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SNX - Q2 2017 SYNNEX Corp Earnings Call

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PRESENTATION

Operator

Good afternoon. My name is Anj, and I will be your conference operator today for the SYNNEX 2017 Second Quarter Earnings Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect.

At this time, I would like to pass the call over to Mike Vaishnav, Senior Vice President, Corporate Finance and Treasurer at SYNNEX Corporation.

Mike Vaishnav - *SYNNEX Corporation - SVP of Corporate Finance and Treasurer*

Thank you, Anj. Good afternoon, and welcome to the SYNNEX Corporation earnings conference call for the fiscal 2017 second quarter ended May 31, 2017. Joining us on today's call are Kevin Murai, President and CEO; Dennis Polk, COO; Marshall Witt, CFO; and Chris Caldwell, EVP and President of Concentrix Corporation.

Please note that some of the information you'll hear today consists of forward-looking statements within the meaning of the federal securities laws. Such statements may relate to, without limitation, market, demand, sales, investment, growth, non-GAAP net income and EPS, margin, profit, revenue, costs, shares, tax rate, seasonalities, strategy, over-performance, cash conversion cycle, location, client relationship and acquisition impact. Actual results or trends could differ materially from our expectations. For more information, please refer to the risk factors discussed in our Form 10-K for fiscal 2017 and discussion of forward-looking statements in our earnings release and Form 8-K filed with SEC today.

SYNNEX assumes no obligation to update any forward-looking statements which speak as of their respective dates.

Also during this call, we will reference certain non-GAAP financial information. Reconciliation of non-GAAP and GAAP reporting is included in today's earnings release and related Form 8-K available on our website at www.synnex.com.

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Now I would like to turn over the call to Marshall for an update on our financial performance. Marshall?

Marshall W. Witt - *SYNNEX Corporation - CFO*

Thanks, Mike. First, I will review our results of operations and key financial metrics and then conclude with guidance for the third quarter of fiscal 2017 before turning the call over to Kevin.

Our Q2 revenue, net income, EPS, both GAAP and non-GAAP, all exceeded our expectations. On a consolidated basis, total revenue was $3.9 billion, up 16.5% compared to $3.4 billion in the same quarter of the prior year. Adjusting for FX of $19.2 million, revenue in constant currency was 17% higher compared to the prior year quarter.

Technology Solutions segment revenues were $3.5 billion, representing an increase of 13.5% compared to the prior year quarter. The Technology Solutions revenue increase was mainly due to strong demand for our cloud-based solutions platforms and other strategic business units. On a constant-currency basis, Technology Solutions' segment revenues increased 14% year-over-year.

Concentrix revenues were $481.7 million, up 43.4% from $335.9 million in the prior year quarter. The Minacs acquisition and strength in our automotive vertical contributed to the increase in revenue, while FX had a negative impact of $4.1 million.

Now turning to gross profit. Our gross profit on Q2 revenues was $372.2 million or 9.5% of revenues compared to $294 million or 8.7% of revenues in Q2 of 2016. The increase in gross profit dollars was due to higher sales in our Concentrix segment, cloud-based solutions platforms and solid performance on our core distribution businesses.

Q2 total selling, general and administrative expenses were $231.5 million or 5.88% of our revenue compared to 6% of revenue or $202.7 million in the second quarter of fiscal 2016. The dollar increase was primarily due to the Minacs acquisition. Both segments effectively managed support costs while revenue grew.

Consolidated non-GAAP operating income was $141.2 million or 3.59% of revenue compared to $91.7 million or 2.71% of revenue in the prior year second quarter, representing an 88 basis point improvement.

At the segment level, Q2 Technology Solutions non-GAAP operating income was $102.4 million or 2.96% of revenue, up approximately 34% from the prior year quarter results of $76.5 million or 2.51% of revenue due to higher value-added services and scale efficiencies.

For Concentrix, non-GAAP operating income in the quarter was $38.8 million or 8.06% of revenue, up from the prior year result of $15.1 million or 4.5% of revenue, primarily due to effective cost management, operating leverage generated from certain ramps and the Minacs acquisition.

Net total interest expense and finance charges for Q2 was approximately $9 million, up from $6.5 million from the prior year quarter due to higher borrowings to fund the Minacs acquisition and growth in our Technology Solutions segment. Net other expense was $0.2 million in the second quarter 2017 compared with other income of $0.9 million in the prior year quarter.

The tax rate for the second quarter of fiscal 2017 was 36.9% compared to 36.4% in the prior year period. For the remainder of fiscal 2017, we anticipate the tax rate to be in the range of 35.5% to 36.5%.

