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DXP Enterprises, Inc. (DXPE)

Q4 2019 Earnings Call

CORPORATE PARTICIPANTS

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

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

OTHER PARTICIPANTS

Blake Hirschman
Analyst, Stephens, Inc.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Carl L. Schemm
Analyst, KeyBanc Capital Markets

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the DXP Enterprises Fourth Quarter and Fiscal 2019 Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, David Little, CEO and Kent Yee, CFO. Please go ahead.

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

Thank you, Kinsey. This is Kent Yee, and welcome to DXP's Q4 2019 conference call to discuss our results for the fourth quarter and fiscal year ending December 31, 2019. 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 is now available on our website at ir.dxpe.com.

I will now turn the call over to David to provide his thoughts and a summary of fiscal 2019 and the fourth quarter results.

David R. Little

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

Thanks, Kent, and thanks to everyone on our 2019 fourth quarter and year-end conference call. Kent will take you through the key financial details after my remarks and after Kent's prepared comments, we will then open for Q&A.

DXP started fiscal year 2019 with the intention of making meaningful investments internally to grow sales and become more productive. We took on various initiatives that require short-term added expenses and capital investment. Some of these large initiatives included enhancing, improving and consolidating our corporate operations to better support our internal customers, moving our flagship fabrication facility in Houston to a new 100,000-plus square foot facility to provide more capabilities and faster deliveries for our customers; implementing several new software applications to support supply chain services, accounts payable and human resource teams; expanding our aftermarket service and repair business, new programs around vendor managed inventory and supply chain services and created multiple new sizes of our PumpWorks private label brand, including two new products PWA-SLs and PW-PCs. We are pleased with these initiatives to make us fast, convenient and technical experts.

Capital expenditures for fiscal 2019 were $22.1 million of which $13.1 million was entirely growth-related and in support of these initiatives and positioning DXP for the future. Our growth initiatives were largely supported by our end markets for three quarters of the year. And as we finish Q3, we experienced a deceleration in our backlog. Subsequent to Q3 oil and gas activity continue to slow and in some instances halted as we closed out the year. Additionally, our industrial end market indicators started to show signs that pointed to a slowness in activity that caught up with our results in Q4.

However, we feel optimistic about 2020 despite the volatility in the market environment, given the strength of our balance sheet, recent acquisition activity, and the future opportunities we have to drive gross margin improvement and to renewed focus on creating efficiencies in 2020. We believe there are projects in 2020 to win and execute and that DXP will participate in this activity.

Our end market indicators have slowly started to rebound, including the PMI, Metalworking Business Index, but the overall health of the economy was trending in a positive direction and seemed to be better until the most recent macro event, the coronavirus, briefly DXP was developing programs to help keep our employees safe as possible therefore, keeping our customers exposure to a minimum. PumpWorks supply channel will not be affected as everything made is made in America.

Our fourth quarter results reflect the abrupt halt to the oil and gas spending as our customers approach their fiscal year end, and as overall slowness in the industrial markets that started to show signs in Q3. Total DXP sales for Q4 were $295.5 million or $4.8 million per business day. However, our profits were also impacted by some onetime or unique items and jobs which shipped that Kent will review during his comments. That would have softened the impact of the slowing in sales.

DXP delivered 4.2% total organic sales growth for the full year. DXPeople continue to provide 100% effort and doing a day's work in a day and driving stakeholder success and value creation. Thank you to the 2,746 DXPeople for your hard work and dedication. It is always my pleasure to share your financial results on your behalf.

We generated $19.2 million of free cash flow in 2019, which is after the significant investments made in the fiscal year 2019. DXP is positioned for significant capital deployment going forward as we look to close additional acquisitions after the two we closed at the beginning of the year, Pumping Systems, Inc. and Turbo Machinery Repair. We believe we continue to take market share in many of our businesses driven by our focus to provide fast, convenient and technical expertise for our customers and all our stakeholders.

Turning to our results. Total DXP sales in fiscal 2019 were $1.3 billion, a 4.2% increase over the fiscal year 2018. Supply chain services sales were 15.4% year-over-year to $201.3 million. Innovative pumping solutions sales increased 4.1% year-over-year to $303.7 million, while service centers sales increased 1.6% year-over-year to $762.3 million.

Supply chain sales growth reflects the addition of new customer sites. They have implemented 14-plus new sites since Q3 of last year, including customers in the medical device, aerospace and food and beverage markets. In innovative pumping solutions, sales increase continue to be driven by our modular package equipment of CTO and ETO jobs for upstream, midstream, refinery, chemical, petrochemical and power customers. In terms of the IPS backlog, it continued to decelerate in October and maintained its levels through the last two months of 2019. IPS yearly average backlog decreased 1.1% from 2018 to 2019. The Q4 monthly average is down 11.4% from the 2018 yearly average backlog.

