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## Conference Call Transcript

HHGP - Q2 2005 Hudson Highland Group, Inc Earnings Conference Call

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## PRESENTATION

**Operator**

Good morning. My name is Lynn and I will be your conference facilitator. At this time I would like to welcome everybody to the Hudson Highland Group earning conference call. The presenters today are Jon Chait, Chairman and CEO, Rich Pehlke, EVP and CFO and David Kirby, Director of Investor Relations. After the speakers' remarks there will be a question and answer. To [ OPERATOR INSTRUCTIONS ] Mr. Kirby you may begin your conference.

**David Kirby – Director of Investor Relations**

Thank you Operator. Good morning and welcome to the Hudson Highland Group conference call for the second quarter of 2005. I am David Kirby, Director of Investor Relations for Hudson Highland Group. Our call this morning will be led by Jon Chait, Chairman and Chief Executive Officer and Rich 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 the 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 market with which we operate, risks associated with acquisitions, competition, seasonality and other risks discussed in our filings made 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 or to update any forward-looking statements whether as a result of new information, future events or other words. I would now turn the call over to Jon Chait.

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**Jon Chait – Chairman & CEO**

Thank you very much David. As has been our pattern in previous calls, I am going to comment on some strategic issues as well as selected highlights -- highly selected highlights. Rich will follow with a much more comprehensible analysis of our second quarter financial statements. For purposes of my remarks I am assuming that all of you have had a chance to read our press release and our of shareholders letter that were issued at the close of trading yesterday. One of our core gross strategies for the company has been to increase the proportion of revenue derived from temporary or contract business in order to offset the volatility inherent in permanent recruitment.

That was particularly important in the second quarter that was just completed because permit recruitment grew at approximately 10%. Nevertheless contract and temporary recruitment grew at 17%. We feel that over the longer term, this shift in the mix is important to our strategic position even though we recognize that the shifting mix will have the result of lowering our consolidated gross profit percentage. That's because permanent recruitment comes in at gross profit of approximately 100%/slightly under 100% and the highest portion of our temporary or contract recruitment stream comes in at about 30%. So over a period of time we would expect that our consolidated gross margin would decline that would be consistent with our strategy.

Actually in the second quarter we did not suffer a decline in consolidated gross margin percentage. We had just a tick up. But over a period of time we would expect to see that decline as the mix shifted. We felt that was a very positive development in the quarter. A second positive development I would like to talk about briefly is that we finished the quarter reporting a consolidated EBITA as a percentage of revenue of 3%. That significant progress compared to the 1.8% that we reported in the same period of 2004, and we think significant progress toward our goal of achieving 7 to 10% EBITDA margins on a normalized bases.

We think this compares very favorably to some of the larger companies in the market place that are not now at 3% and we feel that our company is still emerging from a long downturn period and will improve over a period of time as you can see consistently with our guidance. Turning to regional highlight, as I mentioned in my letter, virtually all regional operating units contributed to the second quarter results, that there were some noteworthy achievements that I would like to draw your attention to. In Hudson Asia-Pacific, we were able to achieve a \$10 million EBITDA in the quarter and EBITDA as a percentage of revenues in the quarter reached 8.7%. We have strong EBITDA growth in our large Australian business and in our New Zealand business, as well as in each of our smaller Asian markets. Despite a weak economy, Hudson Europe achieved an increase of 14% in revenue and 19% in gross margin in the second quarter compared to a year ago.

We think this is a very significant achievement in a geography in the world that has been beset by weak economies and political uncertainty for sometime. Nevertheless, we think that our business responded extremely well in the quarter. It was led by the operation in the U.K., Hudson U.K., with a constant currency growth in temporary contract business of 14% and a gross margin growth of 15% overall. We also had strong gross margin growth in of the Netherlands and in our smaller operations in Spain and Italy. Hudson Europe achieved \$5.8 million in EBITDA in the second quarter compared to 2.5 million in the year-ago period. Also importantly, Hudson-Europe achieved an EBITDA percentage of 4.6% of revenue and returned 38% of the increase in gross margin dollars to the EBITDA line.

The United Kingdom operation, again, was very strong and particularly strong with EBITDA growth increasing by 52% and reaching 5.4% of revenue for the quarter. Belgium, although experiencing moderate top line growth, produced an EBITDA growth of 33% and reached EBITDA percentage of 16% of revenue. The Netherlands also had a strong profit quarter with EBITDA approaching 14% of revenue. We had profit as well in Central Europe, France, and Spain.

Hudson North America achieved the largest growth in the quarter with revenue and gross margin both increasing 34%, compared to the second quarter of 2004. This was fueled by strong growth in our core business lines of legal, accounting and finance, engineering aerospace and defense. On a sequential basis however, revenue declined 3% in Hudson North America in the second quarter compared with the first quarter of 2005 while gross margin increased 3%. Sequential results were impacted by the simultaneous wind down of a few large contracts particularly in the legal IT. Gross margin increased 12% sequentially in accounting and finance and was up slightly in legal and engineering, aerospace and defense. However it was down 6% in IT.

Hudson North America reported 4.6 million of EBITDA in the quarter and reached an EBITDA percentage of 4.3% of revenue. Highland Partners also had a successful quarter. Highland North America and Europe improved EBITDA by 29% in constant currency over the second quarter of 2004.

