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DXP Enterprises, Inc. (DXPE)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the DXP Enterprises Inc. Third Quarter Conference Call. As a reminder today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Mac McConnell, Senior Vice President of Finance and Chief Financial Officer. Please go ahead, sir.

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.

Thank you. This is Mac McConnell, CFO of DXP. Good afternoon and thank you for joining us. Welcome to DXP's third quarter results conference call. David Little, our CEO, will also speak to you and answer your questions.

Before we begin, I want to remind you that today's discussion will include forward-looking statements. We want to caution you that such statements are predictions and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings, but DXP assumes no obligation to update that information.

I will begin with a summary of DXP's third quarter 2016 results. David Little will share his thoughts regarding the quarter's results, then we will open the call to answer questions.

Sales for the third quarter of 2016 decreased $73.1 million or 24.1% to $230 million from $303.1 million for the third quarter of 2015. After excluding July and August 2016 sales of $3 million for Cortech, acquired on September 1, 2015, sales for the third quarter decreased $76 million or 25.1% on a same-store sales basis. This decrease was primarily the result of declines in sales to customers engaged in the upstream and midstream oil and gas markets.

Sales for our Service Centers segment in the third quarter of 2016 decreased $47.3 million or 23.7% to $152 million compared to $199.3 million of sales for the third quarter of 2015. After excluding July and August 2016 Service Centers segment sales of $3 million from Cortech, Service Centers segment sales for the third quarter of 2016 decreased $50.3 million or 25.2% from the third quarter of 2015 on a same-store sales basis. This sales decrease, again, is primarily a result of decreased sales of bearings, pumps, metal working products and safety services to customers engaged in the upstream and midstream oil and gas markets or manufacturing equipment for the upstream and midstream oil and gas markets.

Sales of Innovative Pumping Solutions products decreased $21.6 million or 35.2% to $39.8 million compared to $61.5 million for the 2015 third quarter. This decrease was primarily the result of the decline in capital spending by oil and gas producers in related businesses. Sales for Supply Chain Services decreased $4.1 million or 9.8% to $38.2 million compared to $42.3 million for the 2015 third quarter. The decrease in sales is primarily related to decreased sales to customers in oil field services, oil field equipment manufacturing and trucking industries.

When compared to the second quarter of 2016, sales for the third quarter of 2016 decreased $26.2 million or 10.2%. This decrease was primarily the result of decreased sales to customers engaged in the upstream and midstream oil and gas and related industries. Third quarter 2016 sales by our Service Centers segment decreased $9.8 million or 6.1% compared to the second quarter of 2016. Third quarter 2016 sales for Supply Chain Services decreased $1.9 million or 4.6% compared to the second quarter of 2016. Third quarter of 2016 sales of Innovative Pumping Solutions products decreased $14.5 million or 26.7% compared to the second quarter of 2016.

Gross profit for the third quarter of 2016 decreased 25.5% from the third quarter of 2015 compared to the 24.1% decrease in sales. Gross profit as a percentage of sales decreased to 27.7% in the third quarter of 2016 compared to 28.3% for the third quarter of 2015. This decrease is the net of approximate 435 basis point decrease in the gross profit percentage in our IPS segment, a 140 basis point increased in the gross profit percentage in our Supply Chain segment, and a 110 basis point increase in the gross profit percentage in our Service Centers segment. The decrease in the gross participant percentage for the IPS segment is primarily the result of competitive pressures resulting in lower margin jobs and lower sales resulting in more unabsorbed manufacturing and fabrication overhead in the third quarter of 2016 compared to the third quarter of 2015. The gross profit percentage for the Supply Chain segment increased as a result of decreased sales of lower margin products to oil field service and trucking-related customers.

Gross profit as a percentage of sales for the third quarter of 2016 decreased to 27.7% from 27.9% for the second quarter of 2016. This decrease is primarily the net of a 75 basis point increase in the gross profit percentage in our Service Centers segment, an approximate 480 basis point decrease in the gross profit percentage in our IPS segment, and an approximate 55 basis point increase in the gross profit percentage in our Supply Chain segment. The gross profit percentage for the Service Centers segment increased because of improved gross profit margin percentages for rotating equipment, bearing and safety product groups. The gross profit percentage for the IPS segment decreased because of competitive pressures resulting in lower margin jobs and lower sales resulting in more unabsorbed manufacturing and fabrication overhead in the third quarter compared to the second quarter.

