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## Conference Call Transcript

HHGP - Q3 2006 Hudson Highland Group Inc Earnings Conference Call

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Good morning. My name is Summer and I will be your conference operator today. At this time, I would like to welcome everyone to the Hudson Highland Group third-quarter earnings conference call. All lines had been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. (OPERATOR INSTRUCTIONS)

Thank you. At this time, I would like to turn the call over to Mr. David Kirby, Director of Investor Relations. Sir, you may begin your conference.

**David Kirby - Hudson Highland Group - Director IR**

Thank you, operator, and good morning, everyone. Welcome to the Hudson Highland Group conference call for the third quarter of 2006. 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, 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 SEC.

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

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

Thank you very much, David, and thank you very much for joining us today. I want to start off by reminding you of the context of our financial statements, which were released yesterday at the close of business, together with our letter to shareholders.

For purposes of my remarks, I am assuming that all of you have had a chance to read that, so I won't be repeating any of the numbers per se. Mary Jane Raymond, our chief financial officer, who will follow me with her presentation, will focus more specifically on the numbers.

I want to start off by reminding you of the context in which these results were achieved. The third quarter in our business for our company is a relatively soft quarter due to the holiday season in the Northern Hemisphere. This is particularly impactful as roughly 55% of our gross margin is attributable to permanent recruitment revenues and -- permanent recruitment gross margin, and permanent recruitment is particularly affected by the holiday season. I think in that context, the results that have been achieved this quarter were outstanding.

Since I joined the company, our focus -- and I say focus intentionally; I would hesitate to call this a strategy -- but our focus has been to improve the profitability of our existing business rather than grow for the sake of growth on the revenue line. That focus is critical to understanding the results that were shown in the third quarter and in thinking about the guidance that we released yesterday with respect to the fourth quarter.

As we go through our business, we are shifting our business to higher margin segments of our business, and at the same time, either reducing or exiting lower margin segments of the business. What that means concretely is as we reduce the low margin business or exit it, it reduces our revenues. At the same time, we're growing other portions of our business, the high-margin business, which of course increases revenues. But the net impact is somewhat diluted when you look at our revenue growth than it would be if we were just trying to grow our revenue line.

We think that is in the shareholders' interest. We think that improving profitability is the most important job that we can do as a management team. And I'm happy to say that the third-quarter results I think support that focus.

Turning now to talk about some of the themes emerging from the third quarter, I want to remind you -- and this will be the first of about four reminders -- that our results today reflect the sale of Highland Partners that was effective on October 1, 2006. And the results are treated as discontinued operations in the third-quarter financial statement for all periods presented, including the comparable period in 2005. What that means concretely is that the results of Highland are recorded in net income, but not in the other lines of the financial statements.

After a challenging three quarters, the Company's third-quarter results represent its strongest adjusted EBITDA performance since its inception as a public company. Hudson Americas regained EBITDA profitability, while Hudson Europe and Hudson Asia Pacific each reported significant EBITDA growth against prior year and a significant increase in EBITDA profitability. As you'll recall, we've set out EBITDA profitability -- that is EBITDA as a percentage of revenue -- as a critical element in terms of defining the profitability and the future of our company.

Last quarter was not a great quarter -- when I say last quarter, I'm talking now about the second quarter of 2006 -- was not a great quarter for the company on a consolidated basis, and especially in the North American market for our Hudson unit. But I did point out at that time the importance of the progress that we were making in our Hudson region, particularly Australia, New Zealand and Europe, in terms of improving profitability. I think that the results of this quarter, happily, again are confirming the validity of our approach.

As I mentioned to you, we had a number of recent events and significant events in the quarter, and I went to comment first on just a couple of those. The company completed the sale of Highland Partners to the Heidrick & Struggles, as I mentioned, on October 1, 2006. The gain and loss from that sale will be included in the fourth quarter and is not included in the third-quarter results. But Highland Partners is treated, as I mentioned, as a discontinued operation in the third quarter.

The sale was a strategic move for both the Hudson Highland Group and for Highland Partners. The sale will help Hudson Highland Group focus on its core Hudson management recruitment, professional staffing and talent management solutions markets while allowing Highland Partners to build on its track record of success in a dedicated executive search environment. We wish the Highland Partners the best of luck in their new environment and we're certain that they will be very meaningful contributors to the future success of Heidrick & Struggles.

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Last quarter, we spent quite a bit of time commenting on the PeopleSoft installation in our North American market. I think that at that time, we had mentioned to you that we were in the process of doing an evaluation of the remediation plan in the North American market. And I pleased to say that that evaluation of the plan has been completed and will be discussed in more detail by Mary Jane in her presentation.

As we promised at the time, and we've delivered, we have completed a remediation work plan and we now have an estimate that we can provide you of the total cost and the total time that we believe it will take to complete that plan. Again, Mary Jane will talk to you in more detail about that.

The third significant event that I'd like to mention is the restructuring charge that we also disclosed at the end of the second quarter. And you can see that it was a little over \$2 million in the third quarter. And you can see in our guidance we expect it to be somewhat over \$2 million next quarter.

