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SCSC - Q1 2016 ScanSource Inc Earnings Call

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PRESENTATION

Operator

Welcome to the ScanSource quarterly earnings conference call. All lines have been placed in a listen-only mode until the question and answer session. 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, Vice President, Treasurer, Investor Relations. Ma'am, you may begin.

Mary Gentry - *ScanSource Inc. - VP and Treasurer, IR*

Thank you and welcome to ScanSource's earnings conference call for the quarter ended September 30, 2015.

With me today are Mike Baur, our CEO, and Charlie Mathis, our CFO. We will review operating results for the quarter and then take your questions. A slide presentation that accompanies our comments and webcast is posted in the investor relations section of our website.

Certain statements made on this call will be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are subject to risk and uncertainties that could cause actual results to differ materially from such statements. These risks and uncertainties include but are not limited to those factors identified in the release and in ScanSource's SEC filings.

Any forward-looking statements represent our views only as of today and should not be relied upon as representing our views as of any subsequent date. ScanSource undertakes no duty to update any forward-looking statements to actual results or changes in expectations.

We will be discussing both GAAP and non-GAAP results during our call and have provided reconciliations between these amounts in our slide presentation and in our press release. These reconciliations can be found on our website and have also been filed with our Form 8-K.

Mike Baur will now begin our discussion with an overview of our results.

Mike Baur - *ScanSource Inc. - CEO*

Thanks, Mary, and thank you for joining us today. We delivered strong results for the quarter with net sales within our expected range and non-GAAP EPS above our expected range. We reported record net sales of $871 million and non-GAAP earnings per share of $0.68.

During the quarter we executed well on our strategic initiatives including returning cash to our shareholders through share repurchases. Our three acquisitions during the past year, Imago, Network1 and KBZ all contributed positively to our growth and delivered strong operating performance.

This quarter we went live with our SAP ERP system in North America. This followed our February implementation in Europe and we now have over 80% of our business worldwide using our global SAP ERP platform. The new system went live on time and on budget and we produced very good operating and financial results.

However, our implementation was not perfect as we were replacing the legacy system we had been using for 20 years and our employees have learned plenty of shortcuts that became second nature over that time.

So yes, we had a few bumps in the road and we benefited from the loyalty and patience of our customers, vendors and our own employees who worked tirelessly. We are still learning how to best operate with our new system and we are regaining efficiencies and serving our customers and vendors.

Another key initiative we accomplished was the completion of our acquisition of KBZ on September 4. As Cisco's top video products and solutions distributor worldwide, KBZ focuses its business almost exclusively on Cisco and complementary vendors. The KBZ team is focused on forming deep local relationships and educating resellers on how to be profitable with Cisco programs including our KBZ branded service program called Zcare.

The integration of the KBZ acquisition is going very well and we expect our Cisco collaboration and network security business to be areas for growth. We are very pleased with KBZ's financial results for September, a seasonally strong month due to year end federal spending.

Consistent with our value-added strategy of dedicated business units providing specialized focus in specific technology solutions, we are bringing our networking vendors together. This will allow us to provide more customized solutions and value adds to our networking customers and vendors.

As of October 1, 2015, we branded ScanSource Security as ScanSource Networking and Security to provide more resources and focus on our fast-growing networking vendors and as our security products, especially video surveillance, are increasingly delivered as part of the total network solution.

We are excited about this organizational change and believe it will enhance our go-to-market strategy for this business. Starting with the second quarter of fiscal year 2016, we have moved some business operations from our communications and services segment to our POS and barcode segment, and we will reclassify prior period results to provide comparable information.

With that, I will turn the call over to Charlie to discuss our financial results in more detail and our outlook for next quarter.

Charlie Mathis - *ScanSource Inc. - CFO*

Thanks, Mike. We exceeded our expected financial results due to three main factors. First, the acquisition of KBZ was not in our forecast and we closed that deal at the beginning of September. Because of the greater public sector seasonality, KBZ's financials for the one month we reported were strong.