SG&A for the third quarter of 2016 decreased $16.2 million or 21.6% from the third quarter of 2015. After excluding third quarter expenses from Cortech of $1.1 million, SG&A decreased by $17.3 million, or 23.1%, on a same-store sales basis. The majority of the decline in same-store sales SG&A is the result of a $12.6 million decrease in payroll, incentive compensation, payroll taxes and 401(k) matching, due primarily to the 2015 and 2016 head count and salary reductions. Additionally, amortization expense declined $900,000 and meals, travel, vehicle and legal expenses declined $2.7 million on a same-store sales basis.

As a percentage of sales, SG&A increased to 25.6% for the third quarter of 2016 from 24.8% for the third quarter of 2015 as a result of sales decreasing 24.1%, while SG&A declined 21.6%. SG&A for the third quarter of 2016 decreased $3.9 million, or 6.2% from the second quarter of 2016. The majority of the decline in SG&A is the result of a $3.5 million decrease in payroll, incentive compensation, payroll taxes and 401(k) matching due primarily to 2016 head count reductions. Additionally training, meals, travel and vehicle expenses declined. As a percentage of sales, SG&A increased to 25.6% from 24.5% for the second quarter of 2016 as the result of sales decreasing 10.2% while SG&A declined by 6.2%.

Corporate SG&A for the third quarter of 2016 decreased $2.6 million, or 21.6%, from the third quarter of 2015, and increased $500,000 or 5.9% from the second quarter of 2016. The year-over-year decrease was primarily the result of reduced compensation-related expenses and legal expenses. The increase in corporate expense for the third quarter of 2016 compared to the second quarter of 2016 is the result of a $700,000 increase in health claims.

Interest expense for the third quarter of 2016 increased $1.7 million or 65% from the third quarter of 2015 and $400,000 or 9.8% from the second quarter of 2016. These increases are primarily due to increased interest rates under our credit facility.

Total long-term debt at September 20, 2016 was $319,287,000. This is a decrease of approximately $28.4 million during the third quarter of 2016. The decrease in debt during the quarter is primarily the result of third quarter free cash flow of $23.4 million plus $6.2 million of proceeds from the sale of 238,858 shares in September. DXPE continues to generate free cash flow and pay down debt. Our bank leverage ratio was 6.14 to 1 at September 30, 2016. At September 30, our borrowings under the credit facility were at a rate of approximately 5.65%.

After September 30 DXPE used a portion of the $46.2 million of net proceeds from the sale of 2,484,000 shares of common stock completed on October 31, 2016 and the $31 million of net proceeds from the sale of Vertex completed on October 3, 2016 to prepay the $30 million mandatory payment due by December 31, 2016 and the $25 million mandatory payment due March 31. Additionally DXPE prepaid the $12.5 million amortization payment due on December 31, 2016 and prepaid $12 million of the $15.6 million amortization payment due on March 31, 2016.

As of this morning, our debt balance had decreased to approximately $236.3 million, a decrease of approximately $83 million from the September 30 balance. Capital expenditures were approximately $900,000 for the quarter. Cash on the balance sheet at September 30, 2016, was $3,429,000. At September 30, 2016, the balance of accounts receivable was $152,952,000 and the balance of inventory was $98,189,000.

Now I would like to turn the call over to David Little.

David R. Little

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

Thanks, Mac, and thanks to everyone on the conference call today. Let me begin by reviewing some of the key headlines from the third quarter and subsequent events which we will cover in greater detail as the call continues, and I am sure we will also cover when we have opened questions. Before we do that, however, I want to thank all our DX people for their hard work and perseverance during the third quarter of 2016. While uncertainty continues with respect to timing, pace, trajectory around oil and gas and industrial markets, our people have worked hard and remain focused on winning business, serving customers, working with our supplier partners, and fighting together as a team.

With respect to our results, we are pleased with our free cash flow production as we generated over $23 million in the third quarter, which has allowed us to continue to pay down our debt. As a review, historically our free cash flow has a seasonality, low in Q1 and improves during the year. In Q1, we had usage of $9.4 million driven by unexpected decline in business and working capital working against us, and in Q2 we produced $17.7 million of free cash flow, with year-to-date, we have produced $31.6 million in free cash flow and look to maintain similar performance for the rest of the year.

