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SCSC.OQ - Q4 2022 Scansource Inc Earnings Call

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PRESENTATION

Operator

Hello, 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, Senior 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 President; and Steve Jones, our Chief Financial Officer. We will review our operating results for the quarter and the fiscal year 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 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, 2022, 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 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. - Founder, Chairman & CEO*

Thanks, Mary, and thanks, everyone, for joining us today. Fiscal year 2022 was a year of both strong demand and outstanding execution by our people. We exceeded our full year 2022 outlook, delivering 12% net sales growth and record adjusted EBITDA of $167 million. For fiscal year 2022, our non-GAAP EPS increased 45% to $3.97 per share, and our adjusted ROIC increased to 17%. Our exceptional FY '22 results demonstrate the success of the new ScanSource and the strong growth of our recurring revenue. The new ScanSource strategy is focused on hybrid made easy to enable our channel partners to meet end customer demand for devices and digital solutions.

In FY '22, our recurring revenue grew faster than our overall business up 16% year-over-year. This excellent growth in our recurring revenue provides the strong profitability our team needs to build the hybrid distribution business of the future. As a reminder, last year, we decided to provide an annual outlook for the first time. We previously provided quarterly financial guidance, and we were always explaining to our investors that our hardware distribution business works with limited visibility without bookings or backlog. However, with the change in our business to a hybrid model, where we have more recurring revenue each year and our growing services and software along with our hardware sales, we decided to provide an annual outlook for the first time.

Today, we are introducing a FY '23 annual outlook as well as midterm goals covering the next 3 to 4 years. For FY '23, we expect year-over-year net sales growth to be at least 5.5%, and we expect adjusted EBITDA to be at least $174 million. Our midterm goals are net sales growth of 5% to 7.5% and an adjusted EBITDA margin of at least 4.5%. These goals reflect our confidence in our business model and the opportunity ahead for the new ScanSource.

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

John Charles Eldh - *ScanSource, Inc. - President*

Thanks, Mike. I'm very excited about our Q4 results highlighted by strong demand, market share gains and great work by our team in collaboration with our partners and suppliers. It's rewarding to see the execution and momentum of our winning hybrid distribution strategy. For Q4, we delivered 13% net sales growth and 16% gross profit growth. We took market share due to our amazing team, technology specialization and partner pipeline visibility, while navigating a challenging supply chain environment.

Our hybrid distribution strategy of selling devices plus digital is enabling our partners to win in the marketplace. There is a growing trend of VARs, including some of our largest VARs, actively building hybrid solutions for their end customers, while growing their recurring revenues. As of the end of FY '22, we now have over 540 hybrid partners.

Let me share an example from one of our hybrid partners. In the past, this VAR's salespeople would sell a mobile computing device, and it would be a one-time hardware sale. Today, when they sell that same mobile computing device, their salespeople are proactively discussing cellular connectivity and network security as digital opportunities, orchestrated by ScanSource. Innovative solutions like this are driving incremental value and recurring revenue for our hybrid partners and ScanSource.

Now turning to our segment results. In our Specialty Technology Solutions segment, Q4 net sales increased 13% and gross profits increased 16%. Our excellent growth was fueled by robust demand for our hardware technologies, market share gains, better product availability and increases in big deals. However, not surprisingly, the growth in big deals did lead to a lower gross margin mix for the quarter. Our key areas of growth in Q4 and throughout the year were mobile computing, physical security, networking, payments and point-of-sale solutions. We expect continued growth in these areas in FY '23.

For our Modern Communications & Cloud segment, Q4 net sales increased 13% and gross profit increased 15%. These strong results were achieved with a different hardware mix than we expected going into the quarter. Net sales for Cisco led our strong performance, growing over 40% for the quarter. On the other hand, our premise-based communications hardware and services business declined faster than we expected at a negative 28%.

Our key growth areas are technologies that enable remote work for the enterprise, including UCaaS and CCaaS. Our UCaaS business grew 23%, led by RingCentral, 8x8 and Zoom, and our CCaaS business grew 48%, led by Five9, Genesis, Talkdesk and NICE CXone. For FY '22, our agency end user billings grew to over $2.25 billion. During fiscal year '22, we were very pleased with the adjusted EBITDA margin of 35-plus percent for the agency business in spite of gross margin pressures our sales teams experienced. Agency recurring revenue increased 11% for Q4 and 14% for the full year 2022.

