



DXP Enterprises, Inc.

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Earnings Call

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Call Participants

EXECUTIVES

David R. Little

*Chairman of the Board, President
& CEO*

Kent Yee

*Senior VP, CFO, Secretary &
Director*

ANALYSTS

Cole Alexander Couzens

Stephens Inc., Research Division

Presentation

Operator

Good morning. My name is Julianne, and I will be your conference operator today. At this time, I would like to welcome everyone to DXP Enterprises 2022 First Quarter Earnings Conference Call. [Operator Instructions]

Kent Yee, Chief Financial Officer, you may begin your conference.

Kent Yee

Senior VP, CFO, Secretary & Director

Thank you, Julianne. This is Kent Yee, and welcome to DXP's Q1 2022 Conference Call to discuss our results for the first quarter ending March 31, 2022. Joining me today is our Chairman and CEO, David Little.

Before we get started, excuse me, I wanted 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 on-claim basis are contained in our SEC filings. However, 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, our CEO and Chairman, to provide his thoughts and a summary of our first quarter performance and financial results.

David R. Little

Chairman of the Board, President & CEO

Good morning, and thank you, Kent. Thanks to everyone for joining us today on our fiscal 2022 first quarter conference call.

First, let me say that following a partial recovery in 2021, we are off to a great start in 2022. I personally want to thank all our DXP stakeholders, in particular, all our DXPeople for their determination, hard work and grit as we turn the corner and momentum appears to be building in our business. With 25% organic sales growth, adjusting for the 4 acquisitions we did at the end of 2020 and 30% overall year-over-year sales growth in Q1, we are off to a great start this year. This is DXP's first quarter of meaningful organic growth in total sales and EBITDA, which is great to see. That said, as we get to the tail end of the COVID crisis, we are all facing new challenges that DXP is prepared to navigate. We are encouraged by the improvement in our results and remain focused on growing our business organically and inorganically in the fiscal year 2022.

Although much remains uncertain, including inflationary pressures, supply chain disruptions and constraints and the geopolitical impact of Russia invasion of Ukraine, I am proud that the DXPeople effectively support their customers in this hyped environment. This is a testament to the relentless drive we have made to center our strategy around customers and to remain customer-driven experts. I will begin today with some perspective on our first quarter and thoughts on the remainder of 2022. Kent will then take you through the key financial details after my remarks. And after his prepared comments, we will open up to Q&A.

Overall, we had a great first quarter that highlights good execution and a number of positive trends developing across DXP, including organic growth in most of our industrial markets, plus growth in new markets such as biofuels, carbon capture, air and water and wastewater. We also experienced inorganic growth by continued execution of our acquisition strategy to accelerate our end market

diversification efforts in compressed air and water and wastewater. We are seeing increases in oil and gas CapEx budgets. That said, we are building a more resilient, diversified business that can generate solid performance in more uncertain markets, and we believe you are starting to see evidence of these efforts in Q1.

Again, let me thank all our DXP stakeholders, in particular, all our DXPeople for their continued efforts and adaptability as we grow and evolve DXP into a more diversified and less cyclical business. DXP's broad-based industrial end markets which is 73% of our business today appears to be showing some deceleration in growth, but remains above economic contraction and show signs of consistent demand and activity. The ISM and PMI manufacturing indexes, which give us an indication of how DXP's broad industrial markets will perform moved from 57.6 reading in January to a 57.1 reading in March. This trend is slightly below average over the last 12 months of 59.3% and looks to be a positive indicator for the year should these trends continue, albeit we are at a lower level this year than we are last year. We are also excited to see momentum on this side of our business and look for this to maintain strength throughout the year. These end markets, including food and beverage, chemicals, biofuels, transportation, municipal, manufacturing, general industries should serve us well.

Oil and gas, which is the remaining 27% of DXP is showing signs of recovery, given the geopolitical circumstances and the overall relative strength in prices. A majority of our business that is oil and gas tends to lag in the rig count and is tied closer to actual production or increases in CapEx budgets. We experienced a significant pickup in organic sales activity in Q1, which reflects the increase in backlog, which began last year in Q3. The pickup is consistent with complementary around U.S. majors and smaller exploration and production companies, increasing CapEx budgets from 2021 by low-double digits. We regard the broader demand recovery, underlying trends improving across business as the quarter progressed and trends were the strongest in March, which are sales per day going from \$4.1 million per day in January to \$5.8 million per day in March. We believe this also reflects impacts from price increases from our suppliers. Please note this inflation is -- please note that inflation is normally good for distribution companies, assuming we can pass along supplier increases.

