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## Conference Call Transcript

HHGP - Q2 2006 Hudson Highland Group, Inc Earnings Conference Call

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Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

## CORPORATE PARTICIPANTS

### **Jon Chait**

*Hudson Highland Group - Chairman and CEO*

### **Mary Jane Raymond**

*Hudson Highland Group - EVP and CFO*

### **David Kirby**

*Hudson Highland Group - Director of Investor Relations*

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### **Mike Carney**

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### **Jeff Silber**

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### **Mark Marcon**

*Robert Baird - Analyst*

### **Matt Litfin**

*William Blair - Analyst*

## PRESENTATION

### **Operator**

Good morning. My name is Amanda, and I will be your conference operator today. At this time, I would like to welcome everyone to the Second Quarter Earnings Conference Call. [OPERATOR INSTRUCTIONS]

Mr. David Kirby, you may begin your conference.

### **David Kirby - Hudson Highland Group - Director of Investor Relations**

Thank you, Operator, and good morning, everyone.

Our call this morning will be led by Jon Chait, Chairman and Chief Executive Officer, and Mary Jane Raymond, 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 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' estimates, expectations, or to update any forward-looking statements, whether as a result of new information, future events, or otherwise.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

With that, I will now turn the call over to Jon Chait.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Thank you very much, David, and thank all of you for joining us today.

In my remarks today, I will refer to the press release and letter to shareholders dated yesterday, August 7, as well as the press release and 8-K report filed with the Securities and Exchange Commission on August 3, 2006.

Looking at the second quarter on a consolidated basis, we reported adjusted EBITDA -- that is, earnings before interest, taxes, depreciation, and amortization -- of 9.3 million, and after taking into account restructuring charges of 0.9 million in the second quarter, EBITDA of 8.5 million, compared to EBITDA of 9.6 million in the prior year.

The Q2 2006 results include a number of nonrecurring items in the Hudson Americas unit. Understanding these nonrecurring items is not to excuse the performance in Q2 or to imply in any way that they are not proper but to give you some insight into the earnings power of the company over the remainder of 2006 and going forward. It also provides some background for our guidance for the third quarter that will be discussed shortly.

The EBITDA impact of these non-recurring items includes the 1.6 million that was the subject of our August 3 press release, which related to 2005 and undetermined periods and just over 1.4 million of estimate revisions that are not expected to recur. In addition, expenditures on the PeopleSoft application in Hudson North America for the quarter were \$1.7 million.

Even ignoring the non-recurring items, Hudson America has only operated at breakeven in the quarter. This is far from acceptable. However, on the basis of Hudson Americas at breakeven, the company as a whole would have achieved EBITDA significantly over prior year.

I know that you are most concerned to hear about the actions we are taking in Hudson Americas to accelerate its recovery of profitability. I will comment on that at length, but, first, I want to comment on the other parts of our business.

Hudson Europe and Highland Partners recorded improved results in the quarter. At Hudson Europe, EBITDA increased 43%. Our Balance acquisition, which is performing well, contributed more than half of that. EBITDA reached 6.6% of revenues in the quarter. We had a particularly good quarter in our UK operation, with EBITDA and EBITDA percentage up significantly compared to the prior year. The Continental European operations that contributed to the increased EBITDA were Balance, as mentioned above, Belgium, France, and Spain. In general, our progress in Europe is attributable to our execution of our strategy, focusing on higher-margin professional business and the careful management expenses to leverage revenue growth.

Highland Partners reported an EBITDA increase of over 100%, reaching an EBITDA margin of 10% in the quarter.

Hudson Asia Pac reported a solid quarter, with EBITDA down slightly, less than 2% in constant currency. More importantly, though, EBITDA amounted to a solid 8.5% of revenue, unchanged from Q2 '05. As noted last quarter, we continue to see softer conditions in New Zealand, affecting each of our product lines, but our Australia and New Zealand operations have maintained profit levels in the face of mixed economic conditions.

Corporate expense amounted to 7.2 million in the quarter, a decline of 2.2 million from the prior year, but we think the ongoing run rate is in the range of 8 million a quarter.

Of course, our biggest challenge is Hudson Americas. The region reported a revenue increase of 9% over prior year, as contractors on billing increased 8% over prior year and 4% sequentially over the first quarter. From a top-line perspective, I would characterize this as stabilization rather than a rebound.

A number of our practice groups, however, performed well, particularly the Permanent Recruitment teams and the Legal group, which is a market leader. Overall, however, these positives were offset by the shortfall in the IT group and a large increase in expenses.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Expenses were up 6 million in the quarter over the prior year, resulting in a loss for the quarter of 3.3 million. Expenses included 2.5 million in compensation and market-related costs due to higher revenues, 1.7 million in PeopleSoft expenditures, and 1 million in product and client development in the Financial Solutions Group. That last 1 million is a continuation of the expense level that we discussed in the first quarter.

The EBITDA for Hudson Americas also includes 3 million of costs and charges, including the 1.6 million that was the subject of the August 3 release and other estimate revisions that we do not expect to recur.

Results in Hudson North America have not met my expectations, most importantly from an operational perspective, particularly in the IT and Financial Solutions groups. Tom Moran, President of Hudson North America, has taken a number of actions to provide new leadership within the North American operation and to reduce expenses.