Our second quarter non-GAAP net income attributable to SYNNEX Corporation was $83.2 million or $2.08 per diluted share.

Turning to the balance sheet, our accounts receivable totaled $1.8 billion on May 31, 2017, for a DSO of 42 days, up 1 day from the prior year quarter. Inventories totaled $2.1 billion or 55 days at the end of the second quarter, up 14 days from the second quarter of 2016.

Consistent with our Q1 commentary, inventory remained elevated due to strategic investments in SSD and memory and other buy opportunities within distribution. The increase in inventory this quarter is also weighted more heavily to shipments that had been delivered in Q2, but based on our revenue recognition policy, have been deferred due to the acceptance terms of our customers. Subsequent to quarter end of Q2, the vast majority of these shipments have been accepted by our customers and recognized as revenue in Q3.

Days payable outstanding was 44 days, up 3 days from the prior year second quarter. Hence, our overall cash conversion cycle for Q2 of 2017 was 53 days, an increase of 12 days from Q2 of 2016 but flat compared to Q1 of 2017.

From a financing perspective, our debt-to-capitalization ratio this quarter was 34%. Preliminary cash flows generated from operations were approximately $40 million for the second quarter.

At the end of Q2, between our cash and credit facilities, SYNNEX had over $1.1 billion available to fund growth.

Other financial data and metrics of note for the second quarter are as follows: depreciation expense was $19 million; amortization expense was $16 million; capital expenditures for the quarter were $24 million, primarily due to continued Concentrix investment; trailing 4 quarters' ROIC was 11%; and trailing 4 quarters' adjusted ROIC was 12%.

As described in our earnings release, the Board of Directors approved a regular quarterly cash dividend of $0.25 per common share to be paid on July 28, 2017, to stockholders of record as of the close of business on July 14, 2017.

The Board of Directors also approved a 3-year $300 million anti-dilutive share repurchase program effective July 1, 2017. The previous $100 million share repurchase program will expire on June 30, 2017.

Now moving to our 2017 third quarter expectations. We expect revenue to be in the range of $3.9 billion to $4.1 billion. For non-GAAP net income, forecast is expected to be in the range of $78.1 million to $81.1 million. Non-GAAP diluted EPS is anticipated to be in the range of $1.94 to $2.02. Non-GAAP net income and non-GAAP diluted EPS guidance exclude after-tax costs of approximately $10.4 million or $0.26 per share related to amortization of intangibles. Weighted average shares estimated for diluted EPS are 39.8 million.

Please note that these statements of Q3 expectations are forward looking and actual results may differ materially.

Now I'll turn the call over to Kevin.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Thank you, Marshall, and good afternoon to everyone on the call.

Our strong start to fiscal 2017 continued through our second quarter. We had record revenue of almost $4 billion, representing an increase of over 16% year-on-year. With this growth came exceptional leverage in our business, resulting in non-GAAP EPS growth of over 50% or $2.08 per diluted share.

Our Technology Solutions segment delivered strong results, with revenue growing over 13% year-on-year at an operating margin of almost 3%. Revenue benefited from the strengthening U.S. market and continued growth in our systems integration and design and cloud services business unit.

Canada grew modestly in constant currency and Japan was about flat.

Profitability was above our expectation, fueled by growth and leverage in our business as well as solid margin management in our U.S. distribution business.

Consistent with Q1 trends in our core technology business, we experienced better-than-average growth in network security and software, while demand for client devices and peripherals was good but somewhat softer.

From an end-market perspective, demand in commercial and SMB continued its strength in Q2, with U.S. federal slightly weaker.

Now turning to our Concentrix segment. The team delivered a solid second quarter, growing revenue by 43% and achieving a non-GAAP operating margin of over 8%.

For more color on the Concentrix business, I'll turn the call over to Chris.

Christopher Caldwell - *SYNNEX Corporation - Executive Vice-President and President of Concentrix Corporation*

Thanks, Kevin. I'm pleased to report a very solid quarter for Concentrix, where a number of investments we have been making have started to pay off.

Our revenue this quarter, as Marshall mentioned, topped off $481 million, growing over 43% year-over-year, while our adjusted EBITDA almost doubled during the same period, once again growing our bottom line faster than revenue.

In addition to the growth delivered from the acquisition last August, we saw good growth in the organic base as well as captured expected synergies from the acquisition. Also, a few clients in our automotive vertical experienced unusually higher volumes, which generated higher profits, but we do expect those to start to taper off in Q3.

From a sales perspective, we signed 10 new client relationships in the quarter with solid growth potential.

