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TESS - Q3 2017 TESSCO Technologies Inc Earnings Call

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## CORPORATE PARTICIPANTS

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## CONFERENCE CALL PARTICIPANTS

**Bill Dezellem** *Tieton Capital - Analyst*

## PRESENTATION

### Operator

Good day ladies and gentlemen, and welcome to the TESSCO Technologies Third Quarter 2017 Financial Results Conference Call. (Operator Instructions). Now I would like to turn the conference call over to David Calusdian of Sharon Merrill Associates. Please go ahead.

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**David Calusdian** - *Sharon Merrill Associates - IR*

Good morning, everyone, and thank you for joining TESSCO's Q3 conference call. Joining me today are Murray Wright, TESSCO's President and Chief Executive Officer; and Aric Spitulnik, the Chief Financial Officer.

Please note that management's discussions today will contain forward-looking statements about anticipated results and future prospects. Forward-looking statements involve a number of risks and uncertainties, and TESSCO's results may differ materially from those discussed today. Information concerning factors that may cause such a difference can be found in TESSCO's public disclosures, including the company's most recent Form 10-K and other periodic reports filed with the Securities and Exchange Commission.

With that introduction, I'd like to turn the call over to Murray Wright, TESSCO's President and CEO. Murray?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Thank you, David. And good morning everyone. Thank you for joining us. After four months at TESSCO, I'm optimistic about the position we hold in our markets and our potential to grow revenues and earnings at a faster rate. Most of our markets are forecasting solid growth during the next several years and we all expect TESSCO to capitalize on that growth opportunity. Question of course is how do we do that. As we seek to drive sustainable growth in revenue and earnings we are recalibrating our go to market strategies of looking to rebalance resources to acquire new customers and to gain greater market share with our current customers.

Our focus is on becoming more aggressive in various markets while the developing a more efficient and effective business model to support our efforts. To carry out this mission, we're prioritizing four areas, enhancing our e-commerce and electronic tools, optimizing our go to market strategy, improving our product and vendor management effectiveness and increasing our margins and operating leverage through diligent expense management.

First, we are continuing to invest in our e-commerce capabilities and our electronic tools. As you know from our re-launch of tessco.com, our website is a vital tool in interacting with both new and existing customers. It is imperative that we keep e-commerce and productivity tools at the leading edge of our industry. Although we will continue to allocate the resources necessary to make sure this is the case, we do not expect next year's CapEx to be materially different from our current run rate.



Second, the sales organization is the engine that drives our success. One of my first tasks was to conduct a search for an experienced, dynamic person to lead our sales team. I was delighted in December to appoint Pete Peterson to the position of Senior Vice President of Sales. Pete brings the diversified set of executive leadership skills and discipline to TESSCO. He was previously Vice President of Global Channels, a leading data storage and networking company and a Senior Vice President of both sales and advanced infrastructure solution at Tech Data Corporation where he and I also worked together.

Pete has the skills and leadership to make a difference at TESSCO. He has already begun addressing our go to market strategies creating a more performance oriented sales team and working with other company leaders to streamline our sales processes. He is bringing a fresh perspective and outstanding leadership to our sales organization.

Third, we are striving to ensure TESSCO is a sales centric and customer oriented organization, and to that end this month we named Charles Kriete as our Senior Vice President, Product Management and Solutions. Charles will be responsible for vendor-partner relationships and developing new go to market product and service solutions. His experienced in the Internet of Things and the mobility market will enable us to create more opportunities with our customers and we'll enhance TESSCO's value proposition. Since I came aboard, we have talked about accelerating our growth and we expect Charles's aggressive entrepreneurial spirit and leadership to help drive that acceleration.

And finally we understand our window to implement change is not open ended. We are currently reviewing our cost structure and building a plan to improve sales, enhance productivity and profitability. We expect to have new initiatives in place this quarter to hit the ground running as we begin our 2018 fiscal year in April. We'll share highlights of our progress that we're making on these actions in upcoming quarters.

Now turning to the third quarter performance. We made progress on the top line, achieving both year-over-year and sequence the revenue growth in the same quarter for the first time in more than four years. We were successful in winning orders from key large customers which helped contribute to our growth and gives us optimism about continuing that success. We have instilled more customer focus across the company and we are holding people more accountable for their performance.