I'm not going to talk about that in detail because, again, Mary Jane will in her presentation. But I would just point out to you that -- you may recall that during the second quarter -- and some of you may now realize that in the second quarter, when we announced the restructuring charge, we were anticipating the gain from the Highland transaction. As a result, you can think of it that we've spent "some of the gain" that we knew and some of the cash that we knew we would obtain in the Highland transaction in a restructuring charge that allowed us to accelerate certain actions within our Hudson business that we believe will assist us in improving profitability next year and in coming years.

Again, Mary Jane will talk about that in more detail. But that was the thinking behind the restructuring charge. We knew that we were announcing it in the second quarter at a time where we could not announce at the same time the Highland transaction. In a perfect world, of course, we would have preferred to announce both in the same quarter. But we felt it was important to get the restructuring moves underway at that time and to have the whole third quarter as well. And we were confident that the Highland transaction was going to close.

Turning now to a review of regional results -- and again I'll stay at the thematic level and let Mary Jane talk about the numbers in particular. Hudson Americas returned, as I mentioned, to profitability after a challenging first half of 2006. This was driven by stabilization in contractors on billing and a significant improvement in the temporary contracting margin for the second quarter.

We're pleased with the improved results. We do believe that there is additional room for improvement in that business as we look out both to next quarter and to the following year. And we think Tom Moran and his team are very well focused on that goal. So we think it is a good foundation for the future on what they have achieved in the third quarter.

Once again, I want to give a tip of the hat to the legal business -- to what we call the legal practice group in the Hudson North America business that again reported an outstanding quarter, with a revenue increase of 28% and a gross margin increase of 17% in the legal practice group.

In the Hudson North America business, we had another very strong quarter in the demand for permanent recruitment. Permanent recruitment revenue was up 10% over the prior quarter and represented approximately 30% of gross margin of Hudson Americas in the quarter. Permanent recruitment, again, was very strong in the legal group and in our management search group, which is our retained search business.

Hudson Americas reported an adjusted EBITDA of \$3.8 million in the quarter, more or less flat compared to the prior year. As I said it was a significant improvement from the first half of 2006.

Turning to Hudson Europe, again, they had a very strong quarter with a significant improvement in both EBITDA reported in dollars as well as EBITDA percentage. We think that that improvement in EBITDA percentage is something that is very important for us as a company on a go-forward basis.

And we would remind you once again as shareholders that improvements in profitability in Europe, particularly in Continental Europe, are time-consuming and expensive because of the labor legislation that makes making changes in operations both time-consuming and expensive. So we think it is a very strong result in what is normally a very soft quarter.

Gross margin was driven by continuing strength in permanent recruitment in the UK and Continental Europe, as well as the continued contribution of the Balance business, which we acquired in 2005.

Temporary contracting margin improved significantly in the quarter to 18.9% from 17.1% due to higher gross margins from the balance business and a nice improvement in the UK temporary margin to 16.6% from 15.8%. Our team in the UK, led by John Rose, has done an outstanding job of improving profitability, while managing a shift in the mix of the business. And John and his team delivered another outstanding quarter.

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The European region as a whole achieved an EBITDA of 3.7% of revenue compared to 2.9% in the third quarter of last year. We had key contributions, in addition to the UK, the Netherlands, including Balance, but also including the other portion of our Netherlands business, the workforce and mobility portion, which swung the profit from a loss in the previous quarter, as well as our operations in Belgium and France.

Turning to Hudson Asia Pacific, again, we had record EBITDA performance in dollars and a very strong increase in EBITDA percentage in profitability. In Australia, revenue and gross margin growth were driven by strength in permanent recruitment and a stable and temporary contracting market, even in the face of what I think can only be described as a neutral or neutral-ish economy.

In New Zealand, where the economy has remained soft, gross margin dollars declined 13% in local currency in the quarter compared to the prior year. But through strong expense management and control, the EBITDA decline was minimalized.

Results in our Asian market remained robust as we continued to experience growth in permanent recruitment. As I mentioned Asia-Pacific achieved an EBITDA percentage of 9.2% of revenue for the quarter compared to 7.4% a year ago.

In Corporate, which of course is the domain of our Chief Financial Officer, I'm pleased to say that Corporate expenses were lower in the third quarter of 2006 compared to the prior year due to continued improvement in expense management and lower compensation costs.

I should also mention, as I said in the shareholder letter, that even at that, corporate expense included approximately \$1 million of incremental costs related to the restatement that we announced in August.

With that, I'm going to turn it over to Mary Jane, who will walk through the financial statements in more detail and discuss our guidance. Mary Jane?

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

Thank you, John. Good morning. As I've done with you all in the past couple of quarters, I'll go through the financial highlights in the order of the income statement for our third quarter. I'll also give a few comments on the business mix, currency this quarter, our balance sheet, cash flow, and then guidance, as Jon said.

So just to avoid having to put this on our voicemail messages, I will just remind you again that the numbers that I am going to refer to are from our continuing operations. They exclude the results of Highland Partners, which we will treat as discontinued operations in the third quarter.

As a reminder as well, our financial statements reflect the adoption of FAS 123(R). This is the expensing of stock options. Our company adopted that on a modified retrospective method, which means that the results for both 2005 and 2006 include stock option expense. Costs in the third quarter were about \$1.2 million in 2006, being up slightly, about \$100,000, from prior year.

Our reported revenue was even with prior year at \$352 million in the third quarter compared to the same period in 2005. We had a 7% gain in Hudson Americas, a 2% gain in Hudson Europe and a 1% gain in Hudson Asia Pacific.

