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SCSC.OQ - Q4 2020 Scansource Inc Earnings Call

EVENT DATE/TIME: AUGUST 31, 2020 / 9:00PM GMT

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PRESENTATION

Operator

Hello, and welcome to 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, Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

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

Good afternoon, and thank you for joining us. Joining me on the call today are Mike Baur, our Chairman and CEO; John Eldh, our Chief Revenue Officer; and Gerry Lyons, our Chief Financial Officer. We will review our operating results for the quarter and fiscal year and then take your questions.

We posted a CFO commentary that accompanies our comments and webcast in the Investor Relations section of our website.

Let me remind you that certain statements in our press release and the CFO commentary and on this call 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 we put out today and in ScanSource's Form 10-K for the year ended June 30, 2020, 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.

During our call, we will discuss both GAAP and non-GAAP results and have provided reconciliations between these amounts in the CFO commentary and in our press release. These reconciliations also can be found on our website and have been filed...

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

Thanks, Mary, and thanks for joining us today. We see today's call as a continuation of the call we held on July 23 to discuss the actions we are taking to address the business impact of the COVID-19 pandemic and prepare our business for the next phase of growth.

On our call, we announced our fourth quarter net sales of $636 million, which reflect negative impacts from the COVID-19 pandemic on the VAR channel and end-user demand.

As we worked on our fiscal year 2021 annual plan, we continued to see the impact of COVID-19 on our business. We recognized the need to match our SG&A cost with sales volume declines as a result of the COVID-19 pandemic. We have sized the cost savings to reach an appropriate profitability level, as we expect our sales volumes to begin to increase throughout fiscal year 2021. At the same time, we decided it was strategically important to continue investments in our high-growth, higher-profitability areas.

While the COVID-19 pandemic had a significant impact on our quarterly financial results, I am proud of how our teams have executed and the value we delivered to our suppliers and customers. We have taken the necessary actions to strengthen our balance sheet, improve our cost structure and continue to drive investments in our higher-margin VAR cloud platform and our agency business.

I'll now turn the call over to John to highlight what is working well in our VAR business and our agent business.

John Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP*

Thanks, Mike. For me, the highlight of the quarter was how well our teams executed while also dealing with massive disruption from COVID-19 pandemic.

We delivered exceptional specialized customer service as we transitioned to working remote. As a reminder, this is a high transaction volume business, where we process hundreds of thousands of transactions quarterly with an average order size of approximately $2,000.

Throughout the quarter, I was pleased to see the number of active customers and customer sentiment get better each month. Of course, we do miss seeing our customers and suppliers in person and look forward to resuming more in-person meetings.

COVID-19's challenges are especially critical for small businesses, and many of our customers are small business owners. Early in the quarter, we compiled and distributed an extensive COVID-19 guide to help our partners better navigate government-aid programs, including the CARES Act and PPP program resources. We realized that our customers need it even more. Working closely to support them, we put together customized financial solutions to help them survive and thrive during these challenging times.

In addition, as a part of driving loyalty and satisfaction with our customers, we offered educational webinars designed to promote our Go Remote and work-from-home solutions. We also offered a webinar series on channel financial health, including the value of developing a recurring revenue practice.

Next, I'd like to highlight some positive trends in our VAR business. During the fourth quarter, our top selling product categories included mobile computing, mobile printing, networking, video surveillance cameras and unified communications, hardware, software and services. The new normal is driving more mobile use cases such as applications in e-commerce, delivery, curbside pickup and warehouse expansion.

Our heritage of specialized expertise in these technologies continues to be a differentiator. In our retail and hospitality business, we are seeing growing demand for self-checkout solutions in stores and increased deployment of contactless mobile enablement, mobile-enabled payment devices. And we've continued to see significant growth in everything required for work from home from headsets to access points for WiFi. And in our emerging technologies unit, we're now selling thermal imaging cameras that provide temperature measuring information solutions. Solutions like this help our partners get their customers ready for return-to-office requirements.

I also want to highlight another part of our business that we are calling value-added deployment services. These are essentially services we attach to hardware that drive higher gross margin and profitability. In our payments business, we perform value-added services such as key injection and configuration on over 70% of devices prior to shipping. Leveraging our many years of success in payment provisioning, we are expanding our provisioning services to support cloud-based service providers who need to deliver ready-to-use voice handsets directly to end-user customers.

