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SCSC.OQ - Q4 2024 Scansource Inc Earnings Call

EVENT DATE/TIME: AUGUST 27, 2024 / 2:30PM GMT

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PRESENTATION

Operator

Welcome to the ScanSource Quarterly Earnings Conference Call. (Operator Instructions) This call is being recorded. If anyone has objections, you may disconnect at this time.

I'd now like to turn the call over to Mary Gentry, Senior Vice President, Treasurer, Investor Relations. Ma'am, you may begin.

Mary Gentry - *Scansource Inc - Senior Vice President, Treasurer and Investor Relations*

Good morning, and thank you for joining us. Our call will include prepared remarks from Mike Baur, our Chair and CEO; and Steve Jones, our Chief Financial Officer. We will review our operating results for the quarter and the 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.

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, 2024. 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 Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Thanks, Mary, and thanks, everyone, for joining us today. As we start our new fiscal year, we are seeing accelerated adoption of our hybrid distribution strategy, which we believe will drive more demand. Last week, we hosted 800 attendees at our Partner First Conference where we challenged our sales partners to get out of their comfort zones and embrace new opportunities for growth. Our hybrid distribution strategy enables our sales partners to sell more of the technology stack to meet end user customers' IT requirements. As our channel partners expand their technology stack offering, ScanSource expands our total addressable market.

In July, Ken Mills joined us as President of Intelisys. With a background most recently as CEO of Epic IO, a supplier to all the TSDs in the channel, where he led a private equity funded company through four years of double-digit growth. Ken has many years of channel experience dealing with agents, VARs, MSPs, OEMs and end user customers when he worked previously at Cisco and EMC Dell. At Intelisys, Ken is leading our next phase of growth for the channel as we are making investments in advanced technologies such as AI and private 5G.

We also see partner segmentation as a strategy to demonstrate our differentiated value to partners who require a customized set of services. Our focus will be on the fastest-growing partners, including IT VARs, Advanced Technology Partners and telco agents.

Earlier in August, we announced two acquisitions in different segments of our business for the next phase of our hybrid distribution strategy. Both acquisitions are high-margin, recurring revenue businesses that are working capital light.

As we previewed on last quarter's earnings call, our advisory channel business came to life with our acquisition of Resourcive, which closed on August 8. Starting with Resourcive, ScanSource is creating the advisory channel model of the future, developing best practices that we can share with the Intelisys partner community.

Also in August, we announced the launch of our integrated solutions group. This new group is focused on specialty technology VARs and will provide them with new solutions to deliver more value with their hardware. On August 15, we closed the acquisition of Advantix, a connectivity provider of 5G for mobility solutions. Advantix enables mobility VARs to sell hybrid solutions by combining the recurring revenue stream from the connectivity with the hardware mobility devices.

We are executing well on investments to accelerate our hybrid distribution strategy and the expanded high-margin growth opportunities ahead. As we said last quarter, we will continue to use our balance sheet to invest in the growth opportunities that are part of our strategic plan.

I'll now turn the call over to Steve, to take you through our financial results and outlook for fiscal year 2025.

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Thanks, Mike. As we close our fiscal year, I'm proud of how our teams have executed. As reported by many channel companies and suppliers, we are experiencing soft demand for many of our technologies in both of our segments. However, we did see some technologies have experienced good growth in Q4, including physical security in our specialty technology solutions segment and UCaaS and CCaaS in our modern communication & cloud segment.

While it was a challenging year, our teams stayed focused and were able to deliver strong profitability and significant free cash flow for the full year, including the fourth quarter. For the quarter, our business delivered strong gross profit margins, adjusted EBITDA margins and free cash flow of $53 million.

In our specialty technology solutions segment, net sales declined 14% year-on-year, while gross profit declined 10% year-on-year. In our modern communications & cloud segment, net sales declined 32% year-on-year, while Intelisys net sales grew 6% year-on-year. Q4 end-user billings for Intelisys increased 9% year-on-year and totaled $2.67 billion in FY24. This includes Q4 billings growth in contact-center-as-a-service, or CCaaS, of 35% and UCaaS of 13%.

Gross profit in our modern communication & cloud segment declined 11% year-on-year, less than the sales decline, reflecting a favorable mix, including higher concentration of recurring revenues from Intelisys. For FY24, net sales declined 14% while gross profits declined 11%. GAAP and non-GAAP net income declined 12.5% and 20.5%, respectively. FY24 non-GAAP EPS is $3.08 compared to $3.85 last year. Free cash flow for the year was $363 million, driven by a significant reduction in working capital from lower sales and our working capital efficiency improvements.