Overall, while the backlog has decelerated off of the 2018 high points, we remain encouraged by the total backlog dollar amounts and the market commentary from our customers that point out that there are jobs to win into 2020 and DXP should get its fair share. Keep in mind that we had experienced 43% sales growth from 2017 to 2018 and the volume is slightly down in 2020. We are not envisioning a scenario where we cannot make money. We made adjustments during the last cycle. We should be able to profitably perform at the current levels we are experiencing.

The service center year-over-year sales growth was primarily driven by increases in our metalworking rotating equipment product divisions. Within service centers, we saw particular year-over-year sales strength in DXP-Ohio River Valley, [indiscernible] (00:10:25) and Texas Gulf Coast regions. Our Ohio River Valley region specifically set a record with its highest sales performance year in the history of DXP. Congratulations.

DXP's overall gross profit margins for the year were 27.4%, an 8 basis point improvement over 2018. Adjusting for unique items and IPS' jobs, gross margins were 27.6% or a 28 basis point improvement over 2018. That said we were disappointed in the cost on these jobs and have made internal adjustments, including processes and personnel changes as we should have finished 2019 stronger than we did even in light of changing market conditions. We still are driving improvements in gross profit margins and look to have incremental improvements through 2020.

SG&A as a percent of sales increased 49 basis points going from 21.7% in 2018 to 22.2% in 2019. In terms of my thoughts on SG&A, SG&A will be managed to a targeted percent of sales, as we become more focused on the macro environment while pushing the envelope for accelerated acquisition costs and pushing on cost efficiencies in 2020.

DXP's overall operating income margin was 5.2% or $66.1 million, which includes corporate expenses and amortization. We feel there is the opportunity in our operations to be more efficient as I just mentioned, but we want to make sure this is targeted towards those businesses that still have areas of improvement within DXP.

Service centers operating income margins were 11.4%. IPS operating income margins were 9.5% with Q4 results showing weaknesses due to lower margin jobs and the impact of some onetime cost. Adjusting for these jobs and onetime costs, IPS operating income margins would have been 10.4%. And finally, supply chain services operating income margin was 7.2% with supply chain improving margins in the fourth quarter 126 basis points.

Overall, DXP produced EBITDA of $91.3 million versus $95.8 million in 2018. EBITDA as a percent of sales was 7.2% versus 7.9% in 2018. And in terms of capital allocation, fiscal 2019 was focused on investing internally in the businesses as I've shared with you when I started my comments. Additionally, DXP focused on generating cash, paying down debt, maintaining a pristine balance sheet that would give us the opportunities headed into 2020 to pursue acquisitions more forcefully. For the future successful execution of our strategy, we expect continued improvements towards generating free cash flow and greater shareholder value.

In summary, we are pleased with our first three quarters and disappointed in our fourth quarter. Q4 has a lot of noise and that will not reappear, but sales were down and the outlook seemed okay with backlog building slowly and then oil prices go to $43 a barrel driven by the coronavirus. We look to continue to drive improvement in our gross margins, move closer to our historical average of 28-plus-percent on a combined basis.

We will drive future sales growth through acquisitions and anticipate fiscal 2020 to be another year of volatility, but one where we cannot take anything for granted and need to proactively drive sales growth through acquisitions, improving gross margins through internal initiatives, and look to drive efficiency were appropriate in light of ever-changing market environments.

We know that DXP has a differentiated, compelling value proposition. DXP sales, operation 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 will thrive to improve in the upcoming year, and we will drive change, innovate for growth and lead smarter.

With that, I'll now turn it back over to Ken to review the financials in more detail.

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 fourth quarter and fiscal 2019 financial results. Q4 financial performance reflects a shift in the operating environment specifically by our oil and gas customers. All three business segments were impacted but the greatest impact was felt within Innovative Pumping Solutions.

That said, DXP finished the year in a strong position, poised to execute on our acquisition strategy having closed two acquisitions since year-end, drive further improvements in gross and operating margins within Innovative Pumping Solutions, which I will touch on in my comments later, and continue to drive free cash flow generation as we move into fiscal year 2020.

As David mentioned in his comments, fiscal 2019 was focused on internal investment and positioning DXP to continue to serve our customers, employees and suppliers. We executed our plans while navigating the changing macro and industry environment. Our initiatives were focused on improving our facilities and expanding for growth, enhancing our software tools to be more efficient and manage the business smarter, and offering products and services to continue to be a one stop source for all our customer needs.

