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SCSC - Q1 2019 ScanSource Inc Earnings Call

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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 September 30, 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, tax rates and interest expense for our second quarter 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, risk 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, we reported excellent first quarter operating results and a strong start to our fiscal year. For first quarter fiscal year 2019, on a year-over-year basis, we delivered 5% net sales growth, 6% gross profit growth and 7% non-GAAP operating income growth. Our operating results tracked our forecast expectations and our non-GAAP diluted EPS was at the upper end of our forecast range. We delivered strong net sales growth across our business with year-over-year organic growth for both worldwide segments and for all of our geographic regions.

For the quarter, our gross profit margin increased to 11.5% and our non-GAAP operating margin increased to 3.36%. We are driving higher-margin solutions for our customers and executing on both growing net sales and margin expansion. Our performance this quarter reflects progress in executing our strategic plan. First, strong demand for mobile computing solutions continued, reflecting a refresh cycle from the operating system transition to Android, pent-up market demand and new end-user applications. Year-over-year, we had good growth for mobile computing solutions internationally across multiple vendors and provided more value with transition support for the switch to Android mobile computers.

Second, we had another quarter of strong double-digit growth for video surveillance, driven by offerings of cameras with more intelligence and better image resolution. First quarter results reflect a strong quarter in the education market space and higher attachment rate for video management software solutions, which helped end customers manage their video surveillance systems. Selling, monitoring and storage as-a-service, as part of the overall solution for the end-user, is a key strategy for our teams in our network and security unit.

Third growth area is our POS Portal operating results, which included stronger services revenues at higher margins from value-added services, including terminal replacement services, kitting and configuration services. We're working with customers on an all-in-one solutions bundle that includes hardware configuration, provisioning, a service plan, connectivity, all the created easy-buying experience for end users.

Fourth, in our communications channel, our business increased from the transition of previously direct Mitel customers to ScanSource. The Mitel transition business is off to a great start. We are building customer relationships with new unified communications resellers and are also exceeding sales and profitability targets.

A fifth opportunity for growth is our Network1 business in Brazil. It had strong performance across all of our technologies, the Network1 team had another record sales quarter in local currency. This marks the sixth consecutive quarter of year-over-year sales growth. Over the past few years, our Network1 business in Brazil added new vendors and have significantly increased the total addressable market. An excellent example is Cisco, which we began selling in Brazil in calendar year 2017 and made additional investments in the business. The Network1 team has built a strong Cisco business, including recruiting and enabling new customers. This quarter, our combined teams in Brazil held a 1 ScanSource partner conference with over 1000 customers and vendors attending.

And our sixth opportunity for growth is continuing to grow Intelisys, our recurring revenue business. We had another record quarter for Intelisys, up 24% year-over-year with growth across the supplier portfolio of connectivity, cloud and cable. Our ability to reach the agent channel is drawing top cloud suppliers to us, and we have a portfolio of more than 125 leading cloud carriers and providers offering cloud solutions. For example, we have in our portfolio 11 of the 13 Gartner Magic Quadrant Unified Communications as-a-service providers.

In October, Intelisys hosted over 1200 sales partners at Channel Connect with a customer experience theme. At Channel Connect, Intelisys also celebrated the achievements of top sales partners where we announced 4 new platinum partners, bringing our total platinum partners to 21.

In August, we completed the acquisition of Canpango, a global sales force implementation and professional services business with deep knowledge of CRM and how it integrates with telecom systems. With Canpango, we added capabilities to help channel partners sell customer experience, CX solutions, where CRM integrates with other communication offerings such as UCaaS or CCaaS.

With that, I'll now 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. First quarter 2019 GAAP diluted EPS increased 250% year-over-year and non-GAAP EPS increased 17%. GAAP diluted EPS of $0.56 includes a higher-than-expected expense from the change in fair value of contingent consideration from better-than-expected actual results for Intelisys. Non-GAAP diluted EPS of $0.89 was at the upper end of our forecast range and net sales were near the midpoint.

