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# DXP Enterprises, Inc. (DXPE)

Q4 2018 Earnings Call

## CORPORATE PARTICIPANTS

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

David R. Little

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

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good afternoon. My name is Kelly and I will be your conference operator today. At this time, I would like to welcome everyone to the DXP Enterprises' Fourth Quarter and Fiscal 2018 Conference Call. All lines have been placed on mute to prevent any background noise. After the prepared remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

I would now like to turn the call over to Kent Yee, Senior Vice President and Chief Financial Officer. Please go ahead sir.

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Kent Nee Hung Yee

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

Thank you, Kelly. This is Kent Yee. And welcome to DXP's Q4 2018 conference call to discuss our results for the fourth quarter and fiscal year-ended December 31, 2018. 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 the company investor presentation are now available on our website at [ir.dxpe.com](http://ir.dxpe.com).

I will now turn the call over to David to provide his thoughts and a summary of fiscal 2018 and fourth quarter results.

## David R. Little

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

Thanks, Kent, and thanks to everyone on our 2018 fourth quarter and year-end conference call. DXP started 2018 with some very lofty goals and coined the term smart recovery. Internally, this described our objective to grow the top line 20% and the bottom line 100%. We accomplished both goals. Congratulations to all our stakeholders and a special thank you to our DXPeople you can trust. Customers can trust DXP to be fast, convenient and technical, experts with whom our customers enjoy doing business with, DXPeople they like and trust. Thank you, DXP sales professionals. Thank you, DXP operations for making our sales professionals look good. Also, thank you to corporate support, one team making the customer happy. Thanks, DXPeople, for an awesome year and our future looks bright.

Our smart recovery plan for 2018 included organic growth strategies for both local, regional, and national accounts, such as tech program for finding new accounts, [indiscernible] (00:03:15) to make the point-of-sale faster, selling pumps through our bearing and PT channel, and custom API pumps sold to our global and national relationships. IPS expanded our efforts to sell measurement equipment and better communicate around leveraging local plants into multiple plants or corporate accounts.

Supply chain services continues to add new customers and new sites for existing customers. We have a suite of smart programs to expand value-added services and technology to existing sites. Canada's rotating equipment is in a tough market, yet they had a great year taking market share from the competition, congratulations. PumpWorks, aftermarket, remanufacturing, all had great success selling their products and services through DXP's sales channel. Quality products made in America and a faster supply chain gives us tremendous success.

IT, accounting, inventory management are all working hard to support DXP's sales organization and manage our return on invested capital which has been a success versus our peer group. Working capital is only 16.8% of sales which is truly an outstanding. Our integration team is ready for acquisition, for our acquisition strategy. HR is working hard to keep up with the growth of DX people. We started the year with 2,511 DX people and ended with 2,740.

Innovative Pumping Solutions started 2018 with planned growth strategies of new products, increased fabrication space, applications specialist, service and repair with increased engineering and fabrication support. All of these actions and strategies resulted in a terrific 2018.

Our fourth quarter results rounded out a tremendous 2018 for the DXP. During the year, strong sales growth and the EBITDA expansion delivered triple-digit diluted earnings per share growth and strong free cash flow.

DXP delivered 16.1% organic sales growth for the full year accompanied by a \$47.5 million sales contribution from the closing of an acquisition of ASI, at the beginning of 2018. This translated into a 20.8% sales growth year-over-year. DXPeople continue to provide 100% effort and do a day's work in a day driving stakeholder success and value creation.

We generated \$29.1 million of free cash flow in 2018 which is a significant improvement over fiscal 2017. This will help position us for a significant capital deployment going forward. As we look at our financial performance, DXP has now experienced nine quarters of sequential increases in quarterly total days per business day.

We continue to remain on track for gross margin improvement that we outlined during Q3 of 2017. Our results year-over-year have been consistent with our expectations and in line with our financial goals to grow 20% year-over-year through a combination of organic sales and acquisition growth. We believe we continue to take market share in many of our businesses driven by our focus on being fast, convenient, and technical for our customers and all stakeholders. DXPeople you can trust.

As it pertains to the operating environment, the ISM, PMI manufacturing indexes averaged 58.8% during 2018. This supports the organic sales increases we experienced during the year. The metal working business index shows strength averaging slightly less at 56.8% during fiscal 2018. These sentiment indexes remain in positive territory, but have softened in December. We remain optimistic around the industrial economic despite the news headlines and volatility in the financial markets.

In terms of oil and gas, U.S. market indicator shows some pullback in the fourth quarter where WTI oil prices moved from \$76 per barrel to \$45 per barrel. The significant drop in price in the fourth quarter was driven partially by the U.S. shale producers oversupply to the upside.

Additionally geopolitical negative impact supply and demand balance sentiments. The combination of these factors together with a large selloff in the equity markets due to concerns around global growth and increased U.S. interest rates created a near perfect storm to close out 2018. As a result, we anticipate customers will take a more cautious approach to CapEx budgets and spending levels in response to the continued volatility in the market dynamics.