Total sales for the fourth quarter decreased 5% year-over-year to $295.5 million, reflecting the stall in activity we experienced from our oil and gas customers. Total DXP sales for fiscal 2019 grew 4.2%. First six months of 2019 we were on a pace to grow 7.9%, and through three quarters, we were still on track to grow 7.3%, a majority of the drop off occurred in Q4 and the shift or halting in spending from our oil and gas end markets. As such, for the second half of 2019, Q3 and Q4, we grew 0.6% on a year-over-year basis. Average daily sales for the fourth quarter were $4.8 million per day versus $5 million per day in Q4 2018. Average daily sales for fiscal 2019 were $5 million per day versus $4.8 million per day in fiscal 2018.

In terms of our business segments, all three experienced sales growth year-over-year with Supply Chain Services showing the greatest improvement, increasing 15.4% followed by Innovative Pumping Solutions, which experienced 4.1% growth and Service Centers with 1.6% growth. Supply Chain sales growth reflects the addition of new customer sites, which we have highlighted since Q3 of 2018. SCS has consistent sequential growth quarter-over-quarter through 2019, implementing 14 plus new sites including customers in the medical device, aerospace, and food and beverage markets.

IPS sales growth was driven by configured to order, engineered to order, and our branded private label pump offering. End markets where we experienced growth include the upstream, midstream, refinery, chemical, petrochemical, and power customers.

Regions within our Service Centers segment, which experienced meaningful sales growth in fiscal 2019 include the Ohio River Valley, West, and Texas Gulf Coast regions. Additionally, we saw meaningful increases within our seal, metalworking and rotating equipment product divisions. As David mentioned, we want to congratulate our Ohio River Valley region for setting a sales record growing to over $81.7 million in sales. Congratulations to the ORV team, you had a great year.

Turning to our gross margins, DXP's total gross margins were 27.4%. DXP's total gross margins for 2019 reflect progress. However, in Q1 and Q4, we were negatively impacted by projects that loss gross profit dollars. We were simply too aggressive in building market share and on multiple projects manufacturing made mistakes. There have been some adjustments to improve these processes and personnel changes and we should see gradual improvement in fiscal year 2020. Adjusting for these jobs on a breakeven basis gross margins would have been 27.6%.

In terms of operating income combined all three business segments declined by 49 basis points in year-over-year business segment operating income margins versus 2018. Total DXP operating income decreased by $2.3 million or 3.4% versus 2018 to $60.1 million. Service centers improved operating income margin 62 basis points to $86.8 million. Supply Chain Services decreased 211 basis points year-over-year to $14.4 million followed by Innovative Pumping Solutions, which had a 212 basis point decline to $28.9 million for fiscal year 2019. The decline in SCS is associated with the implementation of new SCS sites and revenue not fully scaling as mentioned during our earlier conference calls.

Additionally, Supply Chain Services was impacted by a significant overrun on costs of implementing software for one of our customers that was intended to increase warehouse management productivity. That said, Supply Chain Services improved operating income margins 126 basis points sequentially from Q3 to Q4, and they are back on track going into fiscal year 2020.

In terms of IPS, not only was IPS impacted by multiple job shipping at the same time that were focused on market share gains versus profitability, but they also impacted by $1.6 million in onetime SG&A items during Q4. In terms of corporate SG&A, DXP incurred an additional $1.5 million in onetime items that will not repeat in 2020. Adjusting for these items, operating income would have been $69.3 million or 5.5% of sales.

Turning to EBITDA. Fiscal 2019 EBITDA was $91.3 million. EBITDA margins for fiscal 2019 were 7.2% compared to 7.9% in fiscal 2018. Again, if we adjust for the aforementioned items, adjusted EBITDA would have been $94.5 million or 7.5% of sales. We do need to remember and note that fiscal year 2018 includes a onetime gain from the sale of our corporate facility, so on a comparative basis, EBITDA would have been flat year-over-year.

In terms of tax, our effective tax rate was lower this year, primarily due to the impact of a future statutory rate change. Alberta, Canada moved from 12% to 8%. We also received an increased benefit from R&D and work opportunity tax credits that DXP has previously received in the past and a favorable change in an estimate due to tax reform.

In terms of EPS, our net income for 2019 was $39.1 million. This is up $3.6 million or 10.1% versus 2018. Our earnings per diluted share for fiscal 2019 was $1.96 versus $1.94 in fiscal 2018. Adjusting for all the items we have discussed previously, earnings per diluted share in 2019 would have been $2.17 or $0.21 per share impact by these onetime or unique items.

