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WAIR - Q2 2018 Wesco Aircraft Holdings Inc Earnings Call

EVENT DATE/TIME: MAY 03, 2018 / 9:00PM GMT



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## PRESENTATION

### Operator

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

I would now like to turn the conference over to Jeffrey Misakian, Vice President Investor Relations. You may begin.

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

Thank you, Nicole. Good afternoon, everyone. Thank you for participating in Wesco Aircraft's Fiscal 2018 Second 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](http://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?



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

Thanks, Jeff. Please turn to Slide 3. Our fiscal 2018 second quarter results reflect continued improvement in our performance. We're beginning to see the results of our efforts over the past year. Improvement initiatives have driven better operating and financial performance for the second quarter in a row. And customers continue to recognize the value proposition that Wesco provides. While I'm pleased with the progress we've made to date, we still have gaps in our execution and results remain short of what we believe is our company's potential.

To address these gaps, we completed our business assessment in the second quarter, as mentioned previously. The assessment confirmed that real opportunities exist for significant improvement in profitability through footprint alignment, organizational changes and broader productivity gains. It also confirms that these changes will require investment in upgrading critical capabilities to serve our customers better. The assessment led to the development of Wesco 2020, which we announced earlier today. I'll talk about Wesco 2020 in greater detail in a moment.

First, I'll provide a quick update on the business. Please turn to Slide 4. Our improvement initiatives led to better performance for the second quarter in a row. We reported solid growth in sales, with increases in hardware and chemicals. Average daily sales were higher, reflecting improving trends. Both long-term contracts and ad hoc sales performed well in the second quarter. Contracts increased at a mid-single-digit pace, benefiting from new business revenue as well as higher volume on existing contracts. We continued to receive awards for new business and renewed 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 Pacific regions.

Ad hoc sales increased at double-digit pace in the second quarter, reflecting higher customer orders. Our customers continue to tell me that they're pleased with our progress, but we'll keep pushing for even more improvement.

Gross margin performance improved compared to the second quarter of last year and our previous quarter, primarily due to inventory provisions and adjustments, which Kerry will explain. Gross margin on major product lines was essentially stable in the quarter.

Inventory grew as the pace of receipts increased, partially to respond to higher demand activity in ad hoc and chemicals, as well as for improved safety stock level on certain hardware contracts to take care of our customers.

Inventory management remains an area where we have a lot more work to do. Active inventory management tools and processes are gaining traction to improve how we monitor and control inventory, as we continue to focus greater efforts on refining our sales, inventory and operations planning or SIOP process. We'll continue to push improvements through Wesco 2020 initiatives. In procurement, we continue to place more SKUs on long-term agreements, tracking to our target of 75% by the end of the fiscal year.

We're broadening this initiative through Wesco 2020, increasing hardware SKUs and expanding to chemicals and electronic products, which we expect to improve our margins.

Our customer service performance metrics remained stable in the second quarter. We maintained overall on-time delivery rates at high levels. But again, we can do better. We also continued to expand commodities at certain sites to serve our customers better.

Finally, while SG&A expenses remain at elevated levels, we maintained tight control over discretionary costs when compared to the previous quarter. Excluding consulting costs incurred to support Wesco 2020, SG&A was essentially stable.

We'll focus on optimizing our cost structure going forward through Wesco 2020. We've made good progress, improving our business in the first half of fiscal 2018, achieving better operating and financial performance.

I'm pleased with this improvement, it's better but still not our best.

We launched Wesco 2020 today, to broaden and institutionalize improvements already made and enhance our earnings potential.

Please turn to Slide 5. Wesco 2020 is focused on 3 principal goals; service excellence, inventory management and profitable growth.

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As we continue to improve in these areas, we believe, Wesco will deliver greater long-term value for our customers, suppliers and shareholders.

Wesco 2020 includes the following key initiatives: first, better align the company's footprint with our customer and supplier base to enhance service; improve operating efficiency and reduce costs. We plan to establish full service distribution centers with multiple commodities, placing more product closer to our customers to improve our ability to meet their requirements.

Our footprint initiative also includes enabling deployment of new technologies to drive efficiency and support future growth.

Second, refine our organizational structure to drive greater accountability, reduce management layers, eliminate duplication that still exists from Wesco's past acquisitions, drive process changes and reduce costs.

