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Transcript of Sharps Compliance
Second Quarter 2014 Earnings Conference Call
January 28, 2014

Participants
Jennifer Belodeau – Investor Relations
David Tusa – President and Chief Executive Officer
Diana Diaz – Vice President and Chief Financial Officer

Analysts
Nick Hiller - William Blair
Brian Butler - Wunderlich Securities
Joe Munda - Sidoti & Company
Ron Legrow - Athena Fund

Presentation

Operator
Greetings, and welcome to the Sharps Compliance Second Quarter Fiscal Year 2014 Earnings conference call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. As a reminder, this conference is being recorded.

It is now my pleasure to turn your conference over to your host, Ms. Jennifer Belodeau, Investor Relations for Sharps Compliance.

Jennifer Belodeau – Investor Relations
Thank you. Good morning, and welcome to our conference call to discuss Sharps Compliance financial results for the second quarter of fiscal 2014. On the call today we have David Tusa, Sharps' President and Chief Executive Officer and Diana Diaz, Sharps' Vice President and Chief Financial Officer.

David will review the company's business operations and growth strategies, and Diana will review the financials. Immediately following our formal remarks, we will take questions from our call participants. If you are listening via Webcast, please note that 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.

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With that out of the way, let me turn the call over to David to begin the review and discussion. David?

David Tusa – President and Chief Executive Officer

Good morning, and welcome, everyone, to our second quarter earnings conference call. Our second quarter represents another solid quarter of growth for the company with revenue of $7.6 million, an increase of 34% over the last year's second quarter and a 22% increase compared to the first quarter of fiscal year 2014. Our revenue growth was driven by increased billings across all of our key markets. I'll get into the market specifics in just a moment.

We're pleased to, again, have achieved profitability with net income of $120,000 or penny a share. But as I've often said to many of you, we are much more focused on revenue growth versus … a penny or two of earnings. The way we build, sustain long-term value and high margin profitability is to drive revenue growth, period.
So, here's what makes me really excited about the second quarter. First, the revenue growth in every single market, which was much higher than the segment growth rate, which means we continue to increase market penetration and garner market share. The incremental revenue was at a higher margin, supporting the operating leverage business model.

Our sales organization is performing and performing well and the long-term trends such as the shift in healthcare delivery to alternate healthcare science, cost pressures for healthcare-related facilities, increased regulation and healthcare reform are all still very much in our favor. So now, let's breakout the performance for our key markets.

Professional Market: The billings grew $360,000, or 38% in the second quarter, contributing $1.3 million, or approximately 18% of consolidated revenues. The Professional Market refers primarily to customers such as dentists, veterinarians and physicians. This growth is largely result of our inside and online sales channel, which drove 22% increase in billings to $49 million in the second quarter. We also continue to see the positive impact in this market from our joint marketing alliance where we offer both the mailback, as well as route-based pickup service where appropriate.

Now, there's many variables in many of our markets that make short-term visibility and short-term performance difficult to predict. However, our Professional Market has achieved consistent quarterly sales growth for trailing 12-month billings, 32% higher than the prior year. Our success in the Professional Market is tied to our targeted sales initiatives, such as our ability to offer customize medical waste solutions to our customers.

Now, our biggest challenge and corresponding focus in the Professional Market is increasing awareness of our mailback solutions so that the prospective customer base understand there's a more economic and efficient alternative to their traditional, costly and inefficient pickup service in the small quantity generator sector.

Onto the Retail Market; our billings grew by 28% to $1.8 million compared to the prior year quarter, and this contributed about 25% of the consolidated revenues. The Retail Market refers primarily to retail pharmacies and clinics who utilize our solutions to collect, transport and process medical waste, which in this case is primarily used syringes.

We've seen growth in this segment during the past two quarters related to a strong flu season, driving increased demands for shots, as well as the continued shift of

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administration of shots to the retail segment. As most of you know, our retail flu business is seasonal. So, we'll most likely not see this level of revenue growth in the third quarter. But, viewed with a longer-term lens, sales for this market were up 27% on a trailing 12-month basis compared to the prior year trailing 12-months. So while the third quarter billings for the market may slow a bit, the longer-term trends are very positive.

With the changing face of healthcare and consumers seeking alternatives to the traditional setting, retail pharmacies are steadily increasing the scope of the services that they provide. With our 75%-plus share of this market, we're in excellent position to see continued long-term growth in this business.

