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ScanSource, Inc. (SCSC)

Value Added Distribution Required in Bar Code Market

				FY: Jun	2002A	2003E	2004E
Price (05/19/03):	**22.66**	**Rating:**	**Outperform**	Q1	0.37 A	0.48 A	0.41 E
52 WK H–L:	**38 – 17**			Q2	0.37 A	0.46 A	0.41 E
Market Cap (mil):	**277**	**Suitability:**	**Higher Risk**	Q3	0.40 A	0.36 A	0.42 E
Shares Out (mil):	12.2			Q4	0.43 A	0.37 E	0.43 E
Float (mil):	12.0			**Total**	**1.56 A**	**1.67 E**	**1.67 E**
Avg. Daily Vol (mil):	0.17						
		Price Target:	**27**	FY P/E	14.5x	13.6x	13.6x
Dividend:	0.00	Previous:	23	**EPS Cal**	**1.77 A**	**1.55 E**	**1.79 E**
Yield:	0.00			P/E	12.8x	14.6x	12.7x

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Action

Tech Data has explicitly stated that it intends to enter the bar code market. We expect TECD will most likely participate in the low end of the market, and given the significant indirect channel shifts underway by Symbol and Intermec, and the expected indirect channel shift by NCR, we see ample growth opportunity for SCSC. We recommend buying SCSC aggressively on any associated weakness.

Summary

- Tech Data intends to enter the bar code market, and has publicly stated that its intent is to capture share from ScanSource by building this business internally.
- We expect TECD's share capture will be limited based on the following.
- First, TECD has attempted to enter this market on multiple occasions, five years ago with Zebra and two years ago with Symbol. Neither relationship has blossomed, and neither Symbol nor Zebra have been seriously (re)approached by TECD to increase business.
- Second, we believe TECD will not deliver the required value add to the channel. TECD is a premier logistics provider, but only intends to use existing resources and less than $1M to advance its bar code effort. This strikes us as insufficient to build the value add desired by new channel programs at Symbol, Intermec and Zebra.
- Given TECD's approach, we expect the most likely opportunity for TECD to participate in the bar code market will be in the lower end products, competing predominantly on fulfillment and price.
- Given the significant indirect channel shifts underway by Symbol and Intermec, and the expected indirect channel shift by NCR, we see ample growth opportunity for ScanSource over the next 18 months.

Details

Tech Data intends to enter the bar code market, and has publicly stated that its intent is to build its business internally and capture share from ScanSource. While we view a TECD move into the bar code market as a potential threat to ScanSource, particularly as it relates to pricing, we believe the near-term threat is modest based on the following.

First, TECD has attempted to enter this market on multiple occasions, five years ago with Zebra and two years ago with Symbol. Tech Data remains an existing distributor for Zebra (we believe with lower-end products), but is not large. Further, given Zebra's unveiling of its "PartnersFirst" channel program, which incents resellers to focus on providing value add to the market, we expect Zebra is not interested in increasing its business with "box pushers" (see #2 below). The program will offer incentives to partners that invest in demand creation and solution development for Zebra products.

Symbol commented to us that it has had ongoing discussions with Tech Data over the past several years, and the last time the company considered using TECD was two years ago. Symbol CEO Rich Bravman is currently unaware of Tech Data having approached Symbol as a distribution partner. Bravman explained to us that Symbol may have an interest in working with TECD, but given Symbol's strong focus on incenting the channel to invest in demand creation and value added services (with Symbol's PartnerSelect program), a TECD role would likely be focused fulfillment of lower-end products. Our conversations with Intermec suggest that it has a similar philosophy. At this time Symbol, Intermec and Zebra have not been seriously (re)approached by TECD to discuss increasing Tech Data's business opportunity. We believe signing these vendors to incremental business will be key to expanding this market in a meaningful manner.

Second, we believe TECD will not deliver the required value add to the channel. TECD is a premier logistics provider, but only intends to use existing resources and less than $1M to advance its bar code effort. This strikes us as insufficient to build the value add desired by new channel programs at Symbol, Intermec and Zebra. Such value added services typically include product configuration (most bar coding related products are not plug and play, but rather have to be configured for a specific application), integration and technical support. Given TECD's approach, we expect the most likely opportunity for TECD to participate in the bar code market will be in the lower-end products, competing predominantly on fulfillment and price.

Given the significant indirect channel shifts underway by Symbol and Intermec, and the expected indirect channel shift by NCR, we see plenty of growth opportunity for ScanSource over the next eight quarters. The following highlights these opportunities.

Bar Code - The overall market for bar coding equipment appears to be trending positively given numerous comments from resellers suggesting solid business momentum. Further, Zebra, Symbol and Metrologic all reported better-than-expected growth during the most recent quarter. We expect that strong incremental opportunities as two key vendors shift increasing amounts of business towards the indirect channel. Our understanding is that Symbol officially began its awaited channel shift May 1. Symbol received very positive reseller feedback regarding this new channel program during its reseller conference in early March. We believe the total incremental channel opportunity from Symbol is in excess of $450M. We expect Symbol will initiate this program in Latin America in June and in Europe by the end of the year. Intermec has also begun to shift more business to the indirect channel. Intermec has not officially indicated how much channel shift may occur with its program, but we estimate that it will exceed $100M.

