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SCSC.OQ - Q1 2025 Scansource Inc Earnings Call

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

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Greg Burns *Sidoti - Analyst*

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Michael Latimore *Northland Securities - Analyst*

Logan Katzmar *Raymond James - Analyst*

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 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 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 - Chair of the Board, Chief Executive Officer*

Thanks, Mary, and thanks, everyone, for joining us today. In the first quarter, we delivered strong free cash flow and EPS growth in a soft demand environment. Our results demonstrate our hybrid distribution success with our focus on specialty technologies and intelisys & advisory recurring revenue.

Our channel partners trust us to broaden their technology offerings to meet the demand of end customers in this increasingly digital world. Our hybrid distribution strategy enables our partners to sell more of the technology stack, including devices, software and services to meet end

customers' requirements. In addition, we give our channel partners the opportunity to build a successful stream of recurring revenue that will result in a more profitable and sustainable business.

As you saw in our results, we realigned our reporting segments based on the different sales models we use, and both segments do include recurring revenue. Over the last eight years, starting with the acquisition of Intelisys in 2016, we have transformed ScanSource from a traditional hardware distributor into the leading hybrid distributor we are today.

With Intelisys, we opened up a new route to market through agents, started our cloud distribution journey and built our first recurring revenue stream. Our realigned reporting segments, specialty technology solutions and Intelisys & advisory reflect our sales models, which have different margin profiles and different working capital requirements.

The specialty technology solutions segment combines our former segments with the exception of our Intelisys business. The Intelisys & advisory segment includes our Intelisys and our technology advisors businesses.

In August, we closed two acquisitions, Resourcive and Advantix. These acquisitions are in keeping with our M&A theme of acquiring high-margin recurring revenue businesses that are working capital light.

On August 8, we acquired Resourcive, a leading technology advisor included in the intelisys & advisory segment. 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 launched our Integrated Solutions Group. This new group is focused on specialty technology VARs, providing them with new solutions to deliver more value with their hardware sales.

On August 15, we closed the acquisition of Advantix, a connectivity provider of 5G for mobility solutions, included in the specialty technology solutions segment. Advantix enables mobility VARs to sell hardware, combined with the recurring revenue stream from data connectivity.

Our Q1 results demonstrate how our cash culture is working and supports our capital allocation strategy to invest in high-margin, working capital-light businesses.

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

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

Thanks, Mike. Our Q1 results are in line with our expectations. Our teams continue to execute well while experiencing soft demand. Our consolidated sales declined 11.5% year-over-year, while our adjusted EBITDA grew 2%, reflecting a higher mix of netted down recurring revenue and lower SG&A expenses.

For the quarter, our business delivered strong gross profit margins of 13.1%, adjusted EBITDA margins of 4.6% and free cash flow of \$42 million. Non-GAAP net income and diluted EPS increased year-over-year 11% and 14%, respectively. We remain focused on delivering strong profitability and free cash flow for the full year. And overall, we are pleased with our Q1 performance.

As Mike laid out in his remarks, we are reporting our Q1 results under new business segments that align with the different sales models we use in executing our hybrid distribution strategy. As a reminder, both segments have recurring revenues.

In our realigned specialty technology solutions segment, net sales declined 12% year-over-year. Net sales from the segment grew 4% quarter-over-quarter, signaling a better demand environment. Gross profits declined 7% year-over-year, less than our sales decline, reflecting a better mix and more of our revenues reported on a net basis.

For the segment, the percent of gross profit from recurring revenue increased to approximately 13%. Segment gross profit margins increased to 10.4% and adjusted EBITDA margins expanded to 3.6%.

In our Intelisys & advisory segment, net sales and gross profits both increased 4% year-over-year, in line with our expectations. Gross profit margins in this segment are nearly 100% as most of the revenues are reported net. Adjusted EBITDA margin of 38.3% reflects our continued SG&A investment in this segment. Q1 end-user billings for Intelisys increased 6% year-over-year to bring the annualized net billings to approximately \$2.74 billion.

