MSM - MSC Industrial Supply Co.
Q2 2023 Earnings Conference Call
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Kristen Actis-Grande, Chief Financial Officer

Analysts:
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David Manthey, Robert W. Baird
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Steve Volkmann, Jefferies
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Presentation

Operator: Good day, and welcome to the MSC Industrial Supply Company Second Quarter 2023 Earnings Conference Call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. (Operator Instructions). Please note today's 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 Chironna: Thank you, and good morning, everyone. 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 webpage.

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 U.S. 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 Gershwind: Thanks, John. Good morning, everybody, and thank you for joining us. On today's call, I'll begin with some perspective on our recent performance and our longer-term outlook. I'll then provide color on the current environment. Kristen will provide more specifics on our fiscal second quarter Mission Critical accomplishments and our financial performance, and then she'll share our expectations for the back half of our fiscal year. I'll wrap things up and then we'll open up the line for questions.

As we move into the back half of our fiscal 2023, there is a growing momentum inside of MSC, and it has me encouraged about our future. Let me provide you with some color, so that you can see from the outside what we see on the inside. First, we continue out-growing IP, or industrial production, by numbers in excess of our long-range targets. We're seeing the strongest contribution from the programs most closely tied to the repositioning of MSC to a Mission Critical partner on the plant floor. In-plant, vending and vendor-managed inventory are all examples of high-touch, high-retention programs that are growing ahead of company average.

I'm equally encouraged by the momentum on new account wins that we see developing through our national accounts and our public sector teams. And while a portion of our performance above IP is price-driven, we're excited by the trajectory of these market share capture programs.

On the M&A front, we continue to bolster our technical and high-touch product categories. Our recent acquisitions are living up to our high expectations in their early days, and are fortifying our position within metalworking and OEM fasteners, areas where we continue to see significant opportunity for long-term growth.

Most recently in January, we completed an acquisition that fits nicely into our core metalworking business. Buckeye Industrial Supply Company is a metalworking distributor located in Ohio and that serves planned production needs of manufacturing businesses in the area. Tru-Edge Grinding, also located in Ohio, brings us new capabilities in the way of custom tool manufacturing and regrinding. Tru-Edge, along with our existing regrinding business, represents an adjacent value-added service to our core cutting tool business, and it therefore, creates a new growth path for us. It also supports our company's effort to drive cost savings for our customers.

Second, on the gross margin line, our success over the past couple of years has come largely from achieving strong price realization during historic levels of inflation. As the market settles, we have reoriented our focus towards improved product assortment, supplier portfolio and cost position. The category line reviews that we announced last quarter have kicked off, with our first wave in full gear. Wave 2 has been launched, as we will roll through our entire product offering over the next several months. We expect to see a slight gross margin benefit in our fiscal fourth quarter and then more substantial savings will come in fiscal 2024.

Third, our productivity efforts remain in full force and continue to yield strong operating leverage in the form of lower OpEx to sales ratios. As we move towards the close of our 3-year targets, our Mission Critical program, under the leadership of Kristen and Martina, is transitioning from a one-time program to an ongoing way of life or continual improvement.

Beyond the numbers, there are four other important elements to our story. First, strategy. The repositioning of MSC into a high-touch Mission Critical partner is taking hold. Customer reception to our enhanced role is high, and this is evident in the growth rates of our high-touch programs and the rate of new customer wins. The plan is working.

Second, culture. MSC has always had a strong culture, one that's grounded in respect for people and an intense focus on the customer. Our new management team is building on that strong foundation. We're adding new elements, including more aspirational target-setting, a more robust execution model and more extensive collaboration across functions, in other words, thinking end-to-end about our business.

Third, technology. It's been nearly a year since John Hill joined us as MSCs first Chief Digital and Information Officer, and progress with our technology function is encouraging. We are enhancing our e-commerce functionality, and expect to see incremental benefits in the coming quarters. We are improving our product information and customer data, making for a better customer service experience and a more efficient business. We’re eliminating inefficiencies as part of Mission Critical, where older systems inhibit productivity or where improvements can unlock further value.

And fourth, the market. We continue to operate in a marketplace with attractive dynamics that support continued growth. The North American distribution market is over $200 billion, and remains highly fragmented with the top-50 distributors still holding just over 30% of the market. The opportunity for organic and inorganic share capture remains vast.

In addition, MSC's concentrated manufacturing exposure sets us up well for the next decade. The reshoring trend that we've all heard about is moving from (inaudible) action, as we are seeing an increased number of new plant construction projects. And while our participation in the early stages of construction is minimal, this bodes well for growth in our end markets over time and should serve as a further growth tailwind.

Before turning it over to Kristen to discuss our second quarter performance, I want to spend a few moments discussing the environment. While sentiment and IP readings continued moderating, the tone on the ground is stable. Most of our customers continue to see solid order levels and demand activity. Of course, we're watching the banking situation closely to monitor any potential ripple effect on the broader industrial economy. At this time though, our overall read on the environment remains constructive.

With respect to pricing, the situation is pretty much the same as we reported last quarter. We continue seeing increases from our suppliers, albeit not at the rate or level of the past 2 years. As such, we're passing those along as warranted, and we continue seeing strong realization. All of this means that the need for our customers to find productivity that offsets their own cost headwinds remains as strong as ever, and this plays very nicely into our value proposition. So we remain focused on delivering that productivity for our customers.

