Corrected Transcript

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# MSC Industrial Direct Co., Inc. (MSM)

## Q1 2023 Earnings Call

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# MANAGEMENT DISCUSSION SECTION

**Operator**: Good day and welcome to the MSC Industrial Supply Fiscal 2023 First Quarter Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to John Chironna, Vice President of Investor Relations and Treasurer. Please go ahead.

## John G. Chironna
*Treasurer & Vice President-Investor Relations, MSC Industrial Direct Co., Inc.*

Thank you, Allison, and good morning to everyone. Happy New Year as well. Erik Gershwind, our Chief Executive Officer; and Kristen Actis-Grande, our Chief Financial Officer, are both on the call with me today. During today's call, we will refer to various financial and management data in the presentation slides that accompany our comments, as well as our operational statistics, both of which can be found on our Investor Relations web page.

Let me reference our Safe Harbor statement, a summary of which is on slide 2 of the accompanying presentation. Our comments on this call as well as the supplemental information we are providing on the website contain forward-looking statements within the meaning of the US securities laws. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by these statements. Information about these risks is noted in our earnings press release and our other SEC filings.

In addition, during this call, we may refer to certain adjusted financial results, which are non-GAAP measures. Please refer to the GAAP versus non-GAAP reconciliations in our presentation or on our website, which contain the reconciliations of the adjusted financial measures to the most directly comparable GAAP measures.

I'll now turn the call over to Erik.

## Erik David Gershwind

*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

Thank you, John. Good morning everybody and thanks for joining us today. I'll start by wishing everyone a happy new year and I hope you had a restful and a happy holiday season.

On today's call, I'm going to reflect on our first quarter performance, I'll offer my perspective on the current demand environment and update you on our accomplishments against our Mission Critical initiatives. Kristen will then provide more specifics on the quarter and our reaffirmed fiscal 2023 framework. And I'll then wrap things up and we'll open up the line for questions.

Before I get into Q1, I'm excited to announce that we produced our first ever ESG report at the start of our fiscal year in November actually. You can view this report in the Investor Relations section of MSCDirect.com. Our ESG journey has been one of continual improvement and we look forward to receiving your feedback as we enhance our reporting each year.

On a related front, we continue to make progress on our DE&I journey by adding diversity to our senior management and our board of directors. Most recently, we welcome Rahquel Purcell as our newest board member. And she brings with her more than 30 years of supply chain, strategy and digital experience and we're very happy to have her on board. This is the latest in what has been a series of moves to infuse new energy and new excitement and intensity into our company's leadership.

Turning to our performance, I'm pleased with another strong quarter that continues our string of success in the face of uncertain conditions. Our primary goals for fiscal 2023 are gaining market share, expanding adjusted operating margins and improving adjusted return on invested capital, or ROIC. Our fiscal Q1 demonstrated success on all of those dimensions.

Looking beyond the quarter, our five growth levers and the productivity momentum that we're seeing have us set up to continue achieving our Mission Critical targets. Our manufacturing-centric end market exposure also provides us with strong resiliency in the event of economic softening. Manufacturing verticals like aerospace are not yet back to pre-COVID levels and therefore have plenty of room for continued growth. Additionally, we stand to benefit from reshoring in the future as we're just beginning to see the positive impacts from those activities.

In addition to our focus on market share capture and productivity, we are pivoting our emphasis within category management. Since COVID began, our priorities were securing product availability for our customers and staying ahead of the rapid cost inflation that we all experienced. And I'm proud of our team's efforts on both fronts.

Our inventory position allowed us to service customers, keep plants running, and drive revenue growth. And thanks to our strong value proposition, we were able to keep pricing ahead of purchase costs and improve gross margins during a challenging time.

As the world now returns to a more normalized state of moderating inflation and stabilizing supply chains, we are initiating a fresh look at our supplier and assortment strategy. Our priorities will migrate towards reducing purchase costs, streamlining operational efficiencies, improving the customer shopping experience and channeling more market share to those suppliers who partner with us.

We will accomplish these objectives through a formalized category line review process that will begin over the next couple of months, led by our new COO Martina McIsaac. We will cycle through our product lines in waves, spanning the better part of the next year. We expect most of the benefits to accrue in fiscal 2024 and beyond, with some benefit hitting the latter portion of fiscal 2023.

I'll now turn to the specifics of the quarter. Results continued to be aided by strong pricing contribution, our recent bolt-on acquisitions and execution of our growth drivers. We achieved average daily revenue growth of 12.9%, well above the IP index. We expanded operating margins by 140 basis points over prior year or 100 basis points on an adjusted basis, driven by the continuation of our Mission Critical initiatives, which yielded additional savings of $6 million in the quarter. We remain on track to achieve our goal of at least $100 million of savings by the end of fiscal 2023.

