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LQDT - Q2 2016 Liquidity Services Inc Earnings Call

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Colin Sebastian *R.W. Baird - Analyst*

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Craig Lukin *Roumell Asset Management - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for your patience. You joined the Q2 2016 Liquidity Services Earnings Call. At this time, all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will be given at that time. (Operator Instructions) As a reminder, this conference may be recorded.

I would now like to turn the call over to your host, Senior Director of Investor Relations, Ms. Julie Davis. Ma'am, you may begin.

Julie Davis - *Liquidity Services, Inc. - Senior Director, IR*

Thank you. Hello and welcome to our [third] quarter fiscal year 2016 financial results conference call. Joining us today are Bill Angrick, our Chairman and Chief Executive Officer; Jorge Celaya, our Chief Financial Officer; and Mike Sweeney, our Chief Accounting Officer. We will be available for questions after our prepared remarks.

The following discussion or responses to your questions reflect management's views as of today, May 05, 2016, and will include forward-looking statements. Actual results may differ materially. Additional information about factors that could potentially impact our financial results is included in today's press release and in our filings with the SEC, including our most recent Annual Report on Form 10-K.

As you listen to today's call, we encourage you to have our press release in front of you, which includes our financial results as well as metrics and commentary on the quarter. During this call, we will discuss certain non-GAAP financial measures. In our press release and our filings with the SEC, each of which is posted on our website, you will find additional disclosures regarding these non-GAAP measures, including reconciliations of these measures with comparable GAAP measures.

We also use certain supplemental operating data as a measure of certain components of operating performance, which we also believe is useful for management and investors. The supplemental operating data includes gross merchandise volume and should not be considered a substitute for or superior to GAAP results.

At this time, I'd like to turn the presentation over to our CEO, Bill Angrick.



Bill Angrick - *Liquidity Services, Inc. - CEO & Chairman of the Board of Directors*

Thank you, Julie. Good morning and welcome to our Q2 earnings call. I'll review our Q2 performance and provide an update on key strategic initiatives. Next, Mike Sweeney will provide more details on the quarter. Finally, Jorge will provide our outlook for the current quarter.

Liquidity Services reported Q2 results in line with our GMV guidance and above the guidance range on adjusted EBITDA and adjusted net income. Q2 results were driven by strong performance in our municipal government, industrial manufacturing and retail verticals, which benefited from growth [in] existing and new customers. We also benefited from the growth of new fee-for-service offerings during the quarter with both commercial and government clients. We exited the quarter in a strong financial position to pursue our growth initiatives with \$117.5 million in cash and zero debt.

Our team remains focused on building a better future for how assets are managed, valued and sold in the reverse supply chain, which translates into a multi-billion dollar business opportunity. Liquidity Services' competitive advantage lies in our ability to provide our clients with better service, scale and results. We're achieving this by making investments in new data driven services, expansion of our buyer base and improvements in our core e-commerce platform to elevate the convenience and value we provide our customers.

First, we are expanding our offering to provide our clients with the data, analytical tools and services to extract more value from their supply chain. For example, on behalf of one of the world's largest consumer packaged goods companies, we completed the valuation of over 40,000 assets using a variety of internal and external data sets. With this information, the client is able to make more informed business decisions on whether to redeploy or sell assets.

For many of our manufacturing clients we are using a data driven process to perform refurbishing and repair services to maximize the value of the products they sell through our marketplaces. In another case, we are providing property verification services to ensure all assets in the reverse supply chain comply with our clients' business rules. In each case, these services provide our clients with one-stop convenience and scale to maximize their bottom line return.

Second, we are investing in the growth of our buyer base using a variety of digital and direct marketing strategies. For example, on behalf of a large energy services company, we recently completed the online auction of 230 lots of directional drilling and production test equipment located in Wyoming and North Dakota. Our online sale drew 142 bidders from throughout the United States, Canada, Mexico, Thailand, Singapore and Australia, resulting in sales proceeds well above the initial expectation. Buyers were acquired and cultivated using an integrated marketing campaign, including digital, social, and trade promotion elements.

