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SCSC.OQ - Q4 2023 Scansource Inc Earnings Call

EVENT DATE/TIME: AUGUST 22, 2023 / 2:30PM GMT

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PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings Conference Call. (Operator Instructions). Today's call is being recorded. If anyone has any objections, you may disconnect at this time. I would now like to turn the call over to Mary Gentry, Senior Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - 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 for 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, 2023, 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 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. Our business is built on relationships, and we recently confirmed the value of the trust we have with our customers, suppliers and employees we developed over 30 years. As you know, on May the 14th, we discovered that ScanSource was subject to a cyberattack that had a broad impact on the company.

Thanks to the amazing work of our employees, working together with external cybersecurity experts, ScanSource's core systems were restored and operations resumed on May 26. I am very proud of the exceptional execution, teamwork, and customer service our employees displayed throughout the cyberattack and system restoration.

For fiscal year 2023, we delivered 7% annual net sales growth exceeding our full year 2023 outlook. We had record adjusted EBITDA of $180 million and a 4.75% adjusted EBITDA margin.

Looking back on fiscal year 2023, we are very pleased with the progress we've made with our midterm 3- to 4-year goals that we introduced a year ago. Our midterm goals are net sales growth per year of 5% to 7.5%, adjusted EBITDA margin of 4.5% to 5%, mid-teens adjusted ROIC and building recurring revenue as a percentage of gross profit to 30%.

Despite recent weakness in some of our technology markets, our business remains healthy with revenues and profits growing. The ScanSource diversified portfolio of products and services is our strategy for long-term growth in the specialized technology markets we have chosen.

These highly specialized markets reward the company not only with revenue growth, but also with higher profit margins because of our focus. ScanSource wins market share with the deep knowledge from our sales teams, specific value-added tools and services and a working capital strategy that flexes based on specific supplier and customer requirements.

As we enter fiscal year 2024, strong free cash flow and focus on Intelisys are keys for our success. Now that the supply chain challenges are behind us, we expect our normal business model that balances days on hand of inventory and days sales outstanding with gross margins to return. With the support of our key suppliers and customers, we are executing a multi-quarter working capital improvement plan with a focus on reducing inventory levels. I will now turn the call over to John to discuss our business performance.

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

Thanks, Mike. Our Q4 results demonstrate the resilience of ScanSource's business amidst the significant disruption to our business generated by a cyberattack. It was rewarding to see the execution and great work by our team in collaboration with our customers and suppliers. The Intelisys business continued to function as normal throughout Q4 as the cyberattack had no impact on our Intelisys customers and suppliers.

Because of the cyberattack, we were unable to use our core systems to accept orders, receive inventory or ship products for 2 weeks in May. Our customers and suppliers were appreciative of our consistent and continuous outreach and collaboration during this outage. Our teams worked hard to minimize the impact of our outage on our customers.

Our working capital results were disappointing for Q4. We're not achieving the appropriate inventory days on hand commensurate with expected slower growth. We are working with our suppliers and customers to reduce our inventory levels quickly and get back to normal, based on supplier-specific return on working capital metrics.

Our goal is to better align profitability and inventory turn metrics. Our employees across the company are laser-focused on improving our return on working capital and ROIC metrics for fiscal '24. Now turning to our segments. In our Specialty Technology Solutions segment, Q4 net sales decreased 3% year-over-year and gross profit decreased 5%.

Record sales in networking and physical security partially offset a slowdown in mobility, point-of-sale and barcoding. Plus this segment was the most impacted from the cyberattack. We are seeing slowing market demand and enterprise project delays in mobile community and point of sale. We continue to see strong demand and growth in networking and video surveillance fueled by more intelligent technologies.

As we head into fiscal 2024, we expect sales growth to accelerate throughout the year, down slightly in the first half and then return to growth in the second half.

Moving on to our Modern Communication & Cloud segment, Q4 net sales and gross profit increased 1% year-over-year. Strength in networking offset lower sales volumes in communication hardware as business shifts to the cloud.

We had double-digit growth in Cisco sales led by networking products, federal and network security. Intelisys continues to be the leader in the agency space. Q4 end user billings increased 8% year-over-year and now are $2.47 billion annualized. Q4 Intelisys net sales also increased 8% year-over-year. We're well positioned for growth with our Cloud offerings, including UCaaS and CCaaS.

