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Transcript of
Sharps Compliance
Third Quarter 2014 Earnings Conference Call
April 30, 2014

Participants

David Tusa – President and Chief Executive Officer
Diana Diaz – Vice President and Chief Financial Officer
John Nesbett – IMS

Analysts

Nick Hiller – William Blair
Brian Butler – Wunderlich Securities
Joe Mundo – Sidoti & Company
Kevin Steinke – Barrington Research
Craig Hoagland – Anderson Hoagland & Company
George Walsh – Gilford Securities

Presentation

Operator
Greetings, and welcome to the Sharps Compliance Third Quarter 2014 Earnings Conference Call. At this time, our participants are in a listen-only mode. A question and answer session will follow the formal presentation. (Operator instructions.) As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Mr. John Nesbett of IMS. Thank you. You may begin.

John Nesbett – IMS
Good morning and welcome to our conference call to discuss Sharps Compliance's financial results for the third quarter of fiscal 2014. On the call today we have David Tusa, Sharps' President and Chief Executive Officer; and Diana Diaz, Sharps' Vice President and Chief Financial Officer. David will review the company's business operations and growth strategies, and Diana will review the financials. Immediately following their formal remarks we will take questions from our call participants. If you're listening via webcast, please note that you have the ability to submit questions through the internet.

As you're aware, we may make some forward forward-looking statements during the formal presentation and the question and answer portion of this teleconference. These statements apply to future events, which are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from where we are today. These factors are outlined in our earnings release as well as on the documents filed by the company in the SEC. These can be found at our website or at Sec.gov.

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With that, let me turn the call over to David to begin the review and discussion. Go ahead, David.

David Tusa – President and Chief Executive Officer

Good morning, everyone, and welcome to our third quarter earnings conference call. I want to begin the call with a few highlights of the March quarter.

First, although the customer billings from March were flat, we grew the business by about 30% when you exclude the retail market billings. I exclude the retail market billings from this comparison because the prior year March quarter included advance flu shot orders that are scheduled this year for the June 2014 quarter. So, just the timing in the orders between flu shot seasons; not a reduction in the business.

Second comment, we're scheduled to launch five more patient support programs with pharmaceutical manufacturers over the second half of calendar year 2014 and during calendar year 2015. We believe this is a direct result of our success and leadership position providing these innovative and customized programs for pharmaceutical manufacturers, which are designed to improve patient experience, increase medication adherence, patient compliance, while creating branding opportunities for our pharmaceutical manufacturer of customers. We estimate these new programs will generate between $2 million and $3 million in incremental annual revenue once they're fully rolled out to the patients.

Next, as many of you remember me stating last year, we had a goal of transforming our treatment facility operations into a profit center versus a cost center. As part of this initiative we began heavily marketing our incineration and other treatment facility services over the past six months and we're beginning to see the impact of these efforts in the financials with about $300,000 in related customer billings for the March 2014 quarter. We should generate similar or maybe even greater amounts in the June 2014 quarter and the outlook for the remaining calendar year of 2014 for these services looks promising.

Next, as I mentioned on our last earnings call, which was in January, I spoke to the fact that the June 2014 quarter is shaping up to be quite strong, led by significant orders expected in the pharmaceutical manufacturer and retail markets. While we can't make any guarantees we can say that we believe that June 2014 quarter revenues could be at least $7 million.

Finally, we've hired more sales professionals and are spending more on marketing initiatives. This is all part of our strategy to drive revenue growth, which we believe is the best way to build long-term value for shareholders.

With that, let's review the March quarter performance by market in a bit more detail. Pharmaceutical manufacturer billings this quarter grew 56%, so about half a million dollars or 10% in consolidated revenue. Now even greater importance is that following the close of the March quarter we received several large orders for new inventory builds for existing customers, which we expect to contribute to the growth of this segment in the June 2014 quarter.

Now, looking past the June quarter, we expect to launch two new patient support programs for new drugs during the second half of calendar year 2014 and we expect to launch at least three new patient support programs for new drugs during the calendar year 2015. We're very focused on this market and we remain bullish in our continued success in this market.