Free cash flow for the quarter of \$42 million exceeded our expectations as in-quarter timing of sales reduced our ending accounts receivable balance, and we benefited from some one-time cash items. We continue to improve our key working capital efficiency metrics, demonstrated by our improvement in our cash conversion cycle.

Now going a bit deeper on our balance sheet and cash flow. We continue to be pleased with the progress we're making on our working capital efficiency. Our team is focused on improving our efficiency while maintaining appropriate inventory levels to meet channel partner demand and supporting our sales with our trade credit offerings.

We ended Q1 with \$145 million in cash and a net debt leverage ratio at 0 on a trailing 12 months adjusted EBITDA basis. Q1 capital allocation demonstrates our plan to balance acquisitions and share repurchases while maintaining a strong balance sheet with a modest net leverage target of 1 times to 2 times adjusted EBITDA.

Share repurchases totaled \$28 million for Q1, and we're excited about what our two acquisitions bring to our channel capabilities and our strategic plans. 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.

For the remainder of FY25, we believe that the demand environment will slowly improve but are still in a cautious tech spending environment. We continually review our resource investments and adjust based on market opportunities. In the quarter, we adjusted our SG&A base to better align to our market expectations and to improve our profitability.

For FY25, we are reconfirming our annual guidance of net sales between \$3.1 billion and \$3.5 billion, adjusted EBITDA ranging between \$140 million and \$160 million and free cash flow of at least \$70 million.

We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Greg Burns, Sidoti.

Greg Burns - Sidoti - Analyst

Could you give us maybe a little bit more insight into some of the product categories within specialty technology? Are there any that are showing relative strength, any that are lagging? If you could just maybe dig into the specifics underlying the quarterly results?

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

Greg, it's Mike. What we decided to do with the new segmentation is to really combine all of the technologies that we've been selling that you're used to hearing from us that were in those two segments of specialty and modern comms. And so, all of those that we used to talk about separately are now all in the one segment. And so that includes all of those various technologies.

And we believe that it's indicative of our opportunity ahead if we talk about our business by segments going forward, because sometimes the technologies themselves that are specific are not indicative of what we think the year will look like. And there's always changes in whether one of the technologies is more -- is growing faster than another, but we're trying to plan our business around the segments and less about the technologies going forward.

Greg Burns - *Sidoti - Analyst*

Okay. And it looked like Brazil was a relative underperformer relative to the US. Is there anything in particular going on in that region that we should be aware of?

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

Greg, really, the Brazil story is an FX story. Year-over-year, the FX, the strengthening dollar has really depressed that growth rate. And even inside of Brazil, with the fluctuation in currency, that can impact their sales motion.

Greg Burns - *Sidoti - Analyst*

Okay, great. And then lastly, it looks like on the Intelisys side, revenue is growing in line with gross profit. So has there been any change in the competitive environment there? Are you seeing less, maybe competitive pricing? Or I guess, is the market becoming more rational in terms of the competitive environment relative to what you've seen over the last 6 to 12 months maybe?

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

Yeah. Greg, Mike again. We haven't seen any change. So there was nothing new in this quarter. And when we put together our annual guidance, we took into account the fact that we wanted to make sure we can grow that business. And in some cases, as you know, in the past, we were challenged on growth because of some of the margin pressure.

And we're very aware of the opportunities in that space. But there's no new news there regarding the margin pressure. And we believe that -- and we said this on our last quarter's call when we hired Ken Mills, our new President, that really our strategy is around partner segmentation right now and trying to find those partners that have better opportunities for growth. And that's also going to help us, we believe, with expanding our margins over time.

Operator

Keith Housum, Northcoast Research.

Keith Housum - *Northcoast Research - Analyst*

Good job on the profitability. In terms of -- obviously, elections are now -- been completed. Any thoughts in terms of how the elections might kind of change the demand environment going forward?

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

Keith, this is Steve. We've always thought that our business was impacted by the uncertainty in the election. How it's going to play out is anybody's guess at this point. We thought going into the year when we gave our guidance that it would have an impact, and that's why we kind of guided to a softer first half and a stronger second half from a growth perspective. That's still what we think, and that's still what we're reflecting in our reconfirmed guidance.

