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LQDT - Q4 2014 Liquidity Services Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter 2014 Liquidity Services earnings conference call. My name is Lisa and I will be your operator for today.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Ms. Julie Davis, Senior Director of Investor Relations. Please proceed, ma'am.

Julie Davis - *Liquidity Services, Inc. - Senior Director of IR*

Thank you, Lisa. Hello and welcome to our fourth-quarter and FY14 financial results conference call. Joining us today are Bill Angrick, our Chairman and Chief Executive Officer; Jim Rallo, our Chief Financial Officer and Treasurer; and Kathy Domino, our Chief Accounting Officer. We will be available for questions after our prepared remarks.

The following discussion or responses to your questions reflect management's views as of today, November 20, 2014, and will include forward-looking statements. Actual results may differ materially. Additional information about factors that could potentially impact our financial results is included in today's press release and in our filings with the SEC, including our most recent annual report on Form 10-K.

As you listen to today's call, we encourage you to have our press release in front of you, which includes our financial results as well as metrics and commentary on the quarter. During this call, we will discuss certain non-GAAP financial measures. In our press release and our filings with the SEC, each of which is posted on our website, you will find additional disclosures regarding these non-GAAP measures, including reconciliations of these measures with comparable GAAP measures.

We will also use certain supplemental operating data as a measure of certain components of operating performance, which we also believe is useful for management and investors. This supplemental operating data includes gross merchandise volume and should not be considered a substitute for or superior to GAAP results.

At this time I'd like to turn the presentation over to our CEO, Bill Angrick.

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

Thanks, Julie. Good morning and welcome to our Q4 earnings call. I'll begin the session by reviewing our Q4 performance and then provide an update on key initiatives heading into our new fiscal year. Next I'll turn it over to Kathy Domino for more details on the quarter. And, finally, Jim Rallo will provide our outlook for fiscal first quarter 2015.

Liquidity Services reported Q4 results of $223.9 million of GMV, $9.1 million of adjusted EBITDA, and $0.13 of adjusted EPS. Our Q4 results were in line with our guidance expectations, led by a rebound in our energy business which grew 30% year over year, and continued solid growth in our state and municipal government business. Adjusted EBITDA and adjusted EPS were at the low end of our guidance, driven by less favorable property mix within our DoD surplus and selected retail programs.

Next I'd like to update you on key business trends and initiatives coming out of Q4. First, the renewal of our DoD surplus contract secures long-term supply in support of our commercial growth strategy. Phasing in our new DoD surplus contract is a significant undertaking, which requires a change in government IT systems and operational procedures, as the new surplus contract is being split between rolling stock and non-rolling stock categories.

There still remain a number of unresolved operational and contractual details related to phasing in the new contract, and we're working together with our agency partner to prioritize and resolve all open issues. We will continue to update shareholders as we conclude this phase of the process.

We would note that our DoD surplus business has seen significant changes in the volume and mix of property we handle, which has reduced sales values and increased our cost. And we are taking actions in response to these fundamental changes, including the workforce realignment we announced in October 1.

Second, as we've discussed, the focus of our long-term growth strategy is on our commercial and municipal government business. By delivering better scale, service and result for clients in the global reverse supply chain we continued to see growing demand from large retailers, municipal agencies and blue chip manufacturers in multiple regions, asset categories and service lines, including sales, valuation and asset management.

To capitalize on our market leadership, we will be relaunching the Liquidity Services brand in the commercial market during the March quarter of next year to communicate a single brand message that explains our superior reach and unmatched expertise. Positioning Liquidity Services as a single global enterprise with a wide range of services, relevant to all of the verticals we serve, will benefit our sales organization over time.

Trends in our capital assets business have improved and we expect our capital assets business to resume organic growth during FY15, led by clients in our energy and manufacturing verticals. Gardner Dudley has had a successful transition into his new role as President of our capital assets business, and we are seeing positive results from our new global sales and marketing organization, which is working closely together to cross sell our full range of services in every region. For example, a number of our corporate clients are now leveraging our cloud-based asset zone enterprise asset-management system and logistic services to manage and sell their vehicle fleets.

Our retail supply chain business is facing crosscurrents. We have a solid new business pipeline and have several new programs with important clients being launched. At the same time, we are seeing declining year-over-year volumes with selected longstanding client based on reduced retail sales in their core business, which is outside of our control.

In some cases the mix of property received under selected retail client programs is unpredictable, resulting in margin pressure and actions on our part to improve the terms under which we do business. A key initiative of our retail supply chain business is expanding our reach to international buyers and continuing to grow buyer participation on our liquidation.com B2B marketplace. We also continue to expand our returns management and refurbishing services to provide retail supply chain clients with a turnkey solution to manage all of their needs.

Our GovDeals municipal government business recorded solid growth in Q4, which we expect to continue in FY15 driven by expansion with existing and new clients in both the US and Canada. The transition to our new President, Roger Gravley, has gone smoothly, and Roger is playing a key support role for our Liquidity One transformation program, given his extensive experience with software development and GovDeals' successful sell-in-place model.

