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PRESENTATION

Operator

Welcome to ScanSource Quarterly Earnings Conference Call. (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 Bauer, 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 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, in the CFO commentary, and on this call are forward-looking statements.

These statements are subject to risks and uncertainties that could cause such 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 statement 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 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. I am incredibly proud of our ScanSource team and our strong execution in an unprecedented operating environment. We achieved better than expected results and net sales grew 19% quarter-over-quarter. This is much stronger than our typical June to September sequential quarter growth of around 4%.

In addition, we had strong operating cash flow driven by working capital efficiency gains. These results demonstrate the strength of our people, our offerings, and our market growth opportunities. ScanSource is uniquely positioned to help channel partners drive growth by providing customers with industry leading endpoints and cloud solutions. ScanSource has become one of the largest and most successful cloud companies in the channel with our acquisition 4 years ago of Intelisys. We are a leader in sales of UCaaS, CCaaS, infrastructure as a service, and SD-WAN solutions

and ScanSource remains, after 28 years, the largest and most successful endpoint distributor in our industry. We remain the leader in video and voice endpoints, mobile computing and barcode printers, IP-enabled high-def cameras, payment terminals, receipt printers, network access points and much, much more.

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

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

Thanks, Mike. I'm very excited about this quarter's sales performance and our focused strategy for growth. We saw a continued adoption of our SaaS and subscription business, growing at 46% year-over-year. In our Barcode, Networking & Security segment, net sales increased 17% quarter-over-quarter led by significant growth in large deals across our mobility, self-checkout solutions, and video surveillance technologies. And we also saw continued strength in networking and access points enabling the remote working trend accelerated by the COVID-19 virus.

For Communications & Services, we saw a 24% quarter-over-quarter increase in net sales driven largely by cloud-enabled video endpoints, headsets, and phone provisioning to support UCaaS service providers. And our Intelisys business had another record quarter driven by the continued market shift to cloud-based solutions.

Our team in Brazil achieved the highest quarterly sales results in Brazil history in local currency while also driving impressive working capital efficiency gains. In addition to their success across hardware solutions, Brazil continues to build momentum in its recurring revenue businesses including SaaS and our master agency. We're also excited about our newly formed cloud partnerships with both Oracle and IBM. This quarter, our supplier services team made significant progress in our working capital management. We're delighted with the work we did to increase inventory turns to 6.2x, the best level we've had in close to 3 years while also delivering on time for our customers and maintaining excellent service levels.

I'm pleased with this quarter's positive results and really inspired by our workforce who continue to primarily work remotely due to the pandemic. We are also very proud of the success we had with our 2 virtual partner conferences with over 3,000 combined attendees. The first, our Intelisys Channel Connect event, helped our partners to re-imagine the new next together exploring opportunities across cloud and connectivity and our virtual VAR partner conference focused on the power of connections and enabling our partners on opportunities across our portfolio including recurring revenue, SaaS, and verticals.

We received huge accolades from our partners and suppliers on our ability to deliver world-class digital events. Now, Gerry, will take you through our financial results.

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

Thank you, John. We made excellent progress this quarter, 19% sequential quarter net sales growth, disciplined cost management, strong cash flow generation, and lower working capital. And unless otherwise indicated, this discussion reflects our results for continuing operations only. For the first quarter, our net sales were \$757 million, down 10% year-over-year or down 7% year-over-year organically. Foreign currency translation negatively impacted non-GAAP sales by approximately \$25 million. As expected, the year-over-year reduction in net sales was primarily due to the impact of the COVID-19 pandemic.

Our gross profits were \$81 million, down 18% year-over-year. Gross profit margin of 10.7% is down from 11.7% for the prior year quarter. And as John said earlier, this quarter's sales reflected a higher mix of large deals compared to last quarter as well as lower supplier program recognition. Our non-GAAP SG&A expenses for the quarter of \$61.6 million, declined 9% year-over-year and declined 2% quarter-over-quarter. At the end of July, we implemented a \$30 million annualized expense reduction program. Our lower non-GAAP SG&A expenses reflect a partial quarter impact and we are on track to achieve the \$30 million in cost reduction -- cost savings. In the first quarter of fiscal year 2021, we recorded a restructuring charge of \$8.3 million for severance and related benefits. We have experienced higher costs from COVID related expenses which totaled approximately \$310,000 in the September quarter. For fiscal year 2021, we estimate the effective tax rate to range from 28.5% to 29.5%.

