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SCSC.OQ - Q3 2023 Scansource Inc Earnings Call

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## CORPORATE PARTICIPANTS

**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*

## CONFERENCE CALL PARTICIPANTS

**Adam Tyler Tindle** *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

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

**Jake Norrison** *Raymond James - Analyst*

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

**Matthew Sheerin** *Stifel - Managing Director*

## PRESENTATION

**Operator**

Welcome to the ScanSource Quarterly Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. Today's call is being recorded. If anyone has any objection, 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.

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**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; and Steve Jones, our Chief Financial Officer. John Eldh, our President, is under the weather and not able to join us today. 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. 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 infographics and in our press release. These reconciliations can be found on our website and have been filed with our Form 8-K today. I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks, everyone, for joining us today. Throughout fiscal year '23, our team has delivered results ahead of expectations, and Q3 is no exception. This quarter, we delivered 5% net sales growth, strong gross and adjusted EBITDA margins and positive operating cash flow. Our diversified portfolio of products and services strategy is working. Our channel customers trust us to broaden their technology offerings to meet the demand of end customers in this increasingly digital world. In addition, we give our channel customers the opportunity to build a successful stream of recurring revenue that will result in a more profitable and sustainable business.

Since John is not able to join us today, I'll provide the business performance update for him. For Q3, both net sales and gross profit increased 5% year-over-year. We were able to meet customer demand with our strong inventory positions. As we enter Q4, we are seeing supply lead times return to normal levels for most of the products we sell, enabling us to be more efficient with our inventory levels. In our Specialty Technology

Solutions segment, Q3 net sales increased 12% year-over-year, fueled by networking, security, and barcoding, and our Q3 segment gross profit increased 7%.

We had strong sales growth in devices that enable productivity, automation and the customer experience. This quarter's growth drivers included data networking, barcode scanners and printers, and physical security. Our sales team was recently named Aruba's North America Distributor of the Year. This recognition demonstrates our specialized expertise in this space and successful engagement with the Aruba team to execute growth strategies. Moving on to our Modern Communications and Cloud segment. Q3 net sales decreased 7% year-over-year, while gross profit increased 3% year-over-year. Strength in networking was offset by lower sales volumes in communications hardware as business shifts to the cloud. We had double-digit growth in our Cisco sales led by networking, growth in our federal business and the fast-growing cybersecurity business. We are well positioned for growth with our cloud offerings, including UC as a Service, UCaaS, and Contact Center as a Service, CCaaS. As part of our Intelisys business, UCaaS billings grew 22%, and our CCaaS billings grew 56%.

While our cloud communication business continues to grow, our on-premise communications business continues to decline. For Q3, on-premise represented only 10% of the total segment sales, but less than 4% of total consolidated net sales for the company.

Intelisys continues to be a leader in the agency space. Our Q3 end user billings increased 9% year-over-year and now exceed $2.4 billion annualized. Q3 Intelisys net sales increased 4% year-over-year.

Our strong results for this quarter demonstrate how our diversified portfolio of technologies is driving our hybrid distribution success.

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

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

Thanks, Mike. Our team delivered Q3 net sales growth and adjusted EBITDA that exceeded our expectations. For Q3, we had 5% net sales growth and positive operating cash flow of $55 million. We delivered Q3 adjusted EBITDA of $45.7 million, and all-time record trailing 12-month adjusted EBITDA of $178.4 million. Gross profits for the quarter increased 5% year-over-year to $112 million with 12.6% gross profit margin with similar benefits from supplier price increases in both quarters. Our transformed business model generated Q3 recurring revenues of $28.7 million, up 4% year-over-year. For the trailing 12-month period, approximately 24% of our consolidated gross profits are now from recurring revenue business. Our SG&A expense for the quarter of $70.7 million increased $4.1 million or 6% year-over-year. Our Q3 adjusted EBITDA of $45.7 million represents 3.5% year-over-year growth and a 5.1% -- 5.16% adjusted EBITDA margin. Q3 non-GAAP EPS of $0.96 decreased 8% year-over-year and includes interest expense of $5.7 million, significantly higher than the $1.5 million in the prior year. Our higher interest expense reflects both higher interest rates and higher average borrowings. As we look to the June quarter, we believe interest expense will be approximately $5 million for the fourth quarter.