We are also keenly aware of the sales as a team effort and we are building deeper collaboration among sales, product management, supply chain, logistics, marketing and finance to construct a faster better customer experience. We believe this is having a positive effect in these early days.

Aric will go into more detail on each of our markets but I want to give you a brief update on what we are seeing in the carrier space. As you know we've been transforming our approach to the carrier market, and based on our recent sales efforts carrier revenues increased by double digits both sequence and compared to the third quarter last year. Revenues from the public carrier market grew 16% from the third quarter a year ago, the first year over year growth in this market in seven quarters. We have also seen a nice lift in carrier revenues in January over the last year -- over last year. And it may be too early to declare this as a trend, but it's certainly good to see this growth.

During the past several months our Tier 1 carrier customers have been working aggressively to cut costs while still maintaining control of their supply chain and procurement and increasing their speed to market. This practice by the carriers can create great opportunities for TESSCO, as we help them serve their customers better by providing a complete solution, leveraging our program management, supply chain, product and logistics expertise.

Utilizing TESSCO enables the carriers to become more efficient with the planning and purchasing of material and the management of the general contractors. It also helps them achieve closer to just in time inventory position improving their inventory turns while maintaining tight deployment schedules. So far we're pleased with these developments.

Looking ahead to our fiscal fourth quarter which historically is our most challenging quarter, we expect modest improvement in revenues from the fourth quarter of last year and better year-over-year bottom line results.

Going forward we are excited about our opportunities to improve productivity and increase operating margins while delivering an enhanced customer experience in fiscal 2017. We are focused on becoming more aggressive and developing a more efficient business model to support our



efforts. TESSCO already is in a terrific position to capitalize on the growth of the wireless industry and the Internet of Things during the next several years. We are focused on accelerating our progress and we look forward to sharing examples of our success in coming quarters.

Now I'll turn the call over to Aric to discuss results in more detail. Aric?

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**Aric Spitulnik** - *TESSCO Technologies Incorporated - CFO*

Thank you, Murray. And good morning everyone. I'm going to provide comments on the overall performance in some detail about what drove the results for each market. In the third quarter, revenues were \$147 million up from \$135 million in the second quarter and \$140 million in the third quarter a year ago. We saw increased revenues across several different markets as we were successful in winning significant orders from a number of key customers.

Gross margin was 20.4% of revenue compared with 21.4% during the second quarter and 21.1% a year ago. The decline in gross margin was due to a product in customer mix change and not a result of a change in our pricing strategy. SG&A expense increased \$1.2 million from the second quarter and \$3.2 million from a year ago. While we have been winning business in a retail market, our costs have been impacted by a significant increase in retail orders that have driven higher freights, marketing and operations costs.

These orders are generally smaller and are more costly to process and ship than those in the other markets. As a percentage of sales, SG&A was 18.9% compared with 19.8% of sales in the sequential second quarter and 17.7% of sales in the third quarter a year ago. As a result of these higher expenses operating income was \$2.1 million compared with \$2 million in the second quarter and \$4.7 million a year ago.

As we said we were formulating a plan to improve operating margins and we expect to have an update on that during our fourth quarter call. Net income for the third quarter was \$1.2 million or 15 cent per share, compared with 1 million, or 12 cents per share in the second quarter and \$2.9 million or 35 cents per share in the third quarter a year ago.

Now turning to the markets. The public carrier market which includes not only the large Tier 1 carriers but also the contractors, integrators, program managers and tower owners that support these carriers improved significantly both sequentially and from a year ago. This increase was primarily due to orders from significant tower owner and program manager customers. Gross profit also improved by double digits from both periods as a result of the increase in sales.

These large customers tend to earn better pricing and therefore we saw a decline in gross margins this quarter. In the government market, sales and gross profit declined sequentially and from a year ago we saw many large federal projects pushed out as customers waited for the new presidential administration and the new budget to be in place.

We expect some of the activity originally scheduled for Q1 to shift into the current fourth quarter. We continue to drive more opportunities in this quarter based on the investments we've made in talent during past few years and we're optimistic about our potential in coming quarters. In the commercial dealer and reseller of our borrower market, revenue and gross profit were down sequentially in from a year ago.

