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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, Senior Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - Senior 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 the -- our operating results for the quarter and then take your questions. We posted an earnings infographic 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 earnings infographic and on this call are forward-looking statements. These statements are subject to risks and uncertainties that could cause 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, 2021, 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 earnings infographic and in our press release. These reconciliations also can be found on our website and have been filed with our Form 8-K filed today.

I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks, everyone, for joining us today. Our Q1 performance was a terrific start to our fiscal year, driven by 13% net sales growth. Our excellent top line growth was driven by strong -- driven by strong demand proves our hybrid strategy is winning. I am extremely proud of the operational excellence delivered by our employees worldwide while navigating the ongoing supply chain challenges.

This quarter, we made changes to our reported segments, now Specialty Technology Solutions, and Modern Communications & Cloud, to align with our go-to-market strategy. Both of the new segments include hardware, services and recurring revenue opportunities. This enables us to follow end user consumption patterns for all of our technologies. The foundation of our hybrid distribution strategy is helping suppliers and sales partners accelerate growth across innovative technologies by providing hardware plus services, software or other recurring offers. We connect devices to the cloud and are enabling our channel partners to meet end user demand in the exciting and fast-growing digital world.

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

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

Thanks, Mike. I'm very proud of our Q1 performance. We delivered impressive results with 13% year-on-year net sales growth and 25% year-on-year gross profit growth. We saw momentum across our business, given our power to combine hardware, software, connectivity and cloud service offerings. This combination of capabilities is enabling us to deliver differentiated value to our partners and suppliers while accelerating growth opportunities across the channel, resulting in expanded margins across both segments.

Our sales and supplier services teams, deep knowledge, trust and specialty technology expertise provide us a competitive advantage in the marketplace. A big differentiator for our business is our focus on specialized technologies. This specialization brings us much closer to our suppliers and, in many cases, makes us their largest or second largest customer. Our suppliers trust us to take care of their business and their customers and work to accommodate our inventory requirements. Our first quarter results reflected strong demand, driven by digital acceleration and technology refresh initiatives. We saw double-digit growth across large deals and run rate business.

As end-user buying and consumption patterns change, ScanSource enables partners to win and sell the technology stack by leveraging our hybrid distribution strategy. A recent example of a hybrid solution included cloud voice, connectivity and SD-WAN controllers for a multi-brand retailer looking to consolidate suppliers across 1,000-plus sites while connecting, securing and maintaining business continuity. ScanSource orchestrated this solution, which resulted in a \$500,000 end-user MRR deal, highlighting our differentiated distribution capabilities.

In our Specialty Technology Solutions segment, net sales increased 23% year-on-year, fueled by strong demand, increases in big deals and market share gains. Our segment gross profit grew 32% year-on-year. A more favorable sales mix, increased supplier sales incentives and price performance drove higher profit margins. With increased demand and continued labor shortages, end customers are implementing mobile computing solutions to increase automation and worker productivity. Retailers are adopting our solutions to reduce friction across the buying experience, including self-checkout, curbside pickup and storefront fulfillment for online purchases.

Key to our hybrid distribution growth strategy is expanding use cases for attaching higher-value services to hardware. Example use cases include key injection for payment devices, wireless connectivity with mobile computers and integrated hardware deployments. These use cases demonstrate ScanSource's unique value proposition and enhance our margin profile.

For our Modern Communications & Cloud segment, net sales increased 2% year-on-year, while gross profits increased 21% year-on-year, reflecting accelerated cloud and subscription adoption. The hybrid work model, considered by many as the new normal, is providing significant opportunities for our partners across UCaaS, CCaaS, cloud-enabled endpoints and connectivity. Hybrid work environments are transforming the way we work. According to Frost & Sullivan Research, pre-2020, only 10% of meeting spaces qualified as huddle rooms. By 2024, approximately 75% of all video meetings will take place in huddle rooms. This expected growth is creating tremendous opportunity for our sales partners to update and refresh collaboration technologies in conference and huddle rooms, enabling hybrid work.