A little over a year ago, we added digital distribution capabilities with the CASCADE cloud platform with our acquisition of intY in July 2019. During fiscal year 2020, we expanded use of the platform for our Microsoft business in the U.S. and in Brazil. With the CASCADE platform powered by Partner Insights, we are helping our sales partners more easily sell strategic cloud solutions and build recurring revenue.

For our business in Brazil, we've been expanding our routes to market and launched a master agent practice similar to our Intelisys business in the U.S. Our software sales increased to approximately 30% of sales in Brazil, representing cyber security suppliers and Microsoft Cloud. During the fourth quarter, our team in Brazil was recognized with multiple excellence in distribution awards that were voted on by our reseller community.

Lastly, we continue to be excited about the growth in our master agency business. 4 years ago, we acquired Intelisys, still today, the largest master agency in the United States, to add a high-growth recurring revenue model for the channel. We have seen opportunities for growth in the indirect channel accelerate as suppliers recognize that the agent community's strong customer relationships lead to slower churn rates.

We have also seen cloud suppliers, UCaaS, CCaaS and other X-as-a-Service suppliers, choose the agent model as a strategic route to market. Intelisys captured the leading market position with these offerings for our agent sales partners. For both fourth quarter and fiscal year 2020, Intelisys had 15% year-over-year sales growth. For fiscal year 2020, Intelisys annual supplier billings exceeded $1.6 billion. Our net commissions associated with those billings, which is what we report as our net sales, totaled $57 million for the fiscal year.

For our UCaaS and CCaaS suppliers, our fiscal year 2020 net commissions grew over 50%. For the fiscal year 2020, approximately 27% of our UCaaS orders and 18% of our CCaaS orders came from VARs.

We continue to see increases in VARs joining the Intelisys agent community. Fourth quarter was a record recruiting quarter for the Intelisys -- for Intelisys overall and also a record recruiting quarter for VARs. For the fourth quarter, more than half of the new Intelisys recruits were VARs. The Intelisys agent business is a way for VARs to add higher-margin solutions and recurring revenue. This is further evidence of our strategy to deliver services that add value to both the agent and VAR communities.

I'm excited about our future and see early signs of momentum and progress towards our goal of successfully delivering our fiscal year 2021 plan.

Now Gerry will take you through our financial results.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Thanks, John. I'll open with a review of all that has occurred since our last earnings call in May. You'll remember that we didn't provide any guidance for the fourth quarter, given the uncertainty around the COVID-19 pandemic. What we did indicate back in May was that we expected our fourth quarter results to be down sequentially, both in terms of revenue and EPS.

On July 23, we announced fourth quarter non-GAAP sales of $636 million. Additionally, on July 23, we announced a $30 million cost reduction plan to reduce our SG&A. On August 10, we announced our -- an agreement to sell our Latin America business outside of Brazil. With the announcement of the agreement to sell the Latin America business outside of Brazil and the progress that we have made in our efforts to sell our European business, we are now accounting for these businesses as discontinued operations.

Our fourth quarter results for discontinued operations (technical difficulty) [include a $89 million dollar] (added by the company after the call) noncash loss to establish a valuation allowance and $14 million for noncash impairment charges. So going forward, our U.S. GAAP numbers will be for continuing operations only. Unless otherwise indicated, this discussion reflects our results for continuing operations.

For the fourth quarter, our net sales were $636 million, down 22% year-over-year or down 19% organically. Foreign currency translation negatively impacted non-GAAP sales by approximately $20 million. And as expected, COVID-19 has impacted our sales volumes negatively in our wholesale VAR business in both segments. This includes the acceleration of the decline in our premise-based communications business.

We had a record sales quarter for our master agency business, Intelisys, where sales increased 15% year-over-year.

Our gross profits were $74 million, down 23% year-over-year. The gross profit margin of 11.7% is up from 11.4% for the March quarter. Our March quarter gross profit included inventory charges following the conversion to a new warehouse management system. We implemented an action plan to address the warehouse discrepancies and were back to more typical warehouse operations throughout the fourth quarter.

During the fourth quarter, we performed our annual test of goodwill for any impairment. And as a result of the COVID-19 pandemic, our test of goodwill concluded that we had an impairment. In the fourth quarter, we had a pretax noncash impairment charges of $120 million. The remaining goodwill on our balance sheet is approximately $214 million.