FInally, we continue to execute on our Liquidity One transformation initiative. What is Liquidity One? And how is this different from prior investments?

Fundamentally, Liquidity One is a change management program to develop an integrated global business with a single set of best practices and processes. Last year, we built cross-site functionality to enable buyers to access offered assets from their home, LSI marketplaces via cross-site search results and onboarding tools. Having identified all the differences between our marketplaces, we are now ready to address these differences by defining and deploying a unified technology platform to support all LSI marketplaces, which will, one, maximize return on technology and product development spend; and, two, share platform enhancements with all Liquidity Services, clients and buyers.

Another difference in our go-forward program is that we will not be making incremental integration changes to our existing legacy marketplace operations. Rather, we will build the future state platform and then incrementally roll our existing marketplaces on to the new platform.

Finally, we are refreshing our data center hardware, traffic management, redundancy and security monitoring systems to support an expanded global community of buyers and sellers. This effort is a major undertaking, which will be largely completed over the next two fiscal years with an estimated investment of $14 million, funded in part through our recent realignment actions. We expect the annual savings from implementing Liquidity One to yield a pay back period of approximately 18 months.

The more profound value-creation impact from this investment will be the new capabilities and unified processes that will enable us to operate more productively, scale faster, and offer new capabilities to the market as a single global company. We will continue to provide you updates as we implement individual modules of the Liquidity One program.

Next, I would like to comment on our approach to future guidance. While we are forecasting solid results for the December quarter, FY15 will be a transition year for Liquidity Services as we reset our DoD and commercial businesses and fund our Liquidity One transformation program, while also operating our as-is technology platform. Forecasting results for the full-year FY15 is very challenging while we are waiting the final specifications and timing of the work we will be performing under our new DoD surplus contract.

Additionally, we plan to further allocate management time and resources to accomplish our Liquidity One transformation program, which may result in reduced productivity and growth during FY15 that is difficult to forecast. In light of these factors, we have elected to change our guidance practices, and beginning with FY15, we will provide shareholders and the investment community with financial guidance on a quarterly basis only.

In closing, we recognize the uneven growth and visibility that accompanies our transition with the new DoD surplus program and our transformation investments during FY15. We are confident that we've assembled the right team and have the right strategic plan to delight customers and create a more diversified, extensible business model that creates continued growth and value for our long-term owners.

Now, let me turn it over to Kathy for more details on the Q4 results.

Kathy Domino - *Liquidity Services, Inc. - Chief Accounting Officer*

Thanks, Bill. We finished the fourth quarter of FY14 at the higher end of our guidance in GMV and at the lower end in adjusted EBITDA and EPS. We had steady growth in our state and local government business as we continue to sign new clients, and strong performance in our energy vertical with its best quarter of the year.

Decrease in product flows around consumer electronics and softness in the buyer market drove retail volumes lower in our consumer goods marketplaces. We continue to move forward with our Liquidity One transformation plan and make the technological and operational enhancements to our marketplaces that will drive an exceptional user experience.

Next I will comment on our fourth-quarter and full-year results. Total gross merchandise volume, or GMV, decreased to $223.9 million, down 10.6% for the fourth quarter, and to $931.6 million, down 4.3% for the fiscal year. GMV in our GovDeals, or state and local government marketplace, increased to $44.7 million, up 5.6% for the fourth quarter, and to a record $171.4 million, up 11.6% for the fiscal year, as we continued to add new clients, bringing total clients to over 7,000 out of a potential 88,000, and, thus, further penetrating the $3 billion state and local government market.

GMV in our DoD scrap marketplace decreased slightly to $16.8 million or 1.3% for the fourth quarter, and increased to $71.3 million, or 4.6% for the year, as a result of a slight increase in property flow from the DoD. GMV in our DoD surplus marketplace decreased to $30.1 million, or 16.9% for the fourth quarter, and to $133 million, down 4.7% for the fiscal year, as a result of an increasing flow of lower-value property from the DoD.

GMV in our commercial marketplaces decreased to $132.4 million, or 14.6% for the fourth quarter, and to $555.8 million, down 9.2% for the fiscal year, as a result of reduced product flows, primarily in our transportation, energy and manufacturing verticals. Total revenue decreased to $118.4 million, or 8.3% for the fourth quarter, and decreased to $495.7 million, down 2% for the fiscal year, primarily due to the decrease in GMV already discussed.

I will now discuss certain fourth-quarter and FY14 expense line items, and will not provide detailed explanations for changes in the fiscal year when those explanations are similar to the ones previously discussed in my comparison for the fourth quarter. Technology and operations expenses increased 15.4% to $26.8 million for the fourth quarter, primarily due to increases in staff and personnel expenses, including stock-based compensation and business realignment expenses, outsourced processing labor and temporary wages, and consultant fees associated with our Liquidity One transformation project. As a percentage of revenue, these expenses increased to 22.7% from 18%.

Technology and operations expenses increased 21% to $108.9 million for the fiscal year. As a percentage of revenue, these expenses increased to 22% from 17.8%.

