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PRESENTATION

Operator

Good day, ladies and gentlemen. And welcome to the Wesco Aircraft Holdings, Incorporated earnings conference call second quarter 2019. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Jeff Misakian, Vice President of Investor Relations. Sir, you may begin.

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

Thank you, Daniel. Good afternoon, everyone. Thank you for participating in Wesco Aircraft's Fiscal 2019 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 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'll turn the call over to Todd Renehan. Todd?

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

Thanks, Jeff.

Please turn to Slide 3. Financial results in the fiscal 2019 second quarter reflect continued improvement in most areas of the business. Sales were robust, quotes were strong and bookings were higher, as we took advantage of a growing market. In addition, our Wesco 2020 initiatives accelerated, and SIOP processes drove more efficient inventory management and increased cash flow.

At the same time, we have an opportunity to capitalize better on market momentum, with sales initiatives focused on further improving gross profit. We're also addressing the challenges faced in EMEA. The improvement seen in the Americas, which represents more than 80% of the company, continues to give us confidence.

Net sales growth of 9% in the second quarter reflected solid performance across all major product categories, particularly in chemical and ad-hoc revenue in our Americas business. The increase in sales resulted from continued market growth and additional penetration.

Reported net income declined in the second quarter primarily due to higher temporary costs associated with Wesco 2020 execution and challenges in our EMEA business. While market conditions where we participate in EMEA remain strong, we're implementing key initiatives to drive stronger performance in this business. Adjusted EBITDA increased year-over-year and represented our best quarter in two-and-a-half years, primarily due to continued improvement in the Americas. I'll discuss our segment results in a few minutes.

We continued to focus on strengthening inventory management to support sales growth with greater efficiency and reduced investment need. As a result, net cash provided by operating activities and free cash flow increased significantly in the second quarter.

Please turn to Slide 4. Looking first at the top line, ad-hoc sales increased at a double-digit pace as we captured more business, particularly with many of our largest customers. In addition, we recorded a double-digit increase in ad-hoc bookings in the second quarter, with the largest gains also coming from our top customers.

Sales under long-term agreements also increased at a solid pace in the second quarter, reflecting higher volumes on existing contracts and new business, especially from chemical products and services. We booked new and expanded business and renewed long-term contracts at a robust pace in the second quarter, supporting key aerospace and defense and other industrial customers with multiple sites around the world. This was one of the strongest quarters for new business that we've seen in more than two years, proof that customers continue to recognize Wesco's enduring value proposition. We also recently renewed a long-term agreement with one of the largest defense prime contractors in the world, extending products and services under the agreement for several more years.

Turning next to expenses, we continued to carry temporarily higher costs associated with the execution of Wesco 2020 initiatives and invested to support our growth in the second quarter. These higher expenses were partially offset by cost savings achieved thus far through Wesco 2020 initiatives. At the same time, we remain vigilant controlling discretionary spending in all areas.

Temporary costs associated with Wesco 2020 increased in the second quarter primarily related to our footprint optimization initiatives, which moved deeper into the execution phase. As expected, overlapping labor costs for such activities as inventory transfers and training increased as we ramped up our multi-commodity distribution centers, while still operating existing locations.

Conversely, consulting fees were lower in the second quarter, as we transitioned more work to our internal project management teams. At the same time, we're redeploying some of the same consulting resources used in the Americas to address our EMEA challenges as quickly as possible. We continue to expect temporary costs associated with Wesco 2020 execution to decline significantly by the end of fiscal 2019.

Apart from temporary costs, we're achieving better leverage of SG&A expenses in our core business, even as we invest in our growth. Excluding these costs, SG&A as a percent of sales would've been approximately 120 basis points lower year-over-year, primarily because of Wesco 2020 cost savings and our control of other discretionary spending.

On the balance sheet. Our ongoing focus on improving inventory management drove greater efficiency while still supporting our customers. Progress was made on all fronts in the quarter. Our SIOP processes continued to be refined and will be enhanced further by new systems. We've strengthened leadership and reorganized functions to speed internal adoption of new processes. And we continue to improve forecast accuracy through more robust metrics and greater use of business tools.

As a result, inventory turns increased, and inventory balances were reduced in the second quarter compared to the first quarter, leading to a significant increase in net cash provided by operating activities while continuing to support robust sales growth.

Please turn to Slide 5. Our Americas business, which represented 81% of total net sales in the second quarter, continued to deliver a strong performance. Sales in the Americas were 11% higher, with growth achieved in all major products, especially in chemical revenue and ad-hoc hardware sales. Income from operations in the Americas in the second quarter essentially was stable with the same period last year. And sales-volume driven gross profit improvement was offset by temporary Wesco 2020 costs.

Temporary costs were $5.4 million in the second quarter, compared with nothing in the Americas last year. The Americas business includes the largest and most complex elements of our footprint optimization initiative. The significant increase in these activities and related temporary costs weighed more heavily on operating income than in previous periods.

As you know, we add back temporary costs to net income and EBITDA to provide a more consistent representation of core operating performance. On this basis, adjusted EBITDA and adjusted EBITDA margin in the Americas gained momentum in the second quarter. In contrast, our EMEA business, which represented 16% of total net sales in the quarter, detracted from overall results. Sales were 3% lower than the prior year in EMEA, and operating income declined $5 million compared to the same period last year.

Our executive leadership team is focusing significant attention on improving EMEA's performance. And I personally have been spending more time there to dig deeper into the issues. To address these issues and drive better performance, we're implementing in EMEA the same initiatives that have worked successfully in the Americas. As I mentioned, we've also deployed the consultants used in the Americas to support our efforts in EMEA.

