We have always said, Avi, that Q2 tends to be one of our strongest quarters in our year because of our geographic diversity. We have seasonalities that impact our business because of the mix. I think one of the interesting things is that in the results that we had in Q1, we actually for the first time saw somewhat of a percentage shift in the component of our business in geography with North America's growth. It is going to be a long time, with the contributions from Asia Pac and from Europe, there are certain quarters where you see stronger growth just because of the nature of the business. And second quarter should be one of them if the economies hold.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

Avi, just to reiterate it. We are one of the few companies around in the industry that has a major component of our business in the southern hemisphere. So, the first quarter is summer and summer holidays are weak everywhere. They are weak in North America. They are weak in Europe. They are weak in the southern hemisphere. The only difference is January is summer holidays season in Australia and New Zealand, which is a major part of our business that is different from everybody else. Coming into the second quarter, we have a quarter where nobody is on summer holiday. Then, we hit the third quarter, where we have the northern hemispheres on summer holidays. So, Q2 is a good quarter. It was a good quarter last year. We are certain that it will be a good quarter this year.

Avi Fisher - *Harris Nesbitt - Analyst*

A strong growth will drive the operating leverage around the same levels of profitability?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

You are not going to get an answer.

Avi Fisher – *Harris Nesbitt – Analyst*

Alright. What should we be using for tax rates at least for Q2 of 2005?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

The only tax that we should see of any significance is whatever you model for Australia.

Avi Fisher – *Harris Nesbitt – Analyst*

You had mentioned the number – I am just not sure about this $86 million benefit from the tax loss carry forward in North America and Europe.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

That is how much is available to create profit over time. That is correct.

Avi Fisher – *Harris Nesbitt – Analyst*

It is basically an umbrella.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Right.

Avi Fisher – *Harris Nesbitt – Analyst*

Could you specify how many additional billing days there were?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

I think it depended on the regions because of the holidays, but it was about 3-4, and they were in the holiday season. They were weekdays. As I said the total company impact was $1.7 million in growth margin of which just over $1 million of that was in North America.

Operator

Your next question comes from Michael Carney with Stephens Inc.

Michael Carney – *Stephens Inc – Analyst*

Good morning. Congratulations. A couple of questions. In North America just looking at these numbers, it looks like pricing is quite strong. Can you speak to that and tell us why that is so strong?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

I think first of all you have to look at the individual segments. It depends really where you look as to what is happening in pricing, and there are also two aspects to it. One is margin which people tend to talk about when they talk about pricing, but the other issue to keep an eye on is bill rate. And one of the good things about our business, if you look at parts of our businesses, is we have excellent bill rates. So, that has been a feature in the quarter, and maybe I will turn over to Rich to talk about the specific numbers.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Well, yes. Just to give you a feel, one of the things I think we talked about Mike, many times over the quarter as both Jon and I have emphasized is that as we grow in North America, which we still believe is the major growth engine at least for the short-term, we want to move up the overall margin in the temp business. That is where we saw a lot of growth. We have an average margin right now in North American for the quarter of just about 21% in the contracting business. When you think about the fact that that includes still the engineering business, which traditionally has always had a lower margin, that tells you that the new business we are adding is up in our target range of what we have been strategically after. So, that's in the legal, accounting, and IT areas where we are getting the right types of margin. On average our margins in Asia Pac and Europe tend to be in the 14-16 range for the same type of business. So, it does reflect accomplishing somewhat of the objective of putting new revenue on the books as the right target margins.

Michael Carney – *Stephens Inc – Analyst*

I guess I was looking at the bill rate in North America and as the contracting business is up well above 50% and you say unit volume is up 36%, that is really strong growth.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Yes, and that is the point. The bill rate is what creates the margin. I mean it is having our people focused at the right level. So depending upon their source of the labor that they provide, they are getting the right target margins as they deliver the project.

