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SCSC - Q2 2020 ScanSource Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

## 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.

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

Thank you, and welcome to ScanSource's Earnings Conference Call for the Quarter Ended December 31, 2019. Our call will include prepared remarks from Mike Baur, our Chairman and CEO; and Gerry Lyons, our CFO. John Eldh, our Chief Revenue Officer, is also joining us. 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. 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 third and fourth quarters of 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, 2019, 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 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.

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

Thanks, Mary, and thank you for joining us today. For the quarter, we missed our sales forecast primarily from lost sales as we reorganized our North American VAR sales team. As we discussed on prior calls, we are executing our One ScanSource strategy. The goal of our One ScanSource strategy is to increase customer value by cross-selling and growing recurring revenue. We are setting up our VAR sales teams to sell solutions, connectivity, cloud and SaaS, including offerings from our Intelisys and intY acquisitions. The strategy behind One ScanSource is to become customer-centric, provide more value and enable growth for our customers. Beginning in April, we combined our 5 North American VAR business units into one. We reorganized our teams by customer segments. We changed customer assignments. We introduced team selling. We implemented Salesforce CRM, and we adopted a new sales compensation plan. With these changes in the realignment of our sales teams, we created customer disruption and negatively impacted our service levels. Since April, as we encountered issues, we made adjustments. And now following this quarter's sales results, we will make more changes.

During this quarter, we had another record quarter with the Intelisys sales partners. This business grew 19% year-over-year with the cloud suppliers growing even faster at 68%. One of our key objectives with Intelisys has been to recruit and sell through more VARs, while still growing the agent channel.

To date, out of 4,000 -- approximately 4,000 Intelisys sales partners, approximately 15% are ScanSource VARs. Over a year ago, in order to accelerate the growth of the VAR sales channel, we started our Ignite program to identify and recruit VARs to join the Intelisys sales community. The Ignite team is focused on the ScanSource strategic sales partners and working with the ScanSource account executives to introduce VARs to the financial benefit of recurring revenue. We've learned that VARs require education and a financial investment to participate successfully in adding recurring revenue to their business.

As an example of a success so far, a long time Barcode strategic VAR recently won a multiyear contract to supply thousands of mobility devices and recurring revenue in the form of connectivity services. These services will be worth minimally $300,000 in recurring commissions each year to the VAR. The Ignite team is currently working with over 600 key accounts in the ScanSource VAR base. This gives us confidence to accelerate our efforts to integrate more closely by aligning with the One ScanSource strategy and creating a teaming approach.

Now Gerry will take you through the financial results and our outlook for next quarter.

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

Thanks, Mike. Net sales for our second quarter declined 5% year-over-year, principally from lower sales volumes in North America and higher-than-expected declines in our premise-based communications business. Because of the lower sales volumes, the GAAP diluted EPS and the non-GAAP diluted EPS fell below our forecasted range.

In August, we announced plans to divest certain physical product businesses outside of the United States, Canada and Brazil. These businesses had net sales of $156 million for our second quarter and at December 31, 2019, had working capital of $167 million. A process is underway to sell these businesses and based upon the interest we have received, we anticipate having an agreement by the end of the third quarter of our fiscal year 2020.

Consolidated net sales for our second quarter totaled $990 million, down 5% year-over-year and also down 5% on an organic basis. Foreign currency translation negatively impacted sales by approximately $7 million. Net sales for our Worldwide Barcoding -- Barcode Networking & Security segment declined 2% year-over-year or 0.4% on an organic basis. This reflected lower sales volumes in North America, partially offset by growth in mobile computing and in our payments business. Net sales for our Worldwide Communications & Services segment declined 12% year-over-year or 14% on an organic basis, primarily from significant headwinds in our premise-based communications business in North America. We also had a record quarter for Intelisys, where sales increased 19% year-over-year. We also added $11 million of SaaS sales from the intY acquisition.

Excluding the planned divestitures, non-GAAP gross profit dollars for the quarter decreased 5% year-over-year. Our second quarter fiscal year 2020 non-GAAP gross profit margin was 11.8%, down slightly from the year-ago period of 11.9% and up from the prior period of 11.6%. SG&A expenses increased $2.2 million from the prior year quarter to $83 million for the second quarter fiscal year 2020. We have made investments for our recurring revenue and services-based businesses. Our investments also include the digital capabilities we've added with the acquisitions of intY, RPM and Canpango. Our second quarter fiscal year 2020 non-GAAP operating income was $28.6 million or 3.4% of net sales compared to $34.6 million or 4% in the prior year quarter.

We have a $45 million contingent consideration liability on our December 31, 2019 balance sheet and this reflects the present value of expected future earn out payments for our Intelisys acquisition. For second quarter fiscal year 2020, we recorded an expense for the increase in fair value of contingent consideration of $3.2 million for Intelisys. For our third quarter fiscal year 2020 forecast, we estimate the change in fair value of contingent consideration to be an expense of approximately $1.9 million. For fiscal year 2020, we estimate the effective tax rate, excluding the planned divestitures to range from 25% to 26%, excluding discrete items.

