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SCSC.OQ - Q1 2023 Scansource Inc Earnings Call

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

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

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

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Gregory John Burns *Sidoti & Company, LLC - Senior Equity Research Analyst*

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

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

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

Good morning, 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 then take your questions. We posted an earnings infographic that accompanies our comments and webcast in the Investor Relations section of our website.

Please let me remind you that certain statements in our press release in the earnings info-graphic 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 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. We started fiscal year 2023 from a position of strength, delivering 10% net sales growth and record earnings per share. This exceptional performance is a result of strong demand and working capital investments to meet the needs of our channel partners.

I'd like to highlight 3 areas that contributed to our record EPS. Number one, our consistent top line growth gives us leverage on our SG&A. In 5 of the last 6 quarters, we delivered double-digit net sales growth. The strong demand across our technologies coupled with our trusted customer and supplier relationships are making a difference in our ability to achieve above market growth rates. Number two, I'm incredibly proud of our team in Brazil and their consistent performance in profitability and return on working capital over multiple quarters. They've proven the scalability and flexibility of our business in Brazil in spite of macro events in the region; and number three, Intelisys. Intelisys was the catalyst for the

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transformation of ScanSource. With Intelisys, we opened up a new route to market through agents and started our cloud distribution journey. The Intelisys business model enabled us to build our first recurring revenue stream. We started from 0 recurring revenue 6 years ago, and now have approximately 24% of our gross profits from recurring revenue on a trailing 12-month basis.

With our proven success in device distribution and recurring revenue, we have transformed the company into the leading hybrid distributor that we are today.

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

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

Thank you, Mike. For Q1, we delivered 10% net sales growth and 12% gross profit growth. Q1 was another quarter highlighted by strong demand for our technologies, and outstanding execution by our team and our partners while navigating ongoing supply chain challenges. In early October, we hosted ScanSource Channel Connect, the largest in-person event in our history with over 1,800 attendees. For the first time ever, we brought together our VAR and agent communities to discuss how they can accelerate growth across hybrid opportunities. Our messaging resonated very well with our partners and created enthusiasm for driving hybrid solutions and growth. What was also evident is the importance and value of our customer relationships, and how critical these deep relationships built on common goals and trust are to our mutual success and growth.

I want to send out a heartfelt thank you to our marketing and events team for designing, architecting and producing this incredible event.

Our outstanding Q1 performance demonstrates how our hybrid strategy and capabilities are enabling partner success and growth. We are committed to helping partners execute on the expanded opportunity to sell device and digital solutions. Let me give you an example of how our hybrid strategy is winning business. An existing customer looking to add more capabilities, brought their cloud and on-prem communications business out to RFP. Through our extensive hybrid capabilities, including our CX practice, our solutions and technical engineering capabilities and our professional services referral program, we won the business bringing all their cloud and the hardware business to ScanSource. We doubled our hardware business from $10 million to $20 million and added a continuing stream of UCaaS and CCaaS subscription revenues.

Innovative solutions like this are driving incremental value and recurring revenue for our hybrid partners and ScanSource. The supply chain challenges are continuing, but this environment plays to our execution strengths, including our position as the largest or second largest customer for many of our suppliers. We're seeing the strongest demand from our VARs who service large enterprise customers. These enterprise solutions consist of multiple products that have various lead times, sometimes across multiple suppliers.

Our strategic advantage is that we can use our balance sheet to allow our customers to secure supply of available product by taking partial deliveries, but pay us when shipments are complete.

Let me tell you in a little more detail about our business results for the first quarter. In our Specialty Technology Solutions segment, Q1 sales grew 15% year-over-year. Robust demand for our hardware technologies and product availability fueled our growth. We help our partners deploy and enable mission-critical devices, including mobile computing, POS and payment terminals, self-checkout systems and video surveillance solutions. We continue to see strong demand and growth in these areas, led by Zebra, Honeywell, NCR, Toshiba and Hanwha. Modern Communications & Cloud segment delivered 3% net sales growth. We had incredible growth with Cisco.