Kristen will now take you through our quarterly performance, capital allocation priorities, balance sheet and our reaffirmed fiscal 2023 guidance.

Kristen Actis-Grande: Thank you, Eric, and good morning, everyone. Please turn to Slide 5 of our presentation, where you can see key metrics for the fiscal second quarter on a reported basis. Slide 6 reflects the adjusted results, which will be my primary focus this morning.

Our second quarter marked another quarter of strong execution and results. We remain on track, or even ahead of schedule, on our primary goals for fiscal 2023 of gaining market share, expanding adjusted operating margins and improving adjusted ROIC. Our five growth levers and productivity improvements have us positioned to meet or exceed our Mission Critical goals.

The execution of our growth drivers, as well as price contribution and our bolt-on acquisitions, continued to fuel our results. Our revenues came in at $961.6 million, which represents average daily revenue growth of 11.5% versus the same quarter last year, well above the IP Index, which was basically flat in our fiscal second quarter. Growth from acquisitions contributed just under 4 percentage points of that increase.

Looking at growth rates by customer type, public sector sales increased roughly 20%; national accounts grew in the mid-teens, and core and other customers continued to grow high-single-digits.

Another way to view our sales performance is through the growth drivers we initiated as part of the Mission Critical program, solidify metalworking, expand solutions, leverage the portfolio strength, grow e-commerce and diversify customers and end markets with an emphasis on the public sector.

Let me update you on each of these growth drivers. Our expertise in metalworking remains the cornerstone of our value proposition, driven by the depth and breadth of our portfolio, our large network of technical metalworking experts and focus on innovation as a tool to elevate productivity, while lowering costs for customers. This expertise is helping us win new customers and penetrate high-growth end markets like aerospace, commercial space and medical. These industries consume large amounts of metalworking tooling by working on intricate, complex and lightweight materials. Our technical expertise applied in these situations is often able to yield considerable savings and throughput improvements.

In a recent large-scale win in the aerospace industry, the customer told us that no other competitor was able to bring the kind of technical advice and productivity savings that MSC offered. It was the primary driver behind the win, which will ramp up over the next couple of quarters. Instances like this are becoming more and more common, and are fueling our National Accounts performance.

Our solutions growth driver is anchored by our vending and in-plant programs, both of which have been delivering market share capture over the past several quarters. Vending machine revenues continued to grow mid-teens and represent 15.5% of total company sales. That compares to 15% of sales a year ago. Q2 in-plant signings remained quite strong and in-plant customer revenues grew nearly 20% year-over-year, and now represent 12.5% of total sales.

Sales to customers with our solutions offerings that includes vending, VMI and in-plant represent over 56% of the company's total sales, up over 200 basis points from prior year.

The third priority is selling the portfolio, which is about increasing share of wallet through ancillary products, especially our Class C consumable product category. Here, we provide an outsourced vendor-managed inventory service that keeps plants running. So we also include this business as part of our overall solutions offering. Q2 growth for this business remains solid with an ADS growth rate of low-teens.

Our fourth priority is digital, which includes all aspects of MSCs digital engagement with customers, suppliers and associates. E-commerce sales reached 62% as a percent of total company sales in our fiscal second quarter, up roughly 130 basis points compared to the prior year. As Erik mentioned, John Hill and team are enhancing our e-commerce functionality, and we expect this number to continue growing over time.

Fifth is customer diversification through our public sector business, and I already mentioned our Q2 ADS growth of roughly 20%. Based on additional program wins, we expect momentum to continue during the back half of fiscal 2023 and into fiscal 2024.

Each of our five growth levers are not only powering our performance, but they are positioning MSC as a trusted productivity partner to our customers, expanding our role from solely a spot buy supplier.

Our gross margin for the fiscal second quarter was 41.3%, down 120 basis points year-over-year. The impact of acquisitions accounted for roughly 50 basis points of the dilution. The remaining 70 basis points are made up of lapping last year's large price increase, the increasing impact of cost through the numbers and mix. Sequentially, gross margin ticked down 20 basis points, as expected, due to a slight compression in the price cost spread and the impact from the Buckeye acquisition in our numbers.

Looking forward, while inflation has tempered, we are still seeing some suppliers move on price, though not at the levels of the past year. In March, we implemented a small increase of 1% to 2%, which follows our similar size increase in late January. The customer cost savings and productivity gains we deliver continue to support strong realization rates.

Reported operating expenses in the second quarter were $281 million versus last year's reported operating expenses of $266 million. Adjusted operating expenses were $280 million or 29.1% of net sales, versus last year's adjusted operating expenses of $266 million or 30.8% of net sales. This yielded a 170-basis point reduction in adjusted OpEx to sales year-over-year.

Our reported operating margin was 11.9% compared to 11.3% in the same period last year. Adjusted for restructuring costs, costs associated with the proposed share reclassification and acquisition-related costs, adjusted operating margin was 12.2% as compared to adjusted operating margin of 11.6% last year, a 60-basis point improvement year-over-year. That improvement was driven by the continuation of our Mission Critical initiatives, which yielded additional savings of $4 million in the quarter. That puts us at $10 million for fiscal 2023 and $95 million for the program's cumulative savings. We remain on track to achieve our goal of at least $100 million by the end of fiscal 2023.