Second, our recently acquired Network1 had better operating performance and forecasts in a difficult Brazilian economic environment. And third, a higher than forecast gross profit margin due to timing of vendor programs.

On a consolidated basis, net sales totaled $871 million, a 10% year-over-year increase or 15% in constant currency. The year-over-year change in foreign currency exchange rates had a negative impact of $37 million.

First-quarter 2016 results include a full quarter for Imago and Network1 and one month for KBZ. Excluding these acquisitions, first-quarter 2016 net sales increased 2% year-over-year in constant currency.

Our first-quarter 2016 gross profit of $87.6 million or 10.1% of net sales compared to $77.6 million or 9.8% of net sales a year ago. This reflects the favorable mix of international business from our acquisitions.

Operating expenses were $59.2 million or 6.8% of net sales compared to $45.8 million or 5.8% of net sales in the prior year quarter. Last year included a $2 million credit for bad debt expense while this year we had SAP related one-time ERP cost of $2.4 million. Excluding these impacts, operating expenses as a percent of net sales would be 6.5% this year compared to 6% last year. In addition, operating expenses were higher year-over-year due to the higher margins from international acquisitions which have correspondingly higher operating expenses.

Our first-quarter 2016 non-GAAP operating income was $28.4 million or 3.3% of net sales compared to $31.8 million or 4% in the prior year quarter. Our effective tax rate was 34.5% for the first quarter 2016 and 33.4% for the prior-year period. First-quarter 2016 non-GAAP net income was $18.9 million or $0.68 per diluted share compared to $21.6 million or $0.75 per diluted share for the first quarter 2015. Foreign currency translation had an estimated $0.04 negative impact when compared to last year and the SAP one-time cost had a $0.06 negative impact as well.

Total shares outstanding as of September 30, 2015, were 27.1 million shares, a decrease of approximately 5% from year ago from share repurchases. Average diluted shares for the first quarter 2016 totaled 27.9 million shares, down 3% from the year earlier period as a result of share repurchases.

Now shifting to the balance sheet and capital allocation plan. We continue to execute on our capital allocation plan and remain disciplined and focused on acquisition opportunities that are strategic, accretive to EPS and increase ROIC.

The acquisitions we completed during the last year were in keeping with our strategic business plan, value-added distribution model and focus on growing our bottom-line profitability.

At September 30, 2015, we had cash and cash equivalents of $41.2 million and debt of $94 million for net debt of $51.8 million. During the quarter, $61 million of cash was used for the acquisition of KBZ and associated working capital and $42 million was used for share repurchases, while cash from operations consumed $58 million principally from higher working capital.

Consistent with our overall financial plan objectives, leverage increased to approximately 0.45 times trailing 12 months EBITDA and lowered our weighted average cost of capital. Our days sales outstanding, DSOs at September 30, 2015 were 56 days, up from 55 days. Higher inventory levels led to lower inventory turns for the quarter, 5.3 times compared to 5.7 times for the prior year. Paid for inventory days increased to 13 days up from 9.7 for the prior year.

These working capital metrics exclude the impact of the KBZ acquisition.

During the quarter, we purchased additional inventory in order to not disrupt our customers and vendors during our SAP implementation in North America. Our return on the invested capital totaled 14.6% for the quarter. As of September 30, we had purchased over 1.6 million shares for approximately $61 million and executed over 50% of our authorization as part of our planned capital allocation strategy. We have now repurchased over 6% of our outstanding shares.

Turning now to our next fiscal quarter and let me add some additional color here. The forecast also assumes a stronger dollar compared to the previous quarter a year ago reflecting US dollar exchange rates of 1.12 for the euro and 1.53 for the British pound and an average Brazilian real exchange rate of 3.91 for the US dollar.

The foreign translation negatively impacts our forecasts versus the prior year by an estimated $33 million for sales. We expect net sales for the quarter ended December 31, 2015 to range from $900 million to $980 million and non-GAAP diluted earnings per share to range from $0.72 to $0.80 per share.

