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SCSC - Q3 2015 ScanSource Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and 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, Vice President, Treasurer, and Investor Relations. Ma'am, you may begin.

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

Thank you and welcome to ScanSource's earnings conference call for the quarter ended March 31, 2015. With me today are Mike Baur, our CEO, and Charlie Mathis, our CFO.

We will review our 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 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. Let's start with the highlights for third quarter on slide 3.

We reported net sales of $763 million and non-GAAP EPS of $0.52, both below our expected range, principally due to foreign exchange impacts from the strengthening of the US dollar. Overall, net sales increased 12% year-over-year.

Worldwide Barcode and Security sales declined 7% from lower big deals for our POS and barcode business units. Worldwide Communications and Services sales increased 50% year-over-year, with growth in each business unit and the completed acquisitions of Imago and Network1.

In January we completed the acquisition of Network1, the largest communications value-added distributor in Brazil and throughout Latin America. This acquisition is consistent with our strategic plan to grow our communications business outside North America. Network1 also complements our existing successful POS and barcode business in Brazil and will provide scale to our back-office operations there over time. This was our first full quarter of results with Network1, and we are excited about the potential for this business.

In February, as planned, we began using our SAP ERP system in Europe and are very pleased to have a new IT system that meets the needs of our employees, vendors, and customers as we grow our business. What we've learned with our successful Europe implementation provides us a solid foundation for our North American implementation planned for July 2015. The SAP ERP system will provide a platform for growth and for simpler and faster integration of future acquisitions.

With that, I'll now turn the call over to Charlie to discuss our financial results in more details and our outlook for fourth-quarter fiscal-year 2015.

Charlie Mathis - *ScanSource, Inc. - EVP, CFO*

Thanks, Mike. The financial information I will be discussing can be found on slides 4 through 10 of our presentation. As a reminder, our non-GAAP measures exclude the amortization of intangible assets, the change in fair value of contingent consideration, and acquisition costs.

Before I dive into the numbers let me point out some overarching themes in the presentation. First, since the beginning of our fiscal year and pursuant to our business plan, we've closed on two international acquisitions, Imago and Network1. In the presentation, when we reference excluding acquisitions in the year-to-year comparison, we are referring to both Network1 and Imago.

Second, due to the stronger dollar as well as a higher percentage of our business in international markets, the foreign currency impacts, both foreign currency translation and the costs associated with hedging, are more noticeable. However, when I reference the excluding the foreign exchange impact, I am referring only to the translation impact.

Third, because our SAP ERP system is a global design, following our successful February 2015 implementation in Europe, we are no longer able to capitalize the expenses associated with the implementation of the North America business. I talked about this last time, and I've included a slide in the presentation for the project; and we will talk more about that later.

Now let me dive into the details of our financial results. Net sales for the third quarter totaled $763 million, a 12% increase over the prior-year quarter or a 16% increase excluding the impact of foreign exchange. The year-over-year change in foreign currency exchange rates negatively impacted sales by approximately $28 million, with most of the impact in the Worldwide Barcode and Security segment. Net sales increased 4% year-over-year excluding our acquisitions and the foreign exchange impact.

Our Worldwide Barcode and Security segment sales decreased 7% year-over-year, or 2% excluding the impact of foreign exchange, while our Worldwide Communications and Services segment sales grew 50%, which includes the acquisitions of Imago and Network1 for the full quarter. Excluding the acquisitions and FX impact, Worldwide Communications and Services sales increased 17% year-over-year.

Turning to profitability, our mix of business led to a 10.5% gross profit margin for the third quarter of 2015. The Worldwide Barcode and Security gross margin decreased to 9.2% from 9.4% for the year-ago quarter, largely due to the sales mix and the impact of foreign currency changes which lowered the overall mix of international business. For Worldwide Communications and Services, the gross margin was 12.1% compared to 13.3% in the prior-year quarter due to customer and product mix.