Finally, we have continued to advance the design and development of our Liquidity One platform to unlock additional network effects by consolidating standalone marketplaces with a single platform. During the quarter, we continued the beta testing of our new transactional platform and we are now working on the user interface and design elements. We expect the first marketplace to go live in our fiscal fourth quarter.

Additionally, we have identified new business opportunities centered on our emerging capabilities and we are continuing to allocate time and investment to bring these to market. We continue to involve customers in the review of our new product and service capabilities and are excited by their feedback and the opportunities to grow our business over the long term.

Current financial results reflect significant current investment on our part, but do not yet reflect the new products, capabilities and business opportunities we are building at Liquidity Services. Our willingness to invest in our business is a direct function of the significant growth opportunities we see ahead to leverage our knowledge, technology platform, customer network, and new capability.

In closing, we recognize the uneven growth and visibility that accompanies the transformation of our business during fiscal year 2016. We are confident that we have the right team and strategic plan to delight customers and develop a more diversified, scalable business. Macro trends in globalization, the growth of e-commerce, and sustainability will drive the need for our platform and services. Liquidity Services is committed to driving innovation and significant value creation for our customers and shareholders as we execute our long-term growth strategy.

Now let me turn it over to Mike for more details on Q2 results.

Mike Sweeney - *Liquidity Services, Inc. - CAO*

Thanks, Bill. So, as Bill mentioned, we finished the second quarter of fiscal 2016 at the midpoint of our guidance in GMV and above the high end of guidance in adjusted EBITDA and adjusted EPS, primarily due to better than expected margins in our state and municipal government and retail businesses as more clients utilized our value-added services and we expanded with key client accounts ahead of our expectations.

Next, I'll comment on our second quarter results with comparison periods provided on a year-over-year basis. Total GMV was \$153 million. GMV in our GovDeals or state and local government marketplace increased to \$49.6 million or 10.1%, due to an increase in the number of new sellers and additional sales volume from existing clients. We now have nearly 8,800 total clients, further penetrating the \$3 billion state and local government market.

GMV in our DoD marketplaces decreased to \$29.2 million or 30.2% as a result of lower commodity prices and the shift in property mix to lower-value property. GMV in our commercial marketplaces decreased to \$74.2 million or 27.6% as a result of the sale of Jacobs Trading Company, the wind down of the NESA refurbishment business in Canada, and reduced product flows in our retail and energy verticals.

Total revenue was \$86.9 million and was impacted by the same factors as provided for GMV. Technology and operations expenses remained flat at \$24.7 million. As a percentage of revenue, these expenses increased to 28.4% from 24.0% as a result of the decrease in revenue.

Sales and marketing expenses decreased 15.3% to \$9.1 million, primarily due to cost incurred in the prior year at Jacobs Trading, which was divested in the fourth quarter last year, as well as to lower staff costs in fiscal 2016. As a percentage of revenue, sales and marketing expenses remained flat with the prior year at 10.5%.

General and administrative expenses decreased 8% to \$10.5 million due to the sale of Jacobs Trading and the wind down of the NESA business. As a percentage of revenue, G&A expenses increased to 12% from 11.1% as a result of the decrease in revenue.

Adjusted EBITDA decreased 66.7% to \$2.9 million, mostly due to the year-over-year decreases in revenue in our commercial marketplaces and DoD businesses already discussed. Adjusted net income decreased 55.4% to \$1.1 million. Adjusted diluted earnings per share decreased 56.2% to \$0.04 based on approximately 30.6 million diluted weighted average shares outstanding.

During the second quarter, Liquidity Services provided \$33 million of operating cash flow, an increase of 208% from the prior year, primarily related to a tax loss benefit for which we received tax refunds of \$35.1 million during the fiscal 2016 second quarter.

We continue to have a strong debt-free balance sheet. At March 31, 2016, we had a cash balance of \$117.5 million, current assets of \$176.7 million, total assets of \$287.1 million and \$108.5 million in working capital. Capital expenditures during the quarter were \$1.3 million.

I'll now turn it over to Jorge for the outlook on the next quarter.