Sales and marketing expenses increased 12.9% to $11 million for the fourth quarter, primarily due to increases in staff and personnel, including stock-based compensation and business realignment expenses and an increase in marketing activity. As a percentage of revenue, these expenses increased to 9.3% from 7.5%.

Sales and marketing expenses increased 4.4% to $41.9 million for the fiscal year. As a percentage of revenue, these expenses increased to 8.4% from 7.9%. These increases are primarily due to an increase in marketing activities and business realignment expenses.

General and administrative expenses decreased 1.2% to $12.9 million for the fourth quarter due to a decrease in performance-based compensation. As a percentage of revenue, general and administrative expenses increased to 10.9% from 10.1% as a result of a decrease in fourth-quarter revenue already discussed. General and administrative expenses increased 1% to $49.4 million for the year. As a percentage of revenue, these expenses increased to 10% from 9.8 %. These increases are primarily due to expenses related to business realignment costs.

Adjusted EBITDA decreased 63.6% for the fourth quarter to $9.1 million. Adjusted EBITDA margin as a percentage of GMV decreased to 4% from 9.9%, driven by a change in product mix in our DoD surplus vehicle, increased inventory levels in our consumer goods vertical, resulting in increased storage and handling costs and lower-margin sales in our commercial capital assets vertical.

Adjusted EBITDA decreased 39.8% for the fiscal year to $63 million. Adjusted EBITDA margin as a percent of GMV decreased to 6.8% from 10.7%.

Adjusted net income decreased 70.4% to $4 million for the fourth quarter, and decreased 43.2% to $32.4 million for the fiscal year. Adjusted diluted earnings per share decreased 68.3% to $0.13 for the fourth quarter based on approximately 29.7 million diluted weighted average shares outstanding.

Adjusted diluted earnings per share decreased 41.1% to $1.03 for the fiscal year based on approximately 31.4 million diluted weighted average shares outstanding. During the fourth quarter and FY14, LSI generated $6.8 million and $11.9 million of operating cash flow, a decrease of 77.4%, and a decrease of 74.6%, respectively, year over year.

We continue to have a strong balance sheet. At September 30, 2014, we had a cash balance of $62.6 million after spending $44.9 million in stock repurchases during the year, current assets of $184.7 million, total assets of $431.7 million, and $77.9 million in working capital. We continue to be debt-free.

Capital expenditures during the quarter were $1 million, and $7.5 million for the fiscal year. Our budget for capital expenditures for the fiscal year was $7 million to $8 million.

I will now turn it over to Jim for the outlook on the next quarter.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Thanks, Kathy. It is difficult for us to forecast the sales and margins of our business in FY15 while we are awaiting the final specifications and timing of the work we will be performing under the new DoD surplus contract. In addition, our DoD business has seen significant changes in the volume and mix of property we handle, which has reduced sales values and increased cost.

Global economic conditions have improved. However, our overall outlook remains cautious regarding our commercial capital assets business due to volatility in capital spending patterns.

Our retail supply chain business has seen significant changes in consumer spending habits, which have been affected by continued weakness in the consumer goods vertical as a result of increases in payroll taxes and continued unemployment, resulting in decreased spending and decreased pricing in the secondary market. In some cases, the mix of property received under selected retail client programs is unpredictable, resulting in margin pressure and actions on our part to improve the terms under which we do business.

Lastly, we plan to further allocate management time and resources to accomplish our Liquidity One transformation program, which may result in reduced productivity and growth during FY15 that is difficult to forecast. In light of these factors we've elected to change our guidance practices. Beginning with FY15 we will provide shareholders and the investment community with GMV, adjusted EBITDA and adjusted diluted EPS guidance on a quarterly basis only.

We expect GMV for the first fiscal quarter of 2015 to range from $200 million to $225 million. We expect adjusted EBITDA for the first fiscal quarter of 2015 to range from $10 million to $13 million. For the first fiscal quarter of 2015 we estimate adjusted earnings per diluted share to range from $0.16 to $0.22. This guide assumes we have an average fully diluted number of shares outstanding for the year of 29.8 million, and that we will not repurchase shares with the approximately $5.1 million yet to be expended under the share repurchase program.

Our guidance adjusts EBITDA and diluted EPS for, one, acquisition costs, including transaction costs and changes in earnout estimates; two, amortization of contract intangible assets of $33.3 million from our acquisition of Jacobs Trading; and, three, for stock-based compensation costs which we estimate to be approximately $3.5 million to $4 million per quarter for FY15. These stock-based compensation costs are consistent with FY14.

We will now answer any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jason Helfstein with Oppenheimer.

Jason Helfstein - *Oppenheimer & Co. - Analyst*

I've got several questions. The first, just to clarify what you guys are saying, on commercial, are you guys basically saying that you are effectively seeing macro weakness, so it's just lower end demand by the consumer which, when it trickles through, and part of that has to do with the mix of the products you're selling? So, just looking for clarity on that comment.

Second, obviously you are going through a significant realignment. When you come out of that, do you think this business can return back to 8%, 9% GMV margin after you're done with the realignment, call it, in 2016 and beyond?

Then, the next question, we are seeing heightened inventory levels. Can you talk about the dynamic behind that? And is there risk of an inventory write-off? Do you want to talk about where those higher inventories are coming from?