There are four other issues that I would like to touch on briefly, that analysts have raised with me and rather than wait for your questions I will try to anticipate them. The first question is of course after the close of the quarter we announced last week the acquisition of a firm -- the agreement to acquire the firm in the Netherlands called Balance. The details of that were contained in a separate press release and I won't repeat those details

here, but it's consistent with our strategy of building a contractor temporary business and the high margin professional space in continental Europe.

The Netherlands is the most advanced professional services market in the contract area in continental Europe and we feel we've made an acquisition which will fit very well with our company. It was critically important to us, and I think I've mentioned it to many of you this issue previously, it was critically important to us that there was a strong cultural fit between Balance and our organization, which we believe there is. So while we believe the financial characteristics of this transition are attractive to our company and of course attractive to the other side as well. The thing that most attracts us to Balance is the strong cultural dynamic between our two companies. We very much welcome them to the company and look forward to working with them in the future. As you may know that transaction is scheduled to close on August 17th.

The second comment I would like to make is with respect to future acquisitions. We continue to think about future acquisitions and we are talking to people from time to time. As I've mentioned to you many times previously, we do think that organic expansion is the principal way that we intend to build our business but there is a role for acquisitions in filling in gaps in our coverage as well as augmenting certain of our businesses where we can speed the development of our business. Our philosophy continues to be to look at these quasar recruitment exercises rather than financial transactions. Of course we always look for strong financial characteristics and that would mean that companies that generally have an EBITDA percentage that's within our target range. But nevertheless we feel that the most important part of these acquisitions is a cultural fit between our company and the acquired organization.

Third point I would like to comment on is the search for a new CFO. As many of you know, Rich Pehlke announced that he had decided that he would be leaving the company at the end of the year, although he will be working as a consultant for our company for another year after that. We have begun that process and I am in the process in the early stages of interviewing potential candidates. Our goal is to have a candidate in place by the end of the year but this is necessarily a process that's difficult to pin down to a precise time line. But it is underway.

The final thing I would just like to talk about is some people have asked me if there will be an impact with respect to the events that have occurred in London since the close of the quarter. Obviously we look at those events first and foremost from the standpoint of the human tragedy of the events. And so I don't want to dwell on the financial impact but at this point, and the very early weeks of the quarter, we don't believe that they will have a material impact on our consolidated financial results for the quarter. With that I turn over to Rich to comment on a much more comprehensive way on the results of the second quarter and year-to-date.

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#### **Rich Pehlke – CFO & EVP**

Thanks, Jon and good morning everyone. First I will start off as I usually do, with talking about the impact of currency on the quarter. We've released the number of constant currency comparisons in our released materials. We did have a difference between the sequential impact and year-over-year impact. Sequentially the U.S. dollar did strengthen, which caused about 1.5% decrease in a revenue gross margin expenses in EBITDA, approximately, as a result the Q2 versus Q1 revenue grew 4.6% in constant currencies, 11.8% gross margin and EBITD improved by a 8.6 million.

In year-over-year, the dollar in the those comparisons the dollar was weaker and that increased revenue gross margin expense and in the balance by approximately 4%. The revenue in constant currencies year-over-year was 14.5%, gross margin was 14.8 and EBITDA improved by 4.4 million year-over-year. The expense line – we did see some expense growth year-over-year in both lines. I would like to comment briefly about both salary and related costs as well as non-salary GNA. First salary and related for the quarter we saw an increase of 14.5% and for the 6 month, 12%.

In reported numbers, I will point out the we did have 113 more full-time equivalent employees across our business year-over-year, largely due to increases in North America and the Asia-Pacific region where we are experiencing good growth and they are people who support the growth and where we are in investing the growth in the business. The stronger business trends have supported this across all of our businesses where we've seen higher headcount. We continue to monitor that closely but we've always said that we do believe, as Jon just pointed out, that we do need to invest in organic growth repeatedly to continue to grow the business. We believe those investments are well in check and we'll continue to seek increased productivity that's reflected in our guidance because of these higher head accounts.

In the non-salary and related sites, the reported increases for the quarter were 18.9 and for the six months 7.6. I think we're a lot closer on our current run rate of expenses today then we were a year ago. For the quarter many of you may recall that we did benefit in the prior year because of some credits due to bad debt reserves and recoveries we made from an earlier write-offs in North America. In addition, our current expense run rates reflect the higher business support expenses such as a travel and expense related to the growth in the business, as our business gets bigger.

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We did have prior professional fees in the second quarter. Some of that is controllable and probably can come down over time. But I expect we're probably closer to our going forward run rate in the non-salary and related expense area.

Still well within the guidelines of what we think we can do and we continue to keep that pressure on repeatedly with our operations. Moving down the expense, the income statement to depreciation, we did see a slight down turn in our depreciation of 4.6 from the first quarter of 4.9. But we continued to target that our depreciation for this year will be somewhere between the \$17 and \$18 million range for '05. We do believe we will continue to trend downward as we hold our CapEx in check. There's no change in our CapEx investment levels anticipated at this time. We did have a slight growth in the intangible asset lines due to a payment that was made in the second quarter for our acquisition in the financial solutions business of North America last year. Those intangibles are not amortized so that balance would stay real.