I would like to turn the call back over to Mike.

Mike Baur - *ScanSource Inc. - CEO*

Thanks, Charlie. We have two reporting segments and I will start with Worldwide Barcode & Security. Net sales of $516 million increased 3% year-over-year and 10% in constant currency. This increase includes our KBZ acquisition for one month. Our security business in North America and our POS and Barcode team in Mexico had record sales quarters. It was a strong quarter for big deals in North America, Europe and Mexico for our POS and Barcode business units.

In North America, we had a strong quarter in enterprise point of sale systems and solutions and continued to realize strong growth in our retail and hospitality payment solutions. Our payment processing terminal sales achieved record results, more than double over the prior year quarter.

The EMV Chip and Pin opportunity is still gearing up in North America and we continue to make investments in our payment terminal configuration center and secure encryption capabilities to support this fast-growing business. We had good results for our mobile computing and printing products and solutions as well.

We are pleased that Alex Conde, who joined ScanSource with the purchase of CDC Brazil, is now our President of ScanSource Point of Sale and Barcode for all of Latin America. Alex's team had another strong quarter in Brazil in spite of the economic challenges that country still is experiencing driven by continued growth in retail and hospitality markets and specialty technology solutions.

A big growth opportunity continues to be the required government mandated fiscal solutions. With the economic slowdown in Brazil, our strong balance sheet gives us a strong competitive advantage and we have gained market share from competition and increased the number of customers served. Our net sales of Brazil increased 10% year-over-year in local currency but declined 29% when translated into US dollars.

Our security business had another record sales quarter driven by growth and networking especially from our wireless vendors and the strong resurgence in our video surveillance products. eRate spending for schools to purchase technology was a seasonal assist to our strong results this quarter. We expect to see strong growth from our change to consolidate our networking vendors in this business unit in the future.

Also as I mentioned earlier, KBZ delivered exceptional results in the month of September principally from the public sector business.

Now to our second segment, Worldwide Communication & Services which had net sales of $355 million. Net sales increased 22% from a year ago or a 23% increase in constant currency. This strong increase includes our successful and ongoing integration of Imago and Network1. In North America, we had solid performance in our enterprise business and good services growth with all of our top vendors.

We also did a very good job growing our smaller audiovisual lines. In late October, we expanded our collaboration offerings with the launch of Unify in North America. Unify's platform of communication solutions fits well with our value-added model and service offerings.

In Europe, we are finding good opportunities for bringing our businesses together. We had year-over-year sales growth in local currency and improved operating performance. We are also benefiting from Imago's services offerings and expanded offerings with newer vendors including Unify.

Network1 rebounded in Brazil and Latin America with solid operating performance that exceeded our planned sales and profitability. This included run rate business and big deals as well as strong growth in Latin America where our team sees opportunities in Chile, Colombia, Mexico and Peru. Network1 successfully kept a focus on the small to medium-sized businesses while also working closely with vendors on big deals.

We are excited about what we accomplished this quarter and we believe we are on track for continued growth. This week we announced an expansion of our headquarters in Greenville and plans to add more than 100 highly skilled positions here in the next five years. During the past year, we completed three acquisitions and all three acquisitions had strong operating performance for the quarter.

We implemented our new SAP ERP system in North America and our team is working very hard to use the new tools in SAP to accelerate profitable growth and we made significant progress in moving towards a more optimal capital structure while returning cash to our shareholders through our share repurchase program.

So now we will open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Co. - Analyst*

Good afternoon. Thanks for taking my questions and congratulations on the strong quarter.

I guess can you just maybe break out the growth rates on an organic basis for both of the two divisions?

Charlie Mathis - *ScanSource Inc. - CFO*

Yes. Chris, we have not broken that out on the growth rates in constant currency excluding acquisitions. We have not done that and we don't intend to disclose that at this point in time.