Quarterly prices for Q4 were down 14% from Q3. That said prices have been improving from our low of \$0.4448 per barrel through January and February and provided optimism as we move through physical 2019.

Turning to our results, total DXP revenue of \$311 million for the fourth quarter of 2018 was a 17.1% increase year-over-year. This reflects stability, rebound and growth in our end markets, as well as the addition of Application Specialties. This result is the DXP's fiscal 2018 sales of \$1.2 billion or a 20.8% increase over fiscal 2017, 16.1% organically and \$47.5 million contributed by ASI.

Innovative Pumping Solution sales increased 43% year-over-year to \$291.7 million, while Service Center sales increased 17% year-over-year to \$750 million. The Supply Chain Services sales increased 8% year-over-year to \$174.5 million. Innovative Pumping Solutions sales increase was driven by modular packaged equipment for onshore markets and products sold into the midstream market.

Additionally, similar to 2017, DXP sold a meaningful amount of LACT and ACT units, HP-Plus pumps, and other modular packages within both our configured and engineered-to-order business.

In terms of the strength in the IPS backlog, it continued to grow through 2018. The IPS yearly average backlog increased 57.6% from 2017 to 2018 versus 39.3% growth from fiscal 2016 to 2017. The Service Center year-over-year sales growth was primarily driven by increases in our rotating equipment and Metalworking product divisions. Within Service Centers, we saw a particular year-over-year sales strength in DXP's Canadian rotating equipment Southwest, Southeast, and West regions.

DXP's overall gross profit margin for the year were 27.3%, a 34-basis-point improvement over 2017. Adjusting for the acquisition of ASI, gross margins were 27.7% or a 76-basis-point improvement over 2017. The improvement in gross margins is in line with our communication back in Q3 of 2017 with what we expected and reflects 116-basis-point improvement from Q3 or an average of 23 basis points quarterly improvement from our [indiscernible]

(00:12:54). We still are driving improvements in gross profit margins and look to have incremental improvement through 2019.

The improvement in gross margins are a result of the combination of sales increases in the IPS segment along with improvements in the average gross margin on capital-related projects as well as the consistent strength and improvement in our Service Centers.

SG&A as a percent of sales declined 196 basis points going from 23.7% in 2017 to 21.7% in 2018. In terms of my thoughts on SG&A, SG&A will decrease as a percent of sales and increase as expected in dollars, reflecting our investment in our people and organization as we focus on accelerating growth through 2019.

DXP's overall income margin was 5.6% or \$68.5 million, which includes corporate expenses and amortization. This reflects a 230 basis point improvement in margins over 2017. That being said, we feel there is opportunity in our operations to be more efficient.

This year, we continue to benefit from the leverage we get as the SG&A growth is less than the overall sales growth within the business, plus gross margin improvements. IPS operating income margin was 11.6%. Service Center operating income margins were 10.8% with the second half of the year showing strength with an average operating income margin of 11.3% and Supply Chain Services operating income margin was 9.3%.

As we mentioned during our Q3 call, Supply Chain Services experienced margin contractions during the second half of 2018, which is a result of higher than normal ramp-up cost associated with seven new sites. We expanded the seven new sites whereby we hire the personnel, convert the customer store rooms to our standards, which causes DXP to incur upfront costs. Once we go live, revenues start.

Sales along with an improvement in margin should come along with the completion of these start-up phases, which is evidenced by a 9% basis point improvement we experienced from Q3 to Q4.

Overall, DXP produced EBITDA of \$95.8 million versus \$61.7 million in 2017; a year-over-year increase of \$34.1 million or 55.2%. EBITDA as a percent of sales was 7.9% versus 6.1% for 2017; a 875 basis point improvement.

Looking forward to 2019 in terms of oil and gas, we expect the supply and demand balance sentiment and the oil prices to improve over the course of the year as the OPEC and Russia cuts take full effect, the dispensation from the Iran export sanctions expired and are not renewed, and as the U.S. and China continue towards a solution to their own ongoing trade dispute.

While the indices for our industrial market show below recent highs, we believe there is strength still in the market and that our domestic focus weigh favorably, should global industrial activity slow. From customer discussions, we're seeing clear signs of oil and gas investment sentiments starting to normalize in positive undertones with our key industrial customers.

In summary, we are pleased with our overall momentum. DXP delivered 20.8% sales growth through both organic and acquisition sales. This is consistent with our strategic financial goals and position us well for the fiscal year 2019. We look to continue to drive improvement in our gross margins and move closer to a historical average of 28-plus percent on a combined basis.

In fiscal 2018, capital allocation was focused on leveraging our inventory, investing in project work, maintaining our working capital as a percent of sales. Additionally, DXP was focused on generating cash, paying down debt

and maintaining a pristine balance sheet that would give us [ph] both (00:18:21) optionality headed into 2019 to pursue acquisitions more forcefully. With the future success – successful execution of our strategy, we expect continued improvements for generating free cash flow and greater shareholder value.

