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CDW Corp (CDW) CEO Chris Leahy on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-31-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $1.7 beats by $0.12 | Revenue of $4.91B (12.22% Y/Y) beats by $248.01M

Earning Call Audio

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CDW Corp (NASDAQ:CDW) Q3 2019 Earnings Conference Call October 31, 2019 8:30 AM ET

Company Participants

Chris Leahy - Chief Executive Officer

Collin Kebo - Chief Financial Officer

Brittany Smith - Vice President, Investor Relations and Financial Planning and Analysis

Conference Call Participants

Amit Daryanani - Evercore

Matt Cabral - Credit Suisse

Adam Tindle - Raymond James

Katy Huberty - Morgan Stanley

Maggie Nolan - William Blair

Ruplu Bhattacharya - Bank of America

Matt Sheerin - Stifel

Shannon Cross - Cross Research

Keith Housum - Northcoast Research

Operator

Ladies and gentlemen, thank you for standing by and welcome to the CDW Third Quarter 2019 Earnings Conference Call. [Operator Instructions] I would now like to hand the conference over to your speaker today, Chris Leahy, Chief Executive Officer at CDW. Thank you. And please go ahead, ma'am.

Chris Leahy

Thank you, Lauren and good morning everyone. It's a pleasure to be with you. Joining me in the room today are Collin Kebo, our Chief Financial Officer and Brittany Smith, our VP, Investor Relations and Financial Planning and Analysis.

I will begin with a high level overview of our third quarter financial and strategic performance and share some thoughts on our outlook, then Collin will take you through a more detailed look at our results, capital strategy and priorities and outlook for 2019. We will move quickly through our prepared remarks to ensure we have plenty of time for Q&A. But before we begin, Brittany will present the company's Safe Harbor disclosure statement.

Brittany Smith

Thank you, Chris. Good morning, everyone. Our third quarter earnings release was distributed this morning and is available on our website, investor.cdw.com, along with supplemental slides that you can use to follow along during the call.

I would like to remind you that certain comments made in this presentation are considered forward-looking statements under the Private Securities Litigation Reform Act of 1995. Those statements are subject to risks and uncertainties that could cause actual results to differ materially. Additional information concerning these risks and uncertainties is contained in the earnings release and Form 8-K we furnished to the SEC today and in the company's other filings with the SEC. CDW assumes no obligation to update the information presented during this webcast. Our presentation also includes non-GAAP financial measures, including non-GAAP operating income and non-GAAP earnings per share. All non-GAAP measures have been reconciled to the most directly comparable GAAP measures in accordance with SEC rules. You'll find reconciliation charts in the slides for today's webcast and in our earnings release and Form 8-K we furnished to the SEC today.

Please note that all references to growth rates are dollar amounts and our remarks today are versus the comparable period in 2018, unless otherwise indicated. In addition, all references to growth rates for hardware, software and services today represent U.S. net sales only and do not include the results from CDW U.K. or Canada. There was 1 extra selling day in the third quarter of 2019 compared to the third quarter of 2018. There were the same number of selling days in the first 9 months of 2019 compared to the first 9 months of 2018. All sales growth rate references during the call will use average daily sales unless otherwise indicated. Replay of this webcast will be posted to our website later today. I also want to remind you that this conference call is the property of CDW and may not be recorded or rebroadcast without specific written permission from the company.

With that, let me turn the call back over to Chris.

Chris Leahy

Thanks, Brittany. Third quarter results were excellent with both strong sales growth and profitability. Consolidated net sales were $4.9 billion, up 12.2% on a reported basis. With 1 additional selling day in the quarter, average daily sales increased 10.5% and 10.9% in constant currency. Gross profit increased 14.4% to $816 million. Non-GAAP operating income increased 13.9% to $380 million and non-GAAP net income per share increased 19.8% to $1.70 per share. On a constant currency basis, non-GAAP net income per share increased 20.4%. These excellent results reflect the combined power of our balanced portfolio of customer end markets, our full suite of offerings that address customer priorities across the IT landscape and our ongoing success executing our 3-part strategy for growth.

First, the balance across our customer end markets. As you know, we have 5 U.S. sales channels, corporate, small business, healthcare, government and education. Each of these channels are meaningful businesses generating annual sales of more than $1 billion. This scale enables us to further align sales teams into vertical customer end markets, including federal government, state and local governments, K-12 and higher education. In addition, we have our Canadian and UK operations, which together delivered over $2 billion of net sales the last 12 months. These unique sales organizations serve us well when end markets behave differently from each other, sometimes that occurs because markets are disrupted by macro or external challenges, sometimes it occurs when consumer behavior differs due to different priorities.

This quarter, our double-digit sales increase was driven by excellent results across the U.S. business, with 4 of our 5 U.S. channels growing double-digits and solid local our performance from our international teams. U.S. customers remained focused on client devices to meet growing needs from full employment as well as refresh driven by older equipment, new use cases and new security features. At the same time, customers continued to modernize their IT infrastructure and adapt more flexible architectures. The teams did an outstanding job helping customers address these priorities.

In corporate, the team delivered 10% growth as they successfully addressed ongoing customer demand for client devices, while driving solid solutions growth. The Small Business team delivered nearly 12% growth for the quarter driven by hardware strength, in particular client devices. Our corporate and small business customers continue to move ahead with technology decisions despite macroeconomic uncertainty, highlighting the importance of technology to achieve business goals. Customer activity and purchasing behavior remained strong in the quarter. The government team drove a 22% increase in sales. Federal had another excellent quarter of sales more than up 35%. The team delivered strong transaction and solutions result from both civilian and defense departments as we continue to benefit from investments we made to become a strategic technology partner to the federal government. In addition, in the quarter, the U.S. Census Bureau Device as a Service project contributed more to growth than previously expected. Changes to the final rollout schedule for 2019 resulted in more revenue recognized in the third quarter than other quarters this year.