Michael Carney – *Stephens Inc – Analyst*

And then on to Hudson in Europe. That is continuing to or maybe even increasing growth there. I know you obviously looked at contracting business there. The first quarter is seasonally weak. I mean how does that remain strong? Have you already added temp there or is permanent placement just simply much stronger year over year?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

We have not added any temporary business per se. We have not bought anything. We have not started anything. It was a good quarter in continental Europe and contrary to some of the economic indicators, we had a good quarter. In the U.K., we are in the temporary business. That is a significant part of our business, and business was good in the U.K. It was particularly good in continental Europe. So, as we look out to the future, I think you know you have been looking at the company for a while, we still are a company in transition. Our regions are moving at different speed depending on where they started from. The North American market was a business that we made a lot of restructuring moves in 2003 that hurt our earnings. You know it is a tired story that I think investors were tired of hearing about, but they are in position now where they are running straight down the highway. They are not consumed with restructuring; they are growing their business. I think it is pretty hard to say anything other than that the results were. It is hard to find the right adjective – were they excellent, outstanding? They were strong. In the European market, we are in the position where we are doing some restructuring; you can see that in the expense savings in the quarter. At the same time we are growing the business. We certainly expect to keep growing the business even on our current business pace for the rest of this year. As we look out to the future as you rightly pointed out our goal in the future is to build temporary business on continental Europe perhaps through acquisition or perhaps for combination acquisition and again organic expansion.

Michael Carney – *Stephens Inc – Analyst*

Thanks Jon and last question on Highland Partners. Growth seems to be pretty good there, probably obviously productivity, but the profits still do not probably cover the bottom line. Is it just a continued productivity growth story there?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

I think first of all we have to look at it regionally. The North American market, which is the market that is most mature amd the market where we have done the restructuring that had to be done and is completed , we had very reasonable growth, I think it is 22% revenues. We are 5% EBITDA. We do think, I do not know what the other companies do, we accounted pretty conservatively from an EBITDA standpoint at this point in the year. So, we are pretty happy with our Highland Partners business in terms of the progress it has made and establishing itself as a global boutique. We are playing at the right level – our average revenue per partner in North America is excellent. I think it compares with any other major players. In the other geographies, again it is more of a transition story, and so when you look at it as a whole I think it is a little bit different than when you look at individual regions. Rich?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Yes, I think the only thing I will add to what Jon said is that on the geographic region we had a very strong Q1 down in the Asia Pac region last year which probably on a year-over-year basis hurts the comparison this year because it had a unique book of business that we got last year. While it is not a big number it is enough to influence just the Highland results on its own.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

Right. Absolutely. I think it was a project that ran off.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Right, it is a project that ran off. Jon is exactly right. The core of the business is in North America, and I think they are going to do fine.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

In Europe, we were in a transition period. We feel the company has made a lot of good progress in the last year and even in the first quarter in terms of bringing additional people to fit our business model. If you look out over the next year, we think that will be a contributor. So, we are not unhappy with the progress that was made in Europe, although it is not in the numbers.

Operator

Your next question comes from Robert Andrade with Caxton.

Robert Andrade – *Caxton – Analyst*

Nice quarter. Just wanted to get a little bit better understanding on the working capital. As you mentioned, as we grow we are going to see some pressure on the working capital, but just so I am clear as the top-line grows should our DSO's grow as well? And what can we do to combat that ? Is it a matter of manpower or what do you see?