Our Mission Critical initiatives and efforts of our entire team on cost containment and productivity has also boosted our adjusted ROIC into the high teens and now stands at 18.3%. We've now already reached our original fiscal 2023 goal and we aim to continue improving that number over time.

Our growth formula remains anchored in the five priorities that we've discussed as part of Mission Critical: solidify metalworking; expand solutions; leverage the portfolio strength; grow e-commerce; and diversify customers and end markets with an emphasis on public sector. I'll now update you on each one of those.

Our expertise in metalworking remains the cornerstone of our value proposition, driven by the depth and breadth of our product portfolio, our large network of technical metalworking experts and our focus on innovation as a tool to elevate productivity and lower cost for customers.

In many cases, we also help our customers to reduce waste and energy consumption. Here is a recent example from the aerospace end market. One of our customers, who is a Fortune 500 company, was using a four-step drilling process that took them 2.5 to 3 minutes to machine a certain part that goes into an airplane. After an in-depth review by our metalworking experts, we were able to take that four-step process and bring it to one step and reduce cycle time from the 2.5 to 3 minutes to just 10 seconds. We also improved quality along the way and by the customer's own calculation, they're not expecting to save over $4 million annually.

Our solutions growth driver is anchored by our vending and in-plant programs, both of which have been fueling market share capture over the past several quarters. Vending signings remained strong, with Q1 signings comparable to Q4. Vending machine revenues grew in the mid-teens and now represent over 15% of total company sales.

In-plant signings also remained strong, with Q1 again running at a similar pace to Q4. In-plant customer revenues were up over 20% year-over-year and now represents 12% of total sales, up 100 basis points from the prior quarter. We will continue to push on this growth driver and would expect in-plant to be at 15% of total sales by the second quarter of fiscal 2024.

Sales to customers with our solutions offerings now represent 56% of the company's total sales, up over 200 basis points from prior year. Importantly, our solutions capabilities are also bringing us into diversified end markets, with recent wins coming in industries spanning from medical manufacturing, packaging and even the hospitality sector.

The third priority is selling the portfolio, which is about increasing share of wallet through ancillary products, especially our CCSG business. Here, we provide an outsourced vendor-managed inventory service for the high-margin C-Part consumables that keep plants running. Momentum in this business continues building, with Q1 ADS growth in the mid-teens.

Our fourth priority is digital, which includes all aspects of MSC's digital engagement with customers, suppliers, and associates. John Hill and his team have completed a comprehensive review of our entire digital offering and have built a road map for our evolution in this space.

For example, in e-commerce, recent work is focused on improving the customer experience on our website by enhancing product discovery and enriching product data. This investment is producing early returns as e-commerce sales grew mid-teens in the first quarter. On an ADS basis, we reached 61.9% as a percent of total company sales, up roughly 150 basis points compared to prior year.

Our fifth growth driver is customer diversification through our public sector business. Over the past few quarters, I've described significant contract wins such as the 4PL contract serving the US Marine base, where we supplemented that win with others at the state and federal level. And these have helped to produce continued strong growth, with Q1 ADS coming in over 20%. And we expect that momentum to continue throughout fiscal 2023.

Each of our five growth levers are not only powering growth, but they're positioning MSC as a productivity partner to our customers, expanding our historic role as spot-buy supplier.

In Q4 of fiscal 2022, we expanded our portfolio through two acquisitions in areas that we consider important to our business. In June, we acquired Engman-Taylor, a premier metalworking distributor in the Midwest that expands our network of technical experts. We also bolstered our OEM fastener distribution business through the acquisition of Tower Fasteners in August, which broadens our end market exposure and increases our geographic footprint in the high-touch VMI inventory category. Both businesses are running ahead of their original case in their early days. We expect both to produce ROIC above our weighted average cost of capital by the end of their first full year of operations.

Kristen will discuss our capital allocation priorities in more detail, but we remain committed to seeking out bolt-on acquisitions that fit our strategic, financial and cultural filters.

Turning to the external environment, the picture remains similar to last quarter, with sentiment readings declining and IP readings moderating. The majority of our customers are seeing stable order levels, demand and general activity.

We are hearing, though, continued talk of softening among a portion of our customers. More recently, we experienced a higher prevalence of extended holiday shutdowns along with weather disruptions during the second half of December. As Kristen will describe, this resulted in a strong start to the month, but a slow finish as activities saw a sharper decline than in the last two weeks of prior year. Zooming out, though, the need for our customers to find productivity to offset their cost headwinds is as strong as it's ever been and this plays nicely into our value proposition. So, we remain focused on delivering that productivity for our customers.

I'm going now turn things over to Kristen.

### Kristen Actis-Grande

*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

Thank you, Erik, and good morning everyone. On slide 5 of our presentation, you can see key metrics for the fiscal first quarter on a reported basis. Slide 6 reflects the adjusted results, which will be my primary focus this morning.