For the quarter, our operating results included 6.5% organic sales growth and 11.5% gross margin and 3.36% non-GAAP operating margin. Our non-GAAP operating income grew 7% year-over-year, outpacing our net sales growth of 5%.

Consolidated net sales for the quarter increased 5% to $973 million. Foreign currency translation negatively impacted sales by -- by $21 million, which is $6 million more than anticipated in our forecast. Effective July 1, we adopted the new revenue recognition standard and, as expected, we had no change to our net sales from adopting that standard.

We had continued strength in our Worldwide Barcode, Networking and Security segment with net sales up 6% year-over-year with organic growth also at 6%. This was led by North America, including physical security and also in Europe. Net sales for our Worldwide Communications & Services segment increased 4% year-over-year or 9% organically, excluding FX. The growth was driven by strong sales in Latin America and North America and record net sales at Intelisys.

Gross profit dollars increased 6% year-over-year from higher sales volumes and the addition of POS Portal. Our first quarter fiscal year 2019 gross profit margin was 11.5%. For the Worldwide Barcode, Networking and Security segment, the gross margin increased to 9.5%, reflecting the addition of our higher-margin POS Portal acquisition.

For the Worldwide Communications & Services segment, the gross margin was 15.8%. SG&A expenses increased $4.7 million from the prior year quarter to $78 million for the first quarter of fiscal year 2019. This increase includes $1.3 million for restructuring costs and $400,000 for acquisition costs, which are both removed from our non-GAAP numbers.

In July, we restructured our communications business in Europe to be appropriate for the size of the business and to take advantage of growth opportunities. In Latin America, outside of Brazil, we combined our business units and moved positions in country to be closer to our customers and to achieve cost savings. We expect operating performance to improve in these areas for the full fiscal year.

Our first quarter 2019 non-GAAP operating income was $32.7 million or 3.36% of net sales compared to $30.6 million or 3.31% in the prior year quarter. For the Worldwide Barcode, Networking and Security segment, the non-GAAP operating margin totaled 2.5%. For the Worldwide Communications & Services segment, the non-GAAP operating margin increased to 5.1%. We have an $80 million contingent consideration liability on our balance sheet as of September 30, 2018. This reflects the present value of expected future earnout payments for our Intelisys acquisition and the final earnout payment for Network1.

Our first quarter fiscal year 2019, we recorded an expense for the increase in fair value of contingent consideration of $4.6 million for Intelisys, which was higher than what we expected due to better-than-expected actual results. For our second quarter 2019 forecast, we estimate the change in fair value of contingent consideration to be an expense of approximately $2.4 million, all related to Intelisys.

For the first quarter 2019, the effective tax rate was 25.5% and this is our first full fiscal year following U.S. tax reform. The non-GAAP effective tax rate was 24.8% for the quarter. For fiscal year 2019, we estimate the effective tax rate to range from 25% to 26%, excluding any discrete items.

Now shifting to the balance sheet and our capital allocation plans. We had $6 million of operating cash flow for the first quarter and $71 million for the trailing 12-month period. We made additional working capital investments to support our growth. Our inventory turns of 5.4 were lower than 5.8 for the prior year quarter and our inventory levels have increased 13% year-over-year. We believe our inventory levels are appropriate given our sales forecast for the December quarter.

Days sales outstanding, excluding Intelisys, came in at 60 days, which is close to our recent trends. Our balance sheet remains very strong and continues to provide us with the ability to execute on our capital allocation plan, which includes, in order, organic growth, strategic acquisitions and share repurchases.

At September 30, 2018, we had cash and cash equivalents of $19 million and debt of $282 million. Our net leverage totaled approximately 1.8x trailing 12-month adjusted EBITDA and ROIC was 12.9% for the first quarter of fiscal 2019. While adjusted EBITDA for the first quarter increased 6% year-over-year, ROIC decreased due to increased borrowings on our revolving credit facility related to acquisitions. We repurchased no shares for the quarter and for the fiscal year and have approximately $100 million remaining under our share repurchase authorization.