On the cash, we did see an improvement in our overall cash position quarter to quarter. As many of you know, for the past few years, we've had concentrated efforts on improving our receivable portfolio and our cash collections. At the end of the first quarter we did comment that we had a very strong spike in North America that contributed to higher DSO's as well as a drain on cash because of the funding of the working capital, that reflected the growth. Our people have responded again and have improved our cash collection efforts. We brought our DSO back down to the 52 days over all for the company and it did have a net inflow for the quarter in terms of our overall cash position. I will point out that this cash position does not reflect the proceeds from our equity offering that was completed early in the third quarter. So we're very pleased.

We think we have adequate capacity both in terms of our cash on hand as well as the committed credit facility to fund the growth in our working capital. In the quarter balance sheet of our current portion of long-term debt, 21 million of that relate to the borrowings of June 30th on the Foothill facility. In terms of our tax expense, many of you asked about the fact that we don't really see a very good effective tax rate on this company because we do pay a high amount of income tax on a book basis relative to our book net income. This is largely due to the fact that we do pay tax – we are a taxpayer in the APAC region and we are profitable there and so we do have tax expense and virtually all of our tax expense that you see recorded on the income statement comes from the APAC region.

We continue to use as we grow profitability in the other regions, we will continue to utilize our tax loss carry forwards to offset that income as we continue to grow. Jon commented briefly about the operating margins – we're very pleased with the progress across our business -- Jon commented on the overall margin for the quarter of 3%. Our Hudson business contributed 5.5% and our Highland business contributed 4.4%. And for the 6 months, Hudson was at 4.5, Highland Partners was at 3.8 and the overall company was at 1.5. Which is at the low end right now of our target guidance range that we gave for this year. So we're very pleased at the continual and consistent progress our operations are making. We by no means believe we're done but we are in good shape to continue progress towards our long-term goals.

Finally to just talk about our guidance – our guidance remains unchanged. I won't restate in full for the first quarter. I think many of you know and it's been posted in all of our public investor disclosures. We do feel that with both of our seasonally strongest and weakest quarters behind us, we are comfortable that our EBITDA performance is in line with the high-end of that range. It does not take into account, I should note, the recently announced acquisition of Balance that Jon just talked about. We expect to close the acquisition in mid August. We do expect, as Jon indicated, that Balance will contribute positively to EPS over the next two years and we will update our guidance to reflect the acquisition once we close it and we expect to do that at the end of Q3. And with that I think we're ready to take questions.

#### QUESTION AND ANSWER

#### Operator

[ OPERATOR INSTRUCTIONS ] Your first question comes from Matthew Litfin of William Blair & Company.

**Matthew Litfin – William Blair and Co - CFA**

Hi, good morning, congratulations on the performance.

**Jon Chait – Chairman & CEO**

Thanks Matt.

**Matthew Litfin – William Blair and Co - CFA**

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Just one quick one clean up question on the cash flow. Rich, you mentioned a positive contribution, can you give us the cash from ops and CapEx in the quarter?

**Rich Pehlke – CFO & EVP**

I will dig that out. I've got it here somewhere.

**Matthew Litfin – William Blair and Co - CFA**

Okay, while you are looking, I've got another one for Jon. Jon, you mentioned a few large contracts in IT and legal that were dropped in Q2. Did you get those people redeployed here in Q3 or are those projects sort of gone forever?

**Jon Chait – Chairman & CEO**

Both of those situations, Matt, were situations that where the projects were more or less came to an end. One was in IT and I would say that those people are gone forever.

It's a situation where we were supplying certain services to a company. The company went to a merger, and they've now taken a number of those services in-house so in fact that opportunity is just gone at this point. The other was a wonderful project that we have in our legal business in North America. That was really a fantastic project and the only thing wrong with it was that it only lasted a couple of months because of the nature of the project that we worked on was a couple of months project. So on a sequential basis that had an impact on the results and the project is over, so more or less done and gone. All of the people involved in these are employed as contractors so we don't have any ongoing expense exposure. In the case of the legal project, because we knew it was a short-term project, we didn't ramp up in any way in terms of our own infrastructure.

**Rich Pehlke – CFO & EVP**

Matt, the cash flow from Ops is 96 in the quarter and 3.2 for CapEx.

**Matthew Litfin – William Blair and Co - CFA**

Okay. That's it for now, thank you very much.

**Rich Pehlke – CFO & EVP**

Thanks Matt.

**Operator**

Next question comes from Mark Macon of Robert Baird.

**Mark Marcon - Robert Baird - CPA**

Good morning and let me add my congratulations.

**Rich Pehlke – CFO & EVP**

Thanks Mark.

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**Mark Marcon - Robert Baird - CPA**

I was wondering if you could kind of go through the monthly sequential trends across the major geographies for Hudson.

**Jon Chait - Chairman & CEO**

The monthly sequential trends across the major geographies for Hudson? Probably David would be better to talk to offline to give you that much detail.

**Rich Pehlke - CFO & EVP**

We generally don't go month by month, Mark. Obviously in our quarters, as we've said many times, we always see a boost at the end of the quarter just because of the 445 reporting periods. And our compensation system that really trend to get people to close business at the end of the quarter. I think from an overall operating trend basis excluding some of the big project that Jon just mentioned in responding to Matt's question, we've seen solid but still modestly good operating trends within the core businesses.

**Jon Chait - Chairman & CEO**

One of the other things just as a sequential date for our business, because such a large component of our business is permanent recruitment. On a monthly basis as Rich said, the last month of the quarter is always the biggest month and there's no possibility on earth that July will be as strong as June and April will be as strong as March. So it's different than say looking at our contractors numbers or something like that.