On a constant currency basis, the revenue increased 2% in the quarter, including, naturally, 7% again in Hudson Americas, 3% in Asia-Pacific, and a 3% decline in Hudson Europe.

Temporary contracting increased 2%; permanent placement revenue increased 9%; and talent management declined by 13%, all of those also on a constant currency basis.

Our reported gross margin increased 6% from prior year, with 5% gains in each of Hudson Americas and Hudson Asia Pacific, and 8% in Hudson Europe. Gross margin as a percent of revenue was 36.2% in the third quarter, up from 35.4% in 2005. The temporary contracting gross margin dollars increased 4%, while the temporary gross margin as a percent of revenue increased 18.4% from 18.2% in the third quarter of 2005. On a constant currency basis, our gross margin dollars increased 4%, including gains of 3% in Hudson Europe and 6% in Hudson Asia Pacific.

Our adjusted EBITDA in the third quarter of this year was \$12.1 million compared to \$6 million a year ago. EBITDA, which is adjusted EBITDA less our restructuring charge, was \$10 million, or 2.8% of revenue. EBITDA was driven by regional EBITDA margins of 9.2 in Hudson Asia Pacific, 3.7 in Hudson Europe and 2.2 in Hudson Americas, as well as Jon just mentioned, reduced costs in Corporate.

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Our depreciation and amortization in the third quarter were \$3.9 million, unchanged from a year ago. Our operating income was \$6.2 million, up from \$2.4 million a year ago.

Our interest expense of \$700,000 was offset by other income of \$700,000, primarily from a gain on the sale of our assets in the Scottish industrial business. This sale is precisely in line with our strategy of focusing on higher margin contracting business, as we have been doing in the UK and around the globe for some time now.

Our provision for taxes in the quarter was \$2.2 million, representing a more normalized rate of 36%, and I'll give you a little bit more color on that in a few minutes.

Our consolidated net income in the third quarter was reported at \$4.3 million, up from \$1.2 million a year ago. Net income from continuing operations was \$4 million, up \$23,000, so roughly flat to a year ago. I'll just remind you that obviously at the net income level we pick up the income from discontinued operations, which would represent the income contribution of Highland Partners.

Basic and diluted EPS were \$0.18 and \$0.17, respectively, compared to \$0.05 on a basic diluted basis in the third quarter of 2005. EPS from continuing operations was \$0.16 on a basic and a diluted per-share basis compared to 0 a year ago.

We have 25 million diluted shares outstanding in the third quarter compared to 25.5 in the third quarter of 2005.

Turning to some of the more interesting technicolor, let me shift to some commentary here on business mix. While our mix by product and geography remains more or less unchanged in Hudson from the prior quarters, we continue to benefit from the strategy we have been executing for the last several quarters.

Our mix within temporary contracting is improving every quarter. The temp margin is up almost 180 basis points, in Europe against the same period last year, and has stabilized in North America, up 200 basis points from last quarter.

Balance, our Netherlands acquisition that we completed in August of 2005, continues to deliver strong results and market-leading temp contracting gross margin levels. We sold the Scottish business in the UK, as I just mentioned. This is a good small business, but not in our core, and selling it allows us to continue to focus on the high-margin strategy in the UK market.

Permanent recruitment remains the largest contributor measured in gross margin dollars, and growth remained strong in this area in every geography, as is part of our strategy as well.

Turning to currency, our results were slightly positive for currencies in the third quarter. On a consolidated basis, currency movements increased the reported revenue, gross margin and EBITDA by about 1%, and increased our reported EBITDA by about 50,000; so really not a whole lot of movement at the EBITDA level.

With respect to expenses, I'll talk to you a little bit about two things in this area, both PeopleSoft and our restructuring charge. First, with respect to the highlights on the numbers, we made solid improvement on the expense front in each region around the globe. SG&A expenses were up less than 1% from prior year. Office & General were down 7%, or about \$2 million. Salary and related costs were up 3%, or about \$3 million on a gross margin increase of \$7 million.

Turning to a little discussion here on PeopleSoft. Our PeopleSoft expenses in the third quarter were roughly \$2 million, including the cost of the restatement. To review a few points with you from the shareholder letter, we engaged Oracle, who is the parent now of PeopleSoft, to perform an external review and assessment in the North America market, where we have the company's only installation of PeopleSoft.

The assessment phase was completed in the third quarter, and the implementation has commenced. We expect that the implementation will continue for approximately the next three quarters, or to about the middle of 2007. The estimated cost for this work is about \$4 million in total, a portion of which we expect to capitalize. We expect good improvements from this work, including faster management reporting, back office efficiencies and lower maintenance costs.

Inclusive of this work, the company expects spending on the system to continue at about the \$2 million level per quarter through the second quarter of 2007. This is similar to the amount we just discussed for Q3 and it is similar to the amount we've discussed in past quarters. The split of that \$2 million is roughly half and half between the remediation work on the system and the resources to perform the manual work around.

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As Oracle commences its work on the remediation, the expenses for their work will replace our previous spending on remediation and the work on the additional resources for the manual work will continue. The manual work expenses will continue obviously until the remediation is complete.