Our Q1 Cisco net sales grew close to 50% year-over-year led by large enterprise projects. Our key areas of growth are technologies that enable remote work for the enterprise, including UCaaS and CCaaS. As part of our Intelisys business, our UCaaS business grew 20% and led by RingCentral, 8x8 and Zoom. And our CCaaS business grew over 60% year-over-year.

Intelisys continues to lead in the agency space. For fiscal year 2023, we expect double-digit year-over-year net sales growth for Intelisys, driven in large part by the strength of our relationships and the trust and credibility we foster with our partners and suppliers. I am so proud of our Intelisys team, our industry-leading events and our enablement and technical capabilities.

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Our partners look to us for thought leadership to drive growth and success across their businesses. In Brazil, over the last 5 years, we achieved scale and operational excellence across the business. Because we've achieved critical mass, this business has been able to self-fund its growth while achieving its expected net profitability. As an example of our team's operational excellence and ability to mitigate risk, our Brazil business unit received recognition and certification from the Brazil government in the areas of importation controls and anticorruption.

Lastly, ScanSource once again was named the Cisco Distributor of the Year in Brazil.

In summary, we are excited about our Q1 results and our trajectory of sustainable, profitable growth as we execute on our strategic plan. I want to send out a massive thank you to all our people for their dedication and commitment throughout Q1 and to our partners and suppliers for their ongoing trust and loyalty to ScanSource.

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

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

Thank you, John. For Q1, we delivered strong top line growth with net sales of $944 million, up 10% year-over-year and record profitability. Our non-GAAP diluted EPS of $1.07 and adjusted EBITDA of $45.3 million are all-time company records for ScanSource, and highlight our consistent, strong financial performance. We achieved 15.6% ROIC for the quarter as investments in working capital allowed us to take advantage of strong demand.

Q1 Intelisys net revenue increased 7% year-on-year. However, Intelisys had double-digit net commission growth, which are the ongoing commissions we earn on partner sales, while supplier rebates were lower due to timing. And as John said earlier, for the full year, we expect double-digit year-over-year net sales growth for Intelisys.

Our gross profits grew faster than sales, up 12% year-over-year to $113 million, with a 12% gross profit margin. This includes benefits from supplier price increases. Our hybrid distribution strategy is winning in the market and strengthens our financial results.

Our Q1 recurring revenue of $26.6 million grew 11% year-over-year, and that business is close to 100% gross profit margins. For the trailing 12-month period, approximately 24% of our gross profits are from our recurring businesses.

Our non-GAAP SG&A expense for the quarter of $71.6 million increased $7.7 million or 12% year-over-year. This increase is primarily attributed to higher people costs from wage increases and headcount investments to support our high-growth areas.

Our Q1 adjusted EBITDA of $45.3 million represents a 9% year-over-year growth rate and a 4.8% adjusted EBITDA margin. Q1 non-GAAP EPS of $1.07 grew 8% year-over-year and includes interest expense of $3.4 million. Our higher year-over-year interest expense reflects both higher interest rates and the investments in working capital that helped drive our higher growth rates and profitability.

Now turning to the balance sheet and cash flow. Our strong balance sheet enables us to invest in higher working capital to support the strong demand across our technologies and the need of our customers and suppliers. We think it's the right investment to make when we can deliver a 15.6% adjusted ROIC like we did in Q1.

We used operating cash of $48 million for the quarter and $116 million for the trailing 12-month period. We believe our higher working capital investment, driven by higher accounts receivable and higher inventory levels is temporary, as we support our sales partners and suppliers in a strong demand environment.

Year-over-year accounts receivable increased $155 million, a 26% year-over-year increase and Q1 DSO increased to 71 days, higher than our typical range. To support the strong demand environment, we are using collared extended AR terms, both project-specific and time-based on a targeted basis with good payers.

