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SCSC.OQ - Q3 2022 Scansource Inc Earnings Call

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

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Christopher Paul McGinnis *Sidoti & Company, LLC - Special Situations Equity 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, Senior Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - SVP 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 President; and Steve Jones, our Chief Financial Officer.

We will be reviewing our operating results for the quarter and then take your questions. We posted an earnings infographic 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 earnings infographic 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, 2021, 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 earnings infographic and in our press release. These reconciliations can be found on our website and have been filed with our Form 8-K filed today.

I'll now turn the call over to Mike.

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

Thanks, Mary, and thanks, everyone, for joining us today. Our exceptional third quarter performance underscores the strength of our hybrid distribution strategy and outstanding execution by our people.

For the quarter, we delivered 16% net sales growth and record non-GAAP EPS for the quarter and for the trailing 12-month period. We had strong demand in our Specialty Technology Solutions and Modern Communications & Cloud segments. Excellent execution by our people drove our top line growth and profitability ahead of expectations.

We are raising our fiscal year '22 outlook and now expect net sales growth of at least 10% and adjusted EBITDA of at least \$165 million. Our hybrid distribution strategy is working, as evidenced by our sustainable, more profitable business model. We measure our success by looking at the gross profit composition from our recurring revenue that is from Intelisys and our SaaS and subscription business, and it's the fastest-growing part of our business.

6 years ago, we had no recurring revenue. We started our hybrid distribution journey with the acquisition of Intelisys in August 2016. Today, our recurring business is approximately 25% of our gross profits on a trailing 12-month basis. This is meaningful validation of our hybrid distribution strategy.

I will now turn the call over to John to discuss our business performance.

John Charles Eldh - ScanSource, Inc. - President

Thanks, Mike. I'm very excited about this quarter's results where demand was strong and execution by our people across the company was amazing. The unique relationship and collaboration between our customers, suppliers and our people led to the strong demand. We delivered impressive results with 16% year-over-year net sales growth and 21% year-over-year increase in gross profits.

Our sales growth was led by increases in large deals as suppliers prioritized allocation to VARs who are delivering to enterprise customers. One of our unique competitive advantages is providing partners with better intelligence about inventory availability.

I'm so incredibly proud of how our sales, supplier services and distribution center teams are performing and working together to serve our partners. As Mike said earlier, our hybrid distribution strategy is winning and driving the growth of our recurring revenue.

Let me give you a couple of examples of how VARs are adopting the strategy and selling hardware and recurring revenue. A communications VAR was working with an end user retailer that wanted to move from premise-based communications to cloud at its 2,200 locations. Our team provided engineering support and a modern communication solution, including hardware, software and cloud connectivity.

A second example is a mobility and barcoding VAR, who was implementing an outdoor video surveillance solution for a construction company at over 3,000 sites that needed connectivity to the cloud. This wireless surveillance solution included surveillance cameras, cellular SIM cards, connectivity and remote monitoring. These are 2 of many examples where our customers look to ScanSource and our hybrid capabilities to drive their recurring revenue growth.

In our Specialty Technology Solutions segment, net sales increased 15% year-over-year, fueled by robust demand for our hardware technologies, increases in big deals and product availability. A more favorable sales mix and increased supplier sales incentives drove higher segment gross profits.

For our Modern Communications & Cloud segment, net sales increased 17% year-over-year. Strong demand across hardware and digital benefited from product availability, and we also saw double-digit growth in Brazil. Cloud and Connectivity recurring revenue increased 18% year-over-year.

During the quarter, we held 97 partner regional and national events, many in person, showcasing our strategy and capabilities across hybrid solutions. Our events team delivered on unique event experiences for our partner and suppliers, including educational summits, trade shows, reward excursions and keynote spotlights.

I'm excited to see the execution and momentum of our hybrid distribution strategy. I want to thank all our people for their outstanding efforts and dedication. I'd also like to thank our suppliers and customers for their trust and loyalty in ScanSource. Now Steve will take you through our financial results.

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

Yes. Thanks, John. As Mike mentioned in his opening remarks, our exceptional financial results underscore the team's strong execution, deep relationships with our suppliers and customers and strong demand for our technologies. It was an outstanding quarter where we delivered strong top line growth and record profitability.

For the trailing 12-month period, our non-GAAP EPS was \$4.01 and our adjusted EBITDA totaled \$163 million. Both are company records and highlight our consistent strong financial performance. We achieved 18% adjusted ROIC for Q3 as we balanced our working capital investments to support our growth and meet future demand.

Q3 net sales of \$846 million, up 16% year-over-year reflects strong customer demand across our technologies and a modest benefit from supplier price increases. Additionally, Q3 benefited by approximately \$30 million of sales pulled forward from Q4 due to timing of product availability near the end of the quarter.

Intelisys net sales increased 18% year-over-year and includes the benefit of timing and supplier commissions. Our gross profit grew 21% year-over-year to \$107 million. Our Q3 margins increased to 12.6%, up from 12.1% in the prior year's quarter and includes a onetime benefit from supplier price increases of approximately 45 basis points.

Our non-GAAP SG&A expense for the quarter of \$66.5 million increased \$6.7 million or 11% year-over-year. This includes people and IT investments ahead of revenues, primarily in our Modern Communications & Cloud segment. Our Q3 results include approximately \$3 million of onetime SG&A expense benefits primarily due to a large bad debt recovery in the quarter.

Third quarter adjusted EBITDA totaled \$44.1 million, up 38% year-over-year, reflecting a 5.21% adjusted EBITDA margin, which includes the benefit of the onetime items we've discussed. For fiscal year 2022, we estimate the effective tax rate, excluding discrete items, to range from 25.5% to 26.5%.