For the year, the specialty technology & solutions segment net sales declined 14% year-on-year, while gross profits declined 16%. Modern communications & cloud segment net sales declined 13%, while gross profit declined 6%, again reflecting a higher mix of recurring revenue from our Intelisys business which saw a 6.6% year-on-year growth in net sales. Recurring revenue represented 27% of the company's consolidated gross profit.

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Now turning to the balance sheet and cash flow. We are very pleased with the progress we're making on our working capital efficiency. Our goal throughout the year was to improve our working capital efficiency while maintaining appropriate inventory levels to meet channel partner demand. We saw inventories decrease $245 million year-over-year and sustainable improvements in our inventory turns. Our accounts receivable balances are in line with our change in revenue, and both our inventory and accounts receivable portfolios are healthy.

Our balance sheet is strong. We ended Q4 with $185 million in cash and a net debt leverage ratio below 0 on a trailing 12-month adjusted EBITDA basis. Our capital allocation plans balance acquisitions and share repurchases, while maintaining a strong balance sheet with a modest net leverage target of 1 to 2 times adjusted EBITDA. Share repurchases totaled $22 million for Q4 and $43 million for FY24.

For FY25, we have an active pipeline of acquisition targets and room to continue to do share repurchases, while staying within our targeted net leverage ratio. As we look to our FY25 annual outlook, the company expects the challenging demand environment to continue in the near term, particularly in the first half of our fiscal year.

As a reminder, we have very little backlog to give us an indication of demand as we ship each day from our inventory based on orders received that day. We continue to manage our SG&A spending to match our revenue growth expectations for FY25 and beyond, by redirecting resources and investing in our recurring revenue businesses. We continually review our resource investment and adjust based on market opportunities.

For FY25, we currently believe our net sales will be between $3.1 billion and $3.5 billion, with adjusted EBITDA ranging between $140 million and $160 million. This reflects an adjusted EBITDA margin of approximately 4.5% to 4.6%.

As we reported last year, the company is building a cash culture as we believe generating predictable free cash flow is a key measure of success. For FY25, we believe that we will generate at least $70 million in free cash flow. While this is significantly lower than FY24, we believe the majority of our working capital reduction actions are complete and will shift to a continuous working capital efficiency improvement. Our outlook includes our recent acquisitions, and we remain confident in our growth opportunities, the resilience of our business model and the strength of our hybrid distribution strategy.

We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Adam Tindle, Raymond James.

Adam Tindle - *Raymond James & Associates, Inc. - Analyst*

Mike, you talked earlier in the call about the appointment of Ken Mills as President of Intelisys in July. And I think that's a really interesting turning point for the company. I wonder if you could maybe just double click on that, maybe a little bit more details on the structure of the organization, how that's changing, the KPIs for that business and how those might be changing?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Yes. Adam, for us, as you know, we took quite a while to actually appoint a new President. And at the time, I was acting in that capacity to make sure I understood not only where we were doing things well, but also where we weren't doing things maybe for the future. And it looked to me like we needed more strategy and vision. Execution is something, I think, that Intelisys has always been very good at.

But I think as the competition changed on us over the last couple of years, we need to take a hard look at where our value is and where our value can become in the future. And Ken brings such a strong background in different channel approaches, that really resonated with our team as we interviewed Ken and looked at others that might come more directly from the TSD channel community. Ken's background, not only at Cisco and EMC Dell, but also at a supplier to all of the TSDs really brings a unique approach to the knowledge base that, frankly, I didn't have.

And so as Ken and myself talked about where Intelisys is, it became more of the conversation about where it can go and what it can become. And so we are very bullish on the TSD model, and why we believe, going forward, we can create more growth. As a matter of fact, Ken and I discussed going forward, we believe we can get back to double-digit growth at Intelisys.

Adam Tindle - *Raymond James & Associates, Inc. - Analyst*

Got it. That's helpful. But I heard that he’s a Clemson Tiger too, so I’m sure that was welcome.

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Well, we try not to use those things to influence us. But yes, it wasn't a bad thing. Go Tigers.

Adam Tindle - *Raymond James & Associates, Inc. - Analyst*

Yes. Steve, I wanted to maybe follow up on that. Obviously, this is part of sort of a broader strategy to also build up the ISS group, and we've got a couple of acquisitions here. Any help that you can maybe provide us in terms of expected contribution from those acquisitions as you build up your fiscal '25 guidance?