We know that DXP has a differentiated and a compelling value proposition. DXP sales, operations and corporate functions remain energized and continue to work together to create value for our customers. DXP has a great team focused on producing great results for our customers, suppliers and our shareholders alike. All three business segments performed well during the year. We will drive change, innovate for growth and leads smart.

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

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## 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 fourth quarter and fiscal 2018 financial results. Q4 was another great quarter for DXP and allowed us to finish the year strong while building momentum going into fiscal 2019.

As David mentioned, we are growing through a combination of organic and acquisition-driven sales. Our balance sheet is poised for us to be acquisitive, and we look to continue the execution of that part of our strategy in 2019. The Q4 2018 financial results marks our ninth consecutive quarter of increases with respect to quarterly sales per business day. Total sales for the fourth quarter increased 17.1% year-over-year to \$311 million. Adjusting for the \$12.4 million Q4 sales contribution from ASI, organic sales increased 12.4%.

Total DXP sales for fiscal 2018 grew 20.8% with 16.1% coming from organic sales growth. ASI contributed \$47.5 million in sales for fiscal 2018, and we are excited to have them as a part of the team. They have performed ahead of plan and they have been a positive addition to DXP. Total sales growth for fiscal 2018 was supported by the DXP's three business segments, reflecting the differentiated go-to-market strategy of each segment, the opportunities available given where we are at in the cycle, and the continued expansion we are seeing from existing and new customers.

Average daily sales for the fourth quarter were \$5 million per day versus \$4.4 million per day in Q4 2017. Adjusting average daily sales for ASI, average daily sales for Q4 increased 10.6% versus Q4 2017. Average daily sales for fiscal 2018 were \$4.8 million per day versus \$4 million per day in fiscal 2017. The overall growth reflects the execution of our strategy supported by our key end market indicators for fiscal 2018.

While we experienced another round of volatility in Q4 in oil prices, we experienced overall strength throughout the year in the rig count, U.S. oil and gas production, drilling, the Metalworking Business Index and the PMI. The ISM/PMI manufacturing index averaged 58.8% compared to 55.4% in 2017 or is essentially still up 140 basis points compared to 2017. This supports the organic sales increases we experienced through 2018 in our non-oil and gas end markets.

Additionally, the Metalworking Business Index averaged reading of 56.9% in 2018 versus 55.5% in 2017 and supports the strength we have experienced in our Metalworking Businesses.

In terms of oil and gas, the average U.S. rig count for 2018 was up 17.9% versus 2017. That said Canada's rig count was down 7.7% from fiscal 2017 to fiscal 2018. This is impacted DXP's Canadian Safety Services business on a year-over-year basis.

In terms of business segments. All three experienced sales growth year-over-year with IPS showing the greatest improvement increase in 43% followed by our Service Centers which experienced 17% growth and Supply Chain Services with 9% growth.

Businesses within our IPS segment, which experienced year-over-year sales growth include our configured-to-order, engineered-to-order, remanufacturing businesses, and our brand of private label pump offering as well as our measurement equipment business.

Regions within our Service Center segment, which experienced meaningful sales growth in fiscal 2018 include the Southwest, Southeast, and West regions. Additionally, we saw a meaningful increase within our seal and metal working product divisions. The metal working product sales were supported by the strong performance from ASI.

Turning to our gross margins. DXP's total gross margins were 27.3%. Adjusting for the acquisition of ASI, gross margins were 27.7%. DXP's total gross margin for 2018 reflect the progress we continue to make since we [ph] troughed (00:23:32) in Q3 of 2017 and improvements reflected through 2018 in our engineered-to-order and our Canadian Safety Services businesses. In terms of operating income, combined all three business segments improved 181 basis points in year-over-year business segment operating income margins versus 2017.

Total DXP operating income increased to 104.4% versus 2017 to \$68.5 million. IPS had the greatest uptick improving operating income margins 604 basis points to \$33.9 million followed by Service Centers which had a 90-basis-point improvement to \$80.7 million.

Supply Chain Services decreased 28 basis points on a year-over-year basis. This is primarily driven by a decrease in gross profit margins associated with implementation of new SCS sites and revenue not fully scaling as mentioned during our Q3 conference call.

Turning to EBITDA, fiscal 2018 EBITDA was \$95.8 million, up 55.2% from 2017. This does include a one-time gain of \$1.3 million associated with the sale of a corporate facility. Adjusting for the gain, EBITDA grew 53.1% year-over-year.

Year-over-year EBITDA margins increased to 175 basis points, primarily reflecting the fixed cost SG&A leverage we experienced as we grow sales. EBITDA margins for fiscal 2018 were 7.8% compared to 6.1% in fiscal 2017. Sales growth of 20.8% with only 13% SG&A growth on a year-over-year basis translated into 2.7 times operating leverage.

In terms of EPS, our net income for 2018 was \$35.5 million. This is up \$18.7 million or 11.6% versus 2017. Our earnings per diluted share for fiscal 2018 were \$1.94 versus \$0.93 in fiscal 2017. Adjusting for the one-time gain, earnings per diluted share would have been \$1.87 or \$0.07 per share impact related [ph] to the gain (00:25:37).

