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WAIR - Q1 2019 Wesco Aircraft Holdings Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

Jonathan Phaff Raviv *Citigroup Inc, Research Division - VP*

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

Michael Frank Ciarmoli *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Myles Alexander Walton *UBS Investment Bank, Research Division - Research Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the First Quarter 2018 Wesco Aircraft Holdings, Inc. Earnings Conference Call. (Operator Instructions)

I would now like to introduce your host for today's conference, Mr. Jeff Misakian. Mr. Misakian, you may begin.

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

Thank you, Muriel. Good afternoon, everyone. Thank you for participating in Wesco Aircraft's Fiscal 2019 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 in 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*

Thank you, Jeff. Please turn to Slide 3. Fiscal 2019 first quarter results reflect solid top-line growth and ongoing execution of our Wesco 2020 initiatives. Net sales growth of 9% in the first quarter of fiscal 2019 outpaced the market, reflecting strong execution and greater demand for our core supply chain services.

Our results were led by strong performance in our Americas business, which represented 81% of total net sales in the first quarter. Sales growth in the Americas was 11%, reflecting strong execution in both ad hoc and contract sales. Operating income in the Americas increased 15% in the first quarter, demonstrating improved operating leverage despite increased cost to support our growth and Wesco 2020 execution.

However, our EMEA business, which represented 16% of net sales, did not perform as well. Sales were 4% lower than the prior year with declines in both ad hoc and contracts, while operating income fell approximately $3 million or 52%. The decline in operating income was due to a decrease in sales and gross profit, which reflects lower pricing on certain contract renewals, volume discounts earned and less volume at some customers.

We focused significant effort on improving our operating model in the Americas, which as I said earlier, is our largest business by far, both through the Wesco 2020 process and in other ways. We're increasing focus in our EMEA business using our successful initiatives in the Americas. This gives us confidence in our ability to jump start EMEA's sales engine and improve its profit generation by the end of the year.

I'm pleased with our continued focus and execution on the top line as seen in our results. As we continue with the implementation of Wesco 2020, including its rollout in EMEA and reduced one-time costs, we expect benefits to become more evident in reported income and operations.

Adjusted EBITDA, which excludes one-time items, increased 7% in the first quarter. We continue to implement Wesco 2020 at an aggressive pace, executing our footprint optimization plans, streamlining our organization and investing in distribution centers and capabilities. There will be a lot of heavy lifting over the next two or three quarters, and this will involve a higher level of temporary costs to ensure the success of our initiatives. We've talked about some of these temporary costs in the past, in particular, consulting fees and certain compensation-related expenses.

In addition, we're incurring transition expense to facilitate footprint optimization plans. A primary example of these transition costs is redundant labor we're carrying to hire and train employees in the distribution centers that are receiving product as well as keeping staff on hand at facilities to be closed during the transition to ensure that we maintain high levels of customer service as we consolidate our operating footprint.

We're willing to support this increased level of spend to protect and service our customers. These transition costs will peak in fiscal 2019 as we enter into the most significant activity in this area. We're confident that Wesco 2020 benefits will increase over the course of fiscal 2019, while one-time costs will decline significantly by the end of the year. I'll talk more about Wesco 2020 progress in a few minutes.

As anticipated, we consumed cash from operating activities in the first quarter to support both our growing business and as part of a large multiyear contract renewal with a significant customer. If you exclude the impact of the contract renewal, we invested less cash in inventory than last year's first quarter. We continue to expect that improvements we're making in inventory management will lead to better leverage of this asset and drive an increasing cash flow in fiscal 2019 as compared to fiscal 2018.

Please turn to Slide 4. Ad hoc sales increased at a double-digit pace again as we captured more business with existing customers. Our customers continue to tell us that they are pleased with the improvements we've made and they are continuing to reward us with more business. This is reflected in our ad hoc sales growth as well as double-digit increase in ad hoc bookings in the first quarter.

Sales under long-term agreements also increased in the first quarter, reflecting higher volumes on existing contracts and new business. We continue to book new business and renew long-term contracts at a solid pace. As I mentioned earlier, we recently renewed a large multiyear hardware contract with a major commercial OEM that also includes significant expansion opportunities.

We also signed a new contract with a major industrial company to support multiple sites around the world as their preferred chemical management services provider. This award follows an 18-month process that involved multiple chemical providers competing for the business. The customer selected Wesco because of our proven experience, technical capability, global footprint and testimonials from other customers.