First, with respect to leadership, he has made changes in leadership in the IT and Financial Solutions practice groups. An internal appointment was made in IT, and a new leader in Financial Solutions is expected to be appointed by the end of the month. A new CIO for North America has also been appointed with experience in the industry and with PeopleSoft. A new finance director was appointed early in the second quarter, and additional changes have been made in the North American Finance function.

Second, Tom has taken a number of actions to reduce ongoing expense levels. A number of unprofitable offices have been closed, and headcount has been reduced through paring of non-revenue producers and termination of non-performers. This is about 25 people and related expenses.

Third, we are undertaking a review of the PeopleSoft system to improve our operating efficiencies. Mary Jane will discuss that during her remarks.

Let me turn to the background on the restructuring charges. When we examined our performance in the first quarter and reviewed the current economic outlook at several of our key markets, we decided to take a number of actions over the course of the year to reduce our costs and accelerate our earnings recovery. The actions in the second quarter mostly affected Hudson Americas, which I've just described.

For the rest of the year, our actions fall into three categories.

First, we have begun a process of collapsing portions of corporate responsibilities into the regions. This will move expenses closer to the revenue generation and eliminate a layer of direction.

Second, we are consolidating layers of management within certain operating units and closing loss-making or low-profit units.

Third, we will continue to exit large, high-cost premises, particularly in those markets with large corporate staff components, such as New York City. To facilitate these actions, we are announcing today a restructuring charge, which we believe will be 4 to 7 million over the course of 2006, of which 0.7 million was incurred in the second quarter for some of the initial actions.

Looking back at our Q2 performance and the performance of our first half, some of our markets were executing well on our strategy. Even within North America, we saw leadership in a number of our practice groups. However, overall, North America is off course. North America was one of our leaders a year ago, but we recognize that at the moment, it is off course.

Actions taken in the North American market, both in terms of leadership and cost management, are designed to help drive a return to profitable earnings, and we will be monitoring those actions closely.

With that, I'm going to turn over to Mary Jane Raymond, our Chief Financial Officer, to discuss the financial results in more detail. Mary Jane?

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Thank you, Jon.

Good morning. As I've done with you for the last couple of quarters, I'll go through the financial highlights with you in the order of the income statement for the second quarter. I will also review our business mix, the currency impact in the quarter, some key balance sheet and cash flow items, and, finally, I will update you on our guidance.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Turning to the P&L, as a reminder, our financial statements reflect the adoption of SFAS 123R, using the modified retrospective method. Therefore, our results include related stock option costs for both 2005 and 2006. The costs in the second quarter were approximately \$1.3 million, flat to the prior year.

Turning to revenue, our reported revenue was even with prior year at \$365 million in the second quarter, compared with the same period in 2005. This includes a 9% gain in Hudson Americas, offset by a 2% decline in Hudson Europe, a 5% decline in Hudson Asia Pacific, and a 6% decline in Highland Partners. On a constant currency basis, revenues increased 2% in the quarter, including a 9% increase in Hudson Americas, a 1% decline in Hudson Europe, and less than a 1% decline in Hudson Asia Pacific. Our Temporary Contracting revenue increased 3%; Permanent Placement revenue increased 7%; and our Talent Management revenues declined by about 20%, all of these also on a constant currency basis.

Turning to the reported gross margin, this was also even with prior year, even as well in Hudson North Americas, a 3% gain in Hudson Europe, offset by a 1% decline in Hudson Asia Pacific and an 8% decline in Highland Partners. Gross margin as a percentage of revenue was 38.6 in Q2 '06, down slightly from 38.7 a year ago. Temporary Contracting gross margin dollars decreased 1%, and temporary gross margin as a percent of revenue decreased to 7.4% from 7.8 in the second quarter of last year. On a constant currency basis, gross margin dollars increased 1%. That includes gains of 4% in Hudson Europe and 3% in Hudson Asia Pacific.

Our adjusted EBITDA in the second quarter was 9.3 million, as Jon said, compared to 9.4 a year ago. Both years, as I mentioned before, include the stock option expense, a non-cash charge of about 1.3 million for both 2005 and '06.

EBITDA, which is adjusted EBITDA less the restructuring charges, was 8.5, or 2.3% of revenue. EBITDA was driven by regional margins of 8.5% in Asia Pacific, 6.6% in Hudson Europe, 10% in Highland Partners, as well as reduced corporate costs. The second quarter EBITDA for '06 includes a small adverse currency impact of about \$200,000. Consolidated net income for the second quarter of 2006 was reported at \$600,000, down from 3 million a year ago. Depreciation and amortization in the second quarter was 4.3 million, down slightly from 4.6 million. Our tax expense in this quarter was \$2.5 million.

Basic and diluted EPS were \$0.02, compared to \$0.15 basic and \$0.14 diluted in second quarter of 2005. We had 25.2 million diluted shares outstanding in the second quarter of '06, compared with 21.6 in '05 second quarter. The increase in the shares is primarily due to our equity offering in July of 2005.

Let me turn to some specific aspects of our performance.

With respect to our business mix, we continue to invest in our core business in a way that will enhance our long-term sustainable profitability. Our mix of business by geography and by product in the quarter remained fairly constant with the ratios we saw during 2005. Permanent Placement revenue again this quarter showed the strongest product growth in the quarter, benefiting from good gains in North America, Continental Europe, Australia and Asia.

