THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

TESS - Q2 2018 TESSCO Technologies Inc Earnings Call

EVENT DATE/TIME: OCTOBER 24, 2017 / 12:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Aric M. Spitulnik *TESSCO Technologies Incorporated - CFO, Senior VP & Corporate Secretary*

David C. Calusdian *Sharon Merrill Associates, Inc. - President*

Murray N. Wright *TESSCO Technologies Incorporated - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

William J. Dezellem *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second quarter 2018 TESSCO Technologies Incorporated Earnings Conference call. (Operator Instructions). As a reminder, this call is being recorded. I would now like to introduce your host for today's conference, Mr. David Calusdian of Sharon Merrill Associates. Please go ahead, sir.

David C. Calusdian - *Sharon Merrill Associates, Inc. - President*

Good morning, everyone, and thank you for joining TESSCO's Q2 2018 conference call. Joining me today are Murray Wright, TESSCO's President and Chief Executive Officer, and Aric Spitulnik, the company's CFO. 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 & Exchange Commission.

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

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Thank you, David, and good morning, everyone. Thank you for joining us on the call today. We showed good progress this quarter as we continued our recent trend of year-over-year top and bottom-line growth. In fact, this was our fourth consecutive quarter of year-over-year revenue growth and our third straight quarter of EPS growth. Our $0.21 EPS was the largest quarterly profit in seven quarters.

Revenue grew in all commercial markets, including a 48% increase in revenue from the carrier market. As you know, we've been intent on improving our engagement in the carrier ecosystem during the past three quarters. It's rewarding to see our efforts in that market continue to deliver results.

The improved bottom line performance was a direct result of the revenue growth we are seeing in the business combined with our effective expense management. The initiatives we have put in place over the past year are targeted at generating higher revenue growth and managing our operating costs to improve profitability. Our financial results this quarter demonstrate that we are executing on our plan. We are continuing to implement significant changes throughout the organization. And as we have previously said, this will likely cause fluctuations in our results through the remainder of the fiscal year. We believe the execution of our strategy this year will provide a strong foundation for success in fiscal 2019.

I'd like to give you an update on the progress we're making on our key priorities. As we've discussed on previous calls, recalibrating our go-to-market strategy is a major undertaking for us this year. We made solid progress on the regionalization of our sales teams, bringing our sales professionals closer to our customers, driving efficiencies, and forging stronger relationships.

We are beginning to win more business because of this stronger engagement at all markets. For example, we've increased our face-to-face meetings with customers, and we're generating valuable market intelligence. In the public carrier market, we've gained market share, in a large part because of strong ecosystem commitments and careful attention to our customers' needs. We are creating relevant solutions to maximize our customers' supply chain demands.

Next, we are striving to improve how we engage with our vendor partners. We are developing deeper relationships and better collaboration with our valued partners. We're working better together to uncover new opportunities and develop new partnerships. To that end, in September, TESSCO held its first-ever Vendor Summit, gathering our key vendor partners to develop mutual objectives for the coming year. The feedback from our vendor partners was overwhelmingly positive, including the unveiling of TESSCO's Vendor Link program, which enables our key vendors to participate in a variety of go-to-market opportunities to better reach our customers.

And finally, we are working diligently to increase operating margins by balancing growth and costs. We are implementing cost efficiency initiatives throughout the organization. We are ensuring that we have the right talent and resources in critical areas throughout TESSCO. And at the same time, we are concentrating our efforts on productivity and process improvements and capitalizing on key market opportunities. We expect these and other actions will increase our operating leverage and improve profitability as we accelerate our sales trajectory.

And now, I'd like to provide a brief overview of our markets. First, the public carrier market ecosystem. As I said earlier, we made significant gains in public carrier market sales from a year ago as the changes we are making in our go-to-market strategy continue to pay off. The key point here is that our plan is working. Our sales, product, supply chain, and program management teams are winning new opportunities while we work with our vendor partners to ensure our product offer and pricing are well-positioned for success.

While we are gaining market share, we've experienced some margin compression in the commercial markets. This is a result of a combination of several small factors, which in the aggregate had a more significant impact this quarter. These factors included more aggressive pricing, product mix skewed toward higher-dollar, lower-margin active equipment, a lower percentage of vendor sales this quarter, and a change in our customer base with larger customer deals. We are taking several steps to improve gross margins, including action plans on pricing, product mix, Ventev, and services.

The government market bounced back with a strong second quarter, with sales and gross profit up double-digits from a year ago. Many of the federal budgets and projects that were delayed from Q1 came through in Q2, driving the sales increase. We are pleased with the growth in this market this quarter, and we are seeking to generate additional opportunities in the quarters ahead.

