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TESS - Q4 2017 TESSCO Technologies Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

Anil Doradla *William Blair - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the TESSCO Technologies Incorporated Q4 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the call over to David Calusdian. You may begin.

David Calusdian - *Sharon Merrill Associates, Inc. - IR*

Good morning, everyone, and thank you for joining TESSCO's Q4 2017 conference call. Joining me today are Murray Wright, TESSCO's President and Chief Executive Officer, and Ted Perez, the company's Controller. Cindy King, Vice President and Treasurer, is also on hand to answer questions. Ted will be sitting in for Aric Spitulnik, TESSCO's Chief Financial Officer, who is dealing with a family emergency today. He will be back next week to answer any follow-up questions you may have.

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?

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Thank you, David, and good morning, everyone. Thank you for joining us. This is an exciting time to be at TESSCO. Our industry is changing, and it is changing very rapidly. Several industry market forecasts call for double-digit compounded annual growth rates during the next three years. This growth and the market expectation of on-demand access with anywhere, anytime connectivity will benefit the entire wireless industry.

The good news for TESSCO is that we are well positioned in the markets and product categories that are anticipating growth, and we have a clear path forward to capitalize on that growth.

In my short time here, it's become apparent we need to be agile, flexible and willing to change to capitalize on growth opportunities. In fact, the market demands it, competition requires it and we know our shareholders expect it.

Last quarter, I introduced four priorities that are required for us to grow revenues and improve bottom-line profitability. Number one, enhancing our e-commerce and electronic tools; number two, optimizing our go-to-market strategy; number three, improving our product and vendor management engagement; and number four, increasing our margins and operating leverage through diligent expense management. All of these initiatives are also centered on providing a differentiated customer experience.



First, on the e-commerce front, we have been investing in TESSCO's Website to improve our online and e-commerce experience for our everyday buyers. This is a journey, not a destination. We are making improvements to the site that will help us reduce expenses and improve our efficiency and effectiveness. We expect more substantial progress on the development of these electronic tools toward the middle of the 2018 fiscal year. Our e-commerce initiatives will impact how our customers and vendor partners work with us. And we expect they will have a direct positive effect on productivity.

Second, in March, we undertook a significant reorganization of our business generation teams. We have combined our commercial sales, product and supply chain teams under one leader, Senior Vice President of Commercial Business Charles Kriete. We have promoted Liz Robinson to Senior Vice President, and she is responsible for our retail sales and product teams. We are confident that this new organization structure will provide better alignment with our manufacturing partners and customers and facilitate a more effective selling strategy.

We are taking many other steps to enhance our go-to-market strategy. We've reassigned many of our customer accounts to different sales representatives to ensure better regionalization of our salesforce. By moving sales professionals closer to their customers, we should drive cost efficiencies. More importantly, regionalization will improve the customer experience by having our reps spend more time in the customers' regions.

In addition, we introduced a new quota-based compensation plan in April that strongly incentivizes portfolio growth. We've also created a team of sales reps who will only focus on customers who have done little or no business with TESSCO in the past, in order to increase our pipeline of purchasing customers.

Finally, we have taken several of our larger VAR customers and consolidated them into a strategic accounts team, with sales reps dedicated only to a handful of accounts to build deeper, stronger relationships with these customers.

Our third priority is to improve our product and vendor management engagement. Here are two great examples. On the network infrastructure side, we are dramatically changing how we structure the product marketing management organization to better align with our vendor partners.

Previously, a product marketing manager would have responsibility for a set of products, such as antennas or site hardware. However, under our new team alignment, a product marketing manager will now have responsibility for a specific vendor or group of vendors. This will improve communication, deepen relationships with the vendor community, enhance our ability to cross-sell specific vendor product lines, and maximize revenue for key vendor partners. Product managers will also be compensated in relation to the performance of their assigned vendors, therefore driving much more accountability for increasing sales.

Fourth and finally, in combination with the business generation reorganization, we have undertaken a number of cost reduction initiatives to make the entire organization more productive and to better control our expenses. These actions should increase our operating leverage and improve profitability as our sales trajectory accelerates.

We're executing well on these priorities. While we are not providing earnings guidance for fiscal 2018 at this time, we are confident we will see growth in revenue and earnings in fiscal year 2018, which should set the stage for accelerated results next year and beyond. I look forward to updating you on our progress as we move forward.

Now I would like to do a brief overview of our markets. The public carrier market, which includes not only the large tier one carriers, but also the contractors, integrators, program managers and tower owners that support these carriers, improved significantly from a year ago.

This increase primarily was due to orders from several key contractors and integrators. Gross profit also improved by double digits from a year ago, as a result of the increase in sales. However, as we experienced last quarter, gross margin declined from a year ago, as these large customers tend to earn better pricing.