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Professional market billings grew $226,000 or 26% in the third quarter, contributing about $1.1 million or about 21% of the consolidated revenues. The professional market refers primarily to customers in the dental arena, veterinarians, physicians or other healthcare related facilities. This growth is largely the result of our inside and online sales channel, which showed a 13% increase in billings to $900,000 in the third quarter. We're right in the middle of launching a few new and innovative marketing campaigns aimed at the professional market, which we believe have the opportunity to drive more growth in this sector.

As I mentioned earlier, we saw a decline in the retail market billings to about $700,000 as compared to the prior year of $1.7 million. Retail refers to retail pharmacies and clinics that use our systems to collect, transport, and process syringes used to administer flu shots and other immunizations. The decrease for the quarter was related, again, to the timing of flu shot orders for the upcoming flu shot season. While the quarter-to-quarter comparisons can be lumpy as retail pharmacies provide more and more healthcare services to meet consumer demand, this segment, which we estimate we have about a 75% market share, remains a focus for continued growth. With that, the way we view this sector is that we believe this sector has the opportunity on a fiscal year-over-year basis to grow at least 25%.

Environmental billings, which are third-party billings for our treatment facility, increased to $300,000 compared to $100,000 for the third quarter of the prior year again, as we focus more on marketing initiatives pushing the third-party services.

Home healthcare market billings increased 17% to $1.8 million or 34% of consolidated revenues. Assisted living billings grew 6% to about $400,000 or 8% of consolidated revenues.

We believe we're well positioned to benefit from the changes the entire country is experiencing in the administration of healthcare, including the shift away from traditional healthcare settings to alternate sites. Also to focus on saving money in healthcare as well as the aging U.S. population. We believe we are uniquely positioned to service the small quantity generator market, which we believe is the fastest-growing sector in the healthcare market. As I have said many times, our most significant challenge is educating the marketplace about our solutions and the opportunity to save our customers as much as 50% over the traditional route-based pickup service in the small quantity generator sector.

With that, I'll turn it over to Diana, and she's going to provide a few more details on the financials. Diana?

Diana Diaz – Vice President and Chief Financial Officer
Thank you, David. During the third quarter the company recorded revenue growth of 2.6% to $5.6 million as compared to $5.4 million in the prior year period. Gross margin was 25% in the third quarter as compared to 28% in the prior year third quarter. The margin decrease is related to product mix and a few one-time charges.

Selling, general, and administrative expenses decreased to $2.23 million or 40% of sales in the third quarter of fiscal 2014 as compared to $2.35 million or 44% of sales in the third quarter of fiscal year 2013. SG&A for the third quarter of last year was negatively impacted by severance costs associated with a former officer of the company. We expect the sales and marketing portion of SG&A to increase in the June 2014 quarter related to the hiring of additional sales personnel and new marketing initiatives.

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The company generated an operating loss of about $935,000 in the third quarter of fiscal 2014 compared with an operating loss of $942,000 in the same prior year period. The company reported an EBITDA loss of almost $700,000 for both the third quarter of fiscal 2014 and the same period of the prior fiscal year. The company reported a net loss of $935,000 or a loss of about $0.06 per basic and diluted share compared to a net loss of $955,000 or a loss of $0.06 per share for the prior year period.

Now let's look at a few highlights from the nine months ended March 31, 2014. Revenue of $19.5 million in the first nine months of the current fiscal year increased 20% compared to revenue of $16.3 million in the first nine months of last year. Customer billings increased 19% to $19.2 million in the first nine months of 2014. Professional billings increased 37% to $3.9 million in the first nine months of the current year as compared to $2.8 million in the same prior year period.

Pharmaceutical manufacturer billings increased 43% to $2.6 million in the first nine months of fiscal 2014 as compared to $1.8 million in the comparable period last year. Retail billings were relatively flat at $4.4 million as compared to $4.3 million in the prior first nine months of the year primarily due to a shift in the timing of orders related to the flu shot season. Flu business for the nine months ended March 31, 2014 of $3.4 million was up 6% in comparison with the prior year period at $3.2 million despite the timing of flu shot related orders described earlier in the call. While this market is traditionally inconsistent quarter by quarter, as demonstrated by the variability of demand during the third quarter, the expansion of healthcare services and retail pharmacies, overall, drives growth for the company.