On August the 24th we filed a shelf registration whereby DXP registered shares of common stock via an ATM, or what is referred to as [ph] a At-The-Marketing (14:10) offer. In September and December, DXP issued shares under the ATM, which resulted in net proceeds of approximately $6 million. Subsequent to the quarter close, we sold Vertex, a master distributor of fasteners, which was a non-core business. This made complete sense after a strategic review and the desire to maintain our focus on DXP's core products and offering. The transaction provided DXP with approximately $31 million in net proceeds.

On October the 20th, we announced a public offering of stock which closed on October 25 and resulted in net proceeds of $46.2 million.

Free cash flow production, combined with proceeds from the sale of Vertex and issuance of stock has allowed us to pay down debt by over $77 million since Q2 and as of December – at November 10th with an approximate debt balance of $235 million, pay down over $100 million. [ph] These actions are in an (15:25) effort to begin to work in pivoting towards a more appropriate capital structure and position DXP for the next up cycle.

With regard to market and DXP's specifically challenges this quarter, we continued to experience challenging macro conditions. Customers have remained cautious and deliberate in their investment and spending decisions. Reflecting this environment, project delays, rolling maintenance deferrals, extended timelines from both order placement and delivery acceptance have become norms.

We were particularly surprised in July with the slow pace of business, but we believe this was attributed to the timing of the holidays and temporary facility shutdowns. August and September were more in line with averages year-to-date monthly performance but did not make up for the July aberration.

Total DXP revenue of $230 million for the third quarter was a 10.2% decrease sequentially and a 24.1% decline year over year. Organic sales decreased 25.1% with the Cortech acquisition positively contributing $2.9 million in sales for the quarter. This reflects monthly sales across all DXP business segments during the month of July. Specifically, sales for July were $68 million versus $79 million and $83 million respectively for August and September.

Service Centers sales were $152 million or sequentially declined 6.1%. Innovative Pumping Solutions sales were $39.8 million and sequentially declined 26.7%. And Supply Chain Services sales were $38.2 million as a sequential decline of 4.6%. Service Centers sales decline is primarily driven by declines in our OEM and Bearing and Power Transmission product division. Service Centers' operating income increased by 0.9% sequentially to $13.3 million from the second quarter. This was primarily driven by our efforts to manage costs, which has had a positive impact on the segment's bottom line.

Innovative Pumping Solutions' sales decrease was primarily driven by continued softness in our API business and more engineered modular process systems, which we call IFS. Our order intake for this year has continued to remain flat with our September backlog, declining very slightly on IPS. A majority of the customers continue to tightly manage budgets, limit project opportunities, and those that are available are competitive, which continued to provide margin pressure.

DXP Supply Chain Services saw the bottom line increase year-over-year sequentially; was slightly down in the third quarter, while the top-line decreased sequentially from the second quarter. This is mainly due to facility shutdowns during July, but our margins remain strong and unmatched within the integrated supply business. Specifically, we continue to increase our product scope with more value-added solutions for our customers and continue to push operational excellence, applying technology in order to drive cost out of the supply chain.

In terms of gross profit, DXP's gross profit margins declined 21 basis points sequentially and decreased 54 basis points versus the same period in 2015. The third quarter decline in gross margins was driven by a 478 basis point sequential decline within our Innovative Pumping Solutions segment. That said, Service Centers and Supply Chain Services gross margins increased 75 basis points and 54 basis points respectively from the second quarter of 2016.

SG&A for the third quarter declined $16.2 million or 21.6% from the third quarter of 2015, and $3.9 million or 6.2% from the second quarter of 2016. The decline in SG&A is the continued result of actions we've taken during the first quarter and reflect our efforts to optimize the business. We continue to benefit from a decrease in payroll with incentive compensation and other expenses moving alongside with head count and salary reductions.

DXP produced EBITDA of $12.8 million for the third quarter versus $16.3 million for the second quarter. EBITDA as a percent of sales was 5.6% versus 6.4% for the second quarter in 2016.

Earnings per diluted share for the third quarter was $0.02 per share compared to $0.34 per share in Q2, and a negative $3.64 per share in Q3 of 2015, which included impairment expense and the B27 working capital expense adjustment. While we do not make a habit of providing quarter or full-year guidance, our view regarding the fourth quarter is cautious as outlined in our previous pre-release due to the less billing days compared to the third and second quarters, as well as the upcoming holiday season.