For us this market is currently heavily dependent on sales to two way radio dealers. These sales have declined steadily throughout fiscal 2017 as customers move away from two way solutions. To mitigate this impact, we are enabling our two way radio VARs to expand their offerings to include public safety DAS. At the same time we've seen improved gross margins in this market as we have been proactively selling more Ventev products and solutions.

In the private system operator market, revenues and gross profits increased double digits both sequentially and year over year. As expected, we saw a pickup in sales from the large repair center customer that purchases higher margin Ventev products. Our value proposition has also been well received in this market specifically with utility customers where we achieve strong results this quarter.

Turning to the retail market, sales were up by high single digits sequentially in mid-single digits year-over-year. The retail channel continues to be a strong business for us and this was evident again this quarter. Most of our customers in this market -- many of our customers in this market have

been consolidated in recent years, leaving a smaller number of larger dealers. This consolidation as well as changes in product mix has resulted in the gross margin decline this year.

While still profitable in total, our retail market profitability has also been impacted by the operations issues I discussed earlier. Ventev sales, which includes both mobile device accessories and infrastructure offerings totaled 15% of overall revenues during the quarter, as both sides of Ventev were very strong. The increase on the accessories side of the business was partially driven by the repair center customer I mentioned earlier, but also by continued strong demand for the high quality power products Ventev offers for a variety of wireless devices.

Their growth inventive infrastructure sales was primarily driven by the Ventev Wifi business which saw strong enterprise customer growth through its VAR channels as we implemented some unique customer solutions. We're also seeing continued success in the private system operator market, which is further validation that our Ventev product and solution offerings are making a difference.

Looking at the balance sheet inventory declined by about \$9 million from the sequential second quarter as we sold through mobile device accessory product during the iPhone 7 launch and retail holiday shopping season. The Samsung Note 7 recall created significant challenges including difficulties for many manufacturers and customers, who had sold their purchased accessories for their new device. We worked diligently with Samsung, our manufacturing partners and our customers to ensure a quick resolution to the situation and successfully resolved all accessory products and inventory relating to the recall with minimal cost TESSCO.

Cash flow from operations was \$1000 during the third quarter and \$600,000 for the first nine months. Overall cash on the balance sheet was \$8.4 million. We really remain committed to our dividend program and have set our dividend of 20 cents per share with a record date of February 15th, and a payment date of March 1.

For the fourth quarter, we expect both revenues and bottom line performance to improve from fourth quarter of fiscal 2016. However the fourth quarter is seasonally almost challenging, and we anticipate results will be lower than in the sequential third quarter. We are very optimistic about TESSCO's future. We remain confident in our ability to grow revenues in the coming quarters and to execute on our plan to improve operating leverage and earnings performance. We look forward to sharing our success with you in the coming quarters.

With that operator we will open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Our first question comes from Anil Doradla with William Blair. Your line is now open.

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### Unidentified Participant

Hi Aric and Murray, this is [Joe Hotas] in for Anil. So welcome to TESSCO to Pete and Charles, that's exciting news. It will be good to see what the sales organization can do with the new SVP. Murray, we talked a little bit last quarter but I think you had just joined so it's maybe a little too early, but can you just give us a sense of what the main takeaways you had are in your first four months and what you think the biggest things to focus on, maybe anything incremental to what you said in your opening remarks?

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### Murray Wright - TESSCO Technologies Incorporated - President, CEO

Well thanks, [Joe]. I think - you mentioned adding Pete and Charles to the team has been a significant addition, both are very experienced and have different skill sets and I'm confident that they will both make an impact. So you know they're clearly in the assessment stages, I'm not that far ahead of them on the business.



But I mean overall, we think there is just some tremendous opportunities for us on the go to market piece and whether that's verticalization, sales force -- how we structure the sales force, compensation, making sure we're aligned with our manufacturer, vendor partners, looking for the vertical market opportunities. Those are initiatives that are pretty detailed and we're working on an elaborate go to market strategy to encompass all of those factors. I think it will have a big impact on the business. It'll take some time to get the momentum going, but you know that's what my assessment would be in these early days.