Fiscal 2014 year-to-date gross margin was 33% as compared to gross margin of 29% in the first nine months of last year. SG&A expense was $6.8 million in the first nine months of fiscal 2014, an increase of 5% over the prior year period as a result of increased investment in sales and marketing initiatives. Our operating loss improved to about $700,000 in the first nine months of fiscal 2014 as compared to an operating loss of $2 million in the first nine months of last year.

Our EBITDA improved significantly to $150,000 in the first nine months of 2014 as compared to an EBITDA loss of $1.2 million in the first nine months of last year. Net loss in the first nine months of fiscal 2014 was $700,000 or a $0.05 loss per basic and diluted share compared with a net loss of $2 million or $0.13 per basic and diluted share in the first nine months of last year.

Our balance sheet remains solid with $14.4 million in cash and cash equivalents as of the end of the quarter and no debt. Our strong balance sheet gives us flexibility as we build a larger company. As we previously disclosed, Sharps has an authorized stock repurchased program in place for up to $3 million extending through calendar year 2014. During the March 2014 quarter the company did not repurchase any shares. However, over the term of the two-year program, the company has repurchased 161,801 shares at a cost of $681,000.

With that, I'll turn the call back to David.

David Tusa – President and Chief Executive Officer
Thanks, Diana. Just a few more comments before we go to the Q&A. We talk about saving money for our customers, and I've got to tell you, I think we land business, new business, and we secure existing business with not only the cost savings but also our excellent customer service, our reasonable contract terms, and our obsession with responsiveness.

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Now, more on the sales front. I'm really pleased that we're bringing in more sales people. We've actually increased our field sales related staff to ten. I think we were up on six, so an increase from six to ten and we may be even bringing in more. I know Brandon Beaver, our Senior VP of Sales, is extremely excited about his new sales team and the opportunity in front of us. It's all about the people and remaining focused on key markets and key opportunities. We believe we have the right personnel in place to grow the company significantly.

Lastly, before the Q&A, I just want to thank our employees in advance for the efforts I know we'll see supporting this June quarter. It's going to be quite busy. I know they're going to do whatever it takes to ensure flawless execution and, again, quality customer service. With that, operator, let's open it up for questions.

Operator
Thank you. At this time we'll conduct a question and answer session. (Operator instructions.) Our first question comes from the line of Ryan Daniels with William Blair. Please proceed with your question.

Nick Hiller – William Blair
Good morning. This is Nick Hiller in for Ryan Daniels. My first question, on the pharmaceutical side, are the three patient support programs that you expect to launch in calendar '15, are those first half for second half of calendar 2015 launches?

David Tusa – President and Chief Executive Officer
They are really throughout the calendar year of 2015. I think you'll see them come in, again, over the calendar year.

Nick Hiller – William Blair
Okay. Great. Just switching gears to environmental, I was just wondering how much capacity do you think you have to grow this segment at your treatment center? What type of customers are you targeting with this segment?

David Tusa – President and Chief Executive Officer
Well, let me just say it this way. I think it's a great question about the capacity, but let me just answer it a little bit differently, which I think will help you. The way we look at it is because we've really freed up our treatment facility because we have about half of our mail backs now going to the closest Daniels facility, which really freed up not only capacity but freed up operationally the ability to use the treatment facility for third party burns. Let me just say it this way, if we burned for, let's say, 15 to 20 days a month that would bring in about $400,000 to $500,000 a month and that's really the way we look at it. That's kind of considering throughput issues and just being conservative of how much we can push through there. We're excited about it and we're marketing the heck out of it and think we have a significant opportunity there. For competitive reasons I really don't want to talk about the kind of target, the customers that we're targeting. We'd rather show you on the P&L.

Nick Hiller – William Blair
Okay. Great. That's really helpful. Then my last questions were on gross margin. I'm assuming most of the decline, at least sequentially, was just a lower sales base and deleveraging there, and on a year-to-year basis you called out product mix. Should we assume that retail margins are higher and any detail on those one-time items you mentioned?