Going forward, we continue to remain encouraged with the moderation we have experienced with a decline in market conditions, and occasionally we see early signs of breaches. It is important to note and remind ourselves that we have successfully navigated previous cycles and are leveraging this experience as we manage our business through the current market environment. Further, I have never been more confident that our current strategic direction and ongoing cost reduction initiatives will position DXP competitively for the next up cycle.

Our strategy has continued to evolve and develop as we have built out our rotating equipment footprint and capabilities, but our goals have remained constant and we will achieve them. Balanced growth that includes organic initiatives, sales alignment, complementary acquisitions will allow us to continue to double our business during the next up cycle and provide unmatched capabilities that focus on serving our customers.

DX people continue to work hard, remain committed to our vision and mission of providing the highest quality of customer service through our expertise of products we distribute and technical services we perform with a keen sense of individual pride and DXP spirit. DXP people, thank you for your commitment to be the best for our industrial customer needs.

Despite the headwinds on our end markets, constantly changing dynamics, and our primary efforts remaining on structurally improving our customer, controlling our cost, and positioning DXP for profitable growth and increasing shareholder and stakeholder value creation in the future.

We are positioning DXP for the eventual improvement in our end markets, which is evidenced by our recent actions to begin to position our capital structure for the future. We believe we are moving along the bottom and the turn is coming.

So with that, we are now open for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Matt Duncan with Stephens, Inc.

Matt Duncan
Analyst, Stephens, Inc.

Q

Hey, good afternoon, guys.

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

A

Good afternoon, Matt.

Matt Duncan
Analyst, Stephens, Inc.

Q

Mac, can you start maybe just by walking through the monthly sales trend for the quarter? I know you guys said July was pretty weak, and David I think gave totaled sales per month, but maybe if we could get sales per selling day by month through the quarter and then here into October, and even November if maybe you have it.

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.

A

Okay. Sure, Matt. July had 20 business days, and the sales per day, these – all these numbers include Vertex for the third quarter. So sales per day including Vertex in July were $3.392 million, August was $3.438 million. September was $3.778 million. The sales per day for Vertex during the quarter averaged $109,000. So if you subtracted Vertex, the sales per day during the third quarter would be $3.669 million per day. October sales – oh, what did I just say – I gave you the September – well, I was trying to give you Q3. The Q3 average sales per day were $3.539 million and if you subtract $109,000 for Vertex, you'd have sales per day without Vertex of $3.430 million.

October sales, obviously excluding Vertex, were $3.481 million, up $51,000 per day or approximately 1.5%. And sales per day in November appear to be up a little, you know, 2% from what they were in October.

Matt Duncan
Analyst, Stephens, Inc.

Q

Okay. That's helpful. So David, with all those numbers in mind, do you feel like you are starting to see demand increase anywhere within your energy customer base? As rig counts going up and activity levels have been a little bit better, is that showing up in your business anywhere at this point?

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

We're – yeah, the part of the business that is certainly the drilling, which we'll call upstream – we're not drillers – but the upstream piece has components that we participate in. Safety Services is one of those components, and we see that division doing better. We saw profitability from them and – even in Canada, and so – and sales are going up. We saw – we see – we have integrated supply agreements with Halliburton to complete wells, and so we're hearing and seeing activity increase there.

Some of our OEM customers that are – have equipment that are on the well site, we're really not seeing a lot of increase there yet. We're seeing some through metal working and the – on the pipe, the pipes that are being used and stuff. So – and we're seeing some activity there. But it's – anyway, all that's not tremendous.

We're seeing new products that we have in the midstream market that are catching hold, and so we feel good about that. They only thing, the big midstream pipeline stuff that we've commented on that – where our API 610 pumps go has been soft throughout the year. But there is a lot of new projects and a lot of stuff that's on the drawing board, so we're not discouraged by that. And I think that's about it.

Matt Duncan
Analyst, Stephens, Inc.
Q

Okay. That helps. So then just helping us sort of bridge the gap over the fourth quarter, Mac, can you tell us how much revenue and EBITDA you had from Vertex in the 3Q, so we kind of know what the baseline is to start from here?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Revenues were $7.1 million and EBITDA was $1.1 million.

