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DXP Enterprises, Inc. (DXPE)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Chris and I'll be your conference operator today. At this time, I'd like to welcome everyone to the DXP Enterprises 2022 Third Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Kent Yee, Chief Financial Officer. You may begin.

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

Thank you, Chris. This is Kent Yee and welcome to DXP's Q3 2022 conference call to discuss our results for the third quarter ending September 30, 2022. 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. However, DXP assumes no obligation to update that information as a result of new information or future events.

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

I will now turn the call over to David Little, our Chairman and CEO, to provide his thoughts and a summary of our third quarter performance and financial results. David?

David R. Little

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

Good morning and thank you, Kent. Thanks to everyone for joining us today on our fiscal 2022 third quarter conference call. I will begin today with some perspectives on our third quarter and thoughts about the full year and our future.

Congratulations, DXPeople. Our third quarter sales of $387.3 million is a sales record for DXP during the quarter. Thanks to each of you for your efforts to be customer driven and your part in diversifying into new markets like food and beverage, water and wastewater, plus growing our existing markets. We as a company have a more stable industrial base that will serve us well into the future. We have also added technical products and service technologies to our outstanding product and service mix that will also serve us well into the future of digital, automation, compressed air, filtration, biofuels, carbon capture, hydrogen that will help us make our lives better.

Every day, DXPeople serve essential customers and help the environment by being more efficient, safe, and environmentally friendly. Our goal is to help our customers with their sustainability goals and for us to lead by example. To be customer driven in a changing world is exciting and fun. It is also hard work, and I thank all the DXPeople for their efforts and enthusiasm for making DXP meaningful by helping our customers succeed.

So, how are we doing? Nine acquisitions over the last two years in water and wastewater in this industry. This is not only a stable industry, but very important to our lives and the environment. Three compressed air acquisitions. Compressed air saves energy and is environmentally friendly. In 2014, energy was 66% of our business and today 27%. Note that this could be a good market for 2023, and we would be glad to see the 20% grow. But long term, our focus is helping make energy environmentally friendly, efficient, and safe.

New markets, hydrogen, biofuels, carbon capture, storage of carbon waste, we have the expertise and products to help our customers succeed in reducing carbon emissions. National Accounts, this is growing, especially in rotating equipment, service and repair initiatives in compressed air and pumps, automation and controls. All mechanical equipment needs controls, and automation creates efficiencies, safety and reliability.

As a distributor, we have very little environmental impact and consume very little energy, but we will do better. And the real fun is helping others with our technical expertise to reduce their energy consumption, carbon capture, renewable energy. These growth strategies, which include both organic and inorganic plans, are what we are doing to grow DXP and help the environment by helping our customers with their sustainability goals.

Our Q3 results were great and everyone did a good job of passing on supplier price increases. Our gross margins are still being affected by payroll costs and inflation, which is to be expected, and overall, inflation is good for DXP. We sold DXP's 49% ownership in PumpWorks Castings to the 51% ownerships at a $1.3 million loss, which is a onetime event. We will still have access to this foundry for supply chain help and quick deliveries.

It is worth noting that all of the acquisitions over the last few years have helped us improve EBITDA margins. Our adjusted EBITDA dollars increased sequentially, which is always our goal. In terms of DXP's industrial, energy, and utility markets, we seem to be well-positioned headed into next year, as our end-users, such as aerospace, water and wastewater, air compression, food and beverage, renewable energy, hydrogen, environmental products, seem to look like growth markets, even in a slow overall economy.

DXP's industrial market, which is our largest market, continues to have legs, and shows signs of positive upward movement. The ISM PMI Manufacturing Index, which gives us an indication of how DXP's broad industrial markets will perform, have an average rating of 53% through June, and a September reading of still 50.9%. These end-markets, including food and beverage, chemical, aerospace, compressed air, manufacturing, general industry, should serve us well.

That said, inflation is good for DXP and a slower economy, or even a declining economy is manageable. But we have not yet seen any decline in activity in the markets DXP is serving. In terms of our energy market, we continue to see growth in oil, gas, biofuels, carbon capture, hydrogen, sequestration. We experienced a significant pickup in organic sales activity in Q3, which reflects the increase in backlog we began to see during Q3 of last year. The pickup is consistent with commentary around US majors and small exploration and production companies increasing cap budgets in 2023. That said, we are seeing delivery impacts related to supply chain issues that is slowing deliveries. Our oil and gas activity is not back to 2018 levels, albeit growing in that direction.