As I mentioned earlier, we continue to carry a temporarily higher expense base to support Wesco 2020 execution. We've also invested to upgrade certain capabilities and added costs to directly support our sales growth. While making these investments, we continue to exercise discipline over discretionary spending in our ongoing business operations. Excluding one-time costs, SG&A as a percent of sales would have been approximately 130 basis points lower year-over-year.

We've continued to improve inventory management processes as well, reducing future investment through better forecast accuracy. We're enhancing our software capability to better institutionalize our improved data and practices in this area. Improvements continue to be made to this critical area of the company.

Please turn to Slide 5. The pace of Wesco 2020 execution is increasing on several fronts. We've closed or announced plans to consolidate 13 single-commodity warehouse facilities to-date. In total, we expect to close approximately 16 such facilities. At the same time, we're establishing three new multi-commodity distribution centers moving closer to our Wesco 2020 target of seven such centers when we're finished.

Most recently, we took action earlier this month to consolidate two warehouses in Europe into a new distribution centers in Poland. We're taking similar steps to consolidate two warehouses into a new distribution hub in the Northeast region of the U.S.

We've also notified our people yesterday of plans to relocate the company's largest hardware warehouse from Valencia to our full service distribution center in Northlake, Texas. We plan to maintain a forward stocking location in the Valencia area, but it will be significantly smaller and focused on serving customers in the region. This relocation will improve our operating cost by providing more efficient floor space, which will better realize the benefits of new warehouse technology and reduce the number of times we handle inventory before it reaches our customers.

Our footprint optimization initiatives are a large and complex element of Wesco 2020. These plans take time to complete and require considerable resources to ensure customer service isn't disrupted during transition, including some investment in new locations. We're taking a careful approach to the process, establishing robust customer care plans, controlling the pace of execution and investing in transition labor to maintain high levels of customer service. So far, we're making good progress.

We continue to streamline administrative functions, while implementing new processes and investing in key capabilities. Over the past 6 months, we've announced the consolidation of several sales offices in the Americas and EMEA. This is a critical part of our efforts to streamline our organization, drive greater efficiency and reduce cost. Overall, we're targeting a reduction in head count of approximately 10% as a result of the Wesco 2020 initiatives. We expect benefit to reported income from operations to increase as the nonrecurring costs decline later in the year.

At the same time, we continue to invest in automation and business tools. Our new warehouse management system is on track with site implementations beginning late this year. We believe the new system will enable us to further optimize processes and deliver significant cost savings. We're also investing in demand planning systems to help drive further improvements in our procurement and inventory management processes that I mentioned earlier.

Now I'll turn the call over to Kerry to discuss our first quarter results, after which I'll provide some closing comments. Kerry?

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

Thank you, Todd. If you please now turn to Slide #6. Net sales were $395 million, increased 9% in the first quarter of fiscal 2019 when compared with the same period last year. Contract sales increased 7% with solid growth throughout the major areas of the business. Chemical products and services increased 10% in the quarter with most of the nominal growth coming from pass-through revenue, but reflective of strength of our overall value proposition with customers in this area, fee revenue grew 12%.

We continue to benefit from participation in the military sector and the ramp-up of the Joint Strike Fighter program as well as generally strong customer relationships. Sales of contract hardware products increased 4%, primarily due to higher business jet and military demand. Ad hoc sales increased 16% in the quarter, reflecting our continued ability to service broad-based demand in a healthy market. As Todd mentioned, the ad hoc sales were particularly strong in our Americas business up 23% in the first quarter. Sales were 1% lower sequentially, excluding previously disclosed one-time sales of $6 million in last year's fourth quarter of last year, reflecting normal seasonality.

If you please now turn to Slide #7. Income from operations decreased $2 million in the first quarter compared to the same period last year. Increased gross profit was more than offset by higher SG&A. Operating income essentially was flat sequentially. Looking deeper into operating income details, gross profit increased $4 million year-over-year, primarily reflecting higher sales volumes, partially offset by a 110-basis-point decline in gross margin percent. The gross margin decline reflects the impact of higher pass-through revenues within chemicals, which diluted the overall margin by approximately 60 basis points, as well as the various discrete items that negatively affected the year-over-year comparison. Specifically, volume discounts earned and excess and obsolete inventory-related charges increased, and we incurred temporarily higher freight costs that were related to Wesco 2020 execution.

Sequentially, gross margin improved 60 basis points, primarily due to lower-volume discounts earned and E&O inventory-related charges as well as higher chemical margins.

