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SCSC.OQ - Q1 2024 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; 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. As you know, certain statements in our press release, infographic and on this call are forward-looking statements and subject to risks and uncertainties that could cause actual results to differ materially from expectations. These risks and uncertainties include the factors identified in our earnings release and in our Form 10-K for the year ended June 30, 2023. Forward-looking statements represent our views only as of today, and ScanSource disclaims any duty to update these statements except as required by law. During our call, we will discuss both GAAP and non-GAAP results and have provided reconciliations on our website and in our Form 8-K.

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 team executed well in a softer revenue environment and our business fundamentals remained strong. It's our purpose to be a trusted partner for our customers and our suppliers, exceeding their expectations in all demand environments.

First quarter net sales were softer than expected. Net sales declined 7% and reflect mixed demand. As in the past, we have benefited from a diverse ecosystem of partners who sell into different areas of technology and end markets. This allows our sales and marketing teams to find growth opportunities as demand changes during challenging market conditions. As an example, during the supply chain crisis, we utilized our strong balance sheet to minimize inventory shortages while enabling our customers to meet stronger than normal demand.

During Q1, technology growth areas included networking and physical security, which have been strong throughout this calendar year. And as we have discussed in previous quarters, our strong growth continued from our Cisco portfolio of products and services, especially in the areas of network security, software and Meraki endpoints. For our barcode, mobility and point of sale business, demand was lower than expected with fewer large enterprise deals. Based on our survey of customers and suppliers at our recent Channel Connect event, we believe the slowing demand for barcode, mobility and point of sale was widespread.

Our Intelisys Technology Services business continues to grow as demand remains solid, with sales growth of 9% in the quarter. This includes growth in contact center, which is CCaaS, up 27%, and growth of UCaaS of 10%. Our gross profit margin for the quarter remained consistently strong, benefiting from sales mix, especially as our recurring revenue from Intelisys grows faster than our device business. As the highest growth opportunity for our company, Intelisys remains an area of investment for the company. As a reminder, we also benefit from the fact that our Intelisys business has very low working capital requirements.

In a quarter like this one with declining net sales, we expect our business to generate strong free cash flow, and it did. Our first quarter free cash flow topped $91 million. Our strong free cash flow demonstrates that our business model is working as expected. As we indicated last quarter, we expected a slower first half of fiscal year '24 with improvement in the second half of FY '24. However, we are now expecting a slower demand outlook for the remainder of our FY '24. With the softening demand expectations, we expect free cash flow to be a bright spot throughout our fiscal year.

Changes in the technology distribution market and our belief in the growth opportunities ahead make this an ideal time to use our balance sheet to be disruptive in the market, both organically and through acquisitions. As in the past, we will make acquisitions where we expect higher growth and higher margins for the company. We have confidence in our business, and are well positioned to take advantage of our opportunities for profitable growth.

I'll now turn the call over to Steve to take you through our financial results for the quarter and outlook for fiscal year 2024.

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

Thanks, Mike. Our Q1 financial results reflect our transformed business model that derives more than 25% of our gross profit from our recurring revenues, including strong growth from our Intelisys business, successful execution of our working capital normalization plan and a mixed demand across technologies in our device business.

Q1 net sales of $876 million were lower than expected, while gross profit margins of 12.2% were slightly ahead of our expectations with a more favorable mix of revenue. While we expected a year-over-year revenue decline, we saw slower demand in our barcode, mobility and point of sale technologies, with fewer large deals in the quarter. These technologies are reported in our Specialty Technology Solutions segment, which saw a revenue decline of 12% year-over-year and a 16% year-over-year decline in gross profits.

In our Modern Communication & Cloud segment, revenue was equal to the strong results we posted last year, with strong networking and security sales from Cisco and 9% year-over-year growth in our Intelisys business, offsetting lower sales of communication devices. Gross profits in our MC&C segment grew 4% year-over-year and benefited from favorable mix of Intelisys revenue.

For the quarter, we delivered $91 million in free cash flow with solid progress on our multi-quarter working capital improvement plan. Inventory levels are normalizing to reflect both a return to normal supply chain lead times and our expectations of demand. Accounts receivable balances are moving with revenue as we would expect. Our Q1 free cash flow got off to a fast start as our business model is working as expected.