Our first quarter sales were up 12.9% versus the same quarter last year and came in at $957.7 million. Our first quarter acquisitions represented roughly 3 percentage points of the growth and FX was a 30-basis-point headwind year-over-year.

Looking at growth rate for average daily sales by customer type, public sector sales increased over 22%, fueled by fulfillment under our 4PL contract with the US Marine bases, and other public sector spending. National account growth was low teens and core customers grew high-single digits.

Our gross margin for the fiscal first quarter was 41.5%, down 10 basis points on a year-over-year basis and up 30 basis points organically, driven by increased price more than offsetting product cost inflation. Sequentially, gross margins ticked down as expected due to the ongoing realization of previously incurred product cost increases, some mix impact from our growth drivers, along with a small impact from the full quarter of Tower Fasteners in our numbers.

Looking forward, we continue to see new cost increases from our suppliers, although not at the fast and furious pace of last year. As a result, we had anticipate taking a small pricing adjustment within the next month. Our ability to deliver continual cost savings and tangible productivity gains to our customers continues driving solid realization rates.

Reported operating expenses in the first quarter were $280 million versus last year's reported operating expenses of $257 million. Adjusted operating expenses were also $280 million, or 29.2% of net sales versus last year's adjusted operating expenses of $257 million, or 30.2% of net sales. This yielded a 100-basis-point reduction in adjusted OpEx to sales year-over-year.

Our reported operating margin was 12.1% compared to 10.7% in the same period last year. Adjusted for restructuring and acquisition-related costs, adjusted operating margin was 12.3% as compared to adjusted operating margin of 11.3% last year, a 100-basis-point improvement year-over-year. That resulted in an adjusted incremental margin for our first quarter of approximately 20%.

Reported earnings per share were $1.45 for the quarter as compared to $1.18 in the same prior-year period. Adjusted for restructuring and current year acquisition-related costs, adjusted earnings per share were $1.48 as compared to adjusted earnings per share of $1.25 in the prior-year period, an increase of 18%. This continues to reflect strong execution at all levels, sales performance, gross profit and operating expenses.

Turning to the balance sheet, at the end of the fiscal first quarter, we were carrying $726 million of inventory, up $10 million from Q4's balance. The inventory build is consistent with our double-digit revenue growth, advantageous year-end buys and continuing inflation. We're targeting an annual cash conversion rate of at least 100% for fiscal 2023 and we are pleased with our performance this quarter at 94% despite double-digit revenue growth and the related receivables growth.

Our capital expenditures were $26 million in the first quarter and included elevated vending installations, new warehouse automation and continued investments in digital. Our capital spending is frontloaded this year and we currently expect annual CapEx spend in the range of $70 million to $80 million in fiscal 2023.

You can see on slide 7 our free cash flow is up year-over-year, $51 million for the current quarter as compared to $43 million in the prior-year quarter. Note that we also spent about $19 million buying back shares during the quarter, just over 200,000 shares at an average purchase price of $79.60. We currently have 4.5 million shares remaining on our current repurchase authorization.

Our total debt at the end of the fiscal first quarter was $780 million, reflecting a $15 million decrease from the fourth quarter of fiscal 2022. As for the composition of our debt, roughly 55% was floating rate debt and the other 45% was fixed rate debt.

Cash and cash equivalents were $26 million, resulting in net debt of $754 million at the end of the quarter, up slightly from $751 million at the end of the fourth quarter. Our net leverage at the end of the first quarter was 1.3 times, in line with our target range of 1 to 2 times.

I would also like to highlight that subsequent to closing our fiscal Q1, we closed on a $300 million receivables facility, which is a committed senior secured revolving trade receivables facility that we will use to reduce our debt and overall funding rate. It will bring our leverage ratio to just under 1 time.

Before updating you on our Mission Critical productivity goals, I would like to spend a few minutes to refresh our capital allocation strategy, which you can see on slide 8. Our top two priorities remain investing into the business and returning capital to shareholders through our ordinary dividend. From there, our next two priorities are tuck-in acquisitions and share buybacks at the right valuation levels. We are deprioritizing use of special dividends as we see higher return prospects in other uses of cash.

Let me now update you on our Mission Critical productivity goals and I am now on slide 9. In our fiscal first quarter, we achieved additional gross savings of $6 million and invested another $1 million. We are targeting our fiscal 2023 goal to be at least $15 million in gross savings. Warehouse automation remains an area of focus as evidenced by our recent capital investment. We're extending new automation technology throughout our fulfillment centers to strengthen our operations and mitigate the effect of labor inflation. For the total program to-date, we have achieved gross savings of $91 million and we remain on target to hit at least $100 million of gross cost savings by the end of this fiscal year.

Now, let's turn to the fiscal year 2023 guidance, which is shown on slide 10. We are reaffirming our 2023 guidance as introduced during our fiscal fourth quarter 2022 earnings call last October. We're estimating average daily sales growth of 5% to 9% and an adjusted operating margin between 12.7% and 13.3%.

