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SCSC.OQ - Q3 2024 Scansource Inc Earnings Call

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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 now disconnect. I would like to turn the call over to Mary Gentry, Senior Vice President, Treasurer, Investor Relations. Ma'am, you may begin.

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

Good morning and thank you for joining us. Our call will include prepared remarks from Mike Baur, our Chair and CEO; and Steve Jones, our Chief Financial Officer. Tony Sorrentino, our President for Specialty Technology, is also joining us. We will review our operating results for the quarter and then take your questions. We've posted an earnings infographic that accompanies our comments and webcast in the Investor Relations section of our website.

As you know, certain statements in our press release, infographic and on this call are forward-looking statements and subject to risks and uncertainties that could cause actual results to differ materially from expectations. These risks and uncertainties include the factors identified in our earnings release and in our Form 10-K for the year ended June 30, 2023. Forward-looking statements represent our views only as of today and ScanSource disclaims any duty to update these statements, except as required by law. During our call, we will discuss both GAAP and non-GAAP results and have provided reconciliations on our website and in our Form 8-K.

I'll now turn the call over to Mike.

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

Thanks, Mary. Thanks, everyone, for joining us today. In the third quarter, our people responded well in a challenging demand environment. However, we were surprised at our lower-than-expected net sales for our hardware business. Third quarter net sales declined 15% due to lower demand from our channel partners across our portfolio of technologies. Our strong margins and robust free cash flow reflect the strength of our business fundamentals.

We operate in highly specialized technology markets with value-added profit margins because of our expertise. ScanSource benefits from this deep knowledge of our sales and supplier services teams, specific value-added tools and working capital investment that is countercyclical with sales volumes. With our hybrid distribution strategy, we are committed to helping our channel partners execute on the expanded opportunity to sell devices and recurring revenues.

For our fiscal year 2024, we identified strong free cash flow and focus on Intelisys as important to management and our shareholders. Again, this quarter, we achieved this aim with free cash flow of $158 million and Intelisys growth of 4% year-over-year. Q3 end user billings for Intelisys increased 7% year-over-year and totaled $2.68 billion annualized. This includes billings growth in Contact Center as a Service, or CCaaS, of 33% growth and UCaaS of 11%. We are expanding our investments in talent, training and tools to increase our value and drive growth as a technology services distributor.

As reported by many channel companies and suppliers, we are experiencing softer demand. Our sales partners tell us that they are seeing a more cautious IT spending environment from end customers accompanied by longer sales cycles. For our third quarter, we expected broad-based declines across our hardware technologies. What surprised us, and what caused our revenue shortfall against our plan, was the significant decline in revenue from our networking products across the board, including Cisco networking.

Our hardware portfolio is comprised of a diverse set of business-critical technologies. Right now, they are at different stages of their end customer demand cycles following the last 2 years of supply chain and pandemic disruption. We believe we are on a path to return to growth and have confidence in our team's ability to navigate the demand cycles with the support of our channel partners. In the near term, we see both macro uncertainty and the continuing normalization of supply and demand, creating a challenging forecasting environment.

We generated another quarter of strong free cash flow and have a disciplined capital allocation plan of share repurchases and M&A. Our preferred use of free cash flow is to fund growth of high margin, recurring revenue businesses that are working capital light.

I'll now turn the call over to Steve to take you through our financial results for the quarter and our outlook for fiscal year 2024.

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

Yes. Thanks, Mike. Q3 demand was weaker than we expected. While sales were lower, our business delivered strong gross profit and adjusted EBITDA margins. Free cash flow exceeded our projections for the quarter. Q3 net sales of $753 million declined 15% year-over-year, while our gross profit margin of 12.6% is higher than we expected, benefiting from a higher mix of recurring revenues.

We expected softer demand across technologies in our Specialty Technology Solutions segment. For our networking business, we saw sharper declines than we anticipated. Segment net sales declined 14% year-over-year and our gross profits declined 22% year-over-year as we're seeing lower benefits from supplier price increases as compared to last year.

In our Modern Communications & Cloud segment, revenues declined 16% year-over-year. Cisco networking sales declined as big deals stalled and demand adjusted for supply chain normalizing. Intelisys revenues grew 4% year-over-year. And our gross profit margins in Modern Communications & Cloud segment declined only 9% year-over-year, reflecting a favorable mix, including higher concentrations of recurring revenues from our Intelisys growth.