In the value-add reseller market, revenue was up mid-single digits from a year ago, while gross profit decreased slightly. We are determined to increase our market share with a target group of the largest value-add resellers. Historically, we have had minimal share with these customers, but we are working closely with these accounts to generate momentum towards stronger synergies with vendors and increased sharing of market intelligence. We also have improved our relevance to these accounts by adding newer technologies to support Internet of Things applications. There's still a significant opportunity to expand share in this market, and we look forward to making additional progress in future quarters.

The private system operator market revenues and gross profit grew almost 10% from a year ago. Our enhanced go-to-market strategy is enabling us to be more aligned with our manufacturing partners and customers, and our value proposition to customers in this market is working well.

Turning to the retail market, sales decreased by high single digits year-over-year as a result of further consolidation in our customer base. Some of our customers are also seeing a reduction in store traffic as consumers hold onto their phones for longer periods of time. Meanwhile, we have one business in some new sectors, including Big Box retailers and tier one customers. Gross margin in retail improved this quarter in part due to customer mix, but also due to investment from our vendor partners to win additional business. We continue to expand our service offering, including systemic integration with drop ship and endless aisle programs to give our retail (inaudible) new ways to capitalize on new consumer spending habits. In the coming quarters, I am confident in our ability to execute in this market.

Before I hand the call over to Aric, I want to leave you with a few key points. First, we are executing well on our strategic plan and are balancing the implementation of our go-to-market strategy with improved operating efficiency. Second, we are delivering improved results. For the past four quarters, we've delivered high single-digit revenue growth while at the same time managing costs to improve profitability. And third, while we still have work to do, we are focused on gross margin and managing through organizational and technology changes. The good news is that we are beginning to see the increased operating leverage we've been planning. We expect this leverage will become more apparent in the next fiscal year. There is strong momentum in our business, and all of the steps we've discussed and taken this year are in preparation for accelerated growth in fiscal 2019, which begins in April. We are confident in our value proposition, and we are encouraged by our ability to drive success in the quarters to come.

And now, I'll turn the call over to Aric for a discussion of the financial results. Aric?

Aric M. Spitulnik - *TESSCO Technologies Incorporated - CFO, Senior VP & Corporate Secretary*

Thank you, Murray, and good morning, everyone. In the second quarter, revenues increased 8% versus one year ago. As Murray mentioned earlier, this is our fourth consecutive quarter of year-over-year top-line growth. The higher revenues resulted largely from a significant increase in sales to public carrier ecosystem, as well as from strong sales in all of the other commercial markets.

Gross margin declined 0.8%, largely due to changes in the customer and product mix, including the increase in lower margin sales to the public carrier market. Gross margin improvement is a major attack area for us in the second half of the year.

SG&A expenses were essentially flat from a year ago despite normal increases in variable costs associated with the 8% revenue growth. This is in part due to the lower portion of retail sales this quarter, but more importantly due to the strong attention we have been giving to expense reductions.

As a percentage of sales, SG&A was 18.4% compared with 19.8% of sales in the second quarter a year ago. Largely as a result of the increase in revenue and gross profit, operating income rose to $3.2 million from $2 million a year ago. Net income for the second quarter increased to $1.8 million, or $0.21 per share, compared with $1 million, or $0.12 per share in the second quarter of last year.

Moving on to the balance sheet, we are investing in working capital to support our growth in the public carrier market. During the second quarter, sales increased 48% from a year ago, and year-to-date, sales in this market have increased 54%. Accordingly, during this fiscal year, we experienced increases in inventory and accounts receivable, and a corresponding decrease in cash, including increased borrowings on our line of credit.

The company's anticipating further growth, and much of this growth is expected to come from larger customer relationships in the carrier market. To better prepare for this growth, on October 19th, we amended our line of credit facility in an effort to ensure our ability to continue to make investments as needed. The new credit facility has a borrowing limit of up to $75 million, with similar terms to the previous facility. We believe the long-term benefits from serving our public carrier and other large strategic customers more than offsets the investments in cash required to support this business.

Finally, we remain committed to our dividend program, and have set our dividend at $0.20 per share with a record date of November 8th and a payment date of November 22nd. We've made excellent progress midway through the fiscal year. We are executing on our plan to grow the top line and to improve profitability in fiscal '18. We continue to expect some fluctuation in our financial results this year as a result of significant changes across the company. At the same time, we're encouraged by our progress, and we look forward to sharing more of our success with you on future calls.

