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SCSC.OQ - Q2 2023 Scansource Inc Earnings Call

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PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings Conference Call. (Operator Instructions) Today's call is being recorded. (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 info-graphic 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 and 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 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 info-graphic 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 to everyone for joining us today. For the quarter, we delivered 17% net sales growth and adjusted EBITDA margin of 4.8% and record adjusted EBITDA for the quarter and the trailing 12-month period. This exceptional performance is a result of strong demand and operating leverage in our hardware and Intelisys businesses. Given our outstanding Q2 results, we are raising our full year outlook for FY '23 and now expect net sales growth of at least 6.5% and adjusted EBITDA of at least $176 million.

We remain focused on executing our hybrid distribution strategy to drive profitable growth for both our customers and ScanSource. Our hybrid distribution strategy of selling hardware, SaaS, Software-as-a-Service, connectivity and cloud services expands profitable growth opportunities in 2 ways. First, our customers have a broader technology portfolio to meet demand in an increasingly digital world. These expanded offerings and capabilities allow our customers to meet the solution requirements of their end users.

And second, we give our customers the opportunity to grow their revenues and build a successful stream of recurring revenue that will result in a more profitable business. We believe our hybrid distribution strategy is a win-win model, and it guides how we operate our business for sustainable growth and profitability. As ScanSource enters its 30th year of business, we are honored to again be named a World's Most Admired Company by FORTUNE magazine, and pleased to see our #1 ranking in people management.

Our focus on people and culture has never been stronger as our employees strive to support our valued customers, suppliers and each other every day. I'll now turn the call over to John to discuss our business performance.

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

Thanks, Mike. Q2 net sales topped $1 billion, an all-time sales record for continuing operations. We delivered 17% net sales growth highlighted by strong demand for our technologies and outstanding execution by our team. During the quarter, we met the demand by building our inventories as lead times from our suppliers improved.

Our business is built for top line growth, and we realized operating leverage in our outstanding bottom line results. We are committed to helping customers execute on the expanded opportunity to sell hardware, SaaS, connectivity and cloud services. ScanSource is guiding our customers on their hybrid journey, starting with discussions with their account managers on their unique hybrid opportunities. I'd like to share a recent hybrid example of how ScanSource is helping our customers transition their end users from on-premise telecommunications products to next-generation cloud-based communication solutions.

In this example, one of many, a traditional telecom VAR transitioned an existing customer, a university with an on-premise communication platform to a hybrid cloud-based solution, along with handsets and headsets. Key to our value proposition was providing access to our team of solutions engineers, who architected and designed the hybrid solution. This hybrid deal, a combination of recurring revenue and hardware, shows how our customers trust ScanSource and our capabilities to provide new opportunities for growth and profitability.

In our Specialty Technology Solutions segment, Q2 net sales increased 26% year-over-year, fueled by strong demand for our hardware technologies and increased big deals. We had double-digit sales growth in devices that enable productivity, automation and the customer experience. This includes barcode scanners and printers, point-of-sale terminals, self-checkout systems, data networking, and physical security --- led by Zebra, NCR, Aruba, Axis and Extreme Networks.

One area to highlight is our physical security business where our dedicated technical support resources, configuration services, speed, and efficiency create a competitive advantage for ScanSource. Moving on to our Modern Communications and Cloud segment. We delivered 4.5% net sales growth for the quarter. We had record Cisco sales with double-digit growth led by large enterprise projects in networking collaboration, growth in our federal business, growth in new customers and outstanding execution by our team.

The fastest-growing area in our Cisco portfolio is cybersecurity. We're driving growth by leveraging our cybersecurity specialists to host customer enablement and threat assessment workshops, expanding our customers' skills and opportunities. We are well positioned for growth with our cloud communication solution offerings, including UCaaS and CCaaS. As part of our Intelisys business, UCaaS grew 14%, led by RingCentral, 8x8 and Zoom, and our CCaaS business grew 60%, led by Five9, Genesys, NiceCX, TalkDesk, and Dialpad.

While cloud communication solutions continue to grow, our on-premise communications business continues to decline. It represented only 10% of total segment sales in the quarter. Intelisys continues to be the leader in the agency space with end user billings of $2.4 billion annualized. Our customers look to us for thought leadership, enablement, and education to drive growth and success across their businesses. Intelisys net sales growth increased 9% for Q2 and drove strong growth in recurring revenue profits.

