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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, 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 Steve Jones, our new Chief Financial Officer, who joined ScanSource in December. We will review our operating results for the quarter 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 our 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.

I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks for joining us today. What a year it has been. A year ago, we discussed our One ScanSource sales team reorganization in North America and introduced new executive leadership at Intelisys. Then a few weeks later, the challenges presented by the COVID-19 pandemic began to unfold. For ScanSource, 2021 is a year for focus, execution and growth. Over the last few years, we have been transforming our business to enable sales partners to deliver industry-leading solutions and respond to the new ways that end customers prefer to acquire technologies.

As you can see from our press release, our second quarter results improved substantially over the first quarter. Excellent performance by our employees drove higher net sales and operating leverage on our SG&A expenses.

As we start the second half of our fiscal year, we believe we have built a foundation for growth, and there are new market opportunities for ScanSource in 2021 that are larger than ever before. I'd like to welcome Steve Jones, our new CFO, to the ScanSource family. Steve's background is an outstanding fit for ScanSource, because of his experiences working with a supplier going through digital transformation and a software company moving from licensing to subscription.

I will now turn the call over to John to discuss our sales performance for the quarter.

John Charles Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior EVP

Thanks, Mike. I'm very excited about this quarter's sales execution and our growth momentum. We had 7% sequential sales growth from the September quarter. Our higher-than-expected net sales this quarter are due to an increase in large deals and year-end budget flush. Our recurring revenue business, including Intelisys, SaaS and subscription, is growing at double-digit rates, representing higher margins and higher growth rates than our product business.

In his opening comments, Mike mentioned our One ScanSource sales reorganization. A year later, in North America, I'm proud to report, with our increased focus on customer satisfaction, that we drove greater sales volumes, higher customer counts, larger average order sizes and an increased number of orders. I really want to thank our employees for truly fighting through this change and restoring the trust, confidence and loyalty of our customers and suppliers.

In our bar code, networking and security segment, net sales increased 5% quarter-over-quarter, led by large deals across mobility, self-checkout and video surveillance solutions. And we also saw continued strength in networking and access points enabling the remote working and learning trend, including strong E-Rate business, which is a federal program that funds the education market. Despite supply chain challenges, which led to some shortages during the quarter, our teams managed to deliver on time for our customers and maintained excellent service levels. Our POS portal payments business, which has higher margins, declined 28% year-over-year.

For communications and services, we saw an 11% quarter-over-quarter increase in net sales, driven by the growth in cloud-enabled endpoints, headsets and phone provisioning in North America and the growth in data center and digital workplace technologies in Brazil.

Our Intelisys business had another record quarter, driven by the continued market shift to cloud-based solutions. Intelisys grew 15% year-over-year with even faster growth for unified communications as a service at 35% and contact center as a service at 65%. Intelisys continues to be a key growth opportunity for us. As a result, we plan to continue investing in Intelisys ahead of the market opportunity. We recently launched new digital tools for our sales partners, such as Cable Finder, which automates the process of buying cable services. We also made investments in our go-to market with a new inside sales team to support partner engagement for newly recruited partners. And in 2020, we had a great recruiting year for new partners, increasing Intelisys agent recruitment by some 22% over the prior year. We also continue to grow the number of our top platinum partners and we continue to see strong growth in their business.

Intelisys offers the partner community differentiated value through trusted relationships, the strongest supplier contracts and the most reliable commission management tool in the industry. We provide partners with confidence and credibility by enabling them with the financial strength and stability of ScanSource, while offering the broadest and deepest supplier portfolio across connectivity and cloud services.

In Brazil, our team achieved a record sales quarter in local currency, led by large deals with double-digit growth across the business, enabling us to take share. In addition to success across our hardware solution, Brazil continues to build momentum across its digital portfolio including top cloud providers Microsoft, IBM and Oracle. In December, our Brazil team also held a very successful virtual partner conference called Innovation Forum, with over 4,700 participants. Just amazing.

Despite COVID-19, we are leveraging our marketing spend to drive innovative digital events and virtual customer engagement. As an example, ScanSource's discover opportunity helped sales partners understand the opportunities available in areas of vertical expertise, such as grocery, education, government and manufacturing. We're also promoting mobile solutions with our mobility future forward campaign, providing resources and tools for our partners. And our anatomy of a CCaaS win is helping sales partners understand how adding contact center as a service solutions can increase productivity for customers.