At the end of this nine-month period, we expect that the cost for Oracle in terms of remediation work on the system will end. We expect that the spending on the manual work will be cut in half -- no back office is totally devoid of manual work. We believe that this work is a very good and well-planned investment, we are pleased with the work plan that we have from Oracle and we are looking forward to achieving through this work, sustainable process improvements and improved economics.

Turning to our restructuring charge, Jon has already commented on this for you. Basically, when we announced this in the second quarter, we were hopeful of the successful completion of the Highland Partners transaction. While the planets did not perfectly align with the timing on that, we nonetheless thought that this program was important, and were certainly relatively confident we would complete the Highland transaction, as we did. We have reported \$2.1 million in the restructuring program this quarter, making our total spend on the program so far \$2.8 million.

Regarding the charge per se, the company's leaders are using this charge very responsibly and taking action that we believe will produce sustainable results. Just to point out to you, one or two actions may fall into Q1, specifically regarding real estate properties -- those being two, New York and London. We are anticipating moving from the New York property -- we have actually signed a lease, and we are reducing our floor space in London.

As many of you can appreciate, real estate actions don't happen overnight and they are a little bit tough to control on timing. The timing of the charge is coincident with our actually moving out. So just to let you know that that may fall a little bit into Q1. Nonetheless, we are happy about both of those actions and think that those are also very good and are continuing to have results from this program, delivering sustainable cost reductions for us.

As I turn to cash flow, the cash flow in our third quarter showed significant improvement. Cash flow from operations was a positive \$15 million compared to a use of cash of \$5 million a year ago. Through the first nine months of the year, our cash flow from operations was a positive \$17 million.

The improvements were primarily from our bottom-line results -- certainly that helps -- as well as better working capital management. Now, our other measure of our cash performance, net cash, which is basically cash less our borrowings, was \$10 million this quarter compared to negative \$3 million, or net debt, in Q2 of '06.

As I mentioned, depreciation and amortization were roughly flat to prior year at \$3.9 million. Capital spending was 1.8, lower than the 2.9 we spent in the third-quarter of '05. I believe that our depreciation and amortization in the fourth quarter will be consistent with recent levels, and we expect our capital expenditures for 2006 to be under \$10 million.

As I turn to the balance sheet, we have, consistent with the cash flow progress, made very good progress in improving our balance sheet in the third quarter. We paid down \$13 million of debt while holding our cash flat to prior quarter.

And just to be clear on what I think might be the last reminder, this does not include the cash from the Highland Partners transaction. Since that was a fourth-quarter deal -- that deal closed on October 1 -- the cash is not recorded in the third quarter. Therefore, our paydown of debt in the third quarter was from the cash that was generated from the operations.

We finished the quarter with \$32 million in cash and accounts receivable of \$234 million. The quality of our receivables base remains good. Our DSO was down one day from Q2 '06 to 56 days in this quarter. While we've made progress in Q3 -- DSO is now two days lower than it was a year ago -- it is no question higher than we would like it to be. The progress that we made in third quarter was due to better collections and continuing to focus on collections is an essential component, as you know, to the reduction of DSO.

At the end of the quarter, we had borrowings against our credit facility of \$22 million, our credit facility, being \$75 million in total. And that was down from borrowings of \$35 million at the end of June.

Turning to taxes, one of our most favorite topics. We had tax expense in the third quarter of \$2.2 million, or, as I mentioned, at a more normalized rate of about 36%. This resulted from paying taxes primarily in the Asia-Pacific region, where we have been for a while a taxpayer.

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Our rate is lower this quarter for a number of reasons, despite the fact that it may seem a little counterintuitive, since our profitability is actually up. First of all, part of the reason the rate is lower is just the math of where our earnings are. The results of North America were the best that we have seen in 2006. The North American results are shielded by NOLs in that region in, and, as a result, contributions and profits from North America helped bring the rate down.

Secondly, in Asia-Pacific, we recorded our strongest quarter since the spin. While we are a taxpayer in that region, our continued success allowed us to release, particularly in New Zealand, the valuation reserve that had been recorded against our deferred tax assets in New Zealand. This is worth about \$900,000. This is, as Jon already mentioned, a good credit to our team in New Zealand, who, despite having based soft economic conditions for several quarters, they have actually remained consistently profitable.

We will continue in our other regions to evaluate decisions about the release of valuation reserves as appropriately, of course, with our external auditors, as we begin to see stronger profit trends around the globe.

Turning to our final topic -- or at least mine -- let me talk to you a little bit about guidance. As we discussed in the second quarter, we have revised our guidance formulation to bring it more in line with what is the industry standard that of giving guidance quarterly. We currently expect fourth-quarter revenue of between \$335 million and \$350 million at the prevailing exchange rates.

We expect EBITDA to be \$10.5 million to \$12 million. This includes \$2 million in restructuring charge. This compares to revenue of \$337 and EBITDA of 4.5 million in the fourth quarter of 2005. To add a little technicolor for you here, we exceeded our guidance in the third quarter; as a result, Jon and I have been very thoughtful about what we think our guidance should be for the fourth quarter. We've reviewed this with our operating leaders and we have set it where we think we will be.

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

## QUESTION AND ANSWER

### Operator

(OPERATOR INSTRUCTIONS) Matt Litfin of William Blair and Company.

