

TESSCO Technologies Incorporated
Q2 2015 Earnings Conference Call
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Executives

David Calusdian – Investor Relations, Sharon Merrill
Robert Barnhill – Chairman and Chief Executive Officer
Aric Spitulnik – Chief Financial Officer

Analysts

Anil Doradla –William Blair

Operator

Good day, ladies and gentlemen and welcome to the Q2 2015 TESSCO Technologies Incorporated Earnings Conference Call. My name is Whitney and I will be your operator for today. At this time, all participants are in a listen-only mode. Later we will conduct a question-and-answer session. (Operator Instructions) I would now like to turn the call over to your host for today, Mr. David Calusdian with Sharon Merrill. Please proceed.

David Calusdian

Good afternoon, everyone and thank you for joining TESSCO Technologies' second quarter 2015 conference call. Joining me today are Robert Barnhill, TESSCO's Chairman and Chief Executive Officer; and Aric Spitulnik, the Company's Chief Financial Officer.

Please note that management's discussions today will contain forward-looking statements about anticipated results or 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 disclosure, including the company's most recent Form 10-K and other periodic reports filed with the Securities and Exchange Commission.

With that introduction, I would like to turn the call over to Bob Barnhill, TESSCO's Chairman and CEO. Bob?

Robert Barnhill

Yes, thank you, good afternoon. Thank you all for joining us today. We want to review with you what is happening, why it's happening, and what are we going to do about it. Bottom line we are disappointed with our second quarter and our year-to-date revenue and earnings results.

Revenues for the quarter were up slightly compared with the year ago but well below our expectations, due to the pull back in 4G infrastructure builds by cellular carriers as well as reduced government purchases.

Gross margins also were lower than expected, driven primarily by a carrier-related contract sale with particularly low margins that were not offset by higher 4G infrastructure sales. With this backdrop, we have been aggressively focused on replacing the reduced carrier and government spend with increased private system and commercial reseller sales, value engineering our business, accelerating the execution of our growth initiatives and improving profitability.

We remain very committed to our strategic investment in the crucial talent and technology necessary to capitalize on the immense opportunities created by the convergence of wireless and the internet and meeting the challenges and opportunities created by the evolving needs and expectation of customers.

We are making significant progress in five key transformational growth initiatives. All five of the initiatives integrate and create what we are calling the Scientific Marketing and Sales System. The goal of this hi-tech, hi-touch system is to drive innovation, speed and productivity, create an extraordinary customer experience and deeper customer relationships, leverage our strong brand and reputation and create new opportunities, sales and profits.

This system build is well underway, but is not fully completed as we continue to identify the components of this system we must change, architect and build. We expect all the components to be fully executed by the end of this fiscal year, driving for improved performance and accelerated growth.

The first initiative is to transform from a company selling products into one that architects and sells complete solutions. We've been focused on this for some time with a continual change in improvement, but these four initiatives will accelerate the major corporate transformation. The second initiative is to expand our offering to provide end-to-end solutions for the building, using and maintaining voice, data and video wireless systems.

Some examples of the systems we support are cellular networks, two-way and critical communications, mobile device performance, Wi-Fi networks, wireless point-to-point broadband data and the Internet communications. An example of this is lease-line replacement and campus data coverage are perfect examples. Our enhanced cellular coverage and capacity, this is a major opportunity for us not only for carrier customers but for our industrial and enterprise customers as well.

Here we provide a complete solution for both indoor and outdoor venues. Remote monitoring and control is a big category, which refers to any system that allows monitoring and the control of remote assets. Examples are positive train control, SCADA, which is supervisory control and data acquisition in oil fields primarily, video surveillance and security, M to M and the Internet of things, which we've all been hearing a lot about. And we are focusing on the smart home building automation, oil field and tank monitoring, asset tracking and fleet telematics.

In event of our proprietary product unit develops a product components required for Wi-Fi, base station infrastructure, mobile device performance and remote monitoring control, system design. Now, I might mention that Ventev had a very successful launch of the iPhone6 cases screen protectors and tower products. We also had a new stadium Wi-Fi enclosure introduction this past quarter.