David Tusa – President and Chief Executive Officer

There were some one-time operational expenses that we've incurred. Anytime you lose mail back related business and even in this market it effects the margin. I guess, the best way to look at it if you kind of look forward and we talked about $7 million, potentially, in revenue for the June quarter. The best way to look at that is the $7 million and because of the operating leverage about a 34% to 35% gross margin.

Nick Hiller – William Blair
Okay. Great. Thank you.

Operator
Thank you. Our next question comes from the line of Brian Butler with Wunderlich Securities. Please proceed with your question.

Brian Butler – Wunderlich Securities
Good morning. Thanks for taking my questions.

David Tusa – President and Chief Executive Officer
Good morning, Brian.

Brian Butler – Wunderlich Securities
Can we start back on the pharmaceutical? I think I might have gotten myself confused. You have three programs running right now that had an expectation of doing about $3 million in revenues. So now you're going to have three more programs? Is that the right way to think about it, that's growing $2 million to $3 million in revenues?

David Tusa – President and Chief Executive Officer
Yes. Actually right now we have about ten programs, of which probably six of them contribute the majority of the revenues. Here's a way to look at it, Brian. If you look at the pharmaceutical manufacturer market billings, what were they, $2.6 for the nine months ended? We think that they'll be about, let's say, $3.8 million for the fiscal year 2014. That's the revenue generated on an annual basis from those existing programs, all right. What we expect is after these new programs, the five new ones get up and running, that it would contribute incrementally and on an annual basis an additional $2 million to $3 million.

Brian Butler – Wunderlich Securities
Okay. That's helpful. The new program, how long do they ramp? Does it take a year, is it 18 months when you think about getting to that $2 million to $3 million run rate?

David Tusa – President and Chief Executive Officer
This is going to be a little bit shorter because these are new programs and new drugs versus launching programs for existing drugs. We think the ramp up time will actually be relatively shorter. I'm going to guess and say maybe six months.

Brian Butler – Wunderlich Securities
Okay. So by the end of calendar year '15 you should be at that full new run rate of, call it, $5 million almost $6 million?

David Tusa – President and Chief Executive Officer
Well, unless some of the ones in '15 are launched later in '15. Maybe say about, to be conservative, mid-calendar '16 to be up at that rate, just trying to allow for any extended or delay in ramp up.

Brian Butler – Wunderlich Securities

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Okay. Of the current programs you have right now, is any of that $3.8 million in revenue expected to go away over that same period?

David Tusa – President and Chief Executive Officer
No. What we're seeing with these programs is we're actually seeing them growing. We've got a couple of them in particular where we're doing a good job in working with the customer and they're doing a great job with working with the patient. We're hopeful. We can't guarantee it, but we're hopeful that there could be some growth opportunities in that $3.8 million.

Brian Butler – Wunderlich Securities
Great. Then, is there any incremental capital required for the new programs?

David Tusa – President and Chief Executive Officer
No. Again, that's the beautiful part about this business. We've got the infrastructure in place to facilitate all of those programs and our maintenance capex phase that's less than $1 million a year.

Brian Butler – Wunderlich Securities
Okay. That's good. Now, let's talk about our retail. That split that was last year like $1.7 million in the third quarter and $700,000 in the fourth quarter, so that basically gets reversed in this fiscal '14, right? Is that the right way to think about it?

David Tusa – President and Chief Executive Officer
Right. That's the right way to think about it. Again, the way to look at it is look on the fiscal year. Again, we always try to look at these things because of the lumpiness, but look at it on a fiscal year 2014 versus 2013 basis and look for, roughly, about a 25% increase in that margin.

Brian Butler – Wunderlich Securities
Okay. Then that will back me into what kind of a fourth quarter is suppose to look like.

David Tusa – President and Chief Executive Officer
Right.

Brian Butler – Wunderlich Securities
The environmental, if I heard that right that was about a $1.5 million a quarter is the potential for that piece? Did I hear that right? You said about a half a million a month?

David Tusa – President and Chief Executive Officer
We said if it's running 15 to 20 days a month then it's $400,000 to $500,000 a month and that is assuming that we're continuing to feed the facility with materials for incinerations. Really, that's how we kind of look at it from a capacity standpoint assuming that we have, again, the business to support that.

