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DXP Enterprises, Inc. (DXPE)

Q1 2020 Earnings Call

CORPORATE PARTICIPANTS

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

OTHER PARTICIPANTS

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Blake Hirschman

Analyst, Stephens, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the DXP Enterprises Inc., 2020 First Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Kent Yee, Chief Financial Officer. Thank you. Please go ahead.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

Thank you, Cheryl. This is Kent Yee, and welcome to DXP's Q1 2020 conference call to discuss our results for the first quarter ended March 31, 2020. Joining me today is our Chairman and CEO, David Little.

Before we get started, I want to remind you that today's call is being webcast and recorded and includes forward-looking statements. Actual results may differ materially from those contemplated by these forward-looking statements. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis are contained in our SEC filings, but DXP assumes no obligation to update that information as a result of new information or future events.

During this call, we may present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in our earnings press release. The press release and an accompanying investor presentation are now available on our website at ir.dxpe.com.

I will now turn the call over to David Little to provide his thoughts and a summary of our first quarter. David?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

Good morning. Good morning and thank you, Kent. Thanks to everyone for joining us today on our fiscal year 2020 first quarter conference call. Kent will take you through key financial details after my remarks and after Kent's prepared comments, we will then open for Q&A. In light of the coronavirus and its impact on the health of our employees, customers and economy, we were going to share with you our thoughts on these items and our responses before we move into the normal format of our earnings call.

Before I start let me first say that our thoughts and prayers go out to all those impacted by the COVID-19 virus. This is a terrible virus and a pandemic unlike anything we have ever seen. In these unprecedented times, I want to thank each of our DX people for their efforts and commitment. DXP appreciates the help of all the medical professionals and first-time responders in our various communities and we pray for their safety and well-being as they put themselves at risk daily to serve the people of their countries worldwide and attempt to make it safer for everyone.

DXP also appreciates the support of our DXP suppliers as we navigate through our new normal together [Technical Difficulty] (00:03:12) with the ample supply of inventory as we were viewing fiscal year 2020 as a growth year for DXP. Accordingly, we are in good shape with our supplier partners having experienced minor constraints as expected with safety PPE as we adjusted inventory in these new environments.

As an essential business, we felt responsible to provide excellent service to our customers, who themselves were deemed as essential. We provided this level of service by providing products and services and insisting – assisting our customers and keeping the economy functioning the best we could during these difficult times.

As COVID-19 spread rapidly in the United States, we quickly rallied our team around three fundamental priorities. Our first priority was the health and safety of our DXPeople and supporting national efforts to stop the spread of the coronavirus. We took immediate steps in the US, Canada and Dubai at our facilities by working in small teams or through working rotations. We did this so that if we needed to quarantine one team, we could still continue to serve our customers.

Additionally, we had facilities deployed social distancing in the workplace, frequent hand washing, sanitizing, temperature testing, quarantines, remote work habits in the situation and circumstance where we could. We strongly encouraged our employees to not just maintain some protocol at work, but also while at home and outside the workplace. Out of DXP's 2,500 DXPeople, I'm proud that we have had only two confirmed cases of the coronavirus so far.

Our second priority has been to continue to provide excellent service and support to our customers as we support various industries that keep the wheels of North America economy going. We are thankful that we had the opportunity to support and serve our customers and make a difference.

During these unusual times DXPeople have done some amazing things for our customers to keep them safe and running as an essential business. The letters and e-mails that we have received showing appreciation and regards for our support have been truly heartwarming.

Our third priority has been to manage our balance sheet on expected lower near-term demand to remain strong and poised for an eventual recovery. I'm very proud of how our DXP team has managed and balanced these priorities in what is an unprecedented and unique environment. All three priorities are critically important in order to successfully manage through the crisis, while protecting our culture and continuing to build DXP for the future.

Let me briefly review in a little more detail the actions we are taking to accomplish these priorities. To keep everyone safe in a coronavirus world, we pivoted rapidly to implement all the CDC guideline and preventive measures. We have canceled all large meetings, gatherings and events and most air travel. We have educated our DXP people on the basis of social distancing and hygiene protocol and then executed these in our offices and locations. We are leveraging our supply chain to ship and replenish supplies of disinfectants, mask and hand sanitizers to our customers and employees.

With these modification policies we're being very aggressive about having DXPeople stay at home, if they have symptoms or potentially exposed, until it is clear they are not infected with the environment – with the virus.

We are performing our own contact tracing and when we hear of a scenario that potentially impacts the DXP employee, we finally – all our DXPeople who have the ability and desire to work for home are doing so in order to reduce the coronavirus risk.

Lastly, we're practicing good hygiene techniques at all of our locations, including constant cleaning of high touch, high traffic areas and overall facilities through all locations – today, all locations remain open, and are providing excellent service and support to our customers while ensuring the safest environment we can for our DXPeople.