Our SG&A expenses for the quarter, excluding a $5.7 million Brazil tax recovery, was $64 million versus $63 million year-over-year. So while our sales and gross margins were down, our adjusted SG&A was not down in the fourth quarter. We have addressed the SG&A cost issue with our $30 million annualized expense reduction plan. This plan, which we began implementing in July, is designed to better align the cost structure for our business with lower sales volumes as a result of the COVID-19 pandemic.

In the first quarter of fiscal year 2021, we expect to record an estimated pretax cash charge of approximately $9 million for severance and related benefits. For the fourth quarter, we recorded a $700,000 charge for the change in fair value of contingent consideration.

Our final earn-out payment to the former owners of Intelisys will occur later this calendar year. The amount of the contingent liability as of June 30, 2020, was $46.3 million. The impairment charges decreased the effective tax rate for fiscal year 2020. And for fiscal year 2021, we estimate the effective tax rate to range from 28.5% to 29.5%, reflecting a higher impact from nondeductible tax items.

A few comments about the full year results. Our net sales for the year were $3.05 billion, down 6% year-over-year or down 5% organically. Our Intelisys agency business grew 15% year-over-year. And our gross margins for fiscal year 2020 were 11.7%, down from the 12.1% the previous year as a result of lower supplier program recognition.

Our non-GAAP operating income for the year was $79 million or 2.6% of sales versus $129 million or 4% in the previous year. The majority of the reduction in operating income is a result of lower sales volumes.

Now turning to the balance sheet and cash flow. We generated strong operating cash flow of $74 million for our fourth quarter and $182 million for fiscal year 2020. Working capital investment declined 25% year-over-year. We are able to strengthen our balance sheet because of the strong and close relationships we have with our customers and suppliers.

Our financial services team stays very close to our customers, more like a financial adviser, and works to develop customized financial solutions, so we can continue to successfully operate together during the pandemic.

Our DSO came in at 63 days versus the previous year of 58 days. And much of this increase is due to the timing of sales and the providing of customized financial solutions. We reduced our June 30, 2020, inventory by 17% year over -- sorry, quarter-over-quarter and 18% year-over-year.

Now I'd like to turn the call back over to Mike for closing comments.

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

Thanks, Gerry. We have a plan in place to advance our business and believe our close relationships with our customers and suppliers are the foundation for the value we bring to the channel. I look forward to updating you on our steps forward and our improving financial results.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Adam Tindle with Raymond James.

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

Mike, I just wanted to start -- last we spoke, the demand picture was so uncertain that I don't think it's gotten a whole lot better. But I was asking about kind of the model and if the current run rate of revenue, kind of in that $650 million a quarter range that you just printed or $2.5 billion annualized, was the right way to think about future quarters. Just wondering, as we sit here today, a month later, if you've got any more clarity on revenue or a way we can kind of think about the normalized top line for your company?

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

Yes. And thanks. We certainly would like to think it will start growing again from the June quarter. As we looked at working on our plan for FY '21 and -- which led us to the $30 million cost reduction exercise, as you know, we had to, in that exercise, make some assumptions about FY '21. And our challenge is, of course, not knowing when we will see that business starting to come back, especially on the -- obviously, the VAR side of our business.

Our Intelisys business has continued, as we said, to do very well. We continue to see that growth in that business. But we do believe that our VAR business will grow in FY '21. We just, today, don't have any more visibility than we did a month ago as to how to ratably communicate that. So we're on the sidelines, doing everything we can to be ready for growth and making sure that we can achieve the appropriate levels of profitability, especially as we get some decent top line growth.

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

Okay. That's fair. And I just wanted to clarify the $30 million of savings. I think you're also -- you've talked a little bit about investments that you're making, which makes sense, in the businesses that are working like Intelisys. Is that $30 million a net number? Because it's about $1 a share of benefit to the EPS line. And I'm wondering if I'm not thinking about incremental investment, what kind of the net number is.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Adam. So this is Gerry. That number is a net number. We've got some investments baked into that $30 million.

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

Okay. That's helpful. And Mike, maybe just if you could double-click on those investments. I know you talked about the higher-margin VAR cloud platform, the agency business is where you're investing. Maybe just (technical difficulty) what we should look forward to start seeing those pay off? Where is the expected return or outcome in the financials?