The new structure is expected to foster greater engagement, alignment and performance.

Our new organizational structure further empowers our business segments to quicken the pace of decision making at a level closer to our customers and day-to-day operations and establishes centers of excellence to guide strategy, enhance capabilities, leverage best practices and lead continuous improvement efforts across the entire company.

Third, invest strategically in people and capabilities, including automation and business tools to drive more effective inventory management and greater efficiency throughout the entire organization.

We plan to enhance our warehouse management systems, implement technology, such as data robotics to automate administrative tasks and improve our e-commerce and customer portals.

As I mentioned earlier, we also plan to continue improving our procurement processes and more effectively manage inventory to drive cash flow generation.

Please turn to Slide 6. Execution of Wesco 2020 is already underway. Our current implementation timeline spans the next 18 to 24 months, with major initiatives expected to be completed by the end of fiscal 2019. This is a multifaceted program in which some issues will be completed sooner than others.

We plan to control the pace of implementation to balance the sense of urgency needed to achieve improvement, with our focus on continuing to provide our customers with outstanding service. This balance could affect the time to complete some initiatives.

We'll keep you informed of our progress. I also want to stress that we expect improvements to continue beyond fiscal 2019. The changes we're making are expected to drive better performance on a sustainable basis.

We believe, Wesco 2020 will deliver significant operational and financial benefits. From an operational perspective, Wesco 2020 provides enhancements to customer service, supports our ability to provide high levels of on-time delivery, enables more effective inventory management and achieves productivity gains and stronger, more sustainable profitability. It pulls together operations that were not fully integrated in the past, taking advantage of our scale and value proposition, while investing in technology to support the future.

From a financial perspective, Wesco 2020 is expected to deliver annualized pretax benefits of at least \$30 million through cost savings and margin enhancements. Benefits realization is expected to begin in the first quarter of fiscal 2019 with the run rate improving steadily as the year progresses.

We expect to incur nonrecurring costs to implement Wesco 2020, approximately equal to the run rate benefit over the implementation period.

Wesco 2020 is a strategic repositioning initiative to support the company's continued growth and enable us to evolve with the needs of our customers. The financial benefits we expect to achieve will provide us with the flexibility we need to make strategic investments to continue supporting our customers and deliver long-term value to shareholders.

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Now I'll turn the call over to Kerry to review our second quarter financial results. And I will then wrap up our prepared notes -- remarks. Kerry?

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

Thanks, Todd. And good afternoon or good evening to everyone. If you would please now turn to Slide #7.

As Todd mentioned, we reported solid top line performance again in the second quarter, with net sales up \$26 million or 7% year-over-year. Growth was achieved in both long-term contracts and ad hoc sales in the quarter. Sales on our contract portfolio increased \$14 million or 5%, with essentially similar performance in hardware and chemical products. Both hardware and chemicals were driven by new business revenue and higher volume on existing contracts. Ad hoc sales increased \$12 million or 14%, primarily due to a broad-based increase in customer orders.

Please turn to Slide #8. Operating income increased \$1 million year-over-year and \$9 million sequentially due to higher gross profit, partially offset by an increase in SG&A expense.

Operating margin was 30 basis points lower year-over-year but 170 basis points higher compared to the previous quarter.

Gross profit was \$11 million higher year-over-year, reflecting sales volume growth and higher gross margin. The 110 basis point expansion in gross margin primarily reflects the impact from lower year-over-year provisions for excess and obsolete inventory and inventory adjustments.

Product margins, essentially were consistent with the prior year with higher ad hoc volumes and margins leading to a favorable mix impact in the second quarter, partially offset by lower chemical margins due to contract transitions and higher pass-through revenues as well as lower hardware contract margins.

Gross margin also improved 110 basis points sequentially, primarily due to lower inventory provisions and adjustments.

SG&A expense in the fiscal 2018 second quarter was \$10 million or 16% higher year-over-year, primarily reflecting staff additions in the second half of fiscal 2017, which led to an increase in people-related costs of \$4 million in the second quarter as well as consulting costs of \$4 million supporting Wesco 2020. Sequentially, SG&A was \$3 million higher, primarily due to higher consulting costs.

