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TESS - Q3 2016 TESSCO Technologies Inc Earnings Call

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## CORPORATE PARTICIPANTS

**David Calusdian** *TESSCO TECHNOLOGIES INCORPORATED - IR, Sharon Merrill Associates*

**Robert Barnhill** *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

**Aric Spitulnik** *TESSCO TECHNOLOGIES INCORPORATED - CFO*

## CONFERENCE CALL PARTICIPANTS

**Joe Hodas** *William Blair & Company - Analyst*

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

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the TESSCO Technologies Incorporated third-quarter 2016 earnings conference call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the conference over to David Calusdian. You may begin.

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**David Calusdian** - *TESSCO TECHNOLOGIES INCORPORATED - IR, Sharon Merrill Associates*

Good morning, everyone, and thank you for joining TESSCO's conference call. Joining me today are Robert Barnhill, TESSCO's Chairman and Chief Executive Officer, and Aric Spitulnik, 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 containing 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 Bob Barnhill, TESSCO's Chairman and CEO. Bob?

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**Robert Barnhill** - *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

Good morning and thank you for joining us today. I believe all of you have seen our earnings release and are as disappointed as we are in our guidance, which reflects the anticipated challenges in the current quarter. This morning, Aric and I want to review with you where we are, what we see in the short term, and where we are going.

We achieved sequential and year-over-year earnings growth and met our third-quarter guidance in spite of the challenges to sales resulting from ongoing softness in many of our markets. Total revenues increased 3% from a year ago. Our performance was led by the government and retail markets, which increased 27% and 10%, respectively. Earnings per share were \$0.35, in line with our guidance and well ahead of last year's third-quarter performance.

Operating margin improved to 3.4% compared to 2% last year. Our balance sheet is strong, with no operating debt. And we reduced inventory. We're also continuing our quarterly dividend of \$0.20 per share.



Our retail and government markets continued to show strength, as sales increased 5% and 12% sequentially. We also saw growth in the utility, oil and gas, and mining sectors within our private system market.

The public carrier market remains very soft, as the carriers continue to delay spending on their network expansion upgrades. Their lower spend impacts not only the carrier, but also our contractors, program managers, tower managers owners, and commercial reseller and customers.

As we mentioned on past calls, consumer demand for broadband coverage and capacity continues to rise dramatically. Carriers need to expand and improve their networks to meet that demand. However, we're seeing little movement towards increased carrier spend so far in fiscal year 2016. We've also heard from several of our manufacturers that a recovery in the carrier spend is more likely to be weighted towards the second half of calendar 2016.

While we continue to work closely with the carrier customers on new opportunities, we are moving beyond our concentration in the carrier market by serving the private system operators. As the third quarter progressed and we entered the fourth quarter, which is traditionally our weakest quarter, we've seen increased purchasing hesitancy in all of our markets due to concerns related to the collapse of the oil industry and weak global economic data.

Additionally, as we continue to operate as normal, the blizzard has impacted the purchases of most -- of all of our mid-Atlantic customers. As a result, we are revising our annual guidance to \$0.76 to \$0.94 per share for the fiscal year ending in March, reflecting the anticipated challenges and uncertainty we are seeing in the near term.

The continued softness in our market does not reflect the progress we're making in changing the way we do business to make a difference in our customers' success in deploying the voice, data, and video systems resulting from the convergence of wireless and the Internet. We are confident that our initiatives to offer end-to-end wireless solutions, develop relationship selling, and execute Internet-based marketing and e-commerce will allow us to gain market share and enter new markets.

After Aric provides details of our financial performance, I will then provide an overview of the progress we're making on our strategic plan to drive sustainable growth and shareowner value. Aric?

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**Aric Spitulnik - TESSCO TECHNOLOGIES INCORPORATED - CFO**

Thanks, Bob. For the third quarter of fiscal 2016, revenues were \$140 million compared with \$142 million in the second quarter and \$135 million in the third quarter a year ago. We achieved both sequential and year-over-year earnings growth. EPS was \$0.35 in Q3, up from \$0.33 during the second quarter and \$0.20 a year ago.