Now turning to the balance sheet and cash flow. We generated strong operating cash flow of \$71 million for our first quarter and \$226 million for the trailing 12-month period. Working capital investment declined 34% year-over-year and 13% quarter-over-quarter. We continue to strengthen our balance sheet and our liquidity position. Our DSO came in at 61 days remaining relatively stable with recent trends. We decreased our inventory levels, down 29% year-over-year and down 7% quarter-over-quarter and we increased our turns to 6.2x as John referenced.

On September 30, 2020, we had cash and cash equivalents of \$56 million and debt of \$169 million including discontinued operations. Our net leverage totaled approximately 1.3x trailing 12-month adjusted EBITDA. On October 30, we completed the sale of our products business in Latin America, outside of Brazil to Intcomex. We are actively working on sales opportunities to divest our products business in Europe and the U.K. Both of these divestitures were classified as held for sale and discontinued operations in our first quarter fiscal year 2021 financial statements.

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

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

Thanks, Gerry. Before we close, I want to take this opportunity to welcome our new Director, Frank Emory, to our ScanSource Board of Directors. Frank currently serves as Executive Vice President and Chief Administrative Officer for Novant Health. Frank's perspectives as a legal expert and executive as well as his many years of public service and deep community involvement bring valuable insight to the Board and ScanSource. The progress we made this quarter gives me confidence in the strategic direction we are taking. We are very excited about the growth opportunities for our channel partners. And with that, we'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Adam Tindle with Raymond James.

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

Good afternoon, this is Madison on for Adam and thanks for taking my questions. I wanted to drill down a bit on the Barcode, Network and Security operating margin. So revenue was up pretty significantly quarter-over-quarter, but margins were flat. So can you just touch on what drove the quarter-over-quarter margin headwind in Q1 and then historically, this segment has operated above a 2% operating margin. So, do you still think this is the right way to think about margins in this segment longer-term?

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

Yeah, Madison, hi, this is Gerry, let me just start and I'll start it kind of top of the income statement, if you will. So if you look within that segment, we had -- and John referenced this on the call, we had some fairly large deals that drove our gross profits down -- our gross profit margin down. If you look year-over-year was 8.7% the year prior and at 7.8% in the current quarter and again we referenced these larger deals and some supplier program recognition as well driving those gross profits down. So that's really the vast majority of what's driving the operating profit down.

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

Okay and kind of longer-term outlook for that segment in particular, do you still think that 2% range is achievable over the kind of intermediate longer-term?

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

Yes.

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

Okay, great. And then wanted to ask quickly on Q2, obviously, normally a budget flush quarter. Just wondering if you can give some initial color on what you're seeing into Q2 and maybe how you're expecting this year to be different or similar relative to prior years?

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

Hey, Matt, this is Mike. I'll take that one. We're not going to give any guidance for this quarter and -- but if you just think about history with this quarter for us, there's a lot of moving pieces in the December quarter and we've never been really a budget flush quarter kind of company. The one thing that's happened to us over the last -- I'll say 4 or 5 years though is it's been a federal quarter where we would see federal business and we used to reference it as either happening on time kind of in the December quarter, sometimes they got delayed -- deals did and they moved into the March quarter. So it generally was characterized with some big deals that were federal in nature and we characterized them -- they were federal/Cisco in nature. I don't know if you recall that. So that's the question frankly for this quarter coming up is we don't know and I would just say that in general, we would love to have another quarter like we just had.

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

Got it. Yes, that would definitely look nice. Thanks for taking my questions guys.

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

Sure.

Operator

Your next question comes from Keith Housum with Northcoast Research.

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

Good morning, guys. Hey, I didn't hear a lot on the call -- maybe I didn't hear anything about how the on-prem business was doing. Obviously, it was a tough quarter last quarter. I kind of imagined we'd see some more pressure here, but looking at the results, it seemed like that the pressure wasn't nearly as bad as we saw last quarter. And then as a follow-up to that, is the work from home strength that you're seeing, are we expecting that to continue into the second quarter perhaps for even into fiscal '22 -- I'm sorry '21?