Now going a bit deeper into the balance sheet and cash flow. We are pleased with the improvement of our working capital. Our goal is to increase our inventory turns while maintaining appropriate inventory levels to meet customer demand. You may recall, we talked about lead times during the supply chain crisis exceeding 12 months. Those days are behind us, and our suppliers have done an outstanding job returning lead times to normal, allowing us to return to more efficient inventory levels.

Q1 inventory turns were 4.4x, well below the normal operating levels for our business. We expect to see improved inventory turns in Q2 given the progress we made on our ending inventory level this quarter. DSO declined slightly to 71 days, and Q1 was a strong quarter for cash collections.

Our balance sheet remains strong. From a net debt leverage perspective, we ended Q1 at approximately 1.2x trailing 12-month adjusted EBITDA with ample liquidity within our existing credit facility. For the remainder of FY '24, our primary capital allocation priority is to focus on M&A opportunities to accelerate our strategic plan.

Looking ahead to Q2 and the rest of our fiscal year, the company expects continued first half revenue headwinds and a slower recovery in the second half than we believed last quarter. We continue to execute on our working capital plan and expect to generate significant free cash flow in the year. We expect to manage our SG&A spend to match our revenue growth expectations for FY '24 and beyond, focusing our investments on faster-growing business areas.

We are updating our annual guidance to reflect our latest expectations. For FY '24, we now believe that our revenue will be at least $3.8 billion and adjusted EBITDA to be at least $170 million. We are increasing our free cash flow estimates to at least $200 million. To help with analyst models, we expect a net expense range for interest expense, interest income and other expenses from $11 million to $12 million for fiscal '24. Our estimated effective tax rate, excluding discrete items, is expected to range from 26.6% to 27.6% for the fiscal year. Our updated guidance reflects our expectations for near-term demand environment. We remain confident in the resilience of our business model and our ability to be well positioned for a return to growth.

I'll now turn the call back over to Mike for some closing comments.

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

Thanks, Steve. We recently held our annual customer and supplier event for the U.S. and Canada for over 1,700 attendees in Orlando, Florida. Our theme was opportunities for growth, and we had many conversations with our customers about where they see growth in the next 12 months. We also held our customer and supplier event in Brazil, where the theme was [Fast and Far: How to find the Balance]. Our customers and suppliers from both events shared feedback on areas where ScanSource can improve and where we achieve high marks.

I'm very proud of our amazing group of employees that constantly achieve excellent results with our customers. We are reminded of our success when we receive industry recognition from our suppliers. Just this week, we received the Americas Distributor of the Year Award from Cisco, which is a first for ScanSource. Our team was recognized at the Cisco Global Partner Summit for our success at recruiting and enabling sales partners and producing double-digit growth with Cisco security, networking and software. Recent awards from additional suppliers demonstrate our leadership in the industry. We are really pleased to be recognized by customers and suppliers with Distributor of the Year Awards from Aruba, Extreme and Zoom.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

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

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

Can you just walk us through how you get -- I guess, you're guiding now to like roughly flat revenue but down 7% in the first quarter, and I guess, expected weakness in the second quarter. So does that imply you're expecting growth in the back half? Like how do you get to flat for the year from starting off in a little bit of a hole here in the first quarter?

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

Yes, Greg, thanks for the question. Thanks for joining us today. This is Steve.

You're right. As we look at the first quarter and the first half, we still see headwinds similar to what we saw in the first quarter to go through the half. And then as we get into the second half of the year, we would see a year-over-year increase or a growth to get to our $3.8 billion. So you're thinking about it the right way.

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

But where -- like what are you contemplating? Like what are you looking at in terms of driving that growth? Like what are the drivers there?

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

Well, we benefit from a diverse portfolio of products and technologies, and so we'll have different growth rates underneath our technologies in the second half that will help us accelerate. So -- also don't forget, we suffered in the fourth quarter last year from our cyber event, and so that makes it a little bit easier compare for us in the fourth quarter as well.

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

And then in terms of M&A priorities, like are you looking to expand on Intelisys' capabilities? Or is there a new technology segment you might be wanting to get into? Like what are your priorities or goals in terms of M&A?

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

Greg, it's Mike. I'll take that one. What we've talked about for the last 2 quarters is that we really see continued opportunity in our Intelisys business. We're very bullish on it. It continues to be an area that we are in investment mode. We love the recurring revenue. We love the high margins. We really believe that, that business is still in growth mode for our company, and frankly, for the industry, as suppliers look to technology services distributors like ScanSource, Intelisys to really lead the way. But we also think for us, we have an opportunity to do some disruptive things this year.