SG&A was $6 million higher year-over-year, primarily due to one-time costs associated with Wesco 2020 totaling $8 million. These costs included higher consulting fees and other project-related expenses and costs that Todd mentioned, which are supporting execution and a smooth transition during our operating footprint consolidations.

Interest expense in the first quarter increased $1 million year-over-year and $500,000 sequentially due to higher interest rates.

Our effective tax rate was 30% in the fiscal 2019 first quarter. This is at the low end of the previous guidance range, primarily because of new treasury regulations issued in the first quarter, clarifying certain provisions of the new U.S. tax law enacted at the end of calendar 2018. As a result, we reduced our expectation for our fiscal 2019 effective tax rate to a range of 29% to 31%. We continue to evaluate potential opportunities to reduce our effective tax rate further in fiscal 2019.

We reported earnings per share of $0.06 per share in the fiscal 2019 first quarter compared with breakeven on a per share basis in last year's first quarter. Last quarter's first year was impacted by additional tax expense of approximately $9 million associated with the new U.S. tax law.

Adjusted earnings per diluted share were $0.17 in the fiscal 2019 first quarter compared with $0.15 per share in the same period last year.

Adjusted EBITDA was $37 million in the fiscal 2019 first quarter compared with $35 million in the same period last year. Adjusted EBITDA margin was slightly lower year-over-year, but improved 50 basis points sequentially.

Turning now to Slide #8. Accounts receivable increased $13 million in the quarter due to collection timing. Inventory was $28 million higher sequentially in the first quarter, primarily due to our investment in sales growth and support for the large customer renewal and expansion that Todd discussed earlier. As Todd also noted, if you exclude the impact of the contract renewal, we invested less cash in inventory than in last year's first quarter.

Accounts payable increased $4 million in the first quarter when compared to last year, primarily due to higher inventory receipts and payments timing around the quarter end cut off.

Net debt, which is total debt minus cash, increased $37 million in the first quarter, reflecting an increase in borrowing against our revolving line of credit to support our investment and working capital growth.

Cash used in operating activities totaled $32 million in the fiscal 2019 first quarter -- I'm sorry, I'm on Slide #9 now, largely due to the inventory investment that Todd described earlier. Cash used in operations was nearly $3 million higher than the same period last year, primarily due to the timing of receivables and payables.

Free cash flow was negative $35 million in the fiscal 2019 first quarter compared with negative free cash flow of $31 million in the same period last year. Capital expenditures were slightly above the first quarter of last year. We do expect capital expenditures to be in the $20 million to $25 million range in fiscal 2019. We still expect positive free cash flow in fiscal 2019 at a level that's higher than fiscal 2018, despite the increased rate of capital spending and our investment in the contract renewal that we've discussed with improvement primarily driven by inventory reductions in the second half of the year.

With that, I'll now turn the call back to Todd for closing remarks.

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

Thank you, Kerry. Please turn to Slide 10. Overall, I'm pleased with our continued focus and execution on the top line, particularly in our core Americas business. We saw good operating leverage in Americas, despite higher cost to support Wesco 2020. We have some operational challenges in EMEA that we're addressing. But I'm confident we'll be able to turn this business around by the end of the year given the success we've seen in the Americas.

We continue to execute Wesco 2020 initiatives at an accelerated pace. We've increased our activities around facility optimization and we've made substantial progress with organizational refinements, and we're increasing investments in capabilities, including automation and new business tools. We have a lot more work to do, but I'm pleased with our progress to-date.

We're tracking well towards the financial benefits that we expect to see this year with Wesco 2020. As expected, we realized modest benefits from Wesco 2020 in the first quarter, and we're confident that as the pace of Wesco 2020 execution continues to accelerate in fiscal 2019, benefits realized from Wesco 2020 will progressively increase during the year and into fiscal 2020. While the higher level of cost to support Wesco 2020 execution are necessary in the short term, I'm confident they will decline significantly toward the end of the fiscal year. We still expect Wesco 2020 to generate run rate benefits of at least $30 million with full realization during fiscal 2020.

We continue to target mid-single digit percentage growth in net sales in fiscal 2019, driven by new business and growth in existing contracts, while our strong customer relationships and inventory position are expected to continue benefiting ad hoc sales. And we still expect higher sales volume, Wesco 2020 benefits and expense leverage to drive the high single-digit percentage increase in adjusted EBITDA in fiscal 2019.

Now I'll turn the call back over to Jeff to facilitate the Q&A session.