Jorge Celaya - *Liquidity Services, Inc. - EVP & CFO*

Good morning. As we reach the midway point of fiscal 2016, we are encouraged by the progress we've made in establishing a foundation for future growth. We have stabilized our business for key contract changes, we've added new client programs, are developing new value-added services, and have continued to make progress in our Liquidity One transformation initiative.

Looking ahead, our third quarter outlook reflects the seasonal increase in our state and municipal government self-service activity, less project activity than our second quarter in valuation services, less project activity in the industrial manufacturing sector that included significant plant closing sales in the quarter and a less favorable product and service fee mix in our DoD programs. In addition, in the third quarter, we anticipate spending on our Liquidity One initiative to increase sequentially over the second quarter.

Entering the second half of our fiscal year, we expect uneven financial performance due to the project-based aspects of our business and the changing mix of activity from our diversified marketplaces and service offerings. Our energy vertical and DoD activity continue to be difficult to predict given volatility in commodity prices. We anticipate cost of approximately \$2 million in the third quarter of 2016 as we implement the final round of development for our first marketplace launch, complete the design and testing ramp up of our ERP and start implementing the ERP and its interfaces to our client-facing Liquidity One system.

Management guidance for the next fiscal quarter is as follows. We expect GMV in the third quarter to range from \$150 million to \$175 million. We expect adjusted EBITDA to range from a negative \$3.5 million to a negative \$1 million and adjusted earnings per diluted shares to range from minus \$0.13 to minus \$0.07. This guidance assumes that we have diluted weighted average shares outstanding for the quarter of 30.6 million.

We will now take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Colin Sebastian, Robert Baird.

Colin Sebastian - R.W. Baird - Analyst

A couple, just to start. First on the margins, the better than expected margins in the quarter, I wonder if you can add a little more detail on the utilization of the value-added services, as well as the expansion with some of the key client accounts? What facilitated those initiatives? Is that something that we'll see carry through potentially over the balance of the year? I ask that, in part, given the margin guidance for the third fiscal quarter.

And then secondly, related to the energy segment of business, I'm curious if you're seeing more or less green shoots from that segment as there appears to be potentially at least more opportunity, more supply on the liquidation side from the oil and gas sector. If you have additional comments, then that would be helpful. Thank you.

Bill Angrick - Liquidity Services, Inc. - CEO & Chairman of the Board of Directors

Thank you, Colin. Starting with your last reference to the energy market, I actually referenced the sale that we did in North Dakota and Wyoming during the quarter, which indicates that we're seeing early signs of market acceptance that it's now time to convert assets into cash and we're benefiting from that. I say it's early because there's still choppy planning and decision-making going on in that supply chain, but we are well positioned to serve our clients as they make the decision to move forward with asset sales. We've got a lot in the pipeline. It is a question of when market clearing prices are embraced by the community of energy supply chain customers, but we do see the improvement in activity in that vertical.

In terms of retail supply chain client expansion, we have long believed that one stop convenience is important for our clients. Not only do they want to access sales channels, but they also want us to handle pre and post-sale logistics, give them data to help make decisions on the right channel to sell their assets in. So a lot of the data driven business logic on what's the right disposition channel, what's the right time of the season to be selling, how to sell, do they upgrade and refurbish items before they bring them to market, driving all of that business logic is part of our service offering and that's helping us grow with large big-box retailers and, increasingly, the manufacturers who supply them.

I think on the manufacturing side, these clients are seeking to exit after-sales support and that gives us an opportunity to leverage our facilities, return to management processes and our sales channels to sustain that, and I think that's a long runway for us to continue to grow.



Omnichannel is the big theme with everybody in retail and clients will tell you that returns are a necessary cost of doing business and in the online world, returns are sharply higher than traditional brick and mortar retail. So that positions us well to help clients outsource the things that are complex and focus on their focus of client satisfaction, having great products, full margin products in their channels. So we think that's a long-term trend.

Relative to margins in the current quarter, we did benefit from a number of high margin activities during the quarter. We have industrial clients that executed large scale, high value projects such as plant closings that are very profitable for us. We currently don't see that re-occurring in the following quarter.