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

That's organically?

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

Both, actually. What we're trying to do is to take a look at the total supply chain from manufacturing to end user, and we've talked about this with a few of our suppliers. How do we work with our key suppliers and our customers to facilitate a more efficient channel as we look out in the future? And we really think there's a lot of friction still in the business model as it exists today, so we're being very thoughtful about where strategic acquisition opportunities are and how we can change our existing business organically. So we're in a great position to do it. We believe now is the time to take advantage of our balance sheet and the fact that we have a team of people that are anxious to do this.

Operator

(Operator Instructions) And your next question comes from the line of Adam Tindle with Raymond James.

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

I just want to start on margins, noticing that gross margin fairly healthy here and understand the mix dynamic. The operating or EBITDA margin was down healthily year-over-year. It sounds like, Mike, you're doing some things to address that when you talked about full year operating expenses in line with revenue. But maybe just double click on this dynamic in the quarter of gross margin versus EBITDA margin. Why that was such a delta? What drove that? And what's happening moving forward to rightsize that?

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

Adam, this is Steve. Let me take that one. So if you look at our SG&A for the quarter, it's really unusually high from what we were running fourth quarter and what we would expect. That's really because of about $4 million worth of unusual expenses that we saw in the quarter. So we would anticipate that, that EBITDA margin would have been closer to our kind of 4.5% excluding those items, and we don't see those going forward.

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

Can you expand on it? Is that like inventory write down or something that would be onetime in nature?

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

Sure. Yes.

We had some specific customer bad debt reserves that we took in the quarter as well as some onetime people costs.

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

Got it. Okay. That's helpful. And this will kind of maybe help answer the second question, but I do want to return to the revenue and EBITDA guidance for the year. We're starting Q1 down 7% on revenue, down over 20% on EBITDA. And when we look at the full year, we've got kind of flattish to modest growth depending on which metric that you want to look at. So it's just a fairly steep climb.

Steve, I wonder if you could maybe give us a little bit of help on the shape of that for the year. I'm noticing that Q2 is -- it looks like the comparison is just as tough, if not tougher. So I'm wondering if we can maybe level set so we don't get ahead of ourselves on Q2 dynamics. And then, Mike, if you don't mind maybe speaking to the acceleration as the year progresses from growth opportunities. And as Steve mentioned earlier, it's kind of a mix depending on the segment. But if you want to maybe talk more qualitatively about the growth opportunities you see to drive this revenue expectation for the year, that would be helpful.

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

Yes. Thanks, Adam. I think from a first half perspective, we're kind of thinking Q2 similar to Q1 in terms of the headwinds, and that's really following what we're hearing both from our suppliers and others in the industry kind of near term.

As we think about the second half, as you know, Adam, it's only been a few years that we've given annual guidance. So we're still learning our way through this and trying to do the best that we can to kind of guide. And some of the things that maybe move our business differently is the fact that we've got technologies growing at different rates, but we still see strong growth expectations for Intelisys. We think that's going to be a bright spot for us in the second half. And then just in terms of the curve of kind of the growth in the second half. When you look at the compares, fourth quarter will be an easier compare for us and have a faster growth just because of the cyber event last year and what -- the business that we lost during that time.

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

Okay. Just to clarify, when you say Q2 looking like Q1 -- this is helpful. But does that mean like in dollar terms or the year-over-year decline will look similar?

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

Similar in year-over-year decline. We're still seeing those same headwinds as we're going through this quarter.

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

And Adam, it's Mike. On the other question you had, what we're having to do right now, and Steve said it very well. For us to give annual guidance with a business that has no backlog to speak of, it doesn't have bookings. It really, of course, has always been a little bit of a guess. What we're trying to do today is to share what we learned from our customer event in Orlando where we had a lot of customers, we had a lot of one-on-one discussions, we had recent meetings. Actually, I was just in Miami this week with our Cisco customers talking about their expectations for growth. Everyone is saying the same thing that right now, their pipelines have emptied out, and now, the supply chain had pretty much gotten to normal. We're now looking more of what's a normal technology year going to be like in next year. When I say next year, I really mean next calendar year.

So when we look out to the typical ScanSource model, we have seasonality in our Q3, which is the March quarter. And we have no idea, are we going to have that seasonality or not, because Q2 is going to be a crapshoot. So we're trying to triangulate on what customers are telling us, what some of our suppliers have already said publicly about this quarter, meaning our Q1 and Q2. We heard that, and you've probably seen from some of our barcoding and point of sale suppliers, they're talking about how they're down 30% or so, and so we certainly are feeling that through our customer base.