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

Well, I'll see if I can try to help. On the Intelisys side, as you know, when we make investments, we've been in 2 different areas. One is headcount. And headcount traditionally for us are people that are doing 1 of 2 things. One is channel managers, we call them. These are the sales teams that are calling on agents and VARs more and more now to help them find customers, sell opportunities along with our suppliers in a joint selling. As we historically, and this is in the 4 years we've owned Intelisys, when we add channel managers, we pick up new business, either new recruits or more business for our existing channel.

However, again, the payoff for that is generally out a couple of years. It's generally where the channel managers recruit and develop, but a new channel manager, unless they come to us with some existing relationships, which by the way many of them do, we don't see the return on that investment for a while. But we believe we need to continue to invest in them this year, just like we did last year, which will pay off over the next 2 to 3 years.

The other part of that investment in Intelisys is in tools, IT tools, tools to help customers sell and manage their business better through the suppliers. And I'll reference our RPM acquisition from 2 years ago. So those type of tools are really a differentiator, and it's why more agents and VARs choose Intelisys over our competitors.

And then if you think about just, again, any other investments, as we mentioned, the VAR cloud platform, CASCADE, we believe that's a way for VARs to better develop their long-term business. And that business also generally is for our subscription or SaaS business. And so you don't see the impact of that significantly in the first few quarters as you ramp up new customers. So again, these are more long-term investments, but we have belief that they're the right investments, which will bring us long-term value.

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

Okay. Maybe just last one from me. Gerry, you mentioned cash flow, that's certainly been a bright spot. Just want to set proper expectations in thinking about future cash flow. Are there items that perhaps don't repeat that we should be thinking about as we think about fiscal '21? Anything maybe related to like divested working capital or something like that, that benefited this quarter?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Anything that doesn't repeat. I think, Adam, mostly what's in the cash flow is -- are normal items. I don't recall there being anything in there that's abnormal to -- obviously, we have a countercyclical balance sheet. So as things -- as the business slowed down, we generated more cash. But there's nothing that I can think of that's unusual in there.

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

Okay. And Mike, maybe updated thoughts on capital allocation?

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

From our perspective -- I can't remember what we actually said back in May. So I'm looking to Gerry.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes, it's really -- that hasn't changed, Adam. It's really organic growth. And if there's an acquisition out there, we would do that.

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

But none planned right now. There's no acquisitions planned. We're using our capital to fund our current operations.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Correct.

Operator

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

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Mike and Gerry, I was hoping you guys might provide a little bit of color on perhaps July and August to give us a sense of, is there any type of recovery happening from the downturn that we saw last quarter?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes. Keith, I think what I would say, and Mike or John can chime in, but what I would say is when you look at how the quarter progressed, so April was a steeper decline -- well, let me say it a different way. April had -- was probably the low point, May got a little better and June got better from there. So I think that's what I would say from a revenue perspective. When you look year-over-year, the quarter got a little stronger as we went on. But obviously, we're down 20-something percent. So it's not -- it's a relative statement.

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

Yes. Keith, this is Mike. I mean, from my perspective, we've got every one of our key suppliers focused on trying to find ways to stimulate growth in the channel. And so there are more programs, more initiatives underway. And as we referenced on the call, we actually signed a new vendor in the middle of the crisis, a thermal scan vendor that we think is interesting. But we've got more programs that we believe we're going to have to do with the suppliers to get growth coming in the pandemic. We have not seen any kind of a dramatic change in the trajectory of volume at this point, nothing that's significant.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Got you. And then coming back to a goal you guys have had over the past several years is getting back to that 3.5% to 4% operating margins. As you stand today, is it safe to say, unless we see a dramatic impact in -- or pick up in the business throughout the year, you're probably unlikely to get that here in fiscal '21?

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

Well, certainly, for the year, I don't see that happening. For us to be able to achieve that during the year at some quarter is possible. And so we've built in a combination of the expense reductions and what we think will be some growth in the business, number one, coming from the Intelisys side of the business and our VAR -- the cloud platform with CASCADE. But really, we've got to see some growth from the traditional VAR business. And if we get that, and we certainly have modeled out, hey, what happens if we start growing again, what happens if we grow another $50 million from here or $60 million or $100 million and what does that do to the profitability.