However, the long-term goal is deepening and widening our pipeline of very large capital-intensive companies that are always going to be bringing high value assets to market. It's just that we don't have the type of visibility that I'm sure everyone would want in terms of when these large projects hit and unlock EBITDA growth.

The other areas we've commented on in terms of services include valuation. So we have a strong data warehouse that is being bundled and offered to clients to value assets. We had some very large valuation assignments that came through in the quarter. That is consistent with our strategy to be that one stop solution for our clients. So when they're making decisions on where to mark their assets to on their own financial statements, when to redeploy the assets, to displace buying new, and when to take the assets to sale, we provide a lot of that information to make it happen. And I would say, the GAAP revenue line is increasingly important, because service offerings that we provide do not have accompanying GMV; they drop straight to revenue and they are higher margin. So many of those key projects we do not expect to continue in the next quarter, which is affecting our guidance.

Operator

Dan Kurnos, Benchmark Company.

Dan Kurnos - Benchmark - Analyst

Good quarter, guys. Just a couple from me. I just want to clarify something, Bill. You were talking about this a lot here just so people understand. We understand the business is lumpy here and think we got some color around kind of the seasonality; we all know that there is a seasonal uptick. But it sounds like the underlying health of the business, in your opinion, is improving, although the step up from what we've seen is sort of this \$125 million to \$150 million range, could be at least near term dictated by seasonality and you're not ready to say, we're starting to move back up towards those previous or higher GMV guidance ranges. Is that all fair?

Bill Angrick - Liquidity Services, Inc. - CEO & Chairman of the Board of Directors

Yes, I think that's fair because fiscal 2016 is a transformation period for us. We are very pleased with our business development activity, very pleased with the uptake of our services and high proposition. So that is fundamentally healthy.

I believe we are expanding our market share in verticals like energy. That's not pulling through these financial statements yet, because there is still some backlog in that industry, but we feel very good about the business development pipeline. We feel very good about the diversification of our business across different industry verticals and I said we've been investing heavily in marketing automation and in marketing services, so we're seeing strong retention and growth with our buyer base. So all those are very healthy metrics for a two-sided marketplace.

Where we are seeing the lumpiness is the fact that we have project spend that is uneven as we bring our Liquidity One platform through the testing, design and ultimate launch phase. So, given those types of project spends, that'll affect margin. We do know that commodity prices have been very pressured in our DoD scrap business, in energy business and that is something that is a headwind.

We do know that the mix of property that we receive in certain industry verticals, including the DoD, including in retail, that can change in the short term and, somewhat out of our control, that affects margin. And, also, we have in the June quarter, the strongest quarter for our municipal government self-service business, GovDeals, and the self-service business, which is a great model, very scalable, does have a lower commission rate and therefore lower margins. So that is, over the long haul, a business we expect to continue grow nicely, but in particular periods, where there are larger share of the mix that affects the margin profile for the next quarter.

Dan Kurnos - *Benchmark - Analyst*

Great, that's helpful. And then just on the retail side, I know you talked about pretty high level penetration gains in both big-box and omnichannel. Are there any specific -- could you give us any specifics or granularity on particular verticals? I know that we went through kind of a period of some intentional churn a while back and maybe some areas where some of your previous endeavors or investments to make gains are starting to pay off now.

Bill Angrick - *Liquidity Services, Inc. - CEO & Chairman of the Board of Directors*

Well, we know that there is a lot of complexity with customers buying online, returning to the store. I think retailers love that because when the customer enters the store, they are exiting a product that for whatever reason they don't want, but they're getting an opportunity to shop the aisles. But those products coming back is not a great fit for retailers' core business. So the more they can rely on partners like us, they can get that product removed and then focus on moving the high margin new product (inaudible) product.

So we're seeing good receptivity in the do-it-yourself home improvement channel, lot of bulky items, high value items. We're doing a lot of work with OEMs in audio, visual, home entertainment, 4K, televisions, gaming systems, and the OEM is very sensitive to their brand and how it's portrayed in the secondary market. And we can ensure that any product that is pulled from a store or returned is certified to the manufacturer's specs and then we can extract a lot of value for those clients by moving it through different channels, B2C to end consumers, to the business customers and export markets to completely insulate the client from any branded channel conflict.