In terms of demand, our sales were impacted starting in March – mid-March. As we closed out the first quarter in light of various shelter-in-place, stay-at-home orders across the United States and Canada. I am sure we will get in to this in our Q&A portion, but as expected we have seen additional declines in orders in the month of April. Noting that our year started off strong, we have pivoted to focus on declining demand. Our plan is to be calculating and smart using marketing intelligence to maximize profits.

Part of this intelligent is we are looking at the market we serve by location and geography to determine their likely demand and adjust accordingly to continue our expected profit profile. So let us look at some of our key end markets. Upstream oil and gas, which is tied to drilling is contracting, the rig count is down and this is primarily affects demand within our safety services division. DXP safety services also performs plant turnaround, which have been delayed but not canceled and should be a positive over time.

Midstream oil and gas, as it relates to pipeline activity, continues to execute small projects and has not cancelled any large orders with DXP today. Downstream or the refinery business has seen their utilization rates go from 91% to 70%. Until people start driving and flying, this market will be a break fix market, which DXP has a strong service and repair business. DXP anticipates demand will be down 30% in these markets and will start to recover when the price of oil hits \$30 to \$35 per barrel.

The IPS segment will suffer the largest impact as new capital projects are put on hold. The oil and gas industry has a demand problem. I believe this will improve when the country starts going back to work. Ultimately, we will start to see demand, we are accustomed to when we have a vaccination, a vaccine, excuse me.

At this point when demand picks up, we will then discover that we have an abundance of supply and that will take a couple of years to fix unless everyone in the industry cuts production, which could happen. This means that DXP's IPS segment, which is CapEx dependent, is cutting expenses to make money on 30% lower demand.

The Service Centers and a small part of Supply Chain Services, supply, aftermarket parts and supplies, services and repair and OEM components, as such they have adjusted a 10% in demand as it relates to this industry.

On a positive note gold mining, specialty polymers, bottled water, water and waste water, certain recreation manufacturers like bicycles, soap, food and beverage, agriculture and some chemical, medical, petrochemical and asphalt markets are doing well. Steel, rubber, paint, manufacturing, automotive, aerospace, and most OEM markets are down. On a segment and on location basis, we are rightsizing to anticipate sales results within a – with a small [ph] hopefully not (00:12:24) recovery starting in the third quarter and beyond.

DXP is not broken and every day we work on being more efficient and productive. We work hard to be fast, convenient, and technical experts. Customers are utilizing DXP's B2B capabilities more and more to increase their efficiencies. Why? DXP's approach is to tailor each B2B experience to that customer specific set of needs rather than take a shotgun approach of trying to have some online portal that is all thanks to all people.

Then we combine that product expertise, with product expertise to DXP's B2B customers appreciate this approach and it is a significant differentiator. Vendor-managed inventory programs are growing sales because being fast and convenient helps our customers be more efficient. DXP sales professionals are using a variety of virtual tools to contact customers, demo new products and troubleshoot. These includes Skype, FaceTime, Zoom, Snapchat and LinkedIn. We use whatever medium the customer prefers and tailor our approach to their needs. DXP is always customer focused even in this environment, especially in the environment we have today, we're listening to the customers' matters.

Marketing has developed videos for our customers for many reasons. But one that comes to mind is the one we used to – use for our customers to come see our manufacturing plants of our Made in America pumps. Now they cannot travel. So we are sending them a video of our capabilities. Training has always been a social learning experience, now it still is, but with Zoom and Skype. DXPeople are doing everything possible to stay in touch with our customers. So we do not miss any opportunities. It is harder to develop relationships with new accounts with [ph] face to FaceTime (00:14:39) but marketing and sales are working on new ideas to do so.

Now I would like to turn – sorry, I'm not ready for that. Now – okay I'm going to discuss some of the results and then I'm going to turn the call back over to Kent for more details. DXP's total revenue was \$301 million for the first quarter of 2020. Acquisitions contributed \$5.2 million in sales during the quarter and we are excited to have Pumping Systems and Turbo teams a part of the DXP family. In terms of our business segments, I was pleased with the contribution from all three segments, Service Centers sales were \$182.6 million, followed by Innovative Pumping Solutions sales of \$70 million and Supply Chain Services sales of \$48.4 million.

Service Centers regions that experienced growth year-over-year included Southwest, North Rockies and Alaska. In terms of the strengths and the IPS backlog we were up 2.6% compared to Q4 quarter, averaging backlog and down 17% versus this time last year. This is consistent with our Q4 commentary around the deceleration of our backlog off of a strong fiscal year 2018 and growth again in fiscal year 2019.

In today's environment we remain encouraged by the strong backlog dollars, however, we are focused on customers' commitment to these projects and the relative timing of completion and delivery as well as managing the cost [ph] through (00:16:43) the job completion. DXP's overall gross profit margins for the first quarter were 27.9%, an 85-basis point improvement over 2019 and more importantly 139 base (sic) [139 basis points] (00:16:59) improvement over the fourth quarter.