Richard Pehlke – *Hudson Highland Group – CFO*

I think there are a number of factors. You're spot on in the issue in a number of ways. Certainly, just by the pure math it grows because if your revenue goes up everyday, a day's worth of sales is worth more. In particular, in our case – and it can't be lost – you've heard us talk in the past about things that we are doing as Jon said, which is to continually refine this business. One of the capital expenditures we have had in last year and this year was to build a front-office back office system in North America which was surely needed. If you go back 2 years for those of who have followed the company we had all kinds of problems on our balance sheet because we had bad processes, bad collection efforts, etc. We fixed a lot of those things but the fact of that matter is we also are putting investments in because we weren't in a position to support the growth of the business. We saw DSO in North America deteriorate this quarter because it is growing and we are actually stretching our capacity in terms of our ability to bill and collect. Just one small example, our legal business which is a very firm grower has a lot of customized billing requirements. The system that was in place to support that did not allow us on a good efficient basis to get that going to where we would want it and that is being fixed. But the reality is you know we are also growing the business. So it is just a logic of the fact that if we put $100 in revenue books today, it takes a while to get the bill out the door. You collect about 60% to 70% of it next month, you collect about another 20% to 30% of it the next month and maybe trail off in month three. If that keeps growing, you are paying your associated expenses from that in month one and month two. That is just the reality is in managing the working capital. So, I think our people are doing a good job. We are going to keep combating this. I can tell you that I work pretty closely with the CFOs and I am going to continue to make sure that we are looking out the front window and not the back window about our needs. But the reality is we will get through in the short-term, we will be better added in the longer-term. Clearly, I will tell you, and I think it is no secret to those who know the company, this company was not supported in an infrastructure way to support a growing environment. That is one of the key changes we have made and are making across all of our businesses because in reality if you look at our balance sheet it is the only asset we have. We do not invest in capital. The reality is when our business grows, you are going to see accounts receivables grow.

Robert Andrade – *Caxton – Analyst*

Okay. That was helpful. And then one other thing I did not see in this press release but perhaps already mentioned and have missed on the call is long-term goal, EBITDA margin of 7% to 10%. Is that still something that we are clearly focused on?

Richard Pehlke – *Hudson Highland Group – CFO*

That has not changed and we are clearly focused on it.

Operator

Your next question comes from Matthew Litfin with William Blair and Company.

Matthew Litfin – *William Blair & Co – Analyst*

A one quick follow-up if I might.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

I thought we talked to you already.

Matthew Litfin – *William Blair & Co – Analyst*

Employee turnover. Is that something that you are able to track now and how did that trend in the first quarter and what is the relationship with prior quarters, up or down?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

I think we probably have to come to you off-line on that. We do not probably have the number right here. I would say conceptually employee turnover has been improving meaning reducing in most of our geographies. Rich, do you have a specific number?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Yes. I am looking at it. It is probably running year over year probably a little bit better. It is probably closer to 11% on the total employee based. My basic answer is that we have gone through our operational reviews on all the businesses. I do not remember being a major movement or the other in any territory. It has been kind of steady as we have seen. You always have some level of turnover; the key is to make sure that most of your turnover is something we create.

Matthew Litfin – *William Blair & Co – Analyst*

Is that 11% an annualized number or is that in the quarter itself?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

It is just in the quarter.

Operator

Next you have a follow-up question from Mark Marcon with Robert W. Baird.

Mark Marcon – *Robert W. Baird – Analyst*

I was curious about Asia Pac. You mentioned strong growth in China, Hong Kong, etc. Can you give us a feel for how big those smaller countries are becoming relative to Australia and New Zealand at this point?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

Rich, correct me if I am wrong here. I think we have given guidance that Australia and New Zealand are about 80% of Asia Pac or more, about 80% to 85%.

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

That is pretty accurate. And you are actually spot on Mark. The smaller portion is growing much more rapidly than the larger.

Mark Marcon – *Robert W. Baird – Analyst*

It looks like a terrific expense controls. How did you do that? I mean you basically had, if you are just looking it on an year-over-year basis, your revenues in Asia Pac basically increase less than $4 million whereas your EBITDA increased by more that $4 million. Is that basically tightening things up a little bit in Australia and New Zealand because obviously you had strong growth?

Jon Chait – *Hudson Highland Group – Chairman & CEO*

I think, again I will talk about it theoretically and let Rich talk about the actual numbers. Again, we have to divide it into two. Asia expenses grew and revenues grew, and profits grew. Operating leverage was consistent with our goal of 25% to 50%, so that is not an issue at all. In Australia and New Zealand, we had much slower growth as I indicated in my remark. We had a big gain through expense savings. Some of that was related to actions that we have taken over the last couple of years. One of the things that we talked to our investors about for several quarters again gets back to 7% to 10% long-term EBITDA range and our regions again are in various points of the transition to getting there. Australia and New Zealand are very mature businesses, in a market where the economy has been good for some period of time. They are at 6.6% in terms of EBITDA margin, which we think for a mature market given the mix of their business, is very satisfactory. They have done an excellent job in terms of expense management, but we did take some actions at the end of last year that we announced that have enabled us to continue to reduce our expense base. Maybe, Rich, you want to touch on?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

