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SCSC.OQ - Q2 2025 Scansource Inc Earnings Call

EVENT DATE/TIME: JANUARY 30, 2025 / 3:30PM GMT

CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Greg Burns *Sidoti & Company, LLC - Analyst*

Keith Housum *Northcoast Research Partners LLC - Analyst*

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, Finance and Treasurer. Madam, you may begin.

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

Good morning, and thank you for joining us. Our call will include prepared remarks from Mike Baur, our Chair and CEO; and Steve Jones, Chief Financial Officer. We will review our results -- 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. Thanks, everyone, for joining us today. The soft demand environment is lasting longer than we expected and large deals remained a challenge in Q2. After our Q1 sequential quarter growth, we expected sequential quarter growth for Q2, but that did not happen. And instead, net sales declined 4%. However, in a soft demand environment, we delivered gross profit growth and a strong gross profit margin.

We are executing our hybrid distribution strategy, providing flexibility and choice with multiple sales models for hardware, SaaS, connectivity, and cloud. Our channel partners trust us to broaden their technology offerings and enable them to sell more of the technology stack, including devices, software, services to meet the 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.

With our recent acquisitions, we have expanded recurring revenue opportunities for our channel partners. We acquired Resourcive, our advisory business, to build the channel model of the future to drive more value by understanding end customer needs. This includes increased offerings of next-gen technologies like CX, cybersecurity, and AI.

We have a plan to develop tools at Resourcive that will also enable our Intelisys channel partners to more efficiently serve the technology needs of end customers. After our first full quarter of operations with Advantix, a managed connectivity experience MCX provider, we are excited about the reception of this opportunity by our channel partners.

This represents a recurring revenue opportunity for many of our VARs and a great example of a hybrid solution, combining devices and recurring revenue. The Advantix solution is a high margin recurring revenue add-on to mobile devices and a way to add more value in the barcode and mobility market. We also see the Advantix solution as a way to drive hardware demand by opening up new hybrid opportunities.

Looking ahead, we are well positioned for profitable growth when demand returns. I'll now turn the call over to Steve to take you through our financial results and our outlook for fiscal year 2025.

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

Thanks, Mike. For Q2, the business continued to experience demand. While our top line was below our expectations, we saw strong gross profit margins led by higher mix of recurring revenue, which for Q2 represents 32% of our consolidated gross profit. Our more profitable mix translated into a higher adjusted EBITDA margin. For Q2, our consolidated net sales declined 15.5% year-over-year. However, our adjusted EBITDA only declined 8%.

For the quarter, our business delivered strong gross profit margins of 13.6% and adjusted EBITDA margins of 4.7%. Non-GAAP net income decreased 4%, while non-GAAP diluted EPS was flat year-over-year.

We remain focused on delivering strong profitability and free cash flow for the full year and believe that our first half financial performance supports our current annual guidance range. This is the second quarter reporting under our new business segments. These segments better align with the different sales models we use in executing our hybrid distribution strategy. And as a reminder, both segments have recurring revenue.

In our specialty technology solutions segment, net sales declined 16% year-over-year and 4% quarter-over-quarter. This includes a double-digit decline for large deals and FX headwinds in our Brazil business.

Gross profit was essentially flat year-over-year, reflecting a higher concentration of recurring revenue and improved vendor rebates. For this segment, the percent of gross profit from recurring revenue increased to approximately 12%. Segment gross profit margin increased to 10.8% and adjusted EBITDA margin was 3.5%.

While we've not seen a broad-based recovery in our portfolio, we do have technologies in this segment with year-over-year growth including barcode mobility, physical security and mobile connectivity, MCX.

In our Intelisys & Advisory segment, net sales and gross profits increased 4% and 3% year-over-year including the addition of the Resourcive acquisition. Gross profit margin of 99% in this segment reflects the higher concentration of recurring revenue.

Our adjusted EBITDA margin of 41.1% reflects our continued SG&A investment to drive billings growth. Q2 end user billings for Intelisys increased 5% year-over-year to bring the annualized net billing to approximately $2.77 billion, including double-digit year-over-year growth in CX, which includes UCaaS, CCaaS, and AI-enabled CX solutions.

We also saw double-digit growth for our SaaS business. During the quarter, we announced Channel Exchange, a new SaaS platform, replacing our intY CASCADE platform. With Channel Exchange, we now have a way for our Intelisys trusted advisers to deliver more SaaS solutions to end customers.

Year-to-date, we generated $34 million in free cash flow. However, for the quarter, we used $8 million of free cash flow due to late quarter timing for both sales and vendor payments. As we've said, we're building a cash culture and our team remains focused on generating free cash flow as it is a key metric in our annual variable compensation plans.

Going a bit deeper on our balance sheet and cash flow, we continue to execute our plans to improve our working capital efficiency while maintaining appropriate inventory levels to meet channel partner demand and supporting ourselves with our trade credit offerings. We ended Q2 with $111 million in cash and a net debt leverage ratio of 0.2 times on a trailing 12-month adjusted EBITDA basis. Adjusted ROIC for the quarter is 13.3% and includes a full quarter contribution from our acquisitions.

