THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SCSC - Q2 2019 ScanSource Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 05, 2019 / 10:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Gerald Lyons *ScanSource, Inc. - Executive VP & CFO*

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

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

CONFERENCE CALL PARTICIPANTS

Christopher Paul McGinnis *Sidoti & Company, LLC - Special Situations Equity Analyst*

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

Madison Suhr *Raymond James & Associates, Inc., Research Division - Research Associate*

PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings Conference Call. (Operator Instructions) Today's call is being recorded. If anyone has any objections, you may disconnect at this time. I would now like to turn the call over to Mary Gentry, Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

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

Thank you, and welcome to ScanSource's Earnings Conference Call for the quarter ended December 31, 2018. With me today are Mike Baur, our CEO; and Gerry Lyons, our CFO. We will review our operating results for the quarter and then take your questions. A CFO commentary that accompanies our comments and webcast is posted in the Investor Relations section of our website. Certain statements made on this call, including our expectations for sales, operating performance, earnings, fair value of contingent consideration, operating cash flow, new facilities, tax rates and interest expense for the third quarter or remainder of fiscal year 2019, are 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, 2018, 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.

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

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

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

Thanks, Mary, and thank you for joining us today. I'm pleased to report another excellent quarter of financial performance and continued execution of our strategic plan.

For second quarter fiscal year 2019, on a year-over-year basis, we delivered 1% net sales growth, 7% gross profit growth and 6% non-GAAP operating income growth.

Our operating results reflect good market demand and excellent execution by our teams. Both GAAP and non-GAAP diluted EPS exceeded the high end of our forecast range.

We delivered record quarterly net sales with 3% organic net sales growth. Our sales growth tracked our expectations given the higher big deal sales volume in the prior year quarter.

During the last 5 quarters, we've had organic net sales growth ranging from 3% to 10% each quarter. We've also had profits growing faster than sales. Second quarter gross profit increased 7% with an 11.5% gross profit margin and our non-GAAP operating margin increased to 3.5%.

Strong growth in the 6 key growth opportunities we've identified continued.

First, market demand, new use cases and operating system transition to Android drove continued growth from mobile computing solutions in North America and Brazil.

Second, we had another strong quarter of growth for video surveillance, driven by more applications for video, increased integration and better technologies, including image resolution and analytics.

Third, POS Portal had double-digit year-over-year growth, reflecting new business from a large customer in our contract deployment business.

Fourth, our communications channel opportunity saw business increase from the transition of previously direct Mitel customers to ScanSource. As part of our cloud voice and contact center solution strategy, we are seeing increased demand for handsets and headsets from Plantronics, Polycom and Jabra.

Fifth, our Network1 business in Brazil had another strong quarter of sales growth across all segments with the fastest-growing growth from Cisco, enterprise and SMB.

And our sixth opportunity is continuing to grow Intelisys, our recurring revenue-based business.

In December, we acquired RPM software, a commissioning platform business that is a primary resource in the telecom channel business for calculating and paying agency commissions in a cloud-based system.

Intelisys net sales increased 14% year-over-year, lower than our typical growth rate. In January, however, we had a record new billings month and expect to return to more normal growth rates this quarter.

We're making investments in our teams, processes and digital tools as we move to a customer-centric operating model. We began making these investments a year ago, beginning with our North American sales, marketing and supplier teams.

We are combining our ScanSource business units to be centered around selling solutions and getting closer to the end customer.

With this focus on delivering specific industry solutions, that include hardware, software, connectivity and services, we are making it easier for our sales and support teams to collaborate and deliver a truly excellent channel-partner experience.

These investments are part of a strategy for faster sales growth and continued operating margin expansion.

Earlier today, we issued a press release, announcing the retirement of our board Chairman Steve Fischer. Steve joined the ScanSource Board of Directors in 1995 and has served as our Chairman since 2009.

I want to thank Steve for his 23 years of service on our board and especially for his leadership and dedicated support as our Chairman. Steve's contributions to our board have significantly influenced ScanSource's growth and achievements. Under his leadership, we successfully implemented a SAP enterprise computer system that replaced our legacy system. In 2016, Steve and the board approved our acquisition of Intelisys, which was the first step in our strategy to move from being a products-focused distributor to a technology solutions provider.

We will greatly miss Steve and wish him and his family all the best. I appreciate the board's confidence in appointing me to the additional role of Chairman and board member Peter Browning was selected to serve as Lead Independent Director.

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

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Thanks, Mike. Our second quarter results reflect continued growth and strong profitability. Second quarter 2019 GAAP diluted EPS increased 152% year-over-year and non-GAAP EPS increased 10%.

GAAP EPS of $0.78 per share and non-GAAP EPS of $0.99 per share exceeded the upper end of our forecast range while net sales were at the midpoint.

