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Transcript of
Sharps Compliance, Inc.
Third Quarter 2015 Earnings Conference Call
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Participants

John Nesbett – Investor Relations, Institutional Marketing Services
David Tusa – Chief Executive Officer and President
Brandon Beaver – Senior Vice President of Sales
Diana Diaz – Vice President and Chief Financial Officer

Analysts

Brian Butler – Stifel, Nicolaus & Co.
Kevin Steinke – Barrington Research Associates
Nick Hiller – William Blair & Company
Shawn Boyd – Next Mark Capital, LLC
George Walsh – Gilford Securities, Inc.

Presentation

Operator
Greetings and welcome to the Sharps Compliance Third Quarter 2015 Earnings Conference Call. At this time all participants are in a listen-only mode. A question and answer session will follow the formal presentation. (Operator instructions.) As a reminder this conference is being recorded.

I would now like to turn the conference over to your host, Mr. John Nesbett of IMS. You may begin.

John Nesbett – Investor Relations, Institutional Marketing Services
Good morning and welcome to our conference call to discuss Sharps Compliance's financial results for the third quarter fiscal 2015. On the call today, we have David Tusa, the company's President and Chief Executive Officer; Diana Diaz, Vice President and Chief Financial Officer; and Brandon Beaver, Senior VP of Sales.

David will review the company's business operations and growth strategies and Diana will review the financials. Brandon will discuss the sales organization and related sales initiatives. Immediately following their formal remarks, we will take questions from our call participants.

If you are listening via webcast, please note you have the ability to submit questions through the Internet. As you're aware we may make some forward-looking statements during the formal presentation and in the question and answer portion of this teleconference. These statements apply to future events which are subject to risks and uncertainties, as well as other factors that could cause actual results to differ materially from where we are today. These factors are outlined in our earnings release as well as in documents filed by the company with the Securities and Exchange Commission. These can be found at our website or at sec.gov.

Okay, so with that concluded, let me turn the call over to David to begin the review and discussion. Go ahead, David, the floor is yours.

David Tusa – Chief Executive Officer and President

Thanks, John. Good morning, everyone, and welcome to our Third Quarter Fiscal Year 2015 Earnings Conference Call. As most of you are aware, our third quarter is historically our slowest. This is a result of the ending of the flu-shot season in the December quarter and the typically strong calendar year-end orders in the Pharmaceutical Manufacturer market. So, consistent with this, third quarter customer billings grew at 11% to $5.9 million, and revenue for the quarter increased by the same percentage to $6.2 million.

The quarterly increases in billings and revenue were attributable to strong growth in the Government market and solid increases in the Professional, Pharmaceutical Manufacturer and Assisted-Living markets. Let's talk a little bit more in detail about the individual markets.

During the quarter, Government billings increased by nearly 470% to $700,000. This was related to the government approval and subsequent sales of our new TakeAway Medication Recovery System Envelopes and our new MedSafe solutions. Our TakeAway envelopes and MedSafe solution were designed to meet all of the requirements of the DEA's new Secure and Responsible Drug Disposal Act, which allows for collection, transportation and treatment of consumer dispensed unused medications including controlled substances. The TakeAway envelopes have recently been approved and added to our Federal Supply and GSA schedules. This is important because it facilitates purchases of the solutions by government agencies.

The TakeAway envelope and MedSafe have both been added to our Distribution and Pricing Agreement, commonly referred to as DAPA, for purchase by Department of Defense agencies. What this means is, the new TakeAway envelopes and MedSafe solutions are currently in use by two major government agencies.

Our Professional market billings grew 42% to $1.6 million in the third quarter as we continued to roll-out sales initiatives and promotional activities, focused on educating doctors, dentists, vets, and other healthcare professionals about our Sharps Recovery System. We believe our mailback systems offer significant cost savings, operational efficiencies, and convenience for the small quantity generator sector.

