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SCSC - Q4 2019 ScanSource Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

Madison Suhr *Raymond James & Associates, Inc., Research Division - Research Associate*

William Tennent Gibson *Roth Capital Partners, LLC, Research Division - MD & Senior Research 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 and year-ended June 30, 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 year 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, interest expense, planned divestitures and results for the first quarter of fiscal year 2020 and fiscal year 2020, 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, as (sic) [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 results.

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

Thanks, Mary, and thank you for joining us today. In looking at our financial results for the quarter, we did not finish our fiscal year as strongly as we started. For fiscal year 2019, we delivered record net sales of $3.9 billion; GAAP EPS of $2.24; and record non-GAAP EPS, up 8% year-over-year.

During the fiscal year following our strategic plan, we began 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 our suppliers. As we began fiscal year 2020, we have identified 6 key growth initiatives for the year. First, we believe we have the best sales channels to grow the collaboration business, including unified communications, contact center and cloud. For example, our Cisco partners have embraced the new digital solutions offers with WebEx in a significant way. Our Cisco subscription business has more than doubled year-over-year. Now with our new CASCADE cloud platform from intY, we are adding capabilities to accelerate our Cisco collaboration subscription business for our sales partners with new billing choices.

Second, strong market demand for video surveillance is expected to continue to grow at double-digit rates during 2020. We believe our channel sales partners represent the best routes to market for the leading video camera suppliers in the industry, and the demand for video management software continues to develop.

Our third area of growth is in the Intelisys cloud business, which continues to grow at 60% year-over-year for fiscal year 2019 with our top cloud suppliers. We are the #1 or #2 master agent for the majority of the unified communications as a service providers, including RingCentral, 8x8 and Mitel.

Fourth, for POS Portal in fiscal year 2020, we see excellent payments opportunities and margins that reflect a higher mix of services. These opportunities include higher complexity from integrated payments and new types of contract deployment business with independent software vendors.

Our fifth area of growth for 2020 is in Brazil, where we've combined our teams as One ScanSource and continue to have strong year-over-year growth, led by our SMB business, Cisco and enterprise businesses. We are also growing our business as a Microsoft cloud provider in this region and are enhancing the intY CASCADE cloud platform for the Brazil market. The CASCADE platform enhancements will strengthen and grow the cloud services business for our suppliers in Brazil.

And sixth, we are excited to add digital distribution capabilities with intY's CASCADE cloud platform, which we acquired on July 1. The CASCADE solution provides ScanSource partners with a highly automated tool that allows configuration, provisioning and billing services for our current suppliers: Microsoft, Symantec and Acronis. It is a scalable platform that is already built and operational with over 1,800 active sales partners. During fiscal year 2020, we plan to add more software, cloud and subscription suppliers, including Cisco to CASCADE, to help our sales partners more easily sell strategic cloud solutions and build recurring revenue practices.

During fiscal year 2019, we implemented a new go-to-market structure and added new capabilities to become a solution-oriented, customer-driven organization. We began making these investments over a year ago, beginning with our North American sales, marketing and supplier teams. During the March quarter, we completed the consolidation of 5 ScanSource business units in North America and have started delivering a new One ScanSource team approach. This transformation of our sales force in North America is designed for top line growth and for selling solutions, services and recurring revenue. As part of a strategic review of our businesses, we made the decision to divest certain businesses outside of the United States, Canada and Brazil which we announced in a press release earlier today. ScanSource will continue to operate and invest in its digital distribution business in these geographies, including its recent acquisitions in intY, Canpango and Intelisys Global. We determined that we need a certain amount of scale to maximize our value-added model, and this led to the focus on Brazil, Canada and the United States for our physical product distribution business. These actions are positioning us for faster-than-market growth for fiscal year 2020, and we are expecting 5% to 7% annual net sales growth in our fiscal year 2020 plan.