In Brazil, the enterprise market is adopting digital solutions very quickly. Our hybrid model with an expanded digital line card is well positioned to help partners deliver digital solutions for their end customers. Our team achieved double-digit sales growth driven by increases in big deals, market share gains and growth in new technologies. In addition to our success in hardware, our business in Brazil continues to build outstanding momentum across our digital solutions. This hybrid growth was driven by best-in-class suppliers, including Fortinet, Cisco, Microsoft and VMware.

In summary, we were excited about the strength and momentum across our business throughout fiscal year 2022. We believe our trajectory of sustainable, profitable growth will set us up for continued success in FY '23. In addition, our productivity anywhere work model is proving to be very effective in driving retention of our people and a better overall customer experience. I want to send out a massive thank you to all our people for their dedication and commitment throughout the year and to our partners and suppliers for their trust and loyalty 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. I'll first review our Q4 results and then provide some highlights on our incredible full year results. As Mike and John mentioned earlier, FY '22 was a year of strong demand for our technologies and outstanding execution by our teams and our partners. For Q4, we delivered higher net sales with lower gross profit margins than we expected. We achieved double-digit growth in revenue and adjusted EBITDA, with net sales in both our segments, up 13%, and adjusted EBITDA of $38.7 million, up 10% year-over-year. Our gross profits grew 16% year-over-year to $111 million, with an 11.5% gross profit margin. Higher hardware sales and a lower margin sales mix contributed to overall lower margins in the quarter. Our non-GAAP SG&A expense for the quarter of $75.9 million increased $11.4 million or 17% year-over-year. Our Q4 results include approximately $2 million of unusual SG&A expense primarily related to higher marketing and performance-based compensation expense recognized in the period.

Q4 non-GAAP diluted EPS totaled $0.91 compared to $0.96 for the prior year period. As a reminder, the prior year period included a $0.19 benefit from discrete tax items.

Turning to our full year results. We had strong top line growth in both segments, with Specialty Technology & Solutions, up 15%, and Modern Communications & Cloud, up 8.4%. Consolidated FY '22 net sales grew to $3.5 billion, up 12% year-over-year, which exceeded our full year outlook. Our gross profit margins increased to 12.1%, up from 11.1% in the prior year, and include a temporary benefit from supplier price increases of approximately 25 basis points. Our hybrid distribution strategy continues to win in the market as we can see in our financial results by looking at the gross profit composition from our recurring revenues. Year-over-year, our recurring revenues grew 16% and is a fast-growing part of our business. For FY '22, approximately 24% of our gross profit is from our recurring revenue businesses.

Our FY '22 adjusted EBITDA of $167 million is an all-time company record, exceeding our full year outlook and represents a 41% year-over-year growth rate and a 4.72% adjusted EBITDA margin. Our FY '22 non-GAAP EPS of $3.97 increased 45% year-over-year.

Now turning to the balance sheet and cash flows. Our working capital investments increased to support our sales growth. We used operating cash of $79 million for the quarter and $124 million for the full year. Year-over-year, working capital, which includes accounts receivable and inventory, net of accounts payable, increased $226 million, a 56% year-over-year increase. Q4 DSO of 68 days is in line with our Q3 DSO and up from the prior year period. This increase is primarily driven by sales timing concentration at the end of the quarter.

Our adjusted return on invested capital increased to 17% for fiscal year 2022, up from 12.6% for the prior year. Our improved adjusted ROIC reflects both higher profitability and our strong balance sheet management. We've been able to leverage the strength of our balance sheet to accelerate growth. In our device business, we increased inventory availability and created programs like ScanSource Flex, which helps our partners win larger deals while maintaining financial flexibility. In our digital business, we have more sales partners than ever taking advantage of our partner investment programs. These investments help our sales partners grow faster and, in turn, help our recurring revenues grow faster.

As an example of the use of this program, we've made a $3.5 million loan against future commissions to a hybrid partner to use to expand their sales force and increase their working capital. On June 30, 2022, we had cash and cash equivalents of $38 million and debt of $271 million. Our balance sheet remains very strong. From a net debt leverage perspective, we ended Q4 at approximately 1.4x trailing 12-month adjusted EBITDA, demonstrating financial flexibility to support our growth opportunities to create long-term value.