Now I'll share a few comments regarding tariffs on certain products imported from China. ScanSource is generally not the importer of record for these products. We are seeing our suppliers who are impacted by these tariffs take a variety of approaches. And thus far, we have not seen any impact on demand and our forecast reflects the impacts of these tariffs.

Now turning to our forecast. We expect net sales for the second quarter of fiscal year 2019 to range from $1.01 billion to $1.07 billion, GAAP diluted earnings per share to range from $0.70 per share to $0.76 per share and non-GAAP diluted earnings per share to range from $0.92 per share to $0.98 per share. The midpoint of our forecast range reflects year-over-year organic sales growth in the low single digits and quarter-over-quarter sales growth of 7%. The prior year December quarter included higher big deal sales volumes at lower margins than what's in our current forecast.

For the second quarter fiscal year 2019, we expect gross margin to be close to 11.5% and we assume approximately $3.1 million for interest expense. And we estimate the tax rate to be in the range of 25% to 26%.

And with that, I'd like to turn the call back over to Mike for closing comments.

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

Thank you, Gerry. We started fiscal year 2019 executing on both strong sales growth and margin expansion. We are excited about continuing this momentum with a customer-driven strategy. We are aligning our teams, tools and processes to support our customer focus. We see excellent opportunities ahead to invest in and grow our business, expand operating margins and deliver strong EPS growth.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Keith Housum from Northcoast Research.

Brendan J. Popson - *Northcoast Research Partners, LLC - Research Analyst*

Brendan on for Keith. So I just wanted to ask about the restructuring efforts going on. You talked about the communication business in Europe, just some more color on what you guys did there and what makes you more excited for -- down the road. And then also just wanted to ask if those efforts were done or if we should expect to see more in the next quarter.

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

Sure, this is Gerry. So on the previous call, we thought that -- we estimated our restructuring cost to be about $1 million -- $1.7 million and they came in at about $1.3 million. And we are complete with that restructuring, so we're very happy that that's behind us, and we are expecting results to show up in the next couple of quarters. So while we were restructuring in this quarter, we didn't have a lot of benefit from those restructurings but we expect those things to show up in the next couple of quarters.

Operator

(Operator Instructions) Your next question comes from the line of Chris McGinnis with Sidoti & Company.

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

I just want to start off, Mike, on something you said talking about -- offering a whole solution, I think it was around the POS Portal. Can you just maybe talk about how you're positioned within that market. Are you the only one that offers that kind of full suite solution and maybe just expand on that.

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

Sure, I'll try to do that, Chris. What we're trying to, I guess, indicate is that we've got a focus more than ever around providing more than just 1 piece of a customer's solution. And when we acquired POS Portal, we actually learned a lot more about how they did that, they've gone down this path for several years, working very close with ISVs, independent software vendors, who needed another partner to help fill out the solution portfolio. In the case of POS Portal, the payment terminal was the -- probably the start of that relationship with their ISVs. And the ISVs were selling, in their case, retail and hospitality software. Payment terminal was 1 piece of the solution that the ISV needed to be filled out. And then what POS Portal has done successfully is piloted a program where we're providing more than just 1 item. And the way we're achieving that, though, is by creating an offer to the end user with the ISV or in some cases with VARs or with agents, letting our channel partners know, hey, we have a broad portfolio of technology that your customer may be interested in buying. Let us help you put together an offer that includes more than just the 1 or 2 things you called us about. And so that's something we've always done intuitively, but we've never really programmatized it and POS Portal has created a tool to make that easier for our sales teams and for our customers to achieve that. So more to come in that area.

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

Okay. And maybe to jump around a little bit, just on the Network1, the strength you're seeing there. Can you maybe just talk a little bit about the competitive dynamics there? I think a while back, when Brazil was going through one of their, maybe, downturns, it seemed like you'd be in great position to go take share. Let's talk about that how the competitive landscape is now in the current environment.