In summary, we're very pleased with our second quarter performance and the momentum we're building. I'd also like to take this opportunity to thank our partners and suppliers for their continued commitment and dedication to growing their businesses with ScanSource.

Now, Steve will take you through the financial results.

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

Thanks, John. It's great to join the ScanSource family and also great to have excellent quarterly results to discuss with you. Our business continued to build sales momentum, gained operating leverage on SG&A and (technical difficulty). This outstanding execution drove strong cash generation and a 12.4% ROIC for the quarter. Unless otherwise indicated, this discussion reflects our results for continuing operations only.

For the second quarter, our net sales were \$811 million, down 2% year-over-year and up 2% year-over-year for organic growth. Foreign currency translations negatively impacted non-GAAP sales by approximately \$28 million. Our gross profits were \$86 million, down 12% year-over-year. The gross profit margin was 10.6%, down from the prior year, primarily due to sales mix and lower vendor program recognition. As John mentioned, our higher-margin POS Portal payments business declined year-over-year.

Our non-GAAP SG&A expense for the quarter of \$59.1 million declined \$7.6 million or 11% year-over-year. We realized the planned quarterly impact of our expense reduction plan announced in July. For fiscal 2021, we estimate our effective tax rate to range from 28.75% to 29.75%, reflecting a higher impact of nondeductible tax items and geographical mix.

Now turning to the balance sheet and cash flow. We generated strong operating cash flow of \$44 million for the quarter and \$215 million for the trailing 12-month period. Working capital investment declined both sequentially and year-over-year. We continue to strengthen our balance sheet and liquidity position. Our DSO remained stable at 60 days. And with our net sales increase and lower inventory levels, inventory turns increased to 6.9x. On December 31, 2020, we had cash and cash equivalents of \$67 million and debt of \$152 million. We have a stronger balance sheet with lower leverage. Our net leverage totaled approximately 1.1x trailing 12-month adjusted EBITDA.

During the quarter, we completed the sale of our product distribution business in Latin America and in Europe and the U.K. These divestitures were classified as discontinued operations in our second quarter fiscal year 2021 financial statement. We are not providing forecast range for the third quarter because of the uncertainty around COVID-19 on our business. Following our historical seasonal trend, we expect net sales to decline quarter-over-quarter.

I would now like to turn the call back over to Mike for closing comments.

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

Thanks, Steve. This was a quarter of strong execution by our employees worldwide, and this gives me confidence in the strategic direction we are taking. ScanSource has the best sales partners and best suppliers. And with them, we are positioned for strong growth in the year ahead. 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 - Senior Research Associate*

Mike, I just wanted to start with your comment where you talked about starting in the second half of this fiscal year, you have a foundation for growth. Just the basis for that comment. Did you maybe finish the quarter strong that give you some momentum going into the back half of the year?

And then secondly, if it's possible -- I know you talked about -- or Steve talked about seasonal sequential decline in Q3. But given your comments on foundation for growth in the back half, do you think you can grow year-over-year in Q3 off of that \$745 million you did last year? Any directional color would be helpful.

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

Adam, thanks for the questions. First of all, on the foundation for growth, really what I was saying, if you look back over last year, and if you recall a year ago, when we talked about the December quarter, it was a disaster. We had customers that were upset at us. We had just executed, frankly, 1.5 years of sales reorganization. And we were not executing as we had expected to. So I believe what we accomplished in the last 4 quarters, even with COVID, proved -- has proven to us with these results, when you look at what John talked about from some key metrics of more customers, more spend on the average size orders and more orders and our ability to execute from a distribution standpoint, a supply chain management standpoint, those are all the things that I feel very confident about. And a year ago, I couldn't say that.

And so if you take our products business, which has stabilized dramatically and resulted in a strong increase in sales, absent a couple of areas that we highlighted. And you throw on top of that, the continued growth in 2 areas, Intelisys and Brazil, we believe that the second half of the year will be good in terms of fiscal year. But as we've always experienced, there is some challenges growing from the December quarter to the March quarter. So that's really what we meant by a decline quarter-to-quarter, it was sequentially.

And that's just the seasonal trend. If you go back and look many, many years now, again, that may not be the way it works. But today, I can tell you, we still are struggling with our ability to forecast the quarter. As we said on the call, we exceeded our expectations with the \$811 million, the revenue. And I mean, it's a good feeling. And I think that's what the company is trying to say today is we feel very good about our position in the market and our ability to execute.