Interest expense in the second quarter increased \$3 million year-over-year, primarily reflecting higher LIBOR rates affecting our borrowings. Our effective tax rate of 29% in the fiscal 2018 second quarter is consistent with our expectation of 28% to 29% for the full year, which excludes the \$9.1 million impact of the transition tax we recognized in the first quarter, as associated with the change in U.S. tax law.

We reported diluted earnings per share of \$0.15 in the fiscal 2018 second quarter, which compares to 18 -- \$0.18 per share in the same period last year. Adjusted earnings per share was \$0.22 compared with \$0.21 in the same period last year.

Adjusted EBITDA increased \$6 million or 15% year-over-year, primarily due to higher gross profit, partially offset by the increase in SG&A expense.

Adjusted EBITDA margin increased 80 basis points compared to the second quarter of last year.

If you'd please now turn to Slide #9.

Key components of working capital all increased in the second quarter. First, higher accounts receivable resulted from the sales increase. Second, the change in accounts payable reflects higher purchasing activity and when compared sequentially, also reflects payment timing around the quarter-end cutoffs.

Third, inventory increased \$33 million in the second quarter. As Todd discussed earlier, our inventory positioning has grown in response to sales demand and customer service needs.

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Net debt increased \$9 million in the fiscal 2018 second quarter. We borrowed a net \$7 million against our revolving credit facility and made \$5 million in term loan repayments in the quarter.

The remaining chart -- change in net debt reflects a lower cash balance, as we continue to drive and improve process to more efficiently manage cash across the business.

Turning now to Slide #10. Cash used in operating activities was \$6 million in the second quarter, which was largely unchanged from the same quarter last year. Sequentially, the improvement reflects stronger earnings, coupled with less incremental net balance sheet investment.

The net change in free cash flow is similar to the comparison of operating cash flow, I just discussed. With that, I'll now turn the call back to Todd for closing remarks.

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

Thanks, Kerry. Our results represent our continued focus on execution across the business. I'm pleased with our performance in the first half of fiscal 2018. Through the execution of our improvement initiatives, we delivered good growth in sales and gross profit, while we maintained a tight focus on discretionary costs, apart from consulting expenses incurred to support Wesco 2020.

We have clearly seen early progress through our improvement initiatives, but we still have a lot more work to do. I remain cautiously optimistic about the second half of the year as we continue our execution of Wesco 2020 initiatives.

Wesco 2020 is expected to drive a step change in our performance. We're just getting started and we have a long road ahead of us. But we believe the opportunities for improvement are significant. Wesco 2020 allows us to invest in our future and better positions the company to meet the evolving needs of customers and deliver long-term value to shareholders.

I appreciate the hard work and dedication of our employees and the support of our customers, supplier partners and shareholders as we continue our improvement journey.

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

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

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

## QUESTIONS AND ANSWERS

### Operator

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

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

On the Wesco 2020 plan, you're sort of talking about the operational improvements, the financial benefits. Just -- can you help level set us, is there some sort of target profitability that we should have in mind once these fixes or these improvements are in place? Or some sort of multiyear cash target we should think about, just to level set what the financial benefit might look like to the bottom line over time?



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

Thanks Jon. We've made improvement in the business that we're happy with. And we've outlined the initiatives that we feel are going to drive even higher performance. I'll put it this way, we expect to achieve at least our previous outlook for full year '18. And we've shared those expectations. We also expect at least run rate benefits of \$30 million through Wesco 2020. And we expect the improvements to even continue beyond that. So while we're not in a position yet to share a specific target, hopefully that gives you a little bit of way to think about the potential opportunity of the company.

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

Yes. Got it. So the -- during the implementation period, it sounds like the benefits or the costs are mostly self-funded through the benefits? And coming out of the 18- to 24-month period is when we'll see some of that really drop through. Is that the right way to think about the cadence there?

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

I think, what we're saying is, the costs are going to about equal the run rate benefit through the implementation period of 12 to 18, 24 months. And then after that, we should see it ramp-up from there.

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

So Jon, it's Kerry. So certainly, there's going to be some of the costs that're going to lead the benefits. I don't think that's unusual in this kind of an effort. Todd certainly talked about investments that we'll be making along the way. There will be some costs incurred in other aspects of the project also to get everything set for our -- for how we'll be running the business, going forward. Partially, just on the benefit side, again, we do not expect a lot to hit in fiscal year 2018, as it's a complex set of things we're working on. And there's going to be some time to implement. So we'll expect the benefits to begin showing and ramp-up in 2019 to the run rate that Todd mentioned.