DXP's technical expertise within energy has positioned us on the forefront of engineering, design, fabrication and many environmental solutions and projects. Specific to renewable DXP has designed and fabricated many biofuel and hydrogen projects. As to the environment, DXP's effort to help our customers with carbon capture and sequestration projects continued to gain momentum. DXP is excited to be participating in the engineering on many projects with our legacy customer base.

Hydrogen is also an emerging technology and DXP is leveraging packaging capabilities to participate in projects around green, blue, gray and other hydrogen solutions. DXP is excited and well positioned to capitalize on the energy transition efforts for years to come. We are seeing increase in energy cap budgets, which have been gradual and should accelerate as we move into 2023.

Our utility market of water and wastewater is gaining traction with nine acquisitions plus organic growth within existing DXP Service Centers. The outlook is great for 2023. Several projects in 2022 have exceeded their budgets because of inflation, so we should see increased demand in 2023 and beyond with three market categories and many markets, we are building a more resilient, diversified business that can generate solid performance in more uncertain markets. And we believe we are seeing the evidence of these efforts. Regarding acquisitions, during the quarter, we closed the Sullivan Environmental Technologies Inc. as we mentioned earlier. We are excited to have them as part of our DXP water division.

We are continuing to see inflation across our product groups. But as we have discussed over the years, inflation is good for our business. Price increases are passed through to our customers. We have received multiple price increase notices from our vendors and expect this to continue throughout the year. The increases have moderated down to more normal amounts for the beginning of next year.

With global supply chain problems, our backlog at all-time high, it does appear that supply chains are not getting worse. As we head into the holiday season, bookings are starting to flatten in some areas as we close out 2022.

All of our segments are doing very well and have positive outlooks for next year. Service Centers is hiring sales professionals. National rotating equipment contracts have reached activity levels that require us to hire two additional sales professionals. Plus, SCS can help with supply chain problems, which puts their services in demand and IPS is busy with environmental projects, renewables, remanufacturing, and energy companies are increasing new capital budgets for 2023.

During our financial results, our third quarter reflects sequential growth and improvements in our end-markets. Total DXP sales for Q3 increased 5.3% sequentially and $38.7 million or 33.8% year-over-year. As always, thank you to our DXPeople family for your hard work and dedication. We are excited to add Sullivan in Q3 and look forward to continued growth in our DXP water division. All of our acquisitions continue to perform during Q3 and we look forward to having everyone's results for a full year in 2023. Again, keep up the good work and we are excited to have everyone as part of our DXP family. It is always my pleasure to share our performance and financial results on everyone's behalf.

We continue to build our capabilities to provide technical set of products and services in all our markets, which makes DXP unique in our industry and gives us more ways to help our customers win. In terms of our segment financial results, Service Centers sales of $260.1 million, followed by Supply Chain Service sales of $68.2 million and Innovative Pumping Solutions sales of $59 million. The diversity of the end markets and MRO nature within Service Centers allows us to continue to remain resilient and grow sales.

Supply Chain Services experienced significant sales improvement in the quarter, driven by the addition of the diversified chemical customer as well as overall growth in existing customer base and expect activity to increase as we move through the year. With disruptions in global supply chain, DXP's SCS is uniquely qualified to help customers with their maintenance, repair, operating and production supplies. We are excited about the supply chain business moving forward because our customers are looking for companies that can digitize the supply chain, resulting in a reliable supply of MROP goods and services.

DX customers are meeting demand, planning and forecasting and someone to monitor transportation, logistics and inventory levels, detecting issues and taking action well in advance of a problem. DXP's Supply Chain Services is well qualified to manage the complete supply chain by increasing efficiencies, eliminating downtime, all while keeping the customer's facility up and running, results in increased production, ultimately saving the customers money while improving their bottom line.

Our IPS segment is growing backlog and continues to increase bookings as our energy business continues to grow, but it is slowed by supply chain constraints. Our utility markets through water and wastewater included in IPS, because of the capital nature of this business, is growing and should have a positive runway for several years looking forward.