Turning to the balance sheet. In terms of working capital, our working capital increased $21.1 million from the prior-year to $225.3 million. Working capital as a percentage of sales at the end of the fourth quarter was 17.8%. This is above our historical average, but reflects 170 basis points improvement compared to Q3. The main drivers of the increase in working capital in 2019 include a $14.5 million increase in inventory and a 5.8 average payables day reduction in accounts payable or $11 million impact. We achieved inventory turns at 7.1 times, down from 7.7 times a year ago. From Q3, inventory is down $2.6 million and accounts payable is down $6.7 million.

We recently invested in a new procure-to-pay platform, Coupa, and we are seeing the impact of this investment in managing our financial relationship with our vendors, which we've mentioned in Q3. While it helped us get more in line with paying our vendors, over time, we would be in a better position to strategically manage accounts payable as we move forward and take advantage of purchasing data and trends in the future.

In terms of cash, we have $54.3 million in cash on the balance sheet at December 31. This is an increase of $13.8 million compared to December 31, 2018. In terms of CapEx, CapEx in the fourth quarter was $7.9 million or 2.7% of fourth quarter sales. CapEx in fiscal 2019 was $22.1 million, or 1.7% of total sales. Compared to fiscal 2018, CapEx dollars are up $12.8 million.

As we have been discussing, CapEx during the year reflects investments made within our facilities including our corporate office, new fabrication facilities in Houston and other service center locations. We also are continuing to make investments in software to enhance our corporate support operations and provide our people with tools to be more efficient. Fiscal year 2019 has been a year where we have focused on growth CapEx versus maintenance CapEx. Of the $22.1 million in CapEx, 59% or $13.1 million has been growth related.

Turning to free cash flow, we generated solid operating cash flow during the fourth quarter. During Q4 and fiscal 2019, we had cash flow from operations of $33.8 million and $41.3 million, respectively. Cash flow from operations increased 15.3% or $5.5 million versus 2018. For fiscal 2019, we generated $19.2 million in free cash flow.

Adjusting for the growth-related CapEx, adjusted free cash flow would have been $32.9 million or an increase of 13.1% versus 2018. While we're always looking to enhance and improve our cash flow generation, we are comfortable with where we're at, at the end of the year with further improvements to come in the future.

Return on invested capital, or ROIC was 24.2%. In terms of our capital structure at December 31, our fixed charge coverage ratio was 2.9 to 1 and our secured leverage ratio was 2.2 to 1. Total debt outstanding at December 31 was $244.4 million.

In conclusion, we remain focused on improving the way we operate our business segments and we have plans to continue to do more to propel disciplined, consistent execution to drive greater productivity, margin leverage, and free cash flow in our businesses. DXP is on the path of achieving its financial goals driving organic and acquisition sales growth, EBITDA margin improvement, and EPS increases.

We will now turn the call over for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Blake Hirschman from Stephens. Please go ahead. Your line is open.

Blake Hirschman Q
Analyst, Stephens, Inc.

Good morning, guys.

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

Good morning, Blake.

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

Good morning, Blake.

Blake Hirschman Q
Analyst, Stephens, Inc.

First one, I'll just start with IPS, the margins essentially breakeven there, you talked about the $1.6 million I believe of onetime cost, can you talk a little bit more about that? And kind of help us bridge to how are you all the way down to basically flat? Yeah, I'll start with that.

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

Well, Blake, this is Kent. First of all, it started off with that we just simply had some jobs that had negative gross margin dollars. So the first adjustment even though that's very uncharacteristic for us as we said it was an effort to build market share and some aggressive nature on the sales side of our business, if you will, and so that was roughly a $2 million impact. So if you just – and that's just the breakeven, that's not to say, hey, maybe those jobs could have performed at closer to our average gross margins, but it's purely a conservative view is just assume those jobs broke even and so that's a $2 million impact.

Then in Q4 as well, you had some SG&A items, some more cash, as well as noncash that related to the IPS segment. And that's where you get that additional kind of $1.6 million impact that flow through to SG&A, and so that – that's where you get the additional kind of $1.6 million there as well.

So, in total, you're really looking at $3.6 million in IPS alone, that's just flowing through. And so that – if we didn't have those items, obviously, you can do the math. We would have been in the positive operating income territory. We would not have been at the margins we were at in Q3, but we surely wouldn't had basically a breakeven quarter. And so that's kind of how we look at it. But, once again, it doesn't reflect that had those jobs performed at our average gross margin, you could potentially add another $2 million on top of that from operating income perspective, so.

Blake Hirschman
Analyst, Stephens, Inc.

Q

Okay. And have the majority of the more aggressively bid jobs flowed through, or is this something we should be thinking about carrying over into the next few quarters or a year within that IPS?