The Pharmaceutical Manufacturer market grew 43% to $754,000 in billings for the quarter. During the quarter we filled an order for new inventory builds for an existing customer, and we expect to launch three additional patient support programs for new drug therapies during the remainder of calendar year 2015 and through the first quarter of calendar year 2017. Once fully rolled out, the two new programs already launched in fiscal 2015, plus the three additional new programs are expected to generate annual revenue of about $4 million or higher. We've built a strong reputation in this market through our ability to provide innovative customized programs for our customers and their patients. We're currently focused on attracting new customers while also adding new programs for existing customers.

In the Retail market, billings actually decreased by about 17% to $610,000 in the third quarter due to the timing of orders. The best way to look at this is the nine-month ended period. For the nine months ended March 31st, billings in this market grew 28% to $5.7 million. As we've said before, we believe this market will continue to drive long-term growth as consumers look to alternate sites to receive their flu shots and other immunizations, and as retail pharmacies increase the variety and volume of the healthcare services they provide. In fact, according to the CDC, 22% of flu shots for adults were administered in the retail clinic sector, and this trend is expected to continue to increase.

In addition to continuing growth from the flu shot business, we believe there are also growth opportunities for more primary care in the retail or alternate site setting. A recent study showed that only 2% of all primary care encounters were administered in the retail setting. So, with about 75% penetration in the retail clinic sector, there looks to be opportunity for more growth.

Looking forward, we expect to see a strong fourth quarter ending June 30, 2015, driven by growth in all of our key markets, rounding out what we believe will be a solid fiscal year end. Also, we're excited about the potential positive impact on sales of our new unused medication management solutions, the TakeAway envelope and MedSafe solution.

With that, let me turn the call over to Brandon, and he'll give an update on our sales initiatives. Brandon.

Brandon Beaver – Senior Vice President of Sales
Thanks, David. As David mentioned, we've made some significant growth this quarter, not only in the Government sector, but also the Professional and Pharmaceutical Manufacturer sectors. In the Professional market, we continue to focus on educating the market about the convenience and cost-efficiency of our mailback solutions. During the quarter, we conducted inside sales initiatives and promotional activities to attract healthcare professionals from all practice areas. Additionally, our Professional market growth benefitted from the closing of larger Professional market multi-location customers by our field sales team. These combined efforts resulted in a 42% increase in Professional market billings for the quarter. Our penetration rate in this market is still very low, and as such will remain a key focus of our ongoing sales initiatives.

Our relationships in the Pharmaceutical Manufacturer market remain strong, as our partners realize the value of our unique solution, which is not just a disposal solution for self-injecting patients in the home setting, but also an opportunity for pharma branding and data related to patient compliance and medication adherence. The feedback we provide alerts the manufacturer if a patient is not using the drug the way they should be, giving the manufacturer a touch point opportunity back to the patients. We're enthusiastic about the opportunities we are seeing in Pharma, especially as we are seeing programs for new indications and higher patient counts. As a result, we're optimistic about the long-term growth prospects of this market.

While we saw a 9% increase in our Assisted-Living market billings, we're still not where we want to be. This is a significant market opportunity for us, and we continue to focus resources on closing new customer deals in calendar 2015. We continue to invest in sales, as evidenced by the increase in our sales team, to a count of 21 individuals. This represents inside, field, and sales support personnel. This compares to 15 sales-related employees as of January 1, 2014, and 17 as of January 1, 2015. Our pipeline of opportunities is strong, and our sales team is among the strongest and most experienced in the company's history. We are intent on accelerating the closure rate for additional new business throughout calendar year 2015.

In addition to the progress we are making in the Government sector, we're selling the new TakeAway envelopes and MedSafe into the Retail Pharmacy and Assisted-Living markets. Sales to date of the MedSafe have been to smaller chains, where they quickly realize the convenience and safety of the new DEA-approved collection receptacle. Our sales team continues to pursue MedSafe opportunities in Retail, Assisted Living, drug treatment, hospice, law enforcement, and other commercial markets.

I'll hand it back to you, David.

David Tusa – Chief Executive Officer and President
Thanks for the update, Brandon. Now let's turn it over to Diana, who can address the financials in a little bit more detail.