Now turning to the balance sheet and cash flows. In Q3, we achieved positive operating cash flow of $55 million. We brought our working capital down $12 million quarter-over-quarter and expect continued improvements in the June quarter as we improve our inventory efficiency to reflect lead times returning to normal. Year-over-year accounts receivable increased $42 million, and Q3 DSO increased to 70 days. Our balance sheet remains strong. From a net debt leverage perspective, we ended Q3 at approximately 1.5x trailing 12-month adjusted EBITDA. During the March quarter, we had approximately $10.7 million in share repurchases and have an outstanding authorization with approximately $70 million remaining. As a reminder, our top capital allocation priority remains investing in growth opportunities to drive long-term value.

Finally, we are raising our full year 2023 outlook for adjusted EBITDA to be at least $182 million and maintaining our year-over-year sales growth of at least 6.5%. In addition, for the full fiscal year, we expect positive operating cash flow and an effective tax rate of approximately 28%. To help with analyst models, we expect a net expense for interest expense, interest income and other expenses to be approximately $14 million to $15 million for the full fiscal year 2023, which reflects approximately $4 million for our fourth quarter. We'll now open it up for questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question is coming from Jake Norrison of Raymond James.

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**Jake Norrison** - *Raymond James - Analyst*

So if you could just talk about linearity in the quarter. Did you see any deals from 4Q get pulled into 3Q? Are you conversely seeing anything get pushed out, delayed a couple of quarters? Just any color there would be helpful.

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

Yes. This is Steve. Thanks for the question. Thanks for joining us today. I would say that we did not see a big pull in, in Q3 that -- on our results, and we really haven't seen anything in Q4 push out. So I think the linearity is very normalized for us. We haven't seen anything changed in our demand pattern.

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**Jake Norrison** - *Raymond James - Analyst*

Okay. Perfect. And then last one for me. So I'm curious why you guys think 4Q will only be down around 4% when other peers have been calling for high single-digit declines in 2023. Is this a function of backlog or mix? Just what's underpinning your confidence there?

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

Yes. I think it's where we are in the quarter. I mean we're 5 weeks in, and we're giving you kind of our best to look at where we think we're going to end over the next few weeks.

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**Jake Norrison** - *Raymond James - Analyst*

Okay, perfect. Thank you.

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**Operator**

And our next question will come from Greg Burns of Sidoti.

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

Morning. I just wanted to follow up on that last question for the outlook for the balance of the year. We did see a little bit of cautious commentary from some of your larger partners. So I just wanted to get a sense of what you're seeing in the market? Are you not seeing sales cycles extending, buying decisions, maybe getting put on hold? Anything that might give you a little bit of a sense of caution as we look out over the next 6 to 12 months?

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

Greg, it's Mike. Maybe a comment would be this is that if you look at what the sales growth is implied in our Q4 full year guidance, it's actually modest, the growth from Q3 to Q4. We think that's in keeping with this macro environment we're in. We're certainly cognizant of what our suppliers are announcing. Our business, as you know, and as we've talked about, especially today is we've got a balanced portfolio that allows us to compete where the markets are moving. And we believe that was evidenced in our Q3 results is that we saw growth in certain areas that really allowed us to, frankly, exceed our expectations. And however, again, we're trying to be cognizant of the environment we're in today, and we believe our guidance for Q4 is appropriate.

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

Okay. And then in the modern communications segment on the communications part of the business. Could you give us the relative growth rates of the on-prem versus cloud portions of those businesses?

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

Yes, Greg, as we talked about on the on-prem side, it's about 10% of our total segment growth, and it's declining still double digits. And that's been a continuation that we've seen in that business over the past few years. So I wouldn't say it's accelerating or decelerating. It's pretty consistent. And now it's really de minimis in terms of the total amount of revenue that is driving for our company.

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

Okay, thank you.

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**Operator**

And our next question will come from Matthew Sheerin of Stifel.