Giving our commentary around unique items in IPS jobs, this rebound was good to see. Albeit, we will need to monitor these as we move through depressed demand environment as a result of the COVID-19 and demand side dynamics as it pertains to oil and gas.

SG&A for the first quarter increased \$3.7 million versus Q1 of 2019. SG&A was a percent of sales increase 200 basis points going from 22.3% in Q1 2019 to 24.3% in 2020 (sic) [Q1 2020] (00:17:43). SG&A reflects the fact that we started the year strong and now have pivoted to decrease expenses with decreasing revenues. DXP's overall operating income margin of 3.6% or \$10.9 million, which includes corporate expenses and amortization. This will impact – this was impacted by normal seasonally high items including commissions and bonuses associated with 2019 as well as payroll taxes and other first of year items.

Service Centers operating income margin was 9.3%, IPS operating income margins of 14.9% and Supply Chain Services operating income margins of 7.8%. Overall, DXP produced EBITDA of \$17.8 million versus \$21.1 million in 2019. EBITDA as a percent of sales was 5.9% versus 6.8% in 2019.

To summarize, I'm very proud of how our team has performed in these extraordinary environment to keep everyone healthy and safe, serve and support our customers, manage our business through lower near-term demand and take care of each other along the way. As a leading distributor of highly engineered products and services, we believe that DXP remains well-positioned to support our customers and navigate this challenging period for the benefit of all stakeholders.

We are closely monitoring the trends and are adjusting as necessary to perform in this short term and we'll continue to build and manage for the long term.

With that I will turn this back to Kent.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

Thank you, David, and thank you to everyone for joining us for our review of our first quarter financial results and David and I practicing social distancing and being in different places, a little unusual but we're working through it.

Let me start by saying that our first quarter results reflect the impact of COVID-19 for about two weeks and does not reflect a full-month of shelter-in-place or stay-at-home orders which are fully reflected in the first month of the second quarter or April. I'm sure we will discuss our trends during the question-and-answer portion of this call and actions we are taking, but I wanted to provide that context as we review our Q1 results.

DXP's first quarter results were in line with our Q4 commentary and reflect improvements in gross margin and other areas that resulted in a strong performance for us during the first quarter. In terms of our capital structure and as an introduction to comments later on since 2015 and 2016 we have done a lot of work around choosing the appropriate instruments to finance our corporate strategy as well as creating financial viability and ensuring liquidity and flexibility regardless of the economic environment. We believe the actions we took back in 2017 would provide us with strategic optionality, so we could not just manage but also take advantage of market cycles. In many ways DXP's capital structure was built for times like this and our current capital structure was put together for such a scenario.

I will discuss this in more detail when reviewing the balance sheet, but let's start with a review of our income statement highlights. Total sales for the first quarter were \$301 million compared to \$311.2 million for the period in fiscal 2019. Sequentially, this is a 1.9% growth over Q4 and a 3.3% decline compared to the first quarter of 2019. As we discussed in Q4, this primarily reflects a deceleration in activity within Innovative Pumping Solutions, but also now reflects early impacts of COVID-19 within the Service Centers and Supply Chain Services segments.

The first quarter performance also includes the acquisition of Pumping Systems, Inc. and Turbo Machinery Repair, which we closed on January 1st and February 1, 2020, respectively. Combined they contributed \$5.2 million in sales during the quarter. As David mentioned, we are excited to have them as part of the DXP and we look forward to integrating and making them a part of the DXP family. Average daily sales for the first quarter were \$4.7 million per day versus \$4.9 million per day in Q1 2019. Adjusting for acquisitions, average daily sales were \$4.6 million per day.

Regions within our Service Centers segment, which experienced sales growth on a year-over-year basis include the Southwest, North Rockies and Alaska regions. Sales for the Service Centers were essentially flat sequentially, excuse me and declined \$3.6 million from Q1 of last year. As David mentioned in his comments, our IPS segment increased backlog from Q4 to Q1 by \$2.6 million – 2.6% excuse me or \$3 million but is down 17.1% from this time period last year of \$24.4 million. IPS sales for the quarter increased \$4.3 million sequentially and declined \$4.7 million compared to this time last year. Our main focus as it pertains to IPS is managing the backlog and scaling our facilities for go forward levels of demand.

Everyone has seen that capital budgets have been significantly reduced and capital commitments are being reviewed based upon individual company circumstances and financial wherewithal. As such, at DXP we are reviewing orders and customer commitments to these projects, the expected timing or anticipated delivery and the associated costs to completion.

Supply Chain Services grew sales \$1 million sequentially and declined \$1.9 million versus Q1 last year. With the impending coronavirus Supply Chain Services is dealing with customers either temporarily closing or for an extended period of time closing facilities and then reopening. As such, we are impacted by our customers' decision as whether to keep their facilities open or close.