Yes, I believe the only things out there to just keep in mind, as we have already said, are the big expenses that move the needle in our company are people and rent. Australia and New Zealand is another area where we have taken dramatic actions to lower our rent costs. We are moving in July 1 to the new location, so the benefit of the lower rent expense, the actions that Jon pointed out, and the management efforts to increase productivity and operating leverage, is what does it. If we do not have our people focused on it and managing those lines aggressively, it just does not happen. The other parts of the G&A line are so small relative to the total business. It really comes down to the people and places, and making sure that the top-line is coming at the right level of margin.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

When we came to the company Mark, we had told our investors that one of our issues in Australia and New Zealand was improving productivity. The compliments go to the local management there. They have done a fantastic job, and they have continued to improve the productivity. Last year was an excellent year. I think if you look at the numbers in the first quarter, it is another excellent quarter, and may continue to improve the productivity every step along the way.

Operator

Your final question comes from Michael Carney with Stephens Inc.

Michael Carney – *Stephens Inc – Analyst*

Rich, on the SOX expense in the first quarter, was there any of that that will not be there going forward?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

There was not any material impact on the professional services line at all.

Michael Carney – *Stephens Inc – Analyst*

Also, do you have any productivity measures at least for Hudson in North America or just kind of a sense of how many people were added maybe year over year and so what the productivity growth was?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

I know for the total company I think we are up in FTE's about 23 people [vs. Q4 2004, and added about 5% to total headcount vs. Q1 2004], so I have got to tell you I think it just implies that I think we saw productivity go across all the regions because certainly there was not large employee head count growth in aggregate and the results were pretty spectacular on the leverage factor, so I think our productivity measure is really boosted.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

In our business it is always a bit of a balance between how fast you add people particularly as you grow. At this point, we are being pretty cautious about adding people. So, in theory we do not add people until we have the revenue.

Michael Carney – *Stephens Inc – Analyst*

Okay. The last question is in Australia revenue. Is that simply a function of getting rid of the lower margin business and then focusing on a higher margin professional business?

Richard Pehlke – *Hudson Highland Group – EVP & CFO*

I think it is a couple of factors. I think it is what you just said. I think it is the fact that after 13 years of positive GDP growth, one of the things we saw in the first quarter in Australia in their accounting was a little nervousness. They had a little bit of a spike in local interest rates, a lot of chatter about downturns and all that but I do not think it had a major factor. It is a region of the world that has a defined population that is not growing dramatically. There is still a candidate shortage for filling jobs. The revenue opportunities are there competitively. The reality is we have to continually find creative ways to find the right candidates and source the right candidates for Australia.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

Yes. Absolutely. Just to add to what Richard said is absolutely right. Remember that this is a business that is 60% firm. So, by definition it is lumpy. Things that go through the market like the current scare about the downtrend in the economy affect permanent employment right away. This is something we said all along that our goal is to increase the percentage of our business derived from temporary employment. So, the way we have looked at the Australian market for some time is a profitability play, and it is continuing to be a good profitability play and also a good cash play. So, we have been much concerned with growing our business in the market of 16 million people than we are growing our business in a market with 250 million people.

Jon Chait – *Hudson Highland Group – Chairman & CEO*

Okay, operator. I think we are done for the day. David, you want to just conclude our remarks.

David Kirby – ***Hudson Highland Group – Director of Investor Relations***

Yes, Jon. Thank you all for joining the Hudson Highland Group first quarter conference call. If there are any further questions, please feel free to contact Richard Pehlke or myself at any time. You can reach Richard at 212-351-7285 or you can reach me at 212-351-7216. The call today has been recorded and will be available after 12 P.M. eastern daylight time today by calling 1-800-642-1687, followed by the passcode 5580704. For calls outside the United States, please dial 1-706-645-9291, followed by the same passcode. Those archived calls will remain available for the next 7 days at those numbers, and they will also be archived on our Investor Relations section of our website, hhgroup.com. Thank you and have a great day.

Operator

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