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

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

Thanks, Mike. We had a disappointing finish to our fiscal year with sales and EPS below our expected range for the quarter. We missed our forecast range, primarily from lower sales volumes. Earlier today, we announced the planned divestiture of certain physical product businesses outside of the United States, Canada and Brazil. These planned divestitures had a fiscal year 2019 net sales of $623 million and at June 30, 2019, had working capital investment of $205 million. The non-GAAP operating income for these planned divestitures was approximately breakeven for the full fiscal year 2019.

Consolidated net sales for the fourth quarter totaled $961 million, down 3% year-over-year or down 2% on an organic basis. Foreign currency translations negatively impacted sales by $15 million. The lower sales volume reflected lower big deals that we believe were delayed, not lost. We have been struggling to grow certain areas of our business due to significant headwinds from our premise-based communications suppliers. Additionally, during the fourth quarter, we missed some sales from partners who are impacted by our sales team transformation efforts in North America.

Gross profit dollars for the quarter decreased 3% year-over-year, consistent with the lower sales volume. Our fourth quarter fiscal year 2020 gross profit margin was 11.4%, consistent with the year ago period and down from the previous quarter. And as we indicated last quarter, the previous quarter margin included higher vendor programs, which we did not expect to continue at those levels.

SG&A expenses increased $1.1 million from the prior year quarter to $78 million for the fourth quarter fiscal year 2019. We have made significant investments in operating expenses to support the planned growth for fiscal year 2020. These expenses were fully realized last quarter as we executed our new sales transformation plan called One ScanSource. We will gain leverage on these expenses as our teams drive higher top line revenue.

Our fourth quarter 2019 non-GAAP operating income was $29.4 million or 3.1% of net sales compared to $30.8 million or 3.1% in the prior year quarter. We have a $78 million contingent consideration liability on our June 30, 2019, balance sheet, and this reflects the present value of expected future earnout payments for our Intelisys acquisition.

For fourth quarter year 2019, we recorded an expense with increase in fair value of contingent consideration of $3.7 million for Intelisys. For our first quarter 2020 forecast, we estimate the change in fair value of contingent consideration to be an expense of approximately $1.6 million.

For the fourth quarter 2019, the effective tax rate was 28.7%. Our non-GAAP items include the net impacts from a favorable tax settlement in Brazil, partially offset by the write-off of the deferred tax asset in Latin America. And for fiscal year 2020, we estimate the effective tax rate, excluding the planned divestitures, to range from 25% to 26%, excluding any discrete items.

And now for a few comments on our full year results. Our fiscal year 2019 net sales of $3.9 billion represented a 1% increase from the prior year or 2% on an organic basis. The gross margins for fiscal year 2019 were 11.7%, up 34 basis points from the prior year. In fiscal year 2019, we had a few things that benefited our margin. We had vendor price increases related to tariffs, and we had higher levels of opportunistic inventory purchases. We're not expecting these events to recur in fiscal year 2020. We are, however, expecting faster growth from our higher-margin businesses.

Our SG&A for the year is up 6% due to expenses for companies acquired during the year and additional investments for our sales organization including Salesforce CRM. We're expecting sales growth to leverage the investments made in SG&A throughout the fiscal year 2020.

Fiscal year 2019 non-GAAP operating income increased 4% to $128.5 million or non-GAAP operating margin of 3.3%.

Now shifting to the balance sheet. Cash from operations used $3 million this quarter and used $27 million for the year. The negative cash flow reflects the higher level of working capital investment, including opportunistic inventory purchases. We expect to generate positive operating cash flow during fiscal year 2020. In addition, the planned divestitures we announced earlier today had approximately $205 million in working capital at June 30, 2019, and we would expect a significant cash benefit from those planned divestitures.

For the quarter, we had inventory turns of 4.7x, which are slower than our typical range. This reflects the higher inventory levels from the opportunistic inventory purchases and lower-than-planned sales in the fourth quarter. We do expect inventory levels to be lower at the end of the first quarter due to higher sales volumes.

