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SCSC.OQ - Q3 2021 Scansource Inc Earnings Call

EVENT DATE/TIME: MAY 10, 2021 / 9:00PM GMT

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PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings 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 Steve Jones, our Chief Financial Officer. We will review our operating results for the quarter and then take your questions. We posted a CFO commentary that accompanies our comments and webcast in the Investor Relations section of our website.

Let me remind you that certain statements in our press release, in the CFO commentary and on this call 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 we put out today and in ScanSource's Form 10-K for the year ended June 30, 2020, 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 both GAAP and non-GAAP results and have provided reconciliations between these amounts in the CFO commentary and in our press release. These reconciliations also can be found on our website and have been filed with our Form 8-K.

I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks, everyone, for joining us today. Last quarter, we highlighted that 2021 is a year for focus, execution and growth as demonstrated by our strong third quarter results. We are excited about the foundation for growth we have built in our market growth opportunities.

First, we are helping our channel partners accelerate their digital transformation. Over the last 4 years, we have been transforming our business to enable sales partners to deliver industry-leading solutions and respond to the many as-a-service ways end customers prefer to acquire technologies. Secondly, the hybrid office and work-anywhere trends provide opportunities for our UCaaS, CCaaS, cloud-enabled endpoints and connectivity.

Third, we are well positioned for mobility opportunities in markets such as retail, hospitality, grocery, manufacturing and warehousing. And a final opportunity to highlight is security, both physical security with video surveillance and cybersecurity.

For the third quarter, excellent performance by our employees drove the achievement of a 3.45% non-GAAP operating margin and a 13.6% return on invested capital. Our employees have done a remarkable job supporting our channel partners with focus, execution and growth.

I will now turn the call over to John to discuss our business performance for the quarter.

John Charles Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior EVP

Thanks, Mike. I'm excited by the energy and momentum we are seeing in the business as evidenced by the broad-based performance we delivered in Q3. Our customer and supplier relationships are strong. And as a result, we continue to deliver joint success. Our employees continue to inspire me with their resilience, customer focus and ability to execute.

In our Barcode, Networking & Security segment, we were encouraged by the demand recovery across our technologies, led by growth in mobility, self-checkout, video surveillance and networking solutions. We had record sales of mobility products, delivering 42% year-over-year growth. Large deals supporting the mobile everywhere trend, including warehousing and logistics, curbside pickup, and e-commerce, drove our growth.

For video surveillance, we delivered double-digit growth and are seeing strong demand as end customers open and stalled projects commence. We are also seeing a stronger need and application of outdoor surveillance systems and cameras to support both public safety requirements and the increase in exterior curbside pickup.

Our payments business, which has higher margins from service offerings wrapped around hardware, increased 13% quarter-over-quarter, supported by the reopening of the economy.

Within our Communications & Services segment, we continue to see growth and expansion across our video, audio and collaboration products. These solution stacks fueled by the shift to cloud are enabling the hybrid workplace to support work from anywhere, collaboration and huddle room technology refreshes, and applications across education for hybrid learning. Thanks to the strong effort of our communications and collaboration VARs and integrators, we had impressive sales growth in next-generation cameras, video bars, displays, headsets, microphones and control panels. We're encouraged by the increasing demand and appreciate our strong partnerships with leading collaboration suppliers.

In Brazil, strong financial performance continued with strength in large deals, expanded margin and impressive returns on working capital. We experienced double-digit growth across barcode and mobility, networking and digital workplace solutions. In addition to its success across hardware solutions, our business in Brazil continues to build outstanding momentum across both SaaS and cloud solutions.

Intelisys continues to be a key recurring revenue growth opportunity for us. Our Intelisys business grew 12% year-over-year with even faster growth for Unified Communications as a Service at 36% and Contact Center as a Service at 67%. We see strength in our Intelisys business as our customers continue with their workload migrations to the cloud.

We are encouraged by the accelerated adoption of the agency model by the VAR community since our 2016 acquisition as witnessed by the 69% year-over-year growth in new supplier billings through VARs. In the last year, we have increased our investment in sales support, engineering resources, digital training, technical certifications and enablement tools and technologies to support our partner community and ensure their continued success.

I'd like to recognize the outstanding efforts of our teams this past quarter as they worked closely with our suppliers to minimize the impact of supply chain challenges for our customers. We are experiencing increased lead times across most of our technologies and anticipate that this will continue through the fall.

And finally, key to our mission to being at the center of the solution delivery channel, we continue to create and innovate on new opportunities for our partners to grow. During the third quarter, we launched ScanSource's discover opportunity series, which showcase growth opportunities in areas of vertical expertise, including grocery, health care, education, government and manufacturing. This is an ongoing program featuring vertical thought leadership content, blogs, web seminars and events, panel discussions and podcasts. The discover opportunity series will enable all routes to market to drive growth and incorporates ideas and solutions for both upfront revenue as well as recurring revenue and services.