For the quarter, our operating results included 3% organic sales growth, an 11.5% gross margin and 3.5% non-GAAP operating margin.

Our non-GAAP operating income grew 6% year-over-year, outpacing our net sales growth of 1%.

Consolidated net sales for the quarter increased 1% to $1.05 billion for a record quarterly sales. Foreign currency translation negatively impacted our sales by $21 million, in line with our forecast expectation.

As we forecasted, net sales in our Worldwide Barcode, Networking & Security segment decreased 3% year-over-year, or down 1% on an organic basis, primarily due to higher big deals sales volume in the prior year quarter.

We had strong growth in video surveillance and with POS Portal. Net sales for our Worldwide Communications & Services segment increased 10% year-over-year or 14% on an organic basis.

The growth was driven by strong sales in North America and Brazil and continued double-digit growth at Intelisys.

Gross profit dollars increased 7% year-over-year from higher margins and higher sales volume. Our second quarter fiscal year 2019 gross profit margin was 11.5%. For the Worldwide Barcode, Networking & Security segment, the gross margin increased to 9.2%, reflecting a lower mix of big deals versus the prior year quarter.

For the Worldwide Communications & Services segment, the gross margin was 16.2% consistent with the prior year. Our SG&A expenses increased $6.2 million from the prior year quarter to $81 million for the second quarter of fiscal year 2019.

This increase reflects the addition of acquisitions and higher employee costs, including investments to support our opportunities for growth. We also had lower SG&A expenses in Europe and Latin America, following the restructuring in those geographies.

Our second quarter 2019 non-GAAP operating income was $36.7 million, or 3.5% of net sales, compared to $34.7 million, or 3.4% in the prior year quarter.

For the Worldwide Barcode, Networking & Security segment, the non-GAAP operating margin increased to 2.9%. And for the Worldwide Communications & Services segment, the non-GAAP operating margin totaled 4.7%. These results reflect operating leverage from record sales volumes as well as improved international operating performance following those restructurings.

We have a $72 million contingent consideration liability on our December 31, 2018 balance sheet. This reflects the present value of expected future earnout payments for our Intelisys acquisition.

For the second quarter of fiscal year 2019 we recorded an expense for the increase in fair value of contingent consideration of $1.9 million for Intelisys.

For our third quarter 2019 forecast, we estimated the change in fair value of contingent consideration to be an expense of approximately $4.9 million.

For the second quarter 2019, the effective tax rate was 25%. This is our first full fiscal year following U.S. tax reform. And for fiscal year 2019, we estimate the effective tax rate to range from 25.5% to 26.5%, excluding any discrete items.

Shifting to the balance sheet. Cash from operations consumed $57.5 million this quarter due to higher accounts receivable from strong sales and also from inventory purchases. We expect to generate operating cash flow during the remainder of fiscal year 2019. We had $60 million of operating cash flow for the trailing 12-month period. Our inventory turns were 5.4x and they were comparable to the prior quarter but down from 6.2x for the previous year.

DSO excluding Intelisys came in at 58 days, a 2 day improvement from the prior and year ago quarters. Our balance sheet continues to be very strong and provide us with the ability to execute our capital allocation plan, which includes organic growth and strategic acquisitions.

At December 31, 2018, we had cash and cash equivalents of $23 million and debt of $372 million. Our net leverage totaled approximately 2.4x trailing 12 months adjusted EBITDA and the ROIC was 13.3% for the second quarter of fiscal year 2019.

And similar to last quarter, I wanted to share just a few comments on the tariffs of certain products imported from China.

ScanSource is generally not the importer of record and we are seeing our suppliers who are impacted by these tariffs take a variety of approaches. And thus far, we've not seen any impact on demand. And our forecast reflects the impact of these tariffs.

Now turning to our forecast. We expect net sales for the third quarter of fiscal year 2019 to range from $910 million to $970 million, GAAP diluted earnings per share to range from $0.48 per share to $0.54 per share and non-GAAP diluted earnings per share to range from $0.76 per share to $0.82 per share.

The midpoint of our forecast range reflects organic sales growth of approximately 7%. The typical mix of sales in our March quarter normally brings a higher gross margin for that quarter.

We assume approximately $3.8 million for interest expense for the March quarter, and we estimate the tax rate to be in the range of 25.5% to 26.5% for fiscal year 2019.

Additionally, in the March quarter we plan to open a new warehouse in the U.K to prepare for potential Brexit impacts and to move inventory from our distribution center in Belgium to the U.K. Our forecast reflects additional expenses associated with the new warehouse in the U.K. And now I'll turn the Mike -- I'll turn the call back over to Mike, for closing comments.

