PARTICIPANTS

Corporate Participants

Mary M. Gentry – Treasurer & Director-Investor Relations, ScanSource, Inc.
Michael L. Baur – Chief Executive Officer & Director, ScanSource, Inc.
Charles Alexander Mathis – Chief Financial Officer & Senior Vice President, ScanSource, Inc.

Other Participants

Chris D. Quilty – Analyst, Raymond James & Associates, Inc.
Dominic Ruccella – Analyst, Northcoast Research Partners LLC

MANAGEMENT DISCUSSION SECTION

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, Treasurer and Director of Investor Relations. Ma'am, you may begin.

Mary M. Gentry, Treasurer & Director-Investor Relations

Thank you, and welcome to ScanSource's earnings conference call for the quarter ended December 31, 2013. With me today are Charlie Mathis, our CFO, and Mike Baur, our CEO. 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 risks 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 press release, which can be found on our website and has also been filed with our Form 8-K.

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

Michael L. Baur, Chief Executive Officer & Director

Thanks, Mary, and thank you for joining us today. Let's start with slide three. For second quarter of 2014, we reported net sales of $741 million at the lower end of our expected range and diluted EPS of $0.64 per share at the upper end of our expected range. For the quarter, we had strong operating performance, including higher margins and a 15.9% return on invested capital.

In looking at our sales for the quarter, I'd like to share a few summary points. For Worldwide Communications & Services, both of our communications business units in North America, the ScanSource Communications and Catalyst units, had solid year-over-year sales growth and our worldwide gross profit margin improved from last year.

In Worldwide Barcode & Security, our sales declined year-over-year. However, each of our POS and barcode units had sequential quarterly sales growth primarily due to better performance in our barcode products. In Brazil, we had a record sales quarter for the second quarter in a row.

As we move into the second half of our fiscal year, we are planning to return to year-over-year growth for all of our business units at value-added margins. And we have a very strong balance sheet that positions us for growth. During the quarter, we continued to invest in expanding our sales force with the addition of new sales team members in many business units.

Now, for an update on our ERP project. We've been evaluating a new ERP platform over the last several months to replace our existing enterprise hardware and software IT system. After careful evaluation and taking into account our prior experiences, we focused on how to achieve certainty with our go-live. Given that, we entered into agreements with SAP for both the software and implementation consulting services for a new ERP system.

We've also assembled a team of experienced ScanSource employees to work on our project with a focus on business processes, training and change management. With SAP, we have selected a partner with a proven solution for wholesale distribution companies similar to ScanSource. Plus, SAP services team has assigned an experienced implementation team to deliver a successful ERP system for ScanSource. We are very pleased with the commitment from the senior executives at SAP for a successful result.

With that, I'll turn the call over to Charlie to discuss our second quarter financial results in more details.

Charles Alexander Mathis, Chief Financial Officer & Senior Vice President

Thanks, Mike. I'll begin with slides number four through seven of the investor presentation, second quarter fiscal year 2014 results. Net sales of $741 million decreased 0.9% from prior year. The net impact of currency exchange fluctuations on the year-over-year change was minor, with higher sales from the strengthening of the euro offsetting lower sales from the weakening of the Brazilian real.

Worldwide Barcode & Security sales of $476 million decreased 3% year-over-year, primarily from slower big deal activity. Worldwide Communication & Services sales of $264 million increased 2% year-over-year. Our North America Communications and Catalyst business units growth was the result of growing key vendor lines and securing larger big deal projects.

The consolidated gross profit margin for the second quarter 2014 was 10.4% compared to 9.9% in the prior-year quarter. The Worldwide Barcode & Security gross margin for the quarter remained at 9%, unchanged from the year-ago quarter. The Worldwide Communication & Services gross margin was 13.1%, up from 11.6% in the prior year, principally from an increase in service fee revenues and better attainment of vendor programs. This increase in gross margin for the communications segment was the driver in an overall consolidated gross margin increase.

Overall this quarter, we received some end-of-the-year vendor incentives and unusually high service fee income that is not expected in the March quarter. SG&A expenses totaled $49.3 million or 6.7% of net sales, relatively unchanged from the year-ago quarter. SG&A for the second quarter

2014 included a severance payment, as previously disclosed in an 8-K filed in November. Also, as you may recall, our second quarter 2013 included a $2.1 million charge for Belgian tax compliance and personnel replacement costs in our European entity.