As a part of our Intelisys business, UCaaS billings grew 13% year-over-year and our CCaaS business billings grew 20% year-over-year. We are winning with customers in the mid-market and SMB space. We see this manifesting in awards from top suppliers like RingCentral, 8x8, NICE and Genesys for driving more new business than our competitors.

We're also excited about driving new growth as the leader in CX customer experience. We are helping our customers close deals through investments we've made in the dedicated CX team. Our consistent execution as a trusted partner enabled us to navigate through the Q4 cyberattack. I want to extend a heartfelt thank you to our people, customers and suppliers for their patience, understanding and offers to help us during the challenges of the quarter. This collaborative spirit makes a tremendous difference for our shared success. 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*

Thanks, John. Our Q4 financial results were negatively impacted by the mid-quarter cyberattack. However, Q4 net sales of $947 million exceeded our expectations, demonstrating the resilience of our business, the momentum we had in the quarter and our position as a trusted partner. Last quarter, we communicated that we expected to generate positive operating cash flow for the quarter and the full year.

Our Q4 timing was off, and we missed our working capital and cash flow goals. As you heard earlier, we are focused on inventory reduction and free cash flow for FY '24.

Q4 adjusted EBITDA of $40.2 million increased 4% year-over-year.

For the full year, sales increased 7% year-over-year, exceeding our guidance. Adjusted EBITDA of $180 million, up 8% year-over-year, was an all-time company record. Full year non-GAAP EPS of $3.85 is a decrease year-over-year of 3%. While our operating income grew 11% year-over-year, higher interest expense driven by higher working capital levels and rising interest rates offset the operating profit performance.

We ended FY '23 with recurring revenues comprising 24% of the company's total consolidated gross profits.

As we look to FY '24, we expect our business model to work as it has in the past, appropriately reducing the working capital to achieve our profitability and ROIC goals while still meeting our customer demand. As John mentioned in his comments, our teams are working hard supplier by supplier to course correct our inventory positions.

This focus by management on improving our working capital efficiency will allow us to generate significant free cash in FY '24.

Now turning to the balance sheet and cash flow. Q4 inventory turns improved quarter-over-quarter to 4.4x, but are well below our normal operating levels and our targeted levels for the quarter.

DSO grew to 72 days, and our AR balance grew quarter-over-quarter faster than revenues. As John stated earlier, employees across the company are very focused on improving these metrics over the next few quarters. Our balance sheet remains strong. From a net debt level perspective, we ended Q4 at approximately 1.6x trailing 12-month adjusted EBITDA.

During the June quarter, we had approximately $5 million in share repurchases and have an outstanding authorization with approximately $66 million remaining.

Looking ahead to FY '24, the company expects modest revenue growth, reduced working capital, and significant positive free cash. Based on inputs from suppliers and customers, we are forecasting market headwinds in the first half of our fiscal year and expect first half revenues to be down slightly year-over-year.

We're projecting better market conditions in the second half, supporting our full year growth outlook of at least 3%. We're projecting SG&A expenses to be flat to slightly up year-over-year as we prepare for growth to return in the second half. Adjusted EBITDA for FY '24 is forecasted to be at least $180 million and represents a 4.6% adjusted EBITDA margin.

With our supply chain normalizing, we'll be focused on operating the business at more historic working capital levels. Operating cash will also benefit from the countercyclical nature of our business model and growth in our recurring revenue, which requires almost no working capital.

Historically, when we grow in mid-single digits, we generate operating cash. And that, along with inventory efficiency improvements, will drive at least $150 million in free cash flow and lower our interest expense for the full fiscal year. For FY '24, our capital allocation priorities will focus on M&A opportunities to accelerate our strategic plan and also on share repurchases. We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Greg Burns with Sidoti.

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

Would you be able to quantify the impact of the cyberattack to revenue and earnings in the quarter?

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

Greg, thanks for the question. This is Steve. I'll be honest, Greg, we're still trying to sort through what the impact is for the quarter. We haven't completely quantified it yet, and we'll be able to do that in the future as we're working through the details of our -- of the impact on our company.