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

Great. Thank you, Todd. We now will open up the Q&A period. Muriel, may we have the first question, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Carter Copeland from Melius Research.

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

Todd, thanks for all the color on the cost elements and the site relocation. I think that's very helpful. I wondered if we might have the opposite side of the ledger, if you will, on the volume. There's been a lot of commentary lately about movements in various airplane production rates -- A330 down, A350 up, news on A380 potentially today --obviously, I think deliver more uncertainty around business jet and clearly that could have some real impacts on needed levels of inventory and lead times and the like. And I just wondered how that increased potential volatility on some of those big programs some of which use a lot of hardware could impact your plans and what your posture to be protected for something like that would be?

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

Okay. First of all, I would say that we are very diversified in our portfolio and very few of our customers have that big of a percentage of our total revenue. We're also, as you know, in chemical management services, manufacturing, pharmaceutical. So the company now has evolved to be more than just hardware. We -- the lead times are actually going to help us, and we're starting to see our ad hoc sales benefit a little bit from lead times being stretched out also from our improved performance. So we're not changing any of the forecasts. We haven't seen any of those recent announcements that you mentioned, specifically around Airbus, hurt us. We're on also platforms that are really growing at high rates, the Joint Strike Fighter, that production, global sustainment around the world is one of our key growth areas as well as seeing some good increase in volumes from our multiple business jet customers. So, so far we have been fairly insulated from some of the things that you're reading about currently.

Operator

Our next question comes from Myles Walton from UBS.

Myles Alexander Walton - *UBS Investment Bank, Research Division - Research Analyst*

I was hoping we can start on the gross margin for a second. I know you alluded to the pass-through weight on the margin in the first quarter. I'm curious for the full year, do you anticipate that you will be able to kind of recover to have flat gross margins year-on-year? Or do you anticipate this pass-through revenue to be there through the entire year 2019?

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

We can't control, obviously, the volume of pass-through, but we still expect and anticipate that our margin percentages will be flat as we announced at the beginning of the year with some of that guidance. Pass-through did have a big impact this quarter. The chemical business grew about 10%, pass-through was by far the largest portion of that growth and just mathematically, it has an impact on the basis points, but we're still sticking with our guidance of flat margin percent.

Myles Alexander Walton - *UBS Investment Bank, Research Division - Research Analyst*

Okay. And then the other is just -- can you put a sizing around the level of improvement you anticipate on free cash flow for the year or operating cash flow for the year, either way? Obviously it had to be pretty significant on the operating cash flow line to be up on the free cash flow line given the CapEx commentary. And I guess, put that, if you can size it in any way, is it doubling of free cash flow? Are you going to be above $25 million, $30 million? Any quantification you can put around it.

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

I'll start and then I'll ask Kerry to maybe give some color. We still expect a significant increase in free cash flow. I guess, not sure if we want to quantify significant or not. We still expect to use cash and build inventory in the first half of the year, but not at such a same pace as the last first half of the year. We expect to generate cash and reduce inventory in the second half of the year. And aside from the one-time or the large renewal investment that Kerry and I both talked about in our opening comments, we would have been at our expectations or better and much better than last year. So Kerry, I don't know if you want to give any other color.

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

I may be just to emphasize the point that the inventory pattern will substantially drive the cash flow pattern. A couple of points though, receivables timing was kind of funny at the first quarter cut off and some collections just didn't come in that were originally anticipated, and those have already come in or we're confident they're hitting the bank in the second quarter. That will drive, I think, a larger turnaround between first quarter and second quarter than I would have originally anticipated talking to you three months ago. That's good.

The contract renewal that we talked about, a great renewal for us despite the investment that we made in that contract, which was not anticipated when we're going through year-end discussions. And with that renewal hitting, we still feel very confident about our significant cash flow growth in the year compared to 2018. Now your specific question was, can you quantify it? And the answer is that we're not going to give a specific quantitative number with regard to the free cash flow growth. We stand by the term significant, and we're confident that we're going to do again substantially better this year than last.

Operator

Our next question comes from Gautam Khanna from Cowen and Company.

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

I was just curious if you could elaborate on what was going on in the European market that you saw some -- I think you said some price renewals were lower -- contract renewals were at lower prices I should say -- and some other items. I was just trying to figure out what sort of the market and what sort of company specific to Wesco?