We also saw strong Perm growth in these regions during the first quarter of this year.

While we remain strategically committed to increasing our business mix in Temporary Contracting, we won't shy away from Permanent Placement growth as it represents over half of our gross margin today and is important in our mix of business offerings to our clients.

Turning to currency impacts, our results, as I mentioned briefly before, were slightly adversely affected by currencies in the quarter. On a consolidated basis, currency reduced our reported revenue and gross margin by about 2% and reduced our reported EBITDA by about \$200,000.

In terms of expenses, the SG&A expenses were about flat with prior year. Office and general were up about 2%, and salary and related costs were down about 1%, and those numbers as -- in dollars, both 600,000 and 700,000, respectively, more or less offset each other.

I'll turn for a moment and speak about the concept of PeopleSoft expenses. We began a conversation about this last quarter. In first quarter, our PeopleSoft expenses were about 2 million in the quarter. Our expenses for PeopleSoft in the second quarter were about 1.7.

As we discussed during our call last quarter, I said that I planned to engage a third party to help us improve the operating efficiencies of the system. We have, indeed, engaged Oracle, who is the parent of PeopleSoft, and we are about halfway through the first part of a two-part engagement.

The first part is an assessment phase. The assessment phase is about four weeks at a relatively modest cost. The deliverable from this four-week assessment phase is essentially a roadmap that will help us improve the operating performance of this system.

The implementation of that roadmap is part two. We will not know the cost for the implementation, or part two, until we have the outcome of the assessment, as you can imagine.

But to give you some general sense of where I think costs may be, I'll just remind you that our initial installation was about a \$7 million capitalized lease. I don't anticipate that we're going to start all over again, so my sense is that we'll be facing costs somewhere less than 7 million as we look at this phase two implementation fixes, but I don't think we're going to be looking at something like 15 million. So while we don't really know the costs until we have the assessment, that may give you some sense of where we think we might be.

Let's turn our attention to cash flow. Our cash flow continues to improve. Cash flow from operations was a source of cash for the six months ended June 30, 2006, or \$2.7 million, compared to the same period last year, which was a use of cash negative 16 million.

For the second quarter, our cash flow from operations was a positive 2.6 million. The improvement is primarily due to working capital management.

We talked last quarter, as well, about another measure that we used to look at our cash, which is essentially net cash or cash less borrowings. This was net debt in this quarter, negative 2.9 million, versus 0.2 million in second quarter of last year. Including investments and financing activity, our cash balance fell by about 1.8 million through six months, compared to an increase of 600,000 for the first half of 2005.

As I mentioned earlier, our depreciation and amortization expense was 4.3 million in the second quarter, compared to 5.1 in the second quarter of last year. Capital spending was 1.4 million in the second quarter, also lower than the 3.2 that we spent in the second quarter of '05, though certainly during '05, we were still investing in the PeopleSoft system. For the full year, we expect depreciation and amortization of approximately 20 million, including the amortization of the Balance intangibles, our acquisition in the Netherlands, and the depreciation of PeopleSoft. Generally speaking, we don't expect capital expenditures to exceed \$10 million this year.

Turning to taxes, we had a tax expense in the quarter of \$2.5 million, or a very high rate of about 80%. This results from taxes being paid in the Asia Pacific region, where we are a taxpayer, as well as in Europe, where we pay taxes in the Netherlands related to the income from the Balance acquisition. Our tax rate was also affected by having lower expected contributions from North America, where we have significant net operating loss carry-forwards, which, when utilized, helped drive our tax rate down. As we've talked about in the past, the tax rate basically is just math.

So to update you on our expectations for the tax rate, as I've noted in last quarter, our tax rate is very dependent on where we geographically earn income. And in the longer term, as we earn income across all our regions, we expect to be able to use our NOLs. Based on current estimates, I expect the range to be somewhere above 50 in 2006, given the mix of income that we are forecasting. This is higher than the 37 or so rate that we talked about last quarter, and the main change in that is the lesser income being contributed from North America. That said, as I noted last quarter, we've not really reached a point in this company where our tax rate is really a steady number, and higher earnings will result in a more reasonable range over time. Driving improvements in North America, as well as corporate, will allow us to harness the NOLs, and our restructuring actions, which Jon spoke about earlier, will be instrumental in helping us achieve that.

Turning to the balance sheet, we finished the quarter with 32.3 million in cash and accounts receivable of 241 million. The quality of our receivables base remains good. Our DSO was down two days from the first quarter to 57 days this quarter, with the most dramatic improvements having been made in North America. While we have made progress in Q2, our DSO is still five days higher than it was a year ago, and lowering the DSO and, in general, improving the cash velocity is a very significant focus for us.

We did have better collections during the second quarter in North America, as I mentioned, the UK and Asia, and we will continue to target these locations to reduce the DSO. At the end of the quarter, we had borrowings against our \$75 million credit facility of 35.2, up 5.1 million from a year ago, most of which was used to fund our receivables.

Finally, let me turn our attention to guidance.