Now Steve will take you through the financial results.

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

Thanks, John. As Mike mentioned, we are very pleased with the financial results for our quarter, and very proud of our employees who continue to execute and deliver value to our channel partners. For Q3, our profits grew faster than sales. We expanded both our gross profit and operating profit margins and gained operating leverage on our SG&A expenses.

Our third quarter net sales of \$730 million were in line with our historical seasonality, which was where we expected entering the quarter. Third quarter revenues were down 2% year-over-year or flat year-over-year on a constant currency. Our gross profits grew 4% year-over-year to \$88 million. Gross profit margins increased to 12.1%. The higher gross profit margins reflect higher vendor sales program achievement, a more favorable sales mix and higher-than-normal margins for Brazil.

Our non-GAAP SG&A expenses for the quarter of \$59.8 million declined \$6.7 million or 10% year-over-year. We realized the quarterly impact of the expense reduction plan we announced in July. We will add strategic headcount for our Intelisys business and in other areas with growth opportunities. For fiscal 2021, we estimate the effective tax rate to range from 28.25% to 29.25%, reflecting a higher impact from nondeductible tax items and geographic mix.

Now turning to the balance sheet and cash flow. Cash flow from operations consumed \$60 million for the quarter, mainly from working capital investments to keep inventories level aligned with our anticipated customer demand. For the trailing 12 months ended March 31, 2021, we generated operating cash flows of \$129 million. Year-over-year, we reduced working capital investment by \$74 million, a 14% year-over-year decline, and strengthened our balance sheet. Q3 DSO came in at 63 days versus the previous year's 61 days, with much of the increase due to the timing of our sales in the quarter.

Our third quarter inventory turns of 5.8x are in line with our expected range. On March 31, 2021, we had cash and cash equivalents of \$49 million and debt of \$199 million. Our net leverage totaled approximately 1.7x trailing 12 months adjusted EBITDA, which is within our targeted range.

I'd now like to turn the call back over to Mike for closing comments.

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

This was another quarter of strong execution by our employees worldwide, and it gives me great confidence in our strategic plan to drive profitable growth.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Adam Tindle with Raymond James.

Catherine Elizabeth Huntley - *Raymond James & Associates, Inc., Research Division - Research Associate*

Hi, this is Catherine Huntley on for Adam. Just wondering, as inflation and price increases ripple throughout the economy and especially through this industry, can you please talk about how inflation generally flows through your financial models? And what are you observing from customer behavior in areas where price has increased thus far? And should we maybe see margin improvement for ScanSource as this unfolds?

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

Catherine, this is Mike. Let me try to take a shot at that. Historically, in distribution, there's not a lot of impact on inflation in the near term. I mean, we basically have our prices set in the marketplace by our suppliers. And the suppliers dictate what the value proposition is in general for everyone in the distribution supply chain. So at this point, obviously, as certain expenses go up for suppliers, we expect that they will pass those through over time. But we don't view that as a near-term item that's going to affect our business.

Catherine Elizabeth Huntley - *Raymond James & Associates, Inc., Research Division - Research Associate*

Okay. That's good to hear. And then also, you have 2 significant competitors that are merging over the next 6 months. What's your reaction to this? And what does this mean for your company?

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

Well, thanks for the question. But we don't comment on our competitor's strategic plans or their actions. So we'll let them speak for themselves. But thank you for the question.

Operator

Our next question comes from Keith Housum with Northcoast Research.

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

Good afternoon, guys. Congratulations on the profitability for the quarter. Mike or John, I'm just trying to reconcile, I guess, your performance with some of your largest vendors. We obviously, saw a lot greater growth in the revenue line this quarter. Can you perhaps give me a little bit more color or context about, I guess, you guys not keeping up perhaps their revenue growth this quarter?

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

Keith, this is Mike. I'll take a shot at it first. Again, thanks for the kind comments on the margins. You know, we have probably -- I'm going to take a stab at it here, John, 500 suppliers of all sizes. We have a group of about, say, 15 that are probably 80% of our revenue. And I would say we look very closely at market share within that top 15, and we continue to see very strong results when we sit down with those suppliers and say, how are we doing in the channel and in the part of the channel that we compete in. So sometimes there's confusion about how a vendor or supplier is doing. And yet some of the business that they're doing well in maybe is not a piece of business that goes through 2-tier distribution. So with where we choose to compete and can compete, we've not seen that happen. We're actually increasing our market share with those key suppliers.