Total DXP sales for Q1 increased 9% sequentially, 30% year-over-year or \$319.4 million or an average of \$5 million per business day for the first quarter. Thank you to the 2,533 DXPeople for your hard work and dedication. We're excited to have Burlingame Engineers and Drydon Equipment join our DXP family. They each had a great first month with DXP, and they both increased our presence in water and wastewater industry. It is always my pleasure to share our performance and financial results on behalf of everyone's efforts.

DXPeople have continued to find ways to deliver financial results and position us well for our stakeholders in the face of extraordinary challenges. This is evident by our sequential growth, closing acquisitions and the overall teamwork of DXP. We continue to build our capabilities to provide a technical set of products and services in all our markets, which gives DXP very unique -- which makes DXP very unique in our industry and gives us more ways to help our customers win.

In terms of Q1 financial results, inventory pumping solutions led the way, followed by supply chain services and then Service Centers in terms of sales growth. In terms of the strength of the IPS backlog, our Q1 average IPS backlog compares to our 2017 average backlog numbers, and we are continuing to grow month-over-month. As we transition to growth, our main focus within IPS is maintaining -- is managing the demand level we have today, finding opportunities in other markets such as biofuels, food and beverage and water and wastewater and pricing appropriately given the supply chain dynamics and inflation.

Supply Chain Services, SCS is having a great year with increased organic growth due to increased activity with existing contracts and plus several new contracts. Procuring products and inflation will be SCS' challenge this year. And so far, they have done an excellent job of managing these 2 headwinds. Demand for SCS services is increasing because of the proven technology and efficiencies they perform for their industrial customers. SC, the Service Centers performed the best during the last few years through COVID as SCS keeps essential customers running with MRDP, which stands for maintenance, repair, operating and

production products and services necessary for the customer to stay in business. SCS bookings, backlog and revenues continue to grow at a steady pace.

DXP overall gross profit margins for the quarter were 29.7%, an 83 basis point improvement over Q4. This reflects strengths within IPS and Service Centers and strong gross margin performance from our recent acquisitions. A special thanks to our DXPeople who have stayed on top of supplier product increases and labor costs. Overall, DXP produced EBITDA of \$29.3 million and EBITDA as a percent of sales was 8.9%, which reflects the operating leverage we expect with significant organic sales growth.

Let me conclude my remarks by saying that I am encouraged with our continued sequential improvement in sales and profitability and firmly we believe that we are well positioned to continue this growth pattern in 2022. We have managed the business through uncertain times, successfully making acquisitions, producing strong free cash flow and continuing to invest in the business that will benefit our future growth. While U.S. unemployment levels are low, wages are increasing, inflation is the highest it has been in decades, we are seeing new stress on supply chains and commodity pricing and U.S. households are facing rising gas prices as well as higher prices for food and housing. In general, moderate inflation is good for DXP and rising interest rates have very little financial impact, and we do not see or feel a recession coming in 2022. That said, stag inflation and recessions can be bad and being in business since 1908, we have lived through some really tough times, and we all hope that our Federal Reserve gets this right in balancing of soft landing.

The ongoing complexity and the economic outlook is certainly something we will keep our eyes on, but whatever the future holds, I believe DXP is well positioned. We continue to make progress on our growth strategy and our commitment to customers is stronger than ever. We are driving growth and improvements at DXP, and we look forward to a successful 2022.

With that, I will now turn it back over to Kent to review the financials in more detail.

Kent Yee

Senior VP, CFO, Secretary & Director

Thank you, David, and thank you to everyone for joining us for our review of our first quarter 2022 financial results.

Q1 financial performance reflects our fourth quarter of sequential sales increases during this COVID cycle and the subsequent and interrelated challenges, including inflation, supply chain constraints and a war with global ramifications. Despite these challenges, DXP continues to successfully navigate through the market and has been able to execute and create value for all our stakeholders. DXP's first quarter financial results were great to see and reflect a combination of business actions we have undertaken.

More specifically, Q1 takeaways are as follows: strong organic sales growth and contribution from acquisitions; meaningful organic sales increase within IPS along with another quarter increase in the IPS backlog; significant operating leverage, leading to improved adjusted EBITDA margins and continued share repurchases.

