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SCSC.OQ - Scansource Inc to Discuss the Expense Reduction Plan - Call

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PRESENTATION

Operator

Thank you. Welcome to the ScanSource Expense Reduction Plan Conference Call. (Operator Instructions) Today's call is being recorded. (Operator Instructions)

I would now like to turn the call over to Mary Gentry, Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

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

Good afternoon, and thank you for joining us. Joining me on the call today are Mike Baur, our Chairman and CEO; John Eldh, our Chief Revenue Officer; and Gerry Lyons, our Chief Financial Officer.

Before we start, let me remind you that our press release and statements made on this call will include forward-looking statements. 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 earnings release that we put out today and in ScanSource's Form 10-K for the year ended June 30, 2019, as filed with the SEC. 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 disclaims any duty to update any forward-looking statements to reflect actual results or changes in expectations, except as required by law.

During our call, we will discuss some non-GAAP items and have provided reconciliations between these amounts in our press release. I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks for joining us today to discuss the actions we are taking to address the business impacts of the COVID-19 pandemic and prepare our business for the next phase of growth.

Starting last year, we announced the review of our international businesses, which led to the decision to divest our LatAm and Europe physical products businesses. Also last year, we executed our One ScanSource go-to-market plan that was designed to provide higher growth and better profits for our North American VAR business. In last year's December 2019 quarter, we realized the accelerating decline of our premise-based communications business, and the difficulties with our One ScanSource sales execution. Meanwhile, our Intelisys business has continued to grow at strong double-digit rates.

In April, as COVID began impacting our business, we started to see a significant decline in sales volumes for our VAR business in North America.

In May, on our earnings call, we reported that our monthly sales for April were down year-over-year at 22%. We then surveyed our customers and suppliers during May and June and validated that the volume decrease we saw in April was expected to continue for multiple quarters.

Today, in our press release, we announced preliminary fourth quarter fiscal year 2020 net sales of approximately $758 million for GAAP and $636 million for non-GAAP. This represents a 21% year-over-year sales decline or a 19% decline for organic non-GAAP net sales. As expected, COVID-19 has impacted our sales volumes negatively, including the acceleration of the decline in our premise-based communications business.

As we've worked on our fiscal year 2021 annual plan, we recognize the need to match our SG&A costs now with the sales volume's declines as a result of the COVID-19 pandemic. For our wholesale distribution business, we wanted to size the cost savings to reach an appropriate profitability level by the end of our fiscal year 2021. And we want our plan to include investing in higher growth, higher profitability areas, including our Intelisys business. Key Intelisys investments are hiring channel managers to recruit, onboard and manage new channel partners with a focus on the VAR channel. We are also making investments in our industry-leading partner commission tool, called RPM, which we acquired 2 years ago. Also, for the fourth quarter of fiscal year 2020, net sales for the Intelisys business increased 15% year-over-year.

Today, we announced a $30 million SG&A expense reduction plan for our wholesale deal distribution business. We are making the necessary structural cost reductions to improve our profitability going forward. This unfortunately has resulted in a reduction in our workforce. Taking these measures, most of all, letting go valued and dedicated members of our team, is very difficult. We are incredibly grateful to the employees for their service to ScanSource and deeply appreciate their loyalty and support.

We also announced that we are winding down our Canpango professional services business, which has not met our profitability and return thresholds. In addition, there has been limited adoption of these implementation and consulting services by our partner community. We determined that we could close this business and replace the offering by partnering with third parties to still deliver a targeted set of services to support our CCaaS and UCaaS business opportunities.

While it's still an uncertain channel and end-user demand environment, we do see opportunities for growth in fiscal year '21 for our wholesale VAR business. Examples of 2 areas, where we are continuing to invest in near-term growth, are our physical securities business -- physical security business and our Microsoft SaaS business for VARs. The actions we are announcing today are setting us up for financial success while continuing to invest in and support our strong bias towards growth.

We will now open up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Adam Tindle from Raymond James.