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**Unidentified Participant**

Great and I guess we'll have to wait until next quarter to hear the details of the plan, but I guess can you kind of talk about what you'll be focusing on or do you not even know to that kind of detail, meaning it's just going to be cutting SG&A on a nominal basis, working on gross profit, getting back to top line growth or is it all kind of mixing together. And I guess any detail you have and what steps are you'll be taking to get full profitability?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

I would yes to all of that, I think it's a pretty comprehensive. We're looking for improvements across the business. And the way I'd like to look at it is, how do we improve productivity in our business, improve the customer experience and still allow us to grow and improve our financials. And we think that we have that responsibility to our shareholders and it's going to take us some time to put the puzzle pieces together, I'm very -- but I feel pretty confident and feel pretty good about the talent that we've added to the team. And I'd also add the responsiveness of the TESSCO organization as well has been excellent.

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**Unidentified Participant**

Great. Aric, can you give any more detail on the SG&A uptick? I know you talked about some factors and that, but can you quantify the Samsung Note 7 impact and then should we be expecting SG&A to decline on a nominal basis going forward or remain flat or is it kind of increase potentially going to continue?

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**Aric Spitulnik** - *TESSCO Technologies Incorporated - CFO*

Yes, as we look at this quarter's -- the Note 7 issue really didn't have a whole lot of impact on SG&A other than it took some time from this the product team and some of the other teams had to work on it. But from a cost standpoint it really wasn't an incremental cost. The biggest increases were primarily in compensation around the operations costs, as I mentioned the retail orders that we saw this quarter were a lot higher than we've seen in the past and that really drove an increase in operations costs.

Some of the sales and the other business generation teams have had some increased costs just from the number of people and the quality of the people that we've hired in the past. So that was an increase over last year. And then a little bit of marketing increase as well.

So those were the big drivers and I think the other one was actually our bonus programs and our bonus program last year was -- we saw a decrease in our bonus expenses based on the way that we calibrate our annual bonuses based on where we are in any given year and we reduced bonuses significantly in the third quarter of last year. So it was kind of an anomaly that has an impact on the comparative quarter. It's not to say this year's bonuses are significant, with our results they're not, but from a comparative standpoint it was an increase over last year.

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**Unidentified Participant**

And going forward?

**Aric Spitulnik** - *TESSCO Technologies Incorporated - CFO*

Going forward we look at the fourth quarter probably we should expect a decrease compared to the third quarter largely based on the variable expenses going down and then as we're successful on what Murray had mentioned as far as operating expense reductions as we look into next year we're not as concerned about the overall number it's more about the margin, the operating margin and we want to see that improve over where we are now. So we're definitely expecting that to happen as we get into next year. There's going to be a lot of movements around the organization. So we're not ready to quantify number to that yet, but we definitely would expect operating margins to improve as we execute that plan.

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**Unidentified Participant**

Murray, this is the quarter I think that you've talked about the impact the election cycle. I think last quarter we thought that it might get push back into fiscal third quarter you're saying there might be an uptick in the fourth quarter as sort of people process the results. Can you talk about just more -- any more detail you can give in that regard and how confident you are that those deals will be able to close in the fourth quarter and what's the general consensus when you talk to your partners and customers about how they're feeling about the general situation?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Well just I'd say some of the brief comments perspective Joe I think everybody still digesting a little bit, but I think from our perspective you know we're in a growth mode with our government business and there is lots of opportunity for us to participate in and you know based on what we see so far we think that as we go forward it could be very good for Tesco I think we just have to remain open minded about this and just see how things play out a little bit, but you can be assured that we are focused on the government business and we have invested in the government business recently in FY '17. So we're expecting to see an uptick in that business as we move forward and there's no reason to believe right now that that should happen.

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**Aric Spitulnik** - *TESSCO Technologies Incorporated - CFO*

And Joe to answer your question about specifically in the third quarter the orders that got pushed out some of those have already closed in January. So we definitely would expect an uptick in the government market in Q4 based on some of those deals closing in Q4.

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**Operator**

(Operator Instructions). Our next question comes from Bill Dezellem with Tieton Capital. Your line is now open.