Diana Diaz – Vice President and Chief Financial Officer
Thanks, David. During the third quarter, the company recorded revenue growth of 11% to $6.2 million as compared to $5.6 million in the third quarter of last year. Gross margin was 27% in the third quarter, as compared to 25% in the prior year third quarter. The margin increase was driven by leverage gained from higher revenue.

Selling, general and administrative expense increased to $2.4 million or 39% of sales, as compared to $2.2 million or 40% of sales in the third quarter of last year. SG&A in the third quarter of 2015 included increased sales and marketing spending as compared to the third quarter of last year. Sharps reported a net loss of $812,000, or a loss of $0.05 per basic and diluted share this quarter, compared with the net loss of $935,000, or a loss of $0.06 per basic and diluted share in the third quarter of last year.

Now let's look at a few highlights for the nine months ended March 31, 2015. Revenue of $21.9 million in the first nine months of fiscal 2015 was an increase of 13% compared to revenue of $19.5 million in the first nine months of fiscal 2014. Customer billings increased 15% to $22.1 million in the first nine months of fiscal 2015. Retail billings grew 28% to $5.7 million in the first nine months of the year, primarily due to increases in flu-shot related business. Sales for this market are trending upward. And, while the Retail market is traditionally inconsistent quarter by quarter, due to the variability in demand for flu shot solutions, the expansion of healthcare services in retail pharmacies overall will drive growth for the company. Pharmaceutical Manufacturer billings increased 33% to $3.4 million in the first nine months of fiscal 2015, and Professional billings increased 22% to $4.7 million. Government billings increased 160% to $1 million in the first nine months of fiscal 2015 compared to the prior year.

Fiscal 2015 year-to-date gross margin was 33%, which is consistent with the first nine months of fiscal 2014. SG&A expense increased to $7.1 million in the first nine months of the year, an increase of 6% over the prior year period, as a result of increased investment in sales and marketing initiatives. The company recorded an operating loss of $138,000 in the first nine months of the year, as compared to an operating loss of almost $700,000 in the first nine months of fiscal 2014. EBITDA improved to $515,000 in the first nine months of 2015, as compared to EBITDA of $150,000 in the first nine months of last year. Net loss in the first nine months of fiscal 2015 was $137,000, or a loss of $0.01 per basic and diluted share, compared to a net loss of almost $700,000 or $0.05 per basic and diluted share in the first nine months of last year.

Our balance sheet remained solid with $16.2 million of cash and cash equivalents at March 31, 2015, compared to $13.7 million at June 30, 2014 with no debt. At March 31, 2015, working capital, stockholders equity, and total assets were $18.2 million, $22.2 million, and $26.9 million, respectively. Inventory of $2.3 million at March 31, 2015 is higher than the balance at June 30 of $1.3 million. That increase is a direct reflection of growth in the business, as well as preparing for the upcoming flu-shot season. In April 2015, we extended and expanded our credit facility into a new $9 million credit facility, which provides up to $4 million for working capital purposes, and $5 million for potential acquisitions.

With that, I'll turn the call back over to David.

David Tusa – Chief Executive Officer and President
Thanks, Diana. Just a couple of statements before we turn it over to the Q&A. We remain committed to, and are very excited about growing the company significantly over the long term through organic growth in our key markets, new product and service offerings, as well as potential acquisitions. Before we get to the Q&A, let me say that I expect you are going to have questions about the Government business. With that in mind, I can tell you that we're very encouraged about the long-term prospects for our Government business, particularly related to our new unused medication management solutions. We believe we're well positioned to capitalize on the interest shown by government agencies in our new solutions and are encouraged by how quickly they have been adopted. With that said, and as I trust you can respect, we're not in a position to provide much more detail beyond that in what we've disclosed in the prepared remarks. While the potential magnitude of the opportunity is not lost on us, we would prefer to abstain from speculating about the Government business and government opportunities.

With that, operator, let’s open it up for questions.

Operator
At this time we’ll be conducting a question and answer session. (Operator instructions.) One moment please, while we poll for questions.

Our first question if from Brian Butler with Stifel. Please proceed with your question.

<Q>: I’ll only ask one government question and it won’t be on an outlook basis. On the government revenues that you saw, and the orders that you saw in the third quarter here, would you classify those as an inventory build, or is that just the normal flow-through?