And then separately from that, just more broadly speaking, as you built up the fiscal '25 guidance, I wonder how that process might have been similar or different from entering fiscal '24? I know that whole process was kind of newer to you guys at that time. And sure there's been some learning since. So if you could maybe just touch on the process to guidance entering fiscal '25, how it was different, and then any acquisition contribution color would be helpful?

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Yes, Adam, thanks for the question. And good morning. Let me talk about the first one about our acquisitions. Again, when we talk about our -- and we've been thinking about this for a while and working through this, when we think about our acquisition strategy, it's really around acquiring higher-margin opportunities that are low in working capital. And this will always be over the context of the right return for the company.

So when we think about are they accretive to our EBITDA, are they accretive to our overall contribution, yes, they are. They're small. These are small acquisitions that we're announcing, more of a programmatic approach to our acquisition strategy. And so they are included in our guidance. But I would say that they're not significant to the consolidated results for FY25 that we've got in our guidance.

Let me maybe move to the second question on we learned a lot. And the thing that we learned is, this is a tough time to try to predict the top line growth. When we entered last year, there was a lot of changes going on in the market. We were coming out of the supply chain constraints and our technologies. We do have this differentiated portfolio, which helps us, but our technologies all went through different cycles of that portfolio. So what we learned is predicting this thing is hard again. And so that kind of guided our decisions as we came into '25 on how we would guide. We wanted to maintain guidance because we think it's important.

But also what's important to us, and one of the things that became crystal clear last year is we needed to focus our whole company on driving free cash flow and making good decisions on our working capital. And so that gave us confidence that we could guide again this year for free cash flow.

But really, I would say the two takeaways is hard to predict the top line as we go through the year. And we gave wider ranges because of that. And keeping everyone laser-focused on the trade-off between expanded top line and the return on free cash flow.

Operator

Our next question comes from the line of Greg Burns, Sidoti.

Greg Burns - *Sidoti & Company, LLC - Analyst*

We've had some, I guess, I don't know if you characterize it as positive, but maybe improving kind of outlook from some of your supplier partners like Cisco and Zebra or maybe just more positive comments or green shoots there in terms of maybe demand firming up. Is it just a function of maybe the cycles of -- like you mentioned, the different technologies or where you sit in terms of the timing of orders that is like maybe clotting demand? I'm just trying to understand maybe the declines you saw this quarter in both segments and your outlook relative to maybe some of the more positive commentary we're seeing from your supplier partners?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Greg, it's Mike. I'll tackle it. I think, as Steve indicated, the approach we took this year, similar to what we've done in many years, is we ask our teams what's their best estimate of what we're going to do. And I've argued for a long, long time that for us as a distributor, really, we don't control the demand, we don't typically create demand, it's very hard for us to know what's coming.

And as you know as well, we don't maintain a backlog except for that brief period during the supply chain crisis where there was no product and so we did kind of understand what demand was. We're more back to where our business normally operated from a distributor standpoint of hardware, which is we have to depend on our partners to tell us what they think they're going to need.

We then place orders with our suppliers. And our suppliers, let me tell you, they're asking us constantly, hey, are we starting to see, as you indicated, green shoots. This idea that we gave for this year, unlike last year, where we had a net lease number for the top line, we decided to come up with this wide range because it's the timing question.

And as Steve indicated in his prepared remarks, there -- we believe right now that there is a first half, second half dynamic that should play out. That's based on all the information we have. That may or may not be true. Meaning, I think the first half of our fiscal year is going to be very hard to forecast. We believe the second half will be easier. But we also said that last year, so we're doing the best we can and bounding it by what we continue to hear as well from the suppliers that you've referenced.

But as you know, we've got a lot of suppliers, and we indicated that some actually did better last year than others. Our physical security business, as an example, really was very strong and resilient. Yet we had some other parts of our business, even beside the Cisco and the Zebras that did not do well. And so we're trying to figure out where we should make an investment decision for '25 and '26 right now.

But we're mindful of the fact that as Steve indicated as well, we want to be mindful of managing our balance sheet appropriately, not get into the position where we're using our balance sheet to drive opportunistic purchases. That's something we used to do. We're going to make sure we're very conservative in our use of the balance sheet to drive working capital.

Greg Burns - *Sidoti & Company, LLC - Analyst*

All right. And then in terms of Resourcive, why was that the right, I guess, first acquisition in the advisory space? Maybe what was unique about them that attracted you to that business?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Well, when we started talking about this idea of creating a new business group, the two key messages we started talking about was we believed that we needed a management team, a leadership team that could -- that we could acquire that would be the people that are staying, not the people exiting.

