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TESS - Q4 2018 TESSCO Technologies Inc Earnings Call

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**Matthew W. Dhane** *Tieton Capital Management, LLC - Senior Research Analyst and Principal*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2018 TESSCO Technologies Incorporated Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, David Calusdian from Sharon Merrill Associates. You may begin.

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

Good morning, everyone, and thank you for joining TESSCO's fourth quarter 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 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 N. Wright** - *TESSCO Technologies Incorporated - President, CEO & Director*

Thank you, David, and good morning, everyone. Thank you for joining us -- joining us on the call today. We had a strong finish to our 2018 fiscal year. Year-over-year revenue growth was 21% for the quarter and revenues for the full fiscal year increased a solid 9%. I'm proud of our team as this was our highest annual year-over-year revenue growth since fiscal 2012 and our first profitable quarter since 2014. From a top line perspective, the significant quarterly increase was driven by 82% growth in sales of the carrier ecosystem as well as higher sales in all other markets. We believe that during the fourth quarter, our revenue growth outpaced the overall market in part because of new customer relationships we established this past fiscal year. We are executing well on these new relationships. For example, the Verizon contract we won in late fiscal 2017 began to contribute to revenues during the 2018 fiscal year and really picked up in the fourth quarter. Additionally, our relationship with AT&T's largest turf contractor, MasTec, began during the fourth quarter. We expect both relationships to generate increasing revenues in the coming quarters.

Our value proposition and dedication to meeting customer expectations is making a difference. We know customers have a choice and they are choosing TESSCO more frequently. During last quarter's call, we set the expectation we would be profitable this quarter and, indeed, we achieved $0.07 of earnings per share. This profitability was the key milestone in our road map to achieving sustained revenue and profitability growth. Here's some information on our specific market results. Total commercial sales increased 30% this quarter as sales grew in each market.

In the carrier ecosystem, several large orders we had projected on our Q3 call came through in Q4, contributing to the overall increase.

Rounding out the commercial markets, government, private systems operators and VARs, all demonstrated solid year-over-year growth with private system sales increasing by over 20%. Our new go-to-market strategy that we launched earlier in the year has allowed our sales teams to get closer to our customers and has helped uncover many new opportunities.

Turning to the retail market. Sales increased 4% year-over-year with a significant contribution from the launch of the Samsung Galaxy S9. Gross profit improved by 16% as a result of better product mix and stronger engagement with our manufacturer partners. This allowed us to work together on collaborative plans with targeted outcomes.

The retail market, in general, faces ongoing challenges amid a very competitive and dynamic landscape. To address these challenges, we are pursuing new business opportunities and introducing expanded services in this market to continue to drive improved profits.

As we look to fiscal 2019, we have 4 main priorities: Number one, increasing our customer focus. Our value proposition is resonating well with suppliers and customers in all markets. We are concentrating on helping our customers and vendors improve their supply chain effectiveness, utilizing our expertise in demand planning, standardization, inventory and warehouse management, optimize logistics and just-in-time delivery.

Last year, we formed a Customer Advisory Council with a broad representation of executives from across the industry. We did this to strengthen our engagement with customers by receiving input directly from these customers regarding their needs, our services and how we can best work together. We are also investing extensively in sales training to ensure that our sales team is critically focused on our customer's needs, both now and in the future. As a result of these customer-centric engagements, we became very focused on Internet of Things or IoT opportunities. We are pleased with the progress we are making in IoT-related revenues. They were up 22% this year. This includes Tier 1 carrier programs, new relationships with leading vendors, such as Sierra Wireless, Samsung and Monnitt and machine-to-machine sales into the utility and oil and gas markets. We are adjusting our product marketing and sales teams to attack key verticals with preconfigured solutions and custom capabilities. We expect to continue to develop new vendor relationships and expand our IoT solutions in the coming years.

Number two, we are raising our compete level. We believe that in order to be successful, innovation and creativity are critical in the solutions we provide to our customers. We recognized that we win when we are aggressive in our approach, and maintain a heightened sense of urgency both internally and externally. We are working to build on the momentum we saw in FY '18 and carry that through the new fiscal year. Our company has a number of internal initiatives to increase the skill levels of our employees and to foster an environment for success. Our TESSCO team is energized, and we're making a difference in the marketplace.