Third-quarter 2015 non-GAAP SG&A expenses were $55.8 million versus $45.8 million in the prior-year quarter. This also included $2.6 million of nonrecurring SAP-related ERP costs that go away once we are live with North America, and the SG&A expenses associated with the recent acquisitions.

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Our recent acquisitions include earnout payments as part of the purchase price. Each quarter we remeasure the fair value of estimated future earnout payments, which is expected to be an expense each quarter. These fair value adjustments can fluctuate based on changes in the assumed discount rate, actual versus forecasted operating results, foreign exchange, and other factors.

In the third quarter of 2015 we recorded a fair value adjustment expense of $285,000 compared to an expense of $981,000 in the prior-year quarter. For the fourth-quarter 2015, we expect the fair value adjustment to total approximately $1.2 million, principally from a higher adjustment for Network1. Given the size of the acquisitions and potential variability of fair value adjustments on operating results, we exclude the change in fair value of contingent considerations from our non-GAAP results, including ROIC.

Our third-quarter 2015 non-GAAP operating income was $24.2 million compared to $27.6 million in the prior-year quarter. Our non-GAAP operating income includes the nonrecurring $2.6 million for SAP-related ERP costs and a $1.3 million impact from the foreign currency translation compared to prior year.

For the Worldwide Barcode and Security segment on slide 6, the non-GAAP operating margin was 2.6% for third-quarter 2015. For the Worldwide Communications and Services segment on slide 7, the non-GAAP operating margin was 3.9% for the third-quarter 2015. These margins include higher SG&A expenses for the SAP-related ERP costs discussed earlier, and the impact from the foreign currency changes, which lowers the mix of international business.

The foreign exchange loss increased to $1.6 million during the March quarter principally from higher costs related to hedging US dollar-denominated accounts payable for Network1, as well as other foreign exchange losses for Network1. With the integration of Network1, we anticipate the foreign exchange losses to be reduced going forward.

Our effective tax rate was 34.7% for the third quarter of 2015 and 34.8% for the third-quarter 2014. We estimate the effective tax rate for the fiscal-year 2015 at approximately 34.5% to 35%.

Third-quarter 2015 non-GAAP net income was $14.9 million or $0.52 per diluted share, compared to $18.2 million or $0.63 per diluted share for third-quarter 2014. On a GAAP basis, net income for the third quarter 2015 totaled $12.9 million or $0.45 per diluted share.

Now shifting to the balance sheet and some key metrics, cash and cash equivalents at March 31, 2015, were $93.6 million, down from the previous quarter, principally from the initial cash payment and repayment debt for Network1, partially offset by positive cash generated from operations of $33.8 million for the quarter. At March 31, 2015, we had $11.9 million of debt, up from a year ago, for debt assumed with the Network1 acquisition.

We assume $34.7 million of net debt from Network1 and repaid $28.3 million during the March quarter. Outstanding debt includes tax-favorable $5.4 million for an industrial development revenue bond for our distribution facility in Mississippi.

Days sales outstanding at March 31, 2015, increased to 57 days with the acquisition of Network1. Inventory levels, inventory turns, and paid-for inventory days as depicted on slide 8 of our presentation are within our normal ranges and consistent with our current operating environment.

During the nine months ended March 31, 2015, capital expenditures totaled $19.9 million, primarily for our ERP project. Capitalized costs for our ERP project totaled approximately $28 million, and we began depreciating these costs over a 10-year life starting in February with the European implementation.

On February 2, 2015, we successfully implemented our SAP ERP in Europe, our first go-live date. We expect North America to go live in July. The project remains on schedule and on budget.

Now turning to slide 9, we incurred $2.6 million of SAP-related costs for the quarter. In addition, we expect SAP-related costs of another $1.9 million in the June quarter and $1.5 million in the first quarter fiscal-year 2016.

These expenses are primarily for outside services related to SAP implementation costs and training after the first go-live that can no longer be capitalized for the project. Again, these costs will not be ongoing expenses for the Company after our North America go-live.