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

A

Yes. That's a great question, Blake. What I would say is we can see another four to six jobs that could ship kind of potentially in 2020 and even as late as 2021 just depending upon the timing of those jobs. And so, we have some more, if you will, in the funnel not in terms of volume or number of jobs, a majority went out in Q4. And so – but there could be some more – well, there will be more into the future. We just don't know the exact timing right now at this point, but we can see it.

Blake Hirschman
Analyst, Stephens, Inc.

Q

Okay. And then on the gross margins, it took a little bit of a step back. Was that mainly kind of due to these IPS segment issues that we talked about or is there more geographical product segment noise, just kind of want to get a better feel for some of the pieces there?

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

A

I guess I'm not following there, Blake. Just maybe clarify the question versus the previous one?

Blake Hirschman
Analyst, Stephens, Inc.

Q

Yeah. So, was the step back in gross margin that we saw, was that mainly due to IPS or were there's some other headwinds in there may be in the other segment?

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

A

Oh, I got you. No, no, the majority of the ones I apologize Blake I follow you, now you're talking total DXP gross margins.

Blake Hirschman
Analyst, Stephens, Inc.

Q

Correct, yeah.

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

A

Yeah, no, the step back was primarily IPS driven. There was a small quarter-to-quarter decline in the Service Centers, but nothing notable. A majority of that headwind was IPS related.

Blake Hirschman
Analyst, Stephens, Inc.

Q

Okay. And then just lastly, can we get the sales per day trends any commentary you guys have...

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

A

Yeah.

Blake Hirschman
Analyst, Stephens, Inc.

Q

...around how things bounced or if they have come back at all since the end of the year and how we should be thinking about the market with this coronavirus situation?

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

A

In terms of sales per business day, I'll just read you the numbers as I normally do. And I'll start as I normally do Q4 and bring you through estimate for February. October was $4.6 million, November $4.7 million, December $4.9 million per day, January $4.4 million per day, and in February $4.6 million. So, definitely a pull off from $5 million per day we were averaging 2019, but we're picking up as we kind of, if you will, bottomed a little bit here, and March is typically a big month for us Blake. So, we're anticipating a big month in March as we normally have when we finish the quarter out.

Blake Hirschman
Analyst, Stephens, Inc.

Q

All right. Thanks a lot. I'll hop back in queue.

Operator: Our next question comes from the line of Joe Mondillo with Sidoti & Co. Please go ahead.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Hi, guys good morning.

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

A

Good morning, Joe.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

I apologize I missed – I missed the beginning of the call. So I apologize if we covered something already. But a couple of things, first off IPS. So in terms of the revenue, much lighter than we were looking for. Just going back to the third quarter call back in November, it seemed like relative to the backlog, you stated that backlog was I think you said slightly down. But this is a long lead time type business. And so I was thinking you know that would be a 2020 type of fact. And you even stated that you thought fourth quarter should be trending pretty good and revenue off what 10% or so, much lighter than that I was looking for. So could you help understand how the fourth quarter progressed relative to I guess your expectations?

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

A

Joe, this David. And you know, the fourth quarter is – I wish we had more color on that. It just seemed like that – that everybody stopped buying. I mean it just really, really quiet [indiscernible] (00:35:01) by the inactivity. And our capital – and you're talking specifically about IPS. So they're working off backlog and the holidays have a tendency to produce quite as much during the holidays as we normally would. But there was plenty of work. So really there's also the component of just weekly business where we get an order and we ship it in a week. That also happens in the capital project side. So that kind of slowed pretty drastically. And so, it – and then I don't really have an answer for it except for the fact that our oil and gas customers, the word on the Street was that they were not going to spend any money for the rest of the year, build up their cash flow and try to get their stock up.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. So, it sounds like the bookings at least in the first half of the quarter, the orders didn't trend so well. How have the orders trended over the last five months or so? Could you help us understand the trend there in terms of new orders and where your backlog is today?

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

A

Yeah. And you said you missed the earlier part of the call, so that Joe, that was in David's comments, but essentially on a year-over-year basis, the backlog is – from a dollar point of view – is just down 1.1%, meaning where we stood at December 2018 versus where we stood December 2019 is just down 1.1%. That said, if you look at the Q4 monthly average backlog, we're down 11.4% versus the total fiscal year 2018 average backlog.

So, from our perspective, the absolute dollars point to the, hey, there's still activity and that follows up and firms up with that we're hearing from our team in the field, interacting with customers. And so dollars do appear to be down but not materially. And there's projects that we know have been won in our backlog that are showing in our backlog in February and likely in March. And so, we feel good with where we're at.