Brian Butler – Wunderlich Securities
Right. So that's kind of the max level you'd expect to get out of this under the current structure?

David Tusa – President and Chief Executive Officer
Right.

Brian Butler – Wunderlich Securities

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Do you have the ability to expand this if there's demand to expand the facility? Can you run it more than 15 to 20 days?

David Tusa – President and Chief Executive Officer
Sure. We can run it more than 15 to 20 days. I'm just trying to be conservative and allowing for a couple of days of down time for potential maintenance. Yes, we do have the opportunity to run it more than 15 to 20 days a month.

Brian Butler – Wunderlich Securities
Okay. To get to that max capacity is there any capital required for that expansion wise?

David Tusa – President and Chief Executive Officer
No. There really isn't any capital required. Actually, the best way to most efficiently run a treatment facility is to keep it running and not to shut it down. We're hopeful that we potentially can really not have much more incremental repair costs because the best way to run it so let's keep it running.

Brian Butler – Wunderlich Securities
Okay. I've got a couple more here. On the revenue growth when you think about $7 million in the fourth fiscal quarter that's up kind of about 33%. How did operating costs track on that? If you have a 50% flow back that being, roughly, operating cost would be up about 15% year-over-year going into the fourth quarter. Is that the right way to think about it or is the mix going to make that potentially better or worse?

David Tusa – President and Chief Executive Officer
I'll help you. If you think about our business when you look at the cost of goods sold think about a million a quarter for the fixed components; operations, the treatment facility. Then, think about the product costs, the costs, the variable costs associated with the product, think about that at 50% to 52% of revenue. So that's the model and that's why I've always said in addition to using that way, another way to model this out is take, roughly, 50% of that incremental revenue and that's your incremental gross profit. You won't really see, I don't think, any significant increase because again we have the infrastructure in place to facilitate this growth.

Brian Butler – Wunderlich Securities
Right. So you should get some good margins–

David Tusa – President and Chief Executive Officer
Sure. Right. When you model that out you'll see the operating leverage.

Brian Butler – Wunderlich Securities
You talked about SG&A costs going up. Can you provide any visibility on the magnitude of that? Is this change where your revenue break-even is? The four year revenue break-even was somewhere around $26 million $27 million. Has that now moved up?

David Tusa – President and Chief Executive Officer
I think it has a bit. Let's just look at it this way. We have about $2.2 million in SG&A in this quarter. About $100,000 of that, Brian, was related to legal fees associated with the CDC claim. In the June quarter we'll replace that $100,000 we spent on the legal fees, we're going to replace that with additional sales and marketing and we may even spend a bit more. Again, I think we started a base of $2.2 in SG&A and I think you escalate that going forward. I've always said increase it 5% to 10% with a focus primarily on additional sales and marketing.

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Brian Butler – Wunderlich Securities
Okay, and just one last one. On the whole healthcare you've had now two quarters where you had really strong year-over-year growth. Has something changed here that's giving you better organic growth that can be sustained kind of going out farther, or is this really longer-term looking still kind of that mid to high single-digit growth rate?

David Tusa – President and Chief Executive Officer
I think, I've always said that home healthcare is an area that's just exploding. That as an industry is growing significantly. I think Brandon and his crew are doing a really good job of working with key distributors in the home healthcare arena to push our solutions. I think it's just a focus on that. At the end of the day, I've always said it should grow at least 10%, maybe we have the opportunity to grow it more than just that 10%. What was it? For the nine months it was 14%. We would be pleased with somewhere on an ongoing basis of 15% increase in home healthcare market.

Brian Butler – Wunderlich Securities
All right. Great. Thank you very much.

David Tusa – President and Chief Executive Officer
All right. Thanks for the questions.

Operator
Thank you. Our next question comes from the line of Joe Mundo with Sidoti & Company. Please proceed with your question.

Joe Mundo – Sidoti & Company
Good morning, David and Diana. Can you hear me okay?

Diana Diaz – Vice President and Chief Financial Officer
Yes.

David Tusa – President and Chief Executive Officer
Yes. We can, Joe.

Joe Mundo – Sidoti & Company
Thanks for taking the questions. David, I'd like to touch on the plant. I know a lot of people have talked about utilization rates. I want to talk a little bit about what expectations are for incremental margins for that business? Would 40% be a safe assumption there?