For the quarter, we delivered $158 million in free cash flow. This reflects lower working capital needed when sales declined and our focus on balancing lasting improvements in our working capital efficiency, without sacrificing profitable growth opportunities.

As we look to close our fiscal year, the company expects the challenging demand environment to continue, and we are updating our guidance to reflect our current views of near-term demand. As a reminder, we have very little backlog to give us indication of demand as we ship each day from our inventories based on orders received that day.

We are managing our SG&A spending to match our revenue expectations for FY '24 and beyond by redirecting resources and investing in our Intelisys recurring revenue business.

We continually review our resource investments. In January, we executed a workforce reduction plan to align our resources with our strategic plans. Q3 GAAP results include restructuring expenses related to employee separation and benefit expenses of $3.9 million. These actions are expected to result in annualized expense savings of approximately $10 million.

For FY '24, we now believe that our net sales will be at least $3.3 billion, and our adjusted EBITDA will be at least $140 million, which reflects an EBITDA margin of approximately 4.25%. We are increasing our free cash flow outlook to at least $275 million. Our guidance reflects our expectations of the near-term demand environment. We remain confident in our growth opportunities, the resilience of our business model and the strength of our hybrid distribution strategy.

Now going a bit deeper into the balance sheet and cash flows. We are pleased with the progress that we're making with working capital improvement plans. Our goal is to improve our working capital efficiency while maintaining appropriate inventory levels to meet channel partner demand. Q3 inventory turns of 4.8x were negatively impacted by the shortfall in revenue. Inventory levels have decreased $224 million and our paid for inventory days improved to 11.2. Days sales outstanding, DSO, of 71 days is a slight increase quarter-over-quarter, reflecting sales timing at the end of the quarter.

Our balance sheet is very strong. We ended Q3 with $159 million in cash and net debt leverage ratio below 0 on a trailing 12-month adjusted EBITDA basis. Our capital allocation plans balance acquisitions and share repurchases, while maintaining a strong balance sheet with modest levels of leverage.

For Q3, share repurchases totaled $20 million. Today, we announced a new share repurchase authorization of $100 million. This is in addition to the $45 million of current authorization remaining as of the March quarter end. Our new repurchase program authorized by our Board of Directors reflects our confidence in ScanSource's business and the strength of our long-term free cash flow generation.

I'll now turn the call back over to Mike.

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

Recently, after much research and market analysis, we identified several key trends affecting the future growth opportunities in our Intelisys business. Since ScanSource acquired Intelisys in 2016, the competitive landscape for our distribution business has been changing. During this time, consolidation reduced the number of TSD competitors from 16 down to 5 today. As we have discussed, we have experienced margin pressure in our Intelisys business, which lowers our Intelisys revenue growth results. However, even with the consolidation, Intelisys remains the largest technology services distributor in the business.

During the last 24 months, we've also seen increasing consolidation in our agency partners. This activity also pressures margins. We haven't seen these agency roll-ups deliver innovation or new offerings to drive increased end customer demand. In addition, our TSD competitors have introduced various offers to acquire books of business and contracts from agencies. And in some cases, they acquired the agency itself. It is this last development that has convinced us to introduce our own offer to acquire contracts and agencies.

Our partners have asked us repeatedly if we were interested in providing this value proposition to them. This offer would give our channel partners a way to take a few chips off the table or exit their business completely as the last stage in the agency business life cycle. So we announced that ScanSource would create a new business entity, separate from Intelisys, to be a platform for the channel model of the future. We are evaluating opportunities to acquire an existing agency that has a strong leadership team and fits with the ScanSource culture.

Second, we are evaluating opportunities to acquire the digital tools our channel partners need to manage supplier and end user contracts. These contract management tools and other best practices we would develop in the new entity will be shared with the Intelisys channel. We expect to have more to share about our investments in the agency channel expansion soon. We look forward to launching the channel model of the future to help all our partners grow their businesses faster and better.

We'll now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Greg Burns with Sidoti.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

In terms of the declines you saw in networking and from Cisco this quarter, I think Cisco has talked about a couple of quarters of backlog of inventory at their customers that still needs to be deployed. Do you have a view on that? How long do you see this hangover lasting on the networking side of the business?