As we announced in our shareholder letter, we are revising our guidance formulation to bring it more in line with the industry standard. We currently expect the third quarter revenue between 355 and 370 at the prevailing exchange rates and EBITDA of 7.5 to 8.5, which includes \$2 million of restructuring charges expected during the third quarter. This compares to revenue of 357 and EBITDA of 7.5 in the third quarter of last year.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

We think the change in our guidance formulation is the right thing to do at this time. It's the right step for our company. The restructuring program we announce will improve our profitability and, therefore, the costs that we're incurring with the restructuring, we believe, are a very smart investment for us at this time.

With that, I'd like to open the line for questions.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Amanda, I think we're ready for questions.

## QUESTION AND ANSWER

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**Operator**

Yes, sir. [OPERATOR INSTRUCTIONS]

Matt Litfin, William Blair and Company.

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**Matt Litfin - William Blair - Analyst**

I wondered what letters of credit you have outstanding at the end of June 30?

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Our letters of credit outstanding at June 30 is just over \$11 million.

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**Matt Litfin - William Blair - Analyst**

Okay. And then I wonder if you could address how you stand versus the EBITDA and other covenants on that line maybe at the end of June 30 and then today?

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Right. We have satisfied our covenants at June 30. Obviously, having had some changes in our reported results with our restatement of Q1, we kept the bank involved in that process with us, and we're presently discussing with them the covenants at this point. We have every confidence that we will have the ability to work through the covenants with the bank very well.

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**Matt Litfin - William Blair - Analyst**

Okay. And then maybe looking out beyond the end of the restructuring period. As you look at the blend of your businesses today and think about some of these -- the one-time items that have cropped up, how do you think about the long-term growth rate of this business over time? What do you think we'll be looking at some point once we get past some of these issues?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, Matt, I think the biggest issue with respect to our long-term growth rate is the -- not so much the restructuring charges as the shift in our business that's occurring throughout the regions. And we've talked about this in prior quarters. We've been focusing on shifting our mix of

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

business to improve our profitability rather than growing our business. What that means is that as we exit low-margin, low profit lines of business within each of our regions, the impact of that, obviously, is to reduce revenues. At the same time, we hope to expand revenues in the higher-margin business. But in the best of circumstances, it's a subtraction of one and an addition of one, meaning revenue growth is very limited while we go through this process.

Obviously, that process has been much more successful particularly in the UK market and Europe than it has been in the North American market. But it's also been pretty successful in the Australian market. So I think, adding that all up, I think the long-term growth rate of the business is 10 to 15% on the top line once we get to the point where we have a stability in our mix of business.

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**Matt Litfin - William Blair - Analyst**

Thanks, and I'll ask one more, if I could.

You may have mentioned this in the prepared comments. I got dropped off the line, but does the restructuring in the back half of this year change at all your appetite for acquisitions or your ability to integrate them at all?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, I think for a practical matter, we appreciate that we have to fix some of our problems, so to speak, rather than focus on acquisitions. We've always had the philosophy of acquisitions that the only acquisitions we've made were things that we felt were compelling from a standpoint of our service offerings or a standpoint of our gaps in our structure. And I think, Matt, it's fair to say we've never overpaid. We've always been purchasing at pretty reasonable multiples of EBITDA of anything we've ever purchased.

So never really been looking for acquisitions. We've been very opportunistic. And some of the things that we call acquisitions are really just recruiting of people, and the people have little business, so we acquire their business and go forward. But I would say we'll continue to be very cautious. Most likely, we will spend the remainder of this year focusing, as I say, on fixing our business rather than acquisitions.

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**Matt Litfin - William Blair - Analyst**

Okay, great. Thank you.

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**Operator**

Mark Marcon, R. W. Baird.

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**Mark Marcon - Robert Baird - Analyst**

Just wondering with regards to the restructuring charges of \$47 million, what do you think on an ongoing basis you're going to end up saving relative to where your expense structure is now?

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

I would expect that we will save at least in a 1-to-1 ratio. So on a \$4 million charge, we absolutely expect to save at least \$4 million on that annually and of expenses that are in cash. And our goal is to save somewhere closer on that charge, in general, in terms of the actions we're targeting at a ratio that's closer to 1.3, 1.4.

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**Mark Marcon - Robert Baird - Analyst**

Okay. And can you give us a sense for where we'll end up seeing the greatest impact?



Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

That's a good question. I would say that probably the greatest impact will be between the North America and the corporate expenses. So as Jon mentioned, one of the themes that we're focused on, so to speak, is essentially the collapse of the corporate North America support structures. In doing that, it allows us to not only combine the people but also to look at premises and things like that. So my expectation is that the biggest impact will be, shall we say, in the North America market, which includes corporate. I think the second area we'll obviously see in international, but our initial actions starting out for a preponderance in North America.

**Mark Marcon - Robert Baird - Analyst**

And when do you expect these savings to actually take effect? When do you think the restructuring will be done?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Well, first of all, part of the reason that we have a range on the charge is to really help us figure out what we can actually get done this year. So we do want to move with some sense of deliberateness, but we also want to make sure that we keep the business operating on an even keel for the rest of the year.

That said, we have already begun to take some actions, as Jon referred to. In the North America market, some of Tom Moran's initial actions obviously dealt with performance. Those were completed in the second quarter and do include actions for which the savings will occur and are occurring in the third quarter.

Other actions that we will action during the third quarter, several of them, over \$1 million of them, have been actioned already. So my expectation is that we will see the savings during the third quarter and into the fourth quarter. And probably the way it will happen is about half the charge will get used -- well, maybe about 40% of the charge will get used in the third quarter and the rest will get used in the fourth. So we would see these savings following shortly on from there.