**Operator**

Our next question comes from the line of Ronald Epstein of Bank of America Merrill Lynch.

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

It's Kristine Liwag calling in for Ron. Todd, can you provide more details on what's going on regarding inventory management? Do you think -- do you need to take on more buffer stock? Or buying the right inventory? Or investment of better ERP system? Is it all of the above, something else? And then how should we think about working capital through this period through 2020?

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

Okay, I'll start with the inventory piece and then I will hand it to Kerry for the working capital. To repeat a little bit, the inventory increased partly in response to receipts that we brought in for higher ad hoc demand and chemical sales, both of which turn inventory relatively quickly. We did also build some safety stock for certain contracts to take care of our customers. And where I was going was, we clearly have more work to do here in terms of improving our ability to measure and monitor and control performance here. And we're investing in critical capabilities and adding resources around demand forecasting in our SLOP process, and we're moving quickly to push out and cancel purchase orders when the activity on the contract is less than the customer forecast. We're developing specific optimal buy tools and inventory build alert tools. We are looking at ERP, but we're very early in that process and more work to do there and more communication to come for you on where we are on that project. But it's very early.



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

Kristine, it's Kerry. Maybe just to supplement a bit of what Todd mentioned. If you look first half to second half, and I won't give you specific numbers, but our free cash flow and the changes therein have largely been a working capital story. As I mentioned, the strong earnings, obviously, have contributed to that in the first half of this year and in the second quarter. But on the working capital component, on the inventory side, Todd just mentioned a lot of the work that we're doing specifically to continue to manage that asset more effectively. But as you look at the span of 2018, right now, based on where we're at and for the reasons that we mentioned, sales growth that we've seen and how to get positioned for, we have had strength in the chemicals business, we have had some contracts ramping up. We expect the inventory situation and growth that we've seen in the first half to be similar in the back half of the year. We have, in our own view -- I think you know about this business and part of its distribution, we bought long on many of the products that we've been building, there's an economic reason to do that. We've had to be prepared. Our timing in all cases hasn't been perfect, to be quite honest. Maybe it's early on some of what we purchased but trying to give you an expectation. The other parts of working capital, and to give you kind of a broader sense of first half to second half, I would expect actually, again, our free cash flow performance to improve, looking into the second half of the year. Beyond the inventory situation, accounts receivable spiked very, very high at the end of the second quarter. And that was reflective of the sales increase. Part of it was really also reflective of the timing of the sales increase, much of which accelerated towards the end of the second quarter. So there was an inordinately high amount of sales that didn't convert the cash. I don't control exactly how that timing is going to happen for the rest of the year, but if that returns back to a more normal sales timing, I would expect, our receivables balance to fall in the second half of the year compared to where we ended up at the end of Q2. Payables, I would expect to be kind of neutral. So the big swing would be just a receivables movement.

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

Great. That's great color. And clarifying on Jon's question. You mentioned that costs will equal synergies. So first, does this cost include the consulting cost? And then second, presumably synergies should pick up over time, does this mean costs will increase too? And at what point will you have a net benefit?

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

So let's try to be crystal clear about this. When Todd talked about implementation cost to be roughly equal to the magnitude of run rate savings, keep in mind that's not run rate cost, costs will be one time, and we're just give -- using the run rate savings goal as being a weighted size those -- reasonably well those one time implementation costs. So, no, there will not be a continued repeating and recurring of the cost that we're talking about here.

Just, again, trying to give you a reasonable order magnitude of what they'll be.

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

You're saying that since synergies are \$30 million run rate annually, your expected cost to generate that in the next 18 to 24 months, if you'll spend about \$30 million in that period?

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

On a one-time basis.

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

On a one-time basis. And then there is consulting cost to end this year? Or does that go through until 2020?





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

Just also be clear, the consulting costs are not included in that comparison, but the consulting costs will begin to feather down as we move into the execution phase. So don't have an exact target for when we'll stop using assistance, but clearly, we are taking control of the execution phase and will be running the project out of our own capability, our own organization.