Turning to the balance sheet, in terms of working capital, our working capital increased \$35 million from the prior year to \$204.2 million. In Q4, we remained focused on providing the capital to support growth in our businesses. Working capital as a percentage of sales at the end of the fourth quarter was 16.8%. This is above our historical average but reflects 129 basis points improvement compared to Q3. While this is above our historical averages, it reflects the growth in our business and investment and project related jobs within IPS.

The main drivers of the increase of working capital include cost in estimated profits in excess of billings and inventory. This has been consistent through fiscal 2018 as we have supported our core distribution business and project-related businesses. Cost and estimated profits has increased \$5.6 from Q4 2017 to \$32.5 million, and

inventories up \$23.4 million from Q4 of 2017 to \$114.8 million. This reflects DXP carrying higher levels to support our revenue growth.

We achieved inventory turns of 7.8 times down from 8.4 times a year ago. From Q3, inventory is down \$1.7 million and cost and estimated profits is down \$5.9 million. In terms of cash, we had \$40.5 million in cash on the balance sheet at December 31, 2018. This is an increase of \$24.3 million compared to December 31, 2017.

In terms of CapEx, CapEx in the fourth quarter was \$1.6 million or 0.5% of fourth quarter sales. CapEx in fiscal 2018 was \$9.3 million or 0.8% of sales. Compared to fiscal 2017, CapEx dollars are up \$6.5 million. CapEx during fiscal 2018 reflects investments made within our IPS business segment including the purchase of patterns for our remanufacturing business, and some smaller items including various tools and equipment. We're also making investments in software to enhance our sales efforts and our corporate operations.

Turning to free cash flow. We generated solid operating cash flow during the fourth quarter. During Q4 and fiscal 2018, we had cash flow from operations of \$26 million and \$35.8 million, respectively. This reflects an increase of 185.7% over fiscal 2017 cash flow from operations of \$12.5 million. For fiscal 2018, we've generated \$29.1 million in free cash flow. While we are always looking to enhance and improve our cash flow generation, we are comfortable with where we are at the end of the year with further improvements in the future.

Return on invested capital or ROIC increased 770 basis points from 2017 to 28.8% and continues to improve as we drive margins and operating leverage. This return does reflect an adjustment to the tax rate assumption used in the calculation to both fiscal 2017 and fiscal 2018. In terms of our capital structure, at December 31, our fixed charge coverage ratio was 3.5:1 and our secured leverage ratio was 2.2:1. Total debt outstanding at December 31 was \$248.7 million.

In conclusion, we are pleased with our ability to have nine sequential quarters of increases in quarterly sales per business day. This has included organic sales and acquisition growth, EBITDA margin expansion with room for improvement and significant diluted EPS growth. Momentum has been good and we look forward to pushing this through the entire year 2019. DXP is on its path of its financial goals, driving organic and acquisition sales growth, EBITDA margin improvement and EPS increases.

With that, now I'll turn the call over for questions.



## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Your first question comes from the line of Joe Mondillo from Sidoti & Company. Please go ahead. Your line is open.

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

Q

Hi, guys. Good afternoon.

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

A

Hi, Joe.

Kent Nee Hung Yee  
*Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.*

A

Hey, Joe.

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

Q

Kent, can you just repeat the gain on sale, how much that was, and confirm that it hit the fourth quarter? And what segment did the – did that hit one of the segment operating income lines?

Kent Nee Hung Yee  
*Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.*

A

No. The gain actually occurred early in the year. You may not remember, Joe. The gain was actually in Q2. It was just – reflects the sale of our corporate facility and it was \$1.3 million.

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

Q

Okay. Great. Okay. That's what I thought. I just wanted to confirm.

Kent Nee Hung Yee  
*Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.*

A

Yeah, yeah. No, absolutely.

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

Q

On the Service Center side of things, organic growth was pretty good. I thought you guys were going to be going up against or I guess you were going up against sort of a tough comp, the fourth quarter of last year. Could you just talk about the trends that you're seeing there? You mentioned that you're seeing some really good growth in the rotating equipment and Metalworking equipment. But the deceleration was not as much as I anticipated. What are you thinking as we are now into 2019?

Kent Nee Hung Yee

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

A

Fair question. You always got to remember, our Service Center business is 80% MRO, roughly 20% OEM. And so I think I saw your note just in general on the industry. And so we – from a majority of our business there, we benefited from that from a maintenance spend. We also benefited from ASI. ASI was a contributor. I don't know if you're looking at on an organic or a total basis, but ASI finished the year roughly \$47 million and that was ahead of plan. And so that kind of pushed us through on the Service Center side as well. And so, we saw strength, yes, on the rotating side, on the MRO side, but also ASI was a huge contributor throughout the year, Joe.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Okay. And then, I feel like I asked this question in almost every quarter. The margins at the Service Centers segment, just sort of really tough for me to get my hands around. It seems like it's quite volatile, it's been actually pretty consistent the last few quarters. Could you just comment on where you are in terms of the Service Centers margins? And is there more room for expansion? Are we going to have a tough comp in 2019, given the expansion that you saw in 2018? Any sort of color or insight that you can provide there that would be helpful?.