Already last quarter, our Mission Critical initiatives and the efforts of our entire team on cost containment and productivity, boosted our adjusted ROIC to 18.3%. During our fiscal second quarter, we increased our adjusted ROIC to 19%, which includes the impact of the $300 million securitization facility we put in place back in December.

Turning to earnings per share, our reported EPS was $1.41 for the quarter as compared to $1.25 in the same prior-year period. Adjusted for restructuring costs, costs associated with the proposed share reclassification and current year acquisition-related costs, adjusted earnings per share were $1.45 as compared to adjusted earnings per share of $1.29 in the prior-year period, an increase of 12%. This continues to reflect strong execution at all levels, sales performance, gross profit and OpEx leverage.

Turning to the balance sheet, at the end of the fiscal second quarter, we were carrying $747 million of inventory, up $21 million from Q1 balance. The inventory build is consistent with our double-digit revenue growth, continuing inflation and calendar year-end buy opportunities. We do expect to bring inventory levels down by year-end.

Our operating cash flow conversion rate for Q2 was 429%, which includes the benefit this quarter from the $300 million sale of receivables related to the securitization program. Excluding the benefit of securitization, we are still targeting an annual conversion of roughly 100% for fiscal 2023. Our capital expenditures were $15 million in the second quarter, and we continue to 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 $325 million for the current quarter, as compared to negative $16 million in the prior-year quarter. Note that we also spent about $12.5 million buying back shares during the quarter, just over 150,000 shares at an average price of $81.76. We currently have 4.4 million shares remaining on our current repurchase authorization.

Our total debt at the end of the fiscal second quarter was $550 million, reflecting a roughly $230 million decrease from the first quarter of fiscal 2023, primarily from the benefit of the securitization facility. As for the composition of our debt, roughly 45% was floating rate debt and the other 55% was fixed rate debt. Cash and cash equivalents were $50 million, resulting in net debt of $500 million at the end of the quarter. Our net leverage at the end of the second quarter was 0.9.

Before I reiterate our capital allocation strategy, let me touch on the current banking environment. We recently conducted a comprehensive review of all of our main banks, those that participate in our revolving credit facility, as well as those banks with whom our recent acquisitions do business with. Three of the six main banks are designated as systematically important financial institutions, such that they are more heavily regulated than regional banks, and all six banks have strong common equity and liquidity ratios. We continue to monitor the situation closely.

As a reminder, we refreshed our capital allocation strategy last quarter, which you can see on Slide 8. Our top two priorities remain reinvesting 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 the other uses of cash. We continue to see buybacks as an attractive way to return capital and enhance shareholder value.

In the near term, however, we will not be buying shares in the open market, while based on legal advice, we work through the share reclassification proposal. As a reminder, the Special Committee of our Board of Directors remains engaged on evaluating the reclassification proposal and we cannot comment on the status of their evaluation at this time.

Now let's turn to the fiscal year 2023 guidance and assumptions, which are shown on Slide 10. We are reaffirming our 2023 guidance of average daily sales growth of 5% to 9% and an adjusted operating margin between 12.7% and 13.3%. For modeling purposes, I'll provide additional color on our expectations for the back half of our fiscal year. As of now, we would characterize the environment as stable. Our growth trajectory likely tempers a bit due to higher prior-year comparisons, including extra selling days last year, but should remain quite solid. March is indicative of this, with estimated growth between 8% to 9%.

I will note that our fiscal March, which extends through the end of this week, has a roughly 1 percentage point headwind due to the timing of Good Friday and Easter weekend, which will be a tailwind in our fiscal April. For the full year, we expect to trend somewhere between the middle and high end of our sales range.

We continue to expect gross margins to be higher in the second half of the fiscal year than the first half, beginning with an expected sequential increase in Q3. This is due to several factors. First, the product cost increases in our P&L during the second quarter should be the peak for the fiscal year. Second, freight costs are moderating in the second half of our fiscal year. Third, as Eric mentioned, we have several gross margin initiatives that will be a tailwind over the remainder of the year and beyond. As of now, the benefits are modest this fiscal year and [builds] for fiscal 2024.

With respect to adjusted operating expenses, we expect our typical seasonal pattern to play out, and adjusted OpEx to sales ratio will decline sequentially in the second half. As of now, this would yield an adjusted operating margin in the middle of our range. If we can achieve a bit more gross margin improvement in the back half of the year, we can move the adjusted operating margin towards the higher end of the range.

The last point I'll make is that we are not changing our full year guidance for our most recent acquisitions of Buckeye and Tru-Edge. These acquisitions add approximately 50 basis points of growth, and dilute both gross margin and operating margin by an additional 10 basis points.

We are proud of the growth in our business during the fiscal second quarter, and we continue to take steps to align the business for further top line and bottom line acceleration moving forward.

I'll now turn it back over to Erik.

Erik Gershwind: Thank you, Kristen. As we crossover the halfway point of fiscal 2023, and we enter the final leg of our 3-year targets, I'm excited by our company's performance. We are meeting or exceeding the targets that we set for ourselves nearly 3 years ago. The most exciting part for me, however, is that no one on our team is satisfied. In fact, we feel as if we're just getting started. We've recently begun our strategy refresh process to create a new set of long-range targets, and we look forward to sharing those with you in a couple of quarters. In the meantime, I'd like to thank all of our associates for their hard work, dedication and strong execution for our customers.