And with that, Operator, we'll open the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Bill Dezellem of Tieton Capital Management.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

Murray, would you please go into more detail on how you anticipate improving gross margin and what the magnitude of the increase is that you are targeting?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Bill, as we mentioned on the call, there's a number of little items that we're addressing right now. So I think there's action plans associated with each one of them. For instance, if you take pricing, for example, we've got new system upgrades that are in place on pricing that will allow us to tailor pricing to specific markets. And we're just approaching pricing, for instance, with more rigor and more focus on how to be more strategic from a pricing perspective.

And so, that's just a small example. In the case of Ventev, for instance, we think that there's some really good opportunities to engage differently with specific markets on the commercial business. And in order to do that, we needed to have some technology improvements on the e-commerce side. We expect that to be completed sort of this quarter. So those are all opportunities for us to address margin compression.

And as you know, we're managing a portfolio of customers and a portfolio of products with different margins, so we also are paying close attention to the mix of products. And like I said, there's action plans against all of those initiatives.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And would you care to identify the magnitude of the gross margin improvement that you are targeting?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

I think we would just want to get back to the run rate in the short term that we experienced last year. I think I've said many times that what we really want to do is focus on accelerating the growth on the top line and holding our gross margins until some of the initiatives that we have in place really materialize. So that's what I would be anticipating in the short-term.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

As you look to improve profitability, are you looking for more from gross margin improvement or sales growth? And if I just heard you right, really sales growth is where you see that coming from. Is that correct?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

That's correct, yes. I think that we think that we can continue to grow that top line, but make the improvements necessary to get us back to our previous rate from a gross margin perspective.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And then, from that point forward, is the gross margin movement really a function of customer mix and product mix, or is it that in addition to some additional initiatives that you think you can employ to enhance margin further?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

You're right on it, Bill. It's yes and yes. So yes, we think that there's some improvements that we can make. But also, we've talked a lot about getting ourselves -- building the foundation in 2018, and the mix of products, including service, recurring revenue services, those are opportunities for us to change the mix of the business. And we're paying close attention to some of that, obviously and then product mix and pricing will be important drivers, as well.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

Thank you. Relative to your win in the Big Box market, would you discuss what you can about that win in terms of products, brands, and future opportunity for additional wins?

Aric M. Spitulnik - *TESSCO Technologies Incorporated - CFO, Senior VP & Corporate Secretary*

Yes. Right now, it's a couple SKUs. I don't know that we can really talk about which vendors and which customers it is right now, but it's really our first step into a big box retailer, so it's exciting. Right now, it's not a material transaction, but there's always the possibility, once you get a couple SKUs in, to continue to expand. Obviously Ventev would be the ideal situation, but there's also other manufacturers that we feel like we can get into those big box stores. So it's the beginning of a journey, and the first time we've been into this one particular big box store ever. So it's exciting. It's not material yet, but stay tuned. Hopefully down the road, it may become it.

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Big box gives us a lot of new doors, Bill, right? So even though there's not a lot of SKUs, there's a lot of doors.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And when did you begin shipping into that retailer?

Aric M. Spitulnik - *TESSCO Technologies Incorporated - CFO, Senior VP & Corporate Secretary*

Right at the end of the quarter is when we finalized the agreement to do that.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And so do you anticipate the fourth quarter to be at a full run -- I'm sorry, the December quarter to be at a full run rate, or will you still simply be working on the initial sell-in (ph) to fill the shelves?

Aric M. Spitulnik - *TESSCO Technologies Incorporated - CFO, Senior VP & Corporate Secretary*

Yes, I think we'll still be working through the initial run-in. But again, it's only a few SKUs right now, so even if it is full, it's not going to be a huge lift in Q3 or Q4.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And then, service, that's an area that you have not had a great presence in in the past. Talk about your strategy there, and how, if you're successful with that strategy, TESSCO may look different with that implementation.

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

On the services side, Bill, I think it's really just determining what's complementary. We have a lot of intellectual capital in the company, and we want to make sure that we're supporting our customers and vendors in the right way. And how we go to market and the services that we provide, we've started to package some of those so that we can offer those services to our current customers today.

And I think, once again, we've got several irons in the fire that we're trying, and some will be very successful, I think, and others will perhaps not be as successful. But I'll give you an example where we've got -- in our retail business, we've got some capabilities around merchandising services, and endless aisle capabilities. And those I would say kind of roll up into a services opportunity.