### Matt Litfin - William Blair & Co. - Analyst

Good morning. Congratulations on the quarter. Can you remind us of any recent leadership changes you've made, say, over the past three to six months -- obviously in the senior ranks? And do you need to do more there or is the team now about where you want it to be?

### Jon Chait - Hudson Highland Group - Chairman & CEO

Well, thank you, Matt. I think we -- that is a good question; thank you for reminding me. Last quarter, I think, we talked about changes -- not in my direct reports, where there have not been any changes, but particularly in the North America market in the reports -- in Tom Moran's direct reports. Tom Moran is the president of the Hudson North America business.

We have made three changes in terms of either individuals or reporting structure within his organization. Those changes, Tim Bosse has taken over as what we call the EVP of IT Services. So this is providing IT professionals to our clients.

Wayne Beaubian has taken over as the EVP of Financial Solutions. And the Engineering, Aerospace and Defense group now reports to Troy Gregory, who expands his responsibility beyond legal. In addition, Mike Whitmer joined us as CIO for North America, and I think that was, plus or minus, at the beginning of the third quarter.

So, I think at this point, all those people are in the early stages of getting their arms around their new responsibilities, their expanded responsibilities. I've met with all of them and interacted with them, and I feel we have a very good team in place.



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I think, Matt, you and other people who have known the company for some time also know that I'm a believer that results speak for themselves. And while I'm very confident that we have the right group and they can deliver the appropriate results, we need to give them time to do it. Obviously we continue to monitor their hopeful success, and certainly give them every tool, and we have every belief that they will be successful. But I would say it's, at this point, too early to declare victory.

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**Matt Litfin - William Blair & Co. - Analyst**

Thanks. And I saw a recent interview with your Asian CEO suggesting that you are close on a Chinese acquisition. I wondered if you could comment on that and maybe give us what would be a general strategic rationale for a move like that.

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

Let me start off by saying that normally we don't comment on acquisitions. And Gary Lazzarotto, who does a wonderful job running our Asian region -- and that has been one of our top performing regions or subregions ever since I joined the company -- was a little bit off the reservation in his comments to a reporter in Hong Kong. But through the miracle of the Internet, they were blasted all over the world.

So let me comment just generically on our acquisition strategy. For the most part, we very much feel and I feel our focus has to be on improving our core business and improving the profitability of our core business.

We make acquisitions on a very opportunistic basis, meaning that we get an opportunity that we think is maybe not -- in our way of thinking about the world is too good to turn down. Which means, first of all the right people, number one -- it's the people, it's the cultural fit. Second, the right business, and third the right geography. And if we can get all of that within our price parameters, which as you know, Matt, are not exactly - we're not the high-priced leader, then we'll think very carefully.

The Balance acquisition, for example, has been a wonderful acquisition. The JMT acquisition, also a wonderful acquisition, brought excellent professionals to our company. People that are just a pleasure to work with every day, as well as significant improvement in parts of our business.

As we look at the Far East, it's a business that has exceptional EBITDA margins, well above our targets. And our focus there has been, contrary to what I've said about the company as a whole, where I said our focus is improvement in profitability, our focus in the Far East has been growing the revenue.

And China is obviously a market that every company in the world is thinking about. We have a very good and dynamic business there, and if we have an opportunity to add to that business with additional people that would open up other segments of the Chinese market for us at a reasonable price, meaning a reasonable multiple, we would continue to be very interested.

One of the rationales with exiting Highland was to turn around and use the proceeds in our -- typically, as we have done, in smaller bolt-on-type acquisitions, where we have the infrastructure -- to improve our earnings. So that is the thinking behind that.

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**Matt Litfin - William Blair & Co. - Analyst**

Okay, I just have a couple more for Mary Jane.

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

She's anxious to answer something.

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**Matt Litfin - William Blair & Co. - Analyst**

Right. So where do you expect the net cash position to be at year end, barring acquisitions, of course. But just given all of the recent divestiture and all that, I wonder if you could give us an estimate there, and talk through that NOL carry forward and where does that stand. And just generally, are you happy with your balance sheet as it stands?

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

Okay. Let's talk about the net cash position at year end. I would say -- first of all, I do not expect the net cash position to be worse than it is; that is always a good thing. My sense is that we could see it inclusive of the Highland cash that would still be with us at that point. We have used, as you know, \$14 million of it to pay down debt that we may see it in roughly the 15 to 20ish sort of range, is my general sense on that for year end. That's the first question.

With respect to the NOLs, just to kind of maybe review the bidding with you a little bit about where the NOLs are. As a company, we have a very extensive number of them around the world, with the interesting exception of the Australia/New Zealand region and some of the countries in Asia.

There are extensive NOLs in the North America market, which is the one that is perhaps primarily of interest to us here. And it would be my expectation that we would see some pretty significant cover on the profits of North America, not only obviously for the remainder of this year, but through- certainly next year, if not more than that. Does that answer your question on the NOLs?

**Matt Litfin - William Blair & Co. - Analyst**

Only add-on I would have is what is the total size of the whole thing?

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

The total size of the NOLs?

**Matt Litfin - William Blair & Co. - Analyst**

Yes.

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

Let me just look that up for you and come back on that.

**Ralph O'Hara - Hudson Highland Group - VP & Controller**

It's in the 10-K --.

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

So as my excellent Corporate Controller is reminding us, in the 10-K, it's just round about \$200 million.