As we have discussed previously, we created a mobile technology solution that supports field data collection for the 2020 census that combine our services and logistics capabilities with our broad product portfolio and deep partner relationship. Census is a great example of the power of the breadth of our offerings and our technical capabilities. The State & Local team delivered flat performance as we lapped last year's mid-teens growth, which was driven by timing of new and existing contracts in the third quarter of 2018. The team continued to expand existing contracts and win new contracts and helped customers modernize their infrastructure and secure their environment. Education's flat performance reflected a double-digit growth in higher ed and a slight decline in K-12. We continued to gain market share on higher ed, leveraging our team's expertise and our broad portfolio to help campuses utilize technology to upgrade and enhance student and teacher experiences. K-12 couldn't fully overcome last year's nearly 20% growth driven by strong Chromebook results.

Difficult compares aside, K-12 customer purchasing priorities otherwise remained consistent, focused on refresh and classroom transformation. The healthcare team delivered excellent performance, up 11% driven by double-digit growth in client devices and NetComm hardware. Healthcare demand continued to be driven by security needs, infrastructure refresh and a heightened focus on patient experience. Other, which represents our Canadian and UK operations, increased nearly 11% on a reported basis. In local currency, Canadian growth was driven by both organic and Scalar performance. Integration is on track, and we're providing expanded portfolio options to both existing CDW Canada and Scalar customers.

The UK team delivered mid-single-digit growth in constant currency, successfully overlapping more than 20% growth for each of the last 2 years. The team continued to help customers transform their infrastructures, gain efficiencies and improve interoperability of their systems. As we have previously shared, our recently established presence in The Netherlands supports our broader growth opportunities in the EU and as needed serves as a Brexit contingency plan.

Clearly, third quarter results demonstrate the power of our balanced portfolio of customer end markets. Third quarter results also demonstrate the power of our second driver of performance, the breadth of our offering, with over 100,000 products, services and solutions for more than 1,000 vendor partners, we are well positioned to meet our customers' total needs across the spectrum of IT. U.S. transactions increased mid-teens led by over 20% growth in client devices. U.S. solutions increased mid single-digits and was the main driver of our gross margin improvement. Sales performance was strong and balanced with U.S. hardware, software and services all increasing double-digits.

Let's take a deeper look. Hardware increased 10% fueled by client device growth. Client device growth was broad-based and driven by continued customer refresh, market share gains and the deployment of our Device as a Service solution to the Census Bureau. 4 of our 5 U.S. channels delivered double-digit client device growth. During the quarter we continued to leverage our competitive advantages and experienced minimal impact from tariffs and supply constraints. As we have discussed before, customers continue to focus on optimizing and modernizing their IT environment, however, infrastructure projects can be lumpy. The variability is driven by the timing of when projects come to fruition and also the mix of hardware and software in the solution. This quarter, data center hardware, including enterprise storage and servers and NetComm hardware, declined single digits on a consolidated basis, with the results mixed across channels. Once again, hyper-converged infrastructure and all-flash storage put us at meaningful double-digit growth as customers continue to seek improved economics and enhanced performance. Customers also sought to enhance the performance of their data centers and networks by investing in software. Success helping customers adopt new architectures, refresh infrastructure and secure their environments drove strong growth in storage management, security, operating system software and network management, driving total software growth of 12%.

As you know, software is becoming a larger component of IT solutions we are working closely with our customers to maximize the return on their IT investment, whether it be hardware, software or services, which leads me to our services strategy. Services' 16% increase was led by warranties, professional services and configuration. Cloud also contributed to this quarter's results with healthy double-digit increases in customer spend and gross profit. Growth was driven by productivity, collaboration, security and mobility workloads. As you can see, we had excellent well-balanced performance in the quarter and were able to have our customers across a broad spectrum of IT needs part. That leads me to the final driver of our performance in the quarter, the impact of investments we are making the three-part strategy for growth. Investments made to ensure we continue to serve our customers' IT needs in this evolving market whether in a physical, virtual or cloud-based environment in the U.S. or internationally.

Importantly, our three-part growth strategy includes acquiring new customers and capture share, enhancing our solutions capabilities and expanding our services capabilities. Importantly, these three pillars work in tandem, each is crucial to our ability to profitably assess, design, deliver and manage the integrated technology solutions our customers want and need today and in the future. Our recent investment in Aptris is an example of our strategy in action. We acquired Aptris, a premier IT service management solutions provider and ServiceNow elite partner on October 1.

As you know, IT service management and digital workflow platforms are rapidly becoming a cornerstone of IT and driving digital transformation across organizations. IT service management implementations and integrations are typically very complex, Aptris is a leader in IT service management solutions helping customers simplify the end-to-end process. Aptris' talent and expertise further expanded our capabilities in this fast growing segment of the IT market and enhanced the value we can deliver to our customers. Aptris has been a partner of CDW since 2017. We knew from our partnership that Aptris is also focused on exceeding customer expectations and that the two organizations are culturally aligned. Let me share an example of how CDW and Aptris partnered to solve a customers' business problem.

A long time CDW customer wanted to migrate to ServiceNow to improve service levels from legacy systems that lacked full capabilities. The joint CDW and Aptris team started with discovery to understand the customer's pain points and goals to develop the right solution. With Aptris' deep team of technical talent and proprietary ServiceNow implementation processes, the team was able to develop precise plans for the migration and module rollout. Given the complexity of ServiceNow implementations, this expertise was critical to gaining credibility with the customer and successfully designing, integrating and delivering the solution. Aptris presents an exciting growth opportunity for our business, our customers, our partners and our coworkers. It brings the right talent and strategic capabilities we want to deliver to our customers. We welcome Aptris' nearly 100 coworkers to the CDW family. We remain focused on utilizing M&A as part of our capital allocation strategy to expand CDW's strategic capabilities and we continue to explore M&A opportunities as part of our three-part strategy for growth. We also continue to invest organically in our three-part strategy for growth. Organic investments in our strategy include the addition of new coworkers, new partners, enhancing internal system and developing new capabilities.

The next example I will share highlights how the three pillars of our strategy work in tandem as well as the importance of consistently executing and delivering for our customers as their trusted IT and business partner. A retail customer needed help modernizing one of its distribution centers. The customer wanted a partner who could assess, design, configure, deploy and implement different technologies from many vendor partners in a very tight window. Our ability to pull technical resources together from several different solutions practice areas enabled us to win the business and then execute the initial engagement at the highest standards.