DXP's overall gross profit margins for the quarter improved to 28.8%. This reflects positive contributions from our acquisitions and continued improvement, albeit a decrease from a year ago because of increased labor cost inflation and a mix shift in increased Supply Chain Services growth, which, as you know, has lower gross profit margins.

Overall DXP's produced EBITDA of $34.3 million, and EBITDA as a percent of sales of 8.9%, which is a 240 basis point improvement over Q3 of 2021. This is a continued sign of DXP gaining – getting operating leverage, which we saw in Q1 and Q2 as well and which we would expect as we grow organic sales.

In summary, DXP's financial performance was great to see with continued sequential increases. We look to continue to drive improvement in our organic sales and marketing strategies and inorganic growth through acquisitions in certain geographies and industries. While we are encouraged by our performance in the third quarter, we are continuing to plan thoughtfully for next year given supplier price increases, labor shortages, supply chain constraints, and concerns of when a slower economy is coming.

We continue to see the industry and consumers we serve continue to grow as our backlog and bookings continue to perform. DXPeople are working hard to give our customers the service they deserve and expect, which is not easy given the headwinds we all face. I am pleased with our performance in Q3 as we continue to move forward to achieve our goals, our strategies, and digital tools are helping us grow sales and we expect to drive productivity, manage working capital, and create free cash flow.

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

Kent Nee Hung Yee

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

Thank you, David, and thank you to everyone for joining us for our review of our third quarter 2022 financial results. Q3 financial performance reflects our eighth quarter of sequential sales increases during this COVID cycle and the subsequent interrelated challenges including inflation, supply chain constraints, and a war. Despite these challenges, DXP continues to successfully navigate through the market and has been able to execute and create value for all our stakeholders. I'm excited to report that our Q3 2022 financial performance is the highest performing sales quarter in DXP's history. While a notable milestone, we look forward to continuing to strive to meet new sales thresholds and build DXP organically and through acquisitions. We have been successful in transforming, growing, and diversifying DXP.

As it pertains to our third quarter, DXP's third quarter financial results reflect the combination of business actions we have undertaken. More specifically, Q3 takeaways are as follows: continued strong organic sales growth and contribution from acquisitions; consistent ability to manage inflation and price increases; strong service center performance, marked by continued gross margin stability; further sales increases within SCS, along with another quarter increase in the IPS backlog; and a consistent operating leverage, leading to sustained adjusted EBITDA margins.

Total sales for the third quarter increased 33.8% year over year and 5.3% sequentially to $387.3 million. Acquisitions that have been with DXP for less than a year contributed $16.1 million in sales during the quarter.

We are excited to have our most recent acquisition, Sullivan Environmental Technologies, as a part of the DXP family. Sullivan Environmental will provide additional sales within the water and wastewater platform and provide margin enhancement and product and end market diversification. We welcome you, Sullivan, and we're excited to have you as a part of DXP.

Average daily sales for the third quarter were $6.1 million per day versus $5.8 million per day in Q2. Adjusting for acquisitions, the average daily sales were $5.8 million per day for the third quarter. That said, the average daily sales trends during the quarter went from $5.5 million per day in July to $6.8 million per day in September, reflecting a typical quarter end push. In terms of our business segments, Supply Chain Services grew sales 68.3% year-over-year this year – excuse me, 68.3% year-over-year. This was followed by Innovative Pumping Solutions growing 62% year-over-year. Excluding acquisitions, IPS grew 55.2%, or sales increased $20.1 million. This was followed by Service Centers growing 22.4% year-over-year. Excluding acquisition sales, sales within Service Centers grew 16% to $33.9 million.

In terms of our Service Centers, regions within our Service Center business segment which experienced sales growth year-over-year included Ohio River Valley, South Central, Texas, Gulf Coast, South Atlantic and North Texas. Key products and end markets driving the sales performance include air compressors, rotating equipment and water and wastewater, food and beverage, mining, municipal, air, transportation and specialty chemicals.