A few reminders as it pertains to our estimates for the year. Specific to the ADS growth range, fiscal 2023 has 252 days, 6 fewer than fiscal 2022. The full fiscal calendar can be found on our website.

Our Engman-Taylor and Tower Fasteners acquisitions are included in the guidance and add roughly 200 basis points to our ADS growth for the year. When we introduced guidance last quarter, forecasts indicated a softening economic environment and we factored that into our annual guidance range. As of now, we would characterize the environment and on our growth trajectory as tempering a bit but still solid.

At the gross margin level, we remain on plan and expect fiscal 2023 to be down 40 to 70 basis points versus prior year, which is inclusive of the 30 to 40-basis-point acquisition headwind. As we think about the cadence of our gross margins for the remainder of the year, we expect the back half of the year to be flat to slightly higher than the first half. This is due to several factors: first, the realization of product cost increases in our P&L is expected to peak over the next quarter; second, freight cost should subside beginning in Q3; third, we have several gross margin initiatives in play, whose contribution builds in the back half of the year. Erik mentioned one, which is a new category line review process, but there are others with a near-term time horizon.

On the operating expense line, we expect a slight increase in operating expense as a percentage of sales in Q2, consistent with our typical seasonal pattern with sequential declines thereafter. Our Mission Critical productivity efforts will allow us to continue investing in our growth strategy despite ongoing inflation headwinds. Factoring in those assumptions, we expect adjusted operating margins to be in the range of 12.7% to 13.3%. Excluding the 20 basis points benefit of the extra week from fiscal 2022, this would reflect operating margin expansion at nearly all points within our range.

As a reminder, our fiscal 2022 fourth quarter acquisitions dilute operating margins by approximately 20 basis points in fiscal 2023, their first full year with us. While dilutive to operating margins in the first year, those acquisitions are accretive to EPS and on track to achieve an ROIC above weighted average cost of capital in their first full year of operations.

Holding fiscal 2023 debt constant with current levels, we would expect roughly $8 million to $10 million of interest and other expense per quarter and tax rates of slightly under 25%.

Given our expectations for an operating cash flow conversion of roughly 100%, we will have flexibility to deploy free cash flow into debt reduction, buybacks or accretive acquisitions.

During our last call, we introduced our downturn playbook that we have at the ready should be experience a significant demand slowdown. We have clearly defined triggers for changes in our actual or forecasted revenue and operating profit that initiate a series of actions we'll take across the business. This includes everything from pullbacks on discretionary spending, changes in staffing levels and reprioritization of investments.

In addition, our balance sheet remains strong and when the economy slows, we generate high levels of cash flow as working capital becomes a source of fund. This will enable us to pay down debt and/or strategically invest through the downturn. We are not in that mode as of now and we remain well positioned to navigate a change in the environment if required by enacting this these levers to control costs.

I will now turn it back over to Erik.

## Erik David Gershwind

*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

Thanks, Kristen. We are pleased with our first quarter performance, which is on the heels of a strong fiscal 2022 in what remains a complex operating environment. We remain on track to achieve each of our Mission Critical goals for the end of fiscal 2023. And we are seeing momentum build quarter-over-quarter inside of the company. This is an exciting time for MSC as we position the company as a partner of choice among our customers. We see a bright future ahead and we'll continue to reinvest into the business.

Regardless of the macro environment, we remain squarely focused on what we can control: capturing market share; growing above IP; and translating that growth into profit expansion.

I'd like to thank our entire team for their hard work and dedication. And we'll now open up the line for questions.

# QUESTION AND ANSWER SECTION

**Operator**: Thank you. And we will now begin the question-and-answer session [Operator Instructions] And our first question today will come from Tommy Moll with Stephens. Please go ahead.

**Tommy Moll**
*Analyst, Stephens, Inc.*

Q

Good morning and thanks for taking my questions.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Good morning, Tommy.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Hey, Tommy.

**Tommy Moll**
*Analyst, Stephens, Inc.*

Q

I wanted to start by circling back on some of the macro commentary that you both offered. Erik, I took note of your comment about a pronounced slowdown in the second half of December. And Kristen, I think the key words from your prepared remarks were the tempering a bit and just in terms of the macro and growth outlook. So, I was hoping you could give us any more insight you have there, in particular if there is any difference across some of the end markets that would be helpful. Thank you.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, Tommy, sure. Look, I think the headline in terms of the macro is pretty much more of the same. On the last quarter, we talked about some pockets of softening in line with some of the readings coming down and I think that's what we're still experiencing. So, we would characterize the environment as very solid. Look, I mean we're still talking about nice growth levels, most of our customers are still talking about solid demand and solid order patterns. There are pockets, though, and it tends to be the closer you get to consumer-facing industries, the more extensive you're going to hear the pockets of softening. So, in general, I think we're not seeing anything that suggests like anything falling off a cliff, the words I think Kristen referred to are tempering, which would be an appropriate characterization.