As Mike previously mentioned, we recently signed contracts with SAP to provide the software platform as well as SAP services to implement the new enterprise software. The project kicked off in January. Although we do not expect significant operating expenses in the current quarter related to our new ERP project, we will discuss the overall project cost and timing of the rollout in greater detail as we finalize the blueprint stage in the next few months.

In the second quarter 2014, the fair value re-measurement of our earn-out for the CDC Brasil acquisition was a charge of $499,000, as expected and in line with the year-ago quarter. Second quarter 2014 operating income was $27.5 million with an operating margin of 3.71%. The operating margin increased from 3.27% for second quarter 2013, or 3.55%, excluding the $2.1 million for the Belgian tax compliance and personnel replacement cost.

Our effective tax rate for the quarter was 34.2%, in line with our expected range of 34% to 34.5% for the remaining quarters of fiscal year 2014. Second quarter 2014 net income was $18.3 million or $0.64 per diluted share. Diluted EPS totaled $0.59 for the second quarter 2013 or $0.64 per share, excluding the Belgian tax compliance and personnel replacement costs. Return on investment capital totaled 15.9% for the quarter compared to 15.2% for the year-ago quarter.

Now let me discuss the balance sheet, which you'll find on slide eight of the presentation. Cash and cash equivalents totaled $157.1 million at December 31, 2013 compared to $148.2 million at June 30, 2013, but down from $193.8 million in the prior quarter, which I discussed last quarter. For the trailing 12-month period, we have generated $140 million in cash from operating activities. I will discuss how we intend to use the cash a little later.

Our days sales outstanding, DSO, was 53 days in December 31, 2013 compared to 55 days in the sequential quarter and 54 days in the prior-year quarter. The increase in the allowance for doubtful accounts contributed to lower days sales outstanding. We continued to execute well and remain disciplined in managing appropriate inventory levels. Although inventory has increased approximately $65 million since our fiscal year-end due to increased demand, inventory turned 5.9 times during the quarter compared to 5.6 times for the prior year. We had 11.3 paid for inventory days at the end of December 2013 compared to 2.2 paid for inventory days at the end of September 2013 and 17.8 days at the end of December 2012.

We had $5.4 million of debt as of December 31, 2013 compared to $27.8 million at December 31, 2012. During the past year, we have borrowed very little under our credit facility. Nevertheless, in the quarter, we extended our $300 million facility for an additional two years with essentially the same terms as the previous facility. We have significant resources and capital to grow the company in the future while maintaining a high ROIC.

Our top priorities on allocating capital are consistent with how the company has created shareholder value in the past. First, we look to invest in the organic business to ensure growth. This means decisions on a range of opportunities such as investing in the inventory on existing and our new vendor lines, extending credit terms to new or existing customers, opening new markets, as well as investing and maintaining our own infrastructure for the future. And second, we look to make acquisitions, acquisitions that meet our strategic and financial goal. The company has made over 20 acquisitions since its inception, adding a strategic geographic area, a strategic vendor and/or customers or a new technology. And has done so at a reasonable multiple valuations. We continue to focus on these top two priorities.

Turning now to our next quarter and a quarter in which we expect to see year-over-year revenue growth, we expect net sales for the quarter ending March 31, 2014 to range from $700 million to $720 million and earnings per share to range from $0.53 to $0.55 per diluted share.

With that, I'll turn the call back over to Mike.

Michael L. Baur, Chief Executive Officer & Director

Thanks, Charlie. Let me start with our Worldwide Barcode & Security. Summarized on slide nine, it represents 64% of overall sales for this quarter. Worldwide Barcode & Security sales of $476 million increased 6% sequentially and decreased 3% year-over-year. We had sequential quarter growth for each of our POS and barcode units across all geographies, including a record sales quarter in Brazil. This quarter-over-quarter increase reflects better performance with our lead vendors.

Similar to the last few quarters, slowness in big deals continued, with larger projects been broken up into small pieces. Though sales were down year-over-year, our POS and barcode team in North America had solid sequential quarter growth led by mobile computing and scanning. Big deals were down from last quarter and last year, including fewer big point-of-sale deals. We continue to have good growth with our small and mid-sized vendors and our payment processing sales were up significantly.

In Europe, our POS and barcode business unit exceeded its sales plans, strong growth in our scanner business and better achievement of vendor rebates. We had good growth in certain regions, including Eastern Europe, Germany, France and Belgium. We recently expanded our U.S. relationship with Code, a new vendor for us, a barcode reader, to include Europe geography. We are very pleased to report that our team in Brazil had a record quarter for the second quarter in a row where sales grew across all product categories, point-of-sale, barcode, AIDC, and communications.