Before I open the line for Q&A, I do want to take a minute to let you know that John Chironna has decided to retire at the end of June. Kristen will keep you updated on progress in replacing John over the next few months. Let me spend a moment though thanking John publicly, and recognizing the great job that he has done over the past decade. John has been a steadying, reliable and consistent face to our investment community, as well as inside the company with our associates.

During a time of change and transformation, both within the company and across the industry, John provided clarity, transparency, honesty, and most of all, integrity. John, on behalf of our entire team, thank you. And on a personal note, it's been a pleasure working closely with you, and I wish you all the best as you enter your next chapter in life.

And we will now open up the lines for questions.

Questions and Answers

Operator: Thank you, sir. We will now begin the question-and-answer session. (Operator Instructions). Tommy Moll with Stephens.

Tommy Moll: I appreciate the insight you provided on the demand environment and wanted to start on the revenue or ADS guidance that you've provided here. So if I'm doing the math correctly, even at the higher end of the range, if you look at the dollars per day, it implies something below the $16 million run rate that you've achieved the last few months. So I'm just curious if there's something you're seeing in the macro in the back half that might change to the downside, if it's a conservative outlook based on limited visibility or something else?

Kristen Actis-Grande: Yes, Tommy, so I think first broadly, let me just reiterate what you heard in the prepared remarks, that we feel very good about what we're seeing right now in terms of the demand environment. The tone on the ground is stable. We're really confident with how we've been executing, confident in our ability to continue executing well. That being said, I think I'd be remiss if I didn't throw the word "cautiously optimistic" in front of that, just given all the same macro information that I'm sure you're looking at around IP and the PMI. But the good thing is that we contemplated all that within the guidance framework, so we always anticipated that the year was going to slow down.

When we set that range at the beginning of the year, we assumed our fiscal 2023 IP was flat to down low-single-digits at the start of the year, with the first half positive and the second half negative. And that's still what we expect to play out, although we see the bottom end of that range probably as being less likely at this point. But if you're thinking about the first half into the second half, there's a few things you need to think about with respect to modeling on the top line. The first is that the benefit from price does continue to decelerate sequentially, as we lapped the biggest increase from last year in our second quarter, so that price benefit does continue to decelerate through the second half.

The second thing I would mention is a similar dynamic on the acquisitions decelerating. And then, of course, we're seeing the market softening, which is one of the things that plays into the sequential ADS changes. Maybe to put a little bit of a finer point on the modeling, because there is a lot of noise like especially in the fourth quarter prior year with the 53rd week. I would think about for the second half that the contribution to growth from price is between 300 to 400 basis points, such that the year looks like a 400 to 500 basis point contribution from price.

And then on the acquisition side, I would say to think about that as 100 to 150 basis points of contribution to growth, such that the year ends up being 200 to 300 basis points. And then, of course, depending how you model IP and volume or (indiscernible) assumptions, that would land you in the mid-to-high end of our guidance range.

Tommy Moll: Got it. That's helpful. Shifting gears to OpEx and the significant leverages in terms of percent of sales that you showed in the second quarter, any additional insight you can provide on some of the company-specific initiatives there would be appreciated.

And then in terms of the second half, if I hear you correctly, I think the way you framed it up was just percent of revenue should improve second half versus first half. Any additional insight you can provide there potentially in terms of a range of dollars per quarter on that line of your P&L, or what the range on a percentage basis could be, would also be appreciated.

Kristen Actis-Grande: Sure, yes, so your interpretation or what you heard in the remarks, I totally agree with that. It's sequentially declining, that's not atypical for us. A couple of the initiatives -- maybe let me talk about a couple of the initiatives first. So obviously, we continue to do really well with Mission Critical; that's going to continue to help us in the second half. Probably not surprisingly, we're tracking ahead of the $15 million savings target for the year. We've been measuring the reinvestment very cautiously, just given some of the uncertainty in the macro environment. So while we haven't given a firm number on the reinvestment guidance, I can definitely commit to at least $10 million of net savings on Mission Critical.

And then I think the second thing I'd mention, Tommy, to your question about the initiatives is just the kind of ongoing productivity engine that we've been generating inside the company, which is really what you're seeing is kind of the spirit of the next evolution of Mission Critical, which is deploying things like lean and continuous improvement, getting a lot more organic kind of grounds-up feedback, and ideating the projects and the productivity opportunities. We're really starting to see that momentum accelerate.

And of course, we're talking specifically about the OpEx line, but our intention kind of post-2023 is that we're using those same principles to really attack the whole P&L and balance sheet to generate opportunity. But then in terms of second half dollars, obviously, there is some dependency there depending on the volume number that you're modeling. But I would suggest definitely a step-up in dollars for the third quarter and then depending where you model Q4, obviously, pick up your volume change. But I think Q4 is where you'll probably see a bit more productivity benefit from us than maybe what would be historically typical.

Tommy Moll: I appreciate it and I'll turn it back. Thank you.

Operator: David Manthey with Baird.

David Manthey: First off, the Buckeye and Tru-Edge acquisitions, that's 50 basis points combined, not each, right?

Kristen Actis-Grande: Correct.

David Manthey: Yes, and then you mentioned reorientation of category management focus. We talked about some benefits in the second half. Could you touch on the efforts and the benefits from that initiative?