The carrier market continues to remain very soft compared with last year, declining another 2% due to the slowdown in the carrier spending. However, the retail and government segments continued to show strength, as sales in these markets increased 10% and 27%, respectively, from a year ago and are up 12% and 11% year to date.

Gross profit was \$29.5 million in Q3 compared with \$28.8 million in last year's third quarter and \$30.5 million in Q2 this year. Gross profit benefited from the year-over-year increases in revenue, with essentially flat gross margins.

One note on gross profit and SG&A expense. As we noted in the earnings release, prior to the third quarter of fiscal 2016, we had classified certain indirect costs relieved from inventory upon a sale as SG&A expenses as opposed to cost of goods sold. The income statements presented in the release now reflect indirect costs relieved from inventory as cost of goods sold for all periods.

While gross margins and SG&A expenses are both now lower than previously stated, the amount of the reclassification is generally consistent from quarter to quarter, which resulted in period-to-period comparisons that are very similar to those previously reported. The classification had no impact on previously reported revenues, operating margins, EBITDA, net income, earnings per share, or on previously reported balance sheets or statements of cash flows.



This quarter, SG&A expense was \$24.7 million, down from \$26.1 million in the third quarter of fiscal 2015. The improvement in SG&A was largely driven by a \$900,000 benefit to bonus expense due to reversal of previously accrued amounts that are no longer expected to be paid this year. We also had a \$500,000 of savings from the Company's value engineering and expense reduction efforts, primarily related to compensation and benefits. As a result, operating margin was 3.4% versus 2% a year ago and 3.3% in the second quarter.

Net income from the quarter was \$2.9 million or \$0.35 per share, up from net income of \$1.7 million or \$0.27 per share in the same quarter a year ago. Net income was also up from \$2.7 million and \$0.33 per share in Q2. EPS was in line with the guidance range.

Now turning to the markets. In the public carrier market, revenues were down 2% year over year and gross profit was down 14%. Carrier spending remains very soft as the carriers continue to delay significant network deployments.

This has affected not only the carriers, but our contractors, program managers, and tower owner customers in the space. Gross margin is down due to product mix, as this quarter we sold a higher portion of lower margin active components and test equipment.

In the government market, sales increased 27% from a year ago and gross profit was up 23%. We won several larger deals this quarter, primarily as a result of a more strategic selling approach. We expect to generate additional revenue growth in this market as more of those deals begin to close.

In the commercial dealer and reseller market, revenues increased 6%, and gross profit rose 8% from a year ago. In the private system operator market, revenues declined 15% and gross profit was down 9% year over year. The year-over-year decline is primarily related to one enterprise customer that had made changes in the supply chain as well as a one-time test equipment sale of more than \$2 million that occurred in Q3 last year. However, we did see year-over-year growth in many of the more traditional sectors of the private system market.

Looking at the retail market, sales were up 10% year over year and gross profit grew 7%. Retail continues to be a strong market for us on the combination of the OtterBox relationship, growth in Ventev accessory sales, and the recent iPhone launch. Total Ventev sales, which includes both mobile device accessories and infrastructure offerings, increased 9%, and now total 13% of overall revenues.

Looking at the balance sheet, we reduced inventory by about \$9 million from last quarter as we were very focused on reducing overall inventory while maintaining strong service levels.

Cash flow from operations was \$3.8 million during the third quarter and \$7.7 million through the first nine months of fiscal 2016. Overall cash on the balance sheet was \$7.5 million and we had no balance on our \$35 million line of credit. We remain committed to our dividend program and set our dividend of \$0.20 per share with a record date of February 10 and a payment date of February 24.

Now turning to the outlook. In light of the lower sequential sales we experienced in the third quarter and a significant reduction in our projected fourth-quarter sales, we are providing fourth-quarter guidance in the range of a loss of \$0.13 to earnings of \$0.05 per share. This compares with the loss of \$0.03 in the fourth quarter a year ago. Therefore, our fiscal 2016 earnings guidance is now \$0.76 to \$0.94 per share.