But we have no reason to think that there won't be come back in the second half of our year. We said this back in August. The challenge now is we think it's got to be softer to some extent. There's no way it's going to be as strong as we thought back in August based on these customer conversations, based on supply chain issues gone. And some of our suppliers are already saying, "Hey, their bookings are not like they were before." So we want to be very clear that we are planning for the second half to be reasonable, but we're also thinking beyond that. That we want to be careful and make sure we've still got investments positioned for the rest of calendar -- calendar '24, which would be our FY '25. We don't want to sacrifice future growth opportunities because the next 2 quarters might be soft.

Operator

(Operator Instructions) And your next question comes from the line of Michael Latimore with Northland Capital Markets.

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

Your comments on Intelisys seem fairly positive. Should we assume that the kind of the growth rates you're seeing in CCaaS and UCaaS are sustainable for the foreseeable future?

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

Mike, it's Mike. Yes, we do. That business for us has continued to grow. The dollars have gotten much larger. So even as in some cases, the UCaaS growth rate is maybe less than it was a year ago, the dollars are still substantial and CCaaS has gone up dramatically. So yes, we're still seeing that happen. We still see the quarter-over-quarter growth happening and the year-over-year happening. Certain suppliers are doing better than others, and that was expected as well. There would be some leveling out last year with the winners, and we think we're in the right place. We have the right suppliers to win in this market.

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

Do you think -- is Intelisys taking share in those categories?

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

We believe we are. We believe we're having more success than the industry growth rates would suggest. And yes, we are. Now that, again, that's part of the challenge we have because we have been, by far, the largest technology services distributor. And so there are always -- our competitors coming after us. And so we're having a battle for some share, too, Mike, just to be fair. And that affects our growth rate as well because as we compete for market share, we have to take a lower margin in some cases, which is very typical of distribution. That's the way it works. So in some respects, our end user billings is actually doing quite well, and we look at that as an indicator of overall success.

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

Have the -- over the last year, have the sort of lead vendors in each category changed much?

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

I would say they've taken more share, yes. I think there's been a shift to the lead vendors, yes. And again, what we're seeing is some of the suppliers and vendors are more willing to embrace the channel, embrace the agent community than others. And those that really go all out to make sure that the agents are profitable and have a long-term return on investment are the ones that are winning.

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

Yes. Can you highlight which vendors are kind of in the top group business point?

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

Not today but -- well, at different times, we've shared that. I would say for example, previous quarters in CCaaS, we've mentioned Five9, Genesys and NICE, but we decided not to really mention any this quarter. So that is a previous quarter comment.

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

Right, right. In the CCaaS world, generative AI has gotten a lot of attention. Does that flow through? Is that visible to your channel and your business? Or is that not really a driver yet?

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

Probably still early days, yes. More to come on that, but we certainly think it's going to be a factor and our channel will benefit. I mean, the thing about the channel is we generally -- partners don't want to sell things that are not ready for prime time, but they certainly want to be at the very early, early stages at the same time. So we'll see.

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

Very last one here. On your -- it sounds like physical security is doing well. Can you highlight which kind of use cases are doing well and what verticals are doing well there?

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

Yes. Over the years, we've talked about our physical securities led by our video surveillance technologies. And if you think about it, gosh, you just look around the world. Every time there's some events, there's more interest in do we have video to capture that. And so the video technologies continue to improve. You've got 4K cameras, you got even better cameras now, color, thermal. And then, well, for example, here in Greenville this week, we had one of our key suppliers, Axis Communications. Axis was here with their mobile experience center. Basically, a big RV with $1 million worth of equipment demonstrating all of the capabilities of video surveillance, and Axis continues to be one of our leading suppliers. And of course, they're also talking about AI and how you can use software and identity capabilities to enhance that.

And so probably the biggest vertical for us historically, Mike, is education. And kind of, again, no surprise there. You have funding from the federal government for school systems, and we have a lot of partners that are very strong in education and in physical security.

Operator

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

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

Hello, Keith? We don't hear Keith. You want to go to the next caller?

Operator

Okay. One moment. (Operator Instructions)

I see no further questions at this time. I'll now turn the call back over to Steve Jones.

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 6, at approximately 10:30 Eastern Time.

Operator

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