During the June quarter, we had approximately $9.7 million in share repurchases under our $100 million share repurchase authorization. As Mike noted in his opening remarks, we are announcing a full year 2023 outlook, and I want to share a few more details around the assumptions for the year. We expect faster growth in the first half of FY '23 than in the second half of the year. We are normalizing our gross profit margin expectations to exclude the temporary benefit from supplier price increases I noted earlier. And as we think about our cash flows, we expect to use cash in the first half of the year and to generate free cash flow in the second half. With this cash pattern and the higher interest rate environment, we expect our interest expense to be higher in FY '23 than in FY '22.

Finally, for our fiscal year 2023, we estimate the effective tax rate, excluding discrete items, to range from 25% to 26%.

We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Adam Tindle with Raymond James.

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

This is Catherine on for Adam. Thank you so much for taking our questions. Was there any potential impact from supply chain embedded in gross margin? Like maybe did you work to secure inventory faster? Like was there anything that affected gross margin on that line?

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

Well, we certainly are taking as much inventory as we can when we look at our working capital usage, Catherine. In terms of margin impact from supply chain, not really. I wouldn't say that that's impacting our margins directly.

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

Okay. Perfect. And then could you also provide maybe a slight update on Intelisys and where that's going?

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

Yes. For Intelisys, for the full year, we saw 14% growth slowed down a little bit as we exited Q4. Still, we're seeing a large top line growth in the billings and the end-user billings. As we noted in the call, it's $2.25 billion now, that's up 20% year-to-year. So we still see a lot of tailwinds in that business as we go forward.

Operator

Our next question comes from the line of Keith Housum with Northcoast Research.

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

Congratulations on a strong top line performance there. Examining that 12% growth in the top line a little bit further, can you perhaps shed a little bit of light on, was the strength more from taking share, was it more expanded product lineup? Because as I see, you probably outperformed many of your largest vendors in the quarter. So just trying to understand where some the strength came from.

John Charles Eldh - *ScanSource, Inc. - President*

Hey Keith, this is John. Good afternoon and thanks for the question. We were -- as you heard, we're very excited about our top line growth. And for us, it really came down to 3 areas. We absolutely took share. We drove larger deals and really strong execution across our teams.

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

I guess how repeatable is that taking share? Is that a unique performance for this quarter? Or do you make some fundamental changes in the business that we can see that repeating in the future?

John Charles Eldh - *ScanSource, Inc. - President*

Well, as you can see from the results of '22, we felt like we took share most of the year, and we believe we'll be able to continue with strong growth as we look into '23.

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

Great. Appreciate it. In terms of your FY '23 guidance, perhaps some of the puts and takes as you're thinking about the guidance for the year. Are you assuming the economy avoids a recession, I guess just your overall thoughts on the guidance there?

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

Yes, Keith, the recession is the big thing that's sitting out in front of everybody that's the unknown. As we look out today, we're sitting in August, we have pretty good visibility to our first half, and so we're kind of at a timing benefit right now in how we're looking at it. Could recession impact our business? Yes. Right now, as we model, we're thinking that the demand will outstrip the recession pressure.

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

Got it. And for the quarter, I know that Cisco goes up 40%. I think you said your on-prem business was down 28%. And your on-prem business has been challenged now for a few years. Can you kind of scope it for us and give us context about how big the on-prem business is overall for the business?

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

Yes, Keith. The on-prem [communications] (added by company after the call) business continues to decline, and we're kind of at that tail end where it's going to remain about where it is. It's fairly small. It's less than 15% of our modern comms space in total on that on-prem space. And it's probably just going to sit there and remain for a long tail as you'll still have users, you'll still have replacements go out. So it's a high-margin business for us, so we like it. But it is definitely not -- it is a growth headwind for us.

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

I appreciate that color. And then I appreciate the near-term guidance going out 3 to 4 years. I think the adjusted EBITDA margin guidance of 4.5%. I guess as we look at the puts and takes of that 4.5%, I kind of think about your Intelisys and your agency business as being a contributor to that going forward. Should we expect that to climb? Or do you think they're going to be offsets that are going to keep your adjusted EBITDA margins more in that 4.5% range?

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

Yes. I think margins will compress a bit in that space as we see more and more competition. It's now not the big secret. Everybody's in that space now trying to compete. The way we'd like to frame it is we did say at least 4.5%. So we do want to beat that number.