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Our AR investments support long project rollouts due to availability and partial shipments. As supply chain challenges ease, we would expect our collared payment terms and DSO to come back down. The overall health of our receivables portfolio is very strong.

Year-over-year inventory increased $182 million, a 37% increase year-over-year and Q1 inventory turns slowed to 5.1x, slower than our typical range. In our current environment, availability is key to capitalizing on strong demand for our technologies. Our working capital investments have enabled us to achieve double-digit sales growth in 5 of the last 6 quarters. Our inventory is current, and we have stock rotation, price protection and obsolescence protection with our suppliers to mitigate downside risk.

On September 30, 2022, we had cash and cash equivalents of $40 million and debt of $326 million. Our balance sheet remains strong. From a net debt leverage perspective, we ended Q1 at approximately 1.7x trailing 12-month adjusted EBITDA. During the September quarter, we had no share repurchases under our $100 million share repurchase authorization.

On September 28, we amended and extended our credit facility for $500 million in committed facilities with a new maturity date of September 28, 2027. It was an opportune time to complete the new facility with a strong banking group and favorable pricing growth. Our amended credit facility provides us with the financial flexibility to support our near-term growth opportunity and our midterm goals that we introduced last quarter, and are included in our latest investor presentation available on our website.

Finally, we are reaffirming our full year 2023 outlook of at least 5.5% for year-over-year net sales growth and at least $174 million for adjusted EBITDA. We expect faster growth in the first half of FY '23 than we see in the second half of the year.

As we think about our cash flows, we expect to use cash in the first half of the year and generate free cash flow in the second half. We expect our increased investments in working capital to continue through December quarter and expect Q2 interest expense to be similar to Q1.

For our fiscal year 2023, we estimate the effective tax rate, excluding discrete items, to range from 26.4% to 27.4%. We are very pleased with our start to FY '23 and how we are executing on our hybrid distribution strategy.

I'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from the line of Greg Burns from Sidoti.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

I just wanted to dig in a little bit more on the net sales growth on the Modern Communications side of the business. Given the kind of the growth you called out from Intelisys in the UCaaS market and the CCaaS market as well as what you saw from Cisco. Were there other offsets to get to that 3% total net sales growth? Like what is driving that? It feels like some of the areas we're growing a lot faster than that 3%.

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

Greg, this is John. Thanks for your question. And yes, we saw a decrease actually of about 26% year-on-year on the on-prem comms business, and that was primarily driven by 3 suppliers that we saw in the quarter.

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Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

And what -- how much of that business is now that on-prem? How much of that is left?

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

Greg, we still have a long tail on the on-prem communications. We're always wondering when that bottoms out and we try to guess at that, but it's still a long tail on that one in our business.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

What percent of Modern Communications are still made up -- does that make up?

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

That's a good question, Greg. I don't -- as we switched over to looking at hardware and comms together. Sorry, Greg, thanks for that, Mary. It's less than 15% of the total segment.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Perfect. And then the decline in the gross profit. Is that just a mix issue? Because typically, I would expect the gross profit to grow faster than revenue on that side of the business given how Intelisys is accounted for?

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

Yes, Greg, this is Steve Jones again. It really is the mix of Cisco in that segment. Cisco typically has a lower margin for us, and that has seen incredible growth. And so it really comes back to mix.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

And then on the Technology side of the business, is there a specific like demand trends, secular trends driving demand there? Because I know that business performed well during the pandemic given the need for like remote computing and payment terminal upgrade cycles. But is there -- is that just continuing? Or what are the drivers in that market that you're seeing driving demand?

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

Yes, Greg, I wasn't exactly sure if you were talking just about Modern Comms or if you were talking about both segments. But we are absolutely continuing -- I guess, first and foremost, remember, we're playing in all large and growing markets. That's the first piece. But automation and worker productivity continue to be strong for us, mobility, physical security, and yes, POS and payments, self-checkout. And then on the Modern Comm side, it continues to be enabling remote work, enabling return to office and collaboration.