And then, lastly, and just a housekeeping, can you give us the breakdown of the business realignment expense and how you are allocating that between G&A and sales and marketing? Thanks.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Thanks, Jason. I think most of these I can take. When you look at the retail part of our business, we've had a very volatile year, as we've discussed on prior calls. And what I mean by that, we had two quarters this year where we had more than 20% growth. And then we had two quarters this year where we were actually down year over year.

Now, for the year, we were up in the retail segment, so, we did get some growth. That growth was single digit. It was obviously not acceptable to us. We expect more growth in that business.

In that vertical right now, what we are seeing is a lot of volatility within our clients. Let me be specific.

We have client programs that we've been managing for years. And the volumes in those program had been coming down, in some cases. In some cases, they will be high for a month or two, and then down for a few more months, and then swap back.

Again, these are programs where we've got all the product flow with the client regarding those specific programs. So, the product hasn't been going to other people; it's simply that the business of some of our clients has been more volatile than you would expect. And a couple of these programs are fairly large.

I think when you look at retail in general right now, what you've seen is the retail recovery has not really occurred at what I would say is the lower end of the market, which, for the most part, is where we're focused on. Specifically, the higher end of the retail market, as we've all seen, has recovered -- your Nordstroms, your Saks, places like that. Our clients have seen either their businesses declining or flat, for the most part, in the space that we are working on.

So, our job, obviously, is to get more clients and to further penetrate our existing clients, which we are working on. Hence, the growth that we have had this year. So, I think we don't see a large change in that occurring next year, and, thus, we are expecting again to see some volatility within our client programs and just the retail sector in general.

I think your next question is, after we come through the realignment in 2016, what do we expect margins to look like. At this point in time, Jason, there are just too many balls up in the air right now with several of our large programs -- I think, obviously, the DoD being the most specific one we can talk about publicly -- that it's difficult for us to address right now what long-term margins are going to look like.

I would certainly not expect them to be double-digit, by any means. Whether or not we're back up at the high single digits, I think we'd probably have a better update on that over the next 16 to 18 months, once we get a few of these things behind us.

On the inventory levels, the inventory levels right now are really high in two areas of our business. One is the Department of Defense. We have been obviously quite open about the buildup of inventory under the DoD surplus contract. We are receiving a tremendous amount of lower-value product.

I want to be clear that that product is very profitable for us. The margins are not as great as everything else, but from a GAAP accounting standpoint, the gross profit on that is very nice, and such that there is no risk of an inventory write-down with our DoD product.

That being said, we are incurring additional average costs, additional man-hours, to manage that product. And it will take us a fair amount of time to sell through that product, even as the contract winds down here over the next six months. So, we will have that product for potentially as long as another year as we move through it.

Again, it is somewhat unpredictable, Jason, because our client, the Department of Defense, has not told us exactly how much more product in these categories they are going to send to us. So, we will certainly update you in early February on our next call on that.

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

And let me take this last question. Relative to the Liquidity One budgeted spend of $14 million, a first point to make is that's not a linear spend over the two years. We would have a phased approach to requirements development, designing the better processes we apply across the entire business, building the new LSI marketplace platform focused on buyer input, seller input, voice of customer input, to make it easier for buyers and sellers to access our services and transact on our platform, and then ultimately deploying that. That will happen in phases.

Part of the forecasting exercise is such that there's going to be some lumpy episodic spend as you move through each gate of that process. So, if we were to broadly estimate the buckets, I'd say half of that spend is in software engineering and project management, roughly 30% of that spend in infrastructure enhancements; hardware, security monitoring, really extending our platform to be multi-currency global with the right provisioning for buyers accessing the platform outside the United States; and then the remaining 20% other soft costs.

I mentioned that we plan to launch our new seller-facing brand to improve awareness in our target markets in calendar year 2015. And all of these things overlapping have profound impacts on our business and relative to forecasting the long-term destination.

I think as we move through the year, we're going to be able to better define what that destination is, Jason. We want to, certainly, better understand the uptake of new services, fee-based services such as Return to Vendor, accessing our platform for asset-management services, valuation services. These are services that are fee-based, non-GMV-driven, so in that affects your margin.

We need to ratify how the pro forma business cost structure will change as we move from legacy IT platforms to a single integrated platform. Certainly we will have a better handle of the mix of property we are processing and selling under our new DoD surplus contract as that rolls out.

And there are lots of open questions on physically which locations we need to staff under that contract. That is going to be informed by what the government decides, not what we model in our own business.

So, those are the issues that we will resolve as we move through the year. And we will likely have, I think, much more visibility or clarity around that future destination as we move through the year. So, we just ask that folks understand that, be patient with us, and we will certainly continue to keep an open communication channel with our shareholders.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Jason, I believe your last question was specifically on the breakdown of the realignment costs, the $1.8 million. That was roughly, I would say, about 40% of that was in the retail supply chain part of our business. The rest was in the capital asset side of our business, mostly associated with the DoD efficiency gains that we're looking to gather with the new contract structure.