In this particular case, the founder and CEO, President of this company is leaving, but the team that he recruited has been there for about seven years, and they're on board, they're staying, and we're excited about their ability to build really a team that can continue to perform well going forward. And so we believe this is kind of the starting point for this leadership team.

The second thing we talked about that we were going to need was some kind of technology tool to help this particular company, Resourcive and others like them that buy from us on the Intelisys side of the fence, manage their contracts, manage renewals, manage selling advanced technologies, and we believe we still need to find that other piece of the puzzle. We need to find a technology tool rather than us building ourselves.

And so for us, if we had to choose between acquiring a technology tool, if you will, or a leadership team first, our preference was the leadership team first and that's where Resourcive really shined. So we're excited. This team is excited to be part of ScanSource. And Mark Morgan, who many of our investors and certainly folks in the community know Mark, he led the discovery of the potential targets and led the acquisition and so Mark leading this gives us a lot of confidence that we picked the right team and that we will be able to get started very quickly to generating the kind of business that we expect Resourcive to become.

Operator

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

Keith Housum - *Northcoast Research - Analyst*

Good morning, guys. Steve, perhaps you can provide some color in terms of the scalability of the companies that you just acquired, were they limited more, like there's some geographies there, where you guys are taking them country-wide now? But how scalable are the businesses? And how quickly can you guys scale them up?

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Keith, yes, the way we are thinking about both of these companies is they are scalable plays. They are smaller companies that we think have unique capabilities, unique management styles and those would then be what we would build on. Advantix that we announced, that's an interesting one because it does two things for us.

First of all, it gives us some advanced capabilities and some value-added capabilities, much like what we did with POS Portal years ago, but it also then should help us sell more hardware. And that's an exciting thing for us as well is this will help our VAR partners sell more of the technology stack. And that's a good thing in that channel for us. We think that will help differentiate our offerings, again, around the technologies that we know very well, and we've been in for a long time.

So in terms of the scale, yes, both of these are scalable acquisitions, both small as we start out, but the right -- to Mike's point, Resourcive the right management team to get that that opportunity off the ground. And with Advantix, very established. They know their stuff. They're in a very exciting and interesting space in that hardware technology stack that we're really excited about.

Keith Housum - *Northcoast Research - Analyst*

I appreciate that. And I know that you guys said a higher margin. Do I assume that these are 100% gross margin businesses as well as much better on the bottom line as well?

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Well, they're primarily recurring revenue businesses, Resourcive more so than Advantix, but Advantix also has recurring revenue. But if you think about Advantix, there'll be little bit more services around that, too, but higher margin for sure. And Resourcive, the net reporting would be close to 100%. Advantix is going to be very high as well, just the mix of services in there might bring it down a bit.

Keith Housum - *Northcoast Research - Analyst*

Okay. Got it. Got it. In terms of the -- switching over to the hardware. In terms of the hardware portfolio, historically, there has been issues, obviously, as the on-prem hardware communication systems were declining. I guess what I'm trying to understand, is there anything in their product portfolio that perhaps we're seeing like just evolution of technology where there is naturally under pressure from being able to grow going forward? Can you perhaps give me an idea of your portfolio if you get any challenges there that perhaps will be hurting hardware growth sales going forward?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Keith, it's Mike. And you're talking about our Comms business and whether there's any new challenges because that's certainly been a story for seven or eight years. Is that really your question? Is there anything new there?

Keith Housum - *Northcoast Research - Analyst*

Yes. I'm looking for new challenges. If it's Comms or Specialty Group, either one?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Got it. Yes, I don't think the -- well, on the Specialty itself, no new news there. I think we expect that business to return to growth. We believe the technologies that customers want to develop and use, they're going to need to refresh their products. And so that -- we believe we're in an opportunity where that will become the story. We don't know yet again, is that first half, second half, when is that going to start to become apparent.

But going over to the comms side, that business, as we said, and again, we got to remember in our Comms segment, we have Cisco which confuses sometimes our story, right? So, Cisco being challenged affects that Comms segment more than normal. So that's probably why there's maybe some -- it maybe looked different than it did a year ago, it's because of the Cisco emphasis there.

But the traditional other business in the Comms segment outside of Cisco, I would say, it's operating as our other hardware businesses are. They're challenged, but we expect them to start doing better, not necessarily. Some of them still declining, but they will do better going forward into fiscal year '25.