But from an absolute percentage point, it is down 11.4%. But once again, that's coming off our – from an absolute dollar perspective, you got to remember 2018 was up you know 40-plus percent off of 2017 and so net-net, what I'm getting at is – we're still comfortable with where we're at. And our Q3 commentary was really that there was this deceleration occurring in the backlog and that's still continued but we're seen in the IPS backlog a pick-up here as we go into the beginning of the year. And so, we'll have greater clarity once we get to Q1, our Q1 earnings call.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. Could you clarify, I thought you said that it was down 1% at the end of 2019, and I thought you just said towards the end of your remarks there, down 11.4%. Could you just clarify?

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

A

Yeah. I'm just giving you two different data points of how we dissect our backlog without giving you the absolute numbers. But if you look at where we ended 2019 versus where we were at the end of 2018, backlog dollars are only down 1.1%.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. And then I thought if you said, you looked...

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

A

And then if you look at the average monthly Q4 backlog and compare that to the entirety of fiscal 2018 average monthly backlog that's only – not only but it's only down. It seemed we had such a strong year in 2018 but that's down 11.4%.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. Okay. I got it. So just a follow up on that and relative to your comments that you made regarding margins and some of the lower margin projects that you're trying to take share. It sounds like and this could be a total coincidence, but it sounds like maybe you're taking – you're trying to go after some share with some pricing strategies in a more competitive weaker demand time period. So, while your backlog is down 1% at the end of 2019, is the margin lower, is that just a coincidence relative to the comments that you made regarding some of that low margin or negative margin type projects?

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

A

So, I'll answer this the best I can. Sale – we actually gained two brand new customers we've never done business with, used to buy from [indiscernible] (00:40:54) and so they bought from us. And we won that business. And I really don't mind the fact that the salesmen get really aggressive and we're trying to gain market share, et cetera. That's a common thing. What's not right and what's not common and not acceptable to me is that that we actually would take orders below our cost. So, there might be a reason to maintain account and sell at cost. There might be, we need work in the shop to maintain and so it might take an order at cost. But it's not acceptable to sell jobs where we're just going to give the customer equipment and money at the same time. And so, that was happening and where the checkpoint on that is not the salespeople, salespeople did their job. They would have got an order. It was the manufacturing side where we didn't have good checks and balances. We had checks and balances, but the person there wanted the order and so we took it and we lost money.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

And in terms of the I guess internal process that you guys manage, was there a effects to this in terms of the strategy and the process?

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

Yeah. We've – we looked at the process there were some personnel changes. And so we fully expect while, Joe, I don't know when you jumped on the call but in the previous question, there are some jobs we still got to work through. But we've put in some changes and personnel changes and so we expect that there will be improvements as we go throughout the year.

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

Okay. And then, Kent, I was hoping that you could clarify exactly what the $1.6 million of onetime items were?

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

So, the $1.6 million, there's a lot of stuff, some of it was some R&D costs that got categorized incorrectly that you can argue. It had to do with some of these jobs. And so that was roughly $769,000. We did – from a corporate perspective, buy out one of the machines there. So that was another $251,000. But also that was just reflecting some bad financial decisions being made there. And then there was impact related to our inventory reserve that we needed to take in the magnitude of $442,000 and then another $181,000 once again that's specific to another job that had been on the books for a while. So you add all that up in Q4 and you get another $1.6 million that we – that impacted our SG&A.

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

Okay. And so, I guess just last question for me and I'll hop back in queue is, so to look at the margin and I know this is sort of addressed, but could you – maybe pin point a little more dependably of what you're thinking margins maybe in the near term or I mean the drop was just so drastic in the fourth quarter. You were doing 10% to 15% earlier in the year and you went to zero in the fourth quarter. Could you just help us maybe directionally if anything does more definitively point to where you're thinking in the near term in IPS in terms of margins?

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

Yeah. No, I mean, hey, I think the place of – yeah, we don't provide guidance, Joe. So here's what I'll say is those onetime items that's $1.6 million that we should not see impact if you will IPS going forward. So that's one place obviously just to start just in terms if you're thinking about IPS margins going forward.

I do think it's fair. We h1ad a disproportion amount of these jobs, I'll call it 10-plus jobs in Q4 that had negative gross profit dollars. And so, you can quantify to breakeven at another $2 million impact, but that from my perspective would be conservative. But then the question is what margin should you bake in on those dollars if they keep the volume at that same level with those jobs performed at. And so, would they have performed closer to our historic average level, that may be appropriate and that could be anywhere between another, I'll call it, $1 million to $2 million impact from the gross margin line. And so, that's probably the best I'll do in a world where we don't provide specific guidance, but I think that gives you a good feel that hey, part of the drop in IPS performance in Q4 is purely volume-related, take any of the noise out. But then on top of it, you have this noise. And so, that's probably what I would say anecdotally.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. Thanks. I have a couple of questions more, but I'll hop back in the queue. Thanks a lot.