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

Hey, I'll take that. This is John Eldh and thanks for your question. Look, we saw real strength in Q2 and it was quite frankly -- it was widespread, meaning it was North America or U.S. and Canada. We also saw strength in Brazil and we saw strength in Brazil across all segments and so it was a positive quarter and we're hoping to see kind of the same trends as we move into Q3. As it relates to the work from home question, there too we saw a lot of strength in Q2 and we believe we're going to see similar strength as we move to Q3 or sorry from Q1 to Q2.

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

Got you, got you. So do I assume here the pressure for the on-prem hardware was not nearly as bad as we saw last quarter?

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

Sorry, I missed the question.

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

The on-prem communication hardware. I'm assuming the pressure was not nearly as bad.

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

It was not and I think it's important to remember that this business is going to continue to shift to the cloud and we were in great position to deliver on both fronts this quarter and we foresee that happening as we move forward.

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

Great. Gerry, in terms of the workforce reduction, can you provide a little bit color in terms of how much of that was completed and you saw the benefit in this quarter versus yet to be seen here in the second quarter?

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

Sure, Keith. So I mean we announced that late in July and so really, we probably had about a month and a half of benefit in the quarter. So as we move forward, you'll obviously get full [quarters] but we're on track as I said.

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

Okay, the sale of the Latin America business, that's closed already, correct?

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

Yes, it closed on the 30th.

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

Right, can you provide any color in terms of the sales proceeds and how much of working capital reduction you guys are seeing?

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

We didn't announce any of that, Keith.

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

Okay, got it. Okay, that's all I got. Thank you.

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

Thank you.

Operator

Your next question comes from Chris McGinnis with Sidoti & Company.

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

Yeah, afternoon. Thanks for taking my questions. Nice quarter, I was just wondering if you can maybe just comment around maybe some pent-up demand and are you seeing continued strength in the sense of maybe on a monthly basis. I know that larger orders play into that somewhat but maybe more volatility in the quarter base but just when you're looking at the business, it sounds like you feel pretty good at this point.

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

Yeah, hi, there, this is John again. We definitely coming out of Q4 saw some pent-up demand clearly as a result of COVID and I think that helped us and will also help us as we move into Q2 especially in light of projects that were on hold and actual physical locations of our customers' customers that were closed that are beginning to open up, which are enabling more installations, things like physical surveillance technology and other things and so as we see more of the economy open up, we should see continued benefit from this.

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

Great and a little surprised by the strength in Brazil. Can you just talk about given their reaction to the pandemic, how are you succeeding down there and how has that performed. I think a little bit better than expected?

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

Yeah, great question. We just, we're really proud of our Brazil team and their performance. We saw widespread -- I mean it wasn't one area, it was widespread performance across SMB and enterprise across both sides of the business whether it's comms or the POS barcode business and we also saw success in hardware as well as our recurring revenue business. So very impressive, large deals were strong this quarter and we're expecting another strong quarter coming up.

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

And Chris, this is Mike, if I can just add one thing to that our team -- John referenced our team and one of the things we heard when we reviewed the quarter was the employees who work for us in Brazil are extremely happy that we've taken the actions we took to allow them to work from home, the employee satisfaction that we measure in Brazil regularly is at one of the highest it's ever been and our team -- our executive team there attributed the morale and loyalty of our employees as a difference.

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

Makes a lot of sense. Thanks. And then just that long-term target. I think a 3% operating margin. Do you see a pathway to get there in this year or what would have to change in the environment? Would you need a little bit more demand or does this cost saving help you get there by year-end you think -- a normal pace of recovery I guess from here?

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

Yeah, Chris, this is Mike again, I'll take it. We talked about it last quarter too that we have a plan for the year that we believe based on our cost savings plan that we've already announced of \$30 million and based on growth returning that we can get leverage on that SG&A at certain volumes and certain mix of volume and get back to 3.5% at a point in time. We're not going to say we're done once we get there either but we do believe that there is a path to get back to 3.5%.

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

Yes. That's all I have for now. Thank you very much for taking my questions and good luck in Q2.

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

Thanks, Chris.

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

Thanks, Chris.

Operator

(Operator Instructions) I'm showing no further questions at this time, I would now like to turn the conference back to Mike.

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

Thank you for joining us today. We expect to hold our next conference call to discuss December 31 quarterly results on Tuesday, February 2, 2021.

Operator

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

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