In addition, as I mentioned last time and show on slide 9, we estimate ongoing incremental ERP cost at $1.5 million per quarter, which includes $0.7 million for depreciation. These costs are additional SG&A expenses that are incremental to our legacy system.

On slide 8, our return on invested capital, which excludes the change in fair value of contingent consideration and acquisition costs, totaled 12.1% for the quarter, compared to 15.3% in the prior-year quarter. Our year-to-date ROIC is 14.5% compared to 16.5% in the prior year to date. The lower ROIC is impacted by the addition of SAP-related expenses, as I discussed previously.

We will continue to pursue strategic opportunities to invest in and grow our business, including through additional acquisitions in keeping with our business plan and value-added distribution model. We successfully completed our acquisition of Network1 in January 2015 with a cash payment and a fixed amount of assumed debt for an initial purchase price of approximately $60 million. The Network1 acquisition is structured to include additional annual earnout payments over the next four years that are based on an adjusted EBITDA multiple and payable in Brazilian reais.

In August, our Board of Directors authorized a three-year $120 million share repurchase program. We repurchased approximately $2.7 million (company corrected after the call) of shares during the March quarter.

We have a strong balance sheet, which provides us with additional opportunities to grow. Over the long term, we believe moving from a positive cash balance and almost no debt to an EBITDA ratio of at least 1 times improves our capital structure and results in better returns.

Turning now to our next fiscal quarter, and let me add some additional color here. The forecast assumes a stronger dollar and includes the assumption of a go-live of our SAP ERP project in North America in July. This includes approximately $1.9 million in the quarter, or a non-GAAP EPS impact of $0.04 for the SAP-related costs.

In addition, this forecast reflects average US dollar exchange rates of $1.08 for the euro, $1.51 for the British pound, and an average Brazilian reais exchange rate of BRL2.98 per US dollar. The FX translation negatively impacts our forecast versus the prior year by about $38 million for sales and $1.8 million for non-GAAP operating income, or a non-GAAP EPS impact of $0.04. This does not include the FX translation impact on Network1 and Imago, which was not in the prior year.

Due to the volatility of foreign exchange and our recent acquisitions, we are increasing our forecast range. We expect net sales for the quarter ended June 30, 2015, to range from $800 million to $850 million, and non-GAAP diluted earnings per share to range from $0.56 to $0.62.

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

Mike Baur - *ScanSource, Inc. - CEO*

Thanks, Charlie. We have two reporting segments, and I'll start with Worldwide Barcode and Security, summarized on slide 11, which represents 55% of overall sales for the quarter. Worldwide Barcode and Security sales of $422 million decreased 7% year-over-year, or down 2%, excluding foreign exchange. We had fewer big deals this quarter across all geographies, as some projects were delayed.

In North America, our payment processing hardware business grew 47% year-over-year, and our key injection services more than doubled. We expect demand for EMV-enabled terminals to continue as we approach the October 2015 date for merchants to install compliant equipment.

Our physical security business in North America grew 9% year-over-year, with strong growth in wireless and networking. This business unit began selling cabling and connectivity products from Hitachi, General Cable, and Signamax and also launched an outdoor wireless networking initiative. During the quarter, we expanded key vendor relationships into additional geographies, including Ruckus Networks in Europe and Intermec by Honeywell in Brazil.

Now to our second segment, Worldwide Communications and Services, on slide 12. With the completion of two international communications acquisitions, Imago in September and Network1 in January, this segment is 45% of overall sales this quarter. Worldwide Communications and Services net sales of $341 million increased 50% from a year ago, or a 17% increase excluding the acquisitions and foreign exchange. This reflects year-over-year sales growth for all of our business units in the segment.

A key element of the growth strategy for this business has been to expand our vendor relationships across other geographies and be a worldwide leader in communications distribution. A great example of this is Polycom, a key vendor of ours that named ScanSource its Global Distributor of the Year in February for the 11th year. Imago is Polycom's largest distributor in Europe, and Network1 also distributes Polycom in Brazil and Latin America.