A few examples that demonstrate the breadth and diversity of the client and brands we recently signed. Within our North American region, we are partnering with a top health care hub, one who specializes in pharma to improve their clients' customer experience and make it world class. Within our Asia region, we signed a large e-commerce client, where we will be providing sales and customer service throughout the Pan-Asian geography and transforming their current delivery network. Within our European geography, we signed with a global products company, where we will be supporting their customers in multiple languages and helping them design a new customer experience. And very importantly this quarter, we were also awarded a robotics process automation contract with one of our large banking clients, winning the business over 8 other industry-leading companies. This demonstrates the success of our strategy to move to higher-value services that embrace new trends that help our clients.

Something that continues to make us proud is the recognition we receive by industry analysts. This quarter, we received 15 industry awards, making a record total of 38 industry awards for the first half of 2017.

Now looking forward to the third quarter 2017, there are a few dynamics in play that I would like to point out. One of the contract wins I spoke of with a large client will require us to open up in some additional geographies in Asia this quarter. We do not expect these countries to be profitable until Q1 2018 when we start to see the business ramp up. In addition, one of our larger clients that historically ramps for seasonal volume in Q4, in which we also capture the revenue, has asked us now this year to ramp earlier in Q3, which will negatively impact our operating margins this quarter. We will still capture the revenue and profitability in Q4, but it represents a shift in our profit profile by one quarter on this client.

Overall, we see continued strength in our existing business and a strong pipeline. We remain focused on driving our day-in, day-out execution to achieve our stated financial goals.

I'd like to close by thanking all of our clients and dedicated staff across the globe for everything that they do.

Back to you, Kevin.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Thank you, Chris. Now looking at our current quarter, we expect the momentum from the first 2 quarters to continue into Q3, with overall revenue performance to be in line with historical seasonality.

With a very strong margin result in Q2, we're guiding conservatively but are still expecting good improvement over our third quarter a year ago. Also, recall that in Q3 2016, we were working through a loss-making contract in our Concentrix segment, which resulted in a $7.5 million in profit that did not repeat. As well, in the short term, we expect to increase our investments to support our growth that has accelerated in both segments recently.

We expect the technology market to grow but remain competitive. And given our differentiating capabilities and focused approach, we believe we will continue to grow faster than the overall market.

Concentrix continues to be well positioned for growth, given the investments we have made and our unique vertical capabilities and solutions. We also have a healthy sales pipeline that puts us in a strong position heading into the second half of 2017 and into 2018.

I'm incredibly proud of the SYNNEX team and their never-ending pursuit of turning the complex into simple. Whether the challenge is technical, time-intensive or navigating our geopolitical climate, we continue to find ways of solving vendor and customer problems and providing growth opportunities for the markets we serve. One example of this is Concentrix's recognition by Gartner, where we were positioned the highest among our peers in Ability to Execute and leader in Completeness of Vision.

So now, moving on to other recent news. Earlier this month, SYNNEX announced our definitive agreement to acquire Westcon-Comstor's North America and Latin America businesses from Datatec Limited. Westcon-Comstor is a world-renowned brand that has been built by a deep and talented team.

Through this acquisition, SYNNEX will gain deep capabilities and strength in the attractive security, UCC and networking market. This opportunity is highly complementary to SYNNEX and provides a global platform for our partners.

Over the past 2 weeks, I've had the privilege of meeting many of the Westcon-Comstor team. Spending additional time with the broader team has not only -- has only validated my belief regarding the common vision and value we will collectively bring to the market. Our teams are energized and they realize that we must keep raising the bar to continue to exceed our partner and shareholder expectations.

So a sincere thank you to all of our associates and the Westcon-Comstor team, who will soon be part of the SYNNEX family who, by the way, just recently became #198 on the Fortune 500, representing a 14-position improvement.