Now turning to the balance sheet and to cash flow. We generated strong operating cash flow of $71 million for our second quarter and trailing 12-month operating cash flow of $143 million. We expect to generate positive operating cash flow during fiscal year 2020. Working capital investment declined 7% quarter-over-quarter and 8% year-over-year. The planned divestitures had approximately $167 million in working capital at December 31, 2019, down $37.5 million from the June 30, 2019 balance. With the completion of planned divestitures, we would expect to use those proceeds to pay down debt. At December 31, 2019, we had cash and cash equivalents of $42 million and debt of $358 million. Our net leverage totaled approximately 2.3x trailing 12-month adjusted EBITDA. ROIC was 9.9% for the second quarter fiscal year 2020. Since August 2018, we have invested $81 million in our Canpango, RPM and intY acquisitions that built strategic capabilities for recurring revenue, but have not yet contributed to our EBITDA growth.

Now turning to our forecast. We are providing our third quarter forecast, excluding the planned divestitures. For the third quarter fiscal year 2020, we expect GAAP net sales to range from $865 million to $915 million and non-GAAP net sales, excluding the planned divestitures to range from $725 million to $775 million. For the next 2 quarters, we are planning to see quarter-over-quarter net sales growth in line with our historical seasonal trends.

Historically, sales were down 10% quarter-over-quarter for the March quarter and up 10% quarter-over-quarter for the June quarter. For the full year -- fiscal year 2020, we expect annual sales growth of less than 1%.

For our third quarter forecast, we expect GAAP diluted earnings per share to range from $0.16 to $0.26 per share and non-GAAP diluted earnings per share to range from $0.44 to $0.54 per share. The GAAP EPS does not include any noncash charges from write-downs or losses associated with the planned divestitures as those cannot be reasonably estimated at this time. For the March quarter, we expect a gross profit close to 12% and a non-GAAP operating income margin below 3%. With the lower sales volume, we are not getting the SG&A leverage that we originally expected in our forecast for the year. For the fiscal year 2020, we expect our non-GAAP operating margin to be a little over 3%, in line with our expected sales volumes.

We are assuming approximately $3.3 million for interest expense in the third quarter, and we estimate the tax rate, excluding planned divestitures to be in the range of 25% to 26% for fiscal year 2020, excluding discrete items.

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

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

Thanks, Gerry. We are confident that completing our One ScanSource go-to-market transformation to drive recurring revenue growth is the right strategy for our business. After we complete this transformation, we expect to be able to deliver fiscal year 2021 results that reflect our strategy, including moving ROIC above 10%, and delivering double-digit non-GAAP earnings per share growth.

We will now open it up for questions.

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## QUESTIONS AND ANSWERS

**Operator**

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

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

This is Madison on for Adam. I wanted to start with some of the commentary around the North America sales reorganization and lost sales. Can you just talk about the timing and the impact for this? Are you expecting it to be a continued headwind throughout the rest of the fiscal year? And then are you seeing any customer attrition related to this? Or is it just the case in missed sales to those customers?

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

Madison, this is Mike. So as we said in our prepared remarks that we started this process in April. And as you heard on the call, we gave a little more color into all the different things we were doing since April, such as new Salesforce CRM system, different compensation plans, moving customers from one team to another. And what we learned was that, that was a lot of moving pieces, and we didn't see the impact of that until this past quarter from a negative perspective. Now that we know what happened, and in certain cases, we have customers that said, "Hey, I'm not happy with the new salesperson or sales team. I want somebody different, or I'm going to go away." We had to make some adjustments, as we said. And in some cases, customers, especially when we think about the customers that maybe are in -- that are not buying from us regularly -- they decided to go somewhere else for now. What we believe is, and it's implied in our forecast for Q3, and what we indicated about Q4 seasonality is that we believe we should experience and we're planning for a normal seasonal change from December. And that means, normally, we would go from December quarter to the March quarter and decline 10%. That's what we're forecasting. We then would say from March to June quarter, historically, we grow 10%. We're forecasting that, or we're suggesting today that, that would be what we are planning for. So we're planning to get through this and -- but yes, we've lost some customers. We believe we can get many of them back, but we know we have to make some changes quickly.

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

Okay. That's really helpful color. Just a follow-up here on cash flow, obviously, a bright spot here in the first half. I know you kind of -- you're sticking by the positive comments for the full year, but can you just help us level set expectations for the second half on cash flow? Do you expect that the second half looking at it from a stand-alone perspective is going to be positive as well? I just don't want to get ahead of ourselves from a modeling standpoint there?

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

No, Madison, this is Gerry. I think that's right. We should expect it to be positive for the second half as well. We -- obviously, we had some working capital come down, which was good. The volume coming down, which isn't a good thing, but it drives cash flow for us. So -- but we do expect -- in short answer to your question, we do expect the second half to be positive.

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**Operator**

Our next question comes from Keith Housum with Northcoast Research.

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

Mike, you're referring to these changes you made in the North American VARs, but you started that in April, what was -- what did it take so long for the ramification to be felt? Why did it take 3 quarters to really see the impact of that?