David Tusa – Chief Executive Officer and President
While it’s a new solution, what we’re most excited about is our TakeAway envelopes and our MedSafe are new in the sense that, finally, for the first time in this country, we’re able to address controlled substances. We launched a new solution subsequent to the October 2014 change in the DEA rules, quickly secured all the approvals we needed, put it on the Federal Supply schedule, and we’re starting to see the orders. We’re very encouraged, and the government has seen the value in what we’re doing. Just like any other of our customers, we talk with them on a regular basis and we’re encouraged. Let us get a little bit more time behind us and see how much more business there may be out there that we can talk more about, and then I think we’ll be able to give you a better idea.

<Q>: But from just a mechanics basis then, you’re paid for these when you send them out to the customer and not when they're sent back, is that correct?

David Tusa – Chief Executive Officer and President
That’s exactly right, the envelopes are paid for, and it’s the same thing with the MedSafe. The government is using both of them right now.

<Q>: And just a point of clarification on the pharmaceutical. When you talked about that $4 million in annual revenues in by 2017, that’s incremental, right? I mean, right now you’re running at a pace that’s probably a little bit above $4 million, so that $4 million would be incremental to where you are right now. Is that correct?

David Tusa – Chief Executive Officer and President
Right. When the programs initially rolled out, they’re small, so you have growth in the recent ones. But more importantly, we’ve got the three new programs that are rolling out; they're rolling out over a period of time, and I'm excited about those. Those are new drugs, new indications, and have the opportunity to be quite large.

Brandon Beaver – Senior Vice President of Sales
And, Brian, we’ve got a couple of programs rolling out; one within the next quarter or two, you’ll see. I think in our Pharmaceutical market, we continue to drive awareness amongst the manufacturers out there. So while we have some depth and breadth within a couple of manufacturers, we’re starting to see other manufacturers gauge interest in this program, and that’s building our pipeline. As we all know, pharma is a very long pipeline. We’re looking at drugs right now with some of these guys that are into 2018 and 2019, literally. As we start to bring on manufacturers, we think that over the next 18 months or so, we’ve got a couple who’ve already locked in with us.

<Q>: Right. I just want to make sure so that when you look at your run rate today, plus that kind of outlook that you gave, you’re talking in the $7 million to $8 million for that segment barring any large attrition.

David Tusa – Chief Executive Officer and President

That’s right.

<Q>: And then on the retail side, is that expected to play out like 2014, where you had the down third quarter, and then it came back very strong in the fourth quarter? Or is it something else timing-wise that’s happening in that segment?

David Tusa – Chief Executive Officer and President
No. We expect to—we’ll start to see that pickup in the June quarter. That’s when I mentioned earlier that the June quarter is expected to be strong. We’ll have the beginning of the flu season, we’ll have some pharma manufacturer business, and I think we’ll see growth in some of the other sectors as well. I think the June quarter is shaping up to be strong.

<Q>: And then just one last one. On the third party incinerator business, I think you have it as environmental. Can you just give a little color on what expectations are, and how that business is shaped up? At one point I think it was expected to be a little bit larger contributor, and it seems to have slowed down.

David Tusa – Chief Executive Officer and President
That’s right. That’s third-party incineration services, and they're really more on a project-by-project basis; it’s not a recurring revenue business. It’s projects where a company or a government agency or someone may need some incineration. They’re very hard to predict, and they happen when they happen. We had a couple of good ones in some quarters; it’s been dry lately, but we’re chasing a few, so hopefully we have the opportunity to increase that sector going forward.

Operator
Our next question is from Kevin Steinke with Barrington Research. Please proceed with your question.

<Q>: I just wanted to ask you about the government, but again not about future prospects, just in terms of sequencing here. So, the two government agency orders that you got, did they come after your solutions were placed on the federal GSA schedule, or before?

David Tusa – Chief Executive Officer and President
The envelopes were purchased after we put them on the Federal Supply schedule. The MedSafe was purchased before that. The MedSafe was in response to the need that’s been out there, Kevin, for years, how do you deal with unused medications, what do you do with controlled substances?