Kent Nee Hung Yee

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

A

Sure. Joe, I'll just walk through the trends in terms operating income margins from Q1 in 2018 through the fourth quarter, and then, I'll kind of jump to your question. Q1 operating margins for Service Centers were 9%, for Q2 11.3%, for Q3 10.9%, and then for Q4 11.6%.

So, directionally, what I'm getting at is there was, call it, a little bit north of a 200 plus basis point improvement of operating income margins for the year, 10.76% operating income margins. Historically, that business has kind of been, call it, in the 12% maybe at the most 14% operating income margins range.

And so, we're seeing improvement and we did through 2018. If we keep that trend, we're starting to get to the higher end of that. And so – but that's natural that typically comes, once again, as we get strength in our rotating equipment business and somewhat becomes a reflection of mix.

David R. Little

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

A

So, some of that Joe -

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

A

Okay.

David R. Little

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

A

Joe, some of that is scaled. I think the bouncing of those margins, I think, are consistent with whether we had a higher sales month – sales quarter or not. And realize that our peak when 2014 was \$1.5 billion. So, we still have ways to go to get back to where our peak was. And so, as we do that, certainly, our operating income is going – as a percent of sales is going to grow.

The other piece of that is gross profit and that's a function of people again not being so scared to get a decent margin on stuff instead of just feeling like they have to sell it at any price. So, I feel good about that. The only thing coming that we look at this as an opportunity is that our manufacturers that we represent are having price increases. And so, our customers are kind of accustomed to price increases. So, we tag along and add 1% for ourselves and that tends to work.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Okay. So, looking at 2019 at segment as a whole Service Center, it seems like growth is moderating in the industry. I'm not sure if you agree or if you started to see that within your business for the first two months of this year. Is it fair to say that you should probably see moderating growth at Service Center in 2019 and maybe not as much of an expansion in margin, but continue to see expansion in margin in 2019? Is that sort of the general theme that you're sort of expecting?

David R. Little

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

A

We're not expecting any decline in sales for the Service Centers.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

No. I'm – I was talking about growth, like a deceleration of growth.

David R. Little

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

A

Yeah.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Still growth...

David R. Little

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

A

Yeah. Yeah. Yeah.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

...moderation.

David R. Little

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

A

Right. Right. Right. And I think that's fair – certainly fair based on – it was fair back in November and December when we thought the sky was falling. But it's – it hasn't played out. We seem to be tracking January and February pretty nicely. So, we feel like yes, we're going to do 16% organically again. It's possible, but it's not probable. And so, I'm going to have to knowing what I know today think that it will be less, but I don't know still know how much less.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Okay. Just a sort of a broader question on the oil and gas sector. It seems like the estimates out there are calling to sort of E&P CapEx budgets being slightly down this year, integrated companies sort of flat to slightly up. So, the CapEx budget seemed sort of maybe flattish, maybe potentially down, maybe potentially up. Given that environment and looking at the rig count and all these other indicators, it looks like a pretty significant slowdown, but you're coming off of a – end of 2018, that was very volatile and oil prices have since rebounded, what is your sort of take on sort of how 2019 looks? Are you anticipating continued growth in your oil and gas markets? Just any sort of color there would be really helpful.

David R. Little

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

A

Right. So the midstream people and the people putting new pipelines in and – in the States, that activity – first of all, we have a large backlog of that kind of activity where we've already sold it and then our coding levels still are good. So we're probably seeing nice growth in midstream. And then when we look at drilling activity which we don't care about, I think that there'll be lesser of that I think from people cut their CapEx budgets, I think the drilling activity is one of the areas they'll look at cutting.

The question becomes where we play is after they frac a well, so they created duct, they drilled it, but it's not completed yet. There's 46,000 of them out there. I don't know exactly. But when they complete those and the oil gets above the ground, that is when we really start playing. So in the area where we play, we're not thinking that we're going to see a decline.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Okay. And then so IPS, that's obviously a big part of this sector and the fundamentals that you just spoke of. What does the backlog – you mentioned that backlog grew – continue to grow throughout 2018, has it started to decelerate in terms of the year-over-year comp? And how is that sort of trended into 2019? Just trying to get a sense of what kind of growth we're sort of anticipating for 2019 there?

David R. Little

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

A

So that's a good question and really yes, we've seen that our backlog is still growing. But it's not as robust as it was at the beginning of last year. So the question that we have is why and because there are still a lot of activity, there's still a lot of coating activity, so the question is, are people just starting to be a little more conservative [Technical Difficulty] (00:40:13) they think they got kind of what supply and demand. They don't want to get way too far ahead of the demand curve because then also oil price will go down and they will have financial difficulties. We all remember 2015 and 2016 quite well.

And so I think there is a lot of conservatism out there. But again, we think that if OPEC continues to cut production, if Russia continues to follow suit, if we're not given [indiscernible] (00:40:58) and if China and the United States can kind of get this tariff playing back in some sort of reasonable [indiscernible] (00:41:13) then in oil and gas, we could still have – we could go back to a pretty big boom.