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

A

Okay.

Operator: Our next question comes from the line of Carl Schemm with KeyBanc Capital Markets. Please go ahead.

Carl L. Schemm
Analyst, KeyBanc Capital Markets

Q

Hi, good morning.

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

A

Hey, good morning Carl.

Carl L. Schemm
Analyst, KeyBanc Capital Markets

Q

So just quickly on the acquisitions, can you just kind of describe what the – kind of the rationale if they're expanding product lines or geographic expansion or what else those acquisitions might bring to the portfolio?

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

A

Yeah. No, absolutely. Carl, I appreciate you mentioning that. In the beginning of the year, we closed Pumping Systems, Inc., they were based in Atlanta, Georgia and they provided us a good amount of new geography for us. We were not in the South Atlantic, we did not have a rotating equipment location, we did have some existing bearing and PT locations, but we did not have our core product category, rotating equipment. Rough sales on a 12-month basis, they're about $18 million to $19 million in sales. And so, we're excited to have them as a part of our portfolio. They also bring with us good end market mix, so they're primarily chemical, pulp and paper, water, wastewater, food and beverage, and some other general industrial markets. So we're excited to have Pumping Systems team with us here at DXP.

And then kind of in February, we closed the Turbo Machinery Repair transaction. It's a single location, roughly around $4 million in sales and it's on the repair side. Once again end market exposure is leaning towards chemical, water, wastewater, municipal power, and some other industrial markets. So, new geography, new end market coverage, and in our core product [ph] engine (00:48:42).

Carl L. Schemm
Analyst, KeyBanc Capital Markets

Q

Great. I guess, I'm just looking at future deals, what kind of leverage ratio are you comfortable getting to? And what's sort of the upper limit on net debt to EBITDA that you would want to push to?

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

A

Yeah. No – and I'll answer that two ways, Carl. First and foremost, we actually have cash on the balance sheet. At year-end, we had in excess of $50 million worth of cash on the balance sheet. And as of today, I had about $47 million worth of cash from the balance sheet. So, as I long as I'm doing these onesies and twosie acquisitions as I call them, we're going to be – we can work through that cash. And so, leverage actually shouldn't rise, all things being equal.

That said, your question about where are we comfortable, historically we've – when we've gotten closer to the 4 times EBITDA, we've probably taken what we call a pause and really kind of delever the business. That said we do have some covenants that you can kind of look up on our Term Loan B that kind of govern us as well. And so, we think about it more just in terms of having access to capital as well and how we're able to structure the transactions.

Carl L. Schemm
Analyst, KeyBanc Capital Markets

Q

Great. Thanks.

Operator: Our next question comes from the line of Joe Mondillo with Sidoti & Company. Please go ahead.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Hi, guys just a couple of follow-up questions. At service center, what would you say really weighed on the business mostly? Is it because of the rig count and everything that's gone on oil and gas? And then number two in terms of the margins, I continue to have a tough time predicting where these margins are, they jump all over the place, doesn't seem to be seasonal. Could you address the sequential tick down and also I guess the year-over-year drop, what drove that outside of volume if anything? And how you're thinking about that going forward?

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

A

Yeah, the service centers – and I'm sure David will chime in here. But the service centers once again you've got to remember they still have the oil and gas exposure, but they're more on the MRO side, so if we see a curtail in activity, Joe, in our oil and gas end markets, the service market end market mix for the most part approximates where DXP's total end market mix is. And so, today roughly that's about 50% of what they do. They have a mix of MRO and they do have some OEM customers, and those OEM tend to be more oil and gas bent. And so, I think some of that volatility here in Q4, that's what you're kind of seeing impact those guys just a touch.

Once again, all segments were impacted by this halt that we saw in the oil and gas spending. Even supply chain services was – even though they're up, 15.4% year-over-year, but it kind of impacted all segments that had – which we've always had oil and gas exposure. David, I don't know if you have some thoughts there.

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

A

Well, are we talking operating margins or are we talking about gross margins?

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

A

Operating margins within service centers.

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

A

Because I think service centers did quite well actually.

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

A

Yeah. No – for the year...