**Mark Marcon - Robert Baird - CPA**

I guess what I was trying to get a sense for is how you felt -- obviously the macro signals, particularly out of Europe, have been mixed to less than stellar in terms of the overall macro environment. I am trying to get a sense for how you're feeling about the business heading into the third and fourth quarters, in light of what we're seeing from a macro perspective.

**Jon Chait - Chairman & CEO**

Well, I think, let's just talk about Europe for a minute.

As I mentioned in my opening remarks, I think we had really an excellent performance and I hate to use adjectives because what's excellent to somebody is not to another but I think anyway you cut it, in light of the political and economic uncertainty in Europe, we had an excellent performance and we had a very strong June. Again, it's a permanent recruitment driven business to a great extent, so we always take that into account but I would say that we're feeling confident as we look forward. We've had some real underlying change management that's been made in a number of the operations in Europe, particularly in our U.K. operation, so we feel very confident about it.

One thing I should mention in terms of sequential revenues is that -- and I know that you and I have talked about it before, Mark -- is that as we look at our business one of our concerns is to improve the profitability of our business rather than focus on revenue growth. And to some extent you can think of it as we are intentionally sacrificing some revenue growth by exiting low-margin business within particular geographies. That's for example, both the U.K. and Australia. That's an intentional strategy to exit low margin contracts and grow what we regard as the core part of our business. There's nothing wrong with those contracts. It's just that our business model is not particularly conducive to a low-cost producer model. And we're becoming much more disciplined about what kinds of contracts we go into. John Rose in the U.K. has done a fantastic job in a very short period of time of managing that shift and we saw the results in the quarter. Again, that would affect some of this sequential numbers on the top line.

**Mark Marcon - Robert Baird - CPA**

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And then in North America, it sounds like the sequential decline was really concentrating in the those two contracts that you mentioned. Other wise, things have been going well in North America?

**Jon Chait – Chairman & CEO**

Things are going well. Just broadly, let's go through them 1 by 1 on a very global basis, in looking at contractors on billing now rather than revenues. Accounting and finance is largely stable in terms of slightly upward bias, but a largely stable sequential business.

As we, like everybody else in the market, are rotating through the Sarbanes impact. We've done better on the gross margin line than we have on the top line. And I think as we look out, we're confident in the third and fourth quarters. IT is a business where we have been down sequentially. In my remarks and in my letter I mentioned actual numbers. We've been down sequentially in terms of contractors on billing – I would say in a very very round numbers, maybe half of that sequential decline is attributable to the contract that ended. But that's a market that has been tougher for us and I think for the industry in this year. So that one we're maybe less confident about but not panicked at all. I think that we have a good team in that group that's very focused and doing a very good job. We certainly feel we have the right people in the right places there.

And in legal, we've had a fantastic business. They're doing a great job. And third quarter is normally a little bit of a tough quarter for legal, lots of people on holidays, but business looks good. Engineering, aerospace and defense has been a real growth engine for us, smaller part of our business but the numbers have looked good and they continue to look good.

**Mark Marcon - Robert Baird - CPA**

Where would you say you are with regards to past the utilization -- if you weren't going to add any more headcount other than balance, how much more could you end up doing on the top line?

**Jon Chait – Chairman & CEO**

I can't put a number on line because Rich Pehlke is staring across the table and is going to assassinate me. And he's bigger than I am.

**Rich Pehlke – CFO & EVP**

We still have a lot of skin to grow into. In all of our business, as we talked with them at the end of the quarter, I think the encouraging thing and Jon touched on it in his remarks, is that we are growing it one by one but there's a lot of room to grow here.

And this is not a case where we feel that we're going to make a dramatic surgery to the operating environment right now, but rather drive the productivity through that infrastructure because we still believe at this expense level, we can still get a lot more productivity out of the business and meet our growth objectives. So we don't have it measured in total percentage actually office by office but we have an idea of where our target productivity should be and we still have a fair amount to go.

**Operator**

The next question comes from Jeff Silber with Harris Nesbitt.

**Jeff Silber – Harris Nesbitt**

Thanks. Wanted to just first focus on Highland Partners segment. If I look at the American portion of that segment, revenues and gross margins were down slightly year-over-year. I was wondering if you could give us a little bit of color on that and what you expect going forward in that segment.

**Jon Chait – Chairman & CEO**



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Well, I'll take a crack at it and then ask Rich to comment. I think that we have expected revenue growth to be basically flat for the year. Be a little bit better than it was but not a lot better. It's a part of our business that we operate as a global boutique. We have chosen not to increase the headcount. We are not aggressively trying to hire partners. This is a business that had lost a lot of money over the last couple of years and we're happily running it as a small profitable boutique business. So we're not doing the things that a lot of other people do which is great.

It's just that we have other parts of our business that we're investing in more aggressively. So our expectation is revenues up a little better than they were, but not a lot. And continue to run it as a very profitable business.

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**Jeff Silber - Harris Nesbitt**

Okay. If I could move on to the tax rate and this is something that I guess I've had some difficulty with in terms of modeling, would it be correct to assume that in the second quarter, for book purposes, that you were able to use some of your NOL in the Americas? So that's correct?

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**Rich Pehlke - CFO & EVP**

Yes. And could you give us an update how much is left in the NOLs to use? Stewart and what. I feel that the value is somewhere around \$50 million. Or just under 50 million in the Americas, for example.