Pharmaceutical Manufacturer: The billings in this market were very strong this quarter, showing a 60% increase to $1.5 million, or approximately 20% of the consolidated revenues. Our Pharmaceutical Manufacturer market encompasses customized branded mailback solutions we provide to patients of large global pharmaceutical manufacturers. We're very excited about the progress we're making in this market and believed its poise for continued long-term growth.

As many of you are aware, our pharma business seems to be lumpier and difficult to predict than our other market sectors. Much of the growth in the December quarter came from resupply orders from several existing pharmaceutical manufacturer customers. We don't expect to maintain the level of billings in the third quarter as we now drawdown on the existing vendor-managed inventory. But, we believe we will see more resupply orders in the June, September and December quarters of 2014.

We also seek growth with existing patient support programs as pharma recognizes the value in our customized solutions, which help them to improve patient interaction, build brand royalty, and create opportunities for increased medication adherence. And finally, we're in the later stages of opportunities with new drug and device patient support programs, which we believe could positively impact our calendar year 2014 and '15 revenues.

The Home Healthcare Market increased 15% to $1.8 million, which represented 25% of our consolidated revenues. Our Assisted Living Market billings grew 10%, about $400,000, or 6% of consolidated revenues. As healthcare migrates from traditional settings to the home, we believe there is a great opportunity to provide our solutions to alternate healthcare sites such as assisted living and home healthcare.

We remain in a very strong position to benefit from several trends, including the shift away from traditional healthcare settings to alternative sites, the development of new regulation and ordinances around the proper disposal of unused medications and of course the aging U.S. population. We also remain very focused on providing more and innovative solutions, and are growing our sales force to ensure that we are introducing our solutions to the right audiences in order to maximize our presence in these growing addressable markets.

Finally, we believe the effectiveness of our solutions, coupled with our excellent customer service and our proactive regulatory support, are key components of the success of our sales process.

With that, I'll turn it over to Diana, who will provide more details on the financials.

Diana Diaz – Vice President and Chief Financial Officer

Thank you, David. Our second quarter results reflect another strong quarter for the company. Gross margin was 35% in the second quarter as compared to 30% in the prior year second quarter. The quarter's margin improvement demonstrates leverage we have in the business on the higher sales volumes.

SG&A expenses in the fiscal 2014 second quarter increased to $2.45 million, or 32% of sales as compared to $2 million, or 35% of sales in the second quarter of 2013. The reduced SG&A as a percentage of sales is a result of higher sales and operating leverage.

On a dollar basis, SG&A for the second quarter of fiscal 2014 was negatively impacted by legal expense of almost $200,000 associated with our claim to the CDC related to the termination of a government contract, severance costs of about $100,000 for a former officer of the company, and increased sales and marketing spending.

The company generated operating income of $120,000 in the second quarter of fiscal 2014 compared with an operating loss of approximately $430,000 in the same prior year period. Earnings before interest, taxes, depreciation, and amortization, or EBITDA was $402,000 for the second quarter of fiscal 2014 compared with an EBITDA loss of $154,000 in the same period of the prior fiscal year.

As David mentioned, net income was $120,000, or one cent per basic and diluted share compared with a net loss of $428,000 or a $0.03 loss per share for the prior year period. Our balance sheet remains solid with $15.3 million in cash and cash equivalents as of December 31, 2013 with no debt. Our strong balance sheet gives us flexibility as we build a larger company.

As we've previously disclosed, Sharps had an authorized stock repurchase program in place for up to $3 million extending through 2014. During the December quarter, the company repurchased 117,441 shares at an average price of $4.73 per share. This brings the total shares repurchased under the program to 161,801 shares at a cost of $681,000.

With that I'll turn it back over to David.

<u>David Tusa – President and Chief Executive Officer</u>
Thanks, Diana. We're making significant progress in fiscal year 2014 as reflected with two solid quarters. As one of only two national providers of medical waste and unused medication management solutions, we believe our solutions offer the best option for the growing market of alternate healthcare sites. We remain focus on educating our addressable market about the economies, efficiencies and availability of our comprehensive, customizable solutions.

It's been a busy quarter and as such, I'd like to thank all of our employees for their contribution to our growth, and their efforts towards building a company that is capitalizing on the changing dynamics of the healthcare industry.

With that, operator, let's turn it over for questions.

<u>Operator</u>
Our first question comes from the line of Ryan Daniels with William Blair.

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<Q>: This is Nick Hiller in for Ryan Daniels. Thank you for taking my questions. I guess, first, on gross margin; at least on a sequential basis, it declined even though revenue grew from the first quarter. I was just wondering if you could highlight what drove that.

