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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Wesco Aircraft Holdings First Quarter Fiscal Year 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to hand the floor over to Jeff Misakian, Vice President Investor Relations. Please go ahead, sir.

Jeff Misakian ***Wesco Aircraft Holdings, Inc. - VP of IR***

Thank you, Karen. Good afternoon, everyone. Thank you for participating in Wesco Aircraft's Fiscal 2018 First Quarter Earnings Call and Webcast. We've included slides with today's presentation to help illustrate some of the points discussed during the call. These materials can be accessed by visiting our website at www.wescoair.com and clicking on Investor Relations.

We are joined today by Todd Renehan, Chief Executive Officer; and Kerry Shiba, Executive Vice President and Chief Financial Officer. Alex Murray, President and Chief Operating Officer also is here and available to answer questions during the Q&A session.

Please turn to Slide #2. As a reminder, today's conference call includes forward-looking statements within the meaning of federal securities regulations. Although the company believes that such forward-looking statements are reasonable, we cannot assure you that any forward-looking statements will prove to be correct. Forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause actual results to differ materially from those anticipated at the time the forward-looking statements are made.

Additional information relating to factors that may cause actual results to differ from our forward-looking statements can be found in the company's filings with the Securities and Exchange Commission, including the company's annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

Wesco Aircraft undertakes no obligation to update or revise forward-looking statements except as required by law.

Now I will turn the call over to Todd Renehan. Todd?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Thanks, Jeff. Please turn to Slide 3. Our fiscal 2018 first quarter results were encouraging, reflecting improved sales and operating income performance compared to the previous quarter. Additional tax expense associated with new U.S. tax legislation resulted in a loss in the quarter. However, on an adjusted basis, net income improved sequentially as well. Kerry will review the first quarter financial details in a few minutes. As you might remember, last quarter we said that we are beginning to see signs of better operating performance as a result of our improvement plan initiatives. Now I'm happy to see that these initiatives are also beginning to drive improved financial results. Of course, this is only one quarter and we have a lot more work to do, but I'm encouraged by our progress. To that end, the business assessment we told you about last quarter is proceeding very well. As we continue the process, we now are further validating the scope, impact and timing of our improvement plan initiatives, while at the same time initiating project execution in several key areas. I'll cover additional details about the assessment process after I provide you with an update on the business.

Please turn to Slides 4 and 5. Execution of the improvement plan initiatives continues to show good progress. In our first focus area of profitable growth and improved margins, we reported solid year-over-year growth in sales with increases in both hardware and chemicals. Sales also increased sequentially despite typically lower seasonality in our first quarter. In addition, average daily sales improved for the second quarter in a row, primarily because of new business and our better service performance. Long-term contracts were the primary driver of sales growth in the first quarter, while ad-hoc sales increased as well. Contracts benefited from sales under new business as well as higher volume on existing contracts. We continued to receive awards for new business and renew long-term contracts in the quarter, supplying multiple commodities and supporting major aerospace defense and industrial companies at sites in North America, Europe and Asia.

We continue to receive positive comments from customers regarding our performance improvement and the value that Wesco provides. I've spent time recently with a few of our major customers and heard firsthand many positive comments about the improvements we've made to service performance. We believe that the increase in ad-hoc sales in the first quarter in part reflects our improved performance, and it's consistent with the bookings trends we told you about last quarter. Overall, product margin performance was stable compared to the previous quarter with a sequential increase in ad hoc and hardware product margins that was partially offset by a decline in chemical margins. In the area of procurement and inventory management, as we stated on our last earnings call, we invested in inventory in the first quarter to better support existing contracts and new business as well as to service ad hoc. We placed more SKUs on long-term agreements, remaining on track to achieve our target of 75% by the end of the fiscal year. We continue to bring greater discipline to buying practices to mitigate supplier price increases and reduce the need for more expensive gap buys. We also expanded the scope of process improvements we mentioned last quarter, to address procurement practices. As a result, we're developing more sophisticated inventory management tools to closely monitor our performance and respond more quickly to changing dynamics.

With respect to service and on-time delivery, efficiency metrics continued at high levels in the first quarter, and we expanded the scope of these process improvements to another large site in North America. We also drove reductions in labor cost per transaction and maintained on-time delivery rates at high levels. Finally, we expanded commodities at certain sites to serve our customers better. In the area of efficiency and reduced costs, we continue to focus on optimizing our cost structure. SG&A in the first quarter reflects a higher expense base relative to a year ago due to the investments we made in the second half of fiscal 2017 to stabilize the business and support our growth as well as consulting costs associated with our turnaround activities. We kept a tight lid on payroll and discretionary costs in the quarter. Apart from the consulting cost just mentioned, SG&A essentially was stable sequentially. However, we have a lot more work to do to drive efficiencies throughout the organization and we're focused on optimizing our cost structure through the initiatives that I'll talk about next.