**Operator**

Our next question comes from the line of Jeff Bronchick of CSC Investment Management.

**Jeffrey Bronchick** - *Cove Street Capital, LLC - Principal & Portfolio Manager*

So I'm puzzled by why you would announce 2020 words and 2020 expenses, but not give like this is what we think the business should really look like over the long run. And \$30 million in savings, I don't know, 200 that's a 200 basis points of margin. I mean, what this business just came public at 24% EBITDA margins. I think it hit 5 or 6 at one point, now you are 300 above that. So -- I mean is it now the time to say, we're going to spend \$30 million and this is therefore, what it would look like over time? Why ...

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

We don't think so yet, Jeff. There's a lot of work to do. We're happy with the first half. It's only two quarters. And we want to continue to let the results speak for themselves. We're very comfortable that we're going to beat the forecast or the guidance that we gave at the beginning of the year. We're very comfortable with the \$30 million. But there's a ton of work to do and a lot of initiatives to get off the ground and to ramp-up. And we need to see those take hold before, I think, we're in a position to go where you're recommending, we're just a little early for that.

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

I think Jeff also ....

**Jeffrey Bronchick** - *Cove Street Capital, LLC - Principal & Portfolio Manager*

I think, you guys have to go to the board and say we're going to spend \$30 million to get \$30 million and this is we're going to look like in 2020, and they approved it. So there is an internal plan that you guys should be comped on that we're not shared on that, that's what I don't understand.

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

We definitely have an internal plan. And we definitely went to and had discussion with the board. And we have the \$30 million target right now that we're disclosing publicly. And we are comfortable that we can beat that, but we need to see it. We need to see it happen and we need to execute a lot of initiatives to make it happen. So it's more a matter of what we're willing to talk about and disclose right now until we see how these initiatives take hold.

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

Jeff, somehow to keep in mind, the \$30 million that we're talking about are predominantly going to be cost savings. And it's based on looking at the business fundamentally, where it stands today, where it stood, using 2017 as a baseline to measure that.



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There is some margin improvement in there, but predominantly, we're talking about cost savings. What we haven't done and what we're not prepared to provide you, is a look from the top line all the way down as far as where the longer range outlook is. And I'd like -- my view to answer the question that you're asking, we'd have to be providing a strategic outlook from the top line all the way through. We're hoping, because again, these items are cost-savings oriented that it gives you a fair frame of reference to look at the business today and kind of reshape its cost structure and its earnings performance to get an idea as to what the profile starts to look like.

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**Jeffrey Bronchick** - Cove Street Capital, LLC - Principal & Portfolio Manager

It's impossible from our standpoint from what you're saying. It's just what I'm saying, is -- there's been a 2000 basis point difference in margins. KLX just got taken out at 15 to 17x, albeit, by maybe someone else who would never do that again, but -- and has a stated margin and it would be nice to just have a long-term view of what this board and the management team are long term striving for, not cropping around with quarter-by-quarter, would be my sense. My second question would be, would you guys care to opine publicly on what Boeing KLX means to you and your customers? And what sort of your initial watercooler take?

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

Yes. Yes, certainly, willing to talk about that. That's a good question, I'm glad that you asked. We know that there is a lot of speculation about this and perhaps some overreaction. And not everyone has the facts. So let me review them with you. We don't think, that Boeing's acquisition of KLX will have a material impact on our business for several reasons. First, we've competed successfully against BASN and KLX for years. We've fought off BASN and we're now winning more than we're losing. Tier-1 suppliers serve multiple OEMs. And we've retained and expanded our work, which you've seen contribute to our growth over the past several quarters. We've got a distinct capability in chemical management services that KLX does not possess nor Aviall. We've got a great value proposition that we think only gets better as we complete the Wesco 2020 initiatives.

Second, even if you set all of that aside, our total hardware exposure to Boeing direct and our estimates of the product we provide to subcontractors who support Boeing platforms is only about 10% of our revenue. Our exposure to that 10% is predominantly in long-term JIT contracts, which are very painful for customers to change, difficult to unwind and frankly, extend out for several more years. A large portion of our hardware work for Boeing is already managed by KLX, as their 3PL, and it's awarded to us, because we're the most price competitive, the best value and have the availability.