Keith Housum - *Northcoast Research - Analyst*

Yes. Just touching on that Networking business. If I remember right, last year, obviously, a lot of tough comparables because you guys were flushing through the supply chain Cisco-wise. Those tough compares are just about ending here after the first -- fiscal first quarter, correct?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Yes, that's right. Yes. Like you said, it was -- they were the last technologies for us to come out of the supply chain problems, yes.

Keith Housum - *Northcoast Research - Analyst*

Yes, absolutely. So last question from me, and I'll turn it back over. Capital allocation strategy, obviously, $185 million, a lot of cash to work with. You guys bought back more shares in the past two quarters, than you probably have historically. Obviously, the acquisition pipeline is large. What's your strategy going forward in terms of mixing your capital cash allocation between M&A and share buyback?

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Keith, this is Steve again. I'll tackle that one. It really goes back to what we generate free cash flow and the focus on our free cash flow that then allows us to do our capital allocation strategy. And we think there's room to do both. We think we were -- we had some of these opportunities coming out of the -- in August to close some of these deals. But we think that there is room to do both.

Particularly to your point, we have cash on the balance sheet, so we're not concerned about where our leverage ratio would go for '25. So the near view that we have, it's do both, take advantage of the opportunities of the acquisitions that are out there, but be disciplined in those to make sure they fit our strategy and fit our profile and then return the share -- through share repurchases, return that capital back to our shareholders through a disciplined share repurchase program.

Operator

(Operator Instructions) Our next question comes from the line of Matthew Harrigan, The Benchmark Company.

Matthew Harrigan - *The Benchmark Company, LLC - Analyst*

Two questions, one more or less derivative of some of the prior questions. When you look at the M&A market right now, is there any loosening up on multiples given the economic uncertainty? I know you're not going to talk about the EV to sales multiples on the two acquisitions you just did, Resourcive and Advantix. But where do you see the -- what's the broad (inaudible) for multiples that you're seeing? I know you've got a nice (inaudible) between the operating contributions between what you see and the perceived sellers multiple, but just any general thoughts on where that's going because it seems like you got a lot of back-end opportunities to roll up more smaller companies in the same genre of the two recent acquisitions.

And then secondly, fairly encouraging noises out of Zebra. And what are you seeing in terms of kind of the equilibrium between sector decline and innovation on the barcode market right now?

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

This is Mike. I'll take part of the first question, and I'll come back to the second after Steve answers. But when I think about our acquisition strategy, we've got a history of acquiring companies that want to be part of ScanSource. And that has always allowed us to frankly make very, I think, good acquisitions from a multiple standpoint, from a return standpoint because these companies see that if they join with ScanSource, their employees and even their founders and sellers do better, especially because many of our acquisitions over the years have included earnouts. So we actually are a generally well received acquirer, and I think that helps us make smart decisions.

And to the earlier question that was being asked about acquisitions, I think what we'll see in '25 is a result of the work we did in '24 working on a target list. So we certainly believe that a year ago, we didn't have the targets aligned like we do today. And I'll leave it to Steve to answer some more about the acquisitions and anything else, Steve, on that.

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Yes. The only thing I would add to that, Mike, I think you covered it really well, is that when you talk about acquiring recurring revenue businesses with higher margins, they come naturally with a higher multiple. But we're not seeing any big shift yet in the multiples that are out there. We just think that we're doing a better job of getting them queued up and fitting them to our strategy so that we can then bring them in and make them, to Mike's point, happy ScanSource family members.

Michael Baur - *Scansource Inc - Chairman of the Board, Chief Executive Officer*

Yes, that's right. And then to the Zebra question or the bar code question, if you will, one of the things that we really are excited about is this idea of creating this group now that we're calling ISG and led with this Advantix acquisition, this is going to actually drive demand for hardware. We know that, and we've experienced this over the last few years, we've had experience with Advantix for about, I think, four or five years. And so this has been kind of we were dating these guys for a long time, not really understanding whether we should own this business or not.

But as we looked at how do we participate as the market comes back, we felt like we need to create a stronger value proposition for our partners, and we believe having recurring revenue and being able to sell mobility devices gives us a stronger position in the market as it comes back. So we believe that a year from now, we'll actually do much better than our competitors in these competitive barcode spaces because of an acquisition like Advantix.

Operator

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

Stephen Jones - *Scansource Inc - Senior Executive Vice President, Chief Financial Officer*

Thank you, and thank you for joining us today. We expect to hold our next conference call to discuss September 30 quarterly results on Thursday, November 7, at 10:30 a.m.

Operator

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