Our days sales outstanding came in at 62 days, up from 60 days in the prior quarter and 59 days in the prior year quarter. At June 30, 2019, we had cash and cash equivalents of $24 million and debt of $360 million. Our net leverage totaled approximately 2.3x trailing 12-month adjusted EBITDA, and ROIC was 12% for fiscal year 2019. During fiscal year 2019, we invested $32 million for acquisitions that built capabilities but have not yet contributed to our EBITDA growth.

Now turning to our forecast. We are providing our first quarter forecast, excluding the planned divestitures that we announced earlier today, and we expect GAAP net sales for the first quarter fiscal year 2020 to range from $970 million to $1.03 billion and our non-GAAP net sales, excluding the planned divestitures, to range from $830 million to $890 million. The midpoint of our non-GAAP sales forecast range reflects organic sales growth of approximately 4%. GAAP diluted earnings per share are expected to range from $0.47 per share to $0.52 per share and non-GAAP diluted earnings per share to range from $0.70 per share to $0.75 per share. I'd like to point out that the GAAP EPS does not include any noncash charges from write-downs or costs associated with the planned divestitures.

And for the quarter, we expected gross margin closer to 11.4% for the ongoing businesses and a non-GAAP operating margin close to 3.5% for the ongoing businesses. Before this forecast appeared, we're assuming approximately $4.4 million in interest expense, and we estimate the tax range also to be at 25% to 26% for full fiscal year 2020, excluding discrete items.

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

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

After our strategic review of our business, we are executing our plan for higher margins and higher growth. We are being driven by a commitment to shift from supplier-driven initiatives to an end-customer-driven growth strategy that is serviced by a network of knowledgeable channel sales partners. By offering digital and physical solutions with value-added services, we believe we will be at the center of the solution delivery channel. The plans we have for fiscal year 2020 will showcase the result of these efforts.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

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

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

This is Madison on for Adam. And I wanted to start. You have several long-term financial targets out there with 2Q. One is being 3.5% to 4% operating margins and mid-teens ROIC. So how should we think about operating margin and ROIC after the divestiture given this was likely dilutive to these metrics?

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

Yes. Madison, this is Gerry. So yes, it is. We certainly think that our operating margin can get to that 3.5%. That's a more short-term sort of outlook. But as we said previously, on the ROIC, it's just going to take some time to get that number up to a higher number, mid-teens. So we've indicated we finished at 12% in order to get that number up to where we need. We're going to need another 12 to 18, 24 months, something like that.

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

Okay. That's helpful. And then just as a quick follow-up, I wanted to clarify. Are you only pursuing a sale of the non-digital distribution business? Or is there a chance that this could potentially cause a write-down? And if so, how much would that be?

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

Yes. So what we've announced at the moment is that there's a planned sale, and that's the only plan that we have at the moment.

Operator

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

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

Guys, as we look at the POS and Barcoding segment, obviously some very disappointing results there. How much of that was impacted by the businesses that you're going to be divesting versus the businesses that are going to be retained?

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

Yes. Keith, we did have some disappointing results in the Barcode segment. I think we indicated on the call that most of that was just lower sales volume, and part of that was in really all geographies, really lower sales volume. So we're expecting that we're going to improve in both segments based upon executing on these planned divestitures. So...

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

Okay. Post the divestitures, what will be the impact to your vendor lineup? I mean is there any risk to the existing relationships that you have in terms of your ability to earn rebates going forward or volume incentives or any of that nature?

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

Keith, it's Mike. We are certainly not expecting that because, today, we get really no program benefits across geographies. All the suppliers negotiate terms and conditions and rebate targets based on what we do in a particular geography. So for example, our revenue in Europe does not affect our rebates and programs and benefits in North America and vice versa.

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

Got it. Appreciate it. Last question, if I may. Again, inventory levels were extremely high. And to be honest, I thought you guys would have worked down a little bit more than you did. I understand the sales were disappointing in the quarter, but is there anything that's preventing the inventory from being worked down further? Or is it just a matter of the sales got to catch up and you got way too much? And is it really with 1 or 2 vendors? Or is it really across the entire platform?