Supply Chain Services performance reflects an increase in key existing food and beverage and energy contracts as well as the addition of a large, diversified chemical customer that we mentioned in Q2 and that began to ramp in Q1. This customer contributed $16.5 million in sales during the quarter. In terms of Innovative Pumping Solutions, we continued to experience increases in the backlog. Our Q3 average backlog grew 6% over our Q2 average backlog and is ahead of our 2017 average backlog and down 6% from the 2015 average backlog.

The conclusion here is that we are now trending meaningfully above 2016 and 2017 levels and we are continuing to move towards 2015 levels based upon where our backlog stands today. We are transitioning to strong organic growth within IPS and look to find opportunities in other markets, including biofuels, hydrogen, carbon capture and sequestration versus our traditional oil and gas but we do expect energy to continue to contribute meaningfully.

Turning to our gross margins, DXP's total gross margins were 28.8%, 121-basis-point decline over 2021. This decline is attributed to the SCS contributing more to the overall DXP quarterly results or business segment mix contribution, as we mentioned in Q2, that historically has been offset by IPS's contribution or higher mix. For the third quarter, SCS was 18% of total sales versus 16% at Q2 and 15% at Q1. IPS for Q3 was 15.2% and Service Centers was 67.2%. Historically, Supply Chain Services has been closer to 14% or less of contribution to DXP.

In terms of operating income combined, all three business segments increased 115 basis points in year-over-year business segment operating income margins or $15.5 million versus 2021. This was primarily driven by improvements in organic operating income margins within IPS. Total DXP operating income increased 299 basis points versus 2021 to $26.5 million.

Our SG&A for the quarter increased $9.3 million from 2021. The increase reflects the growth in the business and associated incentive compensation as well as DXP investing in its people through merit and pay raises. SG&A as a percent of sales decreased 420 basis points year-over-year to 22% of sales, reflecting the leverage inherent in the business that we mentioned earlier despite increased operating dollars supporting our growth, cost inflation, and the impact of acquisitions.

Turning to EBITDA, Q3 2022 adjusted EBITDA was $34.3 million. Adjusted EBITDA margins were 8.9%. Year-over-year EBITDA margins increased 239 basis points or $15.6 million. This reflects the fixed cost SG&A leverage we experienced as we grow sales. This translated into 2.5 times operating leverage. In terms of EPS, our net income was – for Q3 was $13.2 million. Our earnings per diluted share for Q3 was $0.67 per share versus $0.36 per share last year. Adjusting for a onetime non-cash item, our earnings per diluted share for Q3 was $0.75 per share.

Turning to the balance sheet and cash flow. In terms of working capital, our working capital increased $25.7 million from June to $272.7 million. As a percentage of last 12 months sales, this amounted to 19.9%. This primarily reflects a $10 million increase in accounts receivable and $12 million increase in inventory and continued investments in our project work activity. Additionally, Sullivan Environmental and other acquisitions contributed $3.3 million of the increase in accounts receivable.

As discussed during Q2, we are still at a point where we are in line with our historical averages or range in terms of investing and working capital. But we would expect this to level off as a percentage of last 12 months sales as we onboard some of our recent acquisition for a full 12 months.

In terms of cash, we had $17.1 million in cash on the balance sheet as of September 30. This is a decrease of $3.6 million compared to the end of Q2. The reduction was a result of the purchase of Sullivan Environmental, share repurchases, and working capital uses. In terms of project work, activity has increased within IPS and we experienced a $4.5 million increase in costs and estimated profits in excess of billings over Q2 and have increased $12.9 million since Q4 of last year.

In terms of CapEx, CapEx in the third quarter was $1.6 million or an increase of $471,000 compared to Q2.

While we do expect CapEx to pick-up in Q4 2022 and into 2023, our year-to-date CapEx of $3.4 million is minimal, and continues to reflect our ability to control maintenance capital expenditures, with increases primarily driven by strategic investments. As we move forward, we will continue to invest in the business and focus on growth.

Turning to free cash flow. Free cash flow for the year is minus $1.2 million. This primarily reflects significant investments in inventory and project work, as mentioned earlier, throughout the year. Specifically, inventory has increased $30.3 million since December of last year, while our project investments have increased $12.9 million. As we increase project activities in our IPS business, we will experience higher uses of cash, which we are seeing, but this likely will be a little bit more sporadic as we continue to manage through supply chain delays.