With respect to December in particular, from what we could tell, the back half of December is an isolated phenomenon. We saw a really strong start. So, to put some context on that, the first couple of weeks, the growth rates would have been better than Q1. The back half definitely slowed. And we did hear from our sales team that customer holiday-related shutdowns were more widespread than the last couple of years and then throw in weather that disrupted things that week before Christmas. So, it appears to be what we saw back half of December isolated and nothing systemic.

**Tommy Moll**
*Analyst, Stephens, Inc.*

Q

Thank you, Erik. That's helpful. As a follow-up, I wanted to touch on the pricing environment. It sounds like you've continued to see some [ph] higher (00:30:01) price increases there, I think you said you've got another one of your own plan for next month. So, any context you could give there?

And then just thinking through how that ties to your 2023 outlook for ADS, on my math, you saw about a 700-basis-point contribution this quarter. Presumably, the range of expected contributions for the year would be significantly lower than that just given the comps, but if there is any way you could frame what's reasonable for the full year, that would be helpful as well.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, Tommy, sure. And I'll start out. I'll touch on the environment. I can give you a little context on our numbers and Kristen can fill in anything I missed. So, in terms of the environment, it's an interesting time, because on the one hand – like the whole world is suffering from inflation fatigue. And our customers, our suppliers were all not immune from that. At the same time, the reality of the situation is that there is still inflation. And while it is definitely moderating, there is still inflation and there's still cost increases as evidenced by the fact that, yeah, we're still seeing suppliers coming to us with increases. And so, that is what drove, what I described, there's going to be a pricing adjustment coming up in the next month. So, it's a reality that we all have to deal with, even though there is a bit of fatigue. And I think the message for us is we're really focused for our customers on making sure we're generating productivity for them, that's going to offset it. I think that's how I characterize the macro.

Yeah, in terms of our numbers, and I'm pretty sure this is all sort of baked into what we gave as the guidance range at the start of the year. We did anticipate that we would lap the very high pricing of prior year and that's going to happen during our fiscal second quarter, in the next month or so here. So, yeah, as a percentage of sales, pricing contribution will – absent some radical change in the environment, pricing contribution will come down, because of the math of the comp.

**Tommy Moll**
*Analyst, Stephens, Inc.*

Q

I appreciate it and will turn it back.

**Operator**: Our next question today will come from Steve Volkmann of Jefferies. Please go ahead.

**Stephen Volkmann**
*Analyst, Jefferies LLC*

Q

Great. Good morning, everybody. Thanks. Erik, I noted in your prepared comments that you actually said you were starting to see some of the benefits of reshoring, poking their head up. Can you just expand on that a little bit?

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, sure Steve, and good morning. I would say very, very early. So, we're not so much yet seeing it in our revenue – you're not seeing it in our revenues. What we are starting to see from our sales team is lists of new construction and projects that are going up, buildings being put up. And so, as you can imagine, our business development team, we're all over that. It's fairly widespread in terms of geography and in terms of industry type. I would say heavy emphasis on manufacturing obviously. But the tangible evidence now is its going from talk into new construction, so it's a bit early to see it in our numbers. But if we do our jobs right and we get involved with those customers from the ground up that should translate into the numbers in the coming quarters.

**Stephen Volkmann**
*Analyst, Jefferies LLC*

Q

Okay. That's helpful, thanks. And then maybe a Kristen question. I think you've mentioned 20 basis points is the expectation for operating margin dilution from the acquisitions in 2023. Historically – I guess I'm still kind of new to you guys. Historically, as you go out into 2024, 2025, would you expect that to narrow or even reverse, and ultimately you get margin accretion?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Yeah. We would definitely expect it to narrow and it eventually does become on par with the core business. So, 2024, I don't think you're going to hear much about the noise from those two acquisitions. I mean that as we run our integration playbook, there are variety of levers we're pulling that get those businesses on par with the core MSC overall business.

**Stephen Volkmann**
*Analyst, Jefferies LLC*

Q

Great. Thanks. I'll pass it on.

**Operator**: Our next question today will come from David Manthey of Baird. Please go ahead.

**David John Manthey**
*Analyst, Robert W. Baird & Co., Inc.*

Q

Yeah, thank you. Happy New Year, everyone.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Happy New Year.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Happy New Year, Dave.