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

Thanks, Gerry. I want to thank the ScanSource team, our customers and our suppliers for an outstanding quarter. We're excited about continuing this momentum with the partner and end-customer-centric strategy. We see excellent opportunities ahead to invest in our business, accelerate sales growth, expand operating margins and deliver strong EPS growth. We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from Keith Housum from Northcoast Research.

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

My question for you on the Intelisys business, doing really the math here, looks like sequentially was actually down from the previous quarter and that was running 20%-plus year-over-year growth. Is there something that happened during the quarter that you guys kind of stumbled there?

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

Keith, it's Mike. What we said on the call today was that certainly we didn't expect that for the quarter, and what has happened is our January business has picked back up to the rate that we would have expected for the December quarter. So clearly there was a slow down, I don't think it was at all a stumble, there was no mistakes by our team. There was no new market pressures from any competitors, so nothing like that. We've -- and maybe part of it is, this business is still new for us. And we don't know if that is something that might happen again in the December quarter or in any quarter.

So we certainly were disappointed that it didn't hit the forecasted plan, but we feel much better because January has already come in very strong.

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

Help me understand, I thought Intelisys was primarily a recurring revenue business. So it's pretty predictable and as long as you guys are growing in the previous quarter as we'd expected that to grow and actually not fallback sequentially, correct?

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

No, that's true. Yes, it is primarily recurring revenue business. But every quarter we also get new customers. So we're always getting new customers, we have new billings. Of new billings there is a key measure of our future of revenue coming in, yes.

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

Okay, got you. Can you provide a bit color on the acquisition that you announced, the RPM software? I don't remember seeing that anywhere. And just in terms of where does it fit into the overall model? Does it plug into Intelisys or plug in more to the traditional communications side of the business? And perhaps any idea of the size margins or color on that.

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

Sure, yes. RPM is the billing and commission paying engine, that Intelisys has used for many, many years. Frankly, it was actually written back in the day by the Intelisys management team working with a software company out of Canada. So it's a Canadian company that had put this system for sale and we decided to acquire it. It allows us to make sure that we pay our agents timely and accurately because we take data from all of the suppliers and bring it into this RPM system, which designed then to help us manage all the payments out to the agency channel. So we decided to take advantage of the opportunity that it was for sale and we did that and it was a relatively small acquisition.

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

And just a follow-up question before I jump back in the queue. Your Barcoding segment is, obviously, took a step down year-over-year. And you mentioned lack of large deals albeit, obviously there's some great margin improvement there on the bottom line. Were you guys walking away from some deals or just were pressed without the profitability you guys were looking for? Or was the market for large deals just less than what you would expect?

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

Well, I think what we said last quarter is, we forecasted that we would have less big deals. We knew a year ago that it was unlikely to repeat, and I would even characterize these specific large deals as extra-large. When we did some of these a year ago, we were very skeptical that it would be a long-term relationship and a long-term source of opportunity. So we knew it was not going to happen again and you're right though, Keith. If we took a deal like that, the realized margin would be very low. Absolutely.

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

So can I infer this as from a vendor that you perhaps don't do as much business as you do on a regular basis?

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

No. I wouldn't say that. I think it's one of our significant vendors, yes.

Operator

Our next question is from Adam Tindle from Raymond James.

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

This is Madison on for Adam. So looks like your guidance implies operating margins will be down year-over-year despite mid-single digit revenue growth. Can you talk through what's driving this? And then as we think about the back half of the year, would you expect the operating margins to stay flat? Or should we see a type of change?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Madison, this is Gerry. I -- that is not what we're implying. We expect our operating margin to go down from where we ended in the December quarter as it historically has. So typically from December to March, it goes down. But we're actually -- the guidance that we've given should have you going up year-over-year, March to March. So ...

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

Okay, got you, I'll take a look. And then just as a follow-up on the Barcodes segment, I know you mentioned margin improvement related to less large deals year-over-year. I was wondering if that kind of accounts for 100% of the margin improvement? Or if there are other areas that led to some of the improvement year-over-year?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Sure. So we -- I guess what you're talking about gross profit margins. Yes, most of that is really coming from these extra-large deals that Mike talked about. If we're talking about non-GAAP operating margins, we just had a better volume and got some leverage on our SG&A there. And we also got a little bit of the benefit from our restructuring that we did. And we had some better performance in Europe as well. So those 3 things account for kind of the non-GAAP operating margin improvement.

Operator

Our next question is from Chris McGinnis from Sidoti & Company.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

I guess just looking at the -- on the revenue guidance and that 7% organic. Anything -- I guess you have the 6 points that you're focusing on. Anything different than what you're seeing now when you're thinking about that guidance?