So there is a lot of interest from OEMs in the consumer electronics and audiovisual, home entertainment vertical. We are also increasing our presence in the home appliance world and there's a macro trend of the big players have been very effective in the traditional consumer electronics space. I think [home] is the next place where they can add quite a lot of value with smart appliances that communicate with each other, so there's a lot of technology being integrated there and, again, that's not a great fit for the OEMs to handle returns after sale activity. So we've had some great success in that vertical as well.

Dan Kurnos - *Benchmark - Analyst*

That's really helpful. Just one last one if I could, just on the expense side, just to also maybe clarify a bit with the step up in the Liquidity One transformation spend in the coming quarter and the expected launch of your first marketplace in fiscal Q4, just how we should think about the pacing of further expenses when we start to get some more leverage and when we get through sort of the bulk of those upfront expenses and kind of what more of a steady state behind the scenes back on expense profile looks like? Thanks.

Bill Angrick - *Liquidity Services, Inc. - CEO & Chairman of the Board of Directors*

Well, the important thing is to have a quality integration and a quality product. We certainly are focused on having that done in a timely fashion, but what's more important for us is rather than managing the precise amount of money we spend is to ensure that we get a great product that can transform the buying and selling experience. And we know that fiscal 2016 we'll continue that spend.

As we stand up new marketplaces, I think we'll have a better opportunity to address what the tail of that spending is because when you take products to market, you learn a lot about how well the product market fit is and whether there's additional adjustments that are necessary which

translates to whether there's additional spending, if necessary. And so I can't give you precise views on whether we're at the tail end of the spending yet. I think, let's review that in a couple of quarters when we have our first marketplace live in Q4.

Operator

Craig Lukin, Roulmell Asset Management.

Craig Lukin - *Roulmell Asset Management - Analyst*

My question is in regard to the DoD surplus contract that was recently awarded. Is there any concern of a growing competition in that area or is it true that DoD determined that it was only you and I believe (inaudible) had the capability to execute? And to follow on that, if you can give us any color on the economics of the deal and how happy are you with it?

Bill Angrick - *Liquidity Services, Inc. - CEO & Chairman of the Board of Directors*

So, certainly, the competition is done and we have several years, I think it's up to a five year contract, so the competition at this juncture is probably less relevant to where we are with the business. I think as we've interacted with DoD over at least three recompetes, in each case, we have different circumstances and what the client's expectations are, the scope of work that they're asking us to perform and the logistics requirements based on their facilities. And in each case, Craig, we have focused on adjusting our operations and our services to meet their needs and to do so profitably and we expect that to be the case with our current DoD relationship and programs today.

Craig Lukin - *Roulmell Asset Management - Analyst*

Okay. And can you shed any light on the economics related to deal and how satisfied you are on that?

Bill Angrick - *Liquidity Services, Inc. - CEO & Chairman of the Board of Directors*

Well, you know that we bid aggressively to retain the program. So the margins in the program are lower than what they once were. Having said that, it's a terrific program and we're satisfied that we're going to extract a lot of value from the program, from the vantage point of buying the property that's available under that program feeds to our marketplace and is very interesting for many of our industrial customers and our other verticals because we have had great success in categories like aerospace, transportation, biopharma, test and medical equipment, machine tools, all of which are covered under DoD. So both on a standalone basis and as it relates to an integrated marketplace under Liquidity One, we're very satisfied with that program.

Operator

Thank you. At this time, I like to turn the call over to Ms. Davis for any closing remarks. Ma'am?

Julie Davis - *Liquidity Services, Inc. - Senior Director, IR*

Thank you. Thank you to everyone for your participation on our call today. We will now be available for any follow-up questions. Thank you and have a good day.

Operator

Thank you, ma'am. And thank you, ladies and gentlemen, for your participation. That does conclude your program. You may disconnect your lines at this time. Have a great day.

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