Total sales for the first quarter increased 9% sequentially to [indiscernible] DXP for less than a year contributed \$13.1 million in sales during the quarter. We are excited to have our 2 most recent acquisitions, as David mentioned, Drydon Equipment and Burlingame Engineers, who contributed in Q1 as a part of the DXP family. Subsequent to Q1, we also added Cisco Air Systems, and we look forward to their contribution in Q2 and the further margin enhancement and product and market diversification that they bring.

Average daily sales for the first quarter were \$5 million per day versus \$4.8 million per day in Q4 2021. Adjusting for acquisitions, average daily sales were \$4.8 million per day for the first quarter. That said, average daily sales trending during the quarter ramped meaningfully from \$4.1 million per day in January to \$5.8 million per day in March. In terms of our business segments, Innovative Pumping Solutions grew 128.3% year-over-year. Excluding acquisitions, IPS grew 89.1% or sales increased \$20.7 million. This was followed by Supply Chain Services growing 32.2% year-over-year and then Service Centers growing 17.4% year-over-year. Excluding acquisition sales within Service Centers, sales grew 36%. In terms of

our Service Centers, regions within our Service Center business segment, which experienced sales growth year-over-year, this includes Ohio River Valley, South Atlantic, Southwest and the South Rockies. Key end markets driving the sales performance include food and beverage, mining, municipal, air, transportation and specialty chemicals.

Supply Chain Services performance reflects an increase in existing contracts and an uptick in activity with COVID closer to fully subsiding. Additionally, SCS is onboarding some new contracts that should continue to impact the top line as we move through 2022. In terms of Innovative Pumping Solutions, we continue to experience increases in the backlog, which matches the market commentary that CapEx budgets will have increases in 2022 versus 2021. As David mentioned, our Q1 average backlog at this point is flat to the 2017 average backlog and down 19% from the 2015 average backlog, but is up 39% compared to the 2016 monthly average backlog. The conclusion here is that we are now trending meaningfully above 2016 levels, and we are flat to 2017 sales levels based upon where our backlog stands today. We are transitioning to a strong organic growth within IPS and look to find opportunities in other markets versus our traditional oil and gas, but fully expect oil and gas to continue to contribute meaningfully.

Turning to our gross margins. DXP's total gross margins were 29.7%, a 54 basis point improvement over 2021. Drivers of the improvement include organic increases driven by inflation and acquisitions, which were at an average gross margin of 35%. Organic gross margins improved 53 basis points year-over-year.

In terms of operating income, combined, all 3 business segments increased 168 basis points in year-over-year business segment operating income margins or \$13 million versus 2021. This was driven by an improvement in organic operating income margins across all 3 segments, given the pickup in sales. Total DXP operating income increased 421 basis points versus 2021 to \$21.5 million. Service Centers improved operating income margins 62 basis points to \$27.4 million. Supply Chain Services operating income margins increased 199 basis points to \$4 million. Innovative Pumping Solutions operating income margins increased 924 basis points or \$6.1 million compared to 2021, which is notable once again, given the organic improvement of 802 basis points in operating income margins.

Our SG&A for the quarter increased \$7.9 million from 2021. The increase reflects the payout of year-end bonuses associated with 2021, normal seasonal payroll taxes and first of the year items as well as continued audit and legal-related expenses. That said, during a period of normally high seasonal SG&A costs, DXP was able to manage more efficiently and increase margins.

Turning to EBITDA. Q1 2022 adjusted EBITDA was \$28.3 million. Adjusted EBITDA margins were 8.9%. Year-over-year EBITDA margins increased 317 basis points or \$14.3 million. This reflects the fixed cost SG&A leverage we experienced as we grow sales. This translated into 3.4x operating leverage.

In terms of EPS. Our net income for Q1 was \$12.6 million. Our earnings per diluted share for Q1 2022 was \$0.65 per share versus \$0.02 per share last year.

Turning now to the balance sheet and cash flow. In terms of working capital, our working capital increased \$32.2 million from December 31 to \$218.4 million. As a percentage of last 12-month sales, this amounted to 18.4%. This primarily reflects an \$11 million increase in inventory as we continue to manage supply chain shortages and lead times and a \$10 million increase in accounts receivable with \$4.2 million of the increase associated with our recent acquisitions. We are still at a point where we are in line with our historical averages in terms of working capital as a percentage of sales or in the range in terms of investing in working capital, but we expect this to increase as the business grows.