Diana Diaz – Vice President and Chief Financial Officer
Sure. I'd be glad to answer that. We did have a decrease in gross margin from 37% in the first quarter to 35% in the second quarter. It was really due to a combination of higher costs at our treatment facility and a mix of business. Our fixed costs generally run at about $1.1 million a quarter, and our product costs range from 48% to 50% of revenue and this quarter, the product cost was really on the high end of that range.

Operator
Our next question comes from the line of Brian Butler with Wunderlich Securities.

<Q>: Let's start on the Pharma. Can you just give a little update on where you think the pipeline stands, kind of talk about the number of perspective deals that are out there and kind of talk about what you see going forward because last time I remember that you still had I think it was like four attractive opportunities there.

David Tusa – President and Chief Executive Officer
That's right. We have a number of opportunities, about four there, that are in the later stage of award and should we hopefully award and contract those opportunities, they will possibly impact '14 and '15. They would rollout sometime into calendar year 2014. So, we feel pretty good about those. Again, those are in the later stage but also, what we're also doing with our existing customers is we're introducing more solutions, and more customized solutions with existing customers as well that could grow the business. So, we're excited about the pharmaceutical manufacturer market. We're doing many things for them, and I think that's going to continue to play a key role going forward.

<Q>: On the pharma, when you think of the reorders that you had this quarter and then what that kind of—can you quantify the amount of reorders? I mean when you look at the third quarter, does it go back to first quarter levels where you're at like around 600,000 for pharma, or has the base level actually increased a little bit?

David Tusa – President and Chief Executive Officer
Well, as I mentioned, it's a really lovely business. We build in bulk and receive bulk orders that we draw down on. So, while the March quarter may be light, we'll see the buildup of those re-supply orders throughout the remaining calendar year. So, again, it's hard to actually predict when it's going to hit in the quarter, but what are we doing, Diana, on a trailing 12 on pharma?

Diana Diaz – Vice President and Chief Financial Officer
On the trailing 12 for pharma, we increased 14%.

David Tusa – President and Chief Executive Officer
What are we for the trailing 12 for the billings for pharma?

Diana Diaz – Vice President and Chief Financial Officer
$2.6 million.

David Tusa – President and Chief Executive Officer

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Yes. So, $2.6 million. So, you're right; roughly $600,000 or $700,000, I think, is the baseline, but we have the opportunity to increase that. But again, it's not going to always firmly drop in, or smoothly drop in a quarter. But from a long-term perspective, we think we're going to see that number grow on a trailing 12 basis.

<Q>: Those opportunities that are in the later stage, is that a second half of 2014 for you, or is that possibly pushed out further?

David Tusa – President and Chief Executive Officer
We'll probably launch those programs, should we land those, are probably the second half of calendar year 2014.

<Q>: Then on the Home Health, you guys have been showing really good growth in that. Is that growth sustainable kind of in the second half of 2014, and is that being driven by the Daniels' partnership, or is that coming from somewhere else?

David Tusa – President and Chief Executive Officer
No, that's all mailback business. Again, what are we on the trailing 12? Really, you have to look at it because there is some lumpiness even in Home Healthcare because there's a lot of it that runs through distributors. So, what we are on a trailing?

Diana Diaz – Vice President and Chief Financial Officer
On a trailing 12-months, we are at 7.5% increase.

David Tusa – President and Chief Executive Officer
Yes, so 7.5%, 7%-plus. That business should be growing at about 10% and we think we have opportunities maybe to increase it even more. But, I think it would be safe to say about 10%.

<Q>: Then talking about the Daniels' partnership, can you give a little bit of an update, or at least possibly quantify what you think that is in the second quarter and what do you think it might be going forward still?

David Tusa – President and Chief Executive Officer
Well, we work well with the folks at Daniels and as you know, we're able to offer the pickup service customized with the mailback solutions. And I think right now, we're working with them and through that alliance, we're probably generating $600,000 or $700,000 a year. We have a number of opportunities out there that we're chasing where the Daniels alliance could help us. But, instead of trying to predict and provide numbers, I really just like to show it in the P&L when it hits, Brain.

<Q>: No, that's understandable. But still, I guess the point is the pipeline is far from exhausted. There's still a huge amount of opportunity there.

David Tusa – President and Chief Executive Officer
Oh, absolutely.

<Q>: Then a couple bookkeeping ones; on the SG&A, you identified about $300,000 the legal and severance. So, is the right way to think about that going forward is that that $2.5 million for quarterly SG&A kind of comes back down to the $2.2 million to $2.3 million?

David Tusa – President and Chief Executive Officer
Right. Yes, that's the way to look at it.