**David John Manthey**
*Analyst, Robert W. Baird & Co., Inc.*

Q

Yeah, as it relates to deprioritizing special dividends, if I look back over the past, say, 10 years, it looks like it's well over $0.5 billion. And how should we think about the reallocation of capital? Is that higher CapEx? Is it investments in the P&L? And – or is it just more a share repurchase to keep you in that 1 to 2 leverage range? Any details on what you're thinking would be appreciated.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, Dave, sure. I'll take this one. So, I would say this, over time we have had a capital allocation framework that began with two top priorities that are sort of 1A at 1B. And those are reinvestment into the core business to the extent we see high return projects and right now we're pretty bullish there. And then two is continued steady growth in the ordinary dividend, and no change there.

I think the change in emphasis you heard from Kristen is on the next two priorities. The next two priorities are going to be share buyback at the right valuation levels and tuck-in acquisitions, along the lines of what you saw from us in the last quarter, so tuck-ins [ph] to (00:35:30) existing businesses like a metalworking and OEM fastener. And I think the reason there why the change is just the return prospects. We've always sort of never been wed to one tactic. It's more than about where we see deploying the next dollar to its best use. And I think that we feel good about the prospects for the company and when valuation levels are low on the stock, that's a good use of capital. And I think you're also hearing from us our confidence growing in the tuck-in acquisitions based on our track record in the past few years. We feel good about the businesses we bought and the results that they're producing. And so, that makes us more bullish on that as well.

**David John Manthey**
*Analyst, Robert W. Baird & Co., Inc.*

Q

Sounds good. Thank you. Could you just talk about how the benefits of the line review will manifest in your results, which should we be looking for?

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah. Dave, so, a little early to say, but in general, and maybe what I'll do, and Kristen you can fill in any missing pieces, is just sort of step back and talk a little more about the strategy, the philosophy here, and then that will translate into how yields benefits.

But as I mentioned in the prepared remarks, Dave, if I think about the focus of our category organization for the past really three years now since COVID, it's been two things: number one, getting product to make sure we have product on the shelves to keep plants running; and number two, staying ahead of the crazy cost inflation that we've all been experiencing. From our perspective, it was check, check, really good job by our team on both of those.

The world is beginning to migrate to a new normal now, moderating inflation, stabilizing supply chains, this becomes the next natural evolution in the story. So, what we're going to be looking to do is we're going to looking at our assortment and you're going to not see us deviate from our idea of having a really broad and really deep product assortment that's very important to our customers. But what we are going to do is to look for opportunities for efficiencies. I think you can expect to see the benefits accrue in the form of purchase cost improvements and that could either be the straight price we pay for products, it could be in the form of rebates or other adjustments, but that's certainly one area.

I would expect to see benefits accrue in the form of operational efficiencies to the extent we see potential to collapse at the fringe, at the margin, collapse some product lines, or suppliers, et cetera that they'd be operational whether that's inventory savings or some OpEx and productivity improvements through our supply chain. That would be another area where I would expect to see benefit.

**Kristen Actis-Grande**

*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Dave, the only thing I'd add to that is we contemplated that process when we set the framework or the guidance ranges. I alluded to some initiatives coming online in the second half there that are going to change the sequencing of gross margin throughout the year, that would be one of those, but attacking a lot of different things across price, cost and mix as we think about the second half in particular. But all kind of within that original operating margin framework of 12.7% to 13.3%.

**David John Manthey**

*Analyst, Robert W. Baird & Co., Inc.*

Q

That's great. Thank you all.

**Erik David Gershwind**

*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Thanks.

**Operator**: Our next question today will come from Paul Dircks with William Blair. Please go ahead.

**Paul Dircks**

*Analyst, William Blair & Co. LLC*

Q

Hi, good morning, and thanks for taking my questions.

**Kristen Actis-Grande**

*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Good morning.

**Erik David Gershwind**

*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Hi Paul.

**Paul Dircks**

*Analyst, William Blair & Co. LLC*

Q

So, first question from me, Erik, reflecting on the supply chain environment and the disruptions we've seen over the last couple of years, is there a way you can qualify for us how do you think that the tight supply chain that we saw aided in your share gains over the next couple of years? Is there a way to parse out how big of an impact your internal initiatives had in taking share?

**Erik David Gershwind**

*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Paul, what I would say – look, qualitatively what I would say is the past three years created a fairly unique opportunity for a large well-capitalized distributors that were able to – I was talking earlier about getting product on the shelf. In a tight supply chain environment, a couple of things happen. Number one, obviously scarcity of product. So, having product becomes paramount. And then the second thing is obviously tight supply chain means inflation.

And I think the successful distributors, those that fared well through this crazy period were able to stay ahead of that, and maintain or improve margins through what was a historic time. And I feel good about our performance on both of those fronts. I think, as we move forward and things normalize, that the question is, okay, does that opportunity, the share capture opportunity go away? Our view on it is that, like, our North Star has become generating productivity for our customers because particularly, in almost any environment you can think of is they're booming if things get slow, productivity and productivity could mean cost down, or it could meaning increasing manufacturing throughput to allow them to get more products into their customers' hands faster. That is becoming paramount. And that's where – like if you listen to each of our five growth levers I tried to get this point across, they're not just about increasing dollar volume, they're intended to all serve a purpose, it is all around positioning MSC as a partner to our customers to generate productivity. That's our North Star for the next several years.