Please turn to Slide 6. As I discussed in previous calls, we started our turnaround process with the change in leadership last year. After rebuilding Wesco's foundation on people and customers, we then initiated our improvement plan to fix execution issues, stabilize operations and return the business to better profitability. In the first quarter, we engaged consultants to help us with our business assessment and to dig deeper into our processes and broaden them where possible.

Please turn to Slide 7. The assessment has involved a more thorough review of the business to identify areas of further improvement, to sustain improvements already made and determine the steps necessary to realize the company's full earnings potential. We're very encouraged with the findings to date, which reinforce our thinking that significant opportunities exist to reduce costs and further enhance margins through improved efficiency, process, productivity and alignment. We're now taking action to streamline functions, increase automation, improve processes, optimize the footprint in our distribution network and enhance pricing and sourcing activities. This approach remains consistent with our desire to be closer to our customers and empower our people. We believe it will better position us for growth as well as increased shareholder value and allow us to reinvest in the company and our people. Execution of near-term initiatives around streamlining, process improvement and efficiency is already underway and expected to deliver benefits as they are completed.

At the same time, we continue to assess the initiatives that are more complex such as those associated with our distribution network. We plan to provide more information in our next earnings announcement, including more details around the expected costs and benefits associated with our initiatives. Ultimately, our goal remains to return Wesco's earnings power to its full potential.

I'll turn the call over to Kerry now to review the first quarter financials, then I'll wrap up our prepared remarks with comments about our fiscal 2018 outlook. Kerry?

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

Thank you, Todd, and good afternoon or good evening to everybody. If you would now please to Slide #8. We reported solid top line performance in the first quarter with net sales up $24 million or 7% year-over-year. Overall sales growth was led by long-term contracts, which increased $22 million or 8%. Sales of chemical products increased in the high single-digit range while hardware contract sales rose on a mid-single-digit pace. Both reflect new business revenue and higher net volume on existing contracts. Ad-hoc sales increased $2 million or 2% with improved service performance and growth to key customers driving higher orders.

Please now turn to Slide #9. A year-over-year decline in income from operations of slightly less than $2 million reflects improved gross profit, which was offset by higher SG&A expense. Sequentially, income from operations improved by almost $5 million. Operating margin was 90 basis points lower year-over-year but improved 130 basis points sequentially. The year-over-year gross profit improvement was $5 million reflecting higher sales volume that was partially offset by a change in sales mix. A 40 basis point decline in gross margin primarily reflects sales mix changes, including a higher overall proportion of chemical product sales and some shifts within the portfolio of chemical contracts. Ad hoc and hardware contract margins were stable in the fiscal year 2018 first quarter compared to the same period of last year. Gross margin improved 180 basis points sequentially, with underlying product margins overall about flat. As we discussed on our last earnings call, the fourth quarter included a large claims provision and negative year-end inventory adjustments. SG&A expenses in the fiscal 2018 first quarter were $7 million higher year-over-year, primarily reflecting investments in customer-facing functions we made in the second half of fiscal 2017 as we have discussed on previous calls.

This led to an increase in people-related costs of $4 million in the first quarter when compared to the same period last year. SG&A in fiscal 2018, in the first quarter, also included higher consulting costs of $2 million associated with the improvement initiatives that Todd described.

Sequentially, SG&A was $2 million higher primarily due to these consulting costs. Our effective tax rate in the fiscal 2018 first quarter includes an estimated impact of approximately $9 million associated with the change in U.S. tax law. There was discrete recognition of a few large items related to the new law. A charge due to remeasurement of our net deferred tax asset is offset by a favorable adjustment to reverse most of the deferred tax liability we recorded in the fourth quarter of fiscal year 2017 and related to accumulated foreign earnings. A new estimated liability related to accumulated foreign earnings, which we referred to as the transition tax, also was recognized in the first quarter as a tax expense. The transition tax is estimated to be $9 million, and the related liability will be paid out over an 8-year period, beginning in 2019, but with almost 60% of the cash cost not incurred until the years 2024 through 2026.

Estimating the impact of the new legislation required assumptions to be made about complex issues over a relatively short period of time since the new tax law's recent enactment. We will continue to assess the impact of the new law and may revise related adjustments in the future. Excluding the impact of discrete tax adjustments, our effective tax rate for the quarter reflects our current view of between 28% and 29% for fiscal year 2018.