Keith Housum - Northcoast Research - Analyst

Okay. We heard from some large resellers out there that pricing has been really competitive as demand is lower than what I think everybody would hope for. When it's a competitive environment, from the VAR perspective, is that competitive pricing impacting you guys as well or are you guys being able to stay above that?

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

Yeah. Keith, it's Mike. Historically, we try to help our partners secure the deals that they're working on. And what's happened over the years, as you know, is, if we have a partner, a VAR, if you will, that's working on a specific deal that we know about, and it's not just a transaction, but it's actually a project, we work with the VAR and the supplier to ensure that the VAR partner gets paid reasonably good margins for the value they deliver.

And so, we end up having this special arrangement, special pricing on a significant amount of the deals we do. Almost over 50% of our projects are registered with the supplier. There's a special price. And so the margins are determined, frankly, by the supplier based on the value that we provide and the VAR provides to the end user.

So I don't think there's any new pricing pressure, and we don't think that the market itself, the channel itself, is necessarily growing with new partners either. So I think we kind of know who all the partners are that are going to play in a deal and so do the suppliers. And so, they do a good job today of managing the expectations for us and for our VARs on the margin that should be received by us when a transaction happens. So I think it's very rational today. There's no unusual margin discussions that are happening.

Keith Housum - Northcoast Research - Analyst

Appreciate it. You mentioned, I think, at the end of the script there, I think, Steve, it might have been yourself, that you guys made some adjustments to SG&A in the quarter in response to the demand environment. I guess, can you provide any color on those adjustments that you've made for the SG&A?

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

Yeah, Keith, we really do take a proactive approach in looking at our SG&A spend, and we look at it as an investment. And in the quarter, we adjusted our headcount mainly in the North America sections, and that's reflected in our 10-Q, and we expect to get about \$10.5 million worth of annualized savings out of that action.

Keith Housum - Northcoast Research - Analyst

Got you. And have all those actions been concluded or are there still more to go?

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

No. For that particular one, it's concluded.

Keith Housum - Northcoast Research - Analyst

Okay, got you. I'm sorry, I probably didn't ask that question, right, my bad. In terms of the savings, do you think the savings will start here in the second quarter or have they already started?

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

So we did this earlier in the quarter. So part of that's reflected in our quarter. We took the entire -- if you look at our GAAP results, our entire expense is really taken in the quarter as well. And that will be building over -- as we get a full quarter of savings in Q2 and going forward.

Keith Housum - Northcoast Research - Analyst

Great. I appreciate the color there. I guess last question for myself. In terms of the acquisitions that you've made, and I understand you guys still want to get some scale, but what are some of the key performance metrics that you're looking at in order to say, one is delivering the results you expect? I guess that's the primary question there.

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

Yeah. I think we go through this thematic approach that we've got to M&A, it really starts with what are we trying to do with our investments, and that's to grow higher margins -- to grow, first of all, add higher-margin businesses to our portfolio, working capital-light and recurring revenue. So all those things kind of work together. Then on top of that, when we look at targets, we're looking longer term, it's more of a strategic look and really what the ROIC brings. And a lot of that ROIC comes from the growth that we expect to get after we acquire and scale on it.

Operator

Michael Latimore, Northland Securities.

Michael Latimore - Northland Securities - Analyst

Just curious, within the Intelisys business, do you have the growth rates there for UCaaS and separately CCaaS?

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

Michael, as I was talking earlier, we decided, through this new segmentation, to not give color on the particular technologies. We didn't really find that they gave really a great representation of our strategy for the year because we're going to always want to find new technologies that can replace the ones that slow down or go away. And so, I think it's more of a longer-term question about why do we think Intelisys will grow.

We want to make sure we're playing in all of the key technologies that our partners need to sell to the end user. So we referenced earlier the idea that we want to help our partners sell more of the technology stack. And as a result, we're going to be thinking more about how do we help partners do more, even if that says UCaaS or CCaaS is growing well, we want to still help our partners grow in new technologies as well.

So we've decided not to start this year talking specifically about the granularity of our growth. And it's just something we're going to see if that -- how that plays out with our partners because we think they want to know do they have opportunity? And of course, we have specialists in each of the technology areas to help them do that.