Number three, executing on our initiatives. We have a high degree of focus overall -- on overall execution across the entire company. This includes both top line opportunities as well as productivity initiatives. We are already reaping the benefits of the increased operating leverage and that's no accident. We have strategically placed the right people in the right jobs and are allocating resources in the most efficient and effective way possible. While reducing our overall headcount this year, we have added many key individuals to enhance our overall talent. We're investing in smart growth and this should further boost our profitability. We are also stringent in our dedication to improved processes and efficiencies across the entire organization.

We recently obtained an upgraded certification to TL9000 R6, which is a real tribute to our quality management systems in our TESSCO team members and a key differentiator in the market.

Number four, we are continuing to invest in technology tools. New technology is vital to our ongoing success. We are seeing perpetual changes in how technology delivers wireless products and services, and we must be at the forefront of that evolution. We expect to launch several exciting new technologies this year, some are internal tools and we expect them to improve productivity. Others are customer and vendor focused, including a new tessco.com.

We look forward to providing updates on our technology initiatives that are underway on future calls.

Before I hand the call to Aric, I want to emphasize a few key points: first, we had a very strong performance in the fourth quarter with revenue and gross profit both up more than 20%. This was a real team effort with solid execution across the company. We believe our results demonstrate that we are gaining market share; second, we want to emphasize the significance of our fourth quarter bottom line results. We delivered our first profitable fourth quarter in 4 years. This isn't simply about revenue growth, but it's a culmination of our productivity and efficiency initiatives; and finally, our value proposition is resonating with suppliers and customers across our markets. The go-to-market strategy we put in place during the past year is beginning to yield results. We are intent on balancing the implementation of this strategy with improved operating efficiency. We are confident in our value proposition and anticipate new success in the new fiscal year.

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

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

Thank you, Murray. Good morning, everyone. For the fourth quarter, revenues totaled $149 million, up 21% from the prior year quarter as revenues grew in each of our markets. This year's fourth quarter included 14 weeks as opposed to the normal 13 weeks. For fiscal year 2018, sales increased 9% over fiscal of 2017. And as Murray said that this was our second -- this was our largest annual top line growth in 6 years. Gross margin for the quarter was 21.2% consistent with the fourth quarter a year ago. Gross margin for fiscal year 2018 was down slightly from the prior year due to changes in the customer and product mix, particularly the significant increase in large carrier ecosystem revenues. Because of our ongoing expense control initiatives and productivity enhancements, we held the year-over-year increase in SG&A expense for the fourth quarter to 13%, which was significantly lower than the growth in revenue and gross profit. As a percentage of revenue, SG&A was 20.4% compared with 21.9% in the fourth quarter a year ago.

For the year, our productivity initiatives lowered SG&A as a percentage of revenue from 20.3% to 19.4%. Because of the increase in revenue and our effective cost controls, we achieved operating income of $1.2 million compared with an operating loss of $1.8 million a year ago.

Operating margin improved [from] 0.8% from a negative 1.4%. For the 2018 fiscal year, operating margin increased to 1.4% from 0.5% in fiscal 2017. As we pursue increased revenue growth in future quarters, we believe operating margins will continue to improve.

Net income for the fourth quarter increased to $0.6 million or $0.07 per share compared with a net loss of $0.9 million or a loss of $0.10 per share in the fourth quarter of the prior year.

Last year's fourth quarter did include an $800,000 restructuring charge. For fiscal 2018, net income grew more than 200% to $4.7 million or $0.55 per share from $1.4 million or $0.17 per share in fiscal '17.

Moving on to the balance sheet. As we expected, during the fourth quarter, we increased -- we experienced increases in inventory and accounts receivable to support the growth in the carrier business and had a corresponding increase in our line of credit.

Finally, we remain committed to our dividend program and have set our dividend of $0.20 per share with a record date of May 21 and a payment date of June 4.

While we are not providing numerical guidance, we currently anticipate year-over-year growth and revenue and profitability in fiscal 2019. While we expect considerable growth in the carrier ecosystem, we also expect this to result in a lower overall year-over-year gross margin, given the lower-margin nature of many of these large carrier relationships. Also keep in mind that due to the project-oriented nature of many of our larger customers, we expect to see some lumpiness in the quarter-to-quarter results. For example, due in part to the timing of the Samsung Galaxy S9 launch, we expect the retail revenues to be lower in the upcoming Q1 as compared to the 2018 fiscal first quarter. But we do expect commercial revenues to demonstrate solid growth.

As we look ahead to fiscal 2019, we are excited about our progress, the opportunities in the marketplace and the momentum we are seeing across the business. We look forward to providing additional updates on our progress on future calls.