Included in this segment is Intelisys, and we achieved 13% year-on-year net sales growth and exceeded \$2 billion in end user ARR, annual recurring revenue, or billings by suppliers to end users. This marks our 21st quarter in a row of double-digit growth with Intelisys. We are adding additional headcount ahead of revenue to accelerate our growth opportunity. We are encouraged by the continued adoption of the agency model by the VAR community, as witnessed by 23% year-on-year growth in new supplier billings through VARs. These VARs now represent 56% of Intelisys sales partners, up from 30% at the time of acquisition 5 years ago.

Our team in Brazil continues to deliver consistent performance on top line revenue and profitability, along with strong financial discipline. During the quarter, we experienced strength in big deals with double-digit growth across data center, digital workplace and cybersecurity solutions. In addition to our success across hardware, our business in Brazil continues to build outstanding momentum across SaaS and digital solutions.

In summary, we are leading the way in hybrid distribution, accelerating the future of technology for our partners and suppliers across hardware, software, connectivity and cloud services. I'm very excited about our Q1 performance, the strength and momentum of our business and the opportunities that lay ahead. I'd like to thank our employees for all their outstanding efforts in the quarter, and our suppliers and customers for their continued commitment to ScanSource.

Now I'll turn it over to Steve, who will take you through our financial results.

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

Thanks, John. Our strong first quarter results demonstrate our team's successful execution of our strategic plan. It was an outstanding quarter for delivering growth and higher returns. Our business is built on top line growth and we realized operational leverage in Q1 and our bottom line results. Non-GAAP EPS for the quarter was \$0.99 and represents the fifth consecutive quarter of improvement. As Mike noted in his opening statements, we made changes to our reporting segments to align technologies with our go-to-market strategy. Our new segments better reflect how we manage the business today and in the future.

In the first quarter, we achieved strong top line growth, up 13% year-over-year, and expanded our margins. Our gross profit margins increased to 11.8%. Adjusted EBITDA margins increased to 4.83% and non-GAAP operating income margin increased to 4.07%. In both segments, gross profit, adjusted EBITDA and non-GAAP operating income grew faster than sales, demonstrating our increasing operating leverage. Q1 net sales of \$857 million reflects strong demand from our customers. Our gross profits grew 25% year-over-year to \$101 million. Favorable sales mix and higher supplier sales incentives contributed to our gross profit margin of 11.8%, an increase from 10.7% in the prior year's quarter.

Our non-GAAP SG&A expense for the quarter of \$63.5 million increased \$1.9 million or 3% year-over-year, which includes investment in strategic headcount for Intelisys, Brazil and other growth areas, including IT investments to expand our capabilities. We are shifting to adjusted EBITDA as a key profitability metric. First quarter adjusted EBITDA, which now excludes share-based compensation, totaled \$41.4 million, up 98% year-over-year. Our first quarter income tax rate of 25% reflects an increase in forecasted tax-exempt income, primarily from Brazil. For fiscal year 2022, we estimate the effective tax rate, excluding discrete items, to range from 25.5% -- 24.5% to 25.5%.

Now turning to the balance sheet and cash flow. Negative operating cash flow of \$57 million for the quarter and \$11 million for the trailing 12 months reflects working capital investment to support our sales growth. Year-over-year, working capital increased \$93 million, a 24% year-over-year increase. Q1 DSO came in at 62 days, in line with our expected range. Our Q1 inventory turns of 6.3x were up modestly from our typical range.

On September 30, 2022 -- 2021, we had cash and cash equivalents of \$55 million and debt of \$197 million. Our balance sheet remains strong. From a net debt leverage perspective, we ended Q1 at approximately 1x trailing 12-month adjusted EBITDA, demonstrating our financial flexibility to support growth opportunities and create long-term value. During the quarter, we had no repurchases under our \$100 million share repurchase authorization. And finally, first quarter fiscal year 2022 return on invested capital increased to 17.5%, the highest quarterly ROIC in over 5 years.