Michael Latimore - *Northland Securities - Analyst*

Got it. Makes sense. And then maybe just some qualitative color here on the CCaaS business? There's a lot of work around AI and there's different use cases for AI within CCaaS. I guess, do you have any view on -- is that one of the new technology areas you're focused on? And what are the prospects there? And does it even maybe potentially slow some deals because people are doing more analysis?

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

Well, I think we referenced AI at our last call, maybe the last two, because we do hear it a lot. Of course, everybody is talking about it. We do believe that it's going to drive the adoption of some new technologies in our channel. We think our channel tends not to be real early on some of the technologies until they can actually sell the products at a profit.

They're not really there to blaze new territory. A lot of times that's the suppliers and some of the OEMs that are doing that direct with large end users. But we definitely see that the opportunities for AI to accelerate some of the technologies that already exist. And to your example, whether that's CCaaS or other technologies like that, we think that's a positive as we grow our business. So we're going to be aligned with any new direction like AI to make sure we're providing what our partners are asking us.

So stay tuned for more. But we'll be talking about that with our partners as we have conferences and educational sessions around the country. That's where we really focus on the particular technologies they're asking us for.

Michael Latimore - *Northland Securities - Analyst*

Got it. And then just last on Intelisys. I think you said 6% net bookings growth, something like that. Is that kind of a good run rate to think about the next couple of quarters?

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

Well, I think what we're seeing with the end-user billings is there's soft demand there, just like there is in our hardware business. And we don't know, obviously, when that will change, but we certainly see softness there just like we have in the rest of our business.

And so our guidance for the year indicated that we were going to -- at the midpoint of our guidance we're going to be a -- for the total company, basically a flat to 1% grower year-over-year. And I think the Intelisys end-user billings might also reflect something close to that. We think it's probably going to be a low-single-digits growth year.

Operator

(Operator Instructions) Logan Katzman, Raymond James.

Logan Katzmar - *Raymond James - Analyst*

This is Logan on for Adam. So my first question, the SG&A commentary was helpful, but if you -- if we take a step back to the gross margin line, how do you guys think about the gross margin line throughout the year and for the full year as you guys have acquired more recurring revenue

businesses? Is it fair to assume sequential increases throughout the year? I just wanted to get you guys' thoughts on how you expect that to play out.

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

Yeah. Logan, this is Steve. So I think what you have to do if you're going to really dig into the gross profit margins is you have to look at them at a segment level, because the mix between the segments can have a material impact on what our consolidated margins look like.

I would tell you, our first half is probably lighter on hardware than what we're thinking in the second half. So that will be some margin pressure on the consolidated trending for the year, if you're thinking about quarterly -- sequentially, on a quarter view.

But I think overall, what we're seeing in our margin profiles, if you look over the last couple of quarters in the infographic are pretty representative of where we'll kind of blend out in those segments, maybe a little bit high because in the specialty technology just because we had, again, the mix of hardware versus recurring revenue as we start the year probably pushes that up a bit. And so, as we look throughout the year, that probably trends down a bit. But I think you have to look at it from a segment perspective and then aggregate that up to get our consolidated.

Logan Katzmar - Raymond James - Analyst

That's super helpful. The second question I have for you guys is you guys talked about an active M&A pipe, and we've seen you guys do some acquisitions and the color around what goes into the acquisition decision process was helpful. But I was just curious, how do you guys internally or talk about weighing share repurchases versus M&A and how you guys kind of expect to go forward with that? Any color there would be helpful. Thank you.

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

Yeah, Logan, I think it really comes back to the strategy, long-term growth and expanding our margins and ROIC. I think that's the way we look at it, if I'm talking about the larger framework of how we think about it. I think those are kind of our guiding principles when we make a decision.

Operator

Thank you. And I would now like to hand the conference back over to Steve Jones for any closing remarks.

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

Yeah. Well, we'd like to thank you for joining us today. We expect to hold our next conference call to discuss December 31 quarterly results on Thursday, January 30, at approximately 10:30 AM.

Operator

This concludes today's conference call. Thank you for participating, and you may all disconnect. Everyone, have a great day.

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