The third initiative is to enhance our product availability and the delivery of kitted solutions where and when required. TESCO's key value proposition is to provide everything to build, maintain or use wireless and deliver the requirements completely kitted, ready for use, when and where required at the lowest total cost. We do this well today, but we have to continue to enhance our capability to remain a superior supply chain performer in the industry.

The fourth initiative is to reorganize our business generation structure to better serve the customer and gain productivity for us. We are making excellent progress in creating a team of teams that is integrated and synchronized to drive results.

The organization has been rebuilt consisting of three primary units. First, unified sales teams for each customer, consisting of a development executive and account specialist all focused on specific customer segments. Second, solutions development product management teams to research and develop new systems to support and provide the right offering and solution. And then we have the solutions architects and technical experts to be a part of the sales process.

In the third unit, marketing teams to create strategy, design go-to-market campaigns and build or manage the digital platform. While we've been reorganizing we are aggressively training and recruiting to ensure that we have the right capability, commitment, passion, experience and the energy required in each team. Just as an example, last week we finalized an intense, strategic solution-based selling training with all people, all of our sales people and solution architect team members. This program includes continual on-going individual coaching. New industry-experienced executives and team members are joining us in every unit.

And the last initiative is to finalize the build of our digital technology platform. This hi-tech platform integrates and directs the hi-touch component to deliver to the customer an extraordinary experience. For TESCO, the platform provides new opportunities with existing new customers, the insight to develop customer sales strategies to provide relevant communications and interchange and the ability to create a more efficient and productive sales process and end-to-end solution selling.

The TESCO digital platform consists of four integrated technology components. The first is the foundational predictive analytic big database. I reviewed this with you last quarter. This component continues to deliver more and more value to the system. This incredible database brings together sales transaction, customer product, web, marketing and industry data into a single knowledge center, creating the analytics to better understand results, trends and customer behavior

and requirements.

Already we've utilized this tool to design and measure new performance metrics that are critical to our growth and provide metrics and analytical tool to the team members. Sales and marketing receive, and TESCO.com presents, product recommendations and alternative choices for specific customers prior, at or after the point of sale. Today, we are receiving predictive analytic capabilities to anticipate opportunities, develop deeper behavioral segmentation, and provide proactive and actionable guidance to our business generation teams.

The second component is the primary face to the customer, TESCO.com. TESCO.com is positioned as the definitive source for delivering personalized content for each customer to gain knowledge for building, using and maintaining the wireless system, designing and configuring solutions, managing the purchase and direct delivery of their product and solutions requirement and the complete control of the entire procurement supply chain.

The third component is one-to-one customer contextual communication. This component develops and builds customer role-specific digital and personal communication to develop new opportunities, support the sales process and respond to transactional events.

Our customer communication interchange is to treat every customer as our only customer, delivering only the information and knowledge that is relevant to them. Big Data, TESCO.com and our sales talent continue to define the individual's profile and preferences for better and better one-to-one communication and interchange.

And the fourth is the opportunity capture, pursuit, guidance and result-tracking component, opportunities with new or existing customers are generated from the multiple sources of one to one communication TESCO.com, digital campaigns, events, the internet, big data predictive analytics and so on.

These opportunities are fed into our rebuilt, optimized CRM system for assignment, strategic planning, opportunity pursuit, sales process and tracking. This new system is very exciting and provides us a systemic productive process to profit from a vast number of opportunities.

Each technology element is currently been developed and executed. The most visible element of our progress will be a new TESCO.com, which we expect to launch near the beginning of the calendar year. This state-of-the-art website will be well ahead of our current digital presence, supporting both customer's needs and TESCO business developments and productivity objectives.

Our scientific marketing and sales, hi-tech, hi-touch system will drive the customer experience and profitable growth for new customer's end to end solution sales and productivity. The results from this system are now developing and we expect to accelerate in the New Year.

Now I'd like to give you a look into remainder of the year. Considering the current challenging business environment, our six months results, the expectation that the carriers will not renew their spending until after the new year and a quarterly impact of about \$0.10 per share for more talent and technology investment, we're lowering our EPS guidance for fiscal year of 2015 to be in the range of \$1.40 to \$1.55.