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<Q>: Then on the P&L, you have the D&A at like $1.3 million, but in your EBITDA breakdown it's something like $280,000. There's a difference of about $165 and I was just curious where that D&A kind of goes through on the P&L.

Diana Diaz – Vice President and Chief Financial Officer
There is a portion of the depreciation and amortization that's in cost of sales that's related to depreciation at our treatment facility in our warehouse.

<Q>: What was your cap ex spending for the quarter?

David Tusa – President and Chief Executive Officer
We run about a million dollars a year maintenance cap ex.

Diana Diaz – Vice President and Chief Financial Officer
And our quarterly level was right in that range.

<Q>: All right, so right around $250,000?

David Tusa – President and Chief Executive Officer
Right.

Operator
Our next question comes from the line of Joe Munda with Sidoti & Company.

<Q>: David or Diana, just a quick question with that, and following-up on the last caller's question, the CDC expense. Are you expecting a claim from them, or you filed a claim with them? Are you expecting to be paid on that? Can you give us a little bit of clarity there?

David Tusa – President and Chief Executive Officer
Sure. We file a claim after the termination of the contract in 2012. We filed a claim with the CDC because in our opinion, it's a five-year requirements contract. And the claim is about a $1.7 million, or $1.8 million. It looks like that its actually going to go to trial in the third week of February, next month.

So, yes, we made a claim of roughly a $1.7 million and believe that our position is that we need to be repaid for the obligations that we had to make good on because we establish a five-year requirements for the contract.

<Q>: I know the last caller had talked about SG&A; are we to assume that that litigation expense is going to be prevalent, or it's still existing, I guess, for the near-term here?

David Tusa – President and Chief Executive Officer
No. It was heavy in the December quarter because we had depositions and discovery. It was a very busy quarter for the claim. We'll probably have some in the March quarter, but it'll be over. We'll either win or lose.

<Q>: David, in regards to your comments, you talked about the sales force and growing that force. Can you give us some sense of where you guys stand with the number of direct threats and where you would like to be by the end of the year?

David Tusa – President and Chief Executive Officer

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On a field sales side, I think we are about six reps that we have. I'd loved to be eight or nine here over the next quarter or two because we're quite busy. Our markets are quite active, and we're garnering some pretty significant audiences. So, I'd love to get that to eight or nine. On the inside sales side, I think we're up to like eight or nine folks there and I probably see that increasing over the next couple of quarters by about four or five.

<Q>: I know you touched on Daniels here. Now, the pipeline of opportunity with Daniels, where is that? What businesses really do you see that enhancing would be—?

David Tusa – President and Chief Executive Officer
Well, let me just say—that's right, Joe. It affects many of our markets. For competitive reasons, I don't want to talk about any particular market, but there's many markets that we have on our radar that are our core markets that we believe that could benefit from the larger deals where we integrate the pickup in the mailback.

<Q>: I guess my final question; you touched on the regulatory environment as being a driver for growth for the company. Can you give us some sense or some clarity on what you're seeing and why you really think that?

David Tusa – President and Chief Executive Officer
Well, there's a lot of activity on the regulatory side that's surrounding proper disposable of unused medications. And there are some new rules that are going to come out from the DDA in March that will facilitate unused medication disposal, consumer dispense, and will also include controls. All the business that we've done up until now has excluded controlled substances.

So, that's going to change. I think it's going to change the business significantly, and I believe we're well positioned to take advantage of that with our solutions and be able to hopefully increase the business from that product line.

Operator
Our next question comes from the line of Ron Legrow with Athena Fund.

<Q>: Now that we've had such a good result for the past two quarters, now would be a good time to be getting out to the street and getting more creative in your stock. Are you committed to doing that?

David Tusa – President and Chief Executive Officer
Absolutely. We're are working on a pretty active February and March for getting out on the road and talking to folks. I've been out recently as well, but I think February and March will be heavy on the IR side.

<Q>: Good. Obviously, … still seeing stocks being undervalued given that you've been buying back more stocks during the last quarter.

David Tusa – President and Chief Executive Officer
Well, it's an important part of our jobs to make sure that we have a strong IR initiative.

Operator
Ladies and gentlemen, that's all the time we have for questions today. I'd like to turn the floor back over to management for closing comments.

David Tusa – President and Chief Executive Officer
Thank you, and thank you, again, everyone, for dialing in. We believe our mailback solutions for medical waste and unused medication management are the most economical and convenient solutions for the changing healthcare industry, again, in the small quantity generator sector. Our entire organization is very energized about the opportunity before us. We thank you for your support and we look forward to speaking to you next quarter.

Operator
Thank you. This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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