Even with currency fluctuations as a growth headwind, net sales in Brazil grew 15% year-over-year. Our team in Brazil executed well, growing faster than the market, keeping margins at planned levels, and accelerating inventory turns. In the past year, our team won two sales growth awards from HP Networking in Brazil.

We named Yvette McKenzie, who joined ScanSource in 2000, President of ScanSource Latin America and Mexico. Since May, Yvette has been leading our Latin America and Mexico business units, helping our teams execute best practices, building vendor and reseller partner relationships to grow our business, and adding new team members.

Economic struggles in countries like Venezuela and Argentina continue to impact our business there. However, we had good growth in Chile, Ecuador and Guatemala. Our Latin America and Mexico business is very project-driven, and we are working there to grow our run rate business. This quarter, we're launching Motion Computing and POS-X as new vendors in Latin America and Mexico.

Our security sales in the U.S. and Canada declined from weak sales in our networking infrastructure and card printers, offsetting good year-over-year growth in video surveillance and access control. Big deal volume went down, which contributed to a 4% year-over-year sales decline for the security business unit. We had record quarters, however, with four of our top six vendors and higher margins from the sales mix and better achievement of vendor programs. This quarter, we're adding Cisco's Meraki products to our wireless infrastructure offerings and Axis's access control products.

Now turning to Worldwide Communications & Services on slide 10, which is 36% of overall sales this quarter, Worldwide Communications & Services net sales of $264 million decreased 6% sequentially and increased though 2% year-over-year. Both of our business units in North America had solid year-over-year growth and higher big deals. This increase was partially offset by lower sales in Europe communications.

ScanSource Communications in North America had year-over-year sales growth, including record quarters with Polycom and AudioCodes. We continue to have good growth with our Voice-over-IP telephone resellers and the service provider customer segments. For ScanSource Catalyst, a significant increase in big deals drove the year-over-year sales growth.

In addition, we had good growth with our mid-market voice and another quarter of double-digit growth from our wireless vendors here. We're building out the value-added support model to grow our Cisco collaboration business. In October, we held our Catalyst partner conference, branded FUEL, with great business-building opportunities for our reseller and vendor partners.

Sales for ScanSource Communications in Europe declined in both of our biggest countries, the UK and Germany. In the UK, timing of business had an impact on sales results. During the quarter, we launched AudioCodes as a new vendor in our UK market. In Germany, sales declined largely from competitive pressures and some changes to our sales team.

We saw business start to pick up in France with quarter-over-quarter growth. ScanSource Services Group provides education and training, network assessments, custom configurations, marketing, and our SUMO partnership community principally in North America. We had a record operating income for our marketing service offer with increases in both the number of projects and our billable hours. We continue to have good demand for our configuration services with exceptionally high quality metrics and for training classes as an authorized training partner for Avaya, Polycom and ShoreTel.

At this time, we'll be glad to answer your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Chris Quilty of Raymond James. Your line is open.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Thanks, gentlemen. I just wanted to follow up, just to make sure I caught it. You were saying for the fiscal third quarter or for all of calendar 2014 you expect revenues to be up by product line and business segment?

<A – Mike Baur – ScanSource, Inc.>: What we're saying – Chris, it's Mike. What we're saying is that we expect for the calendar year. So we're saying that we expect growth in all of our business units to occur this year. So we're obviously only giving guidance out for one quarter, but we believe based on the investments we've made in 2013 and some of the indicators we're getting from either vendors or customers that we think the calendar year and certainly the last half of this fiscal year will show growth for our company year-over-year in all of our business units.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: That's great. And is there a particular business unit that you – if you were to rank order, where you feel best about?

<A – Mike Baur – ScanSource, Inc.>: For us, it's always a challenge because we look at the businesses, we're trying to manage the portfolio and sometimes we'll miss based on a quarterly basis how much one of the units can grow based on some of these big deals. And I would say that's probably the gating factor, and some of what we're saying is, we saw big deals come back this time in our communication business but not in our barcode/POS business, which historically we saw some significant point-of-sale deals in the December quarter in North America. And because of the change in one of our vendors this year, that didn't happen. So we may see more barcode/POS big deals now move into the March quarter than the December quarter. So we're not really going to prioritize it for you, but we feel good about each one of these business units and their opportunities.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. And are there any underlying technology or market changes in either communications, barcode or security that are worth highlighting as growth drivers? And I'm just thinking off the top of my head something like Target getting burned with their POS terminals and some articles in the Journal about, geez, maybe we should all move to – back to smart card readers to try to mitigate some of the theft. Either that or some other end-market specific drivers?