The tax impact in the first quarter led to a loss of $400,000, which essentially was breakeven on a per share basis. Excluding discrete adjustments for the new tax law as well as other items described as usual in the tables accompanying our earnings press release, adjusted EPS of 15[%] was lower year-over-year, but much improved compared to an adjusted $0.08 per share for the fourth quarter of last year.

Please now turn to Slide #10. Inventory increased in the fiscal 2018 first quarter to better support existing contracts and new business as well as to service ad-hoc demand, consistent with comments we made on our fourth quarter earnings call. The inventory investment and other working capital changes primarily drove the cash decline of $20 million from September 30. We borrowed a net $19 million against our revolving credit facility and made $5 million in term loan repayments in the first quarter.

Please now turn to Slide #11. Cash used in operating activities was $30 million, primarily due to the -- to a $33 million inventory investment, I just mentioned, and a $22 million decline in accounts payable. The largest impact of which was from the timing of payments around the cutoff at both the beginning and end of the quarter. Free cash flow was negative $31 million compared to negative $29 million a year ago. When looking sequentially, the largest change in free cash flow also reflects a difference in the change in accounts payable balance in each period, again related to payment timing around the cutoff.

With that, I'll now turn the call back to Todd for a few comments on our outlook. Todd?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Thanks Kerry. Please turn to Slide 12. Our fiscal 2018 first quarter results represented the better execution by the business and an important sign of tangible financial benefits from our improvement plan initiatives. While we're encouraged by the progress made, a lot more work is needed to sustain and broaden this improvement. We believe the next steps we're taking will allow us to achieve this objective. Until we're confident that we're seeing a sustainable trend we're maintaining our fiscal 2018 outlook. It's important to point out that this outlook does not yet reflect the benefits from these next steps. We continue to expect a low single-digit percentage increase in net sales for fiscal 2018, primarily based on new business and growth in ad-hoc sales.

We also continue to target a low double-digit increase in adjusted EBITDA through sales growth, gross margin expansion and stable SG&A as a percent of sales. Finally, we still expect to end the fiscal year at an adjusted EBITDA margin run rate of more than 10%.

Now, I'll turn the call over to Jeff to direct the Q&A session. Jeff?

Jeff Misakian ***Wesco Aircraft Holdings, Inc. - VP of IR***

Thank you, Todd. We'll now open up the Q&A period. Karen, may we have the first question please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Ciarmoli with SunTrust.

Les Sulewski ***SunTrust Robinson Humphrey, Inc. - Equity Research Associate***

It's actually [Les] in for Michael. I guess first on the business assessment side. Can you just talk a little bit overall, what color are you seeing? Is it the demand increasing? Is it you coming on the penalty box, if you will? Just overall some of the drivers driving the business at the moment.

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Yes, it's a little bit of both. We had good sales performance on a couple fronts. The chemical performance was stronger with a ramp-up of military platforms. The hardware sales were a reflection of both new business and higher volumes. And the ad hoc growth was driven by our better performance as well as some specific customer growth.

Les Sulewski ***SunTrust Robinson Humphrey, Inc. - Equity Research Associate***

Okay. And as far as the chemical margins there and the decline there, can you talk a little bit on that?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Yes, the primary driver of the chemical margin decline was the difference in contract terms and conditions that we have with a couple military contracts where we originally signed these up when cost was independent. And they were a small business enterprise. And on the contract renewal, because Wesco brought Haas, we are no longer a small business enterprise, so the deal changed. And the margins are a little tighter than they were. So we maintained the contract, but the terms of the contract changed.

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

Some of the impacts were simply a result of doing the math also. There's a good proportion of chemical sales that fundamentally are pass-through in nature. So they hit the sales line and the COGS line at about the same value. So as sales rises on those contracts, it's just a higher -- a larger sales number against which to compute the margin. On those types of contracts and in this kind of business it's fee -- it's service fee revenue for the value we provide to our customers that really drives the profitability in those situations.

Les Sulewski ***SunTrust Robinson Humphrey, Inc. - Equity Research Associate***

Got it. Thank you for that additional color. On the $2 million expenses in consulting as part of SG&A, what is the duration in that looking forward? Is that kind of a run rate we'd expect for the next couple of quarters? Does it go up, does it go down? And then perhaps what kind of savings can we see in the margins in the outyear?

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

I think our current view the next quarter I would say in aggregate will probably match, maybe even in exceed a bit what we incurred in Q1. The quarter after that, we directionally would expect those costs to start to drift down, but as Todd mentioned, we're still poking through a lot of detail on the execution phase of what we're working on. So I think as things continue to become more clear over the next couple of months, we'll know better. But that would be the general pattern, I would guess, right now.