Q2 capital allocation again demonstrates our plan to balance acquisitions and share repurchases while maintaining a strong balance sheet with modest net debt leverage of 1 to 2 times adjusted EBITDA. Share repurchases totaled $24 million for Q2.

And as Mike said, we're pleased with the performance of our two acquisitions and what they bring to our channel capabilities and our strategic plans. We continue to have an active pipeline of acquisition targets, and we'll maintain our discipline in evaluating these opportunities.

For the remainder of FY25, we believe demand will improve but are still in a cautious tech spending environment. We are reconfirming our annual guidance of net sales ranging 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 & Company, LLC - Analyst*

Just wanted to talk about maybe the current demand environment a little bit in more detail. As far as how the quarter progressed, can you just talk about maybe the sequential cadence throughout the quarter? Did it worsen as the quarter progressed? Did it improve? How did the quarter play out in terms of maybe where you expected it when you gave guidance last quarter and where you ended up this quarter?

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

Greg, it's Mike. Yes, I'll try to be careful because we don't normally talk about how it progresses during the quarter. But if you think about how a December quarter normally progresses for our business, most of our suppliers with maybe one exception have calendar year ends. And as a result, they typically are very focused on closing out some business by the end of December.

So typically, that quarter is very heavily weighted in the December month of that quarter. So it's not significantly different than our other quarters, but it's significant enough to where we expected to have some large deals happen by the end of the quarter, which means really the end of December.

And so as we gave our guidance earlier, we thought that we would have a typical increase in large deals and to have a double-digit decline year-over-year was the surprise. And so we really believe this was a large deal-driven miss, if you will, on our expectations for that business -- for the specialty hardware business, just so we're clear.

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

Okay. And then are you -- you maintain your guys full year revenue and EBITDA guidance despite the miss this quarter. Are you seeing anything or hearing anything in the channel that gives you confidence that the back half gets a little bit stronger? Is the midpoint of guidance still a good spot to think about? Or are you thinking more towards the low end now?

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

Well, Greg, this is Steve and thanks for the question. We still believe that we have a chance to be in our range. And I think that's where we're thinking about the business. We still believe that there's growth opportunity in the second half, and that's what we said when we actually came into the year, we thought the first half would be down and the second half would have growth.

Our problem is with our top line, most of our top line comes from the hardware, which you know we ship every day. So we're taking orders, we don't work with backlog. So our visibility is tough in that environment. We do have the recurring revenue streams that help us on the GP line and that helps our GP become more predictable. But the top line is really hard for us to have visibility on.

Operator

(Operator Instructions) Keith Housum, Northcoast Research.

Keith Housum - *Northcoast Research Partners LLC - Analyst*

I know you guys usually don't talk about the current quarter here, but we are in an extraordinary time it seems. How was this quarter starting off for you guys? Are you seeing any signs that there is a recovery? I think I was anticipating that following the presidential elections that we saw in November.

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

Well, Keith, this is Mike. We're not going to report on the quarter that we're in today. We don't think that's appropriate. I think the real message that we're sending this morning is -- we've talked to our teams about how do they feel about the second half. And the second half is still attainable for our business based on the guidance we've previously given.

And so we spent a lot of time with our teams reconfirming that the guidance we've given is still achievable. And so as Steve said a few minutes ago, the second half was always going to be a challenge. It's a little more challenging now and for us to reaffirm, we believe we have confidence that the business will start to grow again, but trying to discern between where we're sitting right now versus May 1.

And as Steve said, we're not certain only because we don't have backlog, as you know, Keith. So our challenge is, again, to do what I know many of you do, which is talk to your partners in the channel, get their census. And for us, there's always -- and I would say this. I would say a sense of cautious optimism as you go into a year like this is coming off of last year.

I think all of our channel partners believe that this year will be better. And so we're basing this on sentiment more than we are on any certainty on revenue that's come in already, okay? It's more on sentiment at this stage. And on thinking about what is it that could make us hit the higher end of our expectations versus the lower end. We feel very comfortable with our guidance.

Keith Housum - *Northcoast Research Partners LLC - Analyst*

And you guys didn't know a few of the technologies that we're doing better. But on a broad basis, the challenges that you saw in the quarter, were they pretty broad-based across most of your technologies that you guys sell? Or was there a few that was worse than others?

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

Well, as you know, Keith, I decided last quarter that we weren't going to talk about the technologies and I changed my mind because obviously, you guys need it, especially with the results of the quarter, some indication of what the heck is going on. And where is the -- where are the so-called green shoots and where it is not. And clearly, barcode mobility came through, we feel very good about that. We've already talked about that. And by saying that, and physical security was good.