On the ad hoc side, we already compete on availability of product and on -- and price. And we'll continue to be competitive on product availability and price. And we'll continue to win. And again, you've seen that get better in the past several quarters. The net result of that is our exposure isn't very high.

And then third, may be the final point is, many of these OEMs compete with Boeing and will not want to do business with them. And it shouldn't be lost on folks that there's opportunity here for us. While we can't speak for our customers, it's clear that many of these OEMs would not be thrilled about the prospect of Boeing managing their hardware. So this could end up being positive for us, as the OEMs seek an independent source for their needs.

So again, and where I started, we don't think the Boeing acquisition of KLX will have a material impact on our business.

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**Operator**

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

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

So couple of questions. First, I was wondering, in the past I've asked this question but I need to ask it again. KLX has talked about market share wins aggregating over \$400 million over the last 18 months. I can't imagine the market is big enough for you guys to not see that. So I was wondering, is there, have you seen any evidence that you've lost business or going to lose business from customers who may transition away, either in the JIT, the contracted or the ad hoc market, because certainly your numbers don't bear that market share risk out? It looks like you guys are actually doing just fine. But I'm just trying to square that commentary with what you guys know to be true.

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

Yes, exactly. I can't comment on what they declare, but we are not losing share to KLX. As a matter of fact, over the past quarter we're taking share. So we are continue to grow. We continue to sign-up new business. We continue to expand with our existing customers, products and services all around the world. We continue at extremely high retention rates to renew long-term contracts. We're not losing share to KLX and, if anything, in the last quarter, the opposite is true.

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

And could you provide more granularity on where, for example, you're getting the incremental ad hoc demand? Is it with OEMs of contract manufacturers? Or is it in the MRO and airline space? Where is it coming from? I know you mentioned, it's chemicals and hardware. But any more granularity would be helpful.

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

Yes, of course. No the increase in ad hoc sales for the quarter is really a reflection of customer demand and their orders picking up in their operations, and it's really over all sectors. Not as much on the MRO side but on the OEM and on the -- all around narrowbody, commercial platforms, business jets, military, we're seeing growth in all sectors. And it's being enhanced, frankly, by our improved execution, where we had to do a much better job it's helped us gain share.

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

And in your 2020 plan, how if at all, are you going to approach the aftermarket differently than you have heretofore?

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

The 20 -- Wesco 2020 is a little bit separate than our aftermarket strategy. Aftermarket strategy will continue. We've got specific dedicated resources focused on aftermarket. What will change a little bit is, we're creating some capability in global commercial sales. And we'll have a more global-based strategy on how to handle aftermarket in each of the specific regions, because it is different in the Americas versus Europe versus Asia Pacific. So it'd -- it will be more strategic approach to it from the top level, and then executed locally on the regional side with investment in continued capabilities and sales resources to drive the growth.

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

Last question, if you don't mind is, you mentioned the 10% exposure to the Boeing OE subcontract manufacturers and Boeing. If you were to broaden that to include Boeing Defense, if in fact, BASN over time expands, how would that number change? 10% growth to what 15%, 20%? Just curious, what the BDS and its subcontract manufacturing supply chain is as a percentage of your sales.



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

Yes. It would go up slightly, but not a lot at all, actually. Not a lot at all.

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

Okay, so less than 10%, because we know less than what the commercial exposure is?

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

Well in total -- like we said, in total, if you look at Boeing then that is all -- that's all of Boeing. And ...

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

Oh, that's BD, Boeing Defense, okay.

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

And the subcontractors who provide support to the Boeing platforms.

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

And that's commercial and defense, sorry to belabor the point?

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

Yes, yes.

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

Yes, yes.

**Operator**

Our next question comes from the line of Michael Ciarmoli with SunTrust.

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

Maybe Todd, just to stay on the topic of KLX and Boeing. I mean, is there any -- I know you kind of just articulated on the aftermarket 2020 strategy. But what's the sense -- KLX has a pretty big share of aftermarket revenues dealing direct with the airline. What's the sense that, that airlines might not want to deal directly with Boeing? I mean are there some opportunities on that side of the house? The same way you're seeing opportunities from OEMs? What's kind of the early read there?