Tony Sorrentino - *ScanSource, Inc. - President of North America Hardware Business*

Greg, this is Tony Sorrentino. There's a lot of uncertainty around when this backlog gets worked through. It's a combination of softer demand and working through that backlog. So I don't know that we have a definitive answer on that.

Gregory John Burns - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Okay. And then in terms of this new agency initiative on the -- for Intelisys, is there any risk of, I don't know, just how maybe the industry works, but is there a risk of channel conflict? Any channel conflict there bringing an agency in-house versus servicing your broader agency partners? And what does that do for the margins for the overall Intelisys business?

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

Greg, it's Mike. I'll tackle that one. We absolutely are aware of the potential for channel conflict and actually, we've been doing some surveys of our channel partners just to understand: How are our competitors doing this? Because we have learned that our competitors all are doing something like this in different models in different flavors. And we've asked that question, hey, are you concerned? And as it turns out, many of our partners are still working with those distributors that have also created a somewhat competitive model.

So we looked at what others are doing. We believe we're creating something that has the right amount of separation. We're going to separate this NewCo, this new entity from Intelisys, so it will report to ScanSource not through Intelisys. We'll have a separate management team. Our goal is to firewall off any data between Intelisys partners and this new agency. And we've shared the idea with our partners before because we acquired a product called RPM that some of our investors remember back 2017 or '18, which is -- which became an industry standard commissioning tool that almost all of our competitors have used.

And at the time, I met with each of our competitors and said, we'll firewall off the data, so Intelisys won't see your agency's data. And we've been successfully able to do that for many years. So we've got a track record of separating out the data, that would be the conflict.

But we've also gone further. We said that we will make sure that before this new agency brings on a new -- we call it, a new logo, but let's say, a new end customer that they want to sell to, they'll first check within the ScanSource structure, and we'll have someone at the top who will look at the data and say, have we ever had -- or do we have a current Intelisys partners selling into that end customer? And if we see that we do, we'll immediately notify this Intelisys partner and let them know, hey, your customer is looking for a solution. Have you talked to him lately?

And so we're going to do everything we know how to do to inform our partners first before we try to go in. So our primary goal here is to get a management team, learn how an agency can work in the future and do some things, frankly, that we don't see being done today in the channel. And then I'll let Steve maybe talk about the second part of that question, which is more about how does this affect margins.

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

Yes. Thanks, Mike. Greg, this is Steve Jones. When we look at the margin opportunity, what's happened in our space is margins have really started to get compressed on the Intelisys side as the agent is taking more of the margin share. So we think for ScanSource, this will help expand our margin opportunity in this agency channel. So that's the way we're looking at it. That's the way we're modeling it.

Operator

(Operator Instructions) Our next question comes from Keith Housum with Northcoast Research.

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

Just obviously, want to continue the line of questioning here on the agency initiative. Mike, can you just give me a little perspective about today, like what is the makeup of the agency market? Are we primarily talking people, like 1 or 2 people and small million-dollar shops? Are we talking an end market that today does tens of millions of dollars of large shops? What kind of market are you guys getting into?

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

Yes, Keith. Just as a reminder for everybody, we today have about, I'll just say, about 4,000 Intelisys partners doing business with us, and we have it widely distributed. And I would say the typical partner has 10 employees or less. And remember, their primary function as an agency is selling. They do have technical resources, but they have virtually no back office. Most of these agencies run off of QuickBooks, just to be honest, even the larger one.

We process all the commissions, and the end users are billed by the suppliers. And so they don't really have to have a back office of any significance. So they're really sales organizations, and that's really what an agency does is they go out and work with end customers on opportunities for new.

Where we think we see an opportunity, though, to help the existing partners is with renewals. One of the challenges is most agencies don't have an efficient way to scale over time renewals of contracts, as technologies change, they need to be renewed with new technologies, and as just contracts expire. So we think that's one of the advantages we can build.

If we can build this contract management tool set that goes along with people, we believe we can show the rest of the Intelisys partners how to scale and how to use, frankly, some of our resources to work their installed base so that they have less churn. So this is one of the challenges with the typical agency is they don't have a lot of infrastructure to manage renewals.