By saying that, we end up though not talking about the other areas, and so across the rest of the business, we didn't have a great story. And so without getting any detail about any one of them, once you get outside of what we talked about earlier, there was a challenge in the quarter that we didn't expect. And however, we expect that to attain our annual guidance, we will have to have some of those other technologies come back to life during the next two quarters. And so we do have expectations for that.

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

Keith, and I might add, Mike talked about in his comments about the large deals that we saw across the board that there were some pockets of large deals that came through, but overall, the large deals are really the story of what surprised us.

Keith Housum - *Northcoast Research Partners LLC - Analyst*

And I guess last question for me. The Intelisys business, you guys have called out how that is becoming more competitive and you got a volume versus price or price versus volume, I should say. It looks like excluding acquisitions, I guess, am I right to assume that, that revenue actually dropped year-over-year? And I guess, is there any changes in the dynamics of that business as you guys are pursuing your acquisition strategy and any tweaks that you have to your acquisition strategy after this current few quarters?

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

So a couple of comments. Intelisys business was essentially flat year-over-year. And what we are seeing a couple of things is there's still competitive pressures out there for sure. As you know, Keith, we talked about that probably for the last 1.5 years, maybe even 2 years now. And one of the things we've done in the last six months is, one, we've got a new President, Ken Mills, who's come in and taking a fresh look at, hey, what are some of the challenges that Intelisys is facing in a competitive landscape?

And what we have learned and what we are doing or really two things I'll talk about today, that we mentioned on the call already is that we created a new platform, we're calling Channel Exchange used to be called intY CASCADE as a way to recruit new suppliers to Intelisys. There were some suppliers that we could not attract in the past to provide their technologies to the Intelisys channel. And so this platform is what some of the suppliers required for us to become a distributor. And this now allows us to have offers for the Intelisys channel community -- channel partners that our competitors don't have.

So none of our other TSD competitors have a product and a tool like Channel Exchange. So that's number one. And number two, Ken has put together a new partner segmentation strategy to make sure that we're treating the partners that maybe they are long, very loyal partners who have given us a lot of business over the years, make sure we're treating them in a way that's different from some of our long tail partners. So we're doing more partner segmentation, and we're aligning our value proposition appropriately. What that means is if we have a partner that doesn't need all the value-added services that we'll make sure that we give them the best possible commission split. So I think that this alignment of our offers specific to the partners is something that Ken is bringing in. Now having said all this it's going to take a few quarters before we see the results of this but we believe it's the right long-term strategy to build the Intelisys growth back on a competitive standpoint.

Keith Housum - *Northcoast Research Partners LLC - Analyst*

Okay. And is the strategy still to keep on acquiring some of these agents to help grow this business and with the Chinese wall in between Intelisys business and those?

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

So on the resources side, that's how we started, of course. We said that we believe that the market -- our competitive market has really forced our hand. All of our competitive distributors were doing the same thing. So yes, we started by buying one and our plan right now is to be careful about just buying and rolling up revenues. That's not our interest. We really want to create this channel model of the future and it might be that we acquire some complementary assets. It doesn't have to be just rolling up agents.

So really, we're not looking to roll up EBITDA as it is to create a model that we believe is going to be more successful and we can then use to teach and educate the other Intelisys channel partners. So I would say it's not just a roll up. It's really more of how do we create this unique channel model that we believe will be more successful and the end users will start to gravitate to us. I think it can also grow organically fairly significantly.

Operator

(Operator Instructions) Greg Burns, Sidoti.

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

I just wanted to follow up a little bit on Intelisys. In terms of where you're seeing growth there, you mentioned some of the areas where you've seen double-digit growth in the areas that, I guess, that would imply that are declining, how big of a piece of that business are they still? And do you expect maybe the declines there, either the declining portions of that business to moderate? Or are they getting to a point where there have de minimis impact and you might just see a natural lift with the mix improving in that business?

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

Yeah, Greg. I think it's more like this. So the older technologies are not growing, but they're not necessarily declining either. What we're seeing is these are contracts that as they get renewed, some of them get renewed with newer technologies. And so the technology does shift, but those businesses are still very large.

And one of the dynamics that we haven't talked about in a while that still can happen even in the older technology, and I'll use just network or circuits as an example, they're still principally sold by the suppliers on a direct basis, principally. And we still believe that some of the suppliers, just like we're talking about advanced technologies, guess what they are, too. And they're looking for a lower-cost ways to fulfill those contracts that will still be in effect and be offers for many, many years to come.

And we believe there's still going to be some shift to the channel from the direct side of those businesses even with older technology, sometimes actually it's older technologies, the suppliers don't want their high compensated sales teams to focus on them. They want to focus on new. So we believe these older technologies can still have a long life, but no, they won't have double-digit growth rates like we called out, that doesn't mean we don't have single-digit growth rates in those older technologies, just to be clear.

Operator

Thank you. I would now like to turn the conference back to Steve Jones for closing remarks. Sir?

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

Yeah. Thank you, and thank you for joining us. We expect to hold our next conference call to discuss March 31 quarterly results on Thursday, May 8 at approximately 10:30 AM.

Operator

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