And with that, operator, we will open the call for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question comes from the line of Maggie Nolan from William Blair.

**Margaret Marie Niesen Nolan** - *William Blair & Company L.L.C., Research Division - Analyst*

I was hoping you guys could talk a little bit more about the adjustments that you're making to the sales team in order to verticalize them.

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

Well, Maggie, this is Murray Wright speaking. This has been an initiative that we started through last year on how to fine-tune our go-to-market strategy. And so we are making sure that we are both regionalized and targeting on -- targeting vertical markets and that's both the product strategy and a customer strategy. So, for instance, you heard me make some comments about IoT and that's why we are working hard on putting together solutions and then taking them to applicable vertical markets. And I think, we'll see some good traction in that this year.

**Margaret Marie Niesen Nolan** - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. And then in terms of headcount growth for the next fiscal year, what should we be expecting just given that you did have some cuts in the past year?

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

I think the overall headcount in the company will remain relatively flat. We're going to invest in strategic areas to help us position ourselves in strategic markets for us, but from an operational perspective, I think we are in pretty good shape and have an opportunity to leverage the growth of the business with the current team we have in place.

**Margaret Marie Niesen Nolan** - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. Good to know. And then you talked a little bit about some of the productivity initiatives. What should we expect to see in the next fiscal year in terms of productivity initiatives? And then how is that going to come down to the operating margin line, especially given that you've laid out this expectation for a lower gross margin?

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

Yes. That becomes -- I mean, I'm sure Aric has some comments on that. Just really the key for our business is mix. It's customer mix and product mix in the business. And so from a productivity perspective, I think we've made some investments in technology to improve the productivity of our team across the company and there is more of that, that is currently underway in the business. We're pretty excited about the technology footprint that we have on a go-forward basis. And as we introduced more tools to the company, then we expect the productivity to also go up. As we're doing that, Maggie, we'll also be staying very close to the mix of the business. And do we have the right products, the right vendor relationships, the right solutions going into the right markets? And that's a constant effort from our team, and it has a very high visibility today in the company.

**Operator**

(Operator Instructions) And our next question comes from Damien Amato from DRZ.

**Damien Amato** - *DePrince, Race & Zollo, Inc. - Research Analyst*

First question. On the year-on-year growth in carriers, any chance you can [decompose] between the extra week, the revenue that rolled over and then the new business? Obviously, the growth in the quarter was pretty exceptional. Can you give us a sense for how that looks going forward?

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

Yes. Damien, it's Aric. The extra week was -- it's hard to say exactly what that impact had because it's depending on which week you call the extra week. We don't think it was ultimately all that material in the grand scheme of things and that I think we would certainly have been profitable without having the extra week. The rollover from the prior quarter was a couple large deals probably in the $15 million range that was booked in the previous year -- quarter and shipped this quarter. So that's kind of where we see. So the rest of that growth really came from the new opportunities that we've been creating with some of the bigger carriers and the contractors over the last couple of years. And we certainly expect this -- those relations to continue to grow, especially as we get into the middle part of this new year.

**Damien Amato** - *DePrince, Race & Zollo, Inc. - Research Analyst*

Okay. And what changed between your guidance and what we saw? I mean, when you guys guided the double digits, I don't think you were guiding for 20% growth. I'm just curious what changed in the quarter that maybe surprised you?

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

I don't know that we had -- I think we set the expectation that we were going to head at least the double digits or at least have a very solid growth. I think we had a really good execution of a quarter. All the markets grew and things came together really well. So I think, we're just really about execution and did a great job throughout the organization of closing deals and getting things done. So really excited about what we're able to do this quarter.

**Damien Amato** - *DePrince, Race & Zollo, Inc. - Research Analyst*

Yes. Are you seeing any pickup yet from FirstNets? I know AT&T has basically talked about their intentions. It seems pretty aggressive as we go into the second half of this year. I'm just wondering if you guys are seeing any of that already sort of being lined up?

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

We've seen some. It's sometimes difficult for us to know exactly what's a FirstNet order and what is the normal replacement orders or 5G orders because they all look similar. And it's completely different products, but an order doesn't get called out as a FirstNet order or a 5G order or a 4G order or replacement order. So we don't track it exactly like that. But I think from just speaking with some of the customers, we've seen some of the early stages of it, but I would say not real significant issue at this point.