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

Understood. And I can certainly appreciate the difficulty forecasting in this environment. I guess, as we think about over the intermediate term, let's say, returning to growth, how should we think about the cost structure as that occurs? I know you've done a lot of work there. You have the \$30 million restructuring program. Can you hold OpEx around this \$60 million or so quarterly run rate level and drop through most of that growth on a forward basis? Or how should we think about that algorithm?

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

Yes. That's an excellent point that we have been discussing since the summer. If you recall, Adam, back in the summer when we announced the \$30 million expense reduction plan, we intentionally did not reduce all of our investments in our growth opportunities. So we left those somewhat intact as we talked about what we were trying to accomplish. And so we believe that we are extremely focused.

And Steve, being the new guy, he's already heard us talk about it in a lot of meetings. We've got to manage those operating expenses very, very tightly, while still leaving us room for some very specific investments for the future. And I can just tell you from our Board's perspective, when we had this discussion last week, they were very clear that we need to make sure that we continue to invest for the long-term in these strong, high-margin recurring revenue businesses. And the tools and the people that John talked about earlier that we've added, those are examples of how we will selectively increase the spending. But we're going to be very careful when we do it and how we do it with an eye that we still need to deliver, as we've said many, many times longer term, a 3.5% operating income percent. We're not there yet, and we think it's more important to make sure we take advantage of these high margin, high-growth opportunities than it is to make a specific number in a quarter.

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

Understood. If I could just get one last one in for Steve. I know it's early, but you've got a fresh pair of eyes. I'd just be curious, your view on the biggest pockets of opportunity to do things differently or perhaps emphasize? And if you want to tie in any early thoughts on capital allocation, that would be helpful.

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

Yes. I think the big opportunity is Intelisys. I mean, we've seen growth there and we believe in that model. I think that's our biggest opportunity that's sitting out in front of us.

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

And I think, Adam, on the capital allocation, we believe that with the balance sheet where it is today and with the performance of the team, we want to continue to make sure we have the strong ability to fund the organic growth that we're seeing. But I would also suggest to you with the improvement of the balance sheet, and Steve and I just talked about this, this morning, we do believe that as strategic opportunities for growth appear from an acquisition standpoint, we'll definitely be taking a look at that going forward.

Operator

Our next question comes from Keith Housum with Northcoast Research.

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

Steve, we -- welcome aboard. Glad to have you joined the call. Steve, I guess, I'll point the first question is towards you. I mean, it looks like the balance sheet, the inventories are low -- accounts receivable and accounts payable are high. As you look at your working capital levels as you exit the quarter, what are your thoughts in terms of where they need to be going forward?

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

I'm happy to answer. So I think where we are in the -- as we exit Q2, we're -- we had some supply issues. And so we're looking -- as we look to Q3, we're probably going to have to build back some inventory to catch those sales and to catch up.

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

Yes. Expected. Expanding a little bit more on the supply chain issues, can you perhaps provide a little bit more color on how they progressed during the quarter? And does that give you a bigger than usual pipeline going into the third quarter?

Stephen T. Jones - *ScanSource, Inc. - Senior EVP & CFO*

I'll pass that over to John. He's a little bit closer to it than I am.

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Sure. Look, I mean, as Steve said, and I said it in my comments, we definitely saw some shortages. But even despite those shortages, we beat our internal expectations for sales and sales volumes. And maybe most importantly, we took great care of our customers, working closely in conjunction with our suppliers to deliver a strong outcome for Q2. And we're hopeful we'll see the same thing as we move into Q3.

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

Okay. Great. Do you think it gave you any pipeline going into the third quarter? Or did those issues -- did those sales go elsewhere?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

Sorry, can you say that one more time?

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

Yes. I said the challenges at the end of the quarter in terms of the supply chain, did those sales go elsewhere? Or did that give you a pipeline to start the third quarter with?

John Charles Eldh - *ScanSource, Inc. - Chief Revenue Officer & Senior EVP*

No. They didn't go somewhere else. They will -- they will still be with us and come our way throughout the quarter.

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

Got you. And then, Mike, I may have one question for you. I've got to ask about POS Portal. It wouldn't be surprising, I guess, if this is more COVID-19 related. But any thoughts you have on the significant drop in business for them during the quarter? And what's the prospect for the third quarter?