I want to really make this distinction that the industrial market has been on a upcycle for this 10 year period, it looks like – everybody thinks that after 10 years it's got to go down. And that may or may not happen, I don't quite know how taxes and those things are going to play out. But from an oil and gas point of view, we've not been in

an up cycle. We didn't get an up cycle until 2017. So we got 2017 and 2018. And so there's really not any reason to think that oil and gas will continue to be a really, really good market, and really we prefer, if I could just say this, we prefer a more stable oil and gas market than the one that shoots up to \$110 a barrel of oil and gas goes down to \$2. I mean, if we could just have stability, then that's really better for us and we'll perform really quite nicely.

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

Q

Okay. Great, perfect. Thanks for taking my questions and good luck.

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

Blake Hirschman  
*Analyst, Stephens, Inc.*

Q

Hi, yeah. Good afternoon, guys. Great quarter. First, I just wanted to ask about the ex-ASI organic margins. I think I heard you say 27.7% and I think that was full year, but wanted to clarify. And then as a follow up to that, could you kind of talk through some of the drivers of that organic margin expansion? I think you mentioned engineered order in Canada but just kind of wanted to get a little bit more color there?

Kent Nee Hung Yee  
*Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.*

A

Yeah, you're correct Blake. Sans ASI, gross margins were 27.7%. Just to retrace a little bit of the history real quick, we troughed in Q3, and we troughed partially because of the two businesses you mentioned: Canadian Safety Services, and our engineered-to-order business.

We've seen continued improvement in both of those businesses throughout 2018 really since Q3 of last year. And so on the safety services side, it's in spite of their revenue actually being down on a year-over-year basis, but their gross margins are not back to where they've been. Their gross margins are probably still off roughly around 39 basis points from some of their peaks.

And so, while we're pleased once again with the direction and kind of what they've done, you heard it probably in our comments there's still room for improvement on the gross margin side. And so we look to continue to see that going forward. Engineered-to-order part of that was just a scale aspect. We needed volumes to pick up engineered-to-orders within our API business segment. And so, we saw some of that.

As David's comments throughout the last couple of quarters as quoted is, the ITS backlog, and that's continued to grow. So with that scale, there's just some fixed cost leverage you get out of that business as you move through the cycle. And so, I think that's what you're seeing in that business as well.

Blake Hirschman  
*Analyst, Stephens, Inc.*

Q

Got it. All right. And then, wanted to see what the monthly sales per day looked like throughout the 4Q. I'm curious if you could give us any update on what January or February looked like.

Kent Nee Hung Yee  
*Chief Financial Officer & Senior Vice President, DXP Enterprises, Inc.*

A

Yeah, no, absolutely. So sales per business day through the quarter for Q4. For October was \$4.7 million. November was \$5 million. December was \$5.4 million. In 2019 here, a little sales flash for January and February, \$4.5 million for January and \$5.1 million for February.

Blake Hirschman

*Analyst, Stephens, Inc.*

Q

\$5.1 million. Okay. And then, lastly, on capital allocation and more specifically M&A, I wanted to get an update on how you're thinking about things? How the conversations are going and if you guys think you're getting closer to kind of closing anything here? Thanks a lot.

Kent Nee Hung Yee

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

A

Yeah. No. In terms of acquisitions, obviously 2018 was a year where we were coming fresh off our refinancing towards the back end of 2017. And so we did a repricing. We paid down some debt. We have light amortization on that facility. And then, we are also building cash in the end of the year with \$ 40-plus million of cash on the balance sheet.

We can never time those conversations as I always say, but we engage more heavily in dialog in 2018. That is for sure. And so, hopefully, we'll see some of the fruit of that here in 2019, kind of as we move through the year. And obviously, that's always been a key aspect of our strategy and we look to accelerate that. But you heard that in David and I's comments. But we don't have any secret sauce in terms of turning these guys into sellers immediately. So...

Blake Hirschman

*Analyst, Stephens, Inc.*

Q

Got it. Thanks and good luck.

Kent Nee Hung Yee

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

A

Yes.

**Operator:** Your next question comes from Steve Barger with KeyBanc Capital Markets. Please go ahead. Your line is open.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Good afternoon guys. This is Ryan Mills on for Steve, and congrats on the quarter.

Kent Nee Hung Yee

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

A

Thanks.

David R. Little

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

A

Thanks.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. I wanted to talk about IPS and PumpWorks. I think it's obvious to say you've taken share given the top line performance. So can you talk a little bit about what your customers are saying and what's driving the momentum for that business?