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

Sure. Yes. You got it. The challenges that we saw in EMEA were primarily around lower sales and lower gross profit, and three key areas that we mentioned. One is lower pricing on certain contract renewals. There was a timing around the sales discount rebate that was earned and there was less volume on a few customers quarter-over-quarter. These are temporary challenges. They're not a representation of the market. They are not a loss of share, as a matter of fact we continue to win business and expand work there. We just need to jump start the sales engine in EMEA to improve the overall profit generation and then offset some of these things. And I'm confident that the initiatives through Wesco 2020 and other processes that we put in place here in Americas and share those best practices in Europe and we'll be able to turn this around quickly.

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

Okay. And a follow-up, to the comment on supporting the customer renewal with inventory buys in Q1, are there any other such lumpy contract renewals that are coming up this year? And relatedly, are there any potential or kind of lumpy draws on inventory that might result from those?

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

Yes. That's really hard question to predict. We, of course, have renewals coming up this year. Typically, our contracts are three to five years. So you could argue with $250 million-ish contract renewals up every year. Every customer relationship is different, every contract is different, this particular transaction we bought inventory from the customer, for the customer, it's part of our value proposition as customers continue to try to lower their costs and improve their working capital, this is one of the things that we do with inventory, but very, very hard to predict that.

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

Okay. And last one from me. Just any commentary on changes in the competitive environment either because of the Boeing/KLX combination or otherwise?

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

No. The competitive environment is always competitive. We've been capitalizing on some of the confusion out there. We've been very successful in several recent renewals and competes with the competition, and we are winning the vast majority of them. So -- but markets always competitive and like I said before, especially around renewals. Everybody wants a renewal, because you lock up a contract for three to five years, but no change.

Operator

Our next question comes from Jon Raviv from Citi.

Jonathan Phaff Raviv - *Citigroup Inc, Research Division - VP*

Todd, just following up on that Europe question a bit. Would you be able to diagnose sort of the core of what's causing those particular challenges? What are the root causes? Is it due to facilities consolidations you're running through the region? Is it the realignment that you've been going through personnel? If you could sort of diagnose what do you think is behind it in order to get a better sense for the way out of it so to speak?

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

Yes. Of course. I don't think it has anything to do with the changes that we're making. I don't think it has a lot to do with Wesco 2020 and the footprint optimization moves that we're making. I think it's internal and it's about better sales productivity, improving sales processes, improving sales metrics, and like I said, driving that growth engine. And I think it's been a focus thing. We focused most of Wesco 2020 efforts and energy around the biggest part of the business, which is the Americas, right? 80% of our total revenue is the Americas. And we now continue to shift focus as the Americas are running strong and share some of those best practices with Europe, especially around those sales processes and sales productivity that I talked about. But that's the change that needs to happen is to jump start that growth engine through better sales practices.

Jonathan Phaff Raviv - *Citigroup Inc, Research Division - VP*

Okay. And then in terms of just cost for the Wesco 2020 project, how are those costs tracking versus the original view? And then when all is said and done, is there any update to how much you expect all of this to have cost? And any sense for when you'll be able to say that all is set in timing, when we do see a real clean Wesco emerge here?

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

Right. The costs and the benefits have been about what we expected. We expected a modest Q1, and that's what we got. We never plan Q1 to be our best quarter. As the initiatives continue to ramp up, as our execution takes hold, the benefits and the costs, frankly, both go up, but we are getting the net realization and the net run rate benefit about what we expected. The overall cost and the overall timing of that is still planned to be in 2020. Our run rate savings at the end of this initiative should get us $30 million in net savings. Now we expect the realization of that to be in 2020, not necessarily in 2019.

Jonathan Phaff Raviv - *Citigroup Inc, Research Division - VP*

Would you be able to say almost in what quarter is the cutover in the sense of at what point are the benefits going to be greater than the costs?

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

The benefits are already greater than the costs in the first quarter, and it will continue to be that way successively through the year Q2, 3 and 4. And again, we should be through this at the end of Q4, a little bit of rollover into Q1 of 2020, but we'll be able to see the net benefits of $30 million in 2020.

Operator

Our next question comes from Kristine Liwag from Bank of America Merrill Lynch.

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

Following up on the commentary that you have made on pricing pressure in your European business. I know you've said quite a few things on this. But first, what makes you confident this pricing pressure is only temporary? And second, how is your EMEA business structurally different from your U.S. business? And what is the risk that you might see similar pricing pressure in your U.S. business?