Chris McGinnis - *Sidoti & Co. - Analyst*

No worries. Okay, thank you. I guess maybe can you give an update on obviously you said you saw record sales on the POS side. Maybe just talk about where the chip and pin kind of implementation is at this point and how much longer you have left from that benefit?

Mike Baur - *ScanSource Inc. - CEO*

Sure, Chris, it's Mike. We have been talking about that program as you know for over a year and what our customers tell us is that only a small percentage of the retailers and point of service providers in the US have implemented the new technology to date. It started mostly with the larger retailers first and so October 1 was the official cutover date that the credit card companies suggested would be the critical date.

What we are seeing is that there is a continued need for these products to be sold into the marketplace so we believe it is like typical in the new technology. It is a multiyear process, not a single quarter and certainly not in the near foreseeable future.

Chris McGinnis - *Sidoti & Co. - Analyst*

Okay, thanks for that. Can I just touch on the balance sheet a little bit. It sounds like a little bit maybe acquisition driven but it is kind of the first time in a while since I have been covering just the debt on the balance sheet. Can you just talk maybe a little bit is it somewhat temporary because of the acquisition, maybe a comfortable leverage ratio that you would run the business with? Maybe just kind of talk a little bit about that please?

Charlie Mathis - *ScanSource Inc. - CFO*

Yes, just a couple of points on this on the balance sheet. In the script, I talked about the inventory levels. That was a big driver about the use of working capital. We brought in additional inventory due to the SAP implementation to ensure we were not going to disrupt customers or vendors. It will be determined as how far as how fast we work that inventory down based on the progress that we make going forward. We anticipate longer-term for that use of cash and working capital to come down and our working capital to improve.

Chris McGinnis - *Sidoti & Co. - Analyst*

Right. So it is almost like kind of a timing issue to some degree with the SAP that the cash balance is where it is at. Where do you typically want to keep your cash balance operating?

Charlie Mathis - *ScanSource Inc. - CFO*

So it is temporary and I would say if you remember, we have talked about a leverage ratio of at least 1 times so that is what we are working toward to get to the 1 times and we made progress on that but also there is a great deal of focus on our working capital in order to make sure that that is in line and as I said, the inventory levels were higher due to the SAP implementation in this quarter in North America.

Chris McGinnis - *Sidoti & Co. - Analyst*

Great. Thank you for the time and I will jump back in the queue.

Operator

(Operator Instructions). [Luke Hufstedler], Northcoast Research.

Luke Hufstedler - *Northcoast Research - Analyst*

Just real quick on the decline in the Worldwide Communications operating margin year-over-year. Could you provide some color on that?

Charlie Mathis - *ScanSource Inc. - CFO*

Yes. This is Charlie. So the decline in the operating income is largely driven by this bad debt credit that we had that was a favorable pickup last year, $2 million that we talked about in the September quarter last year. That was a very large contributor to the decline in the operating income percent year-over-year.

Mike Baur - *ScanSource Inc. - CEO*

And I would add the second piece would be the mix.

Charlie Mathis - *ScanSource Inc. - CFO*

The mix and then you have the $2.4 million of SAP one-time cost that gets allocated to these segments so you have that in there. If you take that out then it gets closer to where it was in the prior year.

Mike Baur - *ScanSource Inc. - CEO*

Luke, here is something that was about in our communication some of our fastest-growing product lines have been our lower margin product lines if you will.

Luke Hufstedler - *Northcoast Research - Analyst*

Okay, good stuff. And then the guidance, the range, it is pretty big so could you go into maybe what factors are going into it and are you expecting one segment to outperform the other? Just a little more color on that would be good.

Charlie Mathis - *ScanSource Inc. - CFO*

No, the range that we are giving is consistent with the range in the last quarter. So we have new acquisitions in here. We have three acquisitions in the last year that gives us a little bit of caution about the range and making sure that it is appropriate. So I would say that was the biggest reason for the range being where it is.

Luke Hufstedler - *Northcoast Research - Analyst*

Okay, thanks, guys.