Erik Gershwind: Good morning, Dave. So yes, look, I think we started to tee this up on the last call. But for the last couple of years, our category folks have done a great job in a really difficult environment, and the focus has been on getting product and on staying ahead of inflation. And I think mission accomplished on both fronts. As things are settling in now, we see a great opportunity to reorient through a line review process, which is something that's sort of typical that we'll do over time. But I would say with a stepped-up emphasis on taking a hard look at product and supplier portfolio optimization and refining our purchase cost position.

So we are in the midst of that. We're going to approach this as we've done in the past in waves. So I mentioned Wave 1, we're sort of clustering our product lines, Dave. And we are right now in the midst of the negotiation process on Wave 1, our first cluster, and we've kicked off Wave 2. I think in terms of benefits, certainly, we mentioned gross margin will be the biggest financial beneficiary here. It'll be modest. In this fiscal year, we're looking at something in Q4, but we'll call it modest. Obviously, that'll become more significant as we get to FY 2024.

Just to sort of size it for you, the last time we went through something extensive like this, it was a year or two before Covid, Dave. We achieved, in dollar terms, profit improvement in the neighborhood of $20 million. I'd expect this effort to be at least as great, if not greater, than that given that, number one, we're a bigger company now, for starters. But number two, we haven't done this in a few years and we perhaps will take a slightly more robust and more aggressive posture as we move through the line review.

So that's sort of -- the one other color I'll add, Dave, is just as you think ahead beyond 2023, I wouldn't take the $20 million-plus and just overlay it on top of -- there will be other puts and takes with gross margin. So we're a little early to give sort of gross margin perspective, but absent this move, we probably turn negative price cost, and so this is going to help us buffer that, for sure. So hopefully, that's some helpful perspective.

David Manthey: Yes, that does. And just to clarify, I think last quarter, you were saying that you didn't expect the typical seasonal fourth quarter down-tick in gross margin. You're still tracking that given this initiative and your outlook relative to that 41.5% to 41.8% gross margin guidance?

Kristen Actis-Grande: Yes, that's correct, Dave. So for Q3, as we commented on in the prepared remarks, I'd expect Q2 to Q3 step-up to look pretty similar to what you would see historically, so plus 30 bps to 40 bps. And then Q4, I would think about that being flat to maybe down 10 bps. And then for the year on the gross margin guidance range, yes, we still feel confident with that original range, although I think a little bit more pressure probably towards the bottom end, given the Buckeye acquisition.

David Manthey: Okay. Thank you very much.

Operator: Chris Dankert with Loop Capital.

Chris Dankert: I guess thinking about your Mission Critical, as we kind of move into the next phase here, should we be thinking about it more in terms of kind of offsetting some of the investment costs that you're undertaking here, or do we have to stay tuned until you kind of really talk about longer-term targets?

Kristen Actis-Grande: Yes, Chris, so I would say stay tuned for more specific targets, which we'll give at the end of the fourth quarter. But what I would say is, obviously, the spirit of what we've been doing here over the past 2 1/2 years definitely continues on into Mission Critical 2.0. But it does look a little bit different in terms of how we execute inside the company, sort of the size of the projects that we're taking on and then where the benefit shows up. So largely, the cost savings on Mission Critical has been very focused on the OpEx savings in this Mission Critical 1.0 round. But we see a lot of benefit to be gained by expanding that focus to cost of goods sold, to the balance sheet. I think there's a lot of opportunity we can go after there.

But the broad thing I would reiterate, going back to your question, is, yes, the idea is really to use Mission Critical as a productivity engine on an ongoing basis that helps us to cover sort of core inflation that we see every year at a minimum. And then as much as we can fund through investment, that would be the goal.

Chris Dankert: Got it. Thanks very much for the color there. And then, I guess, kind of thinking about the customer conversations right now, particularly around cost savings, VMI, some of the other optimization you guys bring to customers, I know that was a really big selling point for you back in the slowdown in 2015, 2016. I guess maybe, Erik, you touched on this a bit in your opening comments, but maybe can we put the current conversations and kind of the cadence in these cost saving conversations and what MSC brings to the table in context of prior downturns? Are we seeing a real acceleration in those conversations, or is it kind of what we've been seeing 2022, 2023 to date?

Erik Gershwind: Chris, so I would say the punch line is there has been an acceleration and I think there's two factors I'd point to, a macro factor and a micro factor. So the macro factor is that our customers, they are experiencing unprecedented levels of inflation over the past couple of years of competitive intensity of a once in a -- hopefully, once in a lifetime experience with

Covid. Our customers are under more pressure, I think, than I've seen in my 25 years in the business. So the drumbeat and the need for help is greater than it's been in past cycles, that's the first thing, that's the macro factor.

The micro factor is, look, Chris, relative to prior cycles, we really have changed the face of MSC. So this repositioning that we've talked about to becoming a Mission Critical partner, we've always had kind of like arrows in our quiver as it relates to helping customers with productivity and cost savings, but they're much greater now. And in particular, I think what's happened is, they've extended from the procurement side of things, where we could offer productivity savings in the way of one-stop shopping, in the way of process savings to inventory management, we've really extended that to savings on the plant floor. And I think this is probably where we're fairly unique.

And Kristen, in the prepared remarks, mentioned one of our recent wins where the customer said to us, boy, nobody is doing this. It's extending the savings and the productivity from the process side to the production process, where with our technical experts, between metalworking and OEM fasteners and the C parts products, we're actually able to go in and help re-engineer process. We're helping save labor hours, which right now, are precious. We're saving material. So I think you're seeing, number one, a step-up in customer needs and expectations, and then number two, really a changing of our role.

