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SCSC.OQ - Q2 2024 Scansource Inc Earnings Call

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Michael James Latimore *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings Conference Call.

(Operator Instructions)

Today's call is being recorded. If anyone has any objections, you may disconnect at this time. I would now like to turn the call over to Mary Gentry, Senior Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - SVP of IR & Treasurer*

Good morning, and thank you for joining us. Joining me on the call today are Mike Baur, our Chair and CEO; and Steve Jones, our Chief Financial Officer. We will review our operating results for the quarter and then take your questions. We posted an earnings infographic that accompanies our comments and webcast in the Investor Relations section of our website.

As you know, certain statements in our press release, infographic and on this call are forward-looking statements and subject to risks and uncertainties that could cause actual results to differ materially from expectations. These risks and uncertainties include the factors identified in our earnings release and in our Form 10-K for the year ended June 30, 2023. Forward-looking statements represent our views only as of today, and ScanSource disclaims any duty to update these statements, except as required by law. During our call, we will discuss both GAAP and non-GAAP results and have provided reconciliations on our website and in our Form 8-K. I'll now turn the call over to Mike.

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman & CEO*

Thanks, Mary, and thanks, everyone, for joining us today. As we entered fiscal year 2024, we identified strong free cash flow and focus on Intelisys as keys for our success. For our second quarter, we achieved this aim with free cash flow of \$61 million and Intelisys growth of 7.5%. Our business fundamentals remain strong. However, we were disappointed at our lower-than-expected net sales for our hardware business. As it turns out, we were too optimistic in a changing demand environment. Second quarter net sales declined 13%, reflecting lower demand from our portfolio of technologies.

Net sales for our Intelisys Technology Services business grew 7.5% and drove our recurring revenue growth. Q2 end user billings increased 10% year-over-year and exceed \$2.6 billion annualized. This includes billings growth in Contact Center as a Service, CCaaS, of 24% and UCaaS of 18%. As long-standing channel advocates and thought leaders, we meet our partners where they are and help them grow their business. A recent example is our series of AMP'd for Growth educational events. We held the first 1 last week featuring AI and Communication Platform as a Service, CPaaS, opportunities.

During Q2, barcode, mobility, point-of-sale, security and communications hardware sales declined more than we expected. As we have discussed in previous quarters, strong growth continued from our Cisco portfolio of products and services and our networking products. Our hardware technologies are at different stages of their demand cycles. During the supply chain crisis over the last couple of years, we experienced broad-based demand across our technologies. We used our strong balance sheet to minimize inventory shortages while enabling our customers to meet stronger than normal demand. End users purchased inventory ahead of their needs, and they are taking time to deploy these products. In this environment, forecasting demand is very challenging. And as a reminder, at ScanSource, we work with no backlogs and no bookings.

For the quarter, our adjusted EBITDA and improved working capital efficiency generated another strong quarter of free cash flow. I'll now turn the call over to Steve to take you through our financial results for the quarter and our outlook for fiscal year 2024.

Stephen T. Jones - ScanSource, Inc. - Senior EVP & CFO

Thanks, Mike. Q2 demand was softer than we expected. While revenues were lower, our business delivered EBITDA margins consistent with our expectations and strong free cash flow. We continue to improve our key working capital metrics and recurring revenues grew led by 7.5% year-over-year growth in Intelisys. Q2 net sales of \$885 million declined 12.5% year-over-year, while gross profit margins of 11.4% were in line with the prior year. While we expected a year-over-year revenue decline, the recovery for our barcode and mobility technology is occurring slower than we expected, and we saw a slowdown sooner than expected in physical security.

These technologies are reported in our Specialty Technology & Solutions segment, which saw a revenue decline of 17% year-over-year and a corresponding 17% year-over-year decline in gross profit. In our Modern Communication and Cloud segment, revenues declined 5% year-over-year. Growth in Cisco partially offset lower sales of communication devices. Gross profits in our Modern Communication and Cloud segment declined 9% year-over-year, reflecting an unfavorable product mix. For the quarter, we delivered \$61 million in free cash flow with solid progress on improving our working capital efficiency. Inventory levels and paid for inventory days continue to improve, reflecting both a return to normal supply chain lead times and our expectation of demand. Accounts receivable balances are moving with revenue as we would expect.

We are setting the business up to continue to deliver positive free cash flow when our business returns to growth. Now going a bit deeper into the balance sheet and cash flow. We are pleased with the progress we are making with working capital investment. Our goal is to increase inventory turns while maintaining appropriate inventory levels to meet customer demand. We gained working capital efficiency as demonstrated by improvements in our working capital metrics. Q2 inventory turns increased to 5.1x, the fastest in 5 quarters. Days sales outstanding also improved and declined to 68 days, the lowest in 5 quarters.