In summary, even as we work through the difficult business environment in our less than expected results, we are excited about our progress on our strategic initiatives. Our investment in people and technology will enable TESCO to capture more of the opportunities being created by the convergence of wireless and the Internet.

We're positioning TESCO to meet challenges created by a fast evolving market, and we're using innovation, creativity and scientific thinking to dramatically change how we do business. We remain intensely focused on shareholder value and continuing to return capital through dividends and share repurchases.

So Aric, with that would you please give us the details of the second quarter performance.

Aric Spitulnik

Thanks, Bob. Let's look at the second quarter results. Revenues were \$149 million, compared with \$147 million a year ago. Revenue growth was mixed among our markets, with the retail market showing the most strength on a year-over-year basis. Gross profit was \$35.4 million in Q2, compared to \$36.5 million in last year's second quarter.

Gross margin was 23.9% compared to 24.9% a year ago. The decline in gross margin was primarily the result of a change in product mix, as we experienced increased sales of lower margin distributed antenna systems, or DAS equipment.

As we continue to be successful with DAS, we are trying to offset the lower margins by working on a greater penetration on this market with our higher margin infrastructure and installation test and maintenance products. Outside of the public network market, revenues and gross profits were both up by about 2% with stable gross margins.

SG&A was \$30 million up, about 2% from the second quarter of 2014, primarily due to increased expenses associated with our investments in talent and technology. As a result operating margins was 3.9% versus 5.2% in prior year quarter. While we continue to make these critical investments to drive future growth, we expect improving operating margins as the revenue we expect to see from these investments begins to be realized.

We estimate we'll spend a total of about \$1.5 million on third-party expenses related to these investments during our current fiscal year that will be charged SG&A and almost \$2 million in new business generation talent, specifically tied to the initiatives. Most of the third-party expenses will not reoccur in fiscal year 2016 but will be partially offset by higher depreciation expense.

Net income for the quarter was \$3.5 million, down from \$4.6 million in the second quarter a year ago. EPS totaled \$0.42 this quarter compared to \$0.55 in the second quarter of 2014.

Now turning to the markets, in the public carrier market, revenues were essentially flat year-over-year. However gross profit was down 19%. We expected some slower spending this year from the tier 1 carriers compared with last year. However, the slowdown has been dramatic, and we expect it to continue at least through the end of the calendar year.

DAS demand remained strong. However, it was not enough to offset the decline in the rest of the market. Small cell continues to be an emerging story, but likely not a significant contributor of revenue until at least 2016.

In the commercial dealer and reseller market, revenue increased 1% and gross profit rose 2% from a year ago. We have seen demand for increased indoor cellular and data coverage which should indicate eventual demand for small cell systems once that market develops more fully.

In the private and government systems operator market, revenues declined 5% while gross profit declined 4% year-over-year. On the private system front, we continue to make investments in talent and have several potential significant projects in the works.

Some of these projects will also have a longer sale cycle than some of our traditional customer projects. On the government side, we are beginning to see an up-tick in federal activities, and several projects we developed last year are now receiving initial funding.

At the state and local level, we saw slightly sluggish demand, as new budget approvals were delayed. Government sales make up about 30% of this market and were a major drag on it at this quarter. Excluding the government sales, revenues from the private system operators grew 2% from last year.

Turning to the retail market, the launches of various new Samsung products and Apple's iPhone 6 products have been quite positive for TESSCO. These products are driving strong consumer interest in store and online traffic for our customers.

Tight competition among the carriers has also benefited TESSCO, as pricing wars have encouraged consumers to replace their handsets, leading to the purchase of new accessories. We expect that trend to continue. Revenue and gross profit increased 9% and 8%, respectively, from last year's Q2.

Turning to the balance sheet. Inventory did increase from Q1 as we saw ramp up in orders from one of our customers and as we built inventory for the retail holiday season. However, there is inventory of about \$9 million related to this large customer which is binding, so there is no obsolescence risk for TESSCO. We expect to monetize this inventory possibly by the end of third quarter and almost certainly by the end of the fiscal year.

Our cash balance was \$2.7 million. We continue to have a very strong balance sheet with no operational debt, which is allowing us to continue to make the long-term investments necessary to build the foundation for future growth.