With respect your third question, am I happy with the balance sheet? I would say I will probably never be as happy with the balance sheets as I would like to be. When I came here, Jon was very clear that this was the time, following all the very good profits that had gone on in the prior three years, for the company to begin to look at the balance sheet in general and certainly the cash flow, and that is what we commenced to do.

I am definitely happy that it is moving. I am very happy that the organizations in the field have responded well to beginning to turn their mind to the duplication of not only profits as well as cash flow. But the fact remains that I would like to see it considerably stronger. I do not like a DSO that starts with a five. And I think we have some good work to do there. That said, I think the organization is very committed to that and understands that that is part of our financial health.

**Matt Litfin - William Blair & Co. - Analyst**

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Okay. And one more quick one if I could sneak it in. The situation at Monster, they have said that they pretty much expect to restate earnings. I wondered is there any chance that that could come back to cause a restatement in your number since you were spun out from that company?

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

We have reviewed that situation and reviewed that with our external auditors. And our view at the present moment is no. First and foremost, with respect to -- this is regarding -- as a factual matter, their stock options, the stock options that people held from Monster when they came across to us were cancelled.

It is possible it would affect something in the deferred taxes. The stock option calculation, as you know, is very complicated with respect to taxes. But that would be the extent of it.

**Matt Litfin - William Blair & Co. - Analyst**

Great. Thank you very much.

**Operator**

Mark Marcon of Baird.

**Mark Marcon - Robert Baird - Analyst**

Good morning and congratulations on the significant progress. I was wondering -- two quick the questions. First of all, if we take a look at the EBITDA margin performance of this last quarter, the third quarter, and then what you are implying for the fourth quarter, it looks like we're well north of 3%, somewhere in that 3.3% range.

What sort of implications does that have for next year, particularly given that it sounds like we've got some significant expense reductions, whether it is PeopleSoft, reduced real estate, etc., that are coming down the pike? How should we think about EBITDA margins for next year?

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

Let me try a general comment and then I'll let Mary Jane amend it by specific numbers. I think one of the things that affected our EBITDA margin, which I know is obvious to you, Mark, is the performance of North America in the first two quarters. And when you look at the year as a whole, the performance of North America is a going to be a significant negative in terms of EBITDA margin for the year as a whole.

Obviously, if you look at the results for this quarter and assume that this is a representative run rate under conditions of this quarter -- meaning third quarter is the third quarter; the first quarter is not going to be as strong as the third -- we expect to have a significant improvement in the North American operation in 2007 from what we will report out in 2006.

Some of that is in our run rate right at this point, but we expect to do better. So we would see an improvement -- in our minds, we expect an improvement there.

I think there were a number of one-time events during the course of the year that we do not expect to recur -- charges related to the restatement, etc. Not only the restatement charges, but also the additional expense. And we had, as we mentioned, about \$1 million of expense in the quarter related to that. So, we would expect that will contribute to an improvement in EBITDA next year as well.

So we haven't come up with a number. At this point, we have not turned our minds to do thoughtful analysis. We would like to do help you about 2007, but we certainly expect that we will report an improved EBITDA in 2007 -- absolutely.

**Mark Marcon - Robert Baird - Analyst**

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And I guess the question is basically, if we take a look at the second half of the year from '06, and you still have significant charges in there, is there any reason to believe that the '07 EBITDA -- assuming a normal economic environment, which obviously can change fairly quickly -- but assuming a normal economic environment, is there any reason to believe that you shouldn't do at least better or at least as well as what you did in the second half of the year and more likely better than that?

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

Well, the one thing I would just caution you about is the first half of the year, the first quarter is a weak quarter. Our goal in the first quarter is to produce EBITDA profitability. If you look at 2005 where we did a reasonably good job in the first quarter -- and remember, you have to take out the stock option expense that we continue to carry -- it's a small profit quarter in 2005, which was our best first quarter.

So I think it is not -- seasonality would not support taking the second half and doubling it. But I think certainly from the seasonality you could project a run rate. You could extrapolate a second quarter that would not have the North American company losing money. I would say that's a very unusual. We certainly would not expect that to happen again in the second quarter.

So I think there is some extrapolation in the run rate analysis that you could do, but it is not quite doubled.

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**Mark Marcon - Robert Baird - Analyst**

Okay, great. And what are you seeing from an economic perspective? Jon, I know you keep a close pulse on this. How are you thinking about things?

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

Well, I think there's a couple of different trends running through the world's economies. And in our industry we are all subject to the winds of the world's economy -- I know you know that, Mark. Our business being very focused on permanent recruitment has a few different winds than, say, some of our competitors.

One of the things that I think that is affecting all of us, of course, is the skill shortage. The skill shortage, on a secular basis, is going to get worse over the course of the next decade. Certainly, immigration into the Western world will offset some skill shortage and outsourcing, in essence, does the same thing.

But we are certainly experiencing skill shortages in most of our regions and most of our sectors today. I think that is one thing that certainly will, in essence, hurt revenue growth of the industry. But on the other hand, it will support or improve profitability.

And the skill shortage -- I don't think the skill shortage is so dramatic that there can't be a recession. There will be a recession, and people in our industry, including us, will be negatively impacted. But I think what you are going to see in this cycle is the skill shortage hits earlier in the cycle and lasts longer as the cycle matures. And I think you're going to see the same thing in the next cycle -- you'll see the skill shortage hit even earlier and last longer.