Note I said initial engagement because the team demonstrated CDW's competitive advantages and helped the customer to achieve its objectives, we earned a much larger opportunity to help the company open over 100 new stores and refresh another 400 stores annually, increasing the customer's annual spend with CDW by over 30%. For new stores, we developed an IT Store-in-a-Box, consisting of over 100 SKUs from over 20 different vendors to deliver the store's point of sale and credit card systems, customer interface tools, wireless access points and more. Our logistical excellence in large-scale project management, technical know-how and services delivered unique value to the customer. We have further partnered with the same customer to develop its store of the future and are helping the customer execute on its digital transformation strategy. This is a great example of our exceptional coworkers solving business challenges by leveraging CDW's deep solutions expertise and service capabilities to provide a unique offering and capture market share. That's how our three pillars work in tandem.

Both of these examples highlight the importance of one of CDW's competitive advantages: our coworkers. They get it and make meeting the needs of our customers their first priority. We continue to prudently invest in customer-facing coworkers and ended the quarter up 275 from year-end, excluding Scalar. Additions are primarily due to an increase in service delivery coworkers to support the strong solutions and services growth seen year-to-date as well as technical coworkers and sellers. Fall timing of our account manager class has increased third quarter count, with normal attrition we now expect to end the year with new customer-facing coworkers in the mid-200, excluding Scalar and Aptris. As we always do, we will monitor the market and adjust as appropriate. And that leads me to our expectations for growth for the remainder of the year. Given year-to-date market performance, our current view of 2019 U.S. IT market growth remains in line with the expectations we have shared previously of full year growth of roughly 3%. Reflecting year-to-date share gains and expectations for the fourth quarter, we now target constant currency organic growth between 625 and 675 basis points above the market, roughly 200 basis points above our prior view.

We continue to expect Scalar to contribute an incremental 100 basis points of growth for the year. Aptris is not expected to have a material impact on 2019 net sales. For full year 2019, we expect to deliver constant currency earnings per share growth in the mid-teens, meaningfully above prior quarter guidance. We continue to expect ongoing but moderating strengthen in client devices and solid growth in solutions as we overlap last year's fourth quarter double-digit growth. We will keep a watchful eye all of this, including the wildcards we have spoken about this year, like Brexit, tariffs and supply chain constraints. In the meantime, the team will continue to do what they do best, out-execute the competition and leverage our competitive advantages to help our customer address their IT priorities and achieve their strategic objectives.

I hope you can from tell my comments that this quarter's performance reinforced our confidence that we have the right strategy in place, a strategy that leverages our competitive advantages and flexible business models to deliver both excellent profitability and strong cash flow. This confidence has led our Board to approve a 28.8% increase in our annual cash dividend, which puts us on track to achieve our capital allocation priority of delivering a dividend payout of 30% of free cash flow by year end. I know many of you are maybe wondering what we expect for 2020. We are in the middle of our planning process and Collin and I will provide the 2020 outlook on our year-end results conference call.

Now let me turn it over to Collin to share more details on the financial performance.

Collin Kebo

Thank you, Chris. Good morning, everyone. As Chris indicated, our third quarter results reflect the combined power of our balanced portfolio of channels, broad product offerings and ongoing execution of our three-part strategy. They also reflect successful investments in our business that build on our long-term financial strategy to drive strong cash flow, deliver sustained profitable growth and return cash to shareholders.

Turning to our third quarter P&L on Slide 8, consolidated net sales were $4.9 billion, up 12.2% on a reported basis and 10.5% on an average daily sales basis as we had 1 additional selling day. On a constant currency average daily sales basis, consolidated net sales grew 10.9%. On an average daily sales basis, sequential sales increased 6% versus Q2 of 2019, which was approximately 300 basis points better than historical seasonality and better-than-expected driven by one, client device growth, particularly in corporate, small business and government as we leveraged our competitive advantages to gain market share and help customers refresh their devices and two, successfully delivering device-as-a-service to the United States Census Bureau for the 2019 canvassing phase of the project. The majority of the devices were rolled out and the majority of the 2019 revenue was recognized during the third quarter. Gross profit for the quarter was $816 million, an increase of 14.4%, reflecting the benefit of an extra day in the quarter. Gross margin expanded 30 basis points driven by an increase in the mix of netted-down revenues, such as software-as-a-service and warranties.

Turning to SG&A on Slide 9, our non-GAAP SG&A, including advertising, increased 14.9%. The increase was primarily driven by sales compensation, which moves in line with gross profit growth, incremental Scalar expenses, performance-based compensation consistent with higher attainment against goals and investments in the business consistent with our bold forward strategy, including coworker count. Coworker count of 9,843 was up over 900 coworkers from September of 2018 with nearly 400 of the year-over-year increase from Scalar and the remaining from organic coworker investments. Roughly two-thirds of the 900 plus coworkers added year-over-year were in customer-facing roles. Non-GAAP operating income was $380 million, an increase of 13.9%. Non-GAAP operating income margin was 7.8%.

Moving to Slide 10, interest expense was $42 million, up 15.6%. This was primarily driven by a higher effective interest rate on the term loan in 2019 than 2018 when we had 1.5% caps in place. Our GAAP effective tax rate, shown on Slide 11, was 22.7% in the quarter, down 20 basis points compared to last year. This resulted in Q3 tax expense of $59 million. To get to our non-GAAP effective tax rate, we adjust taxes consistent with non-GAAP net income add-backs, including excess tax benefits associated with equity-based compensation, which is shown on Slide 12. For the quarter, our non-GAAP effective tax rate was 25.8%, down 110 basis points compared to last year's 26.9% rate primarily due to guidance issued by the IRS in the fourth quarter of 2018 on foreign taxes creditable against Global Intangible Low-taxed Income.

As you can see on Slide 13, with third quarter weighted average diluted shares outstanding of 147 million, GAAP net income per share was $1.37, up 14.6%. Our non-GAAP net income, which better reflects operating performance, was $250 million in the quarter, up 14.8% over last year. Recall that 1 additional selling day positively impacts third quarter profit growth by approximately 200 basis points. Not GAAP net income per share was $1.70, up 19.8% from last year. Currency headwinds dampened non-GAAP earnings per share growth by approximately 60 basis points in the third quarter.