David R. Little

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

A

Sure. It's – we actually – this is going to be interesting, but we actually have and produced a made-in-America pump versus oftentimes others with pumps in Italy or components made in China, et cetera. So we usually have a more expensive pump. It's not out-of-line expensive but it tends to be a little more expensive. So, why are we successful? Well, we're successful because the flipside of that is – was our supply channel is all in America, and so we can simply do it faster. And if delivery is important, which in the oil and gas and midstream marketplaces, that's important. Downstream, not so much, so we're not quite as successful downstream, but we make a better pump, we make it exactly like the customer wants it, and we do it faster.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. And then I believe on your last earnings call, you said you had an advantage because your pumps are made in America. So, how are your prices shaping up compared to the competitors or experience in tariff-driven inflation? Is that kind of level in the playing field? Because on your last earnings call, I think you said the price increase that you've seen in your pumps business is 4% to 5% compared to the double-digit increase of some competitors who source overseas might be seeing?

David R. Little

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

A

Right. We haven't seen the major players [indiscernible] (00:49:38) with any kind of 20% price increases. So that hasn't panned out as much as we would have hoped for. The key again is that our – and really made in America is great as long as your competitive. It's not – people aren't going to buy made in America if they cost twice as much. They're just not going to do it. So, they'd like to but they're not going to. So we have to be competitive. So, we're close. What really drives a premium is fast delivery. That drives the premium. The American – if we're equal and we're made in America that may win us the order. If we're 20% higher made in America, well we're not going to get the order.

What gets the order too is that our salesmen have relationships with these accounts. So, we have some influence on the channel as it relates to our salesmen and the customers that we're dealing with. They like us. We're fast. We're convenient. We provide technical support. We build the customer that pump that he wants. It's custom made often times. So all of those things add up to a differentiation that allows us to make a good margin even though our product is a little more expensive. And so – and then the answers specifically, the tariffs have not panned out to be a big, big deal.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. Just couple more from me. Solid free cash flow this quarter and the networking capital actually ticked up throughout this year. So I'm just curious about your free cash flow expectations to 2019. And shall we start to see working capital drawdown or do you still expect that to be use of cash in 2019?

David R. Little

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

A

Steve, what we experienced in 2018 was this gradual pick up. I think we peaked out in terms of working capital as a percentage of sales around 18% and that really reflected the growth and the cost and estimated profits are basically our project business. And so that backlog continues to build, we'll go to that similar cycle more than likely in 2019. But what happened at the backend of 2018 is a lot of those job shifts and we did a better job which I think is stress organizationally in terms of collecting on those jobs. Those jobs are subject to progress, billings, and some other things.

And so you see that the difference between those balance sheets account narrowed in Q4. So that created a free cash flow thus, a lesser drain on working capital as a percent of sales ending the year at that 16% range. And so I think that's what we would normally expect just in our core distribution business, 15% to 16% range. And then with our project business when we invest in that, it tends to drive it up slightly. So...

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. And then going to the oil and gas markets that you play in. Earlier this week there's a report out describing lower productivity rates from wells, because they're being drilled too close together. Are you hearing anything from that, in regards to that from your customers? And what are your thoughts on the implications for that completions, if this is true?

David R. Little

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

A

Well, oil and gasses are both a depleting resource. So the question is, are we experiencing depletion faster than what we anticipate. And I'm not hearing that. We know and I know, I happened to participate in oil well and in the Eagle Ford as an example, and I mean it comes in at thousands of barrels a day and then it drops down, it drops down 80% by the end of that year. So but then at that level it kind of levels out and how long it will last, who knows. But they don't keep going down to just zero.

So there is this curve where you drill a well, you get a lot of production for a year, and then it drops down. That is the reason why, I guess the oil and gas business until we all go to solar or wind turbines, will continue to exist even if we're not trying to do any more than just maintain existing production. And so we feel good about that, we actually make more money on parts and aftermarket and because we're kind of a newbie on – with PumpWorks we don't have a lot of parts in the aftermarket at this particular site. Your aftermarket business is frankly our competitors' pumps, not our pumps.

So there's things to come that will be beneficial and as long as we don't have huge swings where that all goes to \$24 or it goes to \$100, either one of those things. So stability is a lot better for us and it's really better for the country too. So I don't know if that answered your question, but that was my thought processes.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

No. That's good. And then my last question, IPS has been growing at a solid clip for about seven consecutive quarters. So I'm just curious, when do you expect to see a nice benefit from the aftermarket business? Are you starting to see that now and then could you just talk about the margin profile?



David R. Little

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

A

So we actually – our parts business at PumpWorks I believe, I think this is right. I'm not sure I could get you the exact number, but it doubled. It doubled from the year before. But it wasn't a big number. If we double zero, it's still zero. No. But we doubled it. It will continue to probably double again this year. And so it's just a matter of getting pumps out there now.

Now, PumpWorks API product line has been out there. Now they were in the business at least five years before we purchased them before we purchase them. So they have some history out there and et cetera. So we're getting some of that business and it is at high margins. And then like I said, we get the competitions aftermarket also.

Kent Nee Hung Yee

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

A

Hey, Steve just bouncing back on your free cash flow question. Another way to think about that obviously is our free cash flow conversion, our conversion on there. Some times when I'm talking to folks in a more growing market, usually we typically expect 25% to 35% free cash flow conversion. And so I think for the year, this year we finished around that 30% range. So that's aligned. But the quarters in between is where the noise is at, I guess it was to my point earlier I was just trying to make, so.