Our balance sheet remains strong. From a net debt leverage perspective, we ended Q2 at approximately 0.8x trailing 12 months adjusted EBITDA, with ample liquidity within our existing credit facility to support our strategic plans. We have an active pipeline of M&A opportunities. However, we believe there is ample room on our existing \$65 million authorization to return cash to shareholders through share repurchases for the remainder of FY '24, while maintaining our target leverage ratio of 1 to 2x trailing 12 months adjusted EBITDA.

Looking ahead to the second half of FY '24, the company expects revenue headwinds to continue, and we are updating our guidance to reflect our current view of near-term demand. We are managing our SG&A spending to match our revenue growth expectations for FY '24 and beyond by redirecting resources and investing in our Intelisys recurring revenue business. For FY '24, we now believe that our net sales will be at least \$3.5 billion and adjusted EBITDA to be at least \$155 million, which reflects an EBITDA margin of 4.4%. For Q3, we expect net sales to be down 6% to 8% quarter-over-quarter, which is better than our typical Q3 seasonality.

We are maintaining our free cash flow outlook of at least \$200 million as we continue to improve our working capital efficiency. To help with analyst models, we expect net expense for interest expense, interest income and other expenses to range from \$9 million to \$10 million for the fiscal year '24. Our estimated effective tax rate, excluding discrete items, is expected to range from 27% to 28% for the fiscal year. Our updated guidance reflects our expectation of the near-term demand environment. We remain confident in the resilience of our business and our ability to be well positioned for return to growth. I'll now turn the call back over to Mike for closing comments.

Michael L. Baur - ScanSource, Inc. - Founder, Chairman & CEO

Thanks, Steve. We are building a cash culture at ScanSource. In fiscal year '24, for the first time, we included free cash flow as part of our annual outlook. Our aspiration is sustainable and predictable free cash flow that we can forecast and count on. An excellent use of free cash flow is to fund growth of high margin and working capital-light recurring revenue. We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Greg Burns with Sidoti.

Gregory John Burns - Sidoti & Company, LLC - Senior Equity Research Analyst

You talked about the different points in the cycle for different technologies. And obviously, there's been weakness on the mobility point of sale and that side of the business. But in terms of networking and some of the other areas, they seem to be holding up well, but we've seen commentary from like Cisco talking about order pace slowing down and kind of a similar dynamic where customers have preordered or taking delivery of product and they're implementing it now. So are you seeing a slowdown in that area of the business due to that dynamic?

Michael L. Baur - ScanSource, Inc. - Founder, Chairman & CEO

Greg, it's Mike. Yes, that's exactly right. What we experienced in Q2 is that our networking business did grow. However, it didn't grow at the rate that maybe it had been. So I would say we still had growth, pretty good growth year-over-year, but we definitely saw signs of it starting to slow down. And we also mentioned in our prepared remarks, that the security part of that business, our physical security surprised us in the quarter. It slowed down in Q2, and we didn't anticipate that.

Gregory John Burns - Sidoti & Company, LLC - Senior Equity Research Analyst

Okay. And I've seen headlines around some businesses moving away from self-checkout kiosks. I don't know if that's a large part of your business? Or if that's something meaningful that you've seen impacting demand there. But if that's in any way kind of impactful on you, could you just talk about that dynamic, possibly that change in the market?

Michael L. Baur - ScanSource, Inc. - Founder, Chairman & CEO

Yes. We -- I would say, during the last 2 years, we did talk very frequently about the growth of self-checkout. We actually have a strong relationship with NCR and some key partners that deployed self-checkout for at least 2 years during COVID, post-COVID. And that business definitely did slow down last quarter. We saw most of that coming, but still -- as you noted, Greg, we've seen the same stories in the press that some of the retailers are done with their installation plans. And so they've slowed down any new purchases.

We still believe that for us, it's an area that we expect to continue to have point-of-sale, self-checkout opportunities, but they're going to be smaller. The larger retailers acted first, and what we're seeing now is the price points and the customers are smaller than they were in the prior year.

Operator

The next question comes from Mike Latimore with Northland Capital.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. Great. On the UCaaS billings growth rate, I think you said it was 18%. I believe it was 10% in the September quarter. Any reason for that acceleration?

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman & CEO*

Mike, it's Mike. Nothing in particular. I think we continue to do well in the space. We did recently receive an award. You may have seen the press release, RingCentral said that for 2023 calendar year, we were the technology services distributor of the year. And so we do believe within that part of the business, we're doing very well versus our competitors. And so for us, it could have been, Mike, just to be very candid, a market share opportunity that we took in that particular space with Ring being 1 of the key players, as you know. But our UCaaS business has continued to be strong and we'll see what happens going forward.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Great. And then as you think about the UCaaS and CCaaS business for calendar '24, is there any reason for these growth rates to either accelerate or slow?