So with that, let's turn the call over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Matt Sheerin of Stifel.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Just a few questions for me, if I can. Just starting with the strength that you saw in the Tech Solutions business. Kevin, you talked about some of the areas, but if you look at the margin profile, which was up significantly, it looks like a lot of that growth likely came from the Hyve business. So can you give us more color in terms of the strength that you saw there, the growth rates that you're seeing in that business? And you talked about sequential seasonality in the August quarter, but if you do the math on it, unless Concentrix is down sequentially, it looks like it's going to be only sort of low single-digit sequential growth. And because of your consumer exposure, you've had some better growth in previous years, so I'm just trying to figure out whether or not that the Hyve business is just lumpy and you'll see some swings quarter-to-quarter.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Okay. Thank you, Matt. So first, to answer the overall market question and the strength, I'll tell you, it's good having a stronger-demand market. It allows us to be much more selective in the businesses that we choose to take -- or in the business we choose to take. The bigger growth areas for us were in some of the key focus areas, and I have mentioned a few. More on the network security, basically anything that supports 3rd Platform technology. That has been a focus of ours. Those are also higher-margin segments. But the core distribution business margin performance was very, very strong. As I've said in the past, quarter-to-quarter, there's always going to be puts and takes to margins, and in our second quarter, not only did we have an opportunity to be more selective but we had a lot of things line up that drove margin results that exceeded our expectation.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Well, I'm just trying to figure out how much Hyve was as a contributor, the Hyve business.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes, I mean, we're happy with the growth and the profitability performance of both Hyve and the core distribution business. As you know, Matt, we don't break them out any more specifically than that.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Got it. And then in terms of the sequential expectations?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes. So back on seasonality, and again, as I look on the sequential growth over the past number of years, the range has been from low single-digit negative up to mid-single digit positive. So where we land, if you're looking at the midpoint, does fall within that range. And yes, there are going to be aberrations that get driven from seasonal or project-based work that we have. But overall, when I look at the underlying core business that we have and the view that we have on our quarter, we expect in line, seasonal.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And just one other question for me, just regarding the Westcon pending acquisition. When you announced the deal, you said that it was a cash and stock deal based on the lower stock price, and obviously, your stock is up significantly since then. So could you tell us what your plan is there in terms of stock versus stock and cash?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Sure, Matt. I was guessing you were going to ask me that question. But again, as we said before, we only have that choice if the stock is above a certain level, which today it is. But there are other factors involved other than the economics, where the stock price is and everything else, and we will make that decision as we get closer to the time of the close.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

What would those other factors be?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Other factors would be the overall availability of the credit environment, just as one example.

Operator

Our next question comes from Adam Tindle of Raymond James.

Adam Tyler Tindle - *Raymond James & Associates, Inc., Research Division - Research Analyst*

So cash flow was modest, and inventory was up around 50% year-over-year for the second straight quarter, but you did have significant upside in revenue and margin. So, Kevin, first, I just wanted to understand how this inventory build is maybe helping TS revenue and profitability. Are those 2 tied together? And, Marshall, perhaps you could help us understand the composition of the inventory and help us quantify that deferral that you'd mentioned. Seems like we might see somewhere around $300 million to $400 million of operating cash flow next quarter, if I'm reading this correctly.

Dennis Polk - *SYNNEX Corporation - COO and Director*

Adam, this is Dennis. I'll take the first one. Yes, to your question, we have realized that -- over time, that making strategic investments in inventory in our -- in certain segments of our distribution business and, in some parts, in our Hyve business, does make sense as we do earn a higher ROI on that investment by having that inventory at the right time at the right place. So the increase in our inventory has led to some of the increase in our overall profitability.

Marshall W. Witt - *SYNNEX Corporation - CFO*

And, Adam, this is Marshall. We had a strong May, and so because of that, there was a little bit higher percentage, if you will, of the total inventory. That was due to our customer acceptance terms. We don't disclose cash flows going forward, but just in terms of its impact from a days perspective, it probably was a couple, 3 days in terms of the impact on how much got deferred.

Adam Tyler Tindle - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And maybe just one for Chris. Services gross margin looks like it was down year-over-year for 2 quarters in a row, but the loss-making contract is gone. So I'm just trying to understand this trend, given it sounds like investments are going to pick up here. Can you speak to maybe what's driving this?

Christopher Caldwell - *SYNNEX Corporation - Executive Vice-President and President of Concentrix Corporation*

Yes, so, Adam, there's a few things that are going on. Some of it is mix in regards to the business as we move some business around. We're also, as we talked about in the last couple of calls, cleaning up some of the contracts from the acquisitions that we have made and subsequently working those through our system right at the moment as well as kind of ramping some additional new business that we've won. There tends to be a lot longer lead time, from a ramp perspective and, therefore, it compresses on that margin.