And we are certainly being very careful and working with our teams today to be very careful to increase prices. We have a scarce commodity in terms of our ability to recruit people. And we are getting price increases.

Anne Hatton in Australia and New Zealand has been successful in working with her clients, and Australian clients are very about tough about pricing. And she's been successful in pointing out that, given the economic dynamics, we have to increase prices; it takes us longer to find people. So I think the secular trend is creating a very interesting environment for all of us, and gives us all a lot to think about. It certainly gives us a lot to think about in terms of our strategy.

I think in terms of the world's economies, at this point we are seeing a slowdown in growth in Australia/New Zealand, which is a very important market for us. It is not a very important market for almost any of our competitors. But our team has done -- Anne and her team have done an exceptional job of navigating their way through that.

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And I think really we are seeing better results in that region -- in Australia and New Zealand -- than the economy is giving them. So they are taking share, they are improving their relationships with their clients, strengthening their relationships, which I think bodes well for our company. But the economy isn't really being cooperative.

Asia is, for every industry, is the fastest-growing portion of the world. We have a nice position there. We are, as I mentioned, looking forward to building it. We're certainly not seeing any signs of a slowdown in any of those markets; quite the contrary.

And in Continental Europe, with the exception of one or two countries, growth is still slow by Asian standards, but we are beginning to see forecasts of improved growth next year compared to this year. And that is the first time that has happened in quite a few years.

So at the moment, I think the economies are all -- some are not robust, certainly -- but they are in a place where there are positives to mild positives in some cases, rather than negatives.

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**Mark Marcon - Robert Baird - Analyst**

Great, thank you.

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**Operator**

Jeff Silber of BMO Capital Markets.

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

Thanks so much, and let me add my congratulations as well. Just to follow up on Mark's question, maybe looking out a little bit beyond 2007, I know historically the company had set a goal for -- a longer-term goal to reach 7% to 10% EBITDA margins. Has that changed at all with this Highland Partners divestiture?

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

No. I know that seems counterintuitive, because Highland was a high-margin business, but that has not changed. We had always viewed that as the proverbial icing on the cake or whatever you want to call it, cherry on the sundae. We had always looked at our core business as being a very profitable business. We're a 55% permanent recruitment business at a gross margin level and a consolidated basis. We should be able to produce very handsome EBITDA returns. I think personally, I'm pleased that our team, including Christine Raynaud right now in Europe who has, as I mentioned, a difficult challenge in a market where it is tough to make changes has responded very well in moving aggressively to push EBITDA margins up.

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

Great. Now moving back a little bit near-term in terms of the fourth quarter. In looking at your guidance, you are looking for a sequential decrease in revenues from the third quarter but a sequential increase in EBITDA. Can you give us a little bit more color maybe by region how that is going to happen?

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

That sounds like a Mary Jane question.

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

Sure. First of all, I think as we discussed, we are continuing to look at with respect to the revenue the execution of our strategy, which is to look at businesses that -- either businesses as in the case of the Scottish industrial business or actual customer contracts that are lesser profitability levels than we would like, and to reduce our presence in them.

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So in the case of the Scottish industrial business, we sold that. There are a few small businesses like that still there that we continue to look at and will continue to look at. Similarly, we continue to look at contracts that we think will that are not at our levels, and we continue to thoughtfully reduce our standing there.

And, of course, as we have said about 400 times, we will not have Highland with us with respect to our comments on the top-line. So generally speaking, I think if we think about how we expect to see the revenue move sequentially from third quarter, we do expect North America to deliver a quarter that is more in line with what is typical in Q4, which is Q4 is bigger than Q3.

Europe, on the other hand, and Asia-Pacific as they look at various things under their line of sight, we expect to be a little bit more flattish toward the third quarter. With respect to the profits going up, however, as we said if we move the mix of the margin up as we look at higher margin business, that definitely helps us as does our ongoing expense actions.

I would say that the improvement in the margin continues across all the regions for various reasons. North America continues to focus on growing its perm business. That is not their largest business, unlike the other regions of the world. In the other regions of the world, they have made very good strides, both in Europe and Australia/New Zealand, in moving to a better mix of business, particularly in their temporary contracting area.

With respect to corporate, I expect to see that we will continue to make strides in the reduction of corporate expense and all of those, by the time we get to the EBITDA, help the profitability.

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

Okay, great. In terms of just gauging the size of that Scottish business, roughly what debt due in terms of on an annualized revenue and a possible EBITDA basis?

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

Right. So the annualized revenue is roughly \$14 million, and the annualized EBITDA is roughly about \$600,000.

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

Okay, great. Just a couple other questions on the guidance. What kind of tax rate should we be using for the fourth quarter?

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

As I say, one of the things that makes the tax rate a little bit challenging is that as we have continued to deliver profits in some regions, we are continuing to look at our valuation reserve position. But I would say on an ongoing basis if we kind of exclude that sort of stuff, I would expect it in kind of the 30s again.

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

I know you are not giving guidance for '07, but for modeling purposes that is what we should be using as well?

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

Yes, I think so. Among the things we're focused on from a financial point of view, trying to get a little bit more stability in the tax rate has been a goal of our, not that we've been gigantically successful this year. But I think even though it will move -- I mean, I can't tell you it's going to be the same every quarter -- we are looking for it to be at certainly a more normalized looking level in the 30ish sort of range.