In summary, I'm very excited about our Q2 and first half results and wanted to send out a huge thank you to all our people for their dedication and commitment throughout the quarter and to our customers 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*

Yes. Thanks, John. For Q2, we delivered strong top line growth with net sales exceeding $1 billion, up 17% year-over-year. Our Q2 results benefited from supply chain improvements late in the quarter. We estimate that over $40 million of our Q2 revenue was expected to ship in Q3, but early availability allowed us to fill those orders in December.

We delivered record profitability in Q2. Adjusted EBITDA of $48.8 million is an all-time record for ScanSource and highlights our consistent, strong financial performance. We achieved 15.6% adjusted ROIC in the quarter. Gross profits for the quarter increased 7% year-over-year to $115 million, while our gross margin of 11.4% reflects a higher mix of big deals and less favorable sales mix for the quarter. Our hybrid distribution strategy is winning in the market and strengthening our financial results.

Our Q2 recurring revenues of $26.7 million grew 7% year-over-year and that business is close to 100% gross profit margin. For the trailing 12-month period, approximately 24% of our consolidated gross profits are from recurring revenue business. Our non-GAAP SG&A expense for the quarter of $71.9 million increased $2.7 million or 4% year-over-year, demonstrating operating expense leverage. Our record Q2 adjusted EBITDA of $48.8 million represents a 15% year-over-year growth and a 4.83% adjusted EBITDA margin, emphasizing the scalability of our business.

Q2 non-GAAP EPS of $1.06 grew 4% year-over-year and includes interest expense of $5.1 million, significantly higher than in prior year. Our higher interest expense reflects both higher working capital investments and the increasing interest rate environment. As we look to the full year, we believe our interest expense will be between $17 million to $18 million for FY '23 compared to $6.5 million in FY '22. Now turning to the balance sheet and cash flow. Our strong balance sheet enabled us to invest in higher working capital to mitigate supply chain challenges and support the strong demand across our technologies.

We used operating cash of $27 million for the quarter and $124 million for the trailing 12-month period. Year-over-year accounts receivable increased $166 million and Q2 DSO decreased quarter-over-quarter to 69 days. The overall health of our receivables portfolio is strong and Q2 was a record quarter for cash collections for the company. Our balance sheet remains strong. From a net debt leverage perspective, we ended Q2 at approximately 1.8x trailing 12-month adjusted EBITDA.

And finally, as Mike mentioned, we are raising our full year outlook. Our strong first half performance helps offset the macro uncertainties in the second half. We now expect sales growth year-over-year to be at least 6.5% and adjusted EBITDA to be at least $176 million. As we think about our cash flows, we expect to generate free cash flow in the second half, and we expect our working capital to improve in the second half. To help with analyst models, we expect a net expense range for interest expense, interest income, and other expenses from $13 million to $15 million for fiscal year '23.

we are updating our estimated effective tax rate, excluding discrete items, to range from 27% to 28% for the full fiscal year. We'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*

So just to start with the pull forward of some of that revenue into the second quarter from the third quarter. Do you foresee that playing out in the third quarter again? Like are we getting back to more normalized kind of lead times where maybe some of this longer-dated revenue is going to start closing sooner? Like do you expect the same dynamic in the third quarter as in the second quarter?

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

Greg, thanks. This is Steve. Thanks for the question. In the second quarter, what we saw in that pull ahead was really availability. We did nothing to prompt it other than have the available inventory late in the quarter. As we look at 3Q and 4Q, we hope that we're going to continue to see these supply chain issues evolve, but we're not expecting in our guidance to have any pull ahead in 3Q right now.

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

Okay. And with the mix of revenue, I guess, on the specialty technology side, with the larger deals, are those -- I guess they come with lower margin, but are those like kind of land and expand deals? Do they provide longer opportunity over time? Like how do you view kind of balancing some of those larger lower-margin deals with the value they create over time?

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

Greg, it's John. Thanks for your question. And I would offer that absolutely, there are more land and expand value kind of broader solution deals than onetime transactional. And that's just for the mere fact that they're incorporating more solutions, oftentimes more suppliers, which ultimately creates greater value for the customer by really delivering an outcome, which leads to more opportunities due to greater trust with the customer.