Operator

(Operator Instructions) And our next question comes from the line of Keith Housum from Northcoast Research.

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

Just focusing a little bit more on the specialty side. Some of your largest barcode vendors that you mentioned earlier as where you were having success, some pretty cautious guidance for the fourth quarter and obviously, investors have ideas about the rest of the year, but obviously, you guys are seeing some strength from them. So, perhaps you guys can speak a little bit more about your visibility for the next quarter and where some of your excitement's coming from there?

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

Keith, it's John. Thanks for the question. And yes, look, we had -- we had a strong quarter, and we're excited about what was happening in barcode and mobility. As you know, we saw some challenges with one of our suppliers and some of their transitions from one distribution center to another, but we were able to work through that. We had strong inventory flows to us, Q1 and Q2, and we feel good about big deals. And I guess, most importantly, as you know, we just had the ScanSource Channel Connect conference that I referenced, and there was incredible enthusiasm amongst our barcode mobility partners at that event for continuing strength in demand.

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

And speaking a bit coming back to your question before about Cisco, -- did I understand that right that Cisco has now -- grew sales 50% in your Modern Communications segment?

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

Keith, this is Steve. That's correct. That's where a lot of our Cisco revenues sit is in that Modern Communication and Cloud.

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

And obviously, from an investor standpoint the concern is how sustainable is that growth there? Obviously, it's beneficial offsetting the loss in the on-prem business. But is that something that, I guess, investors have a lot of confidence that growth can continue, I guess, as long as we see the on-prem challenges?

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

Yes, we believe so, Keith. We believe that's a very strong business for us, and we're in a good position to take advantage of the opportunity in that space.

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

Keith, it's Mike. Just I can't resist. We were the Cisco distributor of the year again in Brazil, the fact that we're growing so much with Cisco suggests that the customers prefer us because they have other choices. And I think the records that we're achieving is just evidence that we've got the right combination of services and relationships that Cisco appreciates. And so we're not the biggest Cisco distributor, as you know, but we believe we're the best by far.

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

My understanding is Cisco is having their challenges with the supply chain equipment, especially is networking and Meraki equipment, are you guys having success by growing your reseller base or easing access to more products? Maybe any color you can provide on how you guys are achieving that growth.

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

Yes, we're going around the horn here. Now you're back to me, Keith. I think the -- we were able to deal with any supply chain constraints in Q1, very well. As you know, we took some inventory in our own distribution centers, but did a lot of drop-ship. We also are seeing a lot of large enterprise projects as customers move from what was the early days of COVID and just trying to put technologies together short term. Now they're moving towards longer, more sustainable enterprise projects. And I think the last thing that we're so excited about is we're bringing on a ton of new Cisco partners. I think we brought on over 30-plus partners this past quarter. So we've been working hard. And like Mike said, I think the mere fact that they're coming to us is a testament that we're who Cisco prefers.

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

And I guess one more question. Since you drew out 30 is how many you added, how -- what kind of baseline are we comparing that to?

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

Any other question?

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

Yes. What's our baseline for Cisco? So Keith, that's something that we don't disclose. Yes.

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

No, I guess, I'm sorry, not based on revenue, but based on in terms of partners, you brought on 30 new partners. Is that compared to several hundred partners already? Or is that even larger?

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

Yes. Again, Keith, that's not something that we disclose in terms of a number. We just really are saying that the 30 is to say, when we look at our overall base, that's quite a bit to bring on in 1 quarter.

Operator

(Operator Instructions) This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Steve Jones for any further remarks.

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

Yes. Thank you, and thank you for joining us today. We expect to hold our next conference call to discuss December 31 quarterly results on Tuesday, February 7 at approximately 10:30 a.m.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.

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