Turning to year-to-date results on Slides 14 through 19, revenue was $13.5 billion, an increase of 10.9% on a reported basis and in average daily sales basis, since the additional selling day in the third quarter offset 1 fewer selling day in the first quarter. On a constant currency average daily sales basis, consolidated net sales were 11.6% higher than the prior year. Gross profit was $2.3 billion, up 12.4% and gross profit margin was 16.8%, up approximately 30 basis points. Non-GAAP operating income was $1 billion year-to-date, up 11.9%. Non-GAAP operating net income margin was 7.6%. Net income was $551 million and non-GAAP net income was $673 million, up 13.4%. Non-GAAP net income per share was $4.54, up 17.9%.

Turning to the balance sheet on Slide 20, at September 30, cash and cash equivalents were $167 million and net debt was $3.1 billion. Our cash plus revolver availability was $1.3 billion. As shown on Slide 21, we maintained strong rolling 3-month working capital metrics during the quarter. Our 3-month average cash conversion cycle was 17 days, down 1 day from last year's third quarter and at the low end of our annual target range of high-teens to low 20s. Free cash flow year-to-date was $590 million compared to $459 million year-to-date 2018. The year-over-year increase in free cash flow primarily reflects higher cash profits and favorable timing of collections. For the quarter, we returned just over $200 million to shareholders, which included $43 million of dividends and $161 million of share repurchases at an average price of approximately $114 per share.

Turning to capital allocation priorities on Slide 22, we announced earlier today that the Board of Directors declared a quarterly cash dividend of $0.38 per share to be paid on December 10, 2019, to all shareholders of record as of the close of business on November 25. This represents a 28.8% increase over last year's dividend. We are pleased to announce that with this increase, the annualized dividend of $1.52 per share achieves our dividend payout target of 30% of free cash flow based on the midpoint of our free cash flow rule of thumb of 3.75% to 4.25% of net sales. The objective of increasing the dividend to 30% of free cash flow was established when we provided our capital allocation priorities in November of 2014.

Having met our 5-year dividend commitment, we are updating our dividend objective going forward to grow in line with the earnings. We will target our dividend paid in the fourth quarter, annualized, to be approximately 25% of non-GAAP net income. This earnings payout ratio is equivalent to maintaining the dividend at approximately 30% of free cash flow. We are expressing the payout ratio as a percentage of non-GAAP net income because non-GAAP net income is a less volatile metric than free cash flow on an annual basis.

Our capital allocation priorities remain the same and continue to reflect our intent to drive shareholder value through returns of capital and strategic investments. In order of priority: first, increase dividends annually to guide these increases. As discussed, we will target annual dividend at approximately 25% of non-GAAP net income and to grow in line with earnings going forward. Second, ensure we have the right capital structure in place with a targeted net leverage ratio in the range of 2.5 to 3x. We ended the quarter at 2.2x, slightly below the low end of this range. In September we took advantage of favorable capital markets to extend our debt maturity profile by redeeming the outstanding $525 million of 5% senior notes due 2023, with the proceeds from the issuance of $600 million of 4.25% senior notes due 2028. The increased proceeds were used to cover transaction cost and term out a portion of the data from the Scalar acquisition.

Subsequent to the quarter, we further linked the maturities by extending our term loan by 3 years. With these 2 transactions now closed, our weighted average debt maturity increased from 4.7 years as of June 30 to 6.7 years on a pro forma basis as of September 30. Our third capital allocation priority is to supplement organic growth with strategic acquisitions. Our recent acquisitions of Aptris and Scalar are great examples of this. And fourth, return excess cash after dividends and M&A to shareholders through share repurchases. At the end of September we had $842 million remaining on our current share repurchase authorization.

Our capital allocation priorities support our updated 2019 outlook, which you can see on Slide 23. As Chris mentioned, we continue to expect U.S. IT market growth of approximately 3%. We now expect net sales growth of 625 to 675 basis points above U.S. IT market growth in constant currency on an organic basis. Included in the 625 to 675 basis point premium is the Census project, which we now expect to contribute approximately 60 basis points of net sales growth this year.

Given the majority of the Census revenue was recognized in the third quarter, we expect Census to have a modest contribution to fourth quarter growth. We continue to expect Scalar to contribute an additional approximately 100 basis points of growth on top of the 625 to 675 basis points, while Aptris is not expected to have a material impact on 2019 net sales. Currency is expected to represent a 60 basis point headwind for the full year assuming year-to-go exchange range of $1.25 to the British pound and $0.75 to the

Canadian dollar. Given year-to-date exchange rates, this implies currency headwinds of 30 basis points in the fourth quarter. We continue to expect non-GAAP operating income margin to be in the mid-7% range for 2019.

Considering our performance in the first 9 months and year-to-go expectation, we expect to exceed our previous outlook for 2019 non-GAAP earnings per share growth. We now look for non-GAAP earnings per share growth on a constant currency basis to be strong mid-teens, call it, 16% to 16.5%. Currency headwinds are projected to shave 60 basis points from the constant currency rate similar to the top line. Please remember that we hold ourselves accountable for delivering financial targets on an annual constant currency basis.

Slide 24 provides additional modeling thoughts for full year 2019. Moving down the P&L, total annual depreciation and amortization is expected to be approximately $265 million. This includes approximately $180 million of amortization expense for acquisition-related intangible assets, including preliminary estimates for Scalar and Aptris, which could change slightly once the purchase accounting is final. Depreciation and amortization expense and SG&A, excluding the amortization of acquisition-related intangibles, is expected to be approximately $80 million. Equity-based compensation is expected to be approximately $7 million to $9 million higher than 2018.