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

Yes, in Network1 in Brazil specifically, we continue to do better than our competitors there. It has -- as you commented, has been in the past, a very challenging market as some of our competitors, we're trying to make sure they didn't lose market share to us. What's changed I think for us that helped us this quarter and, frankly, the last 5 or 6, is we've added and expanded our vendor portfolio. We referenced 1 of those vendors on the call today. On previous calls, we referenced some of the network security vendors like Fortinet and others, with the idea being that we're expanding our total addressable market down there by adding these new capabilities to, again, fill out a solution set. And that's what's helping us grow. We're growing in a market by adding vendors and then the vendors add us because we're then exposing them to more resellers. This conference I mentioned was the first time we've had our barcode point-of-sale resellers at the same conference as our networking resellers. So it was an opportunity for us to expose our customers in Brazil to a larger vendor portfolio and a solution portfolio, and we believe that's why we're growing in that region.

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

Great. And just two more questions. One, just around Intelisys. It sounds like it was an expansion of growth in the quarter, maybe slightly but still it sounded like expansion. Can you just talk a little bit about what's driving that in terms of maybe you know when you look across your -- the resellers you deal with, how they're using the product? How they're adapting to the product? And how long do you think the growth can continue at this rate?

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

Sure, Chris. So 2 things there. One is, there is, again, the same theme is going to be more solution offers, some more vendors, more products. We've continued to add cloud vendors to the portfolio. And I think we said a couple -- for a couple of quarters in a row, we've acknowledged that we continue to do that, and those cloud vendors are finding a lot of success with our customers. They are finding that the Intelisys agent channel already understands how to sell recurring revenue because that's what they know and that's how they started their companies. And so they're very skilled at working with customers for cloud solutions. So that was really something that has fit their wheelhouse. And we were able to bring those -- that portfolio of new vendors to the market because we do a lot of education. We do a lot of conferences, we had events last year called Mindshare. This 1 event we just had a few weeks ago called Channel Connect, where we had 1200 sales partners, it was an opportunity to talk strategy. It was also an opportunity for all of our suppliers who were there to interact and work with our key sales partners and find out how they can help them grow. And so our suppliers are growing by selling more of their products to the channel. Our channel or sales partners are growing, that's why we added 4 more platinum partners as they now have more to sell. And then at the same time, the reason we got excited about Intelisys 2.5 years ago was because the existing carrier business was principally sold direct by the suppliers without benefit of the channel. And that shift from being direct oriented by carriers to channel -- more channel oriented, we believe that shift of focus has allowed the Intelisys agent channel to grow because the suppliers are pushing business their way. So there's this tremendous opportunity that we're driving to our sales channel and they are staffing up to handle it. So we've added more to our existing partners and we've added more sales partners each quarter, too.

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

Great. And then just one question just sort of on cash flow and maybe your thoughts around capital allocation, just with the 1-year deleverage ratio. Gerry, just talk about your thoughts around capital allocation, the acquisition opportunities that are out there and then even if possible -- leverage, do you want to bring that down or -- obviously you have about $100 million of share repurchase out there.

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

Sure. There's lots of questions in there, Chris. But let me -- I'll give it a shot and then we'll see what I missed. In terms of like the leverage ratio or the debt ratio, we're comfortable where we are at 1.8x. As we said, we're happy that the business is growing comfortable with the amount of debt availability or amount of availability that we have in which we have not gotten anywhere close to the committed quantities that we've got out there. So we have lots of capacity to grow more, lots of capacity to go out and look for other acquisitions as well. And in terms of cash flow, we're -- $71 million was the trailing 12 months and we're expecting that sort of thing to happen or that similar sort of number for our full year as well. So what did I miss when I answered your questions?

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

No, just on, I guess availability that's still under the current repurchase authorization, any thoughts around that.

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

Yes. So we are -- we still have that out there. It's going to expire at the end of August. We're expecting that if the price is right for the shares and we think that's a good return, we'll certainly repurchase shares. That's always been part of our plan but it's got to be a good return for the shareholders. And at the moment, we don't believe that that's the best use of our funds.

Operator

(Operator Instructions) There are no further questions at this time. I would now like to turn the conference back to Mike Baur.

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

Thank you very much for joining us today. We expect to hold our next conference call to discuss the December 31 quarterly results on Tuesday, February 5, 2019.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may now disconnect.