Turning to our gross margins, DXP's total gross margins were 27.9 %, an 85-basis point improvement over Q1 2019. Additionally, this reflects a 139-basis point improvement over Q4. This is a result of improvement within IPS and the removal of the impact of projects that lost gross profit dollars in Q4. In terms of operating income, combined all three business segments improved 74 basis points and year-over-year business segment operating income margins versus Q1 2019 and 258 basis points compared to Q4.

Total DXP operating income decreased 113 basis points versus Q1 2019 to \$10.9 million. This was primarily driven by corporate SG&A and the payout of commissions and bonuses associated with fiscal year 2019. Normal seasonal payroll taxes and first of year items as well as higher than normal legal, audit and an increase in sales tax audit accruals.

Turning to EBITDA, EBITDA was \$17.8 million in Q1 versus \$21.1 million in Q1 2019 and \$13.4 million in Q4. EBITDA margins were 5.9% versus 6.8% in Q1 of 2019. In terms of earnings per share, our net income for Q1 2020 was \$5.7 million. Our earnings per diluted share for Q1 2020 was \$0.31 versus \$0.12 in Q4 and \$0.40 in Q1 2019.

Turning to the balance sheet and cash flow, in terms of working capital, our working capital was \$243.5 million at the end of the quarter. This amounted to 19.4% of our last 12 months sales. This is above our historical average, but reflects the seasonal nature of working on projects, investing in the associated working capital and project related jobs within IPS as well as the impact of lower sales on a year-over-year basis. As I mentioned earlier, we are focused on reviewing orders and customer commitments to these projects, the expected timing or anticipated delivery and the associated cost to completion.

Costs and estimated profits increased \$3.3 million from Q4, but is down from Q1 of last year by \$2.4 million. Inventory is up \$3.6 million from Q4 as well. This reflects DXP carrying higher levels in anticipation of supporting revenue growth in fiscal year 2020. We anticipate inventory levels to decline as we operate in this new environment and we have a focus on collecting and covering costs on existing projects until completion as I've mentioned several times.

In terms of cash, we have \$32.8 million in cash on the balance sheet at March 31. This is an increase of \$2.1 million compared to March 31, 2019. Cash used in operations was lower by \$3.7 million in Q1 of this year versus Q1 of last year or was a use of \$1.6 million versus a use of \$5.3 million last year. As a reminder, we typically have negative cash flow from operations in the first quarter and positive cash flow from operations in the second through third and fourth quarter.

In terms of CapEx, CapEx in the first quarter was \$3.2 million or 1.1% of first quarter sales. Compared to the first quarter of 2019, CapEx dollars are up \$923,000. CapEx during the quarter reflects growth investments we made in fiscal year 2019 and the completion of items tied to these projects that we started last year. As we move forward, capital expenditures will decline on a year-over-year basis as we discussed in Q4 and we have very little maintenance CapEx needs for the business.

Return on invested capital or ROIC at the end of the first quarter was 21%. In terms of our capital structure the two main covenants that we have include a fixed charge coverage ratio under our ABL and a secured leverage ratio calculation under the term loan B agreement. At March 31st, our fixed charge coverage ratio was 3.0 to 1 and our secured leverage ratio was 2.2 to 1.

Total debt outstanding at March 31st was \$243.75 million. As I mentioned at the beginning of this call, our capital structure was built to match our strategy and ensure financial flexibility through different cycles. Additionally, was pairing acquisition capital, which are long-term assets with a long-term financial instrument, a term loan B.

We have no near-term maturities with our ABL maturing in August 2022 and our term loan B maturing in August of 2023. In March, we proactively took steps to enhance our liquidity and capital availability by expanding our ABL facility from \$85 million to \$135 million.

As of this call, we are undrawn on our ABL and have over \$190 million in liquidity, \$59 million in cash and \$132 million in ABL availability. That said, given our cash flow profile and the fact that we typically release working capital and produce a significant amount of free cash flow in the first year of a down cycle, we plan to proactively pay down debt as appropriate.

After Q1 we made an optional \$10 million prepayment on our term loan B to further strengthen our balance sheet. We believe this measure combined with the actions we have taken to reduce our operating expenses and limit capital expenditures give us liquidity and financial strength to manage through these unusual and challenging times.

We have a senior leadership team that has experience managing through multiple cycles, including 2008, 2015 and 2016. And we have the capital structure flexibility and knowledge to get us through a lower demand environment.

In summary, our priority from a balance sheet perspective is to emphasize and maximize our financial strength and flexibility during these uncertain times without sacrificing long term growth or market opportunities and

position us to be opportunistic when any growth opportunities arise. We have seen down cycles and emerged in the past and we will do it again as we manage through this cycle.