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

Okay. And then as you look at the demand outlook or the demand you're seeing in the market and how you've been leveraging your balance sheet, do you foresee the need to continue to use -- keep your working capital at elevated levels? Or do you see that unwinding or is demand still there where you feel the need to continue to kind of flex that balance sheet?

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

Yes. Thanks, Greg. This is Steve again. So I would say that when we think about our balance sheet and our working capital, the first priority is to make sure that we're in a position to take advantage of the strong growth opportunity, but we do think as we exit the year -- our fiscal year, that we'll start working that working capital down provided that the supply chain continues to improve.

I think that's really the point for us is as the supply chain improves that gives us the opportunity to bring our working capital needs down.

Operator

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

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

Good morning guys. Just if I can, I want to focus on the guidance here because I think that's what really investors are most concerned with today. I appreciate the fact that you guys pulled forward some business into the quarter from the third quarter, but it still implies that roughly flat growth for the remainder of the year.

Are you guys seeing a decline in demand as you guys finished the year, but perhaps you can talk about the demand environment that you expect going forward? And is there an opportunity, I guess -- perhaps you can give us a high end of the range here? Because again, at least 6.5% I think, is going to have investors concerned here.

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

Keith, it's Steve again. Thanks for the question. Yes, when we're looking out in Q3, we still see strong demand. One of the reasons why we're guiding -- where we're guiding is we've got a tough compare in the second half. Our fourth quarter last year -- our third and fourth quarter last year were records for us, just really, really big quarters.

So that compares what's tempering our guidance a bit.

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

Got you. And if I focus on your adjusted EBITDA margin guidance, that's suggesting they fall to roughly 4.5% for the rest of the year versus what you've been able to deliver the past several quarters. Is there something on the horizon that suggests that that may change as well?

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

There's -- this is Steve again, Keith. There's nothing fundamental that we're seeing any change in our business. And in fact, we believe that we can add some scale to our business as we go forward, and we're in a position to do that, both on the Intelisys side of our business and the hardware side of our business.

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

Okay. In the fourth quarter, obviously, in the SPS segment 26% growth is outstanding. Would you characterize that as taking market share from your competitors? I'll leave it there.

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

We believe every opportunity to win business is taking market share. So yes, I would say that is the way we look at that. We also look at it as an opportunity to use our balance sheet, to use our relationships with our suppliers, to get our unfair share and be able to execute on that strong demand.

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

Got you. And then was -- the quarterly sales was it dominated by some -- just a few large deals that are unrepeatable? Or was it a healthy mix of large deals as well as the channel work?

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

Keith, it's John. Thanks for your question. We saw really a mix. I mean we saw strength in our large deals for sure, but we also saw a rebound in our run rate. So to characterize it as one versus the other wouldn't be correct. It was kind of across the board.

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

Got you. And last question from me, I apologize. Your inventory levels at the end of the year -- end of the quarter obviously high. Would you attribute that to the fact that inventory availability increased significantly at quarter end, and you expect to be working that down going forward?

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

Keith, this is Steve. Yes, we did see a lot of inventory availability late in the quarter, which was good. We also have higher elevated inventories because of our -- because of all the price actions. So that kind of elevates it even further due to the dynamic that's in there, but we did see late availability improve.

And we think with the continued improvement, we'll be able to work that inventory levels down as lead times come in.

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

And when you say the pricing action, that's just the fact that the value -- for the equal amount of volume, just the average prices increase over the past year is naturally going to be higher?

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

Yes. We've had broad-based price increases across our supply chain. And so that just elevates your inventory level.

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

Yep. Alright guys I appreciate it, thank you.

Operator

(Operator Instructions) Our next question comes from the line of Jake Norrison from Raymond James.

Jake Norrison - *Raymond James*

This is Jake on for Adam. I was just hoping to get a little more color on your sort of capital allocation strategy for the rest of the year. Has anything changed from your perspective given your strength in the macro environment? Are you looking to accelerate or decelerate any investments? Just an overview on capital allocation. Thanks.

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

Jake, thanks. This is Steve again. Let me just talk a little bit about our capital allocation priorities. No, they haven't changed. We're still looking at our first priority as growth in our business, and we also want to protect our balance sheet. So we're always watching our targeted net leverage ratio. And then our third priority would then be to do share repurchases under our $100 million share repurchase authorization.