Interest expense is now expected to be between $162 million and $164 million, reflecting our recent refinancing and expected lower short-term interest rates. Our 2019 non-GAAP effective tax rate is anticipated to be slightly below the low end of the 25.5% to 26.5% range. We expect share repurchases to drive non-GAAP earnings per share growth approximately 400 basis points faster than non-GAAP net income. Additional modeling thoughts on the components of cash flow can be found on Slide 25. Our free cash flow rule of thumb remains unchanged at 3.75% to 4.25% of net sales. We now expect capital expenditures to be roughly 1.25% of sales. This includes business as usual CapEx of slightly above 0.5 point of sales, plus approximately 0.75 of a point of sales to support Device as a Service for the Census. Recall that CDW is the lessor for the devices and procurement of most of the devices is treated as CapEx, which is effectively our cost of goods sold. To be clear, this increase in CapEx does not change our free cash flow rule of thumb. We now expect the cash tax rate to be approximately 24.5% of pretax income adjusted for amortization of acquisition-related intangibles. We expect to deliver a cash-conversion cycle within the annual target range of high-teens to low 20s.

That concludes the financial summary. With that, I will ask the operator to open it up for questions. And we please ask each of you to limit your questions to one with a brief follow-up. Thank you.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question comes from Amit Daryanani with Evercore. Your line is open.

Amit Daryanani

Thanks a lot. Good morning, guys. I guess to start off with, I was hoping we could just talk a little bit more about the Census Bureau ramp and I think Collin you talked about this program that had contributed 60 basis points of growth in year 1 in 2019. That thing is an update from what you guys had talked about before. I guess could you just talk about the scope of this program and is it fair to think that, year two calendar ‘20 should have a much more meaningful contribution than what you have in 2019?

Collin Kebo

Sure. Amit. Good morning. You are right we did pickup the 2019 outlook for the Census to 60 basis points from the 40 basis points we had previously shared earlier in the year. That was primarily due to finalizing the actual device count with the sensors and then deploying those. And as I mentioned in my prepared remarks, the majority of that revenue will be recognized in the third quarter of 2019. As it relates to 2020, we will provide more thoughts on 2020 at our year-end earnings call. I did comment on a tick-up in CapEx and most of that CapEx is for devices that will be deployed in 2020. As you think about that though and the contribution to growth, remember we have 60 basis points of contribution sitting in the base. So as you think about the 2020 growth, you need to think about the delta between the two.

Amit Daryanani

Totally fair. Understood. And then I guess Chris, when you look at the 2019 growth which is going to be at this point plus 650 basis points versus IT spend. As you reflect on that, I am curious what do you think are sustainable in that growth trend versus unsustainable as you go forward, just help us parse that because this seems to be a fairly impressive outperformance versus the broader markets?

Chris Leahy

Yes. Thanks, Amit and really pleased with the team's execution so far this year. I mean look, this is a year where we have been hitting on all cylinders with a strategy that is right for what our customer needs and the capabilities to deliver. So, when you think about client devices as an example, certainly some tailwinds there from a refresh perspective, from an end-of-life market event coming up and full employment and the teams have taken full advantage of that in making sure that we are helping our customers along that journey. By the same token, infrastructure modernization and optimization is also equally important, particularly as organizations continue to digitize across the organization and as IT has become, I call it, front and center. It's really in the middle of driving outcomes for our organizations. So the trends that we see across the full landscape of IT seem to be continuing to be strong. Now all that said, as we move into Q4 and look forward to 2020, we do have some challenging overlaps, that's for sure. When you look in the client side, for example and you look at corporate and small business and double-digits on double-digits. And even as a segment, we're working on double digits on double digits. We've got some headwinds coming forward with that end of life coming to fruition, we've got some wildcards out there that we've talked about, Brexit, and tariffs and trade, etcetera. So we'll have to keep our eye on all of that. I guess what I would say is that, as we said in our prepared remarks, customer sentiment continues to feel strong. And activity is strong, notwithstanding the uncertainties. But it's hard to say what's going to happen next year and our expectation is we'll see solid growth in Q4, although client in particular moderating down.

Amit Daryanani

Perfect thank you and congrats on the quarter, guys.

Chris Leahy

Thanks very much, Amit.

Operator

Our next question comes from Matt Cabral with Credit Suisse. Your line is open.

Matt Cabral

Yes thank you. It sounded like data center hardware was a bit of a drag in the quarter. Just wondering if you can talk a little bit more about what drove the slowdown there. And if you're seeing any impact at all from budget dollars being shifted over to PCs in support of the needed refresh on that side.

Chris Leahy

Yes, Matt. Good question. I would say a couple of things there. First of all, when you see this kind of client growth, customers can only absorb so much. So there is a factor of what customers can absorb and what they're focused on right now. That's absolutely part of it. In terms of data center in particular, what you saw was on a consolidated basis, data center hardware not as strong. It was still up but not as strong. If you look at data center solutions, including software, we had very strong growth in software, as I mentioned in our prepared remarks. And so what you'll find is in these types of projects, I'm going to try and find another word, but lumpy is the best word that we have right now. They really are lumpy. When they come to fruition, when they roll out and frankly what the mix is in the solution between hardware and software. So we are not feeling a tangible softness there. We continue to have conversations with the customers. I would say frankly, that I think uncertainty, macro uncertainty right now, is weighing on these types of decisions that are complex, where there are so many options, where customers are deciding things on-prem, off-prem, private cloud, multi-cloud, consumption models, as a service, all underscored by OpEx and CapEx decisions. It does feel like customers are weighing those options and scrutinizing them with a little bit more carefulness right now. But the conversations continue to take place, and we're feeling good about them.

Matt Cabral

Got it. And then on international, wondering if you can talk a little bit more about, first, how the ramp of Scalar is going? And then I know you just bought Aptris, but curious how you think about the potential for a larger M&A down the road, particular to move more meaningfully into newer geographies?

Chris Leahy

Yes. Thanks for the question. Scalar is going as planned. I have to say and a shout out to the teams up in Canada and also the teams here in the U.S. who have been working diligently to make that integration successful. It's lot of hard work while you are trying to support your customers, deliver performance and integrate. So they've been doing a really terrific job. And our customers have been – what they're telling us is they're really appreciative of the ability for us to bring them a full portfolio and have holistic conversations, and we are seeing wins across the board with customers on the Scalar side and the CDW UK side, where we are able to benefit them both with a broader portfolio. So that's all going well. We said and we continue to expect that Scalar will add 100 basis points of growth this year, and we still expect that to be the case. Regarding Aptris, Aptris is a great example, frankly, of a clear need in the marketplace, a pipeline of opportunity, an organization that brought to bear the type of expertise needed in a fast-growing software area with great implementation and assessment skills and a culture that fit. And as we think of some Aptris smaller sure but what I'd call a mature practice, a well-developed practice, and so for us it's really building that to scale as quickly as we can, and that's what we intend to focus on. We certainly will continue to focus on larger opportunities, but as you know, we've got a number of filters that we use. It's got to be a strategic fit from a capabilities perspective or a deal perspective. Operationally, it needs to be something that we feel confident we can absorb. We know how hard these things are and we know how important it is to get them right. It needs to have – to be a cultural fit. That has proven to be very important, frankly, in the success of our acquisitions. And then finally, obviously, the financials screens. We need to feel that the financial return is going to be where we need it to be.