<Q>: The Federal GSA could be a facilitator in the future?

David Tusa – Chief Executive Officer and President
It is. And the DAPA as well. The DAPA is the Department of Defense. Let me put it this way, of the MedSafes that we’ve sent out, or that are pending, about half of them or more have been ordered by major government agencies.

<Q>: And you mentioned the early adoption by government of both TakeAway and MedSafe; do you think that’s something you can use when you’re marketing to other markets in terms of the government adoption? Is that something you would look to use as kind of a driver of sales in other markets?

Brandon Beaver – Senior Vice President of Sales
Yes. Kevin, this is Brandon. Absolutely. We plan to utilize some of the government’s success and continued purchases with the private sector. Looking at long-term care, looking at our retail pharmacies, hospice, and law enforcement, things like that; that is absolutely something we plan to use as a stepping stone.

<Q>: And, just could you expand a little bit more on your optimism regarding unused medication management solution sales in the upcoming quarter and going forward?

David Tusa – Chief Executive Officer and President
There's significant interest on the government side, we know that. The sales of MedSafe on the private sector side are really more in the smaller chains so far, but we think we have opportunities to expand that as well. I think on the private sector side, they spend a little bit more time studying the solution, looking how it fits into their operations, reading the rules, and we were really pleased how the government ran with it much quicker. We could sit here and speculate, which we won't, or we can show you in the quarterly financials, the progress that we're making and that's what we plan to do.

<Q>: And would you care to offer any comment on the new credit facility you have in place?

David Tusa – Chief Executive Officer and President
Sure. We're planners, right?

Diana Diaz – Vice President and Chief Financial Officer
Right.

David Tusa – Chief Executive Officer and President
Diana worked on that, started working on that back, I don't know, six, seven, eight months ago, and we're planners. We're looking at acquisitions. We talked about that before, so we're making sure that we have financials in place so if we grow the company and opportunities are out there that we think make a lot of sense, then we have plenty of financial fire power to get deals done.

Operator
Our next question is from Ryan Daniels with William Blair. Please proceed with your question.

<Q>: This is Nick Hiller in for Ryan Daniels. Thanks for taking my question. I just had a quick one on home health. It's been down three or four quarters now on a year-over-year basis and trailing 12 months, it's down 8%. Could you help me understand what's driving that? I guess I understand how the timing by distributors can be explaining the sequential step-down, but having a little bit of trouble with that on a year-over-year decline.

Diana Diaz – Vice President and Chief Financial Officer
Right. Thanks, Nick. It is extremely difficult to manage customer relationships through a distributor, but based in the fragmented nature of this market, the home healthcare market, the distributor network is often the only way that we can reach these customers. We're seeing strong sales in the month of April of 2015, but it's really hard to predict whether the quarterly patterns will continue at that level for the rest of the quarter. We're trying to manage as best we can, and try to get growth where we can.

Brandon Beaver – Senior Vice President of Sales
And you know, Nick, I'll add a point onto that. Over the past ten years we've worked really hard to diversify our revenue base. And if you were to go back a number of years, home health was a significant portion of our revenue. I think we've done a great job of diversifying into other markets. Now, home healthcare is no longer over half of our business. On a year-to-date basis, healthcare makes up roughly 23% of our billings. So, while it's certainly not where we want it to be, I think we've done a great job in being able to diversify into other markets.

Operator

(Operator instructions.) One moment please while we poll for questions. Our next question is from Shawn Boyd with Next Mark Capital. Please proceed with your question.

<Q>: A couple of things. On the salesforce, you indicated that we ended the quarter around 21 reps all in, should we expect you to end the year there as well? And then can you give us just a preliminary view, would you expect to build it again by another five or six reps in FY 2016?