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**Jeff Silber - Harris Nesbitt**

Okay, that's actually helpful, so to try to estimate what it called a "normalized tax rate" would be, at least for this year, what should we be using or is harder to model based on the geography?

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**Rich Pehlke - CFO & EVP**

IT'S WAY TO HARD TO MODEL. THE REALITY IS THAT IF PROFIT COMES IN FROM THE APAC REGION, WE'RE GOING TO PAY TAX ON IT. AND IF IT COMES IN FROM JUST ABOUT EVERYWHERE ELSE, ALTHOUGH THERE ARE SPOTTY PLACES, DEPENDING ON WHICH ENTITY THE PROFIT COMES IN FROM, IT'S PRETTY MUCH GOING TO BE SHUTTERED. What you're seeing is you're seeing a tax against the pre-tax income of Australia and Asia.

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**Jeff Silber - Harris Nesbitt**

Okay. All right, that's helpful. I just moving on to the cash flow statement, I have been some old notes that at the beginning of the year you were looking for negative pre- cash flow for this year of about 5 to \$10 million. Is the guidance still accurate?

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**Rich Pehlke - CFO & EVP**

Well, it changes. Obviously we've done an equity offering so we've done a lot of things that have changed and we certainly had some growth in and above itself. A lot of the negative cash flow that we pointed to in the earlier forecast -- Keep in mind we are still paying restructuring charges from a previously announced P&L impact and I think that range was in about the 7 to \$8 million range for this year. So that have a large part to do with it. If our business grows rapidly, especially on the receivable line, that will take cash to grow. So net impact of growth and receivables has an impact on our cash flow. I still think, based upon seeing our operations produced, that we're going to be in reasonable shape relative to that expectation.

It will probably be a negative cash flow year because of the restructuring payments and because of the growth of business.

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**Jon Chait - Chairman & CEO**

One of the consequences that I know your familiar with was our strategy of increasing the proportion of temporary contract revenues, is that it's a call and cash because that's a business that as a grows consumes much more cash and working capital. And it makes a bit of a difficult number. We had a very strong first quarter it in particularly North America and it's the use of cash.

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**Rich Pehlke – CFO & EVP**

As I've looked at over the course of what we've done in the first 6 months, we only have two operations or two regions that were really high, what I would call high DSO's and that's in the low to mid '50's and that's Europe and North America.

Everyone else is in the low 40's and below of any consequence. So our collection of efficiency, which is what we look at very closely along with our DSO's, still remains very good. Our bad debt expense has basically gone down to nothing. It's very strong quality ratio of receivables for this type of business. Our people or doing a great job of exercising credit controls. So it really is going to come down to amortizing the way that those payments on the restructuring charges, which go down considerably next year, keeping CapEx in line, which we're very comfortable with because we're not doing a lot of new properties, and just watching our collections for the business.

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**Jeff Silber - Harris Nesbitt**

Okay, great. To the couple of quick follow-up questions. What share count should we be using for the third quarter once we include the secondary offerings?

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**Rich Pehlke – CFO & EVP**

I haven't done the math for the third quarter. I know that the total shares like 23.2 with the new shares in. But I just haven't done the math to the record,

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**Jeff Silber - Harris Nesbitt**

I will followup on that. And then in your remarks you talking about SG & A and breaking it apart between the salary and non-salary basis. Roughly what percentage of SG & A does each component contribute?

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**Rich Pehlke – CFO & EVP**

I can give you the numbers. Just for example in the quarter, salary and related was 97 versus 33 for non salary related.

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**Jeff Silber - Harris Nesbitt**

I will let someone else jump on. Thanks.

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**Operator**

Your next question comes from Mike Carney of Stephens.

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**Mike Carney - Stephens Inc - CFA**

Good morning, continued congratulations. A few questions first, Jon, on the developmental business, obviously that has some -- that helps other businesses and its growing but is that worth the losses and will those losses get better or are those losses okay with you, given that it helps the other businesses?

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**Jon Chait – Chairman & CEO**

Boy, you're right on both respects, Mike. One is the losses will get better. And we're in the process of taking some actions that we think we'll reduce some of the losses. The losses will also get better because of the fact that we had a particular funky quarter and one of our components of that business that has been profitable in the first quarter -- so there's a little bit of that, but there's also a little bit of depth it's simply, it is in a

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situation where another component of that business is simply a supplier to other parts of the business and rather than allocating expenses and doing a lot of other things, we stick that portion, which is kind of the R&D portion, and other portions, just stick it into that account. And that peace is probably going to continue on indefinitely.

**Mike Carney - Stephens Inc - CFA**

Okay. And then on to Highland and Asia-Pacific. With the realignment there, I assume, are there still some Australian consultants that will remain with the company? And is that going to continue to be reported as we see it now?

**Jon Chait - Chairman & CEO**

I think it is going to be continue to be reported as we see it. There are some consultants that remain with the company – a small group that does remain and we expect that they will be profitable. Whether they will be profitable for the second half or not, I don't know but on a longer-term basis we expect that they'll be able to make a small profit and be a contributor.

**Mike Carney - Stephens Inc - CFA**

Okay and then in Hudson U.K., you had talked about the geopolitical events but the economy's been kind of mixed up and down in the U.K. You mentioned something about getting rid of low market business there but in this quarter, revenues were up and gross margin was just slightly up so it didn't look like that really happened.