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

Okay. Great. And then you mentioned, I guess, with the working capital and free cash flow improvements, that's going to be coming down. Can you just give us your expectations for net interest expense for the year for fiscal '24?

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

Greg, when we look at our net interest expense, we think that's going to be somewhere in the [$9 million to $10 million] (reflects correction provided by Steve Jones later in the call) range as we look at it right now.

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

Okay. Okay. And then last quarter, you had mentioned some pricing pressure in the Intelisys division. It looked like billings and revenue kind of grew in line this quarter. So maybe that hasn't gotten any worse or better. But could you give us an update on the market conditions there for Intelisys?

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

Greg, this is John Eldh. Thanks for the question. As you heard, we had 8% growth in our billings. And also in Q4, 8% year-over-year growth in net sales. And while we did still see some continued downside pressure, it wasn't of any kind of significance for the quarter.

Operator

Our next question comes from Keith Housum with Northcoast Research.

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

Good morning guys, and congratulations on working through the quarter, I think, better than a lot of us expected. You guys had a lot of things thrown at you during the quarter. Just trying to reconcile your guidance here, which is apparently, obviously, better than a lot of your largest vendors. And I'm guessing a lot of it's going to be due to the fact that you guys have a little more diversification, but also the focus on the SMBs. But can you perhaps elaborate a little bit more on what you're seeing for the first half of the year which gives you, I guess, a guidance of perhaps slightly down for the first half?

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

Yes, Keith, thanks for your question. Yes, just to reiterate, as we discussed, we see that first half is probably flat to down a little bit, and then we'll see growth coming back in the second half. And that's driven in large part in the first half due to a slowdown in the barcoding, POS and mobility segment, which we believe will also begin to rebound as we turn the corner into our second half. At the same time, we believe we will still see positive strength across our security, physical security, and networking segments.

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

Great. And John, coming from conversations that you're having with the end customers, your vendors, just what's the source of, I guess, your confidence there?

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

Well, as you know, we're in kind of continuous contact with our partner community that's in touch with the end customer and also the supplier community, so we triangulate across the 3 of us.

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

Great. In physical security and networking, strong points for the quarter. I understand that you're probably working through a significant amount of backlog, at least some of your vendors were in terms of the networking equipment, especially. Is that backlog continuing to be a tailwind for you guys going into next year?

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

Yeah, as we look to the supply chain overall, we see that we are back to kind of pre-COVID and pre-supply chain lead times. There's some slight pressure still in networking. But for the most part, we are moving forward with supply chain lead times back to normal.

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

Got you. Just one more question for me, and I'll turn it back over to queue. In terms of M&A, it's an area that you guys haven't been that active in the market over the past several years. I guess, how would you guys rank the use of capital now in terms of your prioritization between M&A, investing back in the business and share repurchases?

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

Keith, it's Mike. I'll take that one. We've got a strategy of continued investment in the places that we see that ScanSource can differentiate. And we believe that the markets we're in are highly specialized, and we continue to be the leader, yet we also believe we should find a way to expand our growth potential. And as we've looked at some of the acquisitions in the past that were done for geographic reasons to expand our total addressable market that were done for technology reasons.

I think going forward -- and we talked, I think, over the last 3 years at different times about some small tuck-in acquisitions. And part of that was driven by the fact that we were working our balance sheet down. And then when we got into COVID, we then found that our balance sheet got enlarged again with the supply chain issues and the inventory. So as our balance sheet frees up, it now gives us the opportunity to think in a more aggressive and larger way about what acquisitions would help ScanSource accelerate our growth and really accelerate our strategic plan. Let's do it sooner than later.

Operator

Our next question comes from Jake Norrison with Raymond James.

Jake Norrison - *Equity Research Assoicate - Raymond James*

A 2-parter from me. Firstly, I'm hoping you guys could double-click on the guidance and what that embeds in terms of Intelisys performance. And then if you could double-click on the sort of pricing strategy around Intelisys. And if you could provide more color on if you're still pricing for market share gains? And what should we expect there for fiscal '24?

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

Yes, Jake, thanks for the question. When we look at Intelisys for FY '24, we are expecting a 7% growth rate on that business.