Brandon Beaver – Senior Vice President of Sales
Thanks for the question, Shawn. Yes. Definitely. You can see the movement of our sales team, whether it be inside or field support, it continues to drive north. I would anticipate the rest of this fiscal year to be close to that. We may add a couple of bodies here or there, but I would absolutely look at 2016 as seeing some growth. You go back, even to the end of March '14, we're at 14 bodies. You can see the significant growth, and you can see the build that we're putting into our SG&A and our sales force. So certainly it is an absolute strategy of ours to continue to grow methodically. We're not going to add bodies just to add bodies, we're definitely going to do it where we feel it has the strongest ROI.

<Q>: And on the order question, there's been a lot of talk here on the call about both retail and a little bit on the home healthcare side, and timing of orders, and that you expect a strong June quarter. So I guess the way that I come at that from a broader perspective, is your internal outlook for the fiscal year changed? Or do you expect this June quarter strength to make up for the weakness in the March quarter?

David Tusa – Chief Executive Officer and President
There's no guarantee, but I think the June quarter could look close to what the December quarter looked like. What was that, $8.7 million?

Diana Diaz – Vice President and Chief Financial Officer
Right.

David Tusa – Chief Executive Officer and President
About $8.7 million. So I think the June quarter has the potential and the opportunity to be as strong as the December quarter, which was a record quarter.

<Q>: Thanks for that, David. That would be great to see. Now on, well, government, you kind of muzzled us right from the get-go, and the other guys have already taken a shot, so I'll leave it at that. The only question on that would be you're going to have, at the next call you'll have two and a half quarters under your belt with the new solution selling into that market. Would you be able to give us a full year picture into FY '16 on the next earnings call, as to how that is shaping up with these two different agencies?

David Tusa – Chief Executive Officer and President
Yes, I think so. By the time of the June quarter, the fiscal year end call, we should have much more visibility and be able to tell you much more about it. That gives us another three months, but we do that in August, right?

Diana Diaz – Vice President and Chief Financial Officer
Right.

David Tusa – Chief Executive Officer and President
That should be plenty of time to be able to give you a much better perspective on the opportunity going forward.

<Q>: And last question for me. In terms of the margins, it looks like we certainly had a tough quarter here with the timing of orders, etc., and so from an incremental margin standpoint, on the gross margin and then also when I

look at the incremental SG&A, it was a bit low relative to target. Is anything going on that we should move away from that 50% incremental gross margin target and the 10% incremental SG&A?

David Tusa – Chief Executive Officer and President
No. I think that those numbers tell a lot, and so 50% gross margin on the incremental purchases. And we've always said on the SG&A, between 5% and 10% increase over the prior year. I think it's come in at about 6% this year. It's probably a little bit closer to the 5% than 10% on the SG&A.

Operator
Our next question is from George Walsh with Gilford Securities. Please proceed with your question.

<Q>: David, in the press release you do mention in the outlook for fiscal year 2016, the potential contributions from acquisitions. Is there any general statement you can make relative to that in terms of acquisition activity?

David Tusa – Chief Executive Officer and President
Sure. We're looking to grow the company potentially through acquisition and organic growth in new products and services. We're looking, and we've looked at many, many companies that have value-added products and services that we can sell into our existing and prospective customer base. We have the luxury of being methodical, so we're not going to buy a company just to say that we bought a company. We want to make sure that it's well-run, has a solid management team, has value-added products and services, and low to no integration risk. We've looked at many and we're starting to get closer. We're hopeful that maybe by the end of the calendar year, we would have closed one or two. But we're not going to just do it to do it, we're going to make sure. The last thing we want to do is disrupt our core business and everything we've built by going out and doing something that doesn't make sense.

<Q>: And just strategically, I was just wondering, if you did more than one, would they be in the same area, or would it be two different areas that you'd be enhancing the business?

David Tusa – Chief Executive Officer and President
I think it would be in the same area, but we'll see. We're looking and we're traveling all over the country and visiting with a lot of folks. We hope to have some more information again between now and hopefully the end of the calendar year. But we're excited about what we've seen and we have found some things that we think would be a really good fit into the company's strategic plans.

Operator
There are no further questions. At this time, I'd like to turn the call back over to management for closing remarks.

David Tusa – Chief Executive Officer and President
Thank you, everyone, for joining our call. We look forward to speaking with you on the next quarterly earnings call. Have a good day.