**Jon Chait - Chairman & CEO**

It did happen. It's just that our management colleagues did a great job of overcoming it. The U.K., along with Australia, our two markets in which we have larger accounts. Generally our philosophy as the company is to pass on a large account business because as I mentioned, we don't particularly thank we have the business model for it. We have some legacy business in both the U.K. in particular and to some extent in Australia.

We have been much more disciplined about which accounts we will accept at low margins – the problem with low margin accounts is not that they're bad accounts. These are Fortune 50 names, glamour names. Unfortunately, glamour names with huge businesses that have great purchasing power in dealing with their suppliers. It's just not our gig. Our management team in the quarter, if you look at the results, as I said excellence is in the eye of the beholder, but you have to look at these as excellent results because they have migrated out of a significant portion of that business and therefore lost the revenues and yet made it up with other business, all in the quarter. So anyway you cut it, it was a good quarter.

**Mike Carney - Stephens Inc - CFA**

Okay, so on the contract staffing site and you take it seems even with the economic growth not quite as strong as it had been, your business remains strong.

**Jon Chait - Chairman & CEO**

Our business -- I think it comes down to our people. Notwithstanding, as I mentioned, weak economies in political uncertainty over the place, including the UK and our colleagues have come through and they've done that -- Christina no I did not mention but to really want to mention, is a the president of the region has provided excellent leadership and they've done all that at a time when they've been restructuring conduct underneath the blankets, as well. So as I said about anywhere you cut it, it was an excellent quarter.

**Mike Carney - Stephens Inc - CFA**

You probably don't, but do you have any foresight on what the seasonally will be like in both the U.K. and continental Europe compared to prior years? Do you think it will be the same or worse or better?

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**Jon Chait – Chairman & CEO**

I don't have any great insight. I would kind of refer to my default position, which is the same, August is August all the time. While we always jump on the French for being off in August, lots of Continental countries and the Brits take time off in August, so it's a punky quarter no matter how you cut it. I think our business is stronger, our business is better, but it's still a punky quarter.

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**Mike Carney - Stephens Inc - CFA**

Okay, and finally, Hudson U.S., slowing growth but still very strong. But you mentioned that generally your not looking for the larger business on the contract side, in the legal portion that M&A legal is sweet business but are you not necessarily looking for that type of business? Are you looking for the smaller mid market business and you just take that business when it comes along? Is that strategy?

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**Jon Chait – Chairman & CEO**

Yes, that's the strategy is exactly Mike. In most of our business we specifically declined, avoid the large contract that are out there again not because they're bad, just because we're not built around being the low-cost producer. So we're looking at, for the most part, for a solid small business with a motivated sales force that goes out and gets its.

In the legal area, in particular, a little bit of accounting as well. If a project comes along that's a big project and those two areas of the big projects that do come along, don't have severe market compression. So if a project comes along, we'll do the business and we'll do it as long as we can do it within our existing infrastructure or to the extent we add infrastructure will pay for it. So yes, that's a strategy.

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**Mike Carney - Stephens Inc - CFA**

All right, and then on the Engineering, aerospace and defense that seem to be up considerably in the U.S., that's not the lower margin engineering business that you have, I assume.

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**Jon Chait – Chairman & CEO**

That's right.

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**Mike Carney - Stephens Inc - CFA**

Would that be a large contract or would that be just more small business?

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**Jon Chait – Chairman & CEO**

The aerospace and defense is very much again in small business, small in the sense -- the customers are huge. The customers are giant organizations, but small number of contractors spread around. So we again don't play and don't aspire to play in the big business.

But you're right, we have a low margin engineering business which is focused on nuclear engineering and it is a place where we play in the big contracts and it does, while we have a wonderful group of people that run the business extremely efficiently, unbelievably efficiently. The problem is that you're in a market where you have customers with a huge pricing power and the nature of the beast is that the margins come in low.

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**Mike Carney - Stephens Inc - CFA**

And it seems clear that Hudson Asia Pac in Europe can reach the 7 to 10%. Kind of seems like how they are, from my standpoint, but in the U.S., do you think that your business, is right now and the resources you have are now, can it reached the 7 to 10% goal you have or will that need further adding?

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**Jon Chait – Chairman & CEO**

I don't think it means adding but it means growth. Because we have an infrastructure expense in the U.S. And if you look at it in terms of capacity utilization, we have more capacity than we have utilized and that was a strategy we knew, we adopted it in 2003, it was intentional, and I certainly plead guilty, but I think that obviously the growth rate is there and it's coming through. As Rich mentioned, and I think it's an extremely important point to us, which is that we want to make sure that we get the operating leverage. We're extremely focused in the North America market.

Tom Moran, the president of North America does an excellent job, is extremely focused on making sure that we get the operating leverage as we grow. That's a critical issue in Hudson North America. The issue of Hudson Asia Pac is a little different. Australia is a business that is not growing very fast – we've pointed that out in the past. But the management team there led by Anne Hatton, has done a fantastic job at just grinding out additional points of EBITDA percentage of recorded.

But that 8.7% is a blend of a number of geographies, but in the 2 geographies that she's managing, she's done an excellent job. The management challenge and the smaller Asian markets is just like -- fast-growing, excellent EBITDA percentages and continuing to take advantage of the operating leverage inherent in the business.

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**Operator**

Again a lot to remind everyone [ OPERATOR INSTRUCTIONS ]. Next question comes from Ty Govatos of CL King.