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

Got it. I appreciate it. And then I got to hone in on the supply chain challenges that you're seeing again. I guess, a few things. One, if you can give perhaps a little bit more color in terms of if it's one area or another that you're seeing more of the challenges, what some of the challenges are logistical versus finished products? And then finally, the impact that had on the current quarter results? And will that perhaps have an impact on the results for the rest of the year?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Hey Keith, thanks for the question. And I think you heard in my prepared remarks that as it relates to supply chain and lead times, we have been affected like everybody else, and it's the same issues in terms of kind of shipping delays and also chips, right, chip shortages. We actually did not see a big impact in Q3. And thanks to the strong work that our supply chain team is doing in conjunction with suppliers, we feel that the impact in this quarter will be manageable and minimal.

Operator

(Operator Instructions) Our next question comes from Chris McGinnis with Sidoti.

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

Thanks for taking my questions, and congrats on the nice quarter. One question. Last time you highlighted POS Portal and just that you're expecting that to underperform. Can you just talk about maybe how that performed in the quarter and your expectations kind of going forward and how that's performing?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Yes, Chris, thanks for the question. We were pleased with POS Portal and their performance in the quarter. And maybe more importantly, we were pleased with the signs of reopening of the economy and Main Street. So we're looking for positive signs ahead.

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

And then the -- I think you've highlighted the profit profile coming out of Brazil. Is that a sustainable number? And can you just talk about maybe the competitive landscape in that environment and is still a positive spot for you?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Yes. Another good question. Brazil, they had another great quarter, and they're demonstrating really strong consistency. They are absolutely capitalizing on things like the digital transformation that we're seeing happening in Brazil. And I would tell you, I think one of the things that's driving their performance the most is we're seeing real synergies from them combining 2 companies. If you remember, Brazil really is a collection of CDC, which was the Barcode business; and then Network1, which was more of a networking and kind of IT compute company. And so bringing those 2 companies together has really helped to drive consistency in performance and healthier margins.

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

Can you maybe just talk about the outlook for a potential M&A. Is that market maybe opened up for you in this environment? Yes, maybe just elaborate a little bit on that strategy as well.

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

Yes. Chris, this is Steve Jones. Thanks for the comment and the question. I would say that we're still open to M&A opportunities for sure, as we look forward. It's going to just be the -- have to be the right fit and the right opportunity for us. But certainly would be on our strategic plan.

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

Sure. And then, I guess, just -- and thinking about next quarter, the demand trends accelerate. I may have missed this but a commentary on the quarter. But do you expect, I guess, just any expectations for next quarter in terms of demand trends and how you see that playing out?

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

Yes, Chris, thanks for the question. We're actually not going to give guidance for Q4 at this point. We're just not in a position to do that right now.

Operator

(Operator Instructions) We have a follow-up from the line of Keith Housum with Northcoast Research.

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

Just one more follow-up here. Talk a little bit more about the Intelisys business and its ability, I guess, to pull forward some more business. And I think one of you guys, and I apologize if I can't remember which, talked about how you're seeing new supplier billings through the VARs at 69%. Provide, just perhaps a little bit more context of real-world examples of how Intelisys can help drive some new business to VARs?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Yes, Keith, great question. And this is an area of real excitement for us. If you remember back when we made the acquisition of Intelisys, it was always 1 plus 1 had to equal 3 or more. And we are now seeing really strong evidence of not only greater recruitment but greater participation by the VAR community and revenue growth and supplier net billings. So we're excited about what we're seeing there. And looking forward to really doubling down on the effort to continue taking good care of our agents, but also continuing to grow the VAR population that participates in the agency model.

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

And is that coming through a better education or training classes? Or how are you guys able to engage them better?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Well, it's a number of things. It's definitely better education. Our cloud university helps them with training. It's continued innovation around our tools and technologies. But it'll also -- we've invested in Intelisys. And we will continue to invest in Intelisys in terms of account managers and technical resources and the resources that are necessary to help VARs get enabled and get comfortable participating in those cloud markets.

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

And Keith, it's Mike. Just one more add-on is what we've learned is the typical time for any new partner in that ecosystem, whether they're a traditional agent, telecom agent or a VAR, it takes them about 3 years to where they actually see success. So this is taking -- this takes a lot longer than we would typically see recruiting new partners in our products and services business. And so that's why we're seeing this happen now because this has been 4.5 years since we acquired Intelisys. So slower than we would all like, but the evidence is it's working, and it will continue to build going forward. So we're excited about that.

Operator

That concludes today's question-and-answer session. I'd like to turn the call back to Mike Baur for closing remarks.

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

Great. Thank you for joining us today. We expect to hold our next conference call to discuss June 30 quarterly and full fiscal year results on Tuesday, August 24, 2021.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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