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

Yes. So it certainly is a bit of a sales issue, but we also indicated that we were opportunistic in some of our buys. So I wouldn't say it's across the board. It's more pointed at certain places, but we are absolutely committed to driving those numbers down, partly because we're going to have the higher sales volume and partly because we're going to do things a little differently than we have in the past.

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

Again, I apologize. I'm just going to sneak one more here. What gives you the confidence that you guys are going to have higher sales volume in the next -- in the 1Q compared to what you had in the 4Q?

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

Well, one of the things that we indicated to, Keith, is the sales structure changes that we made. We actually started that a year ago in July, and we really phased in a bigger group of our customers into that new sales structure in March. And so we recognized, even then, that -- even though we had learned a lot in the 9 months prior, once we turned on this new structure, which really was a big transformation for our go to market and by combining 5 sales forces into 1, there was definitely some disruption and some customers said, "Hey, I have a new salesperson or sales team. How does this work?" And so we believe that some of the revenue definitely was lost in the quarter and that we'll get that back once the new sales team start to perform. We believe our customers, based on feedback, like this new structure. They may be didn't understand it at first, but we believe that they will actually -- they'll benefit from it and we will, too.

Operator

(Operator Instructions) Our next question comes from the line of William Gibson of Roth Capital Partners.

William Tennent Gibson - *Roth Capital Partners, LLC, Research Division - MD & Senior Research Analyst*

With regard to the divested businesses, could you give us a little more color on what products are involved?

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

Sure. So in Europe, it's both -- it's both segments, so it's both communications products and point-of-sale barcode, primarily barcode products in Europe. In Latin America, it's the same as well, so it's both communications and barcode.

William Tennent Gibson - *Roth Capital Partners, LLC, Research Division - MD & Senior Research Analyst*

And in terms of use of funds once they're divested, is that -- are you going to pay down any debt?

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

Well, we. We -- yes. We certainly will pay down debt. We also have other investments that we want to make. We -- These regions aren't performing at the rate that we need them to perform, so we're going to invest some of those dollars in the higher-performing areas that we still have, which would be the U.S., as we've indicated; and Brazil, as we've indicated.

William Tennent Gibson - *Roth Capital Partners, LLC, Research Division - MD & Senior Research Analyst*

And then one last question. When you report first quarter results, will the businesses to be divested show as discontinued operations or will they be included?

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

Yes. Well, so there's a bunch of accounting guidance around that, and there's a number of tests that we have to meet. And at this point, it's not clear whether we can meet those tests. So they will either be broken out as discontinued operations or we will create some sort of a non-GAAP reconciliation to get you from what we report to non-GAAP without these operations.

Operator

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

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

Just a follow-up around the divestitures. What would have been the organic growth, I guess, for 2019 if you look back and ex out the planned divestitures?

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

Hold on 1 second. Let me find that piece of paper, Chris. It would have been around 3% organic.

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

And so I guess as indicated by the -- or what Mike was saying about that 5% to 7%, I think, for this year is maybe the targeted range for full year. What's the biggest components of the improvement you're expecting on the growth rate?

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

Yes. I think what we identified at the first part of our comments today, Chris, were these 6 growth areas, and we believe that these growth areas are some that are very important and that are growing at much higher rates. And we gave the example of the collaboration area and specifically the Cisco WebEx opportunity. And what's interesting is how quickly the opportunities for selling subscription revenue, for example, is doing well and probably much better than we were actually reflecting in our results from last year. So that was one example. Obviously, the video surveillance, another example we've been talking about for a few years now, continues to do -- to be growing at better than traditional market rates. And so when we look at that, we add Intelisys, POS Portal, obviously our new CASCADE platform and then what we call digital tools, in general, we believe, we have the opportunity to take market share by helping our channel partners make more money selling products and services and software and digital from ScanSource next year. And we believe that will lead us to take market share, and that's better than 5% strategy if we do that well.