This was our first quarter of Network1. Network1 has over 60 vendors and 7,000 new customers. Our team reported good growth in network security and in the SMB customer segment.

Similar to our POS and barcode team in Brazil, Network1 had some projects postponed due to foreign exchange volatility. In North America, we launched Total Coverage, a value-added service for our Cisco collaboration business; and we now have a full suite of services offerings for Cisco.

Near the end of the quarter, our North America Communications team launched Mitel as a new vendor in the US and Canada. Mitel offers a full line of communication solutions including business phones, unified communications, collaboration, and contact center.

We also announced additional cloud offerings developed with our key vendor partners, such as the recently announced offering of ShoreTel Sky. With these offerings we are able to offer both premises and as-a-service cloud-based solutions, giving customers greater flexibility in their unified communications offerings.

Our ScanSource services group works closely with our business units to support hardware sales. We continue to see increased custom configuration activity, led by our key injection services. We are also seeing increases in the number of our reseller partners using our ScanSource services offerings.

We are very pleased to have completed our two acquisitions this fiscal year and accelerate the growth of our international communications business in attractive markets with higher-margin opportunities. As we enter the fourth quarter, we will continue to execute our strategic plan for growth across our worldwide markets.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Keith Housum, Northcoast Research.

Keith Housum - *Northcoast Research - Analyst*

Great, guys. Thanks for taking my questions, guys, and good to talk to you again. Hey, Mike, as you guys implemented the ERP this quarter, did you guys notice any impact on demand? Did you guys have any type of operational issues whatsoever that would've affected international sales?

Mike Baur - *ScanSource, Inc. - CEO*

Hi, Keith; good afternoon. When we implemented our new system in Europe, we were prepared that we might delay some shipping in the first couple days. We even notified our customers a couple weeks in advance and asked them to get some of their orders in early. So I think we did a very good job of preparing for some slowness or difficulties in the first few days, and so we probably had less orders to have to deal with in the first few days.

But by the end of the first two weeks of our go-live, we felt very good that we didn't have any interruption in services. We talked to our vendors to see if they were having any concerns from their perspective, and we believe it went very well. So we don't believe there were any material impacts from our sales side in our ERP implementation in Europe.

Keith Housum - *Northcoast Research - Analyst*

Got you. Okay, appreciate it. As we talk to a lot of the vendors and the VARs out there, there is a lot of discussion regarding the vendors raising prices over in Europe to offset the strengthening dollar. I guess, what is your thoughts in terms of the demand it's going to have on your impact as your vendors are doing that?

Are you guys expected to absorb any of those price increases? Are you hearing anything in terms of the VARs and what their expectations are for the impact on demand?

Mike Baur - *ScanSource, Inc. - CEO*

Well, what's happened so far is the vendors have notified the channel that the increases were coming and some of them were effective the beginning of April and some during the month of April. So far, as of today, we have not seen a negative impact on our business and what we expected to do for this quarter.

So I would say right now, we feel pretty good about the impact of the increases. Certainly the vendors spent time talking to the partner community, making sure they understood the magnitude of the increases, so that they could better test the potential impact on demand. So I believe that our vendors have done a very good job of making sure they've measured the potential impact.

Our conversations with the customers and with the vendors has been that we believe that this increase will happen, will not impact demand materially, and that certainly if there is any impact that we will be sitting down with our vendors and discussing what we can do to mitigate that. But right now, we don't expect to absorb the price increases and we don't expect our VARs to.

We think our VARs can raise the prices to their end customers, because most of the time our components are part of a total solution; and the end customers will expect this to come from any vendors that are selling in US dollars in Europe, for sure.

Keith Housum - *Northcoast Research - Analyst*

Got you. So what's driving some of your customers then to defer some of these projects that you referred to, like in Brazil?

Mike Baur - *ScanSource, Inc. - CEO*

In Brazil, it's a little different than in Europe. The price increases were in Europe.

