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SCSC - Q3 2019 ScanSource Inc Earnings Call

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CORPORATE PARTICIPANTS

Gerald Lyons *ScanSource, Inc. - Executive VP & CFO*

Mary M. Gentry *ScanSource, Inc. - VP of IR & Treasurer*

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

CONFERENCE CALL PARTICIPANTS

Brendan J. Popson *Northcoast Research Partners, LLC - Research Associate*

Christopher Paul McGinnis *Sidoti & Company, LLC - Special Situations Equity 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, Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - VP of IR & Treasurer*

Thank you, and welcome to ScanSource's earnings conference call for the quarter ended March 31, 2019. With me today are Mike Baur, our Chairman and CEO; and Gerry Lyons, our CFO. We will review our operating results for the quarter and then take your questions. A CFO commentary that accompanies our comments and webcast is posted in the Investor Relations section of our website.

Certain statements made on this call including our expectations for sales, operating performance, earnings, fair value of contingent consideration, operating cash flow, tax rates and interest expense for the fourth quarter of fiscal year 2019 are forward-looking statements. These statements are subject to risks and uncertainties that could cause actual results to differ materially from such statements. These risks and uncertainties include, but are not limited to, those factors identified in the earnings release that we put out today and in ScanSource's Form 10-K for the year ended June 30, 2018, as filed with the SEC.

Any forward-looking statements represent our views only as of today and should not be relied upon as representing our views as of any subsequent date. ScanSource disclaims any duty to update any forward-looking statements to reflect actual results or changes in expectations, except as required by law.

We will be discussing both GAAP and non-GAAP results during our call and have provided reconciliations between these amounts in the CFO commentary and in our press release. These reconciliations can also be found on our website and have been filed with our Form 8-K.

Mike Baur will now begin our discussion with an overview of our result.

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

Thanks, Mary, and thank you for joining us today.

This quarter's results reflect continued execution in growing profits faster than sales. While third quarter net sales declined slightly year-over-year, we delivered 6% gross profit growth, 7% non-GAAP operating income growth and 13% non-GAAP EPS growth.

Our net sales of $893 million fell below our expected range. The biggest miss in our sales forecast was the lower volume of big deals throughout most of our business. We chose not to participate in some deals that didn't meet our return threshold. Lower-than-expected big deals contributed to higher gross margins and higher inventory levels. The third quarter has historically been our most difficult quarter to forecast sales. In the past, we've experienced an 11% quarter-over-quarter seasonal sales decline for the March quarter versus December. However, this year, it was a 15% quarter-over-quarter decline.

Overall, we have 2% organic net sales growth with growth in both worldwide segments. During the last 6 quarters, we've had organic net sales growth ranging from 2% to 10%.

Our 6 key growth areas highlight our strategy focused on technology solutions and higher-margin opportunities. First, in mobile computing solutions, market demand, new use cases and operating system transition to Android continued to drive new opportunities for our sales partners to deliver value. However, this is an area where we had lower-than-expected big deal volume, which reduced our quarterly sales in North America and Europe.

Second, we had another strong quarter of growth for video surveillance driven by more applications for video, increased integration and better technologies, including image resolution and analytics.

Our third area, POS Portal, we experienced business growth in our full service contract deployment of payment devices that generally include a higher level of value-added services from our team. We are continuing to see an increase in the payments opportunities as EMV certifications for ISVs are being completed at a faster rate.

Our fourth growth area, the communications channel shift opportunity, continued as the planned transition from 1 tier to 2 tier is completed. We are working with our sales and marketing teams to expand these relationships as part of our cloud voice and cloud contact center solution strategy.

Fifth, our Network1 business in Brazil had another quarter of strong sales growth from our SMB sales team, our Cisco-dedicated team and our enterprise-focused sales team. We are also benefiting from our One ScanSource strategy in Brazil of selling all our products across the business.

Our sixth opportunity is continuing to grow Intelisys, our recurring revenue base business. We had a record quarter for Intelisys, up 19% year-over-year with growth across the supplier portfolio, connectivity, cloud and cable.

During the June quarter, Intelisys will host 3 CX or otherwise known as Customer Experience summits. At these summits, we will help channel partners navigate the customer experience and call center opportunities. This fits with the capabilities we added with our Canpango acquisition, a Salesforce implementation and consulting business, to help channel partners sell CX solutions. In March, Canpango achieved Gold Partner status from Salesforce, which puts us into a smaller group of partners with significant visibility within the Salesforce ecosystem.

Following our strategic plan, we are making significant investments in our employee teams, systems and processes as well as developing new digital tools to enhance our value to our sales channel and to our suppliers. We began making these investments over a year ago beginning with our North American sales, marketing and supplier teams.

During the March quarter, we combined our ScanSource business units in North America to reduce complexity for sales partners interested in selling more complex solutions from our multiple businesses. We organized into sales teams that have deep domain knowledge across multiple technology solutions. With this focus on delivering more complete solutions for end customers that include devices, software, connectivity and services, we believe we are making it easier for our sales partners to drive higher revenues and profits.