POS - ScanSource experienced a fall-off in POS business following a very strong December quarter, where we believe that retailers take advantage of price discounting. However, despite the fall-off, we believe that several stronger retailers are in the process of upgrading their POS systems. NCR reported 18% growth in its POS segment this past quarter. Further, we expect NCR will seek to become increasingly indirect in its retail unit. Currently the unit is 10% indirect, but with mounting losses and a management change, we expect NCR will seek to become increasingly indirect. SCSC management reported that a new NCR program (implemented in the last 45 days) seeks to match smaller NCR retail accounts with resellers, allowing NCR's existing sales force to concentrate on larger accounts. Management expects this program to ramp over the next 6-9 months. NCR's retail unit generates roughly $600M in annual product revenue, approximately 60% from the North American market.

International - We expect channel shift programs from Symbol will improve growth later in the year. From a cost view, management announced that the F3Q03 European consolidation, primarily headcount reduction and facility consolidation, will result in a cost improvement of $450,000 to $650,000 on a quarterly basis. Therefore, Europe, which cost $0.05 per share in F3Q03, will cost $0.02-$0.03 per share less in F4Q03. Europe could be break-even by the September quarter. Recall, SCSC has significant NOLs in Europe, which will drive down the tax rate once profitability is achieved.

Telephony - Weakness persists in the telephony end markets; Avaya is down 22% y/y (this past quarter) in its CSAG and SMB business units (SCSC resells products from these units. However, SCSC in the past quarter is down only 8% as Avaya continues to shift revenue from its direct model to indirect. We estimate that these Avaya units are 40% penetrated towards two-tier indirect distribution. Management has recently conducted meetings with Avaya's new CSAG management team and indicated that several new indirect distribution programs could be moved forward. SCSC management expressed comfort that current quarterly revenue of $90M-$95M should be sustainable given new indirect opportunities.

Investment Thesis

1) We believe ScanSource can generate annual revenue and EPS growth of 15% 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. 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. Avaya and NCR sell roughly 20%-25% indirect and have stated their intent to 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. ScanSource'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 captail improvements to achieve a return on invested captial in between 23%-25%.

5) Following ScanSource's recent decline, we believe the risk reward profile has become favorable. We expect SCSC's long-term revenue and investment return opportunities will remain intact, and view the current valuation, at 13X our F2004 EPS estimate, as compelling. Our price target of $27 is based on 15X our C2004 EPS estimate of $1.79. Historically SCSC trades 15X-17X.

Risk & Caveats

Avaya's Business to ScanSource is regulated by Avaya - Avaya, which represents roughly 30% of ScanSource'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.

Weak Telephony End Markets - Avaya has seen its CSAG and SMB business units, which SCSC distributes, decline 20% over the past year. While a continued shift by Avaya to the indirect channel has mitigated this weakness, we are concerned that a reduction of this shift, or incremental end market weakness, could adversely affect SCSCs future results.

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 remains weak, and may continue to adversely impact 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.

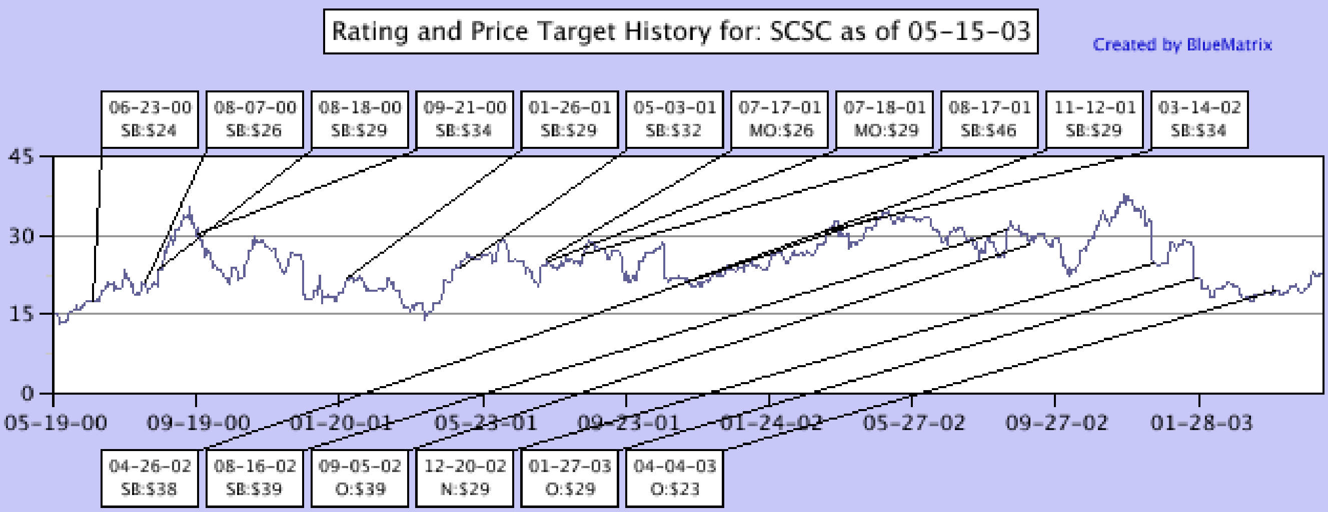
Symbol Accounting - Symbol Technologies, a key ScanSource vendor, has been accused by the SEC and by third party civil litigation for "channel stuffing" during 1999-2001. In the third party litigation, ScanSource is listed (among several others) as a distributor that Symbol used in its channel stuffing practices. We have no reason to believe that ScanSource participated in any illegitimate activities, but are simply concerned that the association may have an adverse impact on the stock. Symbol is under new management, and appears to be working with the SEC to rectify past issues.

Increased competition - TechData has entered the telephony market, and could compete for sophisticated resellers seeking logistical fulfillment, not technical expertise. Further, TECD has expressed a desire to enter the bar code market. TECDs 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.

1 Baird maintains a trading market in the securities of ScanSource, Inc.



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