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

Yes, I'll take it. We are so excited still about that business. And we're disappointed in the impact that COVID has had, kind of, more than some of our other businesses, and we wanted to make sure we highlighted that. That there, they don't have any structural changes in their business. There's no lack of market share opportunities. So we are excited about it because it's still a higher-margin business than our traditional business. And it's a business that we have some very unique skills at delivering.

And it just so happens that when you look at this business year-over-year, that business was challenged more than some of our others, we didn't see that coming. But we want to make sure everyone knew that, because not having as much of the high margin POS Portal revenue in the quarter is part of the reason our gross margins were lower. And right now, we don't know when it's going to come back, but we do have confidence it will. We're just not sure exactly when.

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

Got you. And then last question for me. Several factors build up to your recurring revenue stream. Can you give us an idea of how much recurring revenue is -- as your total percentage of revenue?

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

Mary, I'm going to look to you to kind of -- see if we're willing to give some of that. I'm not sure his point about how much of our revenue is recurring. I mean, I'm not sure exactly what we're pointing to in our Q that might could help him.

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

Sure. So the recurring revenue, as a percentage of revenue, is going to be very small. However, the recurring revenue as a percentage -- the gross profit contribution associated with the recurring revenue is going to be a much more noticeable number. And what we can point you to is the recurring revenue from Intelisys, which is not all of our recurring revenue but the substantial piece of it. And in -- for the second quarter, that was 19% of the gross profit coming from the Intelisys recurring revenue.

Operator

Our next question comes from Chris McGinnis with Sidoti.

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

Congrats, Steve, on the appointment. I guess just maybe in a similar line of question, just the operating income as a percent of sales in communications and services, a big increase over the prior year. Can you just touch on the big driver of that? Is that just the greater growth from the service-based revenue? Can you just highlight that a little bit? Is that -- I'm just...

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

Chris, it's Mike. I'm going to see if I can try. So on the comms segment, you're talking about the services contribution there, right? And remember, in that segment, which I know these things aren't as clean as they used to be, Intelisys is in there. And so that's what drives the strong profitability in that segment is Intelisys, just as kind of a reminder.

And within that also, we had a strong contribution from Brazil. And that's also high margin, high growth. And -- so those are the 2 key pieces of the growth in the comms doing so well, it's those 2 pieces.

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

Great. Okay. And that's higher -- that higher margin really dropping down to the bottom line.

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

Right.

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

And can you just maybe expand on what's happening in Brazil? Is that just that you're just in such a strong position there? Can you just maybe expand a little bit on the success you're having in Brazil at this time?

John Charles Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior EVP

Yes. Chris, it's John. Thanks for the question. It's a great question and one we're excited to answer. Look, Brazil, we have real positive momentum. We have -- we've built it up now for the last couple of quarters. I think a lot of it comes down to having a great team.

It's a senior team. They've been together a long time. It's very stable. And so a lot of it comes down to just the strength of the leadership team. But we are also -- I would offer, we're also seeing strength there in taking share from the departure of one other distributor, but also taking share from local regional distributors.

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

I think it's been a long time coming, so congrats on that, taking the market share gain. And then just last question. John, you highlighted, I think, a 22% growth in partner for Intelisys. Can you just -- I don't know, can you provide more context in the sense of maybe where was that last year? Because that's obviously been growing for a long time in a great rate. And it seems like that sets up well for continued growth. Can you maybe just expand a little bit on that as well, that partner growth that you talked about and you commented on?

John Charles Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior EVP

Yes. I think, Chris, again, the opportunities for Intelisys are substantial. Where we play there, we play in large and growing markets. And so we are seeing increased partner recruitment there from a number of places. But one of the key areas is VARs are recognizing the ever-increasing importance, especially with the advent of COVID-19, of moving to recurring revenue and offering greater cloud-based solutions for their customers. And as a result, it's helping to fuel our recruitment. And we're -- fingers crossed, we're hopeful to see that continue moving forward.

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

And Chris, I want to add one more comment, if I can. A year ago, we moved a couple of our senior executives from the traditional ScanSource business who know a lot of these partners over there. Mark Morgan and Paul Constantine joining Mike Ketchum as the team that really is leading that business. So in a year, those guys have done a fantastic job of recruiting new partners and getting our best partners growing even faster. So yes, they -- just great execution.

Operator

That concludes today's question-and-answer session. I'd like to turn the call back to Mr. Baur for closing remarks.

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

Great. Thank you for joining us today. We expect to hold our next conference call to discuss March 31 quarterly results on Monday, May 10, 2021.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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