Chris Dankert: Got it. So it's more about share capture, not trying to read in too much to customer, the needs versus past. I think that makes an awful lot of sense. Thanks so much, Erik.

Operator: Steve Volkmann with Jefferies.

Steve Volkmann: Congrats, John, thanks for all your help.

John Chironna: Thank you, Steve.

Steve Volkmann: Maybe just to go back to this kind of gross margin outlook, it feels like there's kind of cross-currents for 2024. And Kristen, I think you said that you'd see more of your line review benefits in 2024; I think you said that too, Erik. But you'll obviously see some headwinds, I guess, on price cost. Can you give us a sense, can gross margin be up in 2024, or how are you thinking about just broadly? We don't need a number yet.

Kristen Actis-Grande: Yes, sure. So you're spot on in that we -- because of the way we do the costing at some point here, the price cost benefit does flip to negative. We saw our cost peak in the second quarter, so we expect fiscal 2023 on price cost will be slightly positive to flat. So the implication there would be that you do go negative in fiscal 2024. The category line reviews are a critical part of what we're doing to kind of buffer that impact, of course, as Erik elaborated on a little while ago here. Obviously, the more we can do on productivity generation in cost of goods sold, the more we can offset that impact.

And it is hard to size right now too, Steve, just because we are seeing cost inflation continue to come in. So we'll give a more specific number in Q4, but it is -- you do need a lot more productivity to come through for us to be able to increase margin on a year-over-year basis once that price cost curve inverts. But we see a lot of opportunity in cost of goods sold, and we're going after a lot of things already. So we'll be able to put a finer point to that in the fourth quarter.

Steve Volkmann: Okay, great. That's helpful. And then can you just go back to this quarter and give us a sense of what price and volume were?

Kristen Actis-Grande: Sure, yes, so price in the quarter contributed just under 500 basis points to growth, and then volume was just under 300 basis points of growth.

Steve Volkmann: Okay. And then one final quick one from me. Kristen, you mentioned inventory maybe comes down this year. Any order of magnitude?

Kristen Actis-Grande: Yes. So yes, we do expect inventory to come down. Of course, a bit of dependency there on how growth plays out in the second half, but I'd say in the 10-ish range is probably realistic, coming down about $10 million.

Steve Volkmann: Okay, so pretty modest. All right. Thanks so much.

Operator: Ryan Merkel with William Blair.

Ryan Merkel: John, it's been a great run. Thanks so much for all the help. Wish you all the best.

John Chironna: Thank you, Ryan.

Ryan Merkel: So my first question today is on in-plant, which was up 20%, and is now a little bit higher than 12% of sales. Can you just define what that is and how you execute to it? I imagine there's MSC people on the plant floor more often? Just talk about how you do that and kind of what the outlook is?

Erik Gershwind: Yes, Ryan, look, I think you hit the punch line, which is basically it's sort of the most extreme form we have around our solutions offering of being a Mission Critical partner with the customer. We're actually putting one or more full-time people inside of our customer. Typically, Ryan, this is also -- it's more than just a person, it's accompanied by inventory management system, whether that's vending or VMI; it's accompanied by a regular cadence of visits and audits from our technical folks doing plant improvement reviews. But the cornerstone is definitely that we're putting people in full time. What we're seeing, Ryan, is high-value-add for the customer, particularly now the labor shortage is still as extreme as ever and so all of our customers -- this is sort of one of the two or three biggest things we hear at almost every customer visit. So we're helping satisfy a big need there by putting our people inside.

And what it does, when our people are in there, they're doing everything from procurement to helping out with operations and improvements. And it's freeing up our customers' labor to focus on higher-value-add activities on the manufacturing process. So the win for the customer is clear; the win for MSC has been clear. Typically, what we see, Ryan, when we put a program in place, either this will be in the case of a brand new customer, where it's part of our pitch, or an existing customer where there is a share of wallet capture.

And we see, in the 1 to 2 years that follows program inception, a really healthy growth rate, extremely high retention rates. And you can imagine that the profitability of the program really improves as we start to leverage the fixed costs on volume. So it's been exploding. Based on macro and micro factors again, I would expect it to continue growing at a healthy clip.

Ryan Merkel: Appreciate that, that's helpful. And then you mentioned continuous improvement will be part of the DNA, Mission Critical has gone very well. Can you just give us some examples of how you're thinking about that? And I don't know if you want to give a soft goal today, but how might that look going forward?

Kristen Actis-Grande: Yes, I can take that one, Ryan. So we've been doing a lot of work to improve execution up to this point of Mission Critical. But I'd say it's only recently where we've shifted to educate the organization on lean principles and drive continuous improvement philosophies through the company and we're definitely in the early innings of that effort.

One thing I'll add that I'm really energized by is having our new COO on board, who is a huge believer in these concepts. And she is going to be a great partner in helping us drive this through the organization going forward. So I would hesitate to put a number on it again at this point, but I really see it being the engine for Mission Critical 2.0, whether you're talking about targeting OpEx savings, whether you're talking about targeting cost of goods sold improvements, working capital improvements, this kind of becomes the mechanism or the motor that fuels all of that.

Early wins we've had, I'd say a lot of the work that we've been doing to unlock working capital through the value streams right now have come this way. But again, it's early innings, so what I'm more energized and excited by is there's a ton of parts of the organization that you're not really seeing any material benefit yielding yet. So I'm excited about this, and I think it's a big step in the future of MSC and Mission Critical 2.0 specifically.