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman & CEO*

Well, I think what I would say is this, is we still are talking about UCaaS and CCaaS with our partners. They still have a lot of questions. And where the discussions are going now, we just had this AMP'd event last week with partners and everybody is talking about CCaaS and AI. I mean that tends to be a big part of the discussion, how is AI going to be part of the CCaaS/UCaaS story. And so I think that's going to continue to make the end user customers interested in talking about it, because now you have a way to leverage either your existing UCaaS implementation that doesn't use AI or maybe look at something new. And so I think AI added to CCaaS and UCaaS will be a driver of demand for us in '24.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

That makes sense.

Operator

(Operator Instructions)

The next question comes from Adam Tindle with Raymond James.

Adam Tyler Tindle - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Mike, I just wanted to ask on maybe the cadence of the quarter, obviously below expectations. But I'd be curious how things progressed as the quarter went, how it exited versus began? And any comments that you're seeing on more real-time demand here in January and February?

Michael L. Baur - ScanSource, Inc. - Founder, Chairman & CEO

Adam, I won't talk about January or February other than the guidance that we just gave reflects what we've seen so far. But I will say this, back to Q2, definitely, December, we saw a slowdown would be my comment is that typically, for most of our suppliers, and this is typically, historically, it's a good quarter because especially some of our larger long-standing partners, they tend to have a budget flush, if you will, at the end of the year. That's very common. It didn't happen. So we didn't see some of the end of the year buying and we did see a slowdown in the December month. And I think that was reflected in the results we had. And lots of reasons for that, but all we could hear was there was not this additional budget flush.

And so as a result of that, again, even if January comes in better than historical, we want to make sure that we're careful about how we guide for this quarter and next quarter because this is such a changing demand scenario, we just haven't seen this in a long time. We spent the last 2.5 years with demand increasing across our technologies. And now things are much more difficult for us as a company that has an average order size of around \$2,500 and no bookings and no backlogs to forecast.

Adam Tyler Tindle - Raymond James & Associates, Inc., Research Division - Senior Research Associate

Understandable. And Mike, I think Steve may have mentioned in his prepared remarks about redirecting resources. I just wondered if you could maybe give us a little bit more color on what goes into the logistics behind that. It makes sense, but just kind of wonder if you could share some of the strategy for that.

Michael L. Baur - ScanSource, Inc. - Founder, Chairman & CEO

Well, for us, 1 of the key investment areas is people, always has been. And so I would say we will continue to add head count in that area. For example, we talked about this AMP'd event we did last week. We're going to do events like that across the calendar year, and we'll probably add more as demand tells us that this is what our partners need to hear.

We've got a history of educating the Intelisys community on new technologies, and there's a lot to talk about this year. So we also need frankly, to beef up our in-house experts on these technologies. And we've got some very, very smart people, but we need to add more. And we think that's why partners trust our Intelisys team is because they can come to us for independent advice on what are the key technologies they should invest in also for this year. So you're going to see us add primarily head count in the Intelisys as an investment thesis.

Adam Tyler Tindle - Raymond James & Associates, Inc., Research Division - Senior Research Associate

Okay. And maybe just one more for me. I think it's important that you mentioned building a cash culture, and I know investors probably like to hear that, makes a lot of sense. If I looked at your guidance here, it looks like at least \$200 million of free cash flow for the year is what you're talking about. If you could maybe just double click on capital allocation priorities. I mention that because depending on the second of the day here in the market that the company is valued at a market cap less than \$1 billion, and you've got \$200 million of free cash flow, would seem to be a really good opportunity to consider share repurchase given that sort of a yield. But -- just curious how you would evaluate capital allocation priorities, especially share repurchase?

Stephen T. Jones - ScanSource, Inc. - Senior EVP & CFO

Yes, Adam, thanks for the question. This is Steve. As we've talked about in the past, we really have 2 priorities for our capital allocation, and that is share repurchases and M&A that would help drive our recurring revenue. And as we talked about in our remarks, we've got about \$65 million remaining on our current authorization. We think that's ample to go through FY '24 for us in terms of repurchases, but those would still be our 2 capital allocation priorities and then always looking at our leverage ratio as well as kind of the balancing act of our capital allocation.

Operator

I show no further questions at this time. I would now like to turn the call back to Steve Jones for closing remarks.

Stephen T. Jones - ScanSource, Inc. - Senior EVP & CFO

Thank you, and thank you for joining us today. We expect to hold our next conference call to discuss March 31 quarterly results on Tuesday, May 7, at approximately 10:30 a.m.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect, and have a great day.

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