At this point, David and I will now turn the call over for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question is from Joe Mondillo of Sidoti. Please go ahead. Your line is open.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Hi, Ken, David. Hope you're doing well.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Yeah. Thanks, Joe.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

First question, just – two questions on the quarter itself, Service Center margins were – I mean Service Center margins were a little light, so I'm wondering what was going on there, second lowest quarter since 2016? And then on the IPS segment margins were quite strong. You stated on the last call that maybe some of that low margin work was actually going to flow into the first quarter. So I was surprised to see not only was it a solid quarter relative to 4Q, but it was one of your strongest quarters over the last several years?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Yeah, Joe, this is Kent. You had a multitude of questions there a little bit, so I'll try to take them in order. Just in terms of the Service Centers, we did get some contraction in the Service Centers, revenue wise, and so I think part of that fed into it. A part of it is also is – there is in Q1 across the total business of DXP, but there is elevated SG&A expense in Q1. So that's partially impacting the margins, meaning bonuses and commissions that occur for fiscal year 2019 kind of roll over into the first half of the following year, in this case, our fiscal year 2020. So I think that's making their margins look lower than probably they would streamline out if you will kind of as they as they move through the year.

In terms of your comment or question around Innovative Pumping Solutions and the improvement in that segment's operating income margins, what we said in Q4 was that we still had about six to seven potential negative gross margin jobs but we did not know the timing of the shipment of those jobs on a go forward basis. And what I can share with you is none of those jobs did ship in Q1. And so we – as a result, we did see a natural lift in improvement in the operating income margins for IPS. And so I think that's the greater contributor there to the margins there. Had one or two of those shipped in Q1, more than likely it would had some level of impact to the operating income margins in IPS, but they just merely didn't. So we're monitoring that kind as we go through the quarter and we'll speak to it as best we can when we see it.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. To follow up regarding those comments – those last comments, do you anticipate those jobs still to ship, number one? And number two, do you have any sense of timing with that?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Yes, they're still in our backlog. We're going through that now with that segment going through all the jobs and trying to be sure we understand the timing. So I don't want to misspeak at this point in time because I think what we've now got impacted with a lot of these customers is kind of their budgets in COVID. And so per our comments and our scripts that's kind of what we're doing right now. And so going into this year we anticipated they would have shipped at some point in fiscal year 2020 and I still would presume that. But the specific time, I don't have any specific facts to share at this point in time.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. Understood. David, did you mention that the IPS backlog was down 17% year-over-year. Is that correct?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

That's correct.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

So...

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

From Q1 of 2019 to Q1 of 2020, right.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Great. Okay. So you're expecting oil and gas sectors to sort of be down 30%. Could you provide some more color relative to backlog being off 17%, maybe you can talk about sort of order trends in April and any other thoughts on getting to that 30% level? And then also maybe in the context to 2015, 2016 time period, your sales were off – at IPS were off about 27% each of those years and maybe you can provide some context how it feels to that downturn back then?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

So the backlog being down 17% is a function of order intakes and shipments. So when you look at both of those, I think that we're forecasting that orders are going to be down 30%. But frankly, our revenues for IPS will not be down 30%, it's going to be more like 18% or 20%. So I think we had a really good recovery that started in 2017, it was really good in 2018 and we grew our IPS business, 2019 actually grew on top of that. And then – but we're in the process of the fourth quarter of 2019, the oil and gas people kind of had a little shut down there, they were conserving cash and nothing to do with the virus. They just – they were just in general seeing that – maybe they

were seeing there was an oversupply or the marketplace thought that. So they kind of started shutting down. So we started shipping a lot of our backlog, as Kent pointed out, some of it good and some of it bad backlog. But nonetheless that started to headed down.

So I think I understand that you have to – and then what happens is that in the first quarter of this year, we were seeing our backlog increase and we were anticipating a good year until mid-March and then everything kind of got shut down. So there's a lot of moving parts there. We could, maybe offline, give you a little better detail, but basically that's how I see it and [ph] well that's what (00:37:29) is happening.

I will say [indiscernible] (00:37:33), that there's a few jobs out there that still aren't overly profitable, realize that with percentage completion you kind of – you still have work to do to finish it, but a lot of that's behind us, so I'm not anticipating huge margin degradation. But there's some, there's some. So it was a good quarter this quarter and going forward there's going to be a contraction of new orders that come but even those are going to have some pressure around [indiscernible] (00:38:19) and along with a few jobs that are not doing that well that are to come. So our IPS segment margins we anticipate to go down.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. And last question for me and I'll let someone else have a chance. Your cost management and sort of your cost actions, what are you exactly doing? Did you take any major across the board cuts? Or could you just help us understand a little bit more, not sure if there's anything quantified but at least talk through what you're doing to sort of soften or realign the business to the downturn overall, not just oil and gas but just your overall business?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

I would like to answer that question, [ph] Kent (00:39:09). Because I think it's worth noting that DXP is not a [ph] broker (00:39:20) company. I mean, we have the ability and always have had the ability to make money. I don't know what it looks like if sales were down 80%, now I certainly don't subscribe to that. But at some level of decline we're able to adjust and make money. We didn't make a big deal out of that because it's just part of our DNA to know how to do that. But you have you also need to do it instead of just across the board having people take a 10% pay cut or things like that, that's really unfair. What's fair is to look at the performance of each market and each location and each geography and determine whether we need to be staying the course with that one because it's in some areas that have growth markets like North Central has ag and food and beverage.