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

Damien, I would just -- it's Murray. I would just add to that by commenting that we're also very engaged with our suppliers as well and lots of dialogue and making sure that the supply chain has good visibility so that when the light turns green and the activity level starts to pick up for FirstNet, that the supply chain has products available. And so we're working very closely with our vendor partners, and we haven't seen the expected uptick. There is, I think, as Aric described it, we've seen some of it. Some of it's hard to identify, but from everything that we've discussed with our supply chain, it looks like a Q3 kind of pickup. That's what we're anticipating in our plans.

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**Damien Amato** - *DePrince, Race & Zollo, Inc. - Research Analyst*

And, obviously, on the guide for Q1 guys, you have been a little less clear on this guide than you have on previous guides. You have a single analyst out there who continues to be a [challenge of] estimates. I'm just wondering can you maybe frame Q1 a little more clearly for people so that we don't end up with another negative surprise in the bottom line because it seems like we have that on a regular basis at this point despite your efforts?

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

Well, I think as we said here, we think the retail market will be down. I think the commercial market will be up. We do think we'll have -- ultimately, have revenue growth, but again at lower gross margins. And with the expenses being probably similar, but maybe slightly ahead of where last year it was, I'm not going to give you a number, but that kind of gives you already something to look at there.

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

And then, Damien, I would also just make the comment as well that the way that we're viewing this year is that we've been successful in securing some pretty significant new customers and those customers, their business with us tends to be project based. And as much as we try and get visibility on when the product -- when the project is going to require execution on product, I don't know specifically whether it's going to be the last 2 weeks of our quarter or the first 2 weeks of the following quarter. And I think that's why you're seeing a little bit of cautiousness in how we forecast the business. We feel very confident about the year and anticipate some very good things this year, but from a quarter-to-quarter basis, there's a few variables that are difficult for us to walk in.

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**Operator**

And our last question comes from the line of Matt Dhane from Tieton Capital Management.

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**Matthew W. Dhane** - *Tieton Capital Management, LLC - Senior Research Analyst and Principal*

I was hoping to discuss a little bit more the ramp-up of Verizon. I know you discussed that Q4, you saw significant step-up in that relationship. Curious what you're at relative to your longer-term expectations and thoughts, how much additional business you expect to gain from other suppliers later this year over the next several years? Just want some color around that, if I could.

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

Yes, right now, we're still probably in the -- definitely in the less than $10 million a quarter from the Verizon relationship. It's still been ramped up by Verizon. We're still very aggressively going after all of the carrier -- all of their -- the contractors that now need to buy from one of the several authorized sellers. So that process is still ongoing. And it took a step forward here in Q4 and we think it will continue to ramp. So I think there's still a significant way to go where we have room to really grow that business significantly more than where we at -- we are at today. And probably, again, in middle of the year type, probably will continue to grow as we go through this year, but as we get towards the end of summer -- late summer into fall is where we probably see it really ramping up to more significantly than where it is today.

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

And, Matt, I just -- on that point, it's Murray, I just wanted to remind you that while the supplier list that Verizon's picking from has been dramatically reduced and that's why we were and are very excited about the relationship, it's still hand-to-hand combat with the competitive environment. So Verizon is taking a lot of very positive steps to fine-tune their supply chain and we're actively participating in that, but as the orders and so on come up, we are still in a competitive environment with a smaller group of competition, but nonetheless, it's still a competitive landscape.

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**Matthew W. Dhane** - *Tieton Capital Management, LLC - Senior Research Analyst and Principal*

No, that is helpful. I appreciate that additional info, Murray. And then regarding AT&T, and you mentioned MasTec and obviously that has started ramping, but I was curious is there other new turf contractor wins out there that you are actively working on in AT&T and you hope to win here over the next couple of quarters?

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

So I think our value proposition has been playing out very well in the marketplace and it's still continuing to evolve. Our sales team is very aggressive in delivering that value proposition to all those potential prospects. So we are actively pursuing more business in that contractor space. There is no question about it. I don't have any big announcements to make to you at this time, but we're expecting that business will continue to grow for us.

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**Operator**

Thank you. And speakers, I'm not showing any further questions at this time. I would now like to turn the call back over to Murray Wright for any closing remarks.

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

Well, thank you, and thank you to everyone for joining us. We appreciate your support of TESSCO. We look forward to speaking with investors at the East Coast IDEAS Conference tomorrow and at the Ladenburg Technology Expo on May 31. Hope everyone has a great day and we look forward to talking to you again next quarter.

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**Operator**

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

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