Our Q1 ROIC includes the change in our adjusted EBITDA calculation to exclude share-based compensation. With our Q4 earnings announcement in August, we provided an annual outlook for the first time. We are reaffirming our full year outlook. For fiscal year 2022, we expect our year-over-year net sales growth to be at least 5.5%, and we expect adjusted EBITDA to be at least \$135 million.

We'll 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*

This is Catherine on for Adam. It looks like your new segment for modern communication and cloud beat massively this quarter sequentially and year-over-year. Was this attributable to the reshuffling in segments or increased activity and spend in this channel?

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

Well, I don't think -- from a year-over-year perspective, if you look at the compare, we've restated our year-over-year performance. So this would be strong demand driving our growth.

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

Okay. And then can you dig a little bit into backlog? Are you seeing elevated backlog in lead times? And could you go into the composition of this backlog, please?

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

Yes. This is John Eldh. Thanks for the question. When we think about backlogs, quite frankly, it wasn't material coming out of Q1, and we aren't anticipating it to be material in Q2.

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

Okay. And last one for me. It looks like inventory could be putting a little bit of pressure on operating cash flow. And as you mentioned, turns are up year-over-year. When can we expect this metric to normalize?

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

Well, when we look at our inventory turns, we're kind of in the middle of where we think we should be, at 6.2x, 6.3x. So it's a little bit faster than what we've historically seen, but right kind of in the middle. So we're seeing -- we're comfortable with where our inventory levels are right now.

Operator

Our next question comes from Keith Housum with Northcoast Research.

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

Congratulations on the quarter. Great to see. As we look at your gross margins, obviously, gross margins were very impressive, and vendor rebates were a big part of that. As you kind of look at it and analyze the activity there, how sustainable is that level of achievement? And was it really just an outperformance of the quarter, if we kind of take this in measured doses here?

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

Yes. Let me take that one, Keith. This is Steve. So when we look at our gross margins, we believe that we'll be able to sustain these. And the reason why, let me go into a little detail, we see higher growth rates in our recurring business, and that has a higher margin for us. And so we think that will be sustainable for us, for sure. The one thing that we look at on the gross margin side is our mix of large deals. And so as we see larger deals, we can see some fluctuation in the margins.

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

Got you. Makes sense. And then in terms of the supply chain challenges that you guys are seeing, I'd love to get your perspective just because you guys see a cross-section of industries there. Do you see the supply chain challenges getting worse for you guys? Getting better? I guess how would you guys kind of look at them right now?

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

Keith, it's John Eldh. Thanks for the question. As it relates to the supply chain constraints, clearly, like everybody else, we're seeing supply chain challenges this quarter, and we see them continuing as we move forward. Lead times have extended, as you would imagine. But overall, as you heard in my prepared comments, our team is doing a fantastic job and working through it very well.

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

Got you. Okay. And then in terms of the guidance, first quarter is generally not one of your strongest quarters to begin with, but you guys had an exceptional quarter, especially on the adjusted EBITDA line. Why not raise your guidance at least a little bit? Or is there any thought process here for the rest of the year that things may slow down?

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

Well, Keith, this is Steve Jones again. Let me start off by saying we just gave guidance the first time ever in the company's history from an annual perspective. We stopped giving guidance and -- from a quarterly perspective, and we started the annual guidance. So we're wanting to make sure that we're very comfortable. Q1 definitely gives us confidence in our at least guidance for sure. But there are still challenges out there with the supply chain, and we historically see our seasonality impacted in Q3. So with those things out there, we really don't have any new news other than Q1 performance to update the guidance.

Operator

Our next question comes from Chris McGinnis with Sidoti & Company.