Matt Cabral

Great. Thank you.

Operator

Our next question comes from Adam Tindle with Raymond James. Your line is open.

Adam Tindle

Okay, thanks and good morning. Chris, I just wanted to start maybe on the growth strategy, that the two – the last two enhancing capabilities in solutions and services, if you could just maybe double click to help us understand why each of these are important to your existing customer base? You have always talked about being the trusted adviser you have been with many of them for decades. What's causing the increased focus? Are they to the point where they are willing to pay separately for services in particular?

Chris Leahy

Yes. Actually, let me start with that last comment and work back from there. Yes, they are. Customers are willing to pay for added services. What's important is a service-lead conversation that we are able to have as we develop a spectrum of service capabilities and depth in our service capabilities create conversations with the customers that are, frankly, more rich and strategic. So it allows us to have a seat at the table at the front end of when they're making decisions about their organization. The acquisition of Aptris is a great example of that because the conversations that are taking place when customers are thinking about IT service management are instrumental and fundamental to how they're thinking about overall modernizing their infrastructure and digitally transforming their organization. So those types of things, number one, the projects customers do pay for, but they also get us a seat at the table which creates broader, deeper and larger opportunities for us to help our customers and, obviously, opportunities for us. When you think about Scalar in particular, we really – in Canada, we really replicated, if you will, what we have in the U.S. now, where we have, what I would say, is a very broad-based offering capability. We've got depth in our technical organization now in the areas where customers are needing help sorting through complexity in the area of security, infrastructure, cloud questions and those types of things that they're grappling with. And we've got presence across the whole of Canada at this point. End market presence, the geo presence is also very reflective of what we have in the U.S. We've got nice balance up there. We've got a nice diversity up there. We've got nice depth in Canada. And we become a place where a customer can come as a one-stop shop for their IT needs. So that's how we think about services and solutions capabilities that we have been folding into the larger organization.

Adam Tindle

Okay, that's helpful. Maybe just as a quick follow-up and tie in some financials to that, could you touch on non-GAAP operating margin when you make exchanges? I know you talked about device cycle moderating, spending, shifting to data center and services. You typically expect a higher gross margin, but higher OpEx and similar if not improved operating margin. But is there a difference maybe at this time as we think forward on vendor programs and devices that would theoretically not repeat being a greater headwind to gross margin and offsetting some of that upward mix to where operating margins could be flat or down or maybe just some directional things with mix and operating margin in particular? Thank you.

Collin Kebo

Boy, there's a lot in that question. I would – I guess I'll stick with our – look we expect a mid-7% non-GAAP operating margin. As I think about the quarter and the strength we saw in gross margin, I guess it's a little counterintuitive given the heavy client device strength that the margin would have – the gross margin would've ticked up 30 basis points. We have seen quite a bit of success helping our customers with cloud solutions, and so that mix in the netted down items provided some lift to offset some of the margin pressure from heavy client device growth. What I would say though, and you touched on this in your question, is we do have a highly variable cost structure and pay people on a percentage of GP. So that was mitigated to some extent at the bottom line. I think there was also a question in there on vendor funding. Typically, we'll comment on that if it's growing or contributing meaningfully more or less in the overall rate of sales growth. We didn't this quarter, so that wasn't a material factor. Hopefully, that addresses your question.

Adam Tindle

Yes. Thanks Collin.

Operator

Thank you. Our next question comes from Katy Huberty with Morgan Stanley. Your line is open.

Katy Huberty

Thank you. Good morning. A number of your vendor partners are announcing a shift from CapEx to OpEx model, essentially, subscription model for data center infrastructure. What are you hearing from your customers in terms of where this model makes sense, what type of customers, what types of applications do they want to buy as OpEx? And to the extent that the model were to significantly shift in the direction, is there any difference in the way that you recognize revenue?

Chris Leahy

Hi, Katy. Good morning. Thanks for the question. Yes, we do have, as you know and you've mentioned a number of OEMs who are shifting to that model. The good news for us is that creates, frankly, more complexity and more choices for customer to sort through in terms of understanding a couple of things. Number one, as you point out, OpEx versus CapEx. But also when you think about performance and reliability and scalability and agility in our customers' infrastructure needs, they've got to take all of those and put them together and determine what's going to be the best modern infrastructure that they're looking for. So we do have the capability and have those conversations, frankly, more and more frequently given the technology now becoming available in as a service basis. In terms of the accounting, I'll let Collin take that because the accounting for CDW, as you know, is different than how our OEMs would recognize on as a service basis.

Collin Kebo

Yes, Katy. I'd say very early innings on this in terms of on-prem subscription. So the models are – and there is no standard is the easiest way to say that. It depends on the way the transaction is structured. So if there's a third-party intermediary in there and we're just selling it, then we would recognize it as we typically would, which would be upfront. To the extent that we're performing more of an agent role, we would take that on a netted down basis.

Katy Huberty

Okay, thank you. And Collin, just as a follow-up, cash conversion cycle is stronger year-to-date, as you noted and you are tracking ahead of your free cash flow targets for the year, rule of thumb. Any reason that we shouldn't expect a seasonally strong fourth quarter cash flow and does that put you ahead of the model this year?

Collin Kebo

Yes. I think, Katy, we are still expecting to deliver within our rule of thumb for the full year. We've had some favorable timing that's helped us year-over-year as we moved throughout. This year, in the second quarter, we mixed into vendors with extended payment terms, so that helps us on the payable side. And then this most recent quarter, we had favorable timing of collection just the way the calendar fell. We had a lot of really good cash collecting days in the month. I would expect that to normalize by the time we get to the end of the year.