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

Absolutely, absolutely. We believe that the airlines and the MRO shops like having the alternatives. And we expect that to help our growth. And we also believe that they want to control their own material base. We believe that this might put KLX in a position where they have to give Boeing priority to provide parts against an MRO. And we believe that deals like this, as you guys know, can be disruptive and create opportunities in the marketplace. So we're looking at this as upside.

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

In terms of disruptive, in the one sense you mentioned, your LTA contracts and JIT contracts put you in a defensible position. I'm sure for customers who -- OEMs who buy from KLX, they might not be able to move to you guys that easily. Does it create more of a near-term opportunity for ad hoc? Can they shift that ordering to you? While they still might be on long-term deals with Boeing, even if they are displeased and want to move. Do you expect an ad hoc pickup out of this?

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

They can absolutely shift to ad hoc. Ad hoc business by definition, you know, you buy from who's got the product and who's got the best price and best service availability, et cetera. So yes, that ad hoc market can fluctuate and we do expect some potential opportunity from that.

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

What about -- last one on this topic. Have you guys given any thought, or do you think pricing gets pressured in the marketplace? Does Boeing use some more leverage there, and maybe offer those consumable products at a discounted price that you might have to be forced to compete with? Does that enter into the equation at all?

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

We don't think so. My take on this is, Boeing, one, already has a lot of purchasing power, and adding KLX doesn't materially change that. And their -- with what we know about the company, again, can't speak for Boeing, but pursuing growth at the expense of margins doesn't seem to be consistent with their strategy.

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

Got it. Two separate ones may be, Kerry. On the footprint optimization, can you guys give us some color in terms of what percentage of your total footprint you know you might be looking to shrink? I know there were seemingly a lot of duplicative facilities, maybe with the chemicals being climate control. Just any color on a percent of reduction there?

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

Let me take that if I could. We can't give that color. And hopefully, you guys would recognize. We're in the service business. And we have to be sensitive to the impact that this could have on the customer. We know that our facilities are not optimal. We're going to invest and create these multi-commodity facilities across the world. We will have less facilities, but the detailed plan is still being developed, has some contingencies and we need to be careful in terms of what we communicate there.



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

Got it, okay, and last one, Kerry. Just to understand correctly, the further inventory investment. So we should be expecting about another \$35 million or so investment for the second half? Is that the right way to look at it?

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

While the first half, we were up, I think it was more like in the \$40s somewhere or close to \$50 million. I expect again that the second half will be similar to the first half.

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

Okay, so you ended '17 with roughly \$830 million you're at \$890 million now. So you are talking from end of 4Q, so another \$50 to \$60 million of investment then?

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

Yes.

**Operator**

Our next question comes from the line of Chris Olin of Longbow Research.

**Christopher David Olin** - Longbow Research LLC - Analyst

Just wanted to start off with the basic one, and just confirm that you said, you expect to come in ahead of those guidance parameters. You said, last quarter, I guess, specifically, that low single-digit growth outlook, is that what you are talking about?

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

We are happy with our first half. And it makes us comfortable that we can at least hit the original guidance that we gave you at the beginning of the year.

**Christopher David Olin** - Longbow Research LLC - Analyst

Okay, that's fair. Just switching gears. I've been hearing some positive things in terms of the business jet marketplace in order growth and better backlogs. Just wondering, how I should think about this in terms of impacting your business? And can you talk a little bit maybe about what you are seeing?

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

Yes. We're seeing those business jet customers pickup. We see there ordering pickup, we see there demand pickup, and we're seeing it in both on the ad hoc side and on the contract side.



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**Christopher David Olin** - Longbow Research LLC - Analyst

Is that a big portion of your business right now?

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

Yes, there are some pretty sizable customers there. So, yes.

**Christopher David Olin** - Longbow Research LLC - Analyst

Okay. And then just another question, I guess, kind of tying back to Boeing. What would happen if there was a merger between Boeing and Embraer? Does that change the exposure much? Is it something like that would happen?

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

Yes, I don't know, to speculate on that. I don't think it change -- it doesn't change what we're thinking about the acquisition of KLX, and honestly, I haven't personally thought, I don't know about any of my guys in the room about that potential merger. But I don't think that would be a dramatic change from what we're thinking now.

**Operator**

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

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

Just to follow up on the potential share gain on the back of the KLX Boeing transactions. Is there a -- can you talk to anything out there that you know in terms of re-competed contracts that are coming up over the next 2 to 3 years? Maybe an aggregate value of things that are in play that you might now have a better chance at taking away from KLX because of the combination?