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**Matthew Sheerin** - *Stifel - Managing Director*

Yes, thanks and good morning. I had a couple of questions. One, regarding your comments about the growth in networking, specifically, double-digit growth with Cisco. How much of that is related to just very strong backlog and component constraints and that backlog getting filled? And are you seeing that backlog start to come down as those -- your VAR customers start to fulfill those orders?

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

Matt, it's Mike. I'll tackle that one. In general, we don't speak a lot about backlog because we tend to be able to meet our customers' demand appropriately based on what they believe the end user needs. And as an example, Cisco as an example, has been very good at responding to specific customer lead time needs. And so we really saw after the last couple of quarters that we're able to do a better job, much better job of meeting customer demand. And so I would say it did contribute that we were able to get the supply we need. But we just saw an acceleration in the networking space overall, including Cisco. And I think that's really the story of the quarter for us is Cisco benefited as did Aruba, who we also mentioned on the call, and we have other networking suppliers, too. So I think in general, for ScanSource, we felt that space for our customers, our VAR customers, was very strong.

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**Matthew Sheerin** - *Stifel - Managing Director*

And do you expect that to continue into this quarter?

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

We do. We think that's an ongoing need for the marketplace, and it's one that our customers tell us is the end users are doing a great job of forecasting that demand for our team.

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**Matthew Sheerin** - *Stifel - Managing Director*

Okay. Thank you. And just a question on inventory, which is still up significantly year-on-year. It sounds like given the ease and the component constraints that you're going to be working that down. Could you give us an idea of what to expect in terms of inventory days or other metrics?

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

Well, one of the things -- I'll tackle the -- just the overall thinking on and let Steve talk about metrics. But I would say, in general, Matt, we want to make sure we don't miss a deal. We don't miss a customer's need. And so we've always, as a company, we probably leveraged our balance sheet historically to have higher inventory levels to meet customer demand so that we don't lose a customer for that reason. And we also believe that our customers -- for our customers, we're their first and primary distributor of choice for products like these, and we want to maintain that. However, having said that, as you know, we also have historically used our balance sheet to be opportunistic in some of our inventory purchases. So as those opportunities diminish and as we see that we're able to meet demand with lower inventory, strategically, we will lower our inventory levels.

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**Matthew Sheerin** - *Stifel - Managing Director*

Got it. Okay, thank you very much.

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**Operator**

(Operator Instructions) And our next question will come from Adam Tindle of Raymond James.

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**Adam Tyler Tindle** - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. Thanks, good morning. I just wanted to ask, Mike, I think if I heard this correctly, obviously, very strong growth in UCaaS and CCaaS, double-digit growth in those, and that's becoming a bigger portion of the business. I think you also mentioned that net revenue, including Intelisys, was up maybe 4% or so in the quarter. And if I got that right, just curious any commentary on that business, in particular, I think we've been accustomed to very strong double-digit growth rates in the past, and I know it's getting larger. So maybe any commentary on the growth rate of that piece of the business and the net revenue, the puts and takes at that level.

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

Sure. You bet. The other metric that we've always been tracking, and I think it's maybe for this quarter, specifically a really good indicator of our strategy is our end user billings grew 9% versus 4% on the net sales for Intelisys. And what that tells us is that we're not losing market share at the end customer. What's happening is we're getting margin pressure. And we've talked about this for a few quarters now that we've made a specific strategic decision to make sure that we don't lose customers. And so our goal is, even if we take a lower margin, we're willing to do that. That does result in lower revenue also since the way this business works. As you know, it's netted down to where the revenue is very small because the margin is at 100%. So I think it does reflect the fact that we're the dominant player, we're the leader and that we believe that the leader is always going to have others compete on price and we're having to see and meet more price competition in the market.

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**Adam Tyler Tindle** - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Understood. That makes sense. I guess maybe more broadly in terms of the competitive dynamics, you've obviously got one of the larger players out there still going through a major integration. Just curious, not just Intelisys specifically, but distribution broadly opportunities that you're seeing as a result of competitors that are maybe a little bit distracted if you can speak to the competitive environment, that would be helpful.