David Tusa – President and Chief Executive Officer
I think it's up to probably about 50% on the incremental margin for those third-party services is reasonable.

Joe Mundo – Sidoti & Company
Okay. I know you talked about the possible level of utilization, 15 to 20 days a month. I'm just wondering what's the nature of that business. Is there any recurring component or is it more of an eat what you kill type of situation?

David Tusa – President and Chief Executive Officer
It's both. We do get some recurring revenue but it's also backfilled with lumpy project work. Again, I think our marketing crew has done a great job of going out there and marketing those services and our folks at the treatment facility have done a great job

at making it happen. By the way, we've been really pleased, and the customers have been as well, with the treatment services provided. Again, I'm optimistic and I think that that growth in that market is promising.

Joe Mundo – Sidoti & Company
Okay. Also, I'm jumping around here, you spoke a little about the additional reps you added in the quarter. You said you went from six to ten. Was that six reps in this quarter and then you're going to ten in the June quarter?

David Tusa – President and Chief Executive Officer
What we did, Joe, is we measured that at December 31st through now, through today, and that's a net number. We also replaced some of the ones that we had. I'm really excited because the folks that we're bringing in have significant experience in medical waste. It's such a niche market and to find really solid salespeople that can walk in and potentially make a difference when they start is exciting. Brandon did a great job of going out and spent a lot of time interviewing a lot of people and we're pleased with the people that we have. We may add another one or two.

Joe Mundo – Sidoti & Company
Okay. Staying on that subject, you just spoke about SG&A up 5% to 10%, is that sequentially? So you take that $2.2 million number this quarter and are we looking at a 5% to 10% increase the next quarter or is that year-over-year?

David Tusa – President and Chief Executive Officer
That's year-over-year.

Joe Mundo – Sidoti & Company
Okay. Year-over-year. A lot of my questions, like I said, were answered. My main question here is you're sitting with $14.4 million on the balance sheet, no debt. Any ideas on what you're going to use the cash for?

David Tusa – President and Chief Executive Officer
We do. We actually have some ideas on what to use that cash for. We're just not ready to talk about it, but we do. We're actually looking at potential opportunities to grow the business and to put some of that cash to use in investing in the business.

Joe Mundo – Sidoti & Company
Would that involve M&A or would it be development of your own proprietary business?

David Tusa – President and Chief Executive Officer
It could be both.

Joe Mundo – Sidoti & Company
Okay. I think that's it for me. Thank you.

David Tusa – President and Chief Executive Officer
Thanks, Joe.

Operator
Thank you. Our next question comes from the line of Kevin Steinke with Barrington Research. Please proceed with your question.

Kevin Steinke – Barrington Research
Good morning, David and Diana.

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David Tusa – President and Chief Executive Officer
Good morning, how are you doing?

Kevin Steinke – Barrington Research
Good. How are you?

David Tusa – President and Chief Executive Officer
Doing good.

Kevin Steinke – Barrington Research
Good. Could you just give us an update on the Daniels alliance and what you're seeing in the pipeline there?

David Tusa – President and Chief Executive Officer
Sure. We have landed business with the Daniels alliance. It really has helped us to market. The company is a full-service provider of medical waste management services. The deals that we work on, Kevin, are the larger deals and those are ones with a little bit longer sales cycle. Let's say, it's a 200, 300, 400 location facility. It could be in any of the markets. We actively are going after the markets and we're actively working to bring in the subcontracting of those route-based pickup services for the portion of the business that really is just too large for a mail back. So it's quite active with those opportunities, but then again those are larger deals where their sales cycle is a bit longer.

Kevin Steinke – Barrington Research
Okay. Is the expanded field sales force that you brought in, are they going to be really going after those Daniels opportunities, or what's going to be keeping them busy?

David Tusa – President and Chief Executive Officer
Well, they're going to be going after a lot of things. The folks that we brought in have a lot of experience on the medical waste size to large quantity, medium quantity, and small quantity. I think that they're ahead of the ballgame, in a sense, so they understand all sides to the business. With them, I think that we'll see more and more opportunities where we can combine the mail back with that pickup service to provide a full service to the customer.