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

Yes. Right, I would not certainly get into specific contracts or specific values, but I -- but over the next 2 years, we have contracts that are up for renewal that we either share or that are in play with KLX that we will have a better opportunity to take.

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

Okay, but no quantification, no sizing.

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

I mean I have it but, honestly, not that I'd be willing to share.

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

Okay, do you think that there's any chance that transaction won't go through? I just wonder in terms of the market concentration or whatever, will there be enough push back in the marketplace where that may not actually be healthy for the industry? Just want your statement on that.



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

I personally don't think so. Yes, my personal opinion is, I don't think so, but again, that's not what I do for a living every day, so I'm not sure.

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

No problem and last question. As we think about fiscal '19, you're building inventory this year. Are we going to actually have a net draw down, as we look into '19 and start to implement some of the inventory intelligence that you're developing now? Or should we just, at best, hope that inventory sort of grows in line with sales? How should we think about inventory as a source of cash after this year?

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

Yes, I think a couple of views on that. The tools that we're working on and the discipline we're working on, I think, should begin to benefit us in 2019. There's enough, I guess, lead-time on the order book, some of this what we're seeing this year, some of which stretch back in the prior year. But as we're positioning things this year, even with tighter controls, better tools, we don't see for all the variety of circumstances of the market and how we're running the business to see big impact this year. In 2019, I fully expect that we should be able to accrue some benefit and there should not be an expectation that every dollar of growth or growth in COGS is going to be invested in incrementally. I think, the other side that we didn't talk about is, we are initiating efforts and focus also to look at the parts of our inventory that are slow moving. And excess based on where we are today, the market is today, purchasing practices of the past and will be moving efforts forward to drive you monetize some of that part of the investment also.

**Operator**

Our next question comes from the line of Jon Raviv of Citi.

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

Just following up on that question about inventory. Kerry, you're talking. Can you say when we might see a positive free cash flow on an -- on a full year basis? Is that -- should it be fair to say that, that is '19 event?

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

Yes, I -- couple of things again. I'll reiterate that our back half should be definitely better than our first half. I tried to get in some of the dynamics, notwithstanding the inventory, activity being probably relatively flat from first half to second half. I think our working capital was inordinately high at the end of Q2. So just the run rate at where we're expect things to be going, H1 to H2 should be improved significantly. I'm not going to predict that we're going to be positive or negative, but we're going to be -- it's going to be getting much closer to neutral.

Into 2019, based on what we talked about with respect to inventory and what we'll be focusing on there, I would expect that we'll start to see the inflection point.

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

Okay, and then just some perspective, Todd, that was really helpful in terms of talking about the competitive dynamics with you and some of your customers that might be consolidating. Just when you've beaten BASN and that system. Can you just go on a little more, why that has been -- you talked about product and availability and what not, but just little more just on what you guys are offering versus what they're offering on a head-to-head basis? The question is essentially -- it is capability based and they just upped their capabilities, but I'll let you fill out there.





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

We -- what I would say the difference is, is we are a total hardware and chemical management supply chain solution provider. And that has benefits for customers that BASN doesn't necessarily have. We lower working capital. We improve operating performance. We aggregate the supply base. We drive cost SG&A out of the customer, it's not just the price of the product and storing it. So it's a more complete comprehensive supply chain solution versus what BASN currently offers right now. And we've got large customers that continually grow with us, who have the option to go to BASN and they don't, because of our value proposition. They grow with us and they renew with us, it's a different solution.

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

Understood, and then just lastly on the ad hoc. I know you just talked about a couple times. But to what extent do you sense there is a lot of, I guess, friction in the supply chain in terms of meeting some of the higher, especially, narrowbody production rates. To get a sense any of your ad hoc growth is coming from that?

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

I do, I do think, some of it's coming from that -- some of it from the pent-up demand, lead times are maybe 30 weeks out now. So I do think that that's driving some of it.

**Operator**

(Operator Instructions) I'm showing no questions at this time. I'd like to hand the call back over to management for any closing remarks.

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

Okay, thanks, Nicole. On behalf of everyone here 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 you all again soon. Have a good evening.

**Operator**

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

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