**Mark Marcon - Robert Baird - Analyst**

Okay. And so it's going to be a minimum of \$4 million and could be as high as 7, and we'll know that by the end of the fourth quarter in terms of where that comes out?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Sure.

**Mark Marcon - Robert Baird - Analyst**

Okay. Can you talk a little bit about just the monthly trends that you saw in the US and the Americas? According to the shareholder letter, it sounds like you're seeing some evidence of a bottoming. I'm wondering if you can kind of give us a sense of what you were seeing in the monthly trends, particularly in the key practice areas that are at issue?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

As I mentioned, first, what we saw, Mark, my frame of reference is contractors on billing. And we saw contractors on billing bottom and begin at least to stabilize and even recover a little -- meaning we had additional contractors on billing through the quarter, particularly in IT. So that's really the background of my remark in the shareholders' letter to say that I would characterize it as stabilization.

**Mark Marcon - Robert Baird - Analyst**

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Does that mean, Jon, that it bottomed in May or June, or when did it bottom and start rebounding a little bit?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

My recollection is the latter part of May. So we're going up, but I don't want to say that we're going up so rapidly that I would call it a rebound. I'd say we're going up; we're not going down. It's more the absence of going down rather than a rebound.

Certainly in the Legal business, that's continued to grow. In the other practice groups, we're up in engineering, energy engineering, and flat in the other practice groups.

**Mark Marcon - Robert Baird - Analyst**

And in the Americas, you mentioned that the gross margins in several of practice areas have declined. Can you give us a sense for why that is? Is it the lack of utilization? Is it cost pressures? What's the key issue?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, the biggest issue is in IT. Gross margins in IT have declined, and that's year on year. And I think the biggest driver of that decline is decline of contractors on billing.

As we mentioned in the first quarter call, we're still suffering through the continuation of the fall-off in a couple of accounts that were high-margin accounts that we've been unable to replace at the same margin level. So our contractors on billing in the quarter are down about 15%, and gross margin -- and this is in IT -- and gross margin's down about 25%. So that's showing you the impact of losing the higher-margin - the fall-off in the higher-margin business. It's really nothing new in terms of loss of new accounts. It's not a loss of additional accounts. It's the continuation of the trend that we saw in the first quarter -- you know, that we talked about the first quarter, rather. So that's, by far, the biggest impact.

The other gross margin impacts --

In Legal, revenues are up sharply. Gross margin is up less. The differential is due to, again, what we talked about in the first quarter, to increased pricing pressures in that market. We're still growing strongly. We had a very successful quarter, but there's increasing competition, and that's having an effect on pricing.

**Mark Marcon - Robert Baird - Analyst**

Do you expect -- where are your IT gross margins now on the Temp side?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

We'll have the answer for you in a moment, but we'll have to check to see where they are right at the moment.

**Mark Marcon - Robert Baird - Analyst**

Okay. I was just trying to get a sense for do you think that the gross margins have bottomed, or are they going to continue to fade?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, I think that our biggest challenge in IT is our mix of business rather than margins per se. I think we're subject to the same factors everybody else is in IT that's in the staff augmentation business. But I think the problem is that if you looked at our mix of business at the end of December or if you looked at mix of business a year ago, let's say, to give it a better contrast, we lost some of the pieces of business that were at margins in the 30s, and what we're left with is a mix of business that's, by definition, much lower. We haven't been able to add back pieces that

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

are in the 30s. That's been -- so that's been the biggest impact, I think, on our business when you look at our margin within our IT business as a whole. Right now, our Temp margin in IT is in the low 20s.

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**Mark Marcon - Robert Baird - Analyst**

I mean that should stabilize, shouldn't it?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, I think it should, but again, I think that it depends on the mix of business because if you look at the industry as a whole, there are certainly pieces of business. Let's take large account IT projects within the North American market. There are large accounts that are in the teens. And so everybody has -- that's not particularly our business model, but we have pieces of business like that, just like many other people do.

As I say, what's really hurt us in this year, one of the things that's hurt us, decline in contractors on billing has certainly hurt us. But one of the things that's hurt us in the mix of business. The high-margin business got lopped off, and we haven't been able to replace it.

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**Mark Marcon - Robert Baird - Analyst**

Okay. Last question, and then I'll jump back into the queue.

In terms of the guidance, obviously, you've had really nice improvement in Europe, and then Asia Pac is rebounding well. Can you give us a sense for, in terms of the EBITDA guidance, just generally speaking, how you would see the three major geographies playing out?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

For next quarter?

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**Mark Marcon - Robert Baird - Analyst**

Yes.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, third quarter is a weak quarter in Continental Europe because of the vacation season. So that's a factor that we have to deal with. We certainly expect our guidance includes the assumption that our North American business, the Hudson Americas business, will be profitable in the third quarter. So we expect to be profitable in Europe but less profitable than the second quarter. Third quarter in North America, we expect to be profitable. Highland Partners, we expect to be profitable. In Asia Pac, we would expect a pretty stable business in the third quarter since the holiday season does not have as big an impact.

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**Mark Marcon - Robert Baird - Analyst**

Great, thanks.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

You're welcome.

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**Operator**

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Jeff Silber, BMO Capital Markets.