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

Well, I'll try not to talk about our competitors, but I will comment that we did beat all of those guys as the Aruba Distributor of the Year. And so we were really proud of that because as you recall, Aruba was acquired by HP, and we were not an HP distributor before. And so I was really pleased with our team's performance to be able to compete head-to-head with some of the broad line distributors in that space where, frankly, we believe our specialized knowledge wins even over price in that space. So we're -- I'm pleased with that. I think the whole networking part of our business has historically been the most competitive place. And for the fact that we're winning right now suggests that we understand our customers, what they need and what they expect from a distributor. So I'm really proud of that.

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**Adam Tyler Tindle** - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. And last one for me, Steve. I think you mentioned in your comments that supplier pricing action was basically no impact on a year-over-year basis, but it's obviously impacting the model positively from price increases. Are you able to pin that down and help quantify that and help us to think about the expectations for that piece going forward? I just don't want to get ahead of ourselves if that's something that's going to ultimately reverse itself at some point.

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

Yes. Adam, thanks for the question. It's a good one. I would say that when we think about it from a margin impact, I would say it's similar to what we said last year, which is about 60 basis points on our margin. We are seeing price actions decline as the market shifts a bit on some of our major suppliers. So I think when we think about sustainability, that's the way I would kind of frame it is it's about a 60 basis point impact for this quarter. But that price action, as we think about for our business, it pushes out in the quarters because as we have inventory, remember this Adam, as we have inventory that will roll out in our inventory turns. So when Mike talked about some opportunistic buying and our inventory levels, that does help us there.

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**Adam Tyler Tindle** - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. Yes, that's very helpful. Thank you very much.

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**Operator**

And our next question will come from Keith Housum of Northcoast Research.

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

Just following up on the Intelisys conversation there and the pricing action there. Are we at risk or is the business at risk assuming the price decline being more permanent (technical difficulty) And where could that go in the future?

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

I didn't quite catch that. Keith, I'm sorry, the background. I know it's around Intelisys and the pricing, but give me a little more?

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

Yes, yes, here... I'm sorry. I'm going to take you off my iPhone here. In terms of the pricing for Intelisys, you mentioned that coming down for the quarter as you guys are more price competitive. I guess what's the anticipation that, that is more of a permanent move for the business? And are we at risk of this becoming more like a hardware type margins going forward several years out?

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

Well, I think what's different about the Intelisys margin pressure is this is that it had a unique impact for ScanSource on our revenue. And typically, in our hardware business, as you know, Keith, if we have margin pressure, we can still have strong revenue growth. So really for me, we're just trying to be careful that we don't send the wrong impression that a lower growth rate is suggesting we're losing market share, which we don't believe we are and that we're willing at these margins to maintain that because for all of our investors know, this is an extremely profitable business on the operating income line and the EBITDA line. And remember, with the limited working capital required for this business too, it's a strong, long-term strategic play even at growth rates of 4%. So we believe that might continue, but we're comfortable that we need to maintain market share while this is going on.

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

Got it. Appreciate that. And then Steve, working capital, you guys brought down accounts payable, accounts receivable quite a bit more than inventory in the quarter. And I can appreciate the commentary that you guys just want to make sure you have the inventory, but also the beautiful part of your business is when you guys see the decline in business you guys can decline your working capital. Is there thoughts about how much more on working capital you guys can take and what you guys going to do with the excess cash flow? Are you guys going to throw it more toward your debt or perhaps share repurchases?

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

Well, Keith, it's a great question on the working capital. And yes, as we see the supply chain improve, we'll be able to adjust our working capital, particularly our inventory levels in the next quarter and really for the next few quarters, it's going to take a while to move this through the whole cycle. In terms of our -- what we would do with the excess -- the cash that we would generate or the additional cash that would throw off of that working capital decline. Again, it goes back to our 3 priorities. If our balance sheet is strong, and we're at the lower end of our leverage ratio and if we don't have a growth opportunity that we would pour it into, it would just go back in the term of share repurchases.

**Operator**

I would now like to turn the call back to Steve for closing remarks.

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

Thank you, and thank you for joining us today. We expect to hold our next conference call to discuss June 30 quarterly and full fiscal year results on Tuesday, August 22 at 10:30 a.m.

**Operator**

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