Erik Gershwind: Ryan, I'll just add a little color on top of just from the CEO's perspective on this one. It's really exciting for me to see Kristen and Martina together. And two things I'd highlight sort of zooming out from strict productivity. One is I mentioned this in the prepared remarks, more aspirational target-setting. I think the management team that's in place now is more comfortable setting stretched targets, even if it means you missed, but thinking really big. And so that fits into the continual improvement umbrella.

The second one is a concept that I think Martina has brought with her, which is problem elimination versus problem solving. MSC, we've had a really strong customer-focused culture for a long time. We jump through hoops when there's a problem, we solve it. But what we're trying to do now, with Martina and Kristen leading, is stepping back and saying, wait a second, get to the root cause, why is the problem happening in the first place? And don't celebrate just solving it for the one customer. Get to the root cause, ask why, then figure out how you eliminate it, so the problem doesn't come up the next time. I think both of those are cultural shifts happening inside the company.

Ryan Merkel: I appreciate it, Erik. Thanks so much.

Operator: Ken Newman with KeyBanc Capital Markets.

Ken Newman: So a lot of my questions have already been asked on the call so far. But maybe I'll start with you talked about, Kristen, the capital allocation priorities, obviously, for organic growth as well as it looks like M&A. I know you guys have been pretty active on some tuck-in acquisitions, obviously, but with all the uncertainty in the banking sector, I'm just curious if you could talk a little bit about how difficult it is to maybe drive more M&A going forward?

Erik Gershwind: Ken, I'm happy to take this one. Look, I think Kristen did a nice job of laying out our priorities. While certainly, there is -- yes, there is uncertainty in the macro and the banking, etc., but we feel really good about our balance sheet, it's strong now. We know that if things were to erode in the macro, the balance sheet only gets stronger, our cash generation picks up. So we feel like we can really be on our toes here.

Now, that said, I think we're going to stay very disciplined. So when it comes to M&A, I don't think you're going to see us -- I never say never, but the bar would be really high to stray from the tuck-in approach we've been taking. So I don't think you're going to see us do anything really big, and I don't think you're going to see us do anything outside of the core areas that we've already been highlighted. But we do feel like the execution engine we have rolling now on these tuck-in acquisitions is greatly improved, our confidence is growing.

So it's absolutely one of the priorities with respect to capital allocation. So we will stay on our toes, but we're going to also remain very disciplined with the three filters of strategy, financial and culture.

Ken Newman: Got it. And then for my follow-up, I think there's been a lot of good color on the demand outlook. And I appreciate all the comments on both the customer mix and the modeling comments as well. I guess just given some of the uncertainty that we've talked about in the prepared remarks, can we talk a little bit about what visibility you have in demand relative to the end markets that your customers are serving? Where are you seeing pockets of strength, or maybe some incremental weakness relative to your expectations?

Erik Gershwind: Yes, sure, Ken. Look, overall, I think the tone that we want to underscore here is stable, that's probably -- yes, there's more caution; yes, the sentiment indices are eroding. But on the ground, we're constructive on the environment right now. So in general, our customers are busy. There is certainly -- look, there is more caution now than there was 2 quarters ago, no question. And that was -- was it exacerbated by the banking situation? Sure, but activity levels, backlogs, order flows are generally good.

The pockets where we have seen softening, I would say, Ken, would be, number one, still consumer-facing industries. The other one that would be new would be heavy equipment. We did see sort of a sequential, I would say, more negative tone there. On the flip side though, there is areas like aerospace, like medical, where things feel good, really good. So while there is pockets of softness, I would say on the flip side, there's just as many pockets of real strength. And overall, we characterize it as stable.

Ken Newman: That's really helpful. Thanks for all the color, guys.

Operator: Patrick Baumann with JPMorgan.

Patrick Baumann: I just wanted to first, wish John the best in whatever he decides to do next. He's been a trusted, respected voice for the company over time, and will definitely be missed. So best of luck, John.

John Chironna: Thank you, Pat. Appreciate that.

Patrick Baumann: Yes, of course. Appreciate all your effort over the years. My question is just the clearly continued good results on the Mission Critical initiatives, as per the solution sales growth and the government sales growth, which were highlighted. And I think overall volume growth actually outpaced IP by 200, 300 basis points in the quarter, which was a nice tick-up.

What I wanted to really focus on, or ask about, is the other 35% of sales that's non-solutions and non-government. Just how would you characterize that bucket of sales? What are you seeing there in terms of volume growth? And then what's being done to kind of invigorate that portion of the business?

Erik Gershwind: Yes, Pat, so a great question. So here's what I'd say. First of all, let me start, so overall, we're feeling very encouraged by the trending in the business. And what we look at is what often, I imagine you're looking at, which is, okay, when you strip out IP, certainly, the acquisitions are an important part of the growth engine. But when you strip out IP, you strip out acquisitions, how is the base business performing? And in particular, how is the base business performing ex-price, because we have certainly been in an elevated pricing environment.

And what we've highlighted this morning, and what's exciting to me is if you think about what MSC has become over the past few years, this entire repositioning effort, we've really pivoted the business. And if you look at the areas that are the shining stars right now, they are the areas that we have pivoted to. The high-touch, the solutions, areas like public sector, where we feel like there's a moat around the business. So the stuff that's growing above company average are the portions of the business where we're technical, we're high-touch and we feel like the moat is the deepest, that has me really excited.