**Jeff Silber - BMO Capital Markets - Analyst**

I'm actually going to ask the same question in terms of guidance but if we can focus on revenues by geography?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

You've exceeded my knowledge of detail. I'll have to ask Mary Jane to focus on that one.

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

With respect to the revenues by geography, let's go in the order of what we've typically seen. I think in both Europe and in the Asia markets, we've not had enormous growth in those markets. As Jon said, our focus has really been on advancing profitability, which has included sort of firing low-margin business and replacing it with higher. So the revenue, in general, in those markets we expect to be relatively flat. We are expecting to see growth in the North America market as it has delivered its growth in the second quarter, as well. So by and large, we would expect the growth to come from North America and the other markets to perform, as they have in the past, more or less flat.

**Jeff Silber - BMO Capital Markets - Analyst**

And when you talk about the growth, you're talking sequentially, or are you talking year over year?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

I'm talking year over year.

**Jeff Silber - BMO Capital Markets - Analyst**

And just to clarify, the restructuring charge that you took in the quarter of about 700,000. Where was that? Was that in North America, corporate, or it was kind of mixed?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

It was relatively mixed between North America and corporate. One of the actions which was separately 8-K'd was the CIO position. That was in corporate. Some of the actions that Tom Moran took, small ones that required severance, were in North America. That's basically where the bulk of those charges were.

**Jeff Silber - BMO Capital Markets - Analyst**

Okay. And then the \$1.6 million charge that you talked about last week, is that a reduction in revenues in Hudson North America? Is that correct?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Yes.

**Jeff Silber - BMO Capital Markets - Analyst**

Okay, great. And what is the NOL balance right now?

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Let me come back to you on that, Jeff. It's still pretty high, but let me just check that for you. I'll give you a ring back.

**Jeff Silber - BMO Capital Markets - Analyst**

Alright. That's great. And then one more question.

If I remember correctly, you had a deal with Monster that was going to be restructured, I think, at the beginning of the second quarter. Can we get a little bit more color on that?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Sure. When we sponsored Monster in 2003, we had a marketing contract with them. That was roughly \$3 million a year. That did expire at the end of the first quarter of this year. So from a corporate perspective, it went away.

What then happened is each of our individual regional markets negotiated directly as to what they needed with respect to postings on the board, and they have done that. Obviously, it is a little bit more tied to their actual usage and what's more negotiated, shall we say, more of our [length], and that's now in place in the individual regions.

**Jeff Silber - BMO Capital Markets - Analyst**

So that kind of goes along the line of expenses being taken out of corporate or being pushed down to the specific regions?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Yes. So -- exactly. So they did come out of corporate. They were pushed down to the regions, and they were negotiated at a better rate than we started out with.

**Jon Chait - Hudson Highland Group - Chairman and CEO**

We had a significant net reduction.

**Jeff Silber - BMO Capital Markets - Analyst**

That was my question. Great. Thanks, Jon.

**Jon Chait - Hudson Highland Group - Chairman and CEO**

Yes.

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Yes.

**Operator**

[OPERATOR INSTRUCTIONS]

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Mike Carney, Aperion.

**Mike Carney - Aperion Group - Analyst**

My first question, Jon, is how tired are you?

**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, I'm very disappointed to be talking to shareholders for the third quarter in a row about one-time charges, surprises and other things. I wouldn't say I'm tired, but I'm certainly frustrated and disappointed, and I'm also disappointed that a lot of these things that we're talking about, I think, obscured what was, in fact, a decent, if not stellar, quarter. It was certainly a decent quarter where a lot of things went right, and unfortunately, I mean legitimately, the focus has been on some of the things that need to be fixed.

**Mike Carney - Aperion Group - Analyst**

Mary Jane, you mentioned \$3 million of expenses that would not be going forward. What did that include? The \$1.6 million charge in the second quarter and what else?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Yes. The 1.6 million that we recorded in the second quarter and, in addition, as a subject of our 8-K, we talked about some of the things that we tackled as part of our review of the North America accounting that did lead to our restatement in Q1, some of them like, for example, the treatment of certain revenues, accrued liabilities. What we did as we came out of the second quarter is we just made sure that all those estimates were current. We continued the work that we did for first quarter in the second quarter, and we don't expect to see that level of true-up continuing. So, they're basically the same sort of things that we talked about with respect to the first quarter.

**Mike Carney - Aperion Group - Analyst**

And so that doesn't include any of the restructuring charges or anything that's related to restructuring?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

It does not, Mike.

**Mike Carney - Aperion Group - Analyst**

And then on the PeopleSoft expenses, you said 1.7 million in the second quarter.

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Right.

**Mike Carney - Aperion Group - Analyst**

Should that continue to move, I assume, down?

**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Yes. I mean I wouldn't say -- obviously, we're anxious to get the results of this assessment, and so I don't know that it's going to go from 1.7 to 0.5 million in the quarter, but it should continue to move down because that's the goal of the assessment. If we were going to institutionalize \$8 million of expenses in a year, we should be doing something else, which is why we're doing the assessment. So, yes, we should expect it to go down.

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**Mike Carney - Aperion Group - Analyst**

And then on restructuring, I see some charges in Asia Pacific in Highland Partners. Is that adjustments, or is that specific to this second quarter, too?