Now turning to the balance sheet and cash flow. We generated operating cash of \$30 million for the quarter and \$16 million for the trailing 12 months. Year-over-year working capital, which includes accounts receivable and inventory, net of accounts payable, increased \$80 million or 18% year-over-year to support our sales growth. Q3 DSO of 69 days increased quarter-over-quarter and year-over-year. This increase is primarily driven by sales timing concentration at the end of the quarter, adding approximately 4 days to our reported DSO.

On March 31, 2022, we had cash and cash equivalents of \$44 million and debt of \$182 million. Our balance sheet remains very strong. From a net debt leverage perspective, we ended Q3 at approximately 0.8x trailing 12 months adjusted EBITDA, demonstrating financial flexibility to support our growth and create long-term value.

During the March quarter, we had approximately \$8.3 million in share repurchases under our \$100 million share repurchase authorization. As Mike noted in his opening remarks, we are raising our FY '22 net sales growth and adjusted EBITDA expectations and our updated guidance includes the benefits of the onetime items noted in the quarter. We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

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

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

Congrats on a nice quarter. I was wondering if you could just start -- maybe Steve, just -- what was the pull forward number in Q3 from Q4?

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

It's about \$30 million, Chris, and that really is just availability. The orders were -- when we looked at them, we were thinking that orders were going to ship in Q4, but because that supply came in late, we were able to meet those customer demands.

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

Great. And I guess this follows my next question is just were you at all impacted by supply chain disruption in the period? And I guess, how has availability changed throughout the quarter? If you could just maybe comment on that.

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

Yes. It's still a challenging supply chain environment, Chris. I think you hear that from our suppliers, and you probably hear that from our peers as well. For us, we were glad to get the inventory at the end of the quarter. Still strong demand and lead times are still way ahead of what we saw last year.

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

And just kind of given -- I mean, not looking at your trends today, but just to kind of fear in the marketplace around things slowing down. Any indication from any of your customer base or talking to the VARs or any concerns around that? It doesn't appear so, but just kind of getting your view on the overall market and demand.

John Charles Eldh - *ScanSource, Inc. - President*

Chris, this is John Eldh. Thanks for the question. And to date, I would say no. Demand is still strong. As you know, we play in large and growing markets specialized, and we think we're positioned to win and things like the trends of digital transformation, automation and employee productivity, work from anywhere, all these kind of things are -- have been and continue to drive our success.

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

Great. And maybe, John, could you just talk a little bit about the acceptance of the hybrid model? And I guess, just one by your customer base, do they feel more comfortable with it? And then additionally, can you just talk about the competitive landscape? Are people moving to a similar model? Can you just provide a little bit more color on that?

John Charles Eldh - *ScanSource, Inc. - President*

Yes. Thanks, Chris. It's a great question and something we love talking about. When it comes to the hybrid distribution model, really our strategy, as we've talked about many times before, is all about connecting devices to the cloud and enabling our partners to deliver on end-user buying and consumption requirements. And we're so excited. I mean our strategy really is offering partners choice while at the same time, reducing the complexity and friction in the buying process and shortening their time to value and revenue. And we're seeing great adoption of the strategy as evidenced by the examples that I gave, and we see great upside ahead.

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

Great. And then maybe just on the competitive landscape of that? Or did I miss that? Thanks.

John Charles Eldh - *ScanSource, Inc. - President*

Yes, thanks. Look, we -- as you know, we have different competitors in different parts of the business. But the reality is we have an amazing portfolio of the best suppliers, and we have a large and growing partner base. And based on these 2 things, they're really putting us in a kind of competitively advantageous position to deliver for our customers. And we don't see that slowing down.

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

Great. And if I didn't get to ask about this, I'd be upset. So can I just ask about the strength, the continued strength there. Is that just continued market share gains and I guess the digital as well as maybe the hardware there?

John Charles Eldh - *ScanSource, Inc. - President*

Yes. I mean this is another topic we love talking about is Brazil. I mean you're right. They continue to do a great job of executing. And as we've talked about in the past, we have an amazing leadership team down there and an amazing overall team that have a lot of maturity and a lot of experience and are using that to take share across the business.

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

Great. And then just a little bit of share repurchase in the quarter. Can you just comment on if you're still in the marketplace or what your thoughts are with capital allocation? Thanks.

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

Yes, Chris, I'm going to build on the back of what John said, and really our theme is growth. When we think about what we're going to use from a capital -- our capital deployment. If you look at what we've done in a working capital, it's just been an amazing year of building that working capital, and we think there's lots of opportunity out there to grow and that will be our priority. And then our priorities don't change. So it would still be growth making sure that our balance sheet is strong and then returning any capital through share repurchases.

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

Great. And I guess, Steve, on that, you have -- I think you said 45 basis points from price increases and using that balance sheet. Do you still have that benefit in Q4? Or is that kind of dissipated now?

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

Those price actions are really kind of temporary for us, and so we're not seeing those come back in Q4. When we think about that 45 basis points, I would say that would be normalized out. We need to normalize that out as we think of our forward-looking guidance.

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

Sure. No, 100%. I appreciate it. That's all I had, but thanks for taking my questions and congrats on a really strong quarter.

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

Thanks, Chris.

Operator

I'm showing no further questions at this time. I would now like to turn the conference back to Steve Jones.

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

Yes. Thank you for joining us today. We know today is a very busy earnings release day, and some of our sell-side analysts had some conflicts and weren't able to join us live. But we would be happy to follow up with any questions that you might have. We expect to hold our next conference call to discuss June 30 quarterly and full fiscal year results on Tuesday, August 23, 2022.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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