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**Ty Govatos – CL King**

Hi, congratulations on that quarter.

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**Rich Pehlke – CFO & EVP**

Still trying to keep up with your number.

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**Ty Govatos - CL King**

You're getting there. On the 113 more employees, was that a year-to-year number?

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**Rich Pehlke – CFO & EVP**

Yes, year-to-year.

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**Ty Govatos - CL King**

Mostly sales people?

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**Rich Pehlke – CFO & EVP**

Yes.

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**Ty Govatos - CL King**

Still safe to assume that after 6 or 8 quarters, each 1 of those guys can generate roughly a million in revenues? I want that to the nearest 4 decimal places.

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**Rich Pehlke – CFO & EVP**

Wasn't that your third question?

**Rich Pehlke – CFO & EVP**

Most of them were U.S. Some U.S. and its debt, most of them was what sort think there were about 60 in U.S. So about half that number.

**Ty Govatos - CL King**

Okay this seems to be an continuing ongoing thing of adding more sales people.

**Rich Pehlke – CFO & EVP**

I don't think it's been that continuing. We're trying to organically grow the business and we've certainly changed the mix of the people who were in the business but I will tell you, Jon talked about it just a moment ago, 2 years ago our people didn't even understand or couldn't define few operating leverage.

They are highly focused on it now worldwide and they understand now the value of getting their productivity metrics up. So we have a very serious discussions when people are adding people, because we look at it office by office, desk by desk, to find out where people are. We have a better understanding now how our management manages those numbers. And clearly we're going to give the people that know how to make it happen the tools to make it happen. And in this business that involves people.

**Jon Chait – Chairman & CEO**

And they're doing the job. And it isn't a matter of blind belief, they're delivering the numbers.

**Ty Govatos - CL King**

In the net additions of people is emanating from the geographic or would you have a fixed rule of thumb that you'd like to see sales increased by X?

**Jon Chait – Chairman & CEO**

No, its driven into the geographies where we're going very rapidly. In the Asian part of it back, we're growing very rapidly. In America we're growing very rapidly and in those places both of those managers understand that they have to manage to track the have a different challenge. Their challenge is manage the growth. Funny world we live in.

Tom's business in North America grew 50% in the first quarter and everybody's moaning that it's only 34% here in the second quarter. That's a challenge. Gary Lazzarotto manages the Asian operations done a great job as well. I don't know the number, maybe David/Rich knows off the top of their heads, Asia has grown big double digits.

**Rich Pehlke – CFO & EVP**

And we accept by geography different levels of operating leverage based upon the growth opportunity. You know, if Tom continues to rapidly grow the North American business, which we want him to do, where not going to be pressing him as hard for 50% leveraged. It will be probably closer to the 25%, because we want him to add people because that will mean that he's hitting his productivity targets and he's leading to build the rest of the business. We can accept that investment. If he doesn't have the top line growth, we want him to have a closer to 50%.

**Ty Govatos - CL King**

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Gotcha. Okay, thank you.

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**Operator**

Have a follow-up question from Matthew Litfin with some with William Blair and Co.

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**Matthew Litfin - William Blair and Co - CFA**

Given the recent stock increase, how do you plan to keep your senior managers and staff from so to speak concerned some speak resting on their laurels about margins are still -- and I have a follow-up to that.

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**Jon Chait - Chairman & CEO**

We do spend 1 day celebrating our success and then we spend the next day talking about the challenge and the distance that we have to go and I think every manager, please be assured starting with Rich and I, every manager in this company understands our goal is 7%, that's our first stop, the train doesn't stop until we get to 7 and then it's only a brief stop the "for me and the press release was intentional. We have a good quarter but it's solid progress toward our long-term goal of giving to 7 to 10%.

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**Matthew Litfin - William Blair and Co - CFA**

Okay --

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**Jon Chait - Chairman & CEO**

By the way we think our stock is still ridiculously underpriced.

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**Matthew Litfin - William Blair and Co - CFA**

I never heard that from a CEO before. Stewart if you look at the multiples were trading at and our percentage of revenue compared to our competitors that aren't doing as well, we're just sort of sitting here wondering what analysts are so on unenthusiastic.

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**Matthew Litfin - William Blair and Co - CFA**

Well --

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**Jon Chait - Chairman & CEO**

I'm smiling Matt.

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**Matthew Litfin - William Blair and Co - CFA**

I have no response to that. Do you need to hire any more senior operating managers other than the CFO? But in terms of operating people, are you where you want to be there or there specific regions or businesses where you still feel like you need to flush that out.

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**Jon Chait - Chairman & CEO**

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I think in terms of senior people, we are where we want to be. I can think of any places where we would higher. I think if anything our view of the world is that we have slightly more capacity than we have business, so we're set for a while.

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**Matthew Litfin - William Blair and Co - CFA**

That's great. Keep up the good work.

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**Operator**

The next follow-up question comes from Mark Marcon of Robert Baird.

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**Mark Marcon - robert Baird - CPA**

You mentioned earlier that you had a couple of large accounts in the U.K. that you may not be suited 4 and I'm wondering if you look across your entire portfolio, what percentage of your revenue would you characterize as a moving from a large accounts that may not necessarily be ideal?

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**Jon Chait - Chairman & CEO**

I don't know a number off the top of my head but I would say it's more like 5%. It's not a huge number -- so 5%, 10% - to give you kind of a range of magnitude.