The fourth quarter is traditionally our slowest quarter and also the most difficult for us to forecast due to the timing of calendar budget cycles, weather issues, and retail seasonality. In addition, this quarter has begun very slowly for us as the weak economy and carrier uncertainty continues to weigh on our key markets.

We said last quarter we expect some lift from the carriers in the second half of the fiscal year. We now expect any increased carrier spending to occur later in calendar 2016.

Now I'll hand the call back to Bob to discuss the progress we are making on our strategic imperatives. Bob?



**Robert Barnhill** - TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President

Thanks, Aric. As we have discussed in previous calls, the world of wireless is changing dramatically due to the convergence of wireless and the Internet and technology advances. Our goals are to continue to evolve to meet the changing needs of our customers. We are focused on moving beyond carrier dependence by expanding in government, network VAR, and industrial and enterprise private system markets.

New and existing customers demand partnerships to provide them with the knowledge, product, and supply chain solutions that are complete, simple, and cost-effective. We must respond to the new realities in our customers' requirements and needs. As a result, we are changing the way we do business, as we have outlined previously in our five key strategic imperatives.

These imperatives are a journey, not a destination, and we are reaching milestones that have been helping us build the growth we've seen in our non-carrier customers. Let me provide just a few examples of how we are reinventing ourselves to take TESSCO to the next level of success.

Our first imperative is the enhancement of our policies and procedures. We are standardizing, simplifying, and communicating our policy and procedures to deliver scale and extraordinary customer experience, with the ability to self-serve online while improving TESSCO productivity.

Let me give you an example of what we're talking about. Warranty process -- today if a customer has a warranty claim, it takes a phone conversation, often with multiple TESSCO team members, and may require the manufacturer to approve the return for repair or replacement. When completed, the warranty process will be 100% computerized on tessco.com in what we call the account control center with minimal TESSCO team member involvement.

Additionally, by standardizing, simplifying, and digitizing our policies and procedures, we will be able to make it simple, fast, and painless to process a warranty. We will also be able to solve a delivery problem, builder change in order, confirm pricing and delivery status, and many other features that will simplify the business process for our customers and create significant productivity for both the customer and TESSCO.

Our next three imperatives go hand-in-hand: the end-to-end system solution offering, supply chain excellence, and strategic relationship selling. Today, customers want a complete solution for their requirement, not a bag of parts. They want to work with salespeople that will build a relationship and truly care about creating and delivering solutions at the lowest total cost, on time, error free.

We've identified the systems that we will support to meet our customers' requirements. In addition to our traditional systems that we have been supporting -- base station infrastructure, two-way communications, mobile device performance, and installation, test, and maintenance -- we are expanding into enhanced carrier coverage and capacity: Wi-Fi networks, wireless backhaul, remote monitoring and control, M2M, and Internet of Things solutions.

This quarter, all the system designs and products required will be showcased on tessco.com to guide the customer and create opportunities for TESSCO to pursue.

TESSCO ONE, our exclusive summit for wireless professionals, will be held in Phoenix February 23rd and 24th and will give customers an up-close look at our product and solution software and learn from industry speakers the wireless trends in innovation. As an example, we have an enhanced carrier coverage and capacity, or DAS, track.

This will feature AT&T's Paula Doublin. Paula is an industry leader and will share her insights in the development, implementation, and deployment of DAS in small cells. We will also be giving tours of the University of Phoenix stadium's DAS system and hear from leading DAS manufacturing partners, including CommScope.

The offer must be supported by a flawless supply chain with reliable procurement and product availability to build a configured kitted solution and deliver it complete, error free, when and where needed.

Today, customers, especially contractors, require kitted solutions at a location close to their construction site. Using our east and west megacenters, we can now configure and kit the customer's bill of material and then deliver it to one of 225 independent depots, allowing delivery or pickup for



immediate deployment. This strategy allows us to be local nationwide and assures timely delivery to the customer with lower inventories and lower fixed costs for TESSCO.