We continue to bring on new customers in this market who have the potential to be significant during the next 12 months. In the government market, sales and gross profit were up double digits sequentially and from a year ago. Some large federal projects originally scheduled for Q3 were

realized in Q4, counting for a portion of the increase. We continue to drive more opportunities in this market, and we are optimistic about our potential in upcoming quarters.

In the commercial dealers and resellers or VAR market, revenue was up modestly sequentially and from a year ago. Gross profit was down slightly sequentially and up from a year ago. We saw strong performance from our network VARs, as we have been proactively selling more Ventev products and solutions.

In the private system operator market, revenues and gross profit declined sequentially and increased double digits from a year ago. Our utility customers continued to perform well, while our focus on marketing to the oil and gas sector helped us win business despite the ongoing sector-wide downturn.

Turning to the retail market, sales declined sequentially, as is always the case after the Q3 retail holiday season. Sales also declined year over year, primarily as a result of the delayed launch of Samsung's Galaxy S8 phone into our fiscal first quarter. We shipped a significant amount of product related to the S7 phone in last year's fourth quarter.

Gross profit declined double digits sequentially, but increased low single digits year over year. The increase in gross margin was a result of changes in product mix, including an increased proportion of Ventev sales. We continue to see increased competition in the retail space, but our strong value proposition is playing well, allowing us to maintain our strong customer base.

Ventev sales, which include both mobile device accessories and infrastructure offerings, totaled 15% of overall revenues during the quarter and the fiscal year, as both sides of Ventev have been very strong.

The increase on the accessory side of the business was driven by continued strong demand for the high-quality power products Ventev offers for a variety of wireless devices. The growth in Ventev infrastructure sales was driven primarily by the Ventev Wi-Fi business. We have recently deployed Wi-Fi handrail antennas and stadium enclosures at a few stadiums across the country, such as the newly constructed Orlando City Soccer Stadium.

And now I'll turn the call over to Ted Perez for a discussion of the financial results. I'll then close the prepared remarks before opening the call to your questions. Ted, over to you.

Ted Perez - *TESSCO Technologies Incorporated - Controller*

Thank you, Murray, and good morning, everyone. In the fourth quarter, revenues were \$123 million, compared with \$114 million in the fourth quarter a year ago and \$147 million in the third quarter. This is our second consecutive quarter of year-over-year growth. The increase in revenues from the prior year resulted in part from significant orders from several key public carrier customers and from strong government sales.

Gross margin was 21.2% of revenue, up from 20.2% a year ago and 20.4% during the sequential third quarter. The increase in gross margin was largely the result of changes in the customer and product mix. This included a 28% year-over-year increase in sales of higher-margin Ventev products during the quarter.

SG&A expenses increased \$1.5 million from a year ago. This increase primarily was driven by higher operations costs to service the company's retail market customers, increased compensation, including incentive compensation related to the company's sales and marketing initiatives, and severance costs related to the previously announced organization restructuring. It should be noted that last year's SG&A included a special \$1.6 million accrual for a software audit.

As a percentage of sales, SG&A was 22.6% compared with 23% of sales in the fourth quarter a year ago. Largely as a result of the increase in revenue and gross profit, we narrowed our operating loss to \$1.8 million from an operating loss of \$3.2 million a year ago.

Net loss for the fourth quarter was \$900,000, or a loss of \$0.10 per share, compared with a net loss of \$2 million, or a loss of \$0.24 per share, in the fourth quarter a year ago. Excluding the restructuring charge of approximately \$800,000 or a tax-effected \$0.05 in earnings per share, adjusted EPS was a loss of \$0.05 this quarter.

Looking at the balance sheet, inventory increased by \$900,000 from the sequential third quarter due to some strategic inventory buys. Cash flow from operations was \$2.4 million during the fourth quarter and \$3 million for the fiscal year. Overall cash on the balance sheet was \$8.5 million.

Back to you, Murray.

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Thank you, Ted. While we may see some short-term volatility in our results, I'm confident the steps we are making through our key initiatives, our reorganization, our new leadership, our heightened focus on cost management and our collaboration with our vendor partners will form a strong foundation for future sales growth and improved profitability.

As a demonstration of this confidence, we remain committed to our dividend program and have set our dividend at \$0.20 per share with a record date of May 24 and a payment date of June 7. I'm optimistic about the opportunities and our business this year, as we build momentum even more so in the future.

And now Cindy, Ted and I are available for your questions today. Aric will be back in the office next week. Operator?

QUESTIONS AND ANSWERS

Operator

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

Anil Doradla - *William Blair - Analyst*

Hey, good morning, Murray and Ted. And, Murray, congratulations on all the four initiatives. Sounds like a lot of new energy in the company. So congrats on that.

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Thank you, Anil.