Our sale -- our supplier partners see this new organizational structure as additional opportunities to drive higher revenues. These investments are part of our strategy to drive incremental growth at higher-value margins with more recurring revenues for ScanSource and our sales partners. We believe that this strategy will be well-received by our channel partners as it enhances their capabilities and allows them to serve end customers with a more complete technology offering.

With that, I'll turn the call over now to Gerry to discuss our financial results in more detail and our outlook for next quarter.

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Thanks, Mike.

During

(technical difficulty)

we grew profits -- operating profit and EPS faster than sales. Although net sales fell below our forecast range primarily from a lower volume of big deals, we delivered very good EPS growth. Gross profit and operating profit expansion as well as a lower tax rate drove the EPS growth. Third quarter 2019 GAAP diluted EPS increased 7% year-over-year, and non-GAAP EPS increased 13%.

Consolidated net sales for the quarter were basically unchanged at $893 million. Foreign currency translation negatively impacted sales by $23 million. Year-over-year, we had 2% organic sales growth with organic growth in both worldwide segments.

Net sales in our Worldwide Barcode, Networking & Security segment decreased 1% year-over-year with organic growth of 1%, reflecting a lower-than-expected volume of big deals. We had strong growth in our video surveillance and POS systems in North America.

Net sales for our Worldwide Communications & Services segment increased 2% year-over-year with organic growth of 5%. The growth was driven by strong sales in North America and Brazil and a record quarter at Intelisys.

Gross profit dollars increased 6% year-over-year from higher margins. Our third quarter fiscal year 2019 gross profit margin was 12.3%, higher than prior periods and higher than we expected. The margin includes higher vendor programs which we would not expect to continue at these levels.

For the Worldwide Barcode, Networking & Security segment, the gross margin increased to 10.3%. For the Worldwide Communications & Services segment, the gross margin was 16.3%, consistent with the prior year.

SG&A expenses increased $5 million from the prior year quarter to $78 million for the third quarter of fiscal year 2019. This increase reflects the addition of acquisitions and higher employee-related costs including investments to support our opportunities for growth.

Our third quarter 2019 non-GAAP operating income was $29.7 million or 3.3% of net sales compared to $27.8 million or 3.1% in the prior year quarter. For the Worldwide Barcode, Networking & Security segment, the non-GAAP operating margin increased to 3.2%, principally from higher gross profit margins. For the Worldwide Communications & Services segment, the non-GAAP operating margin decreased to 3.7%. This decrease reflects SG&A investments for future growth and unfavorable operating performance for our International business. Looking at our International business overall, we are disappointed with the operating margins for the quarter.

We have a $74 million contingent consideration liability on our balance sheet as of March 31, 2019. This reflects the present value with the expected future earnout payments for our Intelisys acquisition. For the third quarter fiscal year 2019, we recorded an expense for the increase in fair value of contingent consideration of $2.6 million for the Intelisys acquisition and $2.5 million for the final payment for Network1. For our fourth quarter 2019 forecast, we estimate the change in fair value of contingent consideration to be an expense of approximately $2.6 million.

For the third quarter of 2019, the effective tax rate was 25.8%. And this is our first full fiscal year following U.S. tax reform. For the full year 2019 -- fiscal 2019, we estimate the effective tax rate to range from 25% to 26% excluding any discrete items.

Now shifting to the balance sheet and the capital allocation plan. Cash from operations generated $27 million this quarter, which is typically a strong cash flow quarter, and $6 million for the trailing 12-month period. We expect to generate operating cash flow during the remainder of fiscal year 2019.

Inventory turns slowed to 4.3x, considerably lower than our typical range. And this reflects higher inventory levels from strategic inventory purchases, a new warehouse in the United Kingdom related to Brexit and lower-than-planned sales in the third quarter. The new U.K. warehouse is operating successfully allowing us to provide better service levels to our sales partners and to our suppliers, and we expect inventory levels to be lower by the end of the fourth quarter due to higher sales volumes.

DSO came in at 60 days in line with recent trends.

Our balance sheet remains very strong, and continues to provide us with the ability to execute our capital allocation plan which includes organic growth and strategic acquisitions. At March 31, 2019, we had cash and cash equivalents of $20 million and debt of $348 million.

Our net leverage totaled approximately 2.2x trailing 12-month adjusted EBITDA, and ROIC was 11.1% for the third quarter fiscal year 2019.

On April 30, we amended our credit facility to increase the amount to $500 million, including a $350 million revolving credit facility and $150 million term loan, and we extended the maturity to April 30, 2024. Our previous credit facility matured on April 2022 and totaled $400 million. It was an opportunistic time for us to complete the new facility with a strong banking group, and the new pricing grid is more favorable across all tiers. Our amended credit facility provides us with financial flexibility to meet our working capital needs and to invest in our future growth.