Selling the complete solution requires proactive strategic relationship-based selling. Our historical reactive transaction selling is no longer effective for success. For the past two years, we've been building a relationship-based team allowing us to determine customer needs, create opportunities and present the solutions, and solidify long-term loyal total source customers. We're making good progress in developing our sales talent, but need to accelerate the recruitment of more talent to support the expansion of new customers with new offers.

The last imperative is to build and operate scientific digital marketing system, which is core to providing the customer with an extraordinary experience to gain knowledge and to do business and provide us with the opportunities, sales, and productivity. The system consist of tessco.com, predictive analytics, and targeted marketing and sales campaign components. TESSCO.com is becoming the definitive place to gain knowledge, design, select, configure, procure, direct delivery, and control the entire supply chain.

This quarter, you will see enhancements in the system solution and product presentations to create opportunities and allow the customer to design their solution and build it, a purchase order, and enhancements to the account control system to allow online pre- and post-sale order management. The predictive analytic Big Data engine is used to determine and present companion product choices for cross-sell and predict customer behavior.

Using predictive retention and purchase initiatives, we saw a 90% retention rate in the retail market. We are now using these data analytics in our other markets.

Finally, our targeted marketing and sales campaign system allows the delivery of contextual relevant communications to specific markets, customers, and individuals. Again, to generate opportunities for our sales team for to pursue.

In closing, we remain committed to making the trusted difference in our customer success and we remain confident in our strategic plan to drive renewed growth. Even in the midst of market uncertainty, TESSCO is well positioned to capitalize on the convergence of wireless and the Internet.

I'd now like to open it up for any questions you may have.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Anil Doradla, William Blair & Company.

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**Joe Hodas** - *William Blair & Company - Analyst*

Hi, Bob. This is Joe [Hodas] in for Anil Doradla. So obviously the trends in the carrier market are surprisingly weaker than expected, given the weak 2015 and our expectations for rebound as we enter the year. I think when you look back to the last quarter, I think we were all expecting that to be the bottom.

Can you give us a sense of what your expectations are regarding timing? I know you talked about the second half of 2016, but any more guidance you can give there?



**Robert Barnhill** - TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President

Well, we continue to see activity planning proposals being created, but we are not seeing the actual purchase orders being placed. So again, we think that they are focused on making their plans. They are focused on some of the urban densification, but they are not moving out on the rural macro site builds, which is our primary offering that we have.

So we think it's going to start soon, but we are hesitant to predict because we've been talking about it now for quite a while in terms of what they've been doing. You've got AT&T that is still building in Mexico; Verizon has been working on collapsing their multiple sites or locations into fewer. So there's a lot of dynamics going on in the industry. But they have to build; they have to give the capacity that we are all looking for.

Aric, do you have any other thoughts that you want to share?

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**Aric Spitulnik** - TESSCO TECHNOLOGIES INCORPORATED - CFO

No. I think again, just consistent what with what we are saying. A lot of our manufacturers are seeing very similar things and they are a little bit hesitant as well to pin down exactly when things are going to get going. Everybody thinks it's going to come, but the timing is still pretty up in the air right now.

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**Joe Hodas** - William Blair & Company - Analyst

Okay. So the sense I'm getting there is that you can't really qualify your degree of certainty regarding the timing of the headwinds, but they are certainly existing right now?

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**Aric Spitulnik** - TESSCO TECHNOLOGIES INCORPORATED - CFO

That's right

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**Joe Hodas** - William Blair & Company - Analyst

Okay. And then so I know historically, Q4 has been really difficult for you guys to predict, but would you be willing to try to not necessarily quantify, but maybe rank your expectations for growth by the segments? I know you talked about sort of widespread weakness. I know we can expect retail headwinds just due to the seasonality, but any more granularity you can give there?

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**Aric Spitulnik** - TESSCO TECHNOLOGIES INCORPORATED - CFO

Not really. I think we're going to see challenges in each of the segments. Certainly the carriers are not going to see any kind of growth from them. Our retail is always down significantly from Q4 versus Q3. The other markets might be probably the better performing markets, but are still going to most likely be down a little bit from where they were in Q3.

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**Joe Hodas** - William Blair & Company - Analyst

Okay. Thank you very much. That's all I have. Good luck.