**Paul Dircks** Q
*Analyst, William Blair & Co. LLC*

Got it. That's very helpful, I appreciate that. The other question for me and I appreciate the color you guys gave on the macro environment, but are you seeing here in early January any bifurcation in the order rates between some of your larger customers and the small customers and maybe if not even on order rates and how they're talking about the year ahead, how would you do characterize your conversations with each?

**Kristen Actis-Grande** A
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

Hey, Paul, I'll take that one. So, nothing different than what we've been experiencing for the last few quarters. We're not seeing any deviations there. And we do – that is kind of one other things we tend to watch for any early leading indicators. So, nothing notable to report there. As Erik mentioned kind of the macro sentiment, pretty consistent, we're looking more for pockets of softening per end markets at this point but generally still feeling good about the year, solid about our expectations and within that 5% to 9% ADS guidance range.

**Paul Dircks** Q
*Analyst, William Blair & Co. LLC*

Got it. Appreciate the help. Thank you.

**Kristen Actis-Grande** A
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

You're your welcome.

**Erik David Gershwind** A
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

Thanks, Paul.

**Operator**: And our next question today will come from Patrick Baumann of JPMorgan. Please go ahead.

**Patrick Baumann** Q
*Analyst, JPMorgan Securities LLC*

Hi, good morning.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Good morning.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*

Q

Thanks for taking my question. Hey, how's it going?

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Good. [indiscernible] (00:42:05).

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*

Q

I'm doing well, I'm doing well. Quick one to start on inventories, just wanted to get a sense of how you're feeling about current levels of inventory. And you talked about supply chain pressures and inflation easing, just – and then as well as some advantageous buying you've done maybe at your end, but you've probably been doing that all long. Just curious how you think about inventories moving forward. Do you expect some destock now that the situation has kind of normalized around supply chain and inflation? Any color around that?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Yeah sure, Pat, I can take that one. So, as you mentioned at the end of your question, yeah, the year-end advantageous buys, that's pretty typical for us. We're just – it's part of the normal playbook that we would run. I think more holistically if you look at inventory, obviously, the last few years and we've been in this constrained supply chain environment, we've been flexing the balance sheet and certainly not skimping on inventory as that's been a way that we've been able to support our customers somewhat uniquely relatively to the local distributors in that time period. But going forward, we're definitely taking a closer look at inventory. We're kind of monitoring levels, looking at where it makes sense to adjust things, given the environment, but certainly not doing anything that would compromise our ability to support the customer and to support our continued growth.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*

Q

Based on your standing outlook for ADS growth, I mean, what do you -do you think current levels of inventory are appropriate? Do you think you're overstocked a little bit, or understocked, like how would you [audio gap] (00:43:39)?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

I wouldn't say we're overstocked anywhere and there's definitely been some differences in how we've been seeing kind of inventory levels in certain different product categories, like if we think about kind of metalworking inventory versus MRO. But I wouldn't give you a specific range at this point, but I'd definitely say if you think about the 100% operating cash flow conversion, there's sort of a range of inventory contemplated within that that we feel confident in.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*
Q

I'll follow up after the call on that.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*
A

Pat, the only other color I'd add on inventory is there's times and you've followed us for a little while here, like when we go into a different mode, right now, we're still in growth mode. And in growth mode, even if things are moderating, whatever the growth percentage is, we're still in growth mode. And that means keeping inventory on the shelves for customers. If there comes a point, at some point, there'll a point at which things change and we go into a different mode and we – that's a lever we can turn pretty quickly as part of a downturn playback (sic) [playbook] (00:44:40), we're not there though.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*
Q

Understood. Then on – next question is on OpEx. Can you just help me understand the year-over-year moving parts? I mean, you went from $257 million of OpEx in last year's first quarter to $280 million this year. I think acquisitions maybe add a little bit, but you have some gross savings of $6 million, like I think you talked about $1 million of investments. It just seems like a pretty big increase. I'm guessing a lot of that's inflation related but any color on the key moving parts in that year-over-year dollar number would be helpful.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*
A

Yeah, sure, Pat. So, few things on the big drivers on a year-over-year basis. You're right, inflation, absolutely one of the biggest buckets there. That was around $9 million. We did also have an increase from having those two acquisitions, Engman-Taylor and Towers (sic) [Tower Fasteners] (00:45:35) in the numbers for the first full quarter, that was around $6 million.