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

It looks like, obviously, with the updated revenue, you're going to be just under $650 million or so ex the divestiture in Q4. I'm just thinking, looking forward, do you think that's a good representation of kind of a normal quarterly run rate to where the annual revenue is now kind of in the neighborhood of that $2.5 billion range?

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

Well, Adam, what we're thinking right now is that we are planning that we still have some investment dollars in our SG&A. We believe that, that number does need to grow in FY '21. And so we believe we've still got some investment dollars in that SG&A. And we do believe we will start to grow again. We just can't be sure which quarter it's going to be. But talking to customers, we believe it's prudent to take this action now, but not be afraid to have some investments still being made, so that if we get to some reasonable level of growth going forward, we will see the profitability that you guys and our investors have expected.

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

Okay. And with that cost reduction, and this is probably a little bit premature, but how are you thinking about kind of that mid-3% operating margin goal in light of those cost actions? Is that something that you're going to put on the docket and try to achieve in fiscal '21?

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

Well, our belief is that we would need to see more revenue than we're experiencing right now to achieve that. So the idea would be that if we can see growth from here on the revenue line from this fourth quarter, then we will achieve the 3.5% line at some point. It won't be all in one quarter, obviously. But we believe if we have growth above this number, we will definitely make inroads into the 3.5%.

So we do see that as a key goal still for the company that we've committed. We said this last year, we did achieve it last December. We expect to see it again in '21. Not for the year, but in '21 we expect to get back to that number.

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

Okay. And just to be clear, near term, just maybe if you could -- I think you alluded to some of the communications business. But maybe just double-click on the areas of downside relative to -- I know you didn't have original guidance, but kind of what you were forecasting, what the biggest drags are near-term in terms of businesses? And is that due to volume at the partner? Or is there a change in a partner relationship, something more company-specific that's driving that?

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

Well, let me try to hit a couple of areas. So our historical business, the bar code and point-of-sale business, is heavily weighted on VARs who service hospitality, which was heavily impacted by COVID, it still is; retail, heavily impacted by COVID and still is; and our customers typically are not selling to the big box guys that are still successful, like the big grocery and the big retailers like Costco. So we have had -- those partners get impacted significantly.

We also have partners who are selling into manufacturing. And again, we're principally an SMB-type channel story. And so any SMB-type manufacturers that didn't reopen quickly, they were impacted. So I would say it's across many of the vertical markets that are VAR business services.

Having said that, the comms business, the premise communications business, continues to disappoint and decelerate, no surprise now with COVID with everybody working from home. There are opportunities for us to sell peripherals in that business. We're selling a boatload of handsets, a boatload of headsets. But the traditional business there continues to decline faster than we would have ever thought a year ago.

And again, I said on the call, we've got -- earlier, we've got some areas still of growth. Physical security is still a growth area for our company. So we do have areas of growth. We're trying to help our channel partners, with their unique business, figure out where they can move to, even if they're in a business that's declining like hospitality, what other areas that are adjacent and close enough that they can provide opportunities for growth.

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

Okay. Maybe just one last one, kind of a big picture one, Mike. I know kind of everything as a service and distribution as a service is a key initiative for the company. And Intelisys, clearly, a shining example, little of that on the positive side. Canpango, conversely, didn't play out kind of the way that you had thought it would. Maybe just reflect on that. What are the key differentiators on why one has been so successful and the other one wasn't quite as successful? And moving forward, how you're thinking about your strategy, how to index more towards the Intelisys-type acquisitions?

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

Sure. I think what we learned from the Canpango acquisition is that we try to create a solution set that would enable us to accelerate the adoption, through the channel, of CCaaS and UCaaS in a more sophisticated environment where the clients, the end users are using CRM, in this case, Salesforce. And that's a pretty sophisticated -- takes a sophisticated sale and a sophisticated engagement, and we believe from our research that we had a certain group of Intelisys partners who needed that, and we started by buying a company that was familiar with our channel.