<A – Mike Baur – ScanSource, Inc.>: Well, that particular comment around the data breaches in the retailers, for sure, is a topic of discussion in the point-of-sale industry. And one of the things that we've highlighted for the last year or so is that we've continued to add some vendors in the payment processing terminal arena. We have good relationships with key vendors now. We've added this capability in our distribution center where we can configure payment processing terminals. That means doing what's got a key injection process for our customers.

So we've added the capability and the right vendors. And so if that market starts to accelerate, which if you read the Trade Press and listen to the stories, one of the drivers that could help solve some of the data breaches is to adopt – for the U.S. to adopt the Chip and PIN technology that Europe uses. And that Chip-and-PIN or EMV technology is something that has been predicted to happen in the U.S. And if it happens, it will require, based on everything we've seen, a replacement of the existing payment processing terminals and readers out in the market, as you're saying. So we do see that as a potential driver. We just don't know like any of these technologies how fast they'll be adopted because that's going to be a significant cost for someone to bear, whether that's the retailer or it's the banks. Not sure, right? But that is a potential driving force in our technology.

So, having said all of that, that's not why we're feeling good about growth for this year. That would be more upside to what we're thinking.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. Internally, some of the foreign exchange fluctuations that have happened in the past week, do you expect that to impact revenues in any way?

<A – Charlie Mathis – ScanSource, Inc.>: Well, we didn't see a lot of that in the prior quarter because we had it going both ways. The euro was strengthening, the Brazilian real was weakening. They pretty much offset each other. So, no, we don't really anticipate a big impact to that.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. And did you mention, at some point, in the script that you increased the allowance for doubtful accounts, and can you just talk about whether you're seeing a deteriorating or improving situation with receivables?

<A – Charlie Mathis – ScanSource, Inc.>: Yes. I did mention that and the allowance reserve did go up. There were some customer-specific issues in there that we felt we needed to reserve for. So I think that was the primary thing that was driving it other than the overall deterioration in the portfolio.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. And can you elaborate a little bit more specifically? I mean, the performance in Brazil is pretty outstanding given the economic backdrop there. Is there something specific driving the business, either just the addition of vendors, is it taking market share or some other driver?

<A – Mike Baur – ScanSource, Inc.>: Yeah. I think what we saw – this is Mike here, Chris. I think what we saw is better execution by the ScanSource team in an improving market. So, our team told us that the overall demand for our products has improved in the last few quarters, and then we're executing better against that.

One of our largest vendors down there is a company called Bematech. They're a Brazilian printer company that sells other point-of-sale equipment as well. And we've seen better performance in our Bematech portfolio down there. They're, I would say, therefore representative, if you will, of the overall market. And so we believe that Bematech's business getting better, has been good for ScanSource Brazil. And I think there is some cases where we're taking some market share. We've got a – still at very early-stage business in our Brazil communications business. We referenced HP Networking as one of our couple of vendors. We don't have a real significant vendor yet in that marketplace. We don't have the Avayas or Polycoms in that marketplace. We would certainly hope that our communication business will start to develop over the next year. But we did see some nice growth in those networking products in Brazil that we had not. So that was kind of an upside as well for us in the quarter.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. And final question on the M&A. I think you mentioned geography and one other priority. Was it product line?

<A – Mike Baur – ScanSource, Inc.>: Well, historically the company has made acquisitions to expand strategically in geographic areas and vendor product lines and new technologies, and that's continuing where we're focused on.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Okay. And I mean, historically you've said that when you look at the Asia-Pacific region where you don't have a presence, it's simply too balkanized, and so I'm assuming your M&A efforts would be more focused on beefing up some of your existing markets. Is that a fair assumption?

<A – Mike Baur – ScanSource, Inc.>: I would say, Chris, that we're probably not looking at Asia-Pacific. I think that's fair. But as Charlie said, we would be looking at our existing markets plus new technologies.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Got you. And is that primarily on the barcode/security or communications?

<A – Mike Baur – ScanSource, Inc.>: Could be something new, something that's separate from both of them.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: So a new leg to the story?