In terms of cash, we had \$36.6 million in cash on the balance sheet at March 31. This is a decrease of \$12.4 million compared to December 31, 2021. The reduction was a result of our acquisition activity, share repurchases and working capital uses primarily driven by the \$11 million increase in inventory, as mentioned just a second ago between December and March.

In terms of CapEx. CapEx in the first quarter was \$740,000 or a decrease of \$2.3 million compared to Q4 of 2021. As a reminder, CapEx reflects our ability to control capital investment and the minimal maintenance needs of our business. While we do expect CapEx to pick up in 2022, our Q1 levels were very minimal. Moving into 2022, we will continue to invest in the business as we move towards growth.

Turning to free cash flow. Free cash flow for the quarter was \$1.9 million. 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 the fourth quarter. However, the last 2 years, including Q1, we have created free cash flow as we have moved through the cycles. That said, as we increase project activities in our base business, we historically have experienced high uses of cash during the first half of the year versus the second half, which we are starting to see. Return on invested capital, or ROIC, at the end of the first quarter was 24% and should continue to improve as we drive margins and operating leverage and improve our run rate EBITDA. At March 31, our fixed charge coverage ratio was 2.5:1, and our secured leverage ratio was 3.2:1. Total debt outstanding at March 31 was \$325.9 million.

In terms of liquidity, as of the quarter, we remained undrawn on our ABL. And subsequent to the quarter, we did draw on our ABL by \$11 million to complete the acquisition of Cisco Air Systems. That said, we are turning to the point in the year where we typically increase free cash flow anticipated paying down current borrowings and funding future acquisitions.

In terms of acquisitions, subsequent to the quarter, we closed on the acquisition of Cisco Air Systems. We are excited to have the Cisco team with DXP, and we look forward to them reporting with us starting in Q2. Cisco provides DXP with a leading platform within compressed air, while continuing to diversify, excuse me, DXP's end markets with a primary focus on food and beverage and transportation-related end markets. DXP's pipeline continues to grow, and we anticipate closing more acquisitions as we move through 2022. Our acquisition strategy continues to create significant value for DXP, enhancing end markets, margins and DXP's cash flow profile. More importantly, the talent at the companies joining DXP is very high and brings expertise and valuable experience to our growing company.

The last item I want to briefly update everyone on -- is on our auditor transition. This is the first quarter with PricewaterhouseCoopers as our auditor and the transition is going well, and we were able to quickly get ourselves in a position to release earnings, and we appreciate all the hard work. That said, we will anticipate that we will file past the normal deadline as we close out some additional procedures and follow-up items with PwC related to our first quarter with them. We look forward to working together through the remainder of the year.

And I will now turn the call over for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Cole Couzens from Stephens.

Cole Alexander Couzens

Stephens Inc., Research Division

First question on sales. Now that we're most of the way through the second quarter here, just what kind of commentary could you offer on daily -- on how daily sales have progressed, whether that's month by month or quarter to-date, year-to-date? Any context would be helpful.

Kent Yee

Senior VP, CFO, Secretary & Director

Yes. Cole, I'll take that one and just once again give the sales per business day trends going from January, and I'll pull it through kind of April, if you will. As we mentioned, January, \$4.1 million per day, February \$4.9 million, March \$5.8 million, and then April is at \$5.4 million. So once again, a meaningful ramp kind of as we move through the quarter and then a strong kind of April, if you will, at this point. And so we look forward to kind of seeing how Q2 shapes up.

Cole Alexander Couzens

Stephens Inc., Research Division

Got it. That's helpful. And second, gross margin was strong in the quarter and assuming inflation continues, what is the potential for gross margins throughout 2022? And as we move into this back half, are there any factors that you point to that would drive OpEx higher or lower as we move throughout the year?

Kent Yee

Senior VP, CFO, Secretary & Director

So your first question, Cole, there around gross margins, a couple of comments. A lot of our recent acquisitions have strong gross margins, meaning north of 30%. So that's kind of what's contributed there. Yes, there's been an inflation and we benefit on the base business, and I think a lot of the margin enhancement we're seeing on a more sustainable go-forward basis as a result of the acquisitions. And so we feel good about kind of their contribution, if you will.