Operator

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

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

Thanks for the UCaaS and CCaaS growth rates. For comparison purposes, do you happen to have to have them for the third quarter as well?

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

I'm sorry -- Mike, were you asking if we had a projected growth rate?

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

I'm sorry, for the September quarter, just for comparison purposes.

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

Yes. We're looking at our data bank named Mary Gentry.

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

Very good. I can ask another one in the meantime. So in those categories of UCaaS and CCaaS, was the demand relatively as expected or consistent throughout the quarter? Or did you see some changes in the December month?

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

Mike, it's John. Thanks for your question. And we -- I would characterize it as steady all throughout the quarter, but of course, being calendar and fiscal year-end for so many companies, we definitely saw a bit of a spike in the December quarter.

We also saw a move from -- kind of a move, if you will, to more enterprise deals and larger deals, as the environment moves from where we were at the beginning of the pandemic where people were racing to get tactical solutions deployed. We now see that we've moved into a more strategic kind of enterprise project environment where people are kind of architecting and building for the long term, and we see that in our results.

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

And Mike, it's Mary. I have the Q1 growth rates. The UCaaS, it was 20% and CCaaS, it was 60%. And that's for Q1.

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

Okay. Great. And then just last, how are you thinking about these categories and sort of, I guess, it's the second half of your fiscal year, first half of calendar year. Do you expect kind of similar growth trends here? Or is there anything kind of showing up in the pipeline that would suggest a change in growth rates?

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

Mike, as we look to the second half, we think it's kind of a consistent course and speed as we've seen in the first half.

Operator

(Operator Instructions) Our next question comes from the line of Arthur Winston from Pilot Advisors.

Arthur Michael Winston - *Pilot Advisors, L.P. - CEO, President, and Chief Operations Officer*

I was wondering if you could give an estimate or a guess of what the cost increases are -- unit cost increases for your inventory. And as a follow-on to that, did -- was that somewhat unanticipated so you had contracts in the cost of the inventories went up, so that really impacted your profit margins negatively?

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

This is Steve again. So from a price action perspective, they're really all over the board with our different suppliers. We have a very wide range. And I would say they go from 5% to 10% and some of them have been multiple price actions throughout the year, even starting in last year.

As we sell that inventory through, it really just is part of our cost of goods sold, and we pass that on to our customers. That's our business model is to be able to pass those price actions on to our customers. If we have inventory, we're able to keep some of that, as we've leveraged our balance sheet to be able to do that. And that's kind of our reward for having that extra inventory.

Arthur Michael Winston - *Pilot Advisors, L.P. - CEO, President, and Chief Operations Officer*

So that -- these increases in costs are not a major impact on the profit margins the way you describe it?

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

No, they're not. They will be temporarily as we have that inventory, and we're able to sell through that inventory. So we get a little bit of a pickup -- really kind of an arbitrage pickup of the inventory levels that we have. But longer term, they normalize out.

Arthur Michael Winston - *Pilot Advisors, L.P. - CEO, President, and Chief Operations Officer*

Okay. My last question is, in your beginning talk or speech, you talked -- you mentioned macro uncertainties impacting your guidance. But it doesn't -- can you explain what these macro uncertainties are? Because it doesn't sound like from your answers to these questions, there are a lot of uncertainties going forward.

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

Yes. It's really the length of time that we're looking out. We have pretty good visibility to Q3, and we're confident in our Q3 view. It's really what's going to happen in Q4. And as we know, the big -- the "R" word is out there. And so are we going into a recession? Are we coming out of a recession? So that uncertainty could affect our ability to grow in the fourth quarter.

Now we don't believe that -- in our guidance, we don't believe that there's a big risk to our guidance range.

Arthur Michael Winston - *Pilot Advisors, L.P. - CEO, President, and Chief Operations Officer*

So basically, this is what economists write about, and you read in the newspaper is what you're talking about rather than talking to your customers, et cetera, to create this uncertainty. It sounds like...

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

That's right. That's right.

Operator

(Operator Instructions) I would now like to turn the conference back to Steve Jones for closing remarks.

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

Well, thank you for joining us today. We expect to hold our next conference call to discuss March 31 quarterly results on Tuesday, May 9, at 10:00 a.m.

Operator

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