Kevin Steinke – Barrington Research
Okay. On the five new patient support programs I know $2 million to $3 million in aggregate, but are there any significant differences in the sizes of the programs in terms of the ones launching in '14 versus '15?

David Tusa – President and Chief Executive Officer
They are all different and some of them larger and some of them smaller. It's really difficult with the ones that are going to be first launching to try to quantify. I know where you're going, where you're wondering what's going to hit the quarter. Let's just say that the ones for '14 we think are probably representative of the average type of size of the opportunity of the five.

Kevin Steinke – Barrington Research
Okay. You added some people to the field sales team, but you also talked about launching some new inside sales campaigns. I don't know if you want to get into more color on that and if you are also adding inside salespeople?

David Tusa – President and Chief Executive Officer

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We are adding inside sales folks. At this time, I really don't want to talk about what we're doing with the campaign; I'll just tell you they're new and they're innovative. We're excited and we think that the focus is on educating those 800,000 prospects out there of the alternative to that route-based pickup and of the convenience and the ease of transition of the mail back services.

Kevin Steinke – Barrington Research
Okay. Thanks for taking my questions.

David Tusa – President and Chief Executive Officer
Thanks, Kevin.

Operator
Thank you. Our next question comes from the line of Craig Hoagland with Anderson Hoagland & Company. Please proceed with your question.

Craig Hoagland – Anderson Hoagland & Company
Hi. I was hoping you could just go through maybe at a high level the economics of when you direct mail back volume to a Daniels facility, that is to your own facility, how that kind of flows through the financials in terms of the impact on gross margin, operating margin, and then, eventually, return on capital?

David Tusa – President and Chief Executive Officer
Let me just talk about it from a really bigger picture perspective. It significantly lowers the return transportation costs of a mail back to our facilities for treatment. Some of that is offset with what we pay, obviously, Daniels to process the mail back, but it does reduce our cost, one of the more significant costs, on cost elements in a cost of sales related to a mail back. I'd really like to stay away from getting very granular with that for competitive reasons.

Craig Hoagland – Anderson Hoagland & Company
But the gross margin is lower, is what you pay Daniels is higher than what you save on the transportation costs?

Diana Diaz – Vice President and Chief Financial Officer
No.

David Tusa – President and Chief Executive Officer
No. It's just the opposite.

Craig Hoagland – Anderson Hoagland & Company
It's the opposite.

David Tusa – President and Chief Executive Officer
Right.

Craig Hoagland – Anderson Hoagland & Company
Then you free up capacity at your facility, obviously, which allows you to take other volumes in.

David Tusa – President and Chief Executive Officer
Yes. That shift is equally or more important than the improvement or the reduction in the cost on the return transportation. What it really does is it frees our facility up to go out there and use it for third-party activity, which can be a nice margin business and that's why you saw the $300,000 in environmental services revenue this quarter.

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Craig Hoagland – Anderson Hoagland & Company
Okay. I guess I need to go back to the comment that mix was a negative effect on gross margin year-over-year. What was the higher element of mix that diluted margins?

David Tusa – President and Chief Executive Officer
Again, first of all there was some one-time costs that were included in the cost of sales. Anytime you have a reduction in revenue directly attributable to the mail back business, which is our highest margin business, then the effect is lower; what will reduce the overall margins. As an example, in the home healthcare market, which was higher, there's more than just mail backs that sold. There are a few other products that we sell into the home healthcare market that are at lower margins so you had higher revenues from a little bit lower margin business and lower from a higher margin business.

Craig Hoagland – Anderson Hoagland & Company
Okay. Thank you very much.

David Tusa – President and Chief Executive Officer
You bet.

Operator
Thank you. Our next question comes from the line of George Walsh with Gilford Securities. Please proceed with your question.

George Walsh – Gilford Securities
Good morning.

David Tusa – President and Chief Executive Officer
Good morning, George.

George Walsh – Gilford Securities
I just wondered, David, what's the environment like, is there any pricing pushback you're getting as you did on, let's use some of the bigger deals as the example relative to Daniels? Does it get competitive or is your pricing advantage–how is that going with your prospective customers?