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**Bill Dezellem** - *Tieton Capital - Analyst*

A group of questions, first of all, the carrier rebound that you saw was that concentrated with a limited one carrier or did that really cut across to two or three of them?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

The sales weren't directly to the carriers they were to tower owners and some of the other program manager and contractors but it was, I think the end users were really across several different carriers maybe not all of them probably three of them were really driving it for ourselves. So I think it was more across the board than concentrated with just one.



**Bill Dezellem** - *Tieton Capital - Analyst*

And we have seen some commercials on television that imply that there might be a little ramp up in competition amongst the carriers, is the ramp that you are seeing tied to some of those claims on TV or is it completely different. So I'm hoping you can share some insights as to why you think the rebound is starting to take place now?

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**Aric Spitulnik** - *TESSCO Technologies Incorporated - CFO*

Yes I don't think it's because of competition levels as of yet although at some point that will absolutely help us. Right now, I think it's more based on a couple projects moving forward that have been a little slow to move out especially some of the indoor projects and then I think it's also a little bit about the increased focus we've had on the carriers with some of the new talent that we've brought in and really going to aggressively after some customers they haven't done a lot of business with us in the past whether they are term contractors or some other contractors. So we're starting to see some nice business with some names that haven't been a longstanding TESSCO customers in this space. So it's more about a market share increase for us than it is about the carriers have suddenly taken off while we are seeing more activity from them I wouldn't say the carriers have opened up and are ready to go like they were in 2014 at this point but we're seeing more activity from them and we're being more aggressive and winning some things that we may plan and a year ago.

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Bill I would look at it this way is the way that we have the market segmented, there is an ecosystem around the carriers and we as Aric said we're winning business in the ecosystem and if the CapEx spending ramps up with the carriers we will absolutely participate in that but I think as you've heard on many other calls that transform it -- transformation that was occurring at TESSCO was around selling solutions and selling differently and I think that what we're seeing is some of that starting to take hold now.

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**Bill Dezellem** - *Tieton Capital - Analyst*

And a couple additional questions would you discuss the recalibration of your go to market strategy?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Okay. Is there anything in particular? I'm looking at a couple of things, I think -- first of all based on the assessment of where we are, we are looking at everything from sales compensation, regionalization, the vertical markets, how we deploy our resources, what the coverage models look like for example inside sales during the deal representation and so from a go to market perspective including our pricing strategy and various markets on the web and other places. So it's quite comprehensive we're just doing an assessment of where we are today and making sure that we're positioned in the next fiscal year to execute changes based on what we see happening in the market.

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**Bill Dezellem** - *Tieton Capital - Analyst*

So at this point in the evaluation do you have conclusions as to what you need to do or are you still evaluating that mix of inside versus field sales etcetera?

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**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Well we have two brand new executives and Charles has only been here for six days I think, Bill, so they will be instrumental in helping to formulate that and I think we're putting them on a pretty aggressive timeline to try and get and us ready for our annual operating plans as we launch them the New Year in April. So it's clearly work in progress for us right now and I'd say next call we'll have more detail for you but we're into a lot of the details right now and getting both Charles and Pete up to speed on the company in the market.



**Bill Dezelle** - *Tieton Capital - Analyst*

And my next question may also be a little premature but I will head down the path anyhow. Talk a little if you would please about your strategy to build the commercial dealer and reseller market if you would please?

**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

Well you know once again I think that's an interval part of our overall go to market strategy and we have a significant amount of our business with our (inaudible) and I think the question that we're trying to answer Bill is, is the best that we can do and if the answer is we think we can make improvements then we have to determine how we're going to go and approach our VARs who are crucial partners for us and make sure that we are targeting the right markets, targeting the right VARs and we're delivering a value proposition that will be able to tap into the extensive product line that we've got. So once again it's work in progress but it's a cornerstone for the overall go to market strategy the VARs will play an instrumental role in our future.

**Operator**

Thank you. And I'm showing no further questions. I will now like to turn the call back over to Murray Wright for any further remarks.

**Murray Wright** - *TESSCO Technologies Incorporated - President, CEO*

All right. Well I'd just like to say thank you to everyone for joining us today. We certainly value your support and will look forward to speaking with you all at our next conference call in May. Have a great day.

**Operator**

Ladies and gentlemen thank you for participating in today's conference. You may all disconnect. Everyone have a great day.

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