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

Okay. Got it. And then final question for me. For the $2 million that you saw this quarter for the unusual items. I guess the marketing -- was that a onetime related only? Or do we expect that to continue going forward?

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

No. Both of those are really unique to the quarter when we think about it. The marketing certainly is a onetime event that we saw. And then we just are -- we had such a great year. We were behind on accruing for some of our performance compensation.

Operator

Our next question comes from the line of Mike Latimore with Northland Capital Markets.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Yes. Congrats on the quarter there and outlook. So you gave UCaaS and CCaaS growth rates. So I just want to clarify, that was -- those are quarterly growth rates or were those year growth rates?

John Charles Eldh - *ScanSource, Inc. - President*

Mike, this is John Eldh. Thanks for your question. Those were quarterly.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. Very good. And then also just a clarification. So the end user billings that was for Intelisys and that was for the year. Is that right?

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

That's correct, Mike. Yes, $2.25 billion are annual end-user billing for the Intelisys business.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Got it. And did you say Intelisys had -- was it 35% EBITDA margin?

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

Yes. Just north of 35% EBITDA margin.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. Very good. On the UCaaS and CCaaS business, any general feeling there for kind of sales cycles? Have you seen any changes in the sales cycle, say, June, July, August, anything like that?

John Charles Eldh - *ScanSource, Inc. - President*

Mike, we did not see much difference in the sales cycle timing over the last quarter. It's pretty much been the same. And as you said -- as we said, we're excited about the growth rates and looking forward to them continuing in '23.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Great. And then just last one on the supply chain. I guess, particularly as it relates to your Communications business, do you have any feel for whether the supply chain is going to loosen up kind of during this next 12 months?

John Charles Eldh - *ScanSource, Inc. - President*

When it comes to the supply chain, we are seeing a slightly better supply chain environment, but just slight. We're not too far off from where we've been over the last year, 1.5 years. And we think that lead times are going to be longer probably through mid-'23.

Operator

Our next question comes from the line of Matt Sheerin with Stifel.

Matt Sheerin - *Stifel Financial Corp. - MD & Senior Equity Research Analyst*

Yes. Thanks, and good afternoon. I just wanted to follow up on the last question regarding supply chain and your outlook. I imagine that your partners or your VAR partners are still seeing very strong backlog because of the constraints. Is that what's giving you confidence at least for the first half of the year in terms of strong growth or at least through those next 6 months?

John Charles Eldh - *ScanSource, Inc. - President*

Yes, Matt, thanks for your question. And absolutely, it's part of the equation. As we talked about, we've been taking share. We've been doing larger deals with enterprise projects, strong execution by our team. And we've had the good fortune of being for the most part, #1 or #2 with most all of our key suppliers. And in instances like that, it helps us because they prioritize our inventory requirements.

Matt Sheerin - *Stifel Financial Corp. - MD & Senior Equity Research Analyst*

Okay. And last quarter, you mentioned that I think you saw $30 million in incremental revenue due to some pull-ins. And you had some strong upside this quarter. Did that same thing happen in any of your businesses?

John Charles Eldh - *ScanSource, Inc. - President*

Yes, good memory from last quarter. And yes, again, we had some pull-in wasn't quite as strong as $30 million, but we did have some pull forward business, probably closer to $20 million.

Matt Sheerin - *Stifel Financial Corp. - MD & Senior Equity Research Analyst*

Okay. Great. And in terms of your EBITDA margin or EBITDA outlook for next year. It implies relatively slow -- modestly slower growth than revenue, which implies lower margin. What are the reasons for that? Is that another mix issue due to the higher hardware in the volume business or anything else in terms of OpEx or other reasons?

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

This is Steve Jones. Thanks for the question. Yes, really, it reflects the fact that for FY ['22] (corrected by company after the call), we had the 25 basis points benefit for some of the supplier price increases. We had multiples throughout the year that we saw. So that's really the adjustment that we're making for FY '23 forecast.

Operator

(Operator Instructions)

I am showing no further questions in the queue. I would now like to turn the call back over to Steve Jones for closing remarks.

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

Well, we'd like to thank you all for joining us, and we expect to hold our next conference call to discuss September 30th quarterly results on Tuesday, November 8.

Operator

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