Jason Helfstein - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

Shawn Milne with Janney Capital Markets.

Shawn Milne - *Janney Montgomery Scott - Analyst*

Just, Jim, a quick housekeeping, following up on Jason's question. On the $14 million in spend in the next couple of years, I think Bill was saying 30% in infrastructure. Is that 30% CapEx, or is the $14 million all flowing through the P&L?

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

There will be some component of that that's CapEx, Shawn. As you know, historically, we only capitalize hardware and completely new products. Any enhancements that we make to existing products which we build into our transformation program will be run through the P&L.

At this point I can't give you an exact amount. If I had to ballpark that, I would say that at least 60% of that would be CapEx and is already estimated in our CapEx budget for the next two years, which we would expect to be somewhere between $8 million to $9 million per year. That's up about $1 million for where we are this year. So, we're not expecting a huge jump in CapEx over the next two years.

Shawn Milne - *Janney Montgomery Scott - Analyst*

Okay. And then I'm just trying to reconcile that with you did $9.1 million in the quarter in EBITDA, but then you are guiding next quarter up in EBITDA on, it looks like, maybe flat to down GMV. But you are talking about higher spending.

So, what am I missing as we go into the first quarter? Is it really the realignment costs savings? I know you are not giving guidance beyond Q1, but is that the new run rate, or then do the Liquidity One spending start to kick in more as we go through FY15?

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

A couple of good points in there, Shawn. I think, one, we are seeing the benefits of the realignment costs in this quarter, and also going forward. So, a lot of those savings are being re-funneled back into investments in the business as part of our Liquidity One transformation.

So, what I would say is some margin improvement, if you would, not as much as you would expect. We expect to get full improvement for that, obviously, going into FY16 -- or FY17, actually.

When you look at how we expect the rest of the year, I would not annualize the forecast for next quarter and assume that's going to be the full year. Again, there are a significant number of variables that we're still working on around the business that we don't have the information on, nor are we prepared to give guidance on. So, at this point in time, Shawn, I can't really give you any clear data points on where we would expect to be the rest of the year.

I do think that the margins on the business are improving on the business that we have, other than, again, the DoD. So, let me be clear on that. But we're not in a position to forecast out the rest of the year at this time. So, we will have to update you on the next quarter.

Shawn Milne - *Janney Montgomery Scott - Analyst*

Okay. And then, lastly, just on retail. We've been looking more closely at the business, obviously you knew the numbers for years, but talking more with clients. This has always been the overarching message has been online growth is good for Liquidity Services, we should get higher returns.

But we continue to hear about lumpiness. And obviously I can assume who the lower-end partners maybe seeing some volatility, and the large partner. That makes sense.

But as you talk to some of these clients day to day, what is really the resistance of getting more programs that have more sustainable inventory levels or more consistency versus the old liquidation model of backing up the truck and buying whatever you can at the end of the quarter? I'm just trying to understand. There's always been this governor on that business and I'm curious what you're hearing real time from clients. Thanks.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

A couple of things, Shawn. I know you are familiar with a lot of our clients. When you look at a lot of our clients, unfortunately they, themselves, are not really seeing a lot of growth. I would say there is one glaring exception to that. And you can imagine who that is. And we are growing significantly with that client.

The rest of our clients, we are obviously trying to further penetrate them and take more programs. And that is happening.

So, we are seeing further penetration of our clients. Some of our clients, though, where we have almost all of their product, and we've seen a decline in that product, we need to backfill that with new clients and further penetrate existing clients.

In fact, if I looked at a client-by-client basis, what we've really got going on in the business right now, Shawn, is very strong growth with 10 or so clients, and then we've got a decline in another 5 or 6 clients. So, that growth is muted. So, you've seen a transition in the business or the mix a little bit.

I think one of your counterparts noted the growth of Liquidation.com recently, where you've seen a lot of the newer programs we're bringing online for our clients is moving through the Liquidation.com platform at a very nice clip. And we would expect to grow that significantly over the next year.

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

There s another phenomenon that you would see in certain verticals, where a smaller player is willing to, quote-unquote, buy the business to try to take a run at a product category or specific location. Our attitude has always been, we want comprehensive, large-scale relationships that are sustainable, mutually successful.

We have taken an attitude over the last, I would say, 12 to 18 months, we are not interested in, quote-unquote, buying the business to just push GMV levels up. We're really focused on thoughtful underwriting of programs, investing in these for the long term.

As an example, we took about eight months to discuss a new program up in Canada with a major Fortune 500 retailer. We've been very disciplined about piloting it, setting up terms that are aligned. We are now in lift off and ramping that up in Canada. It's going to be one that we would have a multi-year runway for growth.

But we are not chasing GMV for GMV's sake. I think that's important to understand. That just goes to our philosophy of, got to have profitable growth and return on effort of investment in each of these areas. That's not always the case.

I do think the industry is consolidating. Comparing the landscape today versus two years ago, there's very few players that can do national, significant size programs for clients. A few people have invested in the logistic support, the refurbishing, the handling, the reporting, the account management. Or have the balance sheet strength to give a client comfort that they'll be able to have uninterrupted service over time.