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**Mark Marcon - Robert Baird - CPA**

So it's not a big deal or concern?

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**Jon Chait - Chairman & CEO**

Again, none of these are the accounts but we've fired a couple or more already. In the Australians have been much more disciplined about those. On a day-to-day basis this is something that the local leadership is managing. And they make the tough local decisions. So I don't think we have a huge amount left but we probably still have some.

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**Mark Marcon - Robert Baird - CPA**

Okay, great. In regards to Asia Pac, it's understandable in terms of the huge growth that you're seeing, particularly in China and some of the other Asian markets, but it looks like Australia was still strong as well. And that's interesting given your size over there. I'm wondering if you could tell us a little bit more about what happened in Australia this quarter.

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**Jon Chait - Chairman & CEO**

Australia actually had a small topline growth, only a couple of % in Australia. New Zealand was higher in terms of topline growth. Australia, again have to give Ann credit, brought in greater profitability growth very small topline growth and that the continuing evolution on the part of her and her management team in terms of productivity. Some of that is influenced -- again that is a market where some is influenced by getting out of some of the lower margin large accounts. Although she has a unique situation given her size where she can't exit every low margin account. It would have to be of an impact on the business so she has to be a lot more disciplined about where she plays and where she doesn't play and manage her productivity accordingly which she spent a great job with.

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**Mark Marcon - Robert Baird - CPA**

How much more upside is there to the Asia pac EBITDA margins?



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**Jon Chait – Chairman & CEO**

I don't know, every quarter they do better than I thought it would do. So every quarter, they've continued to build the business but I don't know the answer to that.

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**Matthew Litfin - William Blair and Co - CFA**

Okay. And then in terms of the Corporate expenses, how would you expect those to trend over time?

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**Jon Chait – Chairman & CEO**

Rich, I'm glad to turn this over to you.

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**Rich Pehlke – CFO & EVP**

Well I certainly hope that the corporate -- and I'm talking about the corporate / development costs if you will combined, would it trend a steady or downward. We've talked about this before. The reality is that for the scale of business we are, with the broad geographic coverage and being a public company, we do suffer a bit from having very little productivity on all of our expenses such as audit and legal fees that tend to go with being a public company. Because it just costs too much to do it when you're so dispersed.

We can't get concentrated power because it's just the nature of the beast. We continue to attack that. It's something I'm looking at even now but our emphasis has been to keep a very small corporate structure. As Jon said earlier go there are certain costs that we just don't allocate to the business because we just don't appear in the game of artificial allocations. So therefore if it's truly a corporate cost we keep it at corporate where it's visible and where we're responsible to manage it. But we're trying to keep those costs down with inflation.

We've made a number of structural changes over the past 2 years to adapt the corporate structure to what we think we need for the business. We have the same problems as of everybody else. We have a lot of internal audit costs because it's hard to find people. So we have to use a lot of outside contractors and firms to help us cover our broad diversity for our 404 compliance as well as our internal audit capabilities. And so it's just a matter of keeping that down as much as possible. We have bank fees because of our committed credit facility which really refuels the working capital to grow the business.

We continue to get efficiencies as our credit profile gets better. As our risk profile gets better our insurance costs are going down. So we just continue to stop them 1 by 1. I think we'll see lower cost from our Monster agreement going forward after April of next year. Some of that sits in corporate as well.

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**Operator**

Last question comes from Mike Carney of Stephens.

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**Mike Carney - Stephens Inc - CFA**

One more question. Jon, you've got some pretty big shoes to fill in Rich, simply because he's so physically large. No, but seriously you said a new CFO by year-end. That would be a lot longer than a typical search and I assume the search is external, but does that mean it would be by year-end or you could have someone in the much sooner than that?

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**Jon Chait – Chairman & CEO**

I hope we have someone in sooner than that. The thing is I've listened to so many conference calls from companies that are searching for senior managers. They make promises/optimistic promises and they're not even promises maybe, maybe optimism in terms of assessment. First challenge is finding a person and the second challenge is figuring out how soon and that person, if they are employed, can leave their employer and sometimes you get surprises in terms of that component.

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We have August coming up, which is a dead period. So I don't want to overpromise. Obviously, we recognize in a sense it's better to have this behind us but in another sense, Rich is still working. He is taking a week's vacation next week, but he's back to work right after that.

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**Rich Pehlke – CFO & EVP**

Jon and I have worked on this very constructively and I think it's important for the nature of the job but he has the right candidate and I'm here as long as that takes. So we consider it kind of a non issue, more a planned transition.

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**Jon Chait – Chairman & CEO**

With that, thank you all for attending, that David, do you want to do the concluding remarks?

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

Certainly, if there are any further questions please feel free to contact Rich Pehlke or David Kirby at any time. You can reach Rich at (212)351-7285 -- you can reach me at (212)351-7216. The call today has been recorded and will be available after 11:30 a.m. Eastern time by calling (800) 642-1687 followed by passcode 7859158. For calls outside the U.S. please dial 706-645-9291 called by the same passcode, those archived calls will remain available for the next 7 days at those numbers. Today's webcast will also be available on the investor relations section of our website, [www.hhgroup.com](http://www.hhgroup.com). Thank you very much and have a great day.

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**Operator**

This concludes today's Hudson Highland Group earnings conference call. Thank you for your participation. You may now disconnect.

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