Jake Norrison - *Equity Research Assoicate - Raymond James*

Okay. Perfect. And then if you guys could just provide color on the sort of mix of larger and smaller deals in the quarter and if that had any impact on margin?

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

Yes, Jake, we saw a -- we saw, as you can imagine, a slowdown of our larger deals in the quarter, but we actually saw kind of a positive bounce back of our run rate business in the quarter.

Operator

(Operator Instructions). And we have a follow-up from the line of Greg Burns with Sidoti.

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

I just wanted to ask about the Logitech relationship that you, I guess, entered into this quarter or recently, how does that typically work when you add a new vendor to your line card? Does it take a while for that to ramp up? Do you expect that to be meaningful to your 2024 revenues?

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

Yes, Greg, thanks for the question. We are very excited about the addition of Logitech to our portfolio. It's going to be a great fit for us in the collaboration space and communications. And it'll ramp over time, but we're expecting a positive contribution throughout the year.

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

Greg, this is Steve Jones. I just wanted to clarify something. I think when you asked me about net interest expense, were you thinking interest expense less the interest income that we would have as we reconcile or are you thinking about from our EBITDA?

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

Interest expense less income.

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

Yes, let me just clarify. So that'll be around $9 million to $10 million, not the $5 million to $6 million.

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

Okay, yep, that makes more sense. Thank you.

Operator

And we have a follow-up from the line of Keith Housum with Northcoast Research.

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

Just one more question for you guys. On the working capital, perhaps, Steve, you can walk us through, I guess, the challenges in working down your working capital. I've got to believe that accounts receivable will be easier to work down than inventory. But maybe you can walk us through some of the challenges in doing that in just a few months or a few quarters? And how should we think about it going throughout the year?

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

Yes. Keith, this is Steve. Let me just kind of -- let me kind of break it down between inventory and accounts receivable. It's harder on the accounts receivable once you get into certain conditions with your customers to change that. That's a hard thing to change. So -- and when we look at our accounts receivable year-over-year and we look at the growth in the business, we don't feel like we're that far off.

And we felt like our accounts receivable are healthy. We're going to make some improvements in those DSOs. But really, our focus is on the inventory levels. If you look at the level of inventory that we're operating at. And now that we're looking especially at a slowdown in the first half, we're going to be working -- the teams are going to be working supplier by supplier to really reset those and correct where we are, as we come out of the kind of the supply chain disruption where we were scrambling to get inventory and trying to get orders on the books to a more normalized flow of inventory to support demand.

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

Great. Just one follow-up to that. Do you guys have the ability to send inventory back to your vendors? Or is it just a matter of slowing down your purchases as you sell a lot more?

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

We do have the ability to rebalance our inventory, and so that keeps our inventory fresh. But it really is -- the bigger lever here is going to be getting our orders in line with the demand going forward and allowing that inventory to cycle out of our warehouse.

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

Keith, it's Mike. If I can just add a little more color to the question and the answer. Over the years, we've always had a really close relationship with all of our suppliers on what is the optimal amount of inventory that we need to satisfy demand. And what we're basically saying is we've always been willing to have a slightly more inventory than the market requires, but not to the levels we are today.

The levels we have today are unprecedented. And that's primarily because lead times got distorted during the supply chain crisis. That's over, that crisis is over. And so we believe that our suppliers will understand why we need to match our lead times and inventory levels with demand. And this won't be a surprise to them. But this is something that we can have an impact on much quicker, as Steve said, than AR.

And we believe that the inventory levels are just unsustainable based on what suppliers want. A supplier doesn't want to have the amount of inventory they have to date in the channel because then it gets dated. And back to your question, if something is deemed -- if a product is deemed discontinued, we have rights to return all discontinued products.

So in that case, suppliers don't want to have old inventory because then it's just like bananas and the stuff goes bad and they have to take it back contractually. So our goal is to work with our suppliers cooperatively, supplier by supplier and find the optimal level of inventory.

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

Great. Thank you.

Operator

I'm showing no further questions at this time. I would like to turn it back to Steve Jones for closing remarks.

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

Yes. Thank you for joining us today. We expect to hold our next conference call to discuss September 30 quarterly results on Thursday, November 9, at approximately 10:30 a.m.

Operator

Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.