What we found there in Brazil is that there's so much volatility, and it was in a short period of time, that I don't believe the markets were prepared for that. We got problems with some large projects, but not in a run rate business.

So our team in Brazil is saying, customers are wondering and nervous about has the volatility settled out to where they can price a customer a project, and be able to support that price when it's actually installed, delivered, and invoiced. That was a Brazil issue.

Keith Housum - *Northcoast Research - Analyst*

Okay. Then if I can just follow up, I guess back into Europe, it seems like your European sales dropped a lot more than I would've expected, even with FX. Was there anything else that was happening in Europe that impacted your -- the demand there?

You guys buy in local currency, right? So you guys are competitive with local distributors, correct?

Mike Baur - *ScanSource, Inc. - CEO*

We buy locally in most cases. Remember that you have the pound sterling there as well as the euro, so there are some differences.

But you're right, in most cases we are buying locally, selling locally. So it's not an impact on demand in Europe. That really wasn't the point there. I think in general, we saw a weaker March quarter there than we had originally planned.

Keith Housum - *Northcoast Research - Analyst*

Okay. I'll jump back in.

Mike Baur - *ScanSource, Inc. - CEO*

And in the past we've had quarters where large deals come in and sometimes they don't happen. I think in this case we had some specific large deals that did not happen in the March quarter that we had forecasted; and we do believe most of those deals will happen, and they are in our June forecast.

Keith Housum - *Northcoast Research - Analyst*

Got you. Okay, I'll jump back in the queue and give someone else a chance.

Operator

(Operator Instructions) Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Good afternoon. Thanks for taking my questions. I guess just on the communications side, the organic strength that you saw, can you maybe just dig into that, what was behind that, a little bit? Was it new vendors or maybe demand for certain products?

Mike Baur - *ScanSource, Inc. - CEO*

Well, I think the main message -- and without getting into specific vendor names, Chris, because we try to be careful around trying to tell our vendors' story; as you know we don't want to get ahead of them. But we saw very good strength in our wireless and networking business, and that's been something we've been talking about for a few quarters.

We certainly have, as you know, a strong legacy premises-based phone business, UC business; and that business hasn't changed significantly from a standpoint of growth. I think that business has been a slower-growth business, as you know.

So I think the real emphasis that we are trying to share with you guys today is that our wireless and networking part of that business is doing very well.

Chris McGinnis - *Sidoti & Company - Analyst*

You mentioned maybe some larger deals being pushed out on the barcode side. Is it more of just the temporary markets itself, or do you have some confidence that maybe those deals fall through within the next say -- next quarter to a few quarters out?

Mike Baur - *ScanSource, Inc. - CEO*

Well, what we decided to do was clearly to put a reasonable estimate of which ones would continue to be delivered in the quarter. So our forecast would reflect that.

We certainly don't anticipate all of them would. We put some, again, measured experience against that from prior years. But we believe that most of that business will happen in June quarter, yes.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Then, Charlie, just on slide 9, with the ERP table, is the incremental $1.5 million on top of the $2.2 million? Do you know what I'm saying?

Or should we see some cost benefits, and then this kind of masks it? If I look out at, say, Q3 of 2016, do you have the $2.2 million and then there is an additional $1.5 million? I just want to --

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Charlie Mathis - *ScanSource, Inc. - EVP, CFO*

No, if you are looking out, we're really talking about the $1.5 million per quarter. The $2.2 million is really cost of our internal people that are going to the project and are being trained on the project. So that incremental that you see above the $1.5 million will go away as we go live as well.

Chris McGinnis - *Sidoti & Company - Analyst*

Sure, all right. Then any cost-saving benefits that you -- I know, I think last quarter when we talked, you were a little hesitant. But maybe anything? I know it's still early in the implementation.

Charlie Mathis - *ScanSource, Inc. - EVP, CFO*

Yes. No, we have not factored that in. But as Mike mentioned, it's a global design and it's meant to gain efficiencies in putting future acquisitions on quickly. So we are very pleased with the product and the platform that we've got.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Then one other comment just on the leverage ratio possibly going up to 1. Can you maybe just talk a little bit more about that?