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

With respect to the charges in the second quarter, there are a few true-ups of old charges. That is the difference between the roughly 900,000 and 700,000. They're true-ups of the older restructuring charge, for example, that we took in 2003.

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**Mike Carney - Aperion Group - Analyst**

Okay. And then, Jon, of the one large IT project that was ended, what percent of that was of the, I guess, 15% revenue decline this quarter?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

I -- you know, I don't have the exact number, Mike, and I'd rather not give you a wrong number. But if you call me back, I can -- either I'll check or David Kirby will check and give you some specific --

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**Mike Carney - Aperion Group - Analyst**

Or, rather, more importantly, is the 15% decline, is that mostly from one large project, or a lot of other projects?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

I would say it -- I wouldn't say a lot of other projects, but there are -- there's more than one large project. We had the unhappy circumstance of one large one and another few that accounted for a significant portion of the fall-off.

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**Mike Carney - Aperion Group - Analyst**

And then --

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

It is not a case of just one large project.

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**Mike Carney - Aperion Group - Analyst**

So you've made a lot of changes in personnel, it looks like, in Hudson Americas. But a number of these practice leaders did well for many quarters in terms of growing, especially on the top line, so what gives you confidence that new people in here, in terms of the producers and practice leaders, can change anything going forward?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, first of all, I think your assumption is right. A number of the people that were changed were successful over a period of time. And I think all you can do is evaluate people under the circumstances as you go along. And for whatever reason, they were not able to deal with as the market changes, and the market changes every day. For whatever reason, they weren't able to deal with those changes. In some cases, there were decisions that were made over the course of the last several quarters that have in the proverbial sense come back to haunt them and us.

So I think -- what I'd tell you is I think sometimes you make a change because you need a fresh outlook and new energy into the project, and obviously, my responsibility is to look very closely at what's happening. A year ago, this was an operation that was doing very well, and not to say that I was derelict in my duty, but when an operation's going very well, you give people more responsibility and more latitude. And when things go wrongly, and particularly when they go wrongly when they shouldn't -- you know, this is not a case of the economy going wrong, right? -- then my job is to look a lot more closely at what's going on. And things that I might have tolerated before I can't tolerate now.

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**Mike Carney - Aperion Group - Analyst**

And then, finally, when you're -- the heads of your regions and other individuals with P&L responsibility, how often do they plan for the future, and then how much of the future do they plan? And has that changed with these problems in North America?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, let me tell you, first of all, how often do they plan. We have an annual planning cycle I think like almost everybody. We call it a strategic planning cycle. There's an annual budgeting process. There are monthly updates. I meet or talk to every one of them every month. We get together physically ever quarter for planning and looking at how are we doing, what do we need to fix, etc.

So I'm not a believer in looking out five years and doing five-year plans. I don't believe in that. I think that our business -- I think five-year plans in our business are negative because the key thing to our business is to react to changes, and the great thing about our business is our ability to react to changes in the marketplace because we don't need to build big factories. We just need to be nimble and be quick and make decisions. So I'm more focused on a one-year planning cycle, and then overlaid with sort of a strategic vision of where we want to get to and financial objectives to get there and drive that way. So we do that all the time.

I would say that, again, in the IT business, paradoxically, it's probably the business where we've done the most planning, and we've had the worst result. And we've done the most planning in North America, and we've had the worst result. So I don't think it's a fault of planning. I think it's a fault of execution, and I think it's also a fault of leadership, certainly at the practice group level, and that's why we've made the change. So that's how we're addressing it.

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**Mike Carney - Aperion Group - Analyst**

And how much of the PeopleSoft issue was responsible, do you think, for that?

And then going forward, do you think that you've lost credibility with the ranks of your people because of the PeopleSoft issue and because of the other problem in North America?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Those are very good questions. I hope I have good answers. I think that PeopleSoft has certainly had a significant adverse impact on our business, and it has significantly hampered us in the sense that we went through a long period of time -- I think we talked about this in the first quarter -- where it was not clear what the financial results were. And one of the keys about this business is putting the information in the hands of the people on the ground that can do something about it. And when everybody's distracted because they're arguing about what their results are rather than what they're going to do about it, that's a serious negative. From that standpoint, PeopleSoft and the PeopleSoft issues have been a negative.

They've also been a negative in that we've devoted enormous amounts of resources on the ground to things that should not require enormous amounts of resources, particularly billing, fixing bills, dealing with clients.



Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

You know, in the last quarter, I traveled much more extensively in North America to hear from the people on the ground in terms of what's on their mind. In many of the markets, a significant amount of energy and resources are being devoted to mediating with clients and getting the billing right and so forth and so on.

So I think it has certainly been a distraction, and I don't want to use it as an excuse. We're responsible for PeopleSoft, too. That's our responsibility. We have got to get this fixed. And I think I feel much better and much more confident about the process that we have in place today to both monitor it as we go along and to fix it ultimately to make our operations more successful. I think we have a better team and a better process, far better than we had before, in either case, so I feel much better about that. So I think that it has been a major distraction, and it has been a major frustration.

Have we lost credibility? I would say our credibility as leaders has certainly been damaged. When I go out to the field, there is an enormous amount of frustration surrounding, let's call it, PeopleSoft billing and candidates, some of the basic things about our business. And certainly, that's a concern. I think people are still -- our people have been great. They're very committed to the company. They want to work here. They like working here. We're lucky to have them, and they're working their butts off to make this work. So we have to do a better job of giving them the resources by fixing the PeopleSoft problem.