Now turning to our forecast. We expect net sales for the fourth quarter fiscal year 2019 to range from $970 million to $1.03 billion, GAAP diluted earnings per share to range from $0.56 per share to $0.62 per share and non-GAAP diluted earnings per share to range from $0.80 per share to $0.86 per share. The midpoint of our forecast range reflects organic growth of approximately 2% with growth in both worldwide segments, a gross margin closer to 11.5% and a non-GAAP operating margin closer to the March quarter's level of 3.3%. And we expect to continue to move toward our 3.5% non-GAAP operating margin goal. We are assuming approximately $3.7 million for interest in the June quarter, and we estimate the tax rate to be in the range of 25% to 26% for fiscal year 2019 excluding any discrete items.

And with that, I'd like to turn the call back over to Mike for a closing comment.

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

Thanks, Gerry. We are executing our strategic plan to drive profitable growth, recurring revenues and solution sales. We're devoting resources to drive a customer-centric approach to our channel partners and believe this will fuel our success. We see excellent opportunities ahead to accelerate sales growth, expand operating margins and deliver strong EPS growth.

With that, we'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Keith Housum with Northcoast Research.

Brendan J. Popson - *Northcoast Research Partners, LLC - Research Associate*

This is Brendan on for Keith. I just want to ask a question. We heard that Honeywell on their call talked about destocking issue. And I was wondering if that presented some kind of challenge for you guys. And then I have a follow-up as well.

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

Brendan, it's Mike. We normally don't comment on specific vendors on our call. And I certainly am aware of what they said. In general, we didn't experience any change in our lead time from Honeywell or in our strategy around having the right amount of inventory based on our profitability and our return metrics. So really no news from us on Honeywell.

Brendan J. Popson - *Northcoast Research Partners, LLC - Research Associate*

Okay. Great. And then another question involves obviously I'm sure you've seen and there's been a lot of discussions and rumors about Mitel and Avaya combining. I guess what are your views on that happening? What kind of impact do you think it's going to have on the business and going forward?

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

Well, again, we don't comment on other company's businesses. I will just tell you that we do business with both of them, and we certainly are close to their channel strategy and their approach to the market. And we've always taken a position that we're going to certainly be the best partner we can for our suppliers. And in this case, we have great respect for both of those companies.

Operator

And our next question comes from Chris McGinnis.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

I know most of the -- on your growth initiatives, you got some pretty long runways. I was just wondering maybe how far along on the communications -- the channel opportunity. How much longer do you have on that one specifically offhand?

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

Chris, Mike. That's one that we said in our prepared remarks that the planned transition from 1 tier to 2 tier has been completed. So that one is coming to the end of its runway from just a pure shift from a supplier strategy, selling direct, to a distributor strategy. Our opportunity though is to still grow those customers. And so there's the channel shift piece is basically done. And now it's up to us to grow those customers by certainly helping them sell more as a company and bringing them more solutions to the point as well.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

And I guess just a follow-up on that. How much of -- does that cost in that new customer base for you, maybe use other offerings that you have, if any?

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

Yes. For us, we typically know the customers that are transitioned already. But maybe the brand that's getting transitioned, maybe they're primary brand. But almost all telecom resellers in these days have multiple brands that they work with. There may be a primary and a secondary. So in many of these cases, we are already working with some of them, but there are some that are brand-new to ScanSource. And so we're trying to help them by sourcing some new products for them that we don't even carry today. So we're trying to sell them what we already have in our line card and frankly add other products as well. So we see this as an opportunity to enlarge our business with those customers that are transitioned. Yes.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. Great. And sorry about that, I was on another call. Just on the communications side of the business overall, some SG&A investment, and then a little bit of the unfavorable performance in international markets. Can you maybe just talk a little bit about the unfavorable performance, but also with the Q4 guidance, how does that translate into there? Is it still there or on both of those costs?

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Yes. Sure, Chris. This is Gerry. So on the international side, it was more of a volume sort of story. I think Mike alluded to this on the European barcode side, so you're asking about communications. But we lost some market share in terms of some deals that we walked away from on that side. On the communications side, there were some investments that we made really on -- in some opportunities for future growth. On -- in some other places, we just lost some volumes, and so we weren't able to get the leverage that we were looking for in some of those international locations. And really, in some of those locations we're not the largest player, so it's tough for us from a scale perspective. So we're sort of fighting scale. So I think that -- hopefully that answers your question.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

So I guess that may linger a little bit into Q4. Is that kind of a good expectation or...

Gerald Lyons - *ScanSource, Inc. - Executive VP & CFO*

Well, part of our forecast, Chris, to be honest, is just us being cautious. We missed our -- we missed the top line in Q3, and I think we're just being cautious from what we're hearing in -- from some of our suppliers who've already reported. There's some hesitancy in the market. And so I think that's just us being a little more cautious than perhaps we would normally want to be.

Operator

Thank you. I am showing no further questions at this time. I would now like to turn the call back to Mike Baur for closing remarks.

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

Thanks. Appreciate that. Thanks for joining us today. We expect to hold our next conference call to discuss June 30 quarterly and full year results on Tuesday, August 20, 2019.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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