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

A

Our goal for the year was to get gross profit margins up. And our service center business did a really nice job at that and IPS blew up a bunch of jobs. And so, the overall GP came down for them. I will say this for you, Joe just to kind of help you a little bit. The mix of jobs that did not perform well in IPS was much higher in 2019 than it's going to be in 2020. There's still a few lingering jobs, but the mix is going to be less. So the 9.5% operating income margin that IPS made overall for the year had more of the jobs that did not do well. Then it's going to happen in 2020. So, I mean, we kind of got on to this way before at the end of the year. I mean we've started seeing this come in. So we've been on it. So you should IPS's gross or even operating gross margin, operating income margin, either one go up in 2020.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay.

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

A

Everybody else – go ahead.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

I was going to say just a follow-up regarding my question on service center margins. I think in – I was sort of referencing just the fourth quarter alone. I understand the year actually was really good, definitely. And part of the reason why the year was good, as far as I understand, was especially earlier in the year and second quarter, third quarter. Your rotating equipment was really strong and then I think your business in Canada improved pretty nicely. Could you talk about the fundamentals of those two things, rotating equipment and the Canada business, as we're entering into 2020 just to get a sense of whether those margins are sustainable in 2020?

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

A

So Canada is still faced with a pretty strong oil and gas headwind. Of course, the Eastern Canada is more water-related. So it's doing fine and doing real well. The oil and gas side has got business, got activity, is going to have a – what I think we're forecasting sort of flat. So it's doing well. And then where we picked up margin in Canada was on the safety service side and we hired a new guy and he's doing a great job and we kind of changed our structure up there. So everybody is playing well together and really doing a nice job. So I expect that to continue. And I don't have any reason to think that it's not. So I would say flat sales and continuing to be profitable pretty much the same level as last year, maybe a slight improvement still on the safety service side.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

And then just rotating equipment and the fundamentals there?

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

A

Oh, yes. Well, rotating equipment's where we're having all the issues that we're really talking about. Just for little clarity there, it's not our fabrication business. It's not that we don't know how to estimate, how to fabricate things and etcetera. So really it's a little more on the pump side. But again, the market is only going to pay us so much for these pumps, and we have to manufacture it at a cost that's less than what the market will pay. And so, we have a little work to do there that the activity in midstream is getting softer. But we've got a really strong backlog headed into this year. And so the activity is – I'd really start worrying more about 2021 than I would 2020. 2020 looks to be shaping up to be better than 2019. And a good part of that is just that we don't have as many of these jobs that we kind of got a little overaggressive on. So I think that's kind of what I have to say.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. Just last question, where is your – after executing on these two acquisitions this year, where is your leverage today and what comfort level do you have to go with leverage and in the context of your M&A strategy? I guess that's my question.

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

A

Yeah, Joe. This is Kent. Our leverage ratio as defined in our credit agreement is 2.2:1. And that does reflect only using $30 million of the $50 million worth of cash on our balance sheet just in terms of calculating the ratio. So we're really a little bit less and then if you add the additional $20 million we had at year-end, we had a total of $53 million worth of cash on the balance sheet. Today, we have $47 million worth of cash on the balance sheet. So we were able to execute those two transactions. And really, frankly, almost hold flat in terms of the level of cash that we have on the balance sheet.

Your question just regarding kind of comfortability, at this point, if you will, I don't know if it's appropriate to say at this point in the cycle. You've got a lot of macro black swan events, but we feel comfortable. We built this capital structure when we redid our debt to give us the flexibility for times like this. And so, we're undrawn on our ABL, which we have at $85 million, and we're in the process of creating some additional capacity there. We have an accordion feature where we can flex it up an additional $50 million based upon the net growth at DXP. And so, we'll probably do that, but it'll still be undrawn. So a longwinded way of what I'm getting at is we have ample capacity to go forward and opportunistically pursue acquisitions, meaning get them at the right multiple, get them structured properly and also be sure the businesses are performing.

And so, if we do that and it's some of these smaller transactions, it's going to be a net win for DXP and net win for the shareholders and it's not going to impact leverage as much. Obviously that tends to be the larger transactions that tend to cause us, and we haven't been necessary looking at those here more recently that in the past is when we've kind of peaked the leverage. And so, a lot of what we're looking at today, a lot of what's in the pipeline is closer to what we saw here more recently in Pumping Systems and Turbo Machinery. Pumping Systems was roughly $19 million in revenue and then Turbo Machinery was $4 million in revenues, so.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. And you used cash to finance those acquisitions?

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

A

Yes, we did.

Joe L. Mondillo
Analyst, Sidoti & Co. LLC

Q

Okay. All right. Thanks. Have a great day.

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

A

Thanks.

Operator: [Operator Instructions] We have no telephone questions at this time. This does conclude today's conference call. Thank you for your participation. You may now disconnect.