And so what we did by taking the $30 million out is the number is we believe that if we get a reasonable amount of growth from here that we will get back to the 3.5% before the end of the year, before the end of the fiscal year. Not for the year, but for a quarter before the end of the year, just so we're clear.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Yes. No, I got it. And then in the past few calls, you guys have talked about the investment in software. I guess perhaps you can provide us a little more color on the progress over the past few months in terms of your investments in the software? And is there 1 or 2 areas that we're going to likely to see that before the others?

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

Yes. For sure. John talked about Microsoft and our success there. We had a big task to get the platform, frankly, running in Brazil. And so after we bought the intY CASCADE platform last July, job #1 for those guys was getting it to work in Brazil. And by the way, that was no easy task. That took us longer than we thought. But we had significant growth, again, in Brazil, in cloud, in Microsoft for the quarter and that's continuing. So that was objective number one.

Objective number two was working with some very specific suppliers, I won't name who they are, getting them up on the platform, because we haven't announced them yet. But we've got a significant existing ScanSource supplier that sells a lot of software and services that we needed to migrate from just selling it as a normal buy sell through our SAP system and move it to the CASCADE platform. And so we're in testing on that with that supplier right now. And for the September quarter, we'll have a significant revenue going through the platform. So we will talk to you about that in November. We're excited about it.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Okay. Got you. And then last question from me. Gerry, I appreciate some of the commentary regarding the finance department. But can you speak to about the credit quality that you're seeing in the quarter? And are you seeing credit deteriorate? And is that a concern that you perhaps have in immediate term?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes. Sure, Keith. Yes. So we haven't really seen credit deteriorate. I mean we've had lots and lots of conversations, obviously, with our customers. And our team works very, very closely with our customers. And we think we provide a great deal of value to those customers. We're constantly working with them, trying to figure out how to get deals done in a way that provides value to our company and to their company. And so I've been pleasantly surprised at how resilient the customers have been.

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

And Gerry and Keith, if I can just add to that, I think one of the things that we talked about last quarter and this quarter was our efforts to help our best partners. And we had webinar series that John described on best practices and what the financial health of a VAR, who's in the recurring revenue business and how much better they are. And I believe we've got these strong relationships from this team of financial services. And by the way, Keith, that's a significant amount of headcount that we devote to making sure we have a relationship with those customers. We don't outsource that to an insurance company, credit insurance. We don't outsource it to a collection company.

And so I -- as Gerry said, I have been pleased, not surprised, but pleased that our partners, our customers trust us and they want to buy from us. They will pay us and not pay some of their other distributor partners. And we know that, that's not something you get over 1 quarter or 2. This is because these customers on our VAR business, we've had relationships with many of them for over 10 years.

Operator

Our next question comes from the line of Chris McGinnis with Sidoti & Company.

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

I was just wondering if you could maybe just talk about the competitive landscape and maybe just -- is this an opportunity for you to go out and take some share where -- just given the difficult environment and maybe if competitors can't operate as well as you can?

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

Chris, I'll take it first and see if John wants to jump in too. We've got many, many competitors. In Brazil, we're still the dominant player there. In the Intelisys business, as we said, we're still by far the largest master agent in the U.S. In our VAR business, we've had a lot of competitors really take some market share in different quarters over the last few years. And I would say from listening to our teams that market share and wallet share is a big part of our strategy for FY '21. And maybe, John, I don't know if you want to add something to that. But maybe it's the way the teams are structured this year.

John Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP*

Yes, Chris. This is John Eldh. Thanks for your question. I would absolutely agree with Mike that the wallet share and market share are key priorities for us. And part of what we've built over the last several years is this ability to be able to offer on-prem, hybrid, cloud and agency capabilities. And these are all coming together to be what we think of as real competitive differentiators to add greater value to our customer base, our partner base that drives greater loyalty, greater consideration from them, and it helps us to take share from competitors.

Operator

I'm not showing any further questions in the queue. I would now like to turn the call back over to Mr. Mike Baur for closing remarks.

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

Thank you for joining us today. We expect to hold our next conference call to discuss September 30 quarterly results on Monday, November 9, 2020.

Operator

Ladies and gentlemen, that concludes today's conference call. Thank you for your participation. You may now disconnect. Everyone, have a wonderful day.