I think that's -- unless I am mistaken, I think it's the first time I heard it, bringing that up. That would be more on the acquisition side. Would you ever be that aggressive on a share repurchase, although you probably can't disclose that?

Charlie Mathis - *ScanSource, Inc. - EVP, CFO*

Yes, we probably wouldn't say other than we have a plan that we are trying to execute on, and the idea is to get to at least 1 times leverage in the long term.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Thank you very much and appreciate taking my questions.

Operator

Andrew Spinola, Wells Fargo.

Andrew Spinola - *Wells Fargo Securities - Analyst*

Thank you. I apologize; I missed some of the call. But when I'm -- I heard your comments in the last few minutes. But on the barcode business, Mike, it doesn't sound like you are particular concerned about the result in the March quarter. It sounds like they were mostly pushed out.

Can you say, was the run rate business up in that quarter? Or has there been a change in trend in the run rate business?

Mike Baur - *ScanSource, Inc. - CEO*

I think you understood it right, it's that it's the larger projects or big deals; we call them different names dependent on the region. But the point would be it's those larger transactions that got pushed out, and we have had that happen in other quarters, too.

The last few quarters we've had such strong success with our larger point-of-sale deals, our larger mobility barcode deals, so we've had a nice run of large project, large deal quarters, we anticipated the same in the March quarter. I mentioned earlier that there was some specific reasons in Brazil around the tremendous volatility in the currency. Our guy is saying that's caused people to delay.

In Europe, I think it was other issues; and some of those we expect will be recoverable again in the June quarter, based on talking to our teams. I don't think the run rate business was affected or we would have called that out.

We didn't want to go down each vendor discussion. But we had a good quarter, but it certainly was less than we expected. So we were disappointed, but we do believe that it is recoverable.

Andrew Spinola - *Wells Fargo Securities - Analyst*

Interesting, okay. I guess just -- I'm going to ask the same question a different way. But the last four quarters it's sort of -- you have this crescendo up, the double-digit growth in June and September of the last year, then that stepped down to 5 in December and minus 2 I guess on constant currency in March. We've been talking over the last year, call it, about trying to understand the progression of this particular upgrade cycle in this business.

It looks like it may be we are reaching the end of that. Am I maybe making too much of it? Or is it just we're reaching a more normal run rate?

Mike Baur - *ScanSource, Inc. - CEO*

Well, we're still talking about barcode, right? Just to be --

Andrew Spinola - *Wells Fargo Securities - Analyst*

Yes, sorry.

Mike Baur - *ScanSource, Inc. - CEO*

That's okay. So, you know, if I go back and look at history, the March quarter has always been our toughest quarter to predict. You take that and layer on a lot of changes going on in this space relative to vendor consolidation, changing now to Europe changing prices coming. Everybody knew that was going to happen; they weren't sure when in the March quarter.

But a lot of disruption along how do you do business and what's going to happen. But this time of year the March quarter is when every one of our key vendors, just about, has a partner conference to talk about new initiatives for the year. It's always a tough quarter for us to predict, because when there is a lot of change, things slow down as the channel tries to digest these changes and decide how do they need to execute their business.

So on one hand, I'm disappointed. On the other hand I'm not shocked or surprised that this can happen in the March quarter.

Andrew Spinola - *Wells Fargo Securities - Analyst*

Makes sense. Thank you very much.

Operator

Thank you. I am showing no further questions in the phone queue at this time. I would like to hand the call back over to Mr. Mike Baur for any additional remarks.

Mike Baur - *ScanSource, Inc. - CEO*

Thank you for joining us today. We expect to hold our next conference call to discuss our June 30 quarterly and our year-end earnings results on August 20, 2015.

Operator

Ladies and gentlemen, thank you very much for your participation. This does conclude the program. You may now disconnect.