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**Operator**

Bill Dezelle, Tieton Capital.



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

I'd like to talk or have you talk about the government market a little bit. And we recognize it is the smallest market, but it also is the market that you had the highest rate of growth in. Can you talk about that growth and also how you see that market developing over the coming year or two?

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**Robert Barnhill** - *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

I think the government market is a good example of what we're building and what we're entering. Historically -- and when we're talking history, we're talking about a year and a half ago up until then -- we were very reactive. We would wait for bids to come out. We would quote on the bids and there was no proactive selling at all.

And as we've been talking about is that we're building a strategic-based -- strategic relationship-based sales team. And we built an entire new team for the government, and they are getting into -- they are proactively getting into the various agencies, building the contract devices that we can make -- or the contract relationships that we really start to penetrate. We've got some tremendous things in the pipeline and it's really a new day in terms of how we're going to market with the government. And we expect great things to happen in that market.

Aric, you want to add anything?

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**Aric Spitulnik** - *TESSCO TECHNOLOGIES INCORPORATED - CFO*

No, I think you got it there. It's all about the new talent that we have there and a new focus. We certainly expect that to continue.

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

I'm going to follow up with hopefully not too unfair of a question, but given the success that you are experiencing there, to what degree are some of the other businesses looking at what's going on in the government segment and recognizing that if they make some changes, they also have some opportunity for some significant growth. Or is the government market enough different that it either isn't applicable or those who should be seeing some opportunity and similarities at how they could approach it are just really poo-pooing the idea?

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**Robert Barnhill** - *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

No, the relationship strategic selling is going to cross all markets. And as I said earlier is that we just need to recruit and develop at a faster rate. The government team was smaller and our other market teams are larger, and so we are in the process of developing through training as well as recruiting the talent all the way across the Company.

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

Great. That's helpful. And then one question relative to the carrier market. Is there anything that you see that you all can be doing different at this point to improve the results that you have? Or is it really an environment where almost no matter what you do, you would just be pushing on a string?

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**Robert Barnhill** - *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

Well, what we were talking about with the supply chain. We historically shipped and delivered out of our Reno and then our Maryland distribution center, and now the carriers are requiring that the product is closer to the construction site so they can deploy quickly. So this depot relationship,

this 225 depots across the country is new for us and this is one of the major new value propositions that we're developing for the carrier and this will give them a better sense of our ability to deliver what they need when they need it.

The carriers are very focused because of the dynamics that are going on with their industry in terms of making sure that they get product when they need it to deploy it. They don't want inventory buildups and they want to be able to get -- once they decide that they are going to build in a certain area, they want that product close to that site so it can be deployed simply and easily. And so it's a different dynamic than what we've enjoyed over the past years, but it's at the same time we are really pulling this all together to make our value proposition very strong.

I think one of the other things, as I mentioned earlier, is that the carriers, they are doing some builds as they are densifying in the cities. And the macro cells, which is really our sweet spot in terms of the base station infrastructure, has really not begun in the rural and the areas where they need coverage. We are also working on new products -- in particular, the wireless backhaul -- for the densification of a lot of these small cells that are being deployed within the city.

And you know, they have two ways to backhaul it: one is fiber and the other is wireless backhaul. Wireless backhaul is a lot faster to deployment and is also a lot cheaper. And we have a great product that we're going after that market as well.

So between waiting for the supply chain and then the new products and the whole new system in terms of how we're operating with the carriers, we are looking for really good things once they start to make the decisions.

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

Great. Thank you, both.

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**Operator**

(Operator Instructions) And I am showing no further questions at this time.

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**Robert Barnhill** - *TESSCO TECHNOLOGIES INCORPORATED - Chairman, CEO, and President*

All right. Well, thank you very much for joining us today and we thank you for your continued support. And we are looking forward to driving the sustainable growth and shareowner value in this new year coming up. As I mentioned, we are very excited by our strategic plan and we know that it will drive the results we are all looking for. So look forward to talking to you next quarter about our progress. Thank you very much.

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**Operator**

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Have a great day, everyone.

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