Les Sulewski ***SunTrust Robinson Humphrey, Inc. - Equity Research Associate***

Got it. And I guess one last one for me. On the inventory investment side, you've mentioned you've done some investment this quarter in Q1. How can we look at Q2? And then just I guess how that results in free cash flow for the remainder of the year?

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

Yes, I think the inventory investments certainly should decline significantly from what we saw in Q1. May bounce up and down a little bit as we go through the rest of the year quarter-to-quarter, but nothing near the magnitude of what we saw in Q1. Clearly, that's going to have a benefit on operating cash flow performance as we go through the remainder of the year. We're not providing a full year guidance on that. But directionally, we won't be in nearly as heavy an investment mode as we were in Q1 and certainly compared to last year.

Operator

And our next question comes from the line of Carter Copeland with Melius.

Carter Copeland ***Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense***

Just a couple of quick ones. On the ad-hoc commentary and the growth you mentioned there, especially since it pertained to a key customer or customers. Is that a one-off or do you think that there's a potential for ad-hoc sales growth, broadly speaking, to have turned a corner here?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

The latter, yes. It was not a one-off. We're still seeing strong bookings. And that's always a positive indicator for us, because that will lead to sales in the future. Our bookings have improved year-over-year in general, kind of mid-single digits. And very encouragingly, our bookings for our top 20, 30 customers have increased even better than that. So we're seeing some positive back-to-back quarters on higher bookings and our book-to-bill ratio. So still positive signs there.

Carter Copeland ***Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense***

Okay. And there's been some commentary this quarter around a little bit of destocking on the wide-body side. I think that pertains to the 350. I'm not sure if you guys have any material exposure to that. But wondered if you could comment on whether you'd seen any more of that on the wide-bodies?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

And we don't have a ton of exposure. And we're not seeing a lot of that right now, Carter.

Carter Copeland ***Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense***

Okay. And last one. When you think about the next couple of quarters. And clearly, it obviously seems prudent not to raise the guidance. I'm not sure what you want to see there. But for us trying to evaluate kind of key performance indicators of the business, what are the most important things you want to drive and accomplish that we should be looking for in next couple of quarters to confirm the trends you're kind of outlining here?

Todd Renehan *Wesco Aircraft Holdings, Inc. - CEO & Director*

I'll start and then I'll let Kerry add to that if he wants. We are certainly encouraged with Q1. But as you mentioned, it's only 1 quarter. And while Q4 of last year appears to be the low point, we have a lot more work to do. We still expect a stronger second half. What we're looking for to continue is improvement in ad-hoc bookings; improvement in contract bookings; improvement in average daily sales, which is an important indicator for us; a continued reduction in labor cost per transaction; and a continued focus and reduction on SG&A both as a percentage of sales and a percentage of gross margins. And that's on the financial side. On the customer side it's obviously, maintaining high on-time delivery rates and even improving that further. So those are the big things. And then Kerry, I don't know if there's a cash component on there you want to talk about as well.

Kerry Shiba *Wesco Aircraft Holdings, Inc. - Executive VP & CFO*

Well, I think I would add that on the SG&A side, Todd's comment I think is focusing on kind of the run rate of the business. Obviously, the consulting costs are going to be in there as we continue with the project work that we are in process on. So that's something you have to consider in the SG&A side. On the cash flow side of things, as I mentioned, historically the first quarter is always the down cash flow quarter for this business. I think that's part of the seasonality. But with the inventory investment that we made in the first quarter -- investment of that size, again, will not continue for the remainder of the year. Again, maybe little ups, little downs as we go quarter-by-quarter for the remainder of the year. We had the big kind of red herring, if you will, on just the change in accounts payable balances around the cutoffs. So exactly how the payment runs at the end of the quarter fall before or after cut off has a kind of momentary impact on where we're at. But those are not underlying trends that affect the business overall. They really are just timing oriented.

Operator

Our next question comes from the line of Gautam Khanna with Cowen and Company.

Gautam J. Khanna *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

I was wondering, one of your competitors that's public has talked about some big takeaway contract wins, and specifically, I am referring to KLX. And I wondered, have you lost any business in recent quarters to them? And is that something we got to worry about?

Todd Renehan *Wesco Aircraft Holdings, Inc. - CEO & Director*

No. Look, we trade business on ad hoc and LT agreements with our competitors based on product position, based on certain price and based on potential performance at the time. So that's not -- nothing new. We have not lost any material CMS or JIT or full service agreements or contracts to our competitors. We have a strong renewal rate with our customers. We have a strong growth platform with a big pipeline with our customers. And we have a tremendous value proposition that we believe is unmatched in the industry.