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

Sure. Well, part of what we decided to do was make sure that we made some adjustments as we saw some either deficiencies or gaps or things weren't working quite well. So we made some changes all along. And then what we learned was, in some cases, those changes weren't enough and a customer gave us the benefit of the doubt in the June quarter. They then in the September quarter, may have said, okay, if you guys don't get this fixed, whatever this is in their particular case, then we're going to go somewhere else. And when we gave our forecast back in November for the December quarter, we were looking at what we knew at that point in time. And we were looking at October's sales results, and they gave us confidence in November to still call the December number as we did. So we would say that in the -- from the middle of November to the end of December is when it really became obvious. It was not obvious that we had a big sales disconnect, a volume disconnect, until then.

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

Okay. And that disconnect probably continued into the first quarter, and that's why your guidance for next quarter is probably below our expectations?

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

Well, it's probably this, Keith, it's probably more like we took what happened in December, and we said in any other December quarter, it's always going to be down in the March quarter. So we're really looking at the December as the guide, not what did we do a year ago. It's what we did in December and let's forecast that it's going to be less than that because that's just historic. If we don't -- if we have the business we had in December, this is what we expect to do. Obviously, we'd like to do better. And if we win customers back ratably, it will do better on our forecast.

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

Okay. And you mentioned that you have more changes to make. What gives you confidence that the changes that you make is going to win back these customers?

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

Well, we obviously have talked to a lot of them, and we talk to our sales teams, and we believe that these are self-inflicted. And an example is, we just made some customers mad because we took their sales rep and maybe promoted their rep because they were really good to another team because we thought they could provide the company more value. And that disconnect with their rep is not something that you can easily replace. So it's going to take probably a visit by an executive if we value that customer, go sit down and talk to them and say, "Hey, we're going to put a new team in place. We can't bring Johnny back, but we got Sally and this team, and here's why they can help you better." So this is going to be more blocking and tackling. And what we did in the design, and we've tried not to disclose all the details for our -- for competitive reasons. But as an example, we now have a large group of account executives that we didn't have before prior to April. Account executives, essentially, are a field sales team. We didn't have that for these customers. So we believe the new structure will enable us to go have those conversations and win back the business.

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

Okay. If I can just squeeze one more in here. And I'm going to change gears on you. I know we're very early in the coronavirus, but obviously, we're hearing rumblings about supply chains and potential disruption. I guess, what are you hearing from vendors right now and perhaps customers in terms of how they're thinking about the supply chain impact for -- if this gets any worse?

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

Well, we sent a message out to our teams to give us an update. And based on what we've heard so far, there are some potential minimal disruptions, some of the vendors are saying, they don't have their workers returning to the factory following the New Year yet. That there might be a 1- or 2-week disruption is kind of what we're hearing. If we heard anything that was like no problem, it was 1 or 2 weeks, Keith, in a supply chain scenario.

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**Operator**

(Operator Instructions) Our next question comes from Chris McGinnis with Sidoti company.

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

I just wanted to ask a little bit around the cloud services you're offering, you talked about one of the headwinds being an investment by them -- by the VARs. Can you just maybe talk a little bit about what that investment is and how you're getting them over that hump?

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

Yes, sure, Chris. Thanks for the question. Yes, we created this Ignite team and put together a strategy and a blueprint and a playbook that we designed, so that our team would go, sit down with the VAR's principals, the CFO, and either the President, CFO/Owner and sit down and say, "Here's how this works. To add recurring revenue to a traditional hardware VAR means that you're going to have to invest in salespeople and selling processes that you won't get a return on for 3 years. That is the typical return by making an investment in recurring revenue. Once you get to 3 years, man you start printing money, but that's the financial investment. We walk them through that investment. And we try to help them minimize it and take some risk out, but that's what we mean by a financial investment. This is why it's not easy. Why it takes longer than everybody realizes, but once you get it going, it's a fantastic way to move your business from a hardware business that has a value to a recurring revenue and hardware business that has a much higher valuation, which gives the owners a better exit path one day. And that's our pitch. If you want to have a more valuable business, you must do this and we can help you.

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

Okay. And then just lastly, in terms of the guidance you provided for Q2 versus where you came in, I know, you said a lot of that was obviously the change in salesforce. But can you just maybe talk a little bit about the end-market demand with the communications? And just was there an escalation from the trends you're seeing from Q1 to Q2?

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

Sure. Yes. We -- so we would say for the missed last quarter, this quarter, about two-thirds was our own salesforce reorganization. And a third was continued decline from premise to cloud, and that did accelerate more than we had forecasted. So I would say, yes, there's definitely still a steeper curve happening than we had forecasted back in November. So we do believe, in this quarter, we also are forecasting that. And we're starting the -- as we model out the rest of the year from a planned investment, we clearly are making sure we're moving some of those investments where it makes sense, away from a premise-based strategy towards a cloud-based strategy. So we will be doing that reallocation of resources from the cloud -- to the cloud from the premise business.

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**Operator**

I am not showing any further questions at this time. I would now like to turn the call back over to Mike Baur for any closing remarks.

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**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 March 31 quarterly results on Monday, May 11, 2020.

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**Operator**

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