It's not unusual for you to see sole proprietors literally go out of business after a couple quarters of trying something that was just not well thought out. So, that's some of the context for the industry operating in the retail supply chain.

On the capital asset side, capital assets is largely a consignment model, sell-in-place model, looking at converting in-house sales to the use of a managed service in a global solution. And that requires a global footprint, the full range of services to track assets internally for our clients. That's where our AssetZone software tool comes in, and it's been very well received.

We continue to make enhancements to that AssetZone platform. That really create a lot more integration with our marketplace as we allow clients to catalog their assets globally in this software platform that then feeds into our marketplace.

So, I think the global manufacturers, in particular, are interested in our service. They are interested in compliance management, they're interested in sustainability reporting, what can they redeploy and achieve cost savings and not buy new. And then when we execute sales, they're interested in knowing who the buyers are.

We do a number of buyer-facing compliance checks, which is highly valued in the client business to protect their interest, to provide a buffer for any global rules on how transactions are handled, third-party checks. We do a lot of export control checks and reviews. So, that is very well received in the global capital assets business.

We talked about our seller branding program. Our legacy marketplaces have represented themselves typically under their legacy marketplace brand over time. A company may use multiple marketplaces within our business and not realize it's the same company providing all of those services.

That will change as we roll out a global-aligned brand and we'll get the benefit of top-of-mind awareness as a single enterprise providing these services. And we want to continue to reinforce that message through our marketing collateral. We will relaunch our corporate website, brochures, case studies. And, of course, the training and education of our sales organization calling on these clients.

Shawn Milne - *Janney Montgomery Scott - Analyst*

Thank you very much.

Operator

Dan Kurnos with Benchmark.

Dan Kurnos - *The Benchmark Company - Analyst*

Three for me, please. Digging a little bit more into the retail aspect here and the programs, and thinking about trying to maybe renegotiate terms with some of your partners there, is there any thought to possibly going through some intentional program churn the way we saw with GoIndustry if some of those segments aren't becoming profitable? And is there a way maybe to dictate inventory a bit better, just given that product mix has been a headwind for you guys in the past? Is there a way for you to get maybe more modernized product mix?

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Sure, Dan. I'm not sure I understand what you mean by more modernized product mix. If you are talking about consumer electronics, a large portion of our business is consumer electronics today. That is what I would say is probably the hardest hit vertical that we are dealing in.

Our general merchandise, our home goods and apparel verticals continue to be fairly consistent. That being said, today a large part of our inventory is on the general merchandise side of our business as we have had a significant growth in those programs from some existing clients.

So, when you look at that inventory balance today, a lot of that is general merchandise. That general merchandise is lower-margin business for us than, again, say, apparel or consumer electronics or other verticals. Did I understand the question properly?

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

Let me also add, when you are in the technology industry, there are winners and losers, right? So, certain clients have focus on certain product categories and their core business has to withstand the shocks and peaks and valleys of the very disruptive landscape for consumer electronics, devices, home theater systems, gaming systems, mobile smartphone devices.

We are very well positioned to serve those manufacturers, but those manufacturers will over time have successes and resets of their own product categories and that's what affects the volume in our business. Many of those client programs are revenue-sharing consignment programs.

We're driving great service excellence for them. They are mutually beneficial programs. But the disruptive landscape of consumer electronics means that people will go through the S curve of their own product introductions and that ripples through the secondary marketplace.

Dan Kurnos - *The Benchmark Company - Analyst*

That's more where I was going, Bill, just in terms of -- I don't necessarily want to put it this way, but maybe being leveraged more to the losers in the consumer electronics market and trying to penetrate some of the more popular platforms. Is there a thought to potentially and intentionally churning some of those programs as you switch? Or you just keep the mutually beneficial relationship and just add from there as long as the relationships remain profitable?

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Dan, good question. We're certainly not going to walk away from long-term relationships. That's part of our commitment and partnership that we created with our clients over the years.

I think when you look at consumer electronics, as BIll indicated, we do get a fair amount from manufacturers. We also get a fair amount from retailers. What I would say right now is, when you look at the electronics market -- by the way, we don't do a lot in phones.

I think for those that know our business understand the phone market in the US is a little unique given the fact that it's highly subsidized, obviously, by the carriers. So, the secondary market in phones in the US is not as, what I would say, developed as it actually is in the rest of the world.

But when you start looking at tablets and laptops, game systems, all that, obviously, we play a lot in that area. Game systems have been stronger for us this year with the release of the version 4 for many of the platforms.

Notebooks or laptops have been, frankly, nascent. And you've seen that because you've seen a change in consumer habits moving to tablets.

That being said, the tablet market has been fairly saturated. I think, again, Apple being a prime example of that, has seen a significant decrease in iPad sales. Not that that -- obviously that product is extremely successful, but when you look at the velocity of that product, it has slowed down dramatically, Dan.

I think that's where we are in the cycle right now, as Bill initiated. That being said, we're continuing to work with both our retailers and our manufacturers in all those categories. You're just seeing product flows decrease either from the market or specific variables related to the manufacturers themselves.