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

I guess just a follow-up to piggyback on the guidance question. I guess when you think about the performance in Q1 with the big deals, I know those fluctuate, can you just talk a little bit about how much that played into maybe the margin performance? I thought, typically, the larger deals were a little bit lower margin at times. Can you just walk through how that impacted the margin and where you could have ended up without those, I guess?

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

Yes, Chris, John talked about double-digit growth in our big deals and our run rate business. So we were really pleased with the mix of business that we saw in Q1. As far as the margins, with the supply chain, the way it is and the supply constraints, we actually had some pricing performance that we historically don't see in those big deals. So that was a help to us for the quarter.

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

That makes sense. Okay. And then John, I think you mentioned just some investment for some growth ahead. I don't know if it was specifically around Intelisys. But can you just talk -- are you seeing a greater growth opportunity at this point given the strong performance Intelisys has had?

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

Yes, Chris, thanks for the question. And yes, absolutely. As I said in my prepared remarks, we had a strong quarter. Once again, 13% growth. And absolutely, we see further growth opportunities across Intelisys. And so we're investing ahead of revenue, and we're doing so across customer-facing roles, expanding our inside sales capabilities and also technical sales and technical capabilities, so across the board.

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

And Chris, this is Mike. John, if I can just add to that. I think the other big story that John talked about and we've been talking about for a few quarters is we've expanded dramatically our customer opportunities in Intelisys with the really rush by the VAR channel to be part of our Intelisys story. So we've now got a lot more companies to go visit and cover, and a lot of those VARs are at early stages of selling, and so a lot of John's team have to do a lot of education and development.

So this is a multiyear return kind of plan. So we're adding investments to really help these. And the VARs are just doing a fantastic job. They're contributing so much to our growth. And this is what I talked about 5 years ago that we really wanted to happen is we'd have this great Intelisys master agency that would one day attract VARs at a level nobody else is doing. So I think that's the real story as to where that investment is going.

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

Okay. Great. And then maybe just if you could just touch on Brazil, what's happening in that market. It seems like they're in and out of flux with the pandemic. And can you just -- are you gaining considerable share in that marketplace? Can you just maybe describe a little bit about what's happening there?

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

Yes, Chris, we're really excited about Brazil. They continue to deliver consistent performance. We got a great leadership team, as we've talked about before. Real strength in the overall team. I think there's a couple of things also going on there. Our volumes there are at a real positive level, which is helping us to get greater leverage on our SG&A. And also, we're seeing real strong recurring revenue growth, which is contributing positively, not only on the top line but really to the gross profit and the margin.

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

Great. And I don't know if you'd give this number. Do you have a growth rate of the recurring revenue itself? I don't know if you've separated it out. I don't think I've ever heard you discuss it that way, but I was wondering if you can give us that color.

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

Yes. Chris, this is Steve Jones. We don't aggregate our recurring revenues and report them out, but it is something that we're focused on for sure is growing that recurring revenue base. On both sides of our segments now as well, you'll see recurring revenue.

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

Okay. Yes, thanks for all the data on the realignment, that's very helpful. And then just last question, just given the strength of the balance sheet, I know you have the share repurchase that you put in last quarter, but when you look at is there possible M&A, where you would like to add to the team at this point?

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

Yes. Well, first, if you look at our quarter, we added about \$93 million to our working capital. And we're in our sweet spot, the low end of our capital leverage range. I would tell you that we have an active M&A pipeline, and we are looking to acquire especially to expand our capabilities. So that is more to come on that one, stay tuned, but that is something that we're focused on.

Operator

(Operator Instructions) There are no further questions at this time. I'd like to turn the call back over to Mr. Baur for any closing remarks.

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

This is Steve Jones again. I'd just like to thank everyone for joining us. We expect to hold our next conference call to discuss December 31 quarterly results on Tuesday, February 8.

Operator

This does conclude the conference. You may now disconnect. Everyone, have a great day.

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