Katy Huberty

Thank you.

Operator

Thank you. Our next question comes from Maggie Nolan with William Blair. Your line is open.

Maggie Nolan

I wanted to take a slightly different spin on the M&A question. After that acquisition with the ServiceNow capabilities, is quite interesting. Is M&A going to become a more consistent part of your strategy going forward, and especially considering where your leverage is today? And then, are there any other capabilities or partnerships in particular that you feel like need to be added to the portfolio?

Chris Leahy

Good morning Maggie. Thanks for the question. I would say that M&A is always part of a means to achieving our strategy. And we are, as we've said consistently, actively examining potential targets. And those are folks who come to us. Those are folks that we know in the market. But again, we are a really disciplined buyer. Again, as I know you know this, we hold to those 4 lenses very strongly. And so certainly, M&A is part of how we think about scaling capabilities, filling in areas where we think we could bolster those capabilities. But it just comes down to what's available and whether or not it's affordable and whether or not there's a fit there. So the answer to the question is yes, but it all depends on what's in the market and whether we think it's a good fit. In terms of certain areas, look, we feel like we've got some real strength across the full spectrum of solutions' needs right now. So we're growing those organically. And to the extent we can find some that fit externally, we'll think about that as well. As you know, we've recently brought on a new cloud partner, a couple of – about 18 months ago now, and so you can imagine that we've been building capabilities in our public cloud area pretty aggressively.

Maggie Nolan

Okay, thanks. And then obviously, the Device as a Service census work was a strength this quarter. Are you seeing continued traction with that type of offering? And do you feel confident that you can land additional Device as a Service engagement on a consistent basis or is this something that we should be thinking about as kind of more of a one-off type of engagement for the time being?

Chris Leahy

Yes, it's a great question, Maggie. I think I would suggest you consider it more of a one-off for the time being. Similar to what Collin said about on-prem, private cloud, we are really are at the front stages of Device as a Service being developed as, what I'll call, a repeatable solution. That said, we do have a number of customers, some large customers, some small customers, who are really quite interested in Device as a Service that we are centrally focused on building out the capability and the practice area in a consistent uniform way to approach a solution like that.

Maggie Nolan

Thank you.

Operator

Thank you. Our next question comes from Ruplu Bhattacharya from Bank of America. Your line is open.

Ruplu Bhattacharya

Hi good morning and thank you for taking my questions and congrats on another strong quarter. Just wanted to ask on the government side, you had strong above seasonal growth this quarter. Were there any pull-ins from the fourth quarter? And should we expect above seasonal growth again in the fourth quarter, so just any thoughts on strength going forward on the government side?

Chris Leahy

Yes. Government had a great year. And when I think about federal government, in particular, there are a couple of things happening there. One, as I mentioned in the prepared remarks we have, over the past several years, worked very hard on bringing to bear the right capabilities in terms of internal resources, such as technologists, as well as things like contract capture and project management, and all the things that the federal government needs from a technology supplier like CDW. And we've really seen the teams leverage those capabilities into success. So as a real strategic partner to the federal government, we continue to support them and more and larger projects that they're working on, which is obviously good for us. The other thing about federal government this year is census, as we've just talked about, has also been helpful in terms of the third quarter in particular. And then, lastly, what we are seeing is we are actually seeing refresh in the federal government. You will recall, Department of Defense a few years ago mandated moves to Win 10 client devices, and frankly, we're seeing those devices actually already being refreshed. So, we have a lot of nice momentum. That said, they've delivered very well this year and we expect a solid fourth quarter, but somewhat cautiousness. In terms of pull-ins for the third quarter, we didn't see anything other – out of the ordinary. We saw what I would characterize as a pretty normal year-end for federal government.

Ruplu Bhattacharya

Okay. That's helpful, Chris. Maybe as a follow-up, I think HP as a vendor accounts for more than 10% of your consolidated net sales. On their Analyst Day, they talked about a shift in their business model, at least on the printer side where they're going to charge more for printers upfront. I was wondering if you have seen any changes in their go-to-market and how do you think this impacts CDW if at all?

Chris Leahy

Yes. We wouldn't talk about any, in particular, vendor. I can't say that there is a shift that we've been seeing in the market yet. That sounds like a fairly recent announcement, but we wouldn't comment in any of our particular vendors.

Ruplu Bhattacharya

Okay, thanks. Thanks for taking my questions.

Chris Leahy

Thank you.

Operator

Thank you. Our next question comes from Matt Sheerin with Stifel. Your line is open.

Matt Sheerin

Yes, thank you and good morning. I just wanted to touch again on your comments regarding the strong client refresh cycle that you've seen both on the Government and in Corporate side. As you talk to your customers, do you have any visibility, particularly as we're getting close to this Microsoft deadlines in January? How many of your customers are not complying and still need to upgrade? And then, as you pointed out, Chris, you're already seeing some government customers sort of lap their last refresh because they were the first ones to adopt Windows 7 or Windows 10. Are you starting to see the Corporate customers sort of get in line as well or are you seeing expectations for more of a drop-off following this upgrade cycle?

Chris Leahy

Yes. Hi, Matt, thanks for the question. There is a lot of things in what's happening with client, I would say. First of all, when we look at our customer base, we have a large number of customers who've moved to Win 10, but we still will expect more in Q4, frankly. There's always a bit of a rollover. So we would still expect to see people moving to Win 10 at least through the first quarter of next year. But we do have a lot of customers who have already moved to Win 10. That said, yes, we are seeing refresh. Some that I mentioned Corporate customers from a couple of years ago, we're seeing refresh. When you think about the strength in the employment, full employment that continues to drive purchases and, frankly, refresh as well. And also, new use cases. We talked about that a number of times in terms of tablets and what not being used for a variety of industries from a digital expansion perspective. So if the economy remains solid, we'd expect customers to continue on a refresh trajectory. But again, moderating due to the Win 7 end-of-life coming to an end, we would expect that to dampen the demand a bit. And remember for CDW, we have, as I mentioned earlier, very high overlaps that we're going to have to deal with in 2020. And then lastly, there's been some noise around potential supply chain constraints again in 2020. And obviously, we've done a great job this year. The team's done a phenomenal job of using our advantages to be able to take supply, and really have no impact from that constraint. But we are hearing again potential constraints in the market going into 2020.