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

One of the things we'd also like to add to that is, we understand that there is this network effect of manufacturers and retailers trying to reconcile who's responsible for returns allowances over time, depending upon the individual retailers' different balances of power and who's responsible for returns. One of the things we invested in, in 2015, was the capability to help partners track and manage return product which goes through the Return to Vendor reconciliation process.

That leverages a lot of our key strengths, which is logistics support. We have a national distribution center, over 2 million square feet.

So, all this product leaving retail, if it goes back to vendor it has to be physically transported, manifested, and then it may go back to a manufacturer for a credit., Or we may be able to inform them, using our data, that it would be better off for you to liquidate that item and obviate additional handling and transportation costs and just convert it into cash and recover that working capital.

So, we are continuing to invest in the Return to Vendor service offering to allow clients to both leverage our online liquidation platform, as well as our logistics platform and the data analytics that we continue to work on providing through our investment activities. That's another way that we can play, if you will, with all of the players in the electronics industry.

Whether they are being the winner or loser, they all have this complex process to manage all of the flow of returns, some of which they don't want on the secondary marketplace but, still, you have to be some record keeping, financial reconciliation for that. We look to expand our platform in that area over the next two fiscal years.

Dan Kurnos - *The Benchmark Company - Analyst*

Got it, that's really helpful. Just to ask the two other follow-ups, since you brought it up here Do you think that the secondary market is shrinking in general? We've seen eBay have a lot of company-specific problems. But it doesn't really explain away the slowing marketplace's growth, and that the highly promotional environment, along with technological advancement, is lowering price and cost of new items.

And secondarily to that, you talked about further allocating your time and resources to accomplish this transitional liquidity. One, is the thinking there to not go after new business maybe as aggressively until we have a new platform? Is it more of a manpower issue? What would be driving you, stopping you, or impairing growth there? Thanks.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

On the secondary market areas, Dan, I think the secondary market, itself, I wouldn't say, is shrinking. I think what you've got is a change in mix in the secondary market, as I talked about earlier. You also have what I would say is some demand issues in the secondary market.

When we look at the secondary market, we are a global player. Globally, we don't really see a change in that. As Bill indicated in his remarks, we're highly focused on growing our buyers internationally, and have been very successful with that this year.

I will say, in the US we've seen a slowdown in what I would say is the larger buyer base network within the US. And that's why it's very important in our space to have really the multi-channel approach, which we do.

As you know, Dan, we sell a lot of our product on Liquidation.com. We're the only player that's got that, what I would call, palette level buyer marketplace.

We also move a lot of truckloads, both on that marketplace and on our liquidation direct site. So, we've got the larger buyer base that I discussed earlier. And then we move a tremendous amount of product B2C for our clients when it's customer A grade.

That multi-channel approach is what is creating the winning strategy for our clients, and also, really, our growth for the future. What I have seen, though, is I have seen competitors in our space that really only have a single channel, whether it's just B2C or whether it's a full truckload, they are struggling.

So, there's really a dynamic or a change going on in the secondary market right now on the demand side. And the only way to be successful right now, again, is to focus on that multi-channel strategy.

As far as resources for our transition plan, let me make just a couple of overall comments and then I will turn it back to Bill. Obviously, senior management is heavily involved in that. We have created teams in each functional area of the business, in each operational area of the transition.

So, that cross matrix team is working together. And that's taking time from their day to day. We understand that, but we are taking the best and brightest at Liquidity Services and we're having them drive this program with the oversight of senior management. And that does have some manpower costs.

That being said, it's allowing for people underneath them to step up. We are certainly not shying away from new programs over the next year. We would expect to grow the business, albeit with new programs and further penetrating existing clients.

Whether that growth on an aggregate basis comes out because, as you know, we've got a slowdown in the Department of Defense business, a loss of the rolling stock. We'll see as we roll out through this year and give you further updates.

But, we're a growth company. We are going through a slower period right now. But, again, we are focused on growing with existing and new clients.

Bill Angrick - *Liquidity Services, Inc. - Chairman & CEO*

And I would say, if you were just to think of the framework of what to expect, that 2015 growth would be expected to be slower than the market as we fund the product development activities and also maintain our as-is business. I think as we move to FY16, as we make progress on the transition to the new go-to-market strategy, we will see growth move more in line with market growth.

And then, I think 2017 unencumbered with this one foot in the legacy systems processes and one foot in building the new. I think unencumbered from that we would expect to have growth at or better than market growth, and we'd have Company productivity focused almost exclusively on growing the business, leveraging the benefits of what we've developed. So, that's the way we think about it.

Dan Kurnos - *The Benchmark Company - Analyst*

Got it, great. That's really helpful. Thanks for all the color, guys.

Operator

Rohit Kulkarni, RBC Capital Markets.

Rohit Kulkarni - *RBC Capital Markets - Analyst*

A lot of big picture questions. But two quick September quarter trend questions. Are your registered buyers increased both sequentially as well as year on year?

Auction participants decreased more sequentially and year on year. Why is that? Can you help us reconcile that?