Matt Duncan
Analyst, Stephens, Inc.
Q

Okay. So if I'm doing my math right, then it's [ph] $2.23 million (29:06) in revenue backing out Vertex and about [ph] $11.7 million (29:12) in EBITDA. And then, David, you've commented you are a little cautious into the fourth quarter, and I suspect that that really is just the unknown of how your business is going to be impacted by the holidays. I know that's always difficult to pin down. So I guess the way we should translate that is that the [ph] $2.23 million and $11.7 million (29:31) is probably kind of the high end of what maybe you could do in the fourth quarter. And realistically, you are down a little bit from there. But I know you are still taking actions on the cost side. So am I thinking about that the right way?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Well, those are necessarily my numbers. I think when we look at the fourth quarter, we have had exceptions where we've had tremendous fourth quarters, but that's when the oil and gas business was booming, and so people were trying to spend their money and get ready for next year. That – we don't really see that happening. We see business more just normal.

Matt Duncan
Analyst, Stephens, Inc.
Q

Right.

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

So we don't see a big uptick in the fourth quarter...

Matt Duncan
Analyst, Stephens, Inc.
Q

Right. But down [ph] maybe (30:17) from those numbers then?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Yeah. And then you have Supply Chain Services, et cetera, we have a lot of people that will close a week at a time for the holidays, et cetera. So we're just being cautious. We don't – I think our October and things are trending fine, but we think that the fourth quarter has the ability to be soft, and so we wanted to kind of paint that picture, I guess.

Matt Duncan
Analyst, Stephens, Inc.
Q

Okay. And that makes sense. And so the last thing then on the cost side, was there any severance included in the SG&A number this quarter? And are you guys still operating the business, as when a position opens up you're not filling it so that there's still probably some sequential decline. You obviously got to take out the SG&A associated with Vertex, but in addition to that there would still be some decline in the business since you guys manage the cost side. Is that the right way to look at it?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

There was no severance of significance during the third quarter.

Matt Duncan
Analyst, Stephens, Inc.
Q

Okay. And then just the sequential progression and SG&A, Mac?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

There's obviously some; we're still looking at every opportunity, but clearly when – a four-person location, somebody quits, we're typically replacing them now. I mean they are probably the examples where we're not.

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

We're – I mean ,I think from a philosophical point of view we're thinking that 2017 is going to be better, and so we're trying to hold on to our seasoned employees that are going to help us grow this thing forward. And so, we don't really have any kind of deliberate cost cutting initiative right now.

Matt Duncan
Analyst, Stephens, Inc.

Q

Okay. All right. That helps. I'll hop back in queue. Thanks, guys.

Operator: We'll now go to Ryan Merkel with William Blair.

Ryan J. Merkel
Analyst, William Blair & Co. LLC

Q

Great. Thanks. So first question I had is, how successful have you been replacing the Goulds with alternatives and maybe just discuss some of the challenges that you face there?

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

A

So, the challenges are that Goulds is a 100-year-plus brand and there's – mostly the downstream customers which they also sell direct to, have – they have authorized manufacturer list, they approve vendors that they do business with, and so the challenges are, we're trying to get on those lists and compete with Goulds on a direct basis. The lesser challenge is that DXP has been selling Goulds for a long, long time and now we come to them and say, hey, we want you to buy our PumpWorks product, it's a better product, it's made in America and we don't have double markup on the pricing and so the price is good. And so, when we measure that, we look at it in this way; last year we were a Goulds distributor, we sold 2,000 ANSI pumps and this year we'll sell over 1,700 ANSI pumps of PumpWorks. And so, that's a pretty successful conversion rate. We're actually tracking on a monthly basis now to do over the 2,000. So we really feel about – feel very, very good about our success. Incrementally though, 2,000 pumps is more than 1,700 so there's been a kind of a gap there that we have felt. But we feel like the conversion ratio and where we're headed and where we're going is outstanding.

Ryan J. Merkel
Analyst, William Blair & Co. LLC

Q

Okay. Well, that's encouraging news. Switching to B27, can you just comment on how orders are tracking there? I know they've been pretty ugly recently. And is there any signs of a bottom, or is it still to be determined?