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

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Okay, great. Now, do you guys still own the Highland name, and if not, are you considering a name change for the company?

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

We do not own the Highland name, although we have the right to use the name in our corporate name. I think we were having a healthy discussion about whether or not we want to change the corporate name. Our director of marketing, Rick Gray, who is a great marketing mind in the industry, of course would like to consolidate. It has consolidated on our website and other things around Hudson.

The former lawyer who runs the company is wondering about spending the money to change the corporate name, which doesn't have any relevance in the market for our services because we go to market as Hudson. So we're kind of debating whether we want to do that. But in any event, we cannot do it until the annual meeting of shareholders.

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

Great, thank you.

**Operator**

Michael Storm of Stone Capital.

**Michael Storm - Stone Capital - Analyst**

Thank you and congrats on the quarter again, as well. I had a question as far as, in light of the restatement from a couple months ago. I was just wondering, I know that you talked about in the past that it was primarily with the computer system and that sort of thing. But has there been increased assessment of your internal controls? In light of the past, do you think they really are in the position that they should be?

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

Okay, so let me just take that in a few parts for you. The condition as we said at the time of the restatement and in the restated first-quarter 10-Q, the conditions that led to the restatement and our assessment with the concurrence of our external auditors were that we had a material weakness in the first quarter. The work that we did to address the conditions that we found that did ultimately lead to restatement of the first quarter were very, very extensive, including essentially re-performing the underlying subledger work to support all the ledgers. So we basically went through and re-baselined the ledger in North America.

As a result of doing that, establishing the procedures to continue with being correct, we released in the second quarter of this year believed that we had the material weakness remedied, remediated, as the phrase goes, and therefore signed a clean 404 certification in the second quarter. We do believe that we have remediated that. We have been very diligent. We were very diligent about figuring out exactly what went wrong, and we have reviewed that with our audit committee.

I would say whenever a company is as we are still relatively new, still coping with what is a relatively new system, it is important for us to remain very diligent about our internal controls, and I'd like to think we always will be. And as a result, we are. I do think that our internal controls have improved dramatically as a result of the work that we did, and I believe that the team particularly in North America has maintained the level of both diligence as well as process to ensure that they stay in that corrected state.

**Michael Storm - Stone Capital - Analyst**

Is your internal control work primarily done with your in-house people or do you primarily outsource that to a professional services firm?

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

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We do it with our in-house people. We do it with our internal audit staff. Obviously, the control at the baseline level which are supposed to be performed by the management are performed by the management. But the review of their testing work is done by the internal audit team, which is a very, very good team.

**Michael Storm - Stone Capital - Analyst**

And then going to the external audit issue, as you continue to grow and you certainly are very well, is there any concern as far as your external auditor possibly being too small for your scope as you move forward, especially looking internationally?

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

Well, I would say that we evaluate the quality of our external audit team by the quality of the team that is assigned to us. We have a very healthy ongoing dialog with them about their expectations of us and us of them. And they have a very excellent relationship with our audit committee.

I don't necessarily sit and say I have a view about the firm. I look at the team that is deployed to us. I look at whether they are doing a good job, whether they are capable of assessing our accounts as we grow. At the present moment, we are happy with the services that we have from the team that has been assigned to us.

**Michael Storm - Stone Capital - Analyst**

Okay, thank you very much.

**Operator**

Barry Kaplan of Maple Tree Capital.

**Barry Kaplan - Maple Tree Capital - Analyst**

Good morning. I just wanted to be absolutely clear on the restructuring charges and to what extent it is there ongoing cash expenses or their write-offs of previously capitalized expenses in terms of the cash impact?

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

Okay. I would say that of the charge that we've had so far, let's start there, they are primarily cash expenses. We, for example, in the second quarter -- sorry, in the third quarter -- we recorded the charge to close the center for high performance. The charges associated with that closure are largely severance.

There were primarily two other things that we did in the third quarter. One was the completion of restructuring actions in the North America area with respect to underperforming offices. Again, in those cases while some of it is lease terminations, the majority of it is cash or severance.

Second area is we have decided to exit the Norway market; the restructuring charge there also being compensation. So I would say that you should expect that it will be mostly cash expenses. In the fourth quarter, we have a bit of a higher proportion of lease costs, but generally speaking when we conceived of this charge in our mind, we thought most of it would be cash as opposed to not.

**Barry Kaplan - Maple Tree Capital - Analyst**

Okay, great. Thank you.

**Operator**



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There are no further questions at this time.

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

Thank you very much, operator. David will just make the closing comments.

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**David Kirby - Hudson Highland Group - Director IR**

Thank you, everyone, for joining us today on the Hudson Highland Group third-quarter conference call. If you do have further questions, please feel free to contact Mary Jane Raymond or myself at any time. You can reach Mary Jane at 212-351-7232. You can reach me at 212-351-7216.

This call has been recorded and will be available later today by calling 800-642-1687, followed by the passcode 8713535. For calls outside the U.S., please dial 1-706-645-9291, followed by the same passcode. That will be available on the archived call for the next seven days. And the call is also available via webcast on hhgroup.com. Thank you for joining us.

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**Operator**

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

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