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

Okay. I appreciate that. And Steve, explain a little bit more on the margin question about agencies. I guess, I'm just looking for like a margin profile. I mean we know Intelisys has great gross margins. And before the competitive advantage, I mean, I think your EBITDA margins were north of 30% or 35%. Obviously, that's changed quite a bit in the past several years. But how do we think about like an agency's profile? Is it also going to be more -- gross profit's going to be revenue? And then what type of EBITDA margins, I guess, could your average agency experience?

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

Yes, Keith, thanks. So let me maybe start back at the beginning, as you think through this. So you talked about the Intelisys EBITDA margins being kind of in the 40% when we acquired, that's not really eroded much for us until recently as those margins started getting pressure and that margin started shifting to the agent as we were having to give up more of a split to them in terms of the commission structure. So there's margin setting in the agent that used to be in the TSD that we want to go participate back in.

And then when you look at their margins, again, we're probably looking at this as an agent kind of commission. So it's going to be 100% gross margins from a reported perspective. But as you know, Keith, when we look at our business, that has a problem with our top line growth, right? Because it just doesn't grow as fast, or it doesn't materially impact our $3.5 billion kind of top line number as much.

So we've got to do a good job of really unpacking how this -- how the economics of this are going to work. But we expect this will be margin accretive to our overall company, and that's why it's interesting to us.

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

Okay. If I think about like the barcoding space, where you got a generation of VARs that are kind of retiring out, do you have the same thing in the agency space where they've been around for long enough that you've got owners that are in that 50- to 60-year-old groups that are looking to get out? Or is this a relatively younger, I guess, makeup of owners today?

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

Yes, Keith, it's Mike again. Exactly right analysis. So the reason that these roll-ups have been happening, there have been investors, let's call them all pretty much private equity investors that have come in and acquired agencies or acquired just their contracts because many of those agency leaders are -- frankly, they're at the end of their cycle. They're ready to exit. And they've asked us for the last few years. And we actually said for the last 2 years, no, we will not do that. It's not in our DNA to sell to the end user and own an agency.

So this is a big change for us. And -- but the agency owners, they're actually very interested. And we were nervous about just even talking about it, but it became obvious to us that part of the reason we're getting pressure on our margins from our competitors is because they're already doing this. They're already benefiting from that, and it's because the agents, once they know that there is a buyer out there like, hey, pick me, pick me. And some of them are saying, we don't want to sell the whole business. But as I said in my prepared remarks, they want to take some chips off the table.

And unlike the VAR business, you can't easily buy just a part of a VAR business. You can't just buy because it's not recurring. It's deal by deal. Here, these are contracts that we will have a defined term with, defined amount of profitability, and we'll be able to pretty straightforward, make an offer to just buy, let's say, $1 million annualized of recurring revenue from a partner, and they don't have to sell the whole business. And so that has gotten a lot of interest in the market. So again, we're responding to what the market is doing.

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

And you've announced this several months ago at one of your conferences, and you've had these conversations. So I'm assuming that your M&A strategy is you want to buy a more established agency with some digital tools maybe -- to use your words, an established and good management team. Is it safe to say that you're having these conversations now? And I guess if you're not, is the option to go organically and to build it yourself?

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

For us, we've talked about acquisitions because we want to go faster than we have been, meaning we're catching up. And again, listening to our competitors who have all come out publicly and dodged the question, frankly, of are they doing this, they've already started. We're catching up. So we will absolutely want to do it through acquisition. But then we will grow it with the balance sheet that we have. That means adding headcount, people, tools, and we believe then we can become the player of interest.

And what I mean by that is we're not looking to make this agency the largest. It could happen. That's not our goal. Our goal is to create the best agency so that this has the best practices, the best programs so that we can still recruit new and, frankly, younger partners in the Intelisys channel who want to maybe do something with their business 10 years from now or 5 years from now. And so we're trying to create, as I said in my opening remarks, a different model. So we're calling it the channel model of the future, where you can come to your distributor and take some chips off the table or potentially sell the whole business.

And again, these are, again, relatively, and maybe the point would be, these are all small businesses. These are not the size of Intelisys was. Now having said that, some of them have already been rolled up. Those entities have gotten large. One of our partners today has already rolled up about 30 agencies. And so they've acquired significant EBITDA by rolling them up.