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

A

So, we're two parts of B27. IFS, innovative flow solutions – Integrated Flow Solutions, excuse me, had some really nice wins here lately, very recently. And they're not gigantic orders, but they're orders nonetheless that we're kind of pleased with. Realize that what they do best is around processing gas, and so gas has a nice shot in the arm with LNG and et cetera. So there's activity there and we're very pleased with how they're progressing. The other piece of it was that B27 was in the API 610 business. We call that PumpWorks 610. And that particular part of the business is sold to the big pipelines that carry product from some part of the world – some part of the United States or North America to a refinery or to where multiple refineries are et cetera.

And that infrastructure is in place and the – we're not needing really a huge amount of additional infrastructure except, again, gas. Gas is kind of making a comeback and our pumps are bigger when we use – when we're on a gas pipeline versus an oil pipeline. And hopefully with our new administration, they're going to be a little more forgiving on where pipelines go and where they're useful, et cetera. So we actually have a lot of quoting activity and a lot of these are [ph] crude live (36:58) projects but I wouldn't say that part of our business is booming.

Ryan J. Merkel
Analyst, William Blair & Co. LLC

Q

All right, and then speaking of the new administration, maybe I'll just ask that question. How are you feeling about, potentially, the new policies being a tailwind for your business? And maybe discuss if the Keystone Pipeline happens, is that a positive for your business?

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

A

Well, Keystone would be very positive for our business, and I think it's impossible – you know, politicians can say anything they want to, but it would be impossible to be oil and gas 100% sufficient and not have imports and et cetera. So, that said, I think anybody that's going to be favorable to moving in that direction has to be very, very positive for DXP. Having concerns more about domestic versus being a global international company has to be positive for DXP. So we'll see. I mean, like I said, the politicians can say what they want to, but then when it comes down to reality and what they can get done, we'll have to see. But it doesn't seem to be anything that's negative.

Ryan J. Merkel
Analyst, William Blair & Co. LLC

Q

Right. Okay. Very good. Thank you. I'll pass it on.

Operator: And we'll now go to Joe Mondillo with Sidoti & Company.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Hi, guys. Good afternoon.

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

A

Hello.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

So, IPS. I was just wondering, last quarter you guys were cited as saying that given all the cost stuff that you put in place there that you didn't think that that segment could fall below, sort of, an 8% [ph] op (38:58) margin, given what you did there. Obviously it fell a bit below that at 4% [ph] here (39:04) this quarter. So I'm just wondering A, what sort of happened that didn't go to what you sort of saw, was it more volume based or product mix? And, sort of, how does that backlog look for the next quarter or two?

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

A

So sales were, I guess, sort of spotty. The API business is down. IFS was doing better and now it's getting some orders. So it was down, but it's showing improvement. Canada is doing a whole lot better in making money, so that particular part is good. Our fabrication business is good. So, I really don't – I'm not too worried about that. I think they had a softness in sales, and so we didn't make our 8%. I forgot what it was, Mac. It was like 4%...

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

[ph] 4.1% (40:13).

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

Yeah. We also did a lot of consolidations with B27 during the third quarter. And so in doing so, we kind of spend a little money before we saved some money, and so I'm not worried about [ph] IPS (40:35).

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

Okay. I guess also on Service Centers side of things, the margin was the best that it's been in I think in a year or so. Could you comment on that? Do you think that's sustainable type margins? What sort of drove that? What's your outlook going forward?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Some of that margin improvement largely comes from a gross profit if I'm looking at Q3 compared to Q2. And most of the margin improvement came from an improvement in gross profit, and some of that gross profit improvement came from safety services are doing a little better, and that's a high margin business, and some of it came from the biggest part of the decline in July was selling to OEMs to manufacturers. Those are higher-volume sales and are typically at lower margin. So some of the improvement in the margin actually comes from having a lower sales.

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

Okay. And do you think that...

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

It's the product mix.

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

Do you think that margin is sustainable? Because it is relatively higher that what we've been trending at the last several quarters.

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Well, if the – I guess I want to answer if the OEM customers stay declined like they were in the third quarter, then yes, the margin would be sustainable. Hopefully, that business comes back so we make more money, but the margin might – and, you know, it's – that's comparing a relatively low quarter to an even lower quarter, Q2 to Q3. Eventually when the business truly improves, then the margins will go up, we would assume.

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

Yes. Okay. Also on the working capital, just wondering what your thoughts are there? I saw that receivables came down a little bit, inventory was sort of flat on the quarter, but payables were actually up in the quarter. So just wondering what your sort of thoughts are over the next several quarters into 2017, how you're thinking about working capital as a source or use of cash?