Matt Sheerin

Okay, thanks for that. And then, regarding your Healthcare sector, which has had double-digit growth for two or three quarters now and I know that was prior last 2 or 3 years, fairly lumpy. It seems like more sustainable. Is that tied to just more investments in the Healthcare community as they transform more towards digital or is that – some of that a client refresh story as well?

Chris Leahy

It's a little of both. You hit them both. I think budgets are stabilized. So that's number one. That's good. And we are seeing healthcare systems that are finally adopting Win 10. They are usually little laggards in that area, but they are. And also, as you said, very much focused on infrastructure to drive patient experience, clinical mobility, efficiencies etcetera and M&A activity frankly continues to happen out there and that's an opportunity for us to work with the healthcare systems as well.

Matt Sheerin

Okay, thank you.

Chris Leahy

Thank you, Matt.

Operator

Thank you. Our next question comes from Shannon Cross with Cross Research. Your line is open.

Shannon Cross

Thank you very much. My first question is just you had mentioned customer sentiment remains strong, but I'm curious during the quarter what was the linearity like? Did it strengthen? Is it weakness? And I guess, frankly, was there any variation from what you usually see on a seasonality basis?

Chris Leahy

Yes, Shannon. Hard to answer that question. Throughout the quarter, I would say, that customer sentiment and activity remained pretty much consistent during the quarter and consistent with seasonality. I think that's how I would answer that question.

Collin Kebo

Shannon, just as a matter of policy, we typically don't comment on intra-quarter momentum or trends, unless we feel that there's something noteworthy to call out. And as Chris said, there wasn't anything noteworthy to call out on the floor within the quarter.

Shannon Cross

Okay thank you. And then Tim, last night on the Apple call, talked about utilizing the trade-in program for the iPad business that's going through the census. So I'm just curious, how are you – are you exposed at all to residual risk on those? And I assume, just in general, you talked about how you're setting up sort of a Device as a Service capability. Will you manage that? Are you going to use outside partners to minimize the risk?

Collin Kebo

Sure. So we do not have residual value risk on the census offering. So I think Apple referenced that in terms of the strong residual value being able to drive down a lower cost to the ultimate customer the Census Bureau. And then, I'm sorry, the other question was on the capability?

Shannon Cross

Well, just in general. I'm curious as to how involved you'll be on managing, because that's one of the areas where you can find a lot of profitability, correct, if it's managed correctly and be resold into the market. So I was just curious if that's part of what you are going to do or are you just going to partner with somebody and not get involved?

Collin Kebo

Yes, we will work with a reseller then when those devices come back and we are not going to get into the economics of that.

Shannon Cross

Okay, thank you.

Operator

Thank you. Our next question comes from Keith Housum with Northcoast Research. Your line is open.

Keith Housum

Good morning guys. Chris, just a question for you just in terms of employees, especially customer-facing, obviously, we are in times of full employment here. Can you talk about the opportunity or just the challenge you guys have in terms of retaining your top sales guys and any challenges in recruiting new salespeople and retaining them?

Chris Leahy

Yes, it's a great question. It is a tough market out there. I would say a couple of things. Number one, we pay a lot of attention to it. We are seeing – for a variety of positions, we are seeing an extended time to hire and sometimes requirement of bringing more candidates in to be able to convert. But one of the things that we do very well here as a core competency is talent acquisition and development. And so the teams have really become very creative around uses of data, artificial intelligence and ways to target, very specifically, folks that we know will be high-performing, have the characteristics and will be high-performing at CDW and then really laser-focused in from a recruiting perspective. And they've been very, very successful during this period of a tight labor market. Our attrition rates have not increased higher-than-normal. And in fact, in some of the areas within CDW that you'd expect that they might be, like in our technology teams, they're lower than the average. And look, CDW is a unique culture as we talk about, but the ability to make a good living here, particularly as a seller, when you think about our outperformance of the market and that translates into GP dollars and commissions for our sellers and for our technical specialists, it's a good place to be right now.

Keith Housum

Great. Appreciate it. And just moving back over to the Census Bureau contract, can you give us an idea in terms of how many contracts of that type or size are generally out there in any given year? And I'm assuming the sales cycle is relatively long. Is there any idea what the pipeline looking into 2020 about most of the deals that might be out there where you guys compete with?

Chris Leahy

Yes. I'll start on this one. What I said earlier, and I communicate again, we do have customers, large customers and smaller customers who are very interested in Device as a Service for the obvious reasons. It's an operating expense model. It makes sense. But how these are constructed is pretty complicated we're finding. And so what I wanted to convey is we're at the front end of trying to develop a methodology and practice that allows us to deliver, I'll call it, consistent offerings to our customers in ways that are repeatable, as opposed to highly tailored offerings that are not necessarily repeatable at scale, so that we are really at the front stages of that. If I look across the market, I would suggest that I think most of the folks who are in this business are also at the front stages.

Collin Kebo

Yes. I would just add, I think the census is a very unique use case, right. It's once every 10 years. The devices are deployed for a relatively short period into the field relative to the useful life of the asset. And so you have a unique use case and a unique use period. And so I don't think there are a lot of other things like that floating around out there, but that doesn't mean that customers in general aren't interested. And as we've talked about though, those are all kinds of different flavors.

Keith Housum

Great, thanks.

Operator

Thank you. I'm not showing any further questions at this time. I'd now like to turn the call back to Chris Leahy for any closing remarks.

Chris Leahy

Thank you, Lauren. Let me close by highlighting CDW's addition to the S&P 500 in September. This marks another important milestone in our company's history. I also want to recognize the hard work of our over 9,800 coworkers around the globe and their ongoing dedication to serving our customers. They are the reason we have and will continue to lead the industry. Thank you to our customers for the privilege and opportunity to help you achieve your goals and thank you for your continued interest in CDW. Thanks again everyone. Happy Halloween. Collin and I look forward to talking to you next quarter.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating and you may now disconnect.