Well, we're going to – we're not whacking expenses there. But if you're in the Permian Basin and oil and gas is going down significantly, well then, we have to make adjustments. So we're doing all the normal things everybody else is doing from 401(k) and some things but looking at facility closures, looking at a lot of different things, but it's just part of our nature that we're trying to manage to a profit profile.

And so our people and then you have to tie that to the fact that we're a very incentive oriented company. So if people don't make money, they don't get a bonus and their bonus is normally two times their salary. So it's a significant amount of money that they sacrifice when profits go down. And so they're trying to maximize profits at all times. And in the system works, it's worked in 2008, it's worked in 2015 and 2016, and it's done in a way that's smart and insensitive to the performers versus the nonperformers.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. All right. Well thanks for taking the questions.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Joe, the only other thing I'd just add there, every one of these cycles is different and so what David is getting at is our approach has just always been very kind of calculated and intentional and we probably maybe sometimes don't emphasize it as much because we believe it as being the smart business person. That said, this cycle I think there's two big broad categories. There's the traditional, I'll call it, cost saving areas you can go after whether the reductions and different things and then there's, because of the stimulus package and what the US government offered, there are some of what I'll call cash deferrals in terms of what we see which have free cash flow implications are pretty significant.

One of them that we're taking advantage at DXP is the employer portion of Social Security tax. We've calculated that in terms of cash flow impact in a magnitude greater than \$5 million for DXP this year, and so we're going to be taking advantage of that. And so all these cycles are unique and different. Manage your business to profitability we believe is status quo thinking, but the thing I would point out that's really different in this cycle is probably that the US government provided some cash deferral items that we're able to take advantage of.

Additionally, there's been I think a trend towards some, I'll call it, facility and rent abatements across the United States given the magnitude of this pandemic. And so we're probably no different than a lot of businesses out there that rent and lease facilities. And so where we can take advantage of those, we're taking advantage of those and those will create some temporary cash flow deferrals that in fiscal year 2020 will benefit us once again. But eventually it catches up with you in the future, because you've got – more than likely you got to pay them back, so.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. Appreciate that. Thanks.

Operator: Your next question is from Blake Hirschman from Stephens. Please go ahead. Your line is open.

Blake Hirschman

Analyst, Stephens, Inc.

Q

Yeah. Good morning, guys. I hope you're healthy and well.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Hey, Blake.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Hey. Well, Blake.

Blake Hirschman

Analyst, Stephens, Inc.

Q

To start out I guess just kind of a big picture, one, do you think you guys are being impacted more by COVID-19 or by the drop in oil prices?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Well, I think they're all same. If we hadn't had COVID-19, I don't think oil prices would have dropped near as drastically as they did. But we had a – let's call it a \$2 million or \$3 million oversupply problem and then COVID-19 came along and created a huge demand problem. And so they kind of go hand-in-hand. So my own – my take on this and it's just my personal opinion is that when demand starts recovering, people start going back to work, they start driving, we start doing things more normal. That as demand picks up so will the price of oil. And what our customers are telling us is that they need the price of oil to be \$30 to \$35 to be able to make money. And so at that point we'll feel better about the fact that they're not going to go bankrupt that they're going to be able to pay their bills. And some will make it at that level because of their debt load, but assuming they're appropriately financed and have a balance sheet accordingly, there will be some recovery there.

So we see a pretty quick V-shaped recovery to the price of oil being \$30 to \$35 and we see that being positive. When you get there you still though have a supply problem. You still – we haven't really eliminated the supply problem with the exception that who knows how long Saudi and Russia will support a 9-million barrel a day and no cut and the United States is probably cutting non profitable wells. And so they're cutting back some. And then of course we're not drilling to any great extent, so we're not increasing production and hopefully is going down. So maybe some number of years to get all that supply and demand back in balance. And when we do we'll know it's here because price of oil will be \$60 or \$70. That's my opinion.

Blake Hirschman

Analyst, Stephens, Inc.

Q

Got it. That sounds good. And then if you look at the changes that you guys have made kind of cycle to cycle. Is there any way that you could try to frame out expected decremental margins at different top line declines like if sales are down 10% or if they're down 20% or I guess more than that how to think about the impact to the decrementals?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Hey, Blake this is Kent. You know....

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Are we talking gross margins or net or operating margins?

Blake Hirschman

Analyst, Stephens, Inc.

Q

I mean I'll take it however you want to approach it. But I was kind of referring to EBITDA or EBIT.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Okay that's good. Go ahead, Kent.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Well, I was actually thinking gross margins. That's the main word. To start so, it's a great question David, it was a great question because to get [indiscernible] (00:48:31) – yeah, yeah good thing we clarified. In the last cycle, it was between 100 basis points to 200 basis points ultimately in contraction in gross margins when we when kind of troughed if you will. So I think that's the potential. Once again I don't – I think there's a lot of things we're doing differently around margins. I also don't think we necessarily a 100% got back, if you know what I mean, Blake. And so I think that gives you some color and commentary there.

I think even EBITDA margin wise, David and I aren't iron in the same room, but we've made money through all the cycles, right? And we always make EBITDA. I think the last cycle we may have bottomed out for a quarter around 4% EBITDA margins as a trough. And so I wouldn't see us necessarily going there, but I just think just in terms of previous cycles to put them in context that's kind of where we've kind of troughed at because of our mindset around always making money. So...

Blake Hirschman

Analyst, Stephens, Inc.

Q

All right. That makes sense.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Well, Blake...

Blake Hirschman

Analyst, Stephens, Inc.

Q

Yeah.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Blake, I'll be more specific for you if you like.

Blake Hirschman

Analyst, Stephens, Inc.

Q

Sure.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

We're trying to – I mean to be – looking at April and the results we got in April. If we see Supply Chain Services down 10% and the Service Centers section down 10%, and IPS down 18% to 20% that's going to give us a number. And then we feel that what we're doing to right sizing different things in the company that we can get to – hang in there with sort of a 5% EBITDA margin. As we get leverage going up but we also get deleverage coming down. So...

Blake Hirschman

Analyst, Stephens, Inc.

Q

Yeah. That makes sense. All right. And then I guess it probably be a good time to ask for those the monthly sales trends throughout the quarter and then in the April if you have, Kent?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

No, absolutely I have them. And we don't give formal guidance, I must always remind the world of that. But I think what David's comments are saying is we have internal goals and so we work towards those goals. So in terms of the sales per business day, the January was \$4.3 million per day, February was \$4.6 million, March was \$5.2 million and April was \$4.2 million.

Blake Hirschman

Analyst, Stephens, Inc.

Q

Got it. All right. I'll turn it over. Thanks a lot guys.

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Yeah.

Operator: Your next question comes from Joe Mondillo of Sidoti. Please go ahead. Your line is open.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Hi guys. Just a couple follow-up questions. First off, the corporate cost line – well, I should first ask do you have any – were there any one-time cost items in the quarter itself that you would highlight?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Nothing of significance. I mean part of what you're getting at Joe is kind of what was in our corporate SG&A and some of those items you could construe as one-time. One of them would be and it's probably something we should emphasize, but we – when we filed our 10-K, we came off our material weakness and when you're coming off of material weakness, part of what you shoulder as a public company is you probably had increased audit and some other cost.

And so some of that cost is totally a 100% flowing through in our corporate SG&A in Q1 just reflecting a lot of that activity which occurred in 2019. So audit taxes and some top stock-comp expense were unusually high in Q1. The stock-comp expense was unusually high partially because we use stock as part of consideration in our Pumping Systems acquisition. And so that occurred in Q1 and so that was kind of up.

Additionally, legal expenses were high. Once again that reflects two major buckets. One, we had the natural or what I call normal [indiscernible] (00:53:30) cases and scenarios that we're always working through as a larger company and then we did have the acquisitions. And so you have some legal costs associated with that in Q1. And so, some of that should decrease as we go forward. But essentially that's partially what's driving that corporate SG&A component being up higher than normal.

Additionally, once again you have higher than normal items whether it's healthcare, insurance premiums, different things like that and costs that you shoulder in Q1. And so, we flow that through corporate because we don't

allocate those expenses. So once again some of that's seasonal, but then we had a few items which I just mentioned that were on top of that.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. So last year you averaged around \$12 million a quarter, would you anticipate that to be down just given some cost cuts or how do you think about that relative to the 1Q because 1Q is so high, I'm just trying to...

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

I mean, definitely we'll see it down. And so that's what I would say. I would expect it to be down in Q2 and kind of trend down as we work throughout the year. And so, it should decline as we kind of move throughout the year.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

Okay. Also, you mentioned – I believe David actually mentioned something, you were cutting something by 10% at the Service Center. I missed what you were talking about there, could you just repeat?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Okay. First of all I'm glad you asked that question because I'll recheck my math, Blake (sic) [Joe] (00:55:15) and everybody that really the 5% is still low, we're really more like 5.7% EBITDA margins that we think we can maintain. And I was talking about just in general, just a plus or minus 10% reduction in revenues and Supply Chain and in the Service Centers and a bigger reduction in our CapEx business of IPS.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

All right. And so going back to my question, I think in your prepared remarks you were talking about the oil and gas sector, you said you expect IPS and cost to align to that 30% decline and then you proceeded in the Service Center and you mentioned something that you're cutting something by 10%, was it inventory or was it cost? I missed what you were talking about there in your prepared remarks

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

I'm looking.

Joe L. Mondillo

Analyst, Sidoti & Co. LLC

Q

All right and then another item I should just mention. I was wondering if you could also repeat the end markets that you're actually either you describe them as doing well or actually growing. You mentioned a few that are actually doing better than others?

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

A

Right. So after I talked about the IPS segment showing 30% lower demand and again let me reiterate the fact that we have backlog that prop-up sales not for forever, but – so anyway I was talking about 30% being the go-forward

number. From that sentence, that next sentence I was talking about the Service Centers and a small part of – in the part of Supply Chain Services that are in the aftermarket service and repair and OEM as such, they have adjusted to a 10% reduction in demand as it relates to this industry.

When I talk about the markets, again this may – I wouldn't go buy a bunch of stock necessarily in each of these but for us to and what the results we're getting is I mentioned that gold mining, gold is up and so our friends in Alaska are doing really good with gold mining. The petrochemical industry that produces special polymers is doing well, bottled water, water and waste water, municipal, certain recreational manufacturing like bicycling and kayaks and things people can kind of do can isolate themselves, those things are good. Soap, food and beverage, agriculture, other chemical, medical, of course, petrochemical asphalt that used on the – for the government use in making roads and stuff are all doing well.

Joe L. Mondillo*Analyst, Sidoti & Co. LLC*

Q

Okay. Is there any way for you to define sort of how much that bucket makes up of the total company. I don't know if you have that sort of estimate in there.

David R. Little*Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.*

A

We do. I don't have it in front of me and Kent, I don't know if you do either. But in general, still pretty true to form is that oil and gas which is not all rig counts stuff. We're not a rogue [indiscernible] (00:59:11) company. We sell to upstream midstream and talk about the midstream still doing okay and downstream and how I think the downstream is going to bounce back pretty quick once people start driving again because refineries make gasoline. So, all the three of those though add up to about 50% of our DXP business. And then the other 50% is all these other markets, all these other general industries, all these other things, and I think that's lost in the equation sometimes when we're grouped with a peer group DNOW and MRC.

Joe L. Mondillo*Analyst, Sidoti & Co. LLC*

Q

Okay. All right. Well, good luck with everything and hope you stay safe and well. Thanks a lot.

David R. Little*Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.*

A

Thank you.

Operator: Your next question is from Blake Hirschman of Stephens. Please go ahead. Your line is open.

Blake Hirschman*Analyst, Stephens, Inc.*

Q

Yeah. Thanks. I just had a few more. I was wondering, how big has a safety related PP&E that kind of stuff? What percentage is that of your mix and how do you see any kind of benefit from what everyone else seems to be saying is a nice surge and the demand, that kind of stuff?

David R. Little*Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.*

A

Yeah. I knew someone might ask that question, so can I look that up. It's only about 1% of our business, so it's not a giant number and it's up but it's not three times x. But what happened with this to people like us that aren't quite as bigger players is maybe a Fastenal or an Amazon or somebody like that, as our suppliers kind of rationed us to what we normally sell. And so it wasn't – it was good but it wasn't – it didn't move the needle really.

Blake Hirschman

Analyst, Stephens, Inc.

Q

Yeah, yeah that makes sense. And then lastly, on the capital allocation front I'm just trying to get a sense for – I mean I expect that you guys will probably stay pretty defensive in the near term just with how uncertain everything is, but at what point would have the confidence to get more offensive and look to maybe try to pick off some deals on the cheap or [indiscernible] (01:02:07), I would expect would probably be a lower asking price than what you would have heard a few weeks or months ago?

Kent Nee Hung Yee

Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.

A

Yeah. So Blake on the first part of your question there, I'm glad you emphasized that. So on the defensive side, I don't know if people picked up on my comments but our debt at 3/31 was \$243 million and we're going to make it optional to \$1 million prepayment. As of today we're sitting on close to almost \$60 million worth of cash on our balance sheet. So we're going to do that from a defensive perspective and so after that we would have \$233 million or roughly or so of debt on the balance sheet. And so that's defensive.

You're 100% correct on your second question, when do we turn offensive and we totally are of that mindset. Going into this, we had seven to eight discussions going surrounding acquisitions. And so I think you heard it in both David and my comments that we believe there's going to be opportunities here and we want to be in a position to take advantage of those opportunities. We think that's the advantage of the flexibility of this capital structure and we can do both offensive and defensive moves and we will pivot as soon as we see clarity on when we know there's a bottom, you never want to catch a falling knife.

And then also when you have a good feel of kind of what the status quo will be going forward for the business, you're going to buy, and presuming you can get to an agreement on valuation. The way I put it is we're always fair buyers regardless of the market, but there would need to be adjustment based upon current results. So anyways we wholeheartedly are thinking that way and we're positioning ourselves to act in that fashion.

Blake Hirschman

Analyst, Stephens, Inc.

Q

All right. I appreciate the detail. That's it from me. Thanks a lot guys.

David R. Little

Chairman, President & Chief Executive Officer, DXP Enterprises, Inc.

Thank you, Blake.

Operator: There are no further questions at this time. This concludes today's conference call. Thank you for your participation. You may now disconnect.

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