Return on invested capital, or ROIC, at the end of the third quarter was 25%, and should continue to improve, as we drive margins and operating leverage and improve our run rate EBITDA. As of September 30, our fixed charge coverage ratio was 4.2:1, and our secured leverage ratio was 2.86:1, with a covenant EBITDA for the last 12 months of $122 million. Total debt outstanding on September 30 was $364.8 million. In terms of liquidity, as of the quarter, we were drawn on our ABL at $40.6 million, with $91.7 million of availability.

In terms of acquisitions, we closed on the acquisition of Sullivan Environmental Technologies during the quarter, and we're excited to have Sullivan with the DXP team, as I mentioned earlier. And we look forward to them reporting with us for the full quarter of Q4. Sullivan provides DXP with a leading platform within the municipal and industrial water and wastewater industries in the States of Ohio, Kentucky, and Indiana. Welcome to DXP, Sullivan.

DXP's acquisition pipeline continues to grow and the market continues to present compelling opportunities. While the backdrop may seem challenging, we're finding that there are no shortage of opportunities and sellers are reasonable when it comes to valuation.

Our acquisition strategy has created significant value for DXP, enhancing our end markets, margins, and DXP's cash flow profile. Looking forward, we expect this to continue into 2023.

Regarding capital allocation, our primary goal is to invest in our business, including the execution of our acquisition strategy. We are also committed to maintaining a conservative balance sheet as we demonstrated by a target leverage ratio of 3.5 times or less. To the extent we have excess capital after achieving these objectives, the share repurchase program will provide us the mechanism to return capital to our shareholders.

During the quarter, we repurchased 3.4 million in shares and year-to-date, for the nine months, we have purchased $18.5 million, including open market purchases and private negotiated transactions.

In summary, our priority from a balance sheet perspective is to maintain our financial flexibility and strength without sacrificing long term growth or market opportunities. As we have outlined this morning, we have outperformed the market, delivering impressive sales growth and margin strength while achieving record sales results, all while deleveraging the balance sheet.

Our resilient and critical MRO and supply chain solutions, combined with our project capabilities and exposure to the sustainable secular trends, including water and wastewater and various sustainable energy markets, will drive our future sales and profitability. We are excited because there is still substantial value embedded in DXP. We look forward with great confidence to a future of sustained growth and market outperformance.

Now, I'll turn the call over for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question is from Tommy Moll with Stephens. Your line is open.

Tommy Moll
Analyst, Stephens, Inc.

Q

Good morning, and thanks for taking my questions.

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

A

Good morning.

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

A

Good morning, Tommy.

Tommy Moll
Analyst, Stephens, Inc.

Q

I wanted to start at the top of the P&L on your daily sales. Can you give us any context on what October looked like? And then as we look toward November and December, based on your commentary, it sounds like ex-oil and gas that revenue might continue to trend higher, but then you've got the seasonality or the typical seasonality in that oil and gas market. So I wonder on a consolidated basis, how do you see that daily sales progressing through this quarter?

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

A

Yeah. So, Tommy, I'll jump in there and then maybe David can give a little color just from a market perspective. But the trend – and I'll just really go through the quarter and into October – was $5.5 million per day, $5.9 million, $6.8 million in September, and then on October, another $5.8 million. Our October sales per business day is up 25.1% on a comparative year-over-year basis. So we're seeing the trends continue early on here in the fourth quarter. But you had some other comments. I don't know if David want to jump in there around oil and gas and some other things, so.

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

A

Sure. Oil and gas you either head to the end of the year and people have run out of budget money, or they haven't and they want to spend it. And then you have the holidays. And so, I mean, that's kind of how the oil and gas piece works. The general industrial piece, a lot of manufacturers will shut down a week during the holidays, etcetera, so you have some softness there. So you have a little less days. You have manufacturing probably taken advantage of – or maybe not. I mean, they may be so far behind on their deliveries because of the supply chain problems that they don't take the usual week or two off. I'm not sure how that's going to play out.