The flip side is obviously, if there's portions that are growing higher than company average, there's other portions that have to be growing under company average, and I think that's what you're nipping at. And what I would say there, Pat, is the areas that are growing under company average are more of the legacy business. And by legacy business, I would mean small customers, pure spot buy commodity transactions, that would be the stuff that is growing, but it's growing less than company average. So to me, that's encouraging and it actually paints even more of a runway. And I think what Kristen and Martina and team are digging into right now is two levers that we see, because ultimately, we're not satisfied with growth where it’s at. We want to see it get even better.

And there's two levers. Number one is how do we scale the new stuff, the part of the strategy even faster, in-plant, vending, the high touch, what we're doing in public sector. Like we're gaining momentum and we think we can scale it even faster, that's part one. Part two is how do we get the things that are growing below company average up to at least to company average? And what has me encouraged there, Pat, is this is stuff -- like this is the legacy, the bread and butter, of MSC. So I think it's absolutely doable. And we've sprinkled through the comments a bunch of things that we have going right now to do so.

So number one, we hit on e-commerce enhancements, and that will be a never-ending journey. But I'm really excited by the energy and the talent that John has brought to our e-commerce. So if you look at our e-commerce numbers, and obviously, e-commerce has application across-the-board, all customer sizes. But certainly, for smaller customers, the enhancements we're putting in place, we're already doing pretty well in e-commerce; we think we can be doing better. And so you're going to see those enhancements improve things in the coming quarters.

Number two, the category line reviews, we talked about optimizing the portfolio of both in terms of products and suppliers. In some cases, that will mean new product additions; in other cases, it's going to mean streamlining the offering. And that is not only about cost position; it's about creating a really great shopping experience for the customer. So that's the second thing.

The third one that we didn't highlight, and it's worth mentioning, is we have a bunch of marketing activities. So there has been sort of a regeneration of energy around marketing programs geared towards smaller customers. And what we're trying to tap into right now, Pat, is how we bring our -- this high-touch technical value proposition that is working so well with larger customers, how do we bring it in a cost effective way to smaller customers? And that's where our marketing team is focused right now.

So those would be examples of things that our goal is to re-energize. So you think about the progress we're making at the top right now, where we focus, if we can bring the water level up on the rest, it really gets exciting.

Patrick Baumann: That's helpful color. Do you feel like -- is price a barrier at all to growth in that part of the business, or do you feel like you're kind of in the ballpark on price for that portion of sales?

Erik Gershwind: So I would say this, Pat. Look, I think there's always a trade-off to be made between price and volume. And that's a conscious choice that we've made, and we have this repositioning to a Mission Critical part, and we've made a choice to pivot to a high-priced, high-value-add position, right? So with the value we're bringing, it's going to be hard to do that and be the low price -- low cost, low price player, that's not the goal.

I would say if you look at the vast majority of where our revenues are, anywhere we're touching a customer with a person, with a solution, we're competitively priced. I think what you're getting at and what is real is there are cases where we're not touching, it's a brand new customer or the customer is so small that we're not touching them with a person. There's going to be cases where we're higher priced than other channels, no doubt about it. And so, yes, I think there will be some work there. I think we can take a very surgical approach to that. It's not across the board, it's not across all SKUs, all customers, so it'll be surgical. But certainly, as part of the marketing efforts, we'll take a look at it.

Patrick Baumann: It makes sense. Thanks for the color. And then on the cash dynamics in the quarter, Kristen, you can help on this. So how much of that free cash flow in the quarter was related to this facility? I guess I just didn't quite understand the mechanics around that. Remind me what exactly that facility is? I guess it's off-balance sheet, right, and how does the cost flow through in terms of the P&L?

Kristen Actis-Grande: That's correct, Pat. Yes, so the easy math, if you're trying to adjust the cash flow, is just you benefited cash by $300 million from the securitization. I think you asked the second question about the P&L benefit or the P&L impact. So two things I'd point out real quick at the buzzer. You're going to see interest costs decline because of the securitization, you're going to see other cost increase. And then post the first year of the ongoing annualized benefit of that is about $800,000 to the P&L.

Patrick Baumann: Okay. We can follow up on that offline. And then I had to ask one last; I know it's at the buzzer. Any sense on timing of next steps with regard to the proposed share class consolidation? Like what are the mileposts to watch there?

Kristen Actis-Grande: Yes, I'm sorry, Pat, I can't really comment on that.

Patrick Baumann: Okay.

Kristen Actis-Grande: As soon as we have news to share, we obviously will, but no further information at this time.

Patrick Baumann: Okay. Best of luck.

Operator: Thank you. And ladies and gentlemen, this concludes our question-and-answer session. I'd like to turn the conference back over to John Chironna for any closing remarks.

John Chironna: Thank you, Rocco. Before we end the call, I'd like to thank Erik, Kristen, and the entire MSC team for giving me the opportunity to continue doing what I truly love. I'd also like to thank our analysts and investors for the wonderful relationships we've forged over the last few decades. It's those relationships that have made coming to work each day a true joy.

A reminder that our fiscal 2023 third quarter earnings date is set for June 29. And we look forward to seeing you in person at investor conferences or on the road in the coming months. Thanks again for joining us today.

Operator: Thank you, sir. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.