I mentioned on the call about IoT and the degree of difficulty to start in a new business, in new markets, is pretty high. So we want to have a crawl-walk-run approach to participating in the IoT market, and we've signed some really important vendor relationships. Some we can't release yet because it's all in the process of putting the final touches on that, but that will allow us to move into the IoT world, and there's many services opportunities wrapped around selling IoT solutions.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And then, Murray, I suppose the Q&A wouldn't be complete without a question about the public carriers, particularly given the high growth again this quarter. Would you dive into some more detail in terms of how you are achieving this level of growth? And I guess would be interested in the degree to which you think you can continue it in the future.

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Okay. Thank you, Bill. I mean, it wouldn't be complete if you didn't ask a question around the public carriers. But here's what's happening. I've mentioned this on previous calls, is we can only control the activity level that TESSCO brings to the marketplace and the value proposition that we bring to our customers and to our vendor partners. And we can certainly control the intensity of how we show up in those markets.

And I would say that's the biggest driver right now, is our team is more aggressive. We are showing up in more places. I think that there's evidence to say that the value proposition is working, and so that's one side of it. The other side is that there's some big opportunities that exist in the carrier ecosystem, with FirstNet, for instance, and 5G is on the horizon. And I think it's smart for TESSCO to position ourselves in the carrier ecosystem, which is what I've been describing it as, not only with the carriers but with all the contractors, making sure that we've got a value proposition that will be able to help us deliver in those markets should the carriers really start to accelerate their capital expenditures.

So right now, we're winning more share because I think we're showing up with a very solid value proposition. And in the case on the previous quarter, we talked about a win at Verizon, and we haven't seen really any material changes there because we're working with them very closely on all of the foundational work that needs to be done so that business can be conducted seamlessly. When you go from hundreds of suppliers down to six, you can imagine all the SKU counts and different SKU numbers for similar kinds of products. We have to purge through all of that and get it into a consolidated format so that it's easy to transact and do business together. And we're working on those things right now.

So that's one of the reasons that I think that, to the second part of your question, do I expect it to continue, I'm not sure it's always going to be at the current growth rates, but I'm sure that we're going to be able to participate in this market as a much bigger level than we are today.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And you I think answered part of the next question, which is that Verizon win that you did announce last quarter, the degree to which it contributed to your success this quarter. And it sounds like it was rather small, as you're still in the early stages of that.

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Yes. I think that we're definitely scoring some points. There's no question, Bill. But all of the work -- there's a lot of work that has to be done for this business to be transacted in a seamless way, and that's really what our teams are working on. The Verizon team and the TESSCO team are working closely together on this. So I'm encouraged by the progress. And our target dates, I think we'll start to see more material impact from that. As we turn the corner into the fourth quarter and the first quarter of next year, we'll start to see more activity levels.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And is it correct that, in the public carrier market, you have not seen a large increase in the overall level of activity? So the growth that we are seeing is really a function of TESSCO simply doing a better job and increasing market share?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

I think that's largely true, but I would say that the carriers are probably increasing their capital expenditures. There's, like I said, a lot of things that are big opportunities that are existing in the marketplace today, so I think there's some of that that's happening for sure, upgrading systems and that sort of thing.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

Relative to the government business, it wasn't that many quarters ago that that business appeared as though it had stagnated, and now it appears just the opposite. So (inaudible) the appearance just simply incorrect, or have there been some changes that you all have instituted that are leading to that higher rate of growth?

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

No. I can understand the impression, but here's the answer, Bill, is really the transactions in the business that we've conducted with the government needs to have a little more predictability. That's an opportunity for us on a go-forward basis. Right now, we're very opportunistic in that market, and we've been winning larger transactions, which is great when you're winning them, and when those transactions are available. And if they're not available or you miss a quarter, then it impacts the results so it looks a little spiky.

And what the team's working on right now is continuing to focus on winning those larger transactions, but trying to smooth it out with more run rate business. And once again, that's more of a coverage opportunity for us. I feel like the government value proposition, or the value prop that we have to the government, is very solid. We need more at-bats. We need more opportunities in front of the government business. And I think that that's what we're focused on right now.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

Great. Thank you all, and nice quarter.

Operator

Thank you. And that does conclude our Q&A session for today. I'd like to turn the call back over to Mr. Murray Wright for any further remarks.

Murray N. Wright - *TESSCO Technologies Incorporated - President, CEO & Director*

Okay. Well, thank you, Operator, and thank you to everyone for joining us. We're encouraged by our continued progress and our ability to execute on our plan this year. And we appreciate your interest in TESSCO. We'll look forward to speaking to you again on our next earnings call in January. Have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program, and you may all disconnect. Everyone have a great day.