I do know on oil and gas that people are – at these prices, they're trying to produce as much oil and gas as they can. Doesn't mean they're drilling billion holes or Halliburton and Schlumberger are doing a lot of work around workovers and DUCs and etcetera. So, that's – that's kind of normal stuff. I mean, in general, oil and gas is going to be a good market for the rest of this quarter, really, in my opinion, and through all of next year. So, I don't know if I answered your question or not, but that's – that's my attempt.

Tommy Moll
Analyst, Stephens, Inc.

Q

No, it's helpful context. I appreciate it. And if we just move down the P&L, I would ask you for your outlook on fourth quarter gross margin or SG&A as a percent of revenue, although understanding it's hard to pin down the revenue. There may be some uncertainty there. But maybe we could just start with any qualitative headwinds or tailwinds for gross margin or G&A in third quarter and the extent to which those would improve or get a little worse as you go into fourth quarter.

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

A

Yeah. Tommy, I'll jump on that one. I mean I don't know if they're necessarily headwinds but we've been kind of really communicating it since Q2 is we've got a significant diversified chemical customer within our Supply Chain Services segment that the overall profitability, including the SG&A costs, is in line with where we're typically at. But, from a gross margin perspective, it's put a little bit of weight on the downside to our gross margins.

They're obviously a significant sales volume customer, too. So, it's a combination of the both, and that's what's led to the business segment mix contribution kind of shifting here on us. And we're always looking for more opportunities with both our existing customers and new customers. So, net overall profitability is in line for the segment but from a gross margin perspective, kind of puts a little weight on our gross margins. That said, I don't think we'll continue to see too much further drag unless the sales just extremely ramp up in Q4. We're close to a full ramp at this point, so.

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

A

We – we do a good job. If somebody calls us today, they need a pump, we use replacement costs and mark it up our normal markup and that transaction happens just fine. There's a little bit of fixed cost. We try to avoid those and go with a fixed margin, but there's still some lag between when the supplier gives us a price increase and when we get this – the price increase passed on to the customer, so a little lag there.

And then, on things that – projects that we quote, and we quote a $4 million project, and we get the order, we have the right to not take the order, obviously, if its pricing has gone really astray. But if pricing is pretty normal, then it takes six months to build out the order, maybe longer. Labor costs go up. Things – a lot of the stuff we didn't order everything exactly the day we got the order, goes up. So there's always some lag. And I think the difference between the 30% gross profit margins, which would be more of our targeted gross profit margin number, which is what we did last year at this time. And the 28.9% or 28.8%, wherever we are today is because of those reasons we just listed.

Tommy Moll
Analyst, Stephens, Inc.

Q

So on to cash flow. You called out a couple of areas of investments year-to-date in terms of inventory and receivables that have impacted their performance there. I guess to start just versus your expectations, how have operating cash flows progressed? And as you look into Q4, do you see any potential for a release of cash from inventory or receivables or a pathway to the black, so to speak, on the operating cash flow line this quarter?

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

A

Yeah, Tommy. I'm going to give you a high level answer here and then I'll let Kent put some details. But realistically, if we're growing organically 10% and therefore receivables and inventory go up some percentage of that growth, normally we're in the – working capital is 15% to – a high watermark would be 19% – 15% to 19% of that sales growth. What happens when we grow 35% organically? Well, it takes more working capital. So, within a short period of time, you're going to have to increase your inventory levels to support the greater sales number.

And obviously receivables goes up and then Kent pointed out that we get progress billings on projects and that on those projects, of course, our customer doesn't want to pay us and of course we want to be paid more than our cost. We want the customer to fund the cost of those projects. And so somewhere in the middle is what ends up getting negotiated on the terms and conditions of those contracts.

And really we're, when you look at IPS, it is coming out of a buyer's market and sales were down substantially because of oil and gas and et cetera. So yeah. Have we let the customer beat us up a little bit on cash terms? Yes. Will that continue going forward? No, not as soon as we have a seller's market will get real aggressive. So I don't think there's anything that in the fourth quarter is going to sit there and say that we're just going to have a whole bunch of money fall in our lap, because that's – I don't know what Kent thinks, but I don't – I'm not sure that's going to happen because we need the inventory – we turn our inventory 7 times so – and then, receivables, collection. And then, we'll do the best we can to improve progress billings. But, really, it all gets down to, fundamentally, if you're growing 30%, 35%, you're going to spend more working capital.