Gautam J. Khanna *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Okay. And could you comment on what you're seeing in the aftermarket. How big that business is today for you guys? And was that part of the ad hoc pickup that you saw in the December quarter?

Todd Renehan *Wesco Aircraft Holdings, Inc. - CEO & Director*

No, no. It wasn't. The aftermarket business for us is 6% to 7% of total revenue. It's not tremendous. The ad hoc pickup was just traditional ad hoc business that we have. There's still a lot of opportunity for us to grow in aftermarket. It's still a focus area for us. It's a big market out there that we're attacking.

Gautam J. Khanna *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Okay. And last one, I was wondering if you could comment on whether you have any remaining exposure to potential in-sourcing by Boeing under the BASN program with any of the subcontract manufacturers you're servicing today?

Todd Renehan *Wesco Aircraft Holdings, Inc. - CEO & Director*

No, no. We are -- just the opposite. People are outsourcing more. Again, we have got a big pipeline with our existing customer base. We are in discussions and have been over the quarters with several prospects and customers who want to move away from BASN. So again, it's the testament to that value proposition that we have.

Operator

(Operator Instructions) Our next question comes from the line of Jon Raviv with Citi.

Colin Canfield ***Citigroup, Inc., Research Division - Equity Research Associate***

This is Colin Canfield on for John Raviv. Just want to talk a little bit -- we've touched on this about the call. But the cadence of the sales growth and margin progression through the year?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Kerry?

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

As the -- you mean as 2018 continues to progress?

Colin Canfield ***Citigroup, Inc., Research Division - Equity Research Associate***

That's correct.

Kerry Shiba ***Wesco Aircraft Holdings, Inc. - Executive VP & CFO***

Yes, we -- again it's just think about this from a sequential perspective. We are still projecting a better second half than a first half. We still expect to exit the year at the double-digit margin. So that is continued growth. Again the caveat is that we haven't factored in the improvements that we would expect to see from the major projects that we're working on today. So that's a view of the business more from a run rate perspective.

Colin Canfield ***Citigroup, Inc., Research Division - Equity Research Associate***

Okay. Thanks for that color. And just touching on your comment before, very quickly. You spoke about the full earnings potential of WAIR. If you could just kind of frame that reference for investors today?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

We cannot frame that for investors today. We have a lot more work to do on that. And the last thing that we want to do is throw numbers out there and not have them fleshed out and put ourselves in a position to disappoint. So we've been through this assessment. We've got broad-based initiatives that we're going after. We have some preliminary ranges and timing, but we have a lot of work to do to flesh that all out, to validate it, to refine it. We're encouraged very much by the potential. They are material, but we're not ready to disclose it yet.

Operator

And our next question comes from the line of Ronald Epstein with Bank of America Merrill Lynch.

Kristine Tan Liwag ***BofA Merrill Lynch, Research Division - VP***

It's actually Kristine Liwag. I was wondering, in your release, and I think you mentioned it on the call that you're investing in an inventory management system. I was wondering what does that entail? And then on a high level, can you tell us what this is going to address? And how much the system could cost?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

Let me talk broadly about that. And then I can let Alex get into some details. When we're talking about process and automation, what we're discussing is strategic investments that we're making in tools, in processes and in automation, in sales and finance and procurement. As a matter -- right now, we are highlighting 5 robotics projects that are underway. So what we're talking about there is just giving our field and our people the tools and the process and investing in that automation to drive efficiencies. The specific inventory tools, so just giving us that more -- greater visibility into current positions in inventory, what's coming, what individual forecasts are, how that matches with optimal buy quantities, things like that. So those are some of the details and the color around when we talk about improving process and automation.

Kristine Tan Liwag ***BofA Merrill Lynch, Research Division - VP***

And then going forward, will this process let you integrate with your customers in terms of the quantities they will need under your long-term agreements and just-in-time contracts?

Todd Renehan ***Wesco Aircraft Holdings, Inc. - CEO & Director***

That's already well in place in terms of visibility between our inventory, what our customers have, what the min/max-s have, what their demands are, what their forecasts are. That's already fully integrated into our system, into our folks on-site and that connects to our procurement folks here in Valencia.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the floor back over to Wesco for any closing comments.

Jeff Misakian ***Wesco Aircraft Holdings, Inc. - VP of IR***

Great. Thank you, Karen. On behalf of everyone at Wesco Aircraft, we'd like to thank you for your participation today. We appreciate your interest in Wesco, and look forward to speaking with all again you soon. Have a good evening.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.