We set our dividend at \$0.20 per share with a record date of November 5 and the payment date of November 19. During the quarter, under our recently expanded repurchase program, we bought back about 8,000 shares and we continue to evaluate opportunities to continue. There remains outstanding up to \$9.8 million under our buyback program through April 2016.

Thank you for your support at TESSCO. Operator, we'll now open the call for questions.

Question-and-Answer Session

Operator

(Operator Instructions) Our first question comes from the line of Anil Doradla with William Blair. Please proceed.

Anil Doradla - William Blair

Thanks, for letting me ask the question. Bob, I have a couple of questions here. The issue that you talked around 4G was that limited to a single carrier or was that widespread across multiple carriers?

Aric Spitulnik

Hi, Anil. It's Aric. It was primarily with one – one we've had a relationship with in the past, but there is others that had some impact as well. But it was primarily with one.

Anil Doradla - William Blair

On that carrier, what are the areas of spending weakness? I mean, what parts of the infrastructure are witnessed there?

Robert Barnhill

Yeah, a lot of that was dealing, trying to absorb an acquisition, but it's pretty much – and they even slowdown on some of the DAS builds that they were doing with contractors. So as...

Anil Doradla - William Blair

You've talked – sorry, go ahead.

Robert Barnhill

I'm just saying, there was a lot more than we expected that's for sure.

Anil Doradla - William Blair

You talked about, I think one or two quarter hiccup, what makes you say that as we get into the next year after a quarter or two, that it's going to come back?

Robert Barnhill

What makes us think it will come back?

Anil Doradla - William Blair

Yes.

Robert Barnhill

Well, basically I mean, there is a huge consumption of broadband that they've got to continue to build out, also that they have major interest in putting in these DAS systems into various venues. So, we think that if we get past the first of the year, we're going to see an accelerated spend. And then also that we're getting – we're doing work with other carriers as well and we're expanding that.

Anil Doradla - William Blair

And finally, I mean, you talked about the Ventev doing well, especially on the iPhone 6. Can you give us a little bit more color around the launch of this product and when you compare with your previous versions of the iPhone by what magnitude or what is the – any qualitative color?

Robert Barnhill

Yes, it was a pretty exciting – with cases, you never quite know whether you have the right dimensions and the right product. And we had inventory and we nailed it in terms of the product design, and so we were really one of the first to market.

So that was very exciting, both for the case, as well as for the screen protector, and we've got a very innovative screen protector that's glass and if you drop the phone the glass cover shatters absorbing all the impact away from the phone itself.

And then our Ventev power continues to do very well, and I think Aric mentioned that we've got this Samsung fast charger which – that is – has a Qualcomm chip in it that goes with the Samsung phone. So it's a rapid charge. So that's been very exciting.

So that side has been doing well and then the – as I mentioned the infrastructure, we've got some very innovative product for the stadiums. This is an enclosure for an access point that can go on to the railing or even better yet – it goes on to the bottom of seats, so that you can get Wi-Fi coverage throughout the entire stadium. And it's another example of Ventev discovering the unmet needs and either on the commercial side or on the accessory side.

Anil Doradla - William Blair

So, Bob, coming back to the infrastructure, it was M&A driven pause in the spending, right, is that a fair way to characterize it?

Robert Barnhill

Yes. I mean, spending rate of the carriers? Yes. And then also that we're seeing the overall softness in the private system operators, as well, and that carries over to the VARs. There is a great hesitancy in the marketplace for people to commit and build new systems.

Anil Doradla - William Blair

And finally this is North America centric, obviously, because of your exposure there, and this is not beyond North America, right?

Robert Barnhill

Yes, it's North American centric, yes.

Anil Doradla - William Blair

Thanks a lot guys.

Robert Barnhill

Okay. Thank you. Good to talk to you.

Operator

(Operator Instructions) There are no further questions in the queue. I will now turn the call back over to Mr. Barnhill.

Robert Barnhill

Okay, thank you. Anil, I appreciate your questions. I just want to close with reminding us all that we remain focused on Shareowner value creation and continuing to return capital through investments and share repurchases. We're working hard and we're working smart to value engineer our business, improve profitability and execute on our growth initiatives. I thank you for your support and look forward to talking to you next quarter.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.