Please turn to Slide 6. Our Wesco 2020 execution pace moved much further into the more comprehensive actions associated with our distribution footprint in the second quarter. Some initiatives already have been completed, while others are moving forward more rapidly. Formal steps have been taken to close a few of the single commodity warehouses and open new multi-commodity distribution centers that we announced last quarter. Construction has been completed on our new distribution center in the U.S. Northeast region. Transfers from existing facilities are beginning and will continue to take place over the next few weeks.

The warehouse space in this new multi-product distribution center will be the largest in our network when fully operational, followed closely by our distribution center in Texas. The downsizing of our Valencia warehouse operations is about 50% complete. The transfer of inventory from here to our distribution center in Texas and other hubs has increased significantly. The first wave of staff reductions in Valencia took place last week, with the second wave expected over the summer.

In Europe, our new distribution center in Poland is operational. We're steadily increasing transactions through this hub as we rebalance operations between the U.K. and the continent. We've also broken ground on a new distribution center in the U.K. and expect to complete construction of this facility in September. In addition, we completed the consolidation of sales offices in the Americas and EMEA. This will help us grow our topline more efficiently in the future.

In other areas, our initiatives and focus on sales performance continued in the quarter, as we seek to increase win rates and gross profits. We're improving global processes, enhancing system reporting, increasing training and establishing more robust metrics to measure performance and quickly identify areas needing improvement. We're also expanding long-term agreements with suppliers to reduce costs of sales further, with greater penetration in hardware and new deals in chemical and electrical products.

Our new warehouse management system initiative is on track, with site implementations expected to begin late this year. We're also implementing a new demand planning system mentioned last quarter, which will support ongoing SIOP process improvements and initiatives to deliver even greater inventory management efficiency.

From a financial perspective, we realized more cost savings in the second quarter as a result of Wesco 2020 execution. Through the second quarter, these cost savings primarily have offset investments made to support our growing business. We expect benefits to increase as we move closer to our goal of achieving during fiscal 2020 at least $30 million of cost efficiency improvements since we began the process.

Now I'll turn the call over to Kerry to talk about our second quarter results. And then, I'll provide a few closing remarks. Kerry?

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

Thank you, Todd.

And if you would please turn to Slide number 7? Net sales of $426 million increased 9% in the second quarter of fiscal 2019 compared to the same period last year. Sales under long-term contracts increased 7%, with solid growth throughout the major areas of our business. Within contract sales, chemical products and services increased 9% in the quarter, with most of the growth coming from pass-through revenues.

We continue to benefit from our participation in the Joint Strike Fighter program as well as other strong customer relationships. Sales of contract hardware products increased 4%, primarily due to higher business jet and military demand.

Ad-hoc sales increased 14% in the quarter, reflecting our continued ability to service broad-based demand in a healthy market. Ad-hoc sales were particularly strong in our Americas business, increasing 17% in the second quarter as we continued to benefit from strong relationships with our top customers.

Net sales were 8% higher sequentially, with increases in all product types. The increase reflects more than the typical seasonal pattern in our business from the first quarter to the second, with strong growth particularly in ad-hoc sales.

If you go now to Slide number 8, please? Income from operations decreased $3 million in the second quarter compared to the same period last year. Increased gross profit was more than offset by higher SG&A expenses.

Looking at the various operating income drivers, gross profit increased $3 million year-over-year, primarily reflecting higher sales volume, partially offset by a 160-basis point decline in gross margin. The lower gross margin primarily was due to the decline in our EMEA region, driven by the same issues discussed last quarter. In addition, while we have strong growth in ad-hoc sales in the Americas, we still have the opportunity to improve our pricing discipline. Gross margin in the Americas also was impacted by dilution from higher chemical pass-through revenues.

SG&A was $6 million higher year-over-year, primarily due to the Wesco 2020 temporary costs and investments in growth that Todd mentioned earlier. Temporary costs totaled more than $9 million in the second quarter, of which $6 million related to the footprint transition that Todd also discussed earlier.

Consulting fees supporting major initiatives were $3 million in the quarter. Temporary costs in the second quarter of last year were primarily for consulting fees and totaled about $4 million. Our effective tax rate was 30% in the fiscal 2019 second quarter. We expect our fiscal 2019 effective tax rate to be in the high 20% range. And we continue to evaluate potential opportunities to reduce our effective tax rate further in fiscal 2019.

We reported diluted earnings per share of $0.12 in the fiscal 2019 second quarter, compared with $0.15 in last year's second quarter. Adjusted earnings per diluted share was $0.23 in the fiscal 2019 second quarter compared with $0.22 per share in the same period of last year.

Adjusted EBITDA was $46 million in the fiscal 2019 second quarter compared with $45 million in the same period last year. The increase was primarily due to the strong performance in our Americas business, partially offset by weaker results in EMEA. Adjusted EBITDA margin of 10.9% also was driven by improvement in the Americas region.

From a sequential perspective, income from operations in the second quarter increased $8 million compared to the first quarter due to a $10 million sequential increase in gross profit that was partially offset by higher SG&A costs. Higher sequential gross profit reflects the stronger sales volume that I mentioned, as well as a 60-basis point improvement in gross margin. Sequential increase in SG&A primarily was due to higher temporary costs resulting from the step up in Wesco 2020 execution that Todd described earlier. Adjusted EBITDA improved 24%, and adjusted EBITDA margin improved 140 basis points sequentially, primarily due