Year-over-year, we're still seeing kind of T&E normalize for our associates as we get kind of back to normal and how we've been out in the field, that was a couple million of pressure, little bit of noise on the variable OpEx, and then you got some things in there on higher D&A, some of the investments carrying over from the prior year and then to your point, you got $5 million in net Mission Critical savings.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*
Q

And that $280 million, like as you think about it, moving forward, for the rest of the year, is that kind of – how should I think about that absolute dollar number in the second quarter and the balance of the year? I guess I'm thinking in context of pricing contributions that are probably moderating, would we expect kind of – I'd expect year-over-year to moderate on the OpEx growth as well, is that the right assumption?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*
A

Yeah. So, second quarter, on a dollar basis, probably down a little bit, but on a rate basis, it'll still be up a tad from Q1. And then going forward in Q3 and Q4, kind of given some of the dynamics you described, I think $280 million, low 280s is probably a pretty reasonable, probably good range for Q3 and I think ticking down even a bit there from Q4, but OpEx rate, following Q2, will sequentially decline.

**Patrick Baumann**
*Analyst, JPMorgan Securities LLC*

Q

Okay. I appreciate the color. Thanks.

**Operator**: Our last question will come from Ken Newman of KeyBanc Capital Markets. Please go ahead.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

Hey, good morning, guys.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Good morning.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Good morning, Ken.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

Good morning. Maybe, I'll just kind of dig into the metalworking demand. Obviously, you talked a little bit about activity being relatively stable within your industrial side of your business, but obviously the GBI has kind of been – the metalworking index is kind of in a contraction now for seven months. I'm curious have you seen any weakness within that portion of your business. And how do you view that part of the portfolio going forward?

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, Ken, no question. Look, you look at MBI, you look at the PMI, the sentiment indices are dropping considerably. I would say inside of the company, I would characterize metalworking as a microcosm of what I characterize for the overall customer base, which is moderating and certainly some pockets of softening but not dropping like a rock and not dropping as the indices would suggest.

I think part of the story, Ken, is a lot of – if you take some of the end markets that drive metalworking consumption, many of them, several of them have been really beat up during COVID. And so, they still have room to grow. So, I mentioned, aerospace being one. Another that drives metalworking consumption through the economy, oil and gas, with oil prices being high, activity levels are up, so that's sort of [ph] booing (00:48:38) things. So, I mean, nothing really to speak of out of the ordinary or out of what we described for the total company as it relates to metalworking.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. Are you concerned at all about a potential lag impact of that sentiment index or has there been enough structural changes you think that you can help to offset that because obviously you've outperformed in the last six months relative to that sentiment index?

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*

A

Yeah, look, Ken, I mean, I wouldn't say concerned. We're watching it. And if you go back and you run historic patterns, typically there's a pretty good correlation with the sentiment index like the MBI and our revenues, but, look, really that's why you saw – when we gave the annual guidance of 5% to 9%, that's down considerably from where we're running in Q1. And part of that was comp – there's a little bit of comps in there from the pricing that we talked about. And then part of that is contemplating some further softening. So, we think it is going to happen. So, do we watch it? Absolutely. Are we modeling and planning? Yes. Do we worry about it? No, because from our standpoint, we can make strides almost no matter what happens in terms of capturing share from local distributors, so, yeah, that's our assessment.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

Got it. And then my last question is probably more for Kristen, but Kristen, you mentioned some warehouse automation investments towards the end of your prepared remarks, I'm curious if you could just give a little bit more color of what exactly that entails and maybe the timing of the benefits that you expect to see out of those?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Yeah, sure. So, we obviously have a lot of automation to warehouses today, we're looking at kind of extending that further, modernizing some things, generally in response to a lot of the pressure that we've seen around labor inflation recently, but certainly always just looking for opportunities to be more efficient, provide better service level for the customer.

In terms of when the benefits come online for those, Ken, I'd say it's really not materially until 2024. Some of those are definitely longer-term investments. But when we think about kind of like the ongoing opportunities around Mission Critical and what that looks like post 2023, this would be kind of one of the big rock projects that start to kick up again that delivers savings and operating expenses going forward.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

And I apologize if I missed it, but did you specify how much those investments are?

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

I did not, no.

**Kenneth Newman**
*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. Thanks for the color.

**Kristen Actis-Grande**
*Chief Financial Officer & Executive Vice President, MSC Industrial Direct Co., Inc.*

A

Thank you.

**Erik David Gershwind**
*President, Chief Executive Officer & Director, MSC Industrial Direct Co., Inc.*
A

Thanks, Ken.

**Operator**: And at this time, we will conclude our question-and-answer session. I'd like to turn the conference back over to John Chironna for any closing remarks.

**John G. Chironna**
*Treasurer & Vice President-Investor Relations, MSC Industrial Direct Co., Inc.*

Thank you Allison. As a quick reminder, our fiscal 2023 second quarter earnings date is now set for April 4, 2023 and we will be attending at least one investor conference over the next few months as well as conducting several road shows, so we look forward to seeing you in person. Thank you for joining us today.

**Operator**: The conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.