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

Right. We get renewals based on the value that we add to a company, and price is not the only factor. Price is one of many factors of the total value proposition of any decision that any customer makes. Most customers do not make a decision only on price. Renewals are competitive. They've always been competitive, and we had some specific renewals where it made sense for us to be more competitive on the pricing to keep the business, and we often negotiate growth or other benefits for Wesco as part of the whole deal. So the pressure itself in a competitive environment is not temporary. The value proposition and the way people make decisions are in our favor because we provide such a strong solution to a customer, that's more than just price. Our structure is not different. If you mean organizational design, it's not different in Europe than it is in the Americas. It's the same type of setup. We put the structure in place as we launched our first stage of Wesco 2020. So -- yes.

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

And following up on that, I guess, my point is more that if one customer sees that one of your new renewal contracts customers is getting better service from your better value, then if you have a contract renewal coming up this year, wouldn't they want the same value proposition? And shouldn't you see more pricing pressure through the year?

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

Different customers have different -- completely different values. And we prescribe a different set of solutions based on the specific needs of that customer. And no two customers are alike. Are everybody looking for the best deal that they can possibly get? Yes. But all customers rank value differently. Some of them put price first, some of them put price fifth. So it all depends on the customer-specific needs and what value we bring to the table.

Operator

Our next question comes from Michael Ciarmoli from SunTrust.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Todd, certainly with all the moving components here of the Wesco 2020 and the run rate savings you're expected next year. Can you give us any help as to what you think the model is going to look like either from a gross margin perspective or SG&A as percent of sale, free cash conversion? And may be tie that into the one, obviously, you're investing in the business here, leverage going up, maybe plans to address the debt level?

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

Okay. That's a lot of questions, mostly about guidance. Let me just kind of step back and talk about the guidance that we've given, and it's really all the guidance that we're going to give. And I would ask everyone to look again at 2018 actual performance on all the metrics that you just talked about. Our 2019 guidance that we've already given and reaffirmed here today are Wesco 2020 initiatives where we're confident of $30 million run rate improvements. And factor out some of these redundant costs that we're carrying right now with duplicate labor to take care of our customers to make sure that the transition of inventory is smooth. And we're going to be a better, stronger, more profitable company, but that's the guidance that we're going to give at this point. As far as leverage and debt, Kerry?

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

Yes. One other thing, again may be gives you some directional feel for the landscaping of the improvements, we do expect that about roughly two-thirds of the Wesco 2020 improvements fall into the SG&A line because they're cost-driven items and then about one-third of it will hit at the margin line. That's pretty broad, but it at least gives you a little bit of feeling for landscaping on the P&L. The whole debt and the leverage question, it's very, very clear our capital allocations priorities that will be a result of improved free cash flow generation are going to be focused on paying down debt. So love to get the interest friction off and further improve the cash flow of the business basically, whether or not it falls in operating or financing and reduce the leverage. So that's a clear priority for us.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. And then maybe, Todd, just one another one. I think you talked about a new win at an industrial customer for chemicals. Can you give anymore color there? It sounded like you were working there for quite some time, I mean, do you plan on using that as sort of a launchpad into kind of broaden your customer base in the industrial landscape?

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

Yes. And we already have a pretty good foundation in the industrial base with several customers right now. This particular customer is new in North America and in Europe for us. We actually do business with this customer in South America right now, very small location, but they put several competitors through an 18-month kind of review testing process. And we came out of that 18 months as the victor, and they came to us because of our capability already in the manufacturing space and the experience that they have. They visited 4, 5 different sites. Some of them are warehouses supporting these manufacturing operations, some of them right on site with different manufacturers that we have folks on site we provide chemical management services. They were very happy with what they saw. They added on to the customer testimonials that they sought out independently. We're very happy what they heard there. They are a global company and so there is tremendous site expansion opportunity just with this one customer. And they were happy with our scale, our scope, our global footprint, our proprietary software with tcmIS. So there is a -- this will be a strong platform for this customer and for others to come, but we're already pretty successful in the manufacturing space on chemical management services.

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

Michael, I want to clarify comment I made also with regard to capital allocation. What I should have stated as the first priority is going to be to support growth in the business, to support the CapEx this year for our project execution as this business continues to grow. There are going to be times where despite improving leverage on the inventory investment, there is going to be some investment I'm sure that will be required over the long haul. That will be priority number one, but then there is nothing else standing next in line before paying down the debt.

Operator

I'm not showing any other questions at this time. I would now like to turn the call back over to Mr. Misakian for any further remarks.

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

Thanks very much. On behalf of everyone at Wesco, we would like to thank you for your participation on the call today. We appreciate your interest in Wesco as always and look forward to speaking with you all again soon. Have a good evening.

Operator

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