And on the gross margin, I agree that you are enlisting a lot of the business. But as the business mix shifts and the gross margin is somewhat structured being in the business, if I look at just the September gross margin trends sequentially, does that fully capture how we should think about gross margin going forward?

If you cannot answer that, just maybe call out what are the puts and takes in the gross margin from June quarter to September quarter. I know we are at the end of the quarter, but just two quick questions.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Sure. I would think, one thing on the buyer, Rohit, we have seen what I would say is a steady increase in buyers throughout the year on a macro level. We've seen higher growth in certain areas.

Like, I mentioned earlier our international buyer base is probably growing more quickly than domestic. But we would expect to continue to invest in sales and marketing, and would expect to see decent growth in that buyer base, as we have historically, going forward into next year.

Auction participants, as you know, is somewhat a variable or an output, based on different variables, one of which is completed transactions. When you look at completed transactions up slightly, you look at auction participants up slightly for the fiscal year, a lot of that is driving. There's more auctions for people to bid in.

As you know, we count an auction participant as somebody that bids in an auction one time. If we have people that are bidding in multiple auctions, if there's more of them, then they will get counted one time in each of those auctions.

In the fourth quarter, we had a 2% decrease in auction participants. Frankly, that's somewhat negligible, so I wouldn't have any concern over that.

In general, we're still running about 4.5 on an aggregate basis, 4.5 folks per auction bidding at every single auction, which is quite healthy. As you know, our goal is certainly to be over 3.5. And you really don't want to get much over 5 because what happens from it is those buyers, if they are not winning enough auctions, they will go elsewhere to find their products.

So, our job is to manage the marketplaces we have to continue to move supply into the marketplace and meet the demand, but obviously not overload the marketplace where the auction participation drops so low that we're not getting the return for our buyers. I feel like the team has done a great job, actually, of managing that this year as we've moved, again, more product through the Liquidation.com marketplace.

I think those were your two questions -- buyers and auction participants? Did you have another one?

Rohit Kulkarni - *RBC Capital Markets - Analyst*

Yes. On the gross margin sequential, any more color on whether this has the full effect of the mix in the business going forward?

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

Sorry, I didn't hear the third question. I apologize. On the gross margin, again, as Bill indicated earlier, we've seen an improvement in gross margin as we have focused on programs that had slightly higher margins. That being said, a lot of that is driven by mix shift, Rohit. So, in aggregate, let me explain what's going on.

We've got the rolling stock is being lost, obviously, with the new CV4, or Surplus 4 contract. The rolling stock obviously is higher-margin business. We've talked about that for years.

We're getting an influx of still good margin but lower value or lower margin product from the DoD. So, that's going to put some pressure on that margin moving forward.

We also have a fair amount of general merchandise at our inventory earlier. You heard my comment earlier. I think it was Dan or Jason that talked about the inventory level.

A we pull down that general merchandise into the market, that is slightly lower margin, as well, than our traditional consumer electronics or apparel for household effects or home goods. I do see the possibility of some margin pressure on the gross profit line as we move throughout the year.

Rohit Kulkarni - *RBC Capital Markets - Analyst*

Okay. Thanks a lot. Good luck with next year.

Operator

Jason Mitchell with Bank of America.

Jason Mitchell - *BofA Merrill Lynch - Analyst*

This is Jason here for Nat Schindler. I was wondering if you guys could just remind us for modeling purposes the timing of the DoD contract transition as far as when the new pricing will take effect and when you expect the rolling stock transition to switch to new provider. Does your guidance this quarter assume that you're still having 100% of the rolling stock you're able to sell, or is there some transition amount?

And, also, you mentioned that need to retool some of your IT systems for the rolling stock servicing. Is this just an incremental enhancement or is it a more involved upgrade? Thanks.

Jim Rallo - *Liquidity Services, Inc. - CFO and Treasurer*

The first question on timing, that is one of the inherent uncertainties of where we are with the rollout of the contract. The rollout of the contract, timing has not been solidified. There is contingency of extensions, one-month extensions, that the DoD has at their discretion to bump that out.

But absent any extensions, we would normally be looking at a January timeframe to phase in the new contract. The IT and operational requirements of phasing in the contract largely reside with the government, because it's the government that issues the delivery orders for property and has to make the systems changes to segregate property in the two new contracts.

There are other integration requirements, such as the integration of our business into the federal asset sales portal, govsales.gov, which is both requiring work on our side as well as the federal government's side. Those are just a few examples. There are longer lists of detail. As we get visibility on that, we can come back and give you more clarity on the timing of the rollout.

The rolling stock transition is under way. There's testing and piloting going on with the government and the new vendor under the rolling stock.

There's rolling stock that is no longer in our flow. We do have some rolling stock but that flow has been turned on in anticipation of the stand up of the new rolling stock contract with the other vendor.

Jason Mitchell - *BofA Merrill Lynch - Analyst*

Okay, great. Thanks, guys.

Operator

I would now like to turn the presentation over to Ms. Julie Davis for closing remarks.

Julie Davis - *Liquidity Services, Inc. - Senior Director of IR*

Thank you. That's our time for today's call. We will be available to take additional follow-up questions. Thank you for your participation and have a good day.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day

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