David R. Little

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

A

Sort of my point. Am I wrong about this Kent? I think if we have organic growth of 20%, well, then we're going to – we use a lot of our free cash flow supporting that 20% growth. But if it's more normal and 10%, well then we'll have a build-up of cash. It's just a function and then the number is well, can we have 15% to 17% of sales in working capital. So that's a pretty low number. So, we can have a pretty high growth number and not burn all our cash, which is just proof of the fact that we bought the company in 1986 and grew it to \$1.5 billion. And during that time cycle, we only raised \$25 million onetime. So cash flow is being generated.

Kent Nee Hung Yee

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

A

Yeah. Yeah.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Yeah. That'll make sense and so just add – targeting that 25%, 35% in 2019 as well?

Kent Nee Hung Yee

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

A

Yeah. I think so. I think so. Once again, I was just trying to emphasize that there's [indiscernible] (00:59:13) project business. But to David's point, it's also a mix of where our growth comes from. Once again, if we – I think it was Joe at Sidoti who asked about Service Centers, but if more of our growth is coming through Service Centers, that's not going to require as much. And so, once again, it just depends in the quarters where that growth comes from too. So.

Ryan Mills

*Analyst, KeyBanc Capital Markets, Inc.*

All right. Thanks for taking my question.

Q

Kent Nee Hung Yee

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

Yes. Absolutely.

A

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

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Hey, guys. Most of my questions were actually answered. I actually tried to withdraw. But just one or two clarification questions. The tax rate that you're sort of thinking about for this year, what would that be?

Q

Kent Nee Hung Yee

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

Yeah. Now going back to tax rate, Joe, I gave a range around 28% to 30%. This year, we're around 27%. I think the lower end of that range is still applicable. Year-over-year, we had some measurement adjustments. It makes us look different than most where our tax rate actually looks like it went up in 2018 versus 2017. But I think just in terms of kind of directionally, we're probably at the lower end, if you will on that range back at the end of 2017, when I said 28% to 30%, so.

A

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Okay. And then last question, just the 13.4% operating margin at the IPS segment, how do you think about that as sort of a benchmark or a high – I mean, it has been going through the beginning of 2019. Are you going to see sort of potential of – under that number or is that sort of a low bar and going forward you should see improvement from there?

Q

Kent Nee Hung Yee

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

Right. So, once again and then I'll just trace the trends for everybody else on the call. IPS through the quarters, we had 9.4% operating income margins, 12.1% operating income margins, 11.4% operating income margins and we ended the year with 13.4% operating income margins. We do have a different mix of business today than we have had historically. In the past, I know we've peaked up around a 20% operating income margin today, but I wouldn't want anyone necessarily to have those higher end expectations.

A

I think our business today, the mix is totally different. That said, is there room to go from 13.4%? Absolutely. Once again, it is also going to depend upon mix. We have a measurement business, i.e. [indiscernible] (01:02:07) units that tends to be a little bit lower margin and that's some of my comments around mix. But then we also have some other higher margin API and different things related to that. So, it's all going to be a mix and how we fall out.

David R. Little

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

A

So Joe, you remember when – Joe, you remember when we had 16% operating income margins in that area. And basically, in those days, we were doing a lot more offshore work and complexity and the value-add was higher. And so, we've made higher margins on offshore stuff. And so today we do very little offshore. So, it's more onshore and so it's not quite as technical. And so, therefore the value adds, it's easier for other people to do it too. So our competition is a little greater. So, that's part of it, and so I'll just remind you about that.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

How does the PumpWorks – wasn't there sort of some funky way of accounting? I remember that's from a year or two ago at least, I guess, where the revenue up until breakeven was accounted for in the Service Centers segment and then sort of the profits beyond that were accounted for in the IPS. Is that anywhere correct, or how does the accounting in terms of profitability at PumpWorks business play?

David R. Little

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

A

It doesn't play like that. What does happen is that a manufacturing facility like at PumpWorks, almost everybody has a pretty high fixed cost versus a distribution business where people really – or your highest fixed cost is people. Yet, people are variable too, if you can get rid of them, whereas we have this plant, you got all this equipment, and you got all that stuff, you got to have a high fixed cost. So what does happen almost for everybody is that as you cover that fixed cost, your variable costs are not that high. So your margins will go up with volume.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Right. Now, that makes sense, but where is your in-house manufactured pumps accounted for? Is it in the Service Center segment or IPS?

David R. Little

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

A

No.

Kent Nee Hung Yee

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

A

It's in IPS.

David R. Little

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

A

It's in IPS.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

It is in IPS? Okay.

David R. Little

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

A

Yes.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

And that would – as we go down the road, maybe it's not in a quarter or two. But as that ramps up becomes a bigger percentage, that should help increase the ceiling to margins over time. Correct?

Kent Nee Hung Yee

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

A

Absolutely. Right.

Joe L. Mondillo

*Analyst, Sidoti & Co. LLC*

Q

Okay. Okay. Great. Thank you.

**Operator:** And there are no further questions at this time. This concludes today's conference call. You may now disconnect.

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