David Tusa – President and Chief Executive Officer
As you know, we took the larger deals, what we're typically seeing is that we can pretty easily save the customer 30% to 40% and that's a combination of both the mail back and the pickup.

George Walsh – Gilford Securities
Okay. I'm just saying competitively are guys trying to match that, some of the bigger suppliers? What are you seeing?

David Tusa – President and Chief Executive Officer
Sure. Absolutely. If it's a national deal it's very competitive and even with those savings sometimes, potentially, you'll see from the competitor a reduction potentially to meet that. So we've got to sell on much more than price. The price is important, but, as I mentioned, I've got to tell you there's a significant element that's related to customer service. The contract terms are very, very important as well. We're very reasonable with respect to contract terms. Then, the customer service I think we do a phenomenal job, so it's not always price.

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George Walsh – Gilford Securities
Yes. The customers do not like being locked in or some of the other just whatever some of the other terms may be that they're working under?

David Tusa – President and Chief Executive Officer
Sure. What they do is they like to make sure that if there are price increases that the price increases are very, very reasonable and then they don't want to be locked in. I mean, we closed a deal where we were at the table and said, "You know what? Just give us a shot and let's try this for a year. We're confident that we're going to perform and that you're going to renew the business," and that's exactly what happened.

George Walsh – Gilford Securities
Okay. Good. You mentioned the CDC. Any update on the progress there? I know there was some legal cost, but how is that going?

David Tusa – President and Chief Executive Officer
We're making progress. It's probably not appropriate to comment on pending litigation, but we're making progress. I'll just say this, that if there's going to be a resolution, a favorable resolution, then I think we could potentially see something in the June quarter.

George Walsh – Gilford Securities
Okay. Great. Thanks, David.

David Tusa – President and Chief Executive Officer
Thanks, George.

Operator
Thank you. Our next question is a follow up from Brian Butler with Wunderlich Securities. Please proceed with your question.

Brian Butler – Wunderlich Securities
Hi. Thanks for taking my follow up. Just to clarify, on the pharmaceutical, the new program that means you've won some of those bids that were outstanding. Can you give any update on what bids you still have remaining out there or what that pipeline kind of looks further out?

David Tusa – President and Chief Executive Officer
Well, that's a good question. For competitive reasons I really don't want to talk more than just—no offense, Brian, but for competitive reasons we're just going to leave it at we landed five more deals and we think that that continues to be a significant market for us and we think that we can generate continued and significant growth if we continue to be successful in that market.

Brian Butler – Wunderlich Securities
Maybe I'll ask very generally then. Are there other bids still out there?

David Tusa – President and Chief Executive Officer
Yes.

Brian Butler – Wunderlich Securities
Okay. One last one, on the use of cash that you had talked about, is that somewhat a little bit changing in, I guess, strategy in the sense that for a while you had wanted to keep a significant amount of cash on the balance sheet because that allowed you to

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go to larger customers and gives you the credibility of being able to perform. With the alliance now in place does that allow you now to have a lower cash balance on the balance sheet? What is that right number to have there now?

David Tusa – President and Chief Executive Officer
The way I look at it, Brian, is we've got to have at least, I'm going to say, at least $5 million, maybe $8 million of cash on the balance sheet to show the prospective customers that we are very, very well capitalized. I think we have the opportunity or we've identified some potential growth opportunities where we could invest that cash in either new products or potentially in acquisitions of lines of products.

Brian Butler – Wunderlich Securities
Okay. But the right way to think of it is that gives you $4 million to $6 million that you could be spending on growth, organically, or I guess acquisition as well. That's the right way to think about it though?

David Tusa – President and Chief Executive Officer
Yes. That's correct.

Brian Butler – Wunderlich Securities
Great. Thank you very much, again.

David Tusa – President and Chief Executive Officer
All right. Thank you.

Operator
Thank you. Ladies and gentlemen, at this time I'd like to turn the call back over to management for closing comments.

David Tusa – President and Chief Executive Officer
Thank you, everyone, for joining the call. We look forward to speaking to you next quarter. Thanks again.

Operator
Thank you. This concludes today's teleconference. You may disconnect your lines at this time. We thank you for your participation, and have a wonderful day.