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

You know, I think -- this is Mike, Chris. I think, one of the things that we feel good about is we referenced creating kind of some new solution team focused -- different customer focused. We've been investing for the last year or so in improving our strategy around selling more products to our key customers, including how do we sell more Intelisys services as well as our higher-margin traditional products. And so, I think, what we're seeing, and what we're communicating today is a better execution of our overall strategy to sell higher-margin products. I think we're seeing we can do that and have good top line growth. And that's why we believe we're getting leverage on the bottom line, on the operating margin because we've got a good leverage from the top line and improving gross margins. And I think that's what gives us confidence that we can continue to expand the operating margin.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. And is that the -- I guess the melding of the new business model versus the old? And can you maybe just update us a little bit around -- on what are the traditional reseller is versus the kind of newer transition you're making?

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

Well I think it's -- I think a big part of it is, we've kind of taken down some of the walls around how our teams go to market, so that we don't necessarily have to limit what our sales teams and our marketing teams are trying to accomplish. And historically we were doing that, we were much more focused around particular technologies and today, we're saying that what we've been working on for the last year, is much more of a customer -- end-customer-specific strategy and finding out what it is around that end customer that we can provide them, in addition to what we did 2 or 3 or 4 years ago.

A part of that is the Intelisys type services, part of that is the services we acquired from POS Portal from that acquisition. And obviously, part of that too is from the acquisition of Canpango back -- last quarter too which will help us sell more cloud contact centers. So I think we've got a real strategy that's working around selling more than just a product, of selling a solution, which includes either 2 products or product and a service or more than that. And I think that's what's got us excited.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Great. And then just a couple of minor things. Just one on the new facility. I think you said it was in Belgium for the -- that cost is embedded in the 3Q -- the 3Q guidance?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Yes, Chris, it's actually in the U.K. So we're opening up a warehouse in the U.K. to service whatever disruption may come from, whatever happens with Brexit. And yes, so the costs of that are included in the Q3 guidance.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

And then just 2 more questions. What you just called out, obviously, I know you've been investing to help drive the growth. I guess just how -- I think, in one of the slides you referenced that, that's the factor in the nonoperating income down a little bit year-over-year. How much is that investment? And I guess as long as you're seeing this kind of growth rate, you continue to invest in that manner? Can you maybe just provide a little bit more color on that?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Sure. So we -- Chris, this is Gerry. We haven't really said how much that is, but your thesis is right, is that we'll continue to invest as long as we see the continued growth. Most of that investment is really around our people and trying to, as Mike was saying earlier, just trying to make them more effective. So I think we'll continue to invest for the next little while still.

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

But I think -- and I think the other part of that though is we've got a clear focus as we've said to our investor community for the last 2 years on how do we get that operating margin back to 3.5% and higher going forward. And so we've got that as a clear target and we believe this quarter we achieved that. The forecast is indicative of the fact that our March quarter always goes down sequentially from a revenue standpoint. So we lose some leverage. But we expect that quarters past that, we'll be back on that 3.5% and higher rate. And continue to make that investment, Chris, sorry. So we're going to make the investments ratably, so that we still maintain the operating margin.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

And then just last question. I know very minor in the quarter, but a little bit of share repurchase just with the cash coming through in the back half of the year. Can you just talk about -- maybe get your thoughts about cash going forward?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Yes, Chris, so that was just really opportunistic. That happened when the share price happened to take a dip. That's not really our focus, our focus is not to repurchase a lot of shares as we go forward. We've got better places that we think we can invest our cash. We're expecting our cash collections in the March quarter to improve. So our -- we'll pay down some debt in the March quarter. So yes, I don't think we're expecting any more share repurchases really.

Operator

(Operator Instructions) And we have a follow-up question from Keith Housum from Northcoast Research.

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

Just quick one more in here. Inventory, you guys note that it was 20% higher or so year-over-year. And I assume that doesn't account for or maybe it does, the new inventory you have in the U.K. But can you provide a little bit color on what was the driving factor of that? Is it onetime or you guys expect you'll work that down?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Keith, this is Gerry. So it does not include what's going on in the U.K. and we're expecting really to transfer inventory from Belgium to the U.K. So the increase there would be minor or is going to be fairly minor in the March quarter. And you followed us for a long time, I think you know we're very disciplined about where we spend our time and our money. And so we're making investments in inventory when it pays for us to make them. And where we see opportunities. So, again, our forecast has 7% organic growth, so we think that we need some additional inventory to take care of that. Plus there have been opportunities for us to take advantage of our balance sheet to buy some additional inventory.

Operator

At this time I am 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, CEO & Executive Director*

Thank you for joining us today. We expect to hold our next conference call to discuss the March 31 quarterly results on Thursday, May 9, 2019.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect.