



## ScanSource, Inc. (SCSC)

### Positive Revenue Pre-Release

<b>Price: (07/08/04)</b>	<b>56.17</b>	<b>Rating:</b>	<b>Outperform</b>	<b>FY: Jun</b>	<b>2003A</b>	<b>2004E</b>	<b>2005E</b>
<b>52WK H-L:</b>	<b>60 - 28</b>			Q1	0.48A	0.59A	0.65E
<b>Market Cap (mil):</b>	<b>725</b>	<b>Suitability:</b>	<b>Higher Risk</b>	Q2	0.46A	0.58A	0.64E
Shares Out (mil):	12.9			Q3	0.36A	0.57A	0.67E
Float (mil):	12.2			Q4	0.49A	0.60E	0.69E
Avg. Daily Vol (mil):	0.16			<b>Total</b>	<b>1.79A</b>	<b>2.34E</b>	<b>2.65E</b>
		<b>Price Target:</b>	<b>66</b>	Previous		2.27E	2.52E
Dividend:	0.00	Previous:	60	FY P/E	31.4x	24.0x	21.2x
Yield:	0.00			<b>EPS Cal</b>	<b>2.03A</b>	<b>2.46E</b>	<b>2.75E</b>
				P/E	27.7x	22.8x	20.4x

Please refer to "Appendix - Important Disclosures."

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### Action

We believe continued improvement in the bar code market, strong vendor transition to the indirect model, and improving telephony conditions have driven SCSC's revenue above previous forecasts

### Summary

- ScanSource pre-released that revenue would be in the \$328M-\$338M range for F4Q04. Our estimate was \$294.2M (consensus was \$293M). Management made no comment with respect to earnings, but we believe EPS will be \$0.60-\$0.62. Our estimate had been \$0.53 and consensus was \$0.55.
- Although management provided no additional details, we believe the following factors contributed to the better-than-expected results:
- First, industry contacts continue to be positive on end-user demand. Our most recent reseller survey indicates that conditions and expectations continue to improve in the bar code market.
- Second, we believe that Avaya, Symbol, Zebra, Intermec, and other vendors continue to shift revenue to the indirect channel more rapidly than expected as part of their new distribution programs. Particularly, we believe SCSC is beginning to see a ramp of the indirect model in Europe.
- Third, we believe POS trends are becoming increasingly positive. Several of our reseller contacts continue to suggest that retailers are upgrading their POS systems.
- Based on these factors, we have increased our F2005 EPS estimate to \$2.65 from \$2.52.
- Our price target of \$66 is based on 24x our CY2005 estimate of \$2.75. During periods of strong growth SCSC has traded 20x-25x.

## Details

ScanSource pre-released that revenue would be in the \$328M-\$338M range for F4Q04. Our estimate was \$294.2M (consensus was \$293M). Management made no comment with respect to earnings, but we believe EPS will be \$0.60-\$0.62. Our estimate had been \$0.53 and consensus was \$0.55. Management provided no additional details, but we believe the following factors contributed to the better-than-expected results:

First, industry contacts continue to be positive on end-user demand. Thus far, most reseller comments suggest that business conditions have improved slightly in the past six months, and will further improve over the next six months. We also believe the POS market is in the early stages of a significant upgrade cycle. In SCSC's most recent quarter they reported a significant increase in POS sales, which represented their second consecutive quarter of increased POS business. Additionally they added several new POS vendors to their list including Microsoft and HP's POS line.

Second, we believe that Avaya, Symbol, Zebra, Intermec, and other vendors continue to shift revenue to the indirect channel more rapidly than expected as part of their new distribution programs. Particularly, we believe SCSC is beginning to see a ramp of the indirect model in Europe. Several vendors have indicated that partner programs in Europe have begun to ramp faster, recently. We expect these opportunities were led by Symbol and Datalogic. In addition, SCSC seems to be attracting additional business through its SolutionsCity marketing offering, which offers hands-on demonstrations in a road show format.

In addition, we believe trends for Avaya continue to be positive. In F3Q04, SCSC management suggested that business trends for Avaya are positive, with both end-market improvement and incremental channel shifts helping business. Additionally, SCSC has hired additional salesforce in the Catalyst unit that should start contributing more meaningfully to sales.

Third, we believe POS trends are becoming increasingly positive. Several of our reseller contacts continue to suggest that retailers are upgrading their POS systems. ScanSource has received several large POS deals in the last two quarters, which we believe continued into the June quarter. Recall, SCSC has added several POS vendors in the past year, including HP (rp5000) and incremental IBM business (SurePOS 300)

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## Investment Thesis

1) We believe ScanSource can generate annual revenue and EPS growth of 15%-20% over the next several years.

2) Most point-of-sale, AIDC, and telephony vendors are shifting a majority of their business to the indirect channel to reduce costs and expand their market reach. Vendors can reduce costs by off-loading technical support, transaction costs, and VAR recruitment to distributors. We believe that this can be a key catalyst in the current business environment, where vendors are searching for opportunities to reduce costs. For example, key shifts are expected from Symbol, Intermec and NCR. Symbol has stated that it expects indirect sales to reach 85%-90% in the next 18 months, up from 55% in 2Q03. Intermec, while not stating specific targets, has also indicated an intent to build its indirect presence. NCR sells roughly 10% indirect; we expect that it will increase indirect sales to approximately 25% to 30%. Other key vendors remain less than 50% indirect, with an expectation of achieving 65% to 70% indirect over the next several years.

3) ScanSource is well-differentiated in the industry and has strong competitive advantages and barriers to entry: a) Specialty technology requires the strong

value-added knowledge that ScanSource possesses. Smaller competitors have difficulty acquiring the expertise, while the niche aspect to specialty technology keeps larger "PC" distributors from entering the segment, as it is too small to warrant developing specialty technological knowledge. b) ScanSource has a distinct size advantage over competitors with its large inventory position, which allows for better customer fulfillment and lower costs. Key competitive advantages include the largest available inventory (rapid fulfillment), a larger allocation of cooperative marketing dollars, and reduced average procurement costs.

4) ScanSource's specialty technology focus and quality execution protects margins. Scan Source's 4.0% operating margin over the past year is over 200 basis points higher than "commodity" distributors (i.e., PC distributors). The specialty technology niche allows ScanSource to offer value-added services that protect against price and margin pressure typically seen from distributors who offer commodity products. While we expect near-term margin pressure, we expect that margins will return to the 4.0% range. Margin declines are typically offset with working capital improvements to achieve a return on invested capital in between 23%-25%.

5) We believe SCSC has strong, long-term revenue and investment return opportunities. Given positive end-market momentum and possible tax benefits, we believe upside exists to our estimates and price target.

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## Risk & Caveats

Avaya's Business to ScanSource Is regulated by Avaya - Avaya, which represents roughly 30% of Scan Source's business, maintains control over its distribution channel (Avaya must approve all VARs), and could decide on short notice to slow all approvals. However, Avaya has articulated its intention of increasing its indirect presence. ScanSource is one of three distributors serving Avaya's voice products.

International Expansion - ScanSource has historically operated in North America. The company is now simultaneously expanding into Latin America and Europe. The risk of international expansion includes investment in new infrastructure as well as developing an understanding of multiple cultures and rules, most of which are new to the company. A longer-than-expected ramp may cause unexpected margin pressure.

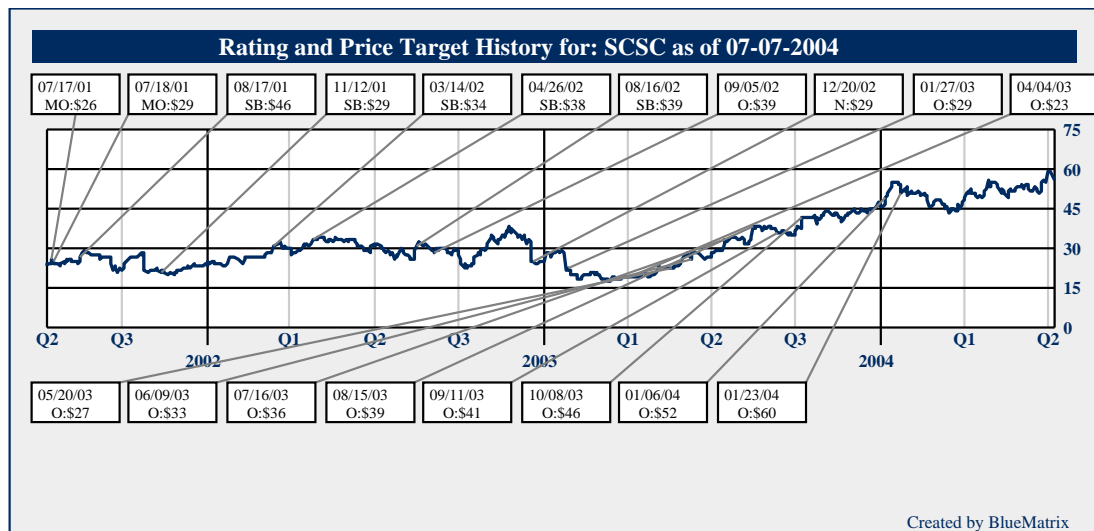
General IT Weakness - The IT environment has recently experienced several negative pre-releases, which could suggest broader weakness in a number of ScanSource's end markets. We believe SCSC can at least partially mitigate this weakness with continued market share gains and international expansion.

Increased competition - TechData has entered the telephony market, and could compete for sophisticated resellers seeking logistical fulfillment, not technical expertise. Further, TECD is in the process of entering both the bar code and POS markets. We understand that TECD is currently trying to undercut SCSC's price on IBM products, which we believe is having limited success given TECD's limited value add in the area. While we believe vendors seek a greater value add than TECD typically offers, we are concerned that TECD's presence could generate incremental pricing pressure.

## Company Description

ScanSource is the leading value-added distributor of "specialty technology" products in North America, including automatic identification and collection (bar-coding, scanning, mobile computing), point of sale (terminals and receipt printers), and telephony equipment (telephones, PBX's , voice mail systems, computer telephony integration). ScanSource sells approximately 23,000 products from over 60 vendors to over 13,000 value-added resellers. Key vendors include Symbol Technologies, Zebra Technologies (ZBRA), Intermec, PSC, IBM, and Avaya.

## "Appendix - Important Disclosures"



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ROBERT W. BAIRD & CO. INCORPORATED 777 EAST WISCONSIN AVENUE MILWAUKEE, WI 53202

July 8, 2004

Fiscal year ends: June

ScanSource

Earnings Model

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(\$ thousands)	1Q03	2Q03	3Q03	4Q03	2003	1Q04	2Q04	3Q04	4Q04E	2004E	1Q05E	2Q05E	3Q05E	4Q05E	2005E
<b>Net Sales</b>	\$ 260,603	\$ 250,117	\$ 227,452	\$ 253,022	\$ 991,194	\$ 276,474	\$ 288,966	\$ 293,574	\$ 332,587	\$ 1,191,601	\$ 333,696	\$ 334,008	\$ 345,679	\$ 373,481	\$ 1,386,865
Cost of Sales	230,408	223,207	202,029	223,667	879,311	245,630	258,063	261,803	295,670	1,061,166	296,489	297,935	307,485	332,398	1,234,308
Gross Profit	30,195	26,910	25,423	29,355	111,883	30,844	30,903	31,771	36,917	130,435	37,207	36,073	38,194	41,083	152,557
Selling, general and administrative	19,677	16,467	16,815	18,400	71,359	18,884	18,795	19,828	23,946	81,453	23,359	22,379	23,852	26,330	95,920
Amortization of intangibles	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total expenses	19,677	16,467	16,815	18,400	71,359	18,884	18,795	19,828	23,946	81,453	23,359	22,379	23,852	26,330	95,920
<b>Income from operations</b>	<b>10,518</b>	<b>10,443</b>	<b>8,608</b>	<b>10,955</b>	<b>40,524</b>	<b>11,960</b>	<b>12,108</b>	<b>11,943</b>	<b>12,971</b>	<b>48,982</b>	<b>13,848</b>	<b>13,694</b>	<b>14,342</b>	<b>14,753</b>	<b>56,637</b>
Interest and other expense (income)	674	400	253	654	1,981	16	256	27	300	599	400	400	400	400	1,600
Income before income taxes	9,844	10,043	8,355	10,301	38,543	11,944	11,852	11,916	12,671	48,383	13,448	13,294	13,942	14,353	55,037
Income tax expense	3,933	4,221	3,806	4,090	16,050	4,405	4,380	4,463	4,688	17,936	4,841	4,786	5,019	5,167	19,813
<b>Income before extraordinary items</b>	<b>5,911</b>	<b>5,822</b>	<b>4,549</b>	<b>6,211</b>	<b>22,493</b>	<b>7,539</b>	<b>7,472</b>	<b>7,470</b>	<b>7,933</b>	<b>30,314</b>	<b>8,557</b>	<b>8,458</b>	<b>8,873</b>	<b>9,136</b>	<b>35,024</b>
Extraordinary Gain (Loss) - net of tax	-	-	-	-	-	(1,409)	(775)	734	-	(1,450)	-	-	-	-	-
<b>Net Income</b>	<b>\$ 5,911</b>	<b>\$ 5,822</b>	<b>\$ 4,549</b>	<b>\$ 6,211</b>	<b>\$ 22,493</b>	<b>\$ 6,130</b>	<b>\$ 6,697</b>	<b>\$ 8,204</b>	<b>\$ 7,933</b>	<b>\$ 28,863</b>	<b>\$ 8,557</b>	<b>\$ 8,458</b>	<b>\$ 8,873</b>	<b>\$ 9,136</b>	<b>\$ 35,024</b>
Weighted average common shares outstanding	12,408	12,646	12,500	12,496	12,513	12,681	12,942	13,095	13,128	12,961	13,161	13,226	13,259	13,293	13,235
<b>EPS before extraordinary items</b>	<b>\$0.48</b>	<b>\$0.46</b>	<b>\$0.36</b>	<b>\$0.50</b>	<b>\$1.80</b>	<b>\$0.59</b>	<b>\$0.58</b>	<b>\$0.57</b>	<b>\$0.60</b>	<b>\$2.34</b>	<b>\$0.65</b>	<b>\$0.64</b>	<b>\$0.67</b>	<b>\$0.69</b>	<b>\$2.65</b>
One-time expense items	-	-	-	-	-	(0.11)	(0.06)	0.06	-	(0.11)	-	-	-	-	-
<b>EPS</b>	<b>\$0.48</b>	<b>\$0.46</b>	<b>\$0.36</b>	<b>\$ 0.49</b>	<b>\$ 1.79</b>	<b>\$0.48</b>	<b>\$0.52</b>	<b>\$0.63</b>	<b>\$0.60</b>	<b>\$2.23</b>	<b>\$0.65</b>	<b>\$0.64</b>	<b>\$0.67</b>	<b>\$0.69</b>	<b>\$2.65</b>
<b>Calendar EPS</b>					<b>\$2.03</b>					<b>\$2.46</b>					<b>\$2.75</b>
<b>% of Sales</b>															
Gross Margin	11.6%	10.8%	11.2%	11.6%	11.3%	11.2%	10.7%	10.8%	11.1%	10.9%	11.2%	10.8%	11.0%	11.0%	11.0%
Operating Margin	4.0%	4.2%	3.8%	4.3%	4.1%	4.3%	4.2%	4.1%	3.9%	4.1%	4.2%	4.1%	4.1%	4.0%	4.1%
Pretax Margin	3.8%	4.0%	3.7%	4.1%	3.9%	4.3%	4.1%	4.1%	3.8%	4.1%	4.0%	4.0%	4.0%	3.8%	4.0%
Net Margin (before extraordinary items)	2.3%	2.3%	2.0%	2.5%	2.3%	2.7%	2.6%	2.5%	2.4%	2.5%	2.6%	2.5%	2.6%	2.4%	2.5%
SG&A	7.6%	6.6%	7.4%	7.3%	7.2%	7.2%	6.5%	6.8%	7.2%	6.8%	7.0%	6.7%	6.9%	7.1%	6.9%
Total Operating Expenses	7.6%	6.6%	7.4%	7.3%	7.2%	6.8%	6.5%	6.8%	7.2%	6.8%	7.0%	6.7%	6.9%	7.1%	6.9%
<b>Growth Rate</b>															
Total Revenue	38.0%	20.3%	7.6%	8.3%	17.7%	6.1%	15.5%	29.1%	31.4%	20.2%	20.7%	15.6%	17.7%	12.3%	16.4%
Gross Margin	44.4%	22.6%	10.0%	14.7%	22.2%	2.1%	14.8%	25.0%	25.8%	16.6%	20.6%	16.7%	20.2%	11.3%	17.0%
Operating Income	33.0%	34.7%	1.6%	13.4%	19.9%	13.7%	15.9%	38.7%	18.4%	20.9%	15.8%	13.1%	20.1%	13.7%	15.6%
Pretax Income	34.8%	35.9%	3.2%	8.5%	19.4%	21.3%	18.0%	42.6%	23.0%	25.5%	12.6%	12.2%	17.0%	13.3%	13.8%
Net Income (excluding extraordinary items)	30.6%	27.1%	-7.9%	13.8%	12.8%	27.5%	28.3%	64.2%	27.7%	28.3%	13.5%	13.2%	18.8%	15.2%	21.3%
EPS (excluding extraordinary items)	29.8%	24.8%	-8.0%	14.7%	14.9%	24.8%	25.4%	56.8%	21.6%	30.1%	9.4%	10.8%	17.3%	13.7%	13.2%
Share count	0.6%	1.9%	0.2%	-0.9%	0.6%	2.2%	2.3%	4.8%	5.1%	3.6%	3.8%	2.2%	1.3%	1.3%	2.1%
<b>Other</b>															
Income Tax Rate	40.0%	42.0%	45.6%	39.7%	41.6%	36.9%	37.0%	37.5%	37.0%	37.1%	36.0%	36.0%	36.0%	36.0%	36.0%

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**ScanSource  
NASDAQ - SCSC**

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Fiscal Year Ends: June

<b>Balance Sheet</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>1Q04</b>	<b>2Q04</b>	<b>3Q04</b>	<b>4Q04E</b>
<b>Assets</b>							
Cash and Equivalents	294	1,296	2,565	1,239	736	3,245	(4,955)
Receivables, Net	86,917	119,158	129,105	138,648	146,644	151,595	164,715
Inventory	154,182	182,636	152,261	156,568	153,262	183,808	190,051
Other Current Assets	18,662	19,343	15,657	13,534	13,873	14,642	20,000
<b>Total Current Assets</b>	<b>185,392</b>	<b>185,393</b>	<b>185,394</b>	<b>309,989</b>	<b>314,515</b>	<b>353,290</b>	<b>369,810</b>
Property Plant and Equipment	21,746	25,995	27,270	26,450	25,767	25,115	25,965
Other Assets	2,084	10,604	17,489	17,266	18,545	19,182	11,000
<b>Total Assets</b>	<b>209,222</b>	<b>221,992</b>	<b>230,153</b>	<b>353,705</b>	<b>358,827</b>	<b>397,587</b>	<b>406,775</b>
<b>Liabilities and Equity</b>							
Payables	154,561	175,406	151,389	149,886	147,621	163,937	175,124
Other	9,877	11,524	13,222	12,757	14,137	17,449	11,000
<b>Total Current Liabilities</b>	<b>104,848</b>	<b>104,849</b>	<b>104,850</b>	<b>162,643</b>	<b>161,758</b>	<b>181,386</b>	<b>186,124</b>
Long-term debt	8,866	8,319	7,385	7,188	6,997	6,804	6,700
Line of Credit/ Other	17,219	45,734	21,464	24,942	21,932	32,474	37,474
Shareholders Equity	93,362	118,049	150,887	158,932	168,140	176,923	176,478
<b>Total Liability and Equity</b>	<b>224,295</b>	<b>276,951</b>	<b>284,586</b>	<b>353,705</b>	<b>358,827</b>	<b>397,587</b>	<b>406,775</b>

<b>Balance Sheet Analysis</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>1Q04</b>	<b>2Q04</b>	<b>3Q04</b>	<b>4Q04E</b>
Total Debt/Total Capital	22%	31%	16%	17%	15%	18%	20%
LT Debt/Equity	9%	7%	5%	5%	4%	4%	4%
Current Ratio	1.8	1.8	1.8	1.9	1.9	1.9	2.0
Quick Ratio	0.8	1.1	1.3	0.9	0.9	0.9	0.9
Days Sales Outstanding	45	45	46	51	49	45	45
Inventory Turns	4.4	4.5	5.3	5.8	6.1	5.9	6.2
Working Capital	80,544	80,544	80,544	147,346	152,757	171,904	183,687
Book Value/Share	7.62	9.50	12.06	12.53	12.99	13.51	13.44

<b>Cash Flow Statement</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004E</b>
Net Income	7,470	13,785	16,464	19,942	22,493	28,901
+Dep. and Amortization	1,256	2,678	4,434	4,666	5,745	5,176
+Other/Deferred Taxes	(5,564)	(192)	2,521	7,507	9,462	1,552
-Working Cap. Changes	18,333	(39,813)	(4,138)	(30,270)	(6,329)	(58,517)
Cash Flow from Operations	21,495	(23,542)	19,281	1,845	31,371	(22,888)
-Capital Expenditures	(2,081)	(6,588)	(7,619)	(8,520)	(6,324)	(4,051)
Free Cash Flow	19,414	(30,130)	11,662	(6,675)	25,047	(26,939)
Shares (millions)	11,322	11,938	12,249	12,432	12,513	12,961
Operating Cash Flow/ Share	\$1.90	(\$1.97)	\$1.57	\$0.15	\$2.51	(\$1.77)
Free Cash Flow /Share	\$1.71	(\$2.52)	\$0.95	(\$0.54)	\$2.00	(\$2.08)

<b>DuPont Formula</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004E</b>
Net Margins (N/S)	2.6%	2.8%	2.6%	2.3%	2.3%	2.5%
Asset Turnover (S/A)	3.0	3.0	2.6	2.6	2.8	3.2
Leverage (A/E)	1.8	2.5	2.9	3.0	2.6	2.3
Return on Equity	14.0%	20.7%	19.6%	18.4%	16.7%	18.5%

<b>Valuation Measures</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004E</b>
Stock Price (fiscal year)	\$ 12.38	\$ 24.94	\$ 36.28	\$ 34.97	\$ 36.50	\$ 38.36
	\$ 6.69	\$ 10.50	\$ 13.60	\$ 19.75	\$ 19.73	\$ 23.39
	6/30 \$ 10.82	\$ 19.44	\$ 23.71	\$ 30.71	\$ 26.75	\$ 46.82
Historical P/E	29.4	28.5	26.4	22.4	22.0	17.0
	14.8	16.4	10.4	12.6	11.0	10.0
Historical P/CF	6.5	NA	23.0	235.6	14.6	-21.7
	3.5	NA	8.6	133.1	7.9	-13.2

<b>Debt Adj. Market Value</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004E</b>
Market Value	122,504	232,045	290,412	381,725	334,709	606,914
Liabilities/Other	1,743	26,085	54,053	28,849	44,174	44,174
<b>Cash &amp; Equivalents</b>	<b>15,282</b>	<b>294</b>	<b>1,296</b>	<b>2,565</b>	<b>(4,955)</b>	<b>(4,955)</b>
Total DAMV(Enterprise Value)	108,965	257,836	343,169	408,009	383,838	656,043
EBITDA	13,485	25,551	33,232	38,466	46,269	54,158
DAMV/EBITDA	8.1	10.1	10.3	10.6	8.3	12.1

## "Appendix - Important Disclosures"

### **ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST**

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