Operator

Our next question comes from Shannon Cross of Cross Research.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

Can you talk a bit more about your comments regarding the stronger end market and the ability to be pickier, which is obviously a positive from a margin perspective? I'm just curious as to how sustainable you see it is, what you're hearing from your customers, how much you think it -- your competitive advantage versus others. Just any color you can give us on the sustainability of the end markets, and then I have a couple more questions.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Sure. And keep in mind, Shannon, that just by the nature of our business, for the most part, our view into the future is relatively short. A lot of what we see -- or what we saw in the last quarter was just more opportunity to bid on certain large opportunities as well as strength, as I said, in certain product markets, like communications and security software was also a strong category. Going forward, what we're hearing from our partners, both on the vendor side and the customer side, is they're optimistic. They continue to see strength in the market. In particular, we are also looking forward to a strong federal end of year coming up within our quarter now, too. So the optimism is there. The underlying strength we've seen over the past quarter, and so far, in this quarter, we've seen it continue.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

And then, sort of a follow-on to that, a number of your partners and -- have talked about needing to raise prices, obviously, to offset the higher component costs and that. Have you seen pushback from customers as the price increases have gone through? Is there an impact from elasticity of demand? Or are people just sort of feeling better and, therefore, are continuing to buy?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes, I mean, that one is really hard to call because we -- from week-to-week, we do see some variation in overall opportunity and activity, but when I look at a longer viewpoint, as you probably know, that -- the pricing actions really were focused around the PC, notebook category, and as you've seen from others reporting, that continued to be pretty strong. So I think the price increase, although the end market may not like it, seems to have been accepted.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

Okay. And then, just my final is with regard to component prices, and you used your balance sheet to sort of help, I think, to outrun it, I guess, to some extent. But I'm curious as to how you're thinking about component prices as you look toward the end of the year. And I guess you've been able to pass them through to your customers, so from the standpoint of like Hyve and all of that. But just in general, what are your thoughts there? And is there a way to continue to use the balance sheet? Or do you think you're at a point now where maybe you can draw down a little bit more on the inventory versus what maybe a normal situation would be if prices are going to come down toward the end of the year?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes. I mean, so much of it depends on the supply/demand equation. And as you know, we have a business in the buy and resell of components as well as consuming them in our Hyve business, so it's really twofold there, Shannon, when you look at it. The investments that we make in inventory is, in part, to support our manufacturing business. It's also in part to fulfill demand that we have in the market just for selling the components themselves. Anecdotally, in particular, if you look at SSDs as one of those components that are in shorter supply, what we're hearing is that shortages will likely continue at least through the end of this year, perhaps even longer than that. So at least in the near term, if there's going to be the same supply-and-demand imbalance, we will continue to search for inventory where it makes sense for us to do so.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

Okay, great. And then actually one last question. How aggressive do you anticipate being on the share repurchase, just literally to offset dilution? Or would you be more aggressive depending on the closing of the acquisition or timing of share -- where your stock price is, et cetera?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes. I mean, the intent of the share repurchase program is to dilute -- is to offset dilution in our equity programs. However, this is a $300-million program over 3 years, which provides even more headroom beyond just what we see as our average dilution over the past number of years. So it does give us the opportunity to be opportunistic if we choose to do so.

Operator

Your next question comes from Jim Suva of Citigroup.

Jim Suva - *Citigroup Inc, Research Division - Director*

If I could spend a few minutes focusing on the Concentrix business. Can you let us know, the operating margins, is that something for this calendar quarter that you think is sustainable? Is there more upside there? I know in the past, you struggled with some contracts, struggled with some various items. Just trying to think about the sustainability of that, which I believe should meaningfully wrap -- ramp in the next couple quarters as revenues seasonally get better.

Christopher Caldwell - *SYNNEX Corporation - Executive Vice-President and President of Concentrix Corporation*

So, Jim, it's Chris. Clearly, we've stated a goal of getting to a consistent double-digit operating income sort of going into next year. And if you look back at our Q4 for the last 2 years, it's certainly been in that realm, so clearly, we see some ability to expand. I think our comments around some of the things that are happening within Q3, you need to look at that as probably muting that a little bit for the Q3 quarter. But then our goal, as stated, is to continue to grow it and get into a consistent double-digit fashion.

Jim Suva - *Citigroup Inc, Research Division - Director*

Okay. And my follow-up is also focused on Concentrix. When we think about the future investments of the full company, are they more aimed at Concentrix or more the solutions side? Or how should we think about how you're allocating future resources?

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Yes, and, Jim, that really is across the organization. Our growth that we've seen in Q2 and, even prior to that, in Q1, we've had significant growth across the entire business, and it does require more infrastructure to support growth that we do expect to continue. And so don't just think Concentrix, think Technology Solutions as well.

Operator

We show no questions on queue at this time. (Operator Instructions) We show no questions on queue at this time.

Kevin M. Murai - *SYNNEX Corporation - CEO, President & Director*

Thank you, Anj, and thank you, everyone, for joining our call.

Operator

That concludes today's conference. Thank you for your participation. You may now disconnect.