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

Okay. And can you just maybe elaborate a little bit on what CASCADE brings to you and how that changes the -- like that -- or helps you with that change in strategy and going to market?

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

Yes. Sure. One of the key areas that we needed as part of our strategy was a platform so that a sales partner, one of our VARs or one of our agents or any of those types of sales partners could go to a central place and place an order. First, they have to be able to configure what they call provision software, and let's use Microsoft as the example, to sell Microsoft Azure or 365 or their CRM or any of their software products today, you have to have a configuration tool. And so we looked at building one years ago. We decided a few years ago we need to buy one. To build one was going to take us too long, and we weren't sure it would be the right place to invest our resources. So we have a platform that lets us work with many suppliers, Microsoft, one example, to configure, provision the software that a customer needs and an end customer needs, then you have to be able to bill it in either -- in the Intelisys model, we had a billing model where the suppliers bill the software or the solution or the connectivity. But we have a lot of VARs that want to bill the software or they want us to bill it. So what CASCADE is, is a billing -- it's a configuration platform but also a billing platform. And then following that, it's also a way to keep up and track all of the products you sold. So then we have this tool called Partner Insights that actually takes the data that we are using to provide this provisioning in sales and allow a sales partner to be much more knowledgeable about what products a customer owns and when the renewals are, how do you sell them more in the future based on the growth of their business. So this becomes a real important tool to a channel partner, and that's why we believe this is significant and will impact us positively in 2020.

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

Great. And maybe one last question. I don't know if you could break this out. But how much is now of the business maybe around the services? I know it's been a few years now on this investment, so can you disclose that yet? Or is it still maybe not enough to disclose?

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

Well, we're looking at different ways we can disclose it. When we looked at the example we gave in our call around the Cisco WebEx and talked about it doubling in revenue year-over-year. We want to be more clear than that, if we can, and so we're trying to gather the right metrics. And also, some of this new digital revenue comes in at -- as a commission and more as 100% margin, much like the Intelisys model works, so you don't get the benefit necessarily at the top line as you do at the margin line. So we do have some of the products that may look like they're being sold in a subscription model but still aren't. So it's kind of a combination of how suppliers and our channel partners want to purchase and have someone bill the product. So we are working on that. We hope to give you more clarity on that, maybe as soon as next quarter.

Operator

(Operator Instructions) We have a follow-up question from Keith Housum of Northcoast Research.

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

Mike, you outlined those 6 strategies or 6 catalysts for growth going forward. Can you quantify how much revenue of those 6 catalysts currently provide?

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

Not today, but we'll certainly be talking about it more over the next few quarters. We want to definitely be able to give you more insight into that, though. But this was the first opportunity we had to really refresh our growth areas, and we thought this would be a great place to start, but stay tuned. We'll give you more in the future.

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

Okay. Got it. And then to follow up on that, Gerry, you mentioned that with the cash you'll get from the divestitures here, you guys will make investments in the growth areas. I guess will these be investments that we'll see come through in the income statement? Or would these be through additional acquisitions?

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

Keith, I would think they would be more through the income statement because I think if when we look at our portfolio now, we think -- you've seen our investor slides, right? And you've seen the things that we've outlined. We think now we've basically filled most of those holes or all of the holes that we needed to fill, so we're not really expecting that we're going to need to make any other acquisition investments.

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

Okay. So is it too early to say that operating margins going forward will be 3.5% or higher or no?

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

Well, I think with Madison's question earlier, I indicated that that's a short term -- we should be able to get to there, short term, yes.

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

Okay. Even with those investments, okay.

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

Yes.

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

Yes.

Operator

At this time, I'd like to turn the call back over to Chairman and CEO, Mike Baur, for any closing remarks. Sir?

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

Thank you. Appreciate you joining us today. We expect to hold our next conference call to discuss our September 30 quarterly results on Tuesday, November 12, 2019.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may disconnect your lines at this time.