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

So we feel like that working capital will be a source of cash in the fourth quarter. We think things are a little softer so receivables will come down and then the inventory is always going to lag a little bit. So it will come down. We actually hope that 2017 that we start investing in working capital but realize that our investment in working capital is – I think it averages around 10% to 15% of sales. So we're going to look forward to sales going up and working capital going up a little bit, so the net result will be, that will actually generate a lot of cash flow, but it'll be through EBITDA.

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

Okay. And then just lastly, Mac, could you talk about where the balance sheet is now and do you anticipate any further refinancing capabilities? I know you had that sort of holiday until next July, I think it was, but can you talk about sort of the cost of capital that you're running at here and anything that you anticipate?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

I'll point out that the July 1 date when the leverage and fixed charge are scheduled to come back doesn't apply until September 30, which then doesn't really apply until November, when we have to submit a Compliance Certificate. So we have a fair amount of time to continue to generate cash flow and pay down debt and, if need be, pursue other alternatives, whether it's sell another business unit or refinance.

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

And if it stays at these levels relative to where your EBITDA is, the interest rate should be fairly similar to what you saw in the third quarter?

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.
A

Under our loan agreement, the interest rate, the margins don't change. Whether our leverage ratio goes up or down under the existing loan agreement, the interest rate is the same. As LIBOR changes, the interest rate could change. And so if the Fed raises interest rates in December or whenever they're supposed to do that, presumably LIBOR will go up and so our interest rate will go up. But as we pay down debt, there's less debt that we're paying interest on, but the rates only fluctuate really with the market rate.

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

Okay. Great. Thanks a lot.

Operator: [Operator Instructions] And we'll now go back to Matt Duncan with Stephens, Inc.

Matt Duncan
Analyst, Stephens, Inc.

Q

Hey, guys. So, I'm going to piggyback on what Joe was asking about there. So, as you look at the balance sheet Mac, and David this is probably for you as much as Mac, how do you guys think about what you may want to, or need to do with your current debt structure as we move into next year? What is the ultimate goal? What is maybe the range of possibilities that you're looking at for how you'll sort of take care of this last step and restructure the debt on your balance sheet, whether that be with a new bank group or some other debt instrument, how are you guys thinking about that?

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

A

Well, we'd like to see our EBITDA run rate beat $60 million and our debt be in $200 million, and then we're definitely very bankable again and so our focus right now is to generate as much free cash flow as we can and to increase EBITDA. And we've talked about, you know, we're thinking in a declining market we can maintain 6% EBITDA margins, around there, which I think we're showing that we can do.

So then the question becomes when does sales start picking up, and when they do we get leverage of the business and our bottom line improves pretty rapidly and we should be able to get run rate around that level. And so our focus right now is not about selling anything, it's not really about cutting costs, it's really about growth. All our initiatives, all our thoughts going into next year, are designed to not spend money, but grow.

Matt Duncan
Analyst, Stephens, Inc.

Q

So along that line then, David, does that mean you're still going to be out of the M&A game for a little while here? I know you guys have historically been very successful with the small bolt-on type acquisition, but obviously, the first part has got to be to get the balance sheet on a more solid footing. So does that put you on the sideline for a while longer yet? Or do you maybe consider a debt instrument that would have less restrictive covenants that maybe would allow you to start doing that [ph] again (48:33) that's been a key part of your growth story in the past?

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

A

Yeah. I think we want to participate fully in the upturn that's coming. So I think that we're talking to people, and we're trying to do everything we can to make sure that when the turn happens that we could be in a position to do an acquisition. But if we don't get a turn or we just stay flat, well, then you're right, it's going to be a while before we can start executing on the acquisition front. But if – I just want to be in a position to where, if things turn like they eventually will some day, some time, then we're in a position to participate in that. And we're not far off from being able to do that and so all's we need is a little bit of recovery. I don't need some big V-shaped recovery or anything. I just need things to start headed in a positive way.

Matt Duncan
Analyst, Stephens, Inc.

Q

Okay. That helps. I appreciate it. Thanks, David.

Operator: And we're showing no further questions, that concludes today's conference call. Thank you for your participation.

Hugh H. McConnell
Senior Vice President - Finance, Chief Financial Officer and Secretary, DXP Enterprises, Inc.

Thanks.

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

Have a good day. Thanks.