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

A

Yeah. And, Tommy, the only thing I'd add there is a couple of things. Our cash from operating activities was really actually positive in Q1 into Q2. So, our – we produced free cash flow in Q1 and Q2, which was a little bit of an aberration from our historical trends where we're typically free cash flow negative in Q1 and Q2. And then it's Q3 and Q4.

Point being is, and I kind of mentioned it in my comments is I think, it's project work activity. It's the sporadic nature of the supply chains. There's a lot of, I think, factors contributing into it. So, [indiscernible] (40:25), will we collect some cash in the fourth quarter to that? Yes. Will it be larger than normal? I don't think so. I think we're always working to collect on those projects that David's talking about. And then, we've made some investments in inventory. And so, as we move through Q4, some of that naturally slows just from a seasonal perspective. But then, we're going to be quickly going into Q1 again next year. So...

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

A

And really, to emphasize one point, too, is that, part of the eliminating risk in our business is the fact that when sales go down, well, then receivables and inventory go down and we generate a ton of cash flow. So, I'm not sure we want that. I think growing 30% is more fun than going down. But when we're growing 30%, we're going to be – we're going to use a lot of our cash for organic growth.

Tommy Moll
Analyst, Stephens, Inc.

Q

Right.

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

A

No, we are. Yeah.

Tommy Moll
Analyst, Stephens, Inc.

Q

Well, maybe one more on M&A. Kent, I think it was your comment about a growing pipeline there. I'm curious about or I'm curious whether you can put any bands around the sizes of potential deals you've – in terms of number of deals, been quite active in terms of size of deals were, I think, probably trending below the historic average for DXP. So, I wondered if you could characterize the pipeline as it sits today.

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

A

Yeah. I would say the pipeline sits in a few buckets. One is, and David mentioned in his comments, I mentioned it around Sullivan, but is – we have a pocket or a pool of water/wastewater transactions, which I think you kind of hinted at. But on average, those transactions have been smaller than I think historically for DXP, meaning I'll call it, $ 10 million or less on average. We've had some one or two sizable ones in there. But on average, you're talking in terms of revenue $10 million or less.

And then we have some air compressors, which we've done here more recently as well. And those transactions have been – some of them have been our average transaction size. Some of them have been a little bit larger. And so, I think you'll continue to see that as well. And then, the last bucket is probably, we opportunistically are also looking at some automation and some other things and some kind of closer to the bearing and PT space. And once again, some of those are much bigger than our average, and some of those are in line with our average.

And so, point being, it's like I said, I see a fulsome pipeline, and I see some opportunities out there for DXP. And we've been able to get reasonable valuations. And so we look to kind of push into 2023 with us closing on hopefully some acquisitions and kind of keeping that ball moving forward. Once again, all assuming valuations are reasonable. We're disciplined around valuation and it makes sense for DXP.

Tommy Moll
Analyst, Stephens, Inc.

Q

I appreciate all the time and I'll turn it back.

Operator: [Operator Instructions] And it appears that we have no further questions. I'll turn it over to David Little for any closing remarks.

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

Yeah. Thanks everybody for your participation today. I think DXP is really in an interesting inflection point where we have a tremendous amount of organic initiatives that we're pretty excited about. We continue to do what we've always done, which is our founding was selling pumps, but there's a lot else that we can do. And in terms of providing products that require technology and that require a level of expertise which we love.

And so we're pretty excited about the transition that DXP is moving towards the diversity of the markets. We're in energy, but it's moving toward storage and carbon capture and some really neat stuff. And so that's exciting for us. And so we see energy and its relevance improving. We're also in the utility market. Water and wastewater is a big utility market that is important to all of us. And so we're excited about that. And then the industrials, normal manufacturing, chemical, aerospace, etcetera, all those markets seem essential to us and will, I think, serve us well. I think, we're obviously – the Fed's trying to slow down the economy, and so that's probably going to happen from a overall perspective. But when we look at the things we're doing, we think we're going to fare really well.

So with that, again, thank you for your participation. Thank you for your understanding of our story. And you all have a great day.

Operator: Ladies and gentlemen, this concludes today's conference call. You may now disconnect.