Operator

(Operator Instructions). Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Co. - Analyst*

Thanks for taking some more questions. Can you just talk a little bit just with the -- obviously the currency is outside of your means of control but how has the macro issues in Brazil maybe changed the way you think about the market, approach the market, can you maybe just talk about that just because obviously there is a lot of issues in the region itself?

Mike Baur - *ScanSource Inc. - CEO*

This is Mike. I will make a couple of comments. One is in our market business we have been fortunate that there has been this underlying demand for these fiscal printing solutions and that was mandated by the government. We are the primary go-to-market distributor frankly the only distributor for the Bematech product line in Brazil. And Bematech focuses a lot of effort and always have at fiscal printing and so we are benefiting from this requirement that these retailers and point of service providers who take cash have a fiscal printing solution that is updated. So that is happening even though the rest of the business has had some delays in purchasing.

We mentioned that two quarters ago that some of our larger projects in our Barcode and POS business were delayed because of the impact of the currency because obviously a lot of these products that we still bring in the country are US-based so the pricings are higher now. So we have seen that. The fiscal printing has offset that decline.

And on the communications side, Network1, they have been opportunistic at taking advantage of the business that is available in the market right now because our competitors are weaker. We generally are competing against smaller local companies and our guys believe that our ability to provide credit terms, reasonable credit terms and provide inventory stock in inventory is allowing us to increase our market share in a market that is not growing to the one that we are taking share in.

So we really believe locally we are doing well even though the translation still is weak that we are able to gain market share in this time and so that is from a long-term perspective, we think it is very positive. Because we will be able to come out once things start to settle down where we will have even stronger market position in the future. So we really like the fact that we got into Brazil, we like the fact that we have got a great team that knows how to manage their margins, manage their expenses and still show strong profitability even though the translated revenue is less than we would like.

Chris McGinnis - *Sidoti & Co. - Analyst*

Great. And then just a follow-up on that, one of the things you commented on the fiscal printing, I would imagine you will give me the same answer as on the chip and pin but maybe is that sustainable for a good amount of time especially while you are seeing some weakness maybe in other parts?

Mike Baur - *ScanSource Inc. - CEO*

That is true. The difference here is the rest of the ScanSource North America point-of-sale market business is so much larger than the chip and pin business. Even though chip and pin business doubled for us year-over-year, it wasn't enough to move the needle on that entire business as much as it would in Brazil. But yes, we like the fact that we have located in each of our markets opportunities to grow even when the rest of the market is not doing so well. And we recognize that even in North America there are always opportunities and we have got the best network of resellers and customers. And these guys, they are independent business people and they find ways to sell something to somebody and that is why we feel good about our business model long-term because we have got the best customers in the marketplace and they will find a way to sell product.

Chris McGinnis - *Sidoti & Co. - Analyst*

Great. Thanks for the extra detail. One last question just on ERP implementation and costs for Q2. Can you maybe just talk a little bit about that and then maybe how that phases out throughout the rest of the year just to remind us on that? Thank you.

Charlie Mathis - *ScanSource Inc. - CFO*

Chris, this is Charlie. On the SAP, it is related ERP cost that we have been calling one-time in nature, that actually goes away. So in the first quarter was the last quarter that we will have those type of costs at that level of spending. So we will continue to work on SAP and we will continue to look to gain efficiencies and additional functionality but those costs that we have been reporting in the last couple of quarters is one-time related go away and are not in the forecast.

Chris McGinnis - *Sidoti & Co. - Analyst*

Great. Again, nice quarter and good luck with the next quarter. Thank you very much.

Operator

Now I'm not showing any further calls. I will turn the call back over to Mike Baur for closing remarks.

Mike Baur - *ScanSource Inc. - CEO*

Great. Thank you for joining us today. We expect to hold our next conference call to discuss December 31 quarterly earnings results on Tuesday, February 9, so that is a new day of the week for ScanSource, so Tuesday February 9, 2016. Thanks very much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone have a great day.