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**Mike Carney - Aperion Group - Analyst**

Thanks.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Thank you, Mike.

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**Operator**

Mark Marcon, R. W. Baird.

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**Mark Marcon - Robert Baird - Analyst**

Just a follow-up to that. In terms of -- you do have a lot of changes in terms of personnel in North America. How long have those people been in place, and how well are they gelling at this point? Is it too early to tell?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

It's pretty early to tell. Let's look -- let's just walk through the changes.

Our new finance director joined in April. He's, unfortunately, had to spend most of the quarter dealing with accounting issues rather than dealing with the part of the job where we think he can add much more value, which is from an operational standpoint. But he's been there one -- less than a quarter, basically.

The CIO joined, I think, July 31.

The new leader of IT was appointed Monday, although he's been with the company -- Tim Bosse, who's done really a fabulous job running our energy engineering business.

The accounting and finance change was announced internally about three weeks ago. We're going through -- Tom is going through a process. I'm involved in interviewing the candidates. We expect to have an appointment, though, by the end of this month, so that's not in place.

And we've made a number of changes in the accounting department, which, you know, the bowels of the company, the engine room, we would normally not talk about. We want Mary Jane out of there once in a while. But I think that when you look at some of the challenges we've had that have resulted in the restatement, we have a new team in place, and I think we've certainly had a few challenges in terms of the transition.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

Again, I think those challenges were things where we put people in a position where there's a lot of manual stuff that had to be done and a lot of workarounds, and we've spent a lot of time regularizing things in the last quarter.

Our new finance director in North America has done a great job in terms of providing the stability and regularizing the process. So I think that team is working pretty well.

So I think it's pretty early days, Mark.

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**Mark Marcon - Robert Baird - Analyst**

Okay. And, Jon, you've always given us straight answers in terms of the trends that you're seeing. Obviously, there's a lot of concern about from a macro perspective that we might be slowing down or something worse. What are you seeing? What are you hearing from your clients? And if we do go into a slowdown, what would be the contingent steps that you would take above and beyond what you've already announced?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Well, like everybody else in the world, I'm concerned about the course of the American economy, and I don't have any crystal balls. The paradox is that permanent recruitment, which is normally the most economically sensitive part of the industry, is going great at the moment, and I think we're not alone. It's great for us. I think, Mary Jane, we're up 65% in the quarter --

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Well over 50.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

-- in [terms of] improvement in North America. So but on the other hand, there are plenty of signs of -- in the general economy in terms of interest rates, housing starts, price of oil, gas, consumer spending. There are plenty of things to be concerned about.

One of the things we're doing, and this is part of the background of the restructuring charge, is that we're using the restructuring charge, as I mentioned, to exit some of our high-cost premises, such as our corporate office in New York City. We've always had it in mind to do that. I think you and I have talked about this. We've recognized that we need to do that, and we've been treading water waiting for the market to rebound. And we're still at a point where current rents are not up to a level where we could sublease our space in New York City at no loss or at no cost. We are still at a rent level that's higher than the market here in New York, and we're higher than the market in London, and we have massive expenses devoted to those two facilities.

So one of the things, as a contingency plan as part of this restructuring, is exiting those premises, which will cost us money. And our goal six months ago was to ride the wave of the recovery and be able to exit at a time where it would not cost us money. And we would save money by distributing the people in other regions and other locations, less expensive locations, as well as simply moving from Class AAA office space down to Class B-plus office space. So that's our contingency plan, and that's part of what is behind this restructuring charge. We just think that the economies of the world, and particularly, looking at our big economies -- North America, Australia, and New Zealand in particular -- have enough question marks surrounding them that it's prudent at this point to take these actions.

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**Mark Marcon - Robert Baird - Analyst**

Okay, great. Thank you.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

You're welcome.

Aug. 08. 2006 / 9:00AM ET, HHGP - Q2 2006 Hudson Highland Group Inc Earnings Conference Call

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**Operator**

At this time, there are no further questions. Mr. Chait, do you have any closing remarks?

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Yes.

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**Mary Jane Raymond - Hudson Highland Group - EVP and CFO**

Jeff, you -- just to come back on your question about what the outstanding NOL balance is, the number's so big I didn't want to get it wrong. The NOL balance estimated is about \$250 million. It's about 190 in the US and a little bit north of 60 in the non-US regions. So you can see why we're anxious to improve the profitability in North America and use it.

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**Jon Chait - Hudson Highland Group - Chairman and CEO**

Okay. With that, David, will you make the concluding remarks?

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

Thank you, Jon, and thank you, everyone, for joining the Hudson Highland Group's Second Quarter Conference Call. If there are any further questions, please feel to contact Mary Jane Raymond or myself at any time. You can reach Mary Jane at 212-351-7232, and my number is 212-351-7216.

Today's call has been recorded and will be available later today by calling 800-642-1687, followed by the passcode 3401282. For calls outside the US, please dial 1-706-645-9291, followed by the same passcode. The archived call will remain available for the next seven days at those numbers. Today's webcast will also be available on the Investor Relations section of our website, HHGroup.com.

Thank you very much.

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**Operator**

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

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