<A – Mike Baur – ScanSource, Inc.>: Correct. Yeah, that's right.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Very good. It's been, what, a decade? Well, that's not true. Security -

<A – Mike Baur – ScanSource, Inc.>: Yeah, that's right. 2004, when we started security, yeah. Yes, you're right on.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Yeah, okay. What a decade.

<A – Mike Baur – ScanSource, Inc.>: Yes.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: All right. Very good. Interested to see what you have in the pipeline and -

<A – Mike Baur – ScanSource, Inc.>: Yeah, stay tuned. More to come on that.

<Q – Chris Quilty – Raymond James & Associates, Inc.>: Great. Thank you.

<A – Mike Baur – ScanSource, Inc.>: Thanks, Chris.

Operator: The next question comes from Dominic Ruccella for Keith Housum of Northcoast Research. Your line is open.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Thank you very much. Thank you for taking my call. Just a few questions for you guys on the quarter. Did you guys see any type of competitive benefit from Westcon's troubles with their ERP?

<A – Mike Baur – ScanSource, Inc.>: This is Mike. We didn't hear that from any of our team members. We certainly sympathize with anyone that has ERP challenges because we certainly had ours, unless you're trying to go live, but no. I would say no one on our team said, hey, we were able to steal some business or take some market share because of challenges with that.

It's generally – especially in the communications business where we've got larger customers, they really – they make some really long-term decisions when they choose distribution partners. So I think that one is less transactional-oriented, frankly, than some of our other businesses. And so I would say, no. We didn't see that in the quarter.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Okay. All right. Fair enough. Thank you. For Avaya's new channel programs, what are your guys' initial thoughts, positive, negative for you guys? I know you guys mentioned that a little bit earlier in the script.

<A – Mike Baur – ScanSource, Inc.>: Well, in general for us, we're really reflecting on just a normal development of vendor programs as they go. We try to shy away from talking about any specific vendors if we can. And so I don't think I said Avaya's programs. I was talking about our vendor programs and that really encompasses lots of them.

But in general, if we have problems with programs where we believe we're providing value-added services and not getting compensated, we'll call that out. And since we didn't, we feel good about our vendor programs right now. They seem to be, and maybe that's the point is we seem to see improvement, I would say, more broadly with our programs.

Having said that, as you heard from Charlie, still had some unexpected gains from a margin perspective in the quarter because we got some program benefits that we don't believe we can forecast will happen again in March.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Okay. All right. Thank you very much. And then for the – [ph] let me see (29:22) for the – kind of keeping with your outlook on the vendor programs, any type of gut feeling right now and if any changes from Motorola or Zebra or any of the large vendors coming down the pipe? Do you have any foresight on that?

<A – Mike Baur – ScanSource, Inc.>: Well, it's kind of early days because these guys are all calendar year oriented programs. So I would say it's too early to call anything for the year. I would say the way we exited the calendar year with our key vendors, we feel better about that whole situation than we did a year ago. But it's still – we got to sit down and work with them. March being the first quarter for all these vendors and it's our fiscal third. It's always the quarter where they're trying to figure out what they really want from their teams and expect from the channel. Then they got to figure out what they can expect from the ScanSource team. So, still too early to call for the year, but we'll certainly be able to put a lot more on the vendor programs to you in April when we report our next quarter results.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Okay. Great. And then – I'm sorry, [indiscernible] (30:34) Avaya, is it safe to assume that that's less than 29% of your business now, your relationship with Avaya?

<A – Mike Baur – ScanSource, Inc.>: Well, we haven't – we haven't reported a percentage. I mean, we talk about them being a significant vendor and we talk about them a lot, but we don't have a specific number that we're out there with. So we -

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Okay.

<A – Mike Baur – ScanSource, Inc.>: We view that as a proprietary information.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: Okay. Fair enough. And – okay. Well, I think that that's going to take care of all my questions. Thank you very much.

<A – Mike Baur – ScanSource, Inc.>: Great. Thanks. Take care.

<Q – Dominic Ruccella – Northcoast Research Partners LLC>: You too.

Operator: [Operator Instructions] We are showing no further questions at this time.

Michael L. Baur, Chief Executive Officer & Director

Great. Thank you so much for joining us today. Our next conference call to discuss our March 31 quarterly earnings is expected to be on May 1, 2014. Thank you very much.

Operator: That concludes today's conference. Thank you for participating. You may disconnect at this time.