Canpango knew our channel. We had even some executives who knew the executives at Canpango. So there was a lot of familiarity. The reality is none of the business very -- I would say, very little of the business they were doing when we bought them was done through the Intelisys channel. We thought it would become an opportunity for Intelisys agents to add this to their solution set.

It turned out it was not, as John Eldh would say, it was not down the middle of the road. It was not as easy as it could have been to add to this. And so we made the investment, believing it would be difficult, but that we would have a profitable business just providing the existing sales force business opportunities while the channel learned. The reality is we hired additional talent to go after opportunities, and we can't afford as a company right now to have parts of our business losing money, and this one was. So we had to decide -- we can't wait on the channel to adopt this opportunity. We can't see it changing in the near term. We had to make prudent decisions across the company, and this was one of them.

Operator

(Operator Instructions) Our next question comes from the line of Keith Housum from Northcoast Research.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Mike, it sounds like from your polling with the VARs that this COVID-19, I guess, disruption, is not going to be temporary by any means. You guys -- they expect it to go for several quarters. And then it sounds like for the on-prem business for communications, it's a permanent change. And I think you said it's accelerating the decline. So it's happened a lot quicker than you thought. Are they all correct?

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

That's correct.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Got it. In terms of the roughly 200 employees you're going to be getting rid of, is there a concentration of where these employees will be? I mean, will they be in the warehouse, or would be sales and marketing? Or can you dimensionalize a little bit about where you see the cuts coming from?

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

Sure. So we've already made the decisions on which groups of people we're asking to leave. 46, by the way, are in Canpango, so just to give you an idea of the size of that. There are a few that are international. We did everything we could to obviously not affect the growth opportunities, but there were clearly some areas of the business that, with the 20% reduction in volume, we have more people in some areas than we needed.

And as John Eldh and I were talking about previously and earlier, some of those areas are in the support areas. So maybe I'll let John talk a little more about the impact in sales.

John Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP*

Yes, sure. I think the -- as Mike said, one of the biggest things that was most important to us was to not affect the customer experience. So we went to great lengths to look at other parts of the business to attain these savings. And so there were some reductions in sales operations, there were some reductions in sales support, sales administration, but more so in kind of support organizations as opposed to customer-facing.

As well, as Mike talked about before, some of the areas that were affected were the on-prem communication space in both the sales side and the supplier side due to the decline in revenue. And as it relates to the sales support side, with less volume, there's less orders being entered. And it was less of an impact than to address customer-facing roles.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Appreciate that. How about the POS portal, is that going to be impacted at all?

John Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP*

POS portal will be impacted, but to a minimal degree. It will be in the single digits of people. And the reason that, that will be impacted minimally is because, as you know, Keith, it is a high-margin business for us. We're in really good segments and we see good growth in a number of the, what we're calling, value-added deployment services, these capabilities where we're adding higher-margin attached services to hardware.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Got you. And these are all North American cuts. So there's no impact on Brazil, correct?

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

There is a small impact on Brazil. Yes.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Got you. And then, Mike, do you expect all of these cuts to be completed by the end of the first quarter, so the $30 million run rate will kind of kick in, in the second quarter?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Keith, this is Gerry. Yes, we're expecting that most of these things will happen very quickly. So most of the headcount reductions took place Tuesday, and there's a few employees, or handfuls of employees who're staying a little bit longer, but most of it is -- most of the folks have already been impacted.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Got you. And then is there any update on the sale of the international operations outside of Brazil?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Sure. So for Latin America, we're really expecting, before we finish July, to have an agreement with a strategic buyer there. And then for Europe, we're continuing to explore our options for that business.

Operator

At this time, I'm showing no further questions. I would like to turn the call back over to Mike Baur for closing remarks.

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

Thank you, today. We will provide our fourth quarter and full year fiscal year 2020 results on August 25, and we'll host another conference call on that date. Thanks so much, and stay safe.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may disconnect.