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

Got it. And I appreciate that you're not going to let time dictate your schedule here. But do you have a goal in your mind about when you want to be able to have an agency under your roof and be running with the strategy?

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

Yes. I think I said earlier, we expect to have more to share about our investments -- and channel expansion soon.

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

All right. I appreciate that. I'm going to change gears on you here and just talking about more traditional business, the hardware business. Some of your larger barcoding partners have expressed some optimism for an improvement in the second half of the calendar year. I'm not sure I'm hearing that from your conversation here today. And I appreciate the fact that your backlog is 1 day, 2 days, it's very short. But are you hearing any constructive conversations that would give you optimism for the second half of the calendar year?

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

Yes. Let me have -- I'm going to have Tony comment on that because he can talk about we have different technology, not all of those suppliers have been public. And so maybe Tony can just kind of give you a little summary of where we are.

Tony Sorrentino - *ScanSource, Inc. - President of North America Hardware Business*

Yes, Keith. It's Tony. So there's certainly still a lot of uncertainty in the near term. But I would say we're seeing green shoots of opportunity for growth in our physical security, barcode and mobility businesses for sure. That said, there's some optimism there, but there's also a lot of concern as well. So I've spent a lot of time with our top customers over the past month and they're cautiously optimistic, but certainly, all the uncertainty in the macro environment is creating concern for them.

Operator

(Operator Instructions) Our next question comes from Mike Latimore with NCM.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

It looks like another good quarter of CCaaS and UCaaS billings growth. I guess, can you just talk a little bit about the sales cycles you're seeing there? Has there been any change in sales cycles for either one or both those categories?

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

Mike, it's Mike Baur. No real change in that, but what I would say is we're doing a lot of educational seminars around the country, as you probably know. And no surprise, the big story is about how is AI going to affect our business, and the place that everyone is wanting to hear about is AI and contact center. So we're getting a lot of traction with interest. We're going to see how that affects really results, but the contact center story and the contact center space remains very attractive to our agents. They want to learn more.

We're having -- again, we're having tremendous attention and attendance at these events. And we're continuing to make sure we're building our team out, so that we learn more about how contact center is probably the best example can utilize AI to drive future revenues.

But I think, again, the idea is we see a longer sales cycle when this technology change happens, for sure, because now there might be some hesitation of do I buy what's available today? Or do I wait another 6 months or 12 months? And so I wouldn't be surprised to see some of the transactions slow down. But as we just reported, it was still a very strong growth with our partners. And that's the beauty of this Intelisys recurring revenue model is we're building off of that base every quarter and that's why we're very attracted to this space.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Yes. Yes. How about the pipeline? Any comment on just pipeline growth in UCaaS and CCaaS?

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

Well, we don't typically give out the pipelines. But again, if I just think about the overall opportunity, and that's one reason that we are excited about this new entity and being closer to the end user, Mike, is we believe we'll benefit from understanding better what the end users are thinking about relative to CCaaS and UCaaS and I think that will help inform us for some of our decisions about the future.

And what I hope will happen is we're going to develop some best practices to help our Intelisys channel close business actually faster. And that will be one of our goals with some of the tools.

Michael James Latimore - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Great. And just lastly, you talked about some pricing pressure perhaps related to consolidation in the industry. I guess, can you talk about pricing at the end user? Are you seeing pricing pressure for the software vendors themselves and what kind of their charging in the UCaaS, CCaaS market?

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

In general, I would say there is absolutely pressure on the seat prices continuing to go down. Significant pressure there. Agents have to decide -- and let's just go back to the obvious, a couple of years ago, UCaaS was growing at the rate CCaaS is growing now. So we can see that the unit price, the seat price going down, makes it harder to grow off the base.

And I think that's critically important because the channel needs to know how are they going to sell more in the future. They have to sell more seats for the same amount of revenue that they got 2 years ago. So definitely pressure on the seats, more on the UCaaS today, but CCaaS is also seeing that pressure at the end user.

Operator

(Operator Instructions) At this time, seeing no further questions, I'd now like to turn it back over to Steve Jones for closing remarks.

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

Well, thank you for joining us today. We expect to hold our next conference call to discuss June 30 quarterly and full fiscal year results on Tuesday, August 27th at approximately 10:30 a.m.

Operator

Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.