Anil Doradla - *William Blair - Analyst*

A couple of questions. So these four initiatives that you're kicking in, obviously, you said it's not a near-term thing. It'll take some time. But if I were to look at the business longer term, can you comment on what you think should be the margin profile of the company and the growth profile of the company? Do you feel that the growth can revert back to double digits and margins at a certain level, not necessarily in the near term, but more longer-term once it gets to a more normalized operating model?



Murray Wright - *TESSCO Technologies Incorporated - CEO*

I think, Anil, that's a great question, and I'd love to be able to provide you with some specific details on that. I think, as we go through the transitions and launching the new initiatives that we've discussed this morning, I think it's going to take us a little bit more time before I can give you a good answer on that.

Here's a few things that we know. The marketplace that we participate in looks to be growing, and we are evolving the company to participate and more aggressively pursue that growth.

So I feel good about the initiatives that we've put in place. But -- and I think that we're going to continue to grow and experience some positive results this year. But I would still look at this year as a launch pad for the future for us. We're really focused on building that foundation. And I think, over the next couple of quarters, Anil, I'll be in a better position to give you a more definitive answer to your question.

Anil Doradla - *William Blair - Analyst*

Great. So, Murray, another question. Last several quarters, we've had some issues around service provider spending, right, CapEx spending with large mobile operators. Can you give us an update on that front? How are they behaving? And how is that impacting your business? Clearly, there's some turnaround in that part of the business for you, but would like to know how the service providers are behaving right now.

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Well, I think, right now, there's some new initiatives that are underway. But right now, I'd describe it pretty much as stable. What I would like to reinforce, though, Anil, is that our approach to those service providers has become more aggressive with better coverage. And I think that's leading to us participating in more opportunities and winning more market share there.

Anil Doradla - *William Blair - Analyst*

Okay. Great. You talked about some Galaxy S8 push-outs into the next quarter due to the retail side. How large -- can you give us a perspective of how large do you think this business could be as a proportion of that subsegment?

Murray Wright - *TESSCO Technologies Incorporated - CEO*

I'm sorry. I missed the first part of the question, Anil.

Anil Doradla - *William Blair - Analyst*

No, the Galaxy S8 you talked about, when you get to full production, can you give us a sense of how large this business could be for TESSCO?

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Well, we're in the midst of that right now. The launch is just occurring. So we had a good day yesterday. And a lot of that's attributed to fulfilling Samsung and / or Samsung accessories and back orders and replenishments. So we're in the midst of it right now. I don't even know what to give you from a prediction on that necessarily, Anil, but I can tell you that we're definitely seeing an uptick based on the launch of the S8 in our first quarter here. It will continue for the next few weeks, we expect, as well.

Anil Doradla - *William Blair - Analyst*

All right. Ventev now is 15% of sales. Clearly, that's a very differentiating product line for TESSCO. You talked about infrastructure. Sounds like infrastructure will be an area of focus. Right now, just to -- I know most of it is on the handset side, but what is the breakdown between infrastructure and handsets? And --

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Yes, it's about -- go ahead. Sorry.

Anil Doradla - *William Blair - Analyst*

And what I was asking is that, over the next couple of years, do you have a sense of where you would like to see the mix between infrastructure and handsets?

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Yes, it's about -- right now, Anil, it's about 50/50. And I think there's opportunities on both sides of that business to continue to aggressively grow the business, although it will be different, right? You know that both those product sets are different. The sale of the infrastructure products into scenarios like stadiums, for instance, is much different than the intellectual capital and engineering creativity on the power side for the retail customers. But you can be assured that we are currently focusing on both of those and intend to grow our Ventev business in the 2018 fiscal year.

Anil Doradla - *William Blair - Analyst*

Great. And if you don't mind squeezing in one last one. You talked about a strategic inventory increase of what, \$900K? What was that?

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Correct. Yes, what we did is we were positioning ourselves for purchasing product to get us in a better position for the fourth quarter. As you know, the fourth quarter from a calendarization perspective doesn't allow us to finish as strong as we would like. So we were placing some bets on bringing inventory and aggressively selling it through, which we're continuing to do in the first quarter of the new fiscal year. So that's really why we up-leveled the inventory, to take a run at having improved results in the fourth quarter and get us off to a fast start in the first quarter.

Anil Doradla - *William Blair - Analyst*

Very good. Alright. Thanks a lot. And looking forward to all the [great changes] in the company.

Murray Wright - *TESSCO Technologies Incorporated - CEO*

Yes, thank you for your questions, Anil.

Operator

(Operator Instructions) At this time, I'm showing no further questions. I would like to turn the call back over to management for closing remarks.



Murray Wright - *TESSCO Technologies Incorporated* - CEO

Alright. Thank you, everyone, for joining us today. We're optimistic about our progress and anticipate additional success during the new fiscal year. We look forward to speaking with some of you at the East Coast IDEAS Conference on May 18 and the Marcum MicroCap Conference in June. We will have our next earnings conference call in July. Have a great day. Thank you for attending the call.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect, everyone. Have a great day.

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