Your next question just around kind of operating leverage in the business, typical in distribution you get that on the upswing where you can grow kind of 5%, 10% and 2 or 3x or more -- you can get that operating leverage. Once again, in this quarter, we got 3.4x operating leverage, meaning dividing your EBITDA growth and sales growth, if you will. And so we expect that as we kind of move through the cycle, and I don't know if David has any thoughts, but that's what we expect to see as long as we've got some meaningful sales growth.

David R. Little

Chairman of the Board, President & CEO

So Cole, I would add on the gross profit side of the equation that the challenge is to pass on supplier and labor costs going up. They are going up. They're going up pretty significantly with inflation and stuff. So the challenge is to pass those on, and we're normally pretty good at that. And I don't see any reason why we wouldn't continue to be good at it. We were good at it in the first quarter here. And I would just say from a customer point of view, they're expecting it. So it's not -- there's not a lot of pushback.

Cole Alexander Couzens

Stephens Inc., Research Division

Awesome. Great color there. Just one last quick one from me on M&A. First off, congrats on the Cisco acquisition. And on that point, outside of the attractive margins and end market diversification, is there any other rationale that you'd point out that went into the decision? And -- or any details related to price if you're able to go there would be helpful.

David R. Little

Chairman of the Board, President & CEO

So I think that we've -- we earlier back in 2020, bought 2 companies, one's Total Equipment and the other one's APO. And both of those businesses had air -- compressed air components to it, they were both in the rotating equipment business, but they were also in pumps and stuff, but they also had a compressed air component. And in the process of digesting those 2 companies, we learned a lot about compressed air, and it can be a very clean, nice, environmentally friendly type business that doesn't relate to oil and gas or anything. And so -- and very profitable. So we've targeted compressed air, and you should see us purchasing more companies in the compressed air business, and we like that. We equally like water and wastewater. And so we're trying to buy those. And so those are kind of the 2 areas -- main areas that we're targeting for acquisitions is to build up a pretty national presence on those 2 marketplaces.

Kent Yee

Senior VP, CFO, Secretary & Director

Cole, your other question was related, I guess, you used the word pricing. So I'm going to take that as multiples out in the marketplace. It's a pretty robust M&A market in general out there. I guess from our capital allocation standpoint, we're always balancing it in today's environment and kind of where we've built our capital allocation model is, hey, we look at yes, where the multiples are in the market, but also we have a share repurchase program, and we have some other things out there. And kind of with, I'll call it, the suppressed earnings that are starting to release with DXP, share repurchases are on the table. A lot of things are on the table for DXP. And so we're always balancing that, but we won't -- we're pretty disciplined, I guess, is the point around kind of the price we're going to pay for acquisitions in today's market given the relative valuation of DXP as well.

David R. Little

Chairman of the Board, President & CEO

And really one more thought is both of these companies or most of -- all of them that we've been buying of late have had 5-year track records of growing their business through each year, COVID, no COVID, oil and gas being ugly, et cetera. And so that was part of our diversification part of our strategy around having businesses that are less cyclical.

Operator

[Operator Instructions]

David R. Little

Chairman of the Board, President & CEO

And Cole, if you have other questions, feel free to ask us.

Operator

[Operator Instructions] We have no further questions in queue. I'd like to turn the call back over to David Little for any closing remarks.

David R. Little

Chairman of the Board, President & CEO

Yes. Thank you. Just thanks, everybody, for who are listening in today. We have just one analyst and we thank Cole for your participation.

Just in closing, I think it's an interesting story of DXP looking at ESG, sustainability, et cetera, and all those things are important. And so we're on top of that. The main focus to me is that our people are

looking at different ways of helping our customer, be environmentally friendly from biofuels to carbon capture, et cetera. And so that's pretty exciting. But in addition to that, as we just mentioned, these last acquisitions are targeted around some markets that are less cyclical. We've been in the water and wastewater business, but we're now pushing it even more and so -- and trying to grow it into a bigger piece of what DXP does. And in compressed air, likewise, we've been in that business, but it hasn't been a real big focus of ours. And so both of those things are making DXP different than it's been in the past, and I think it's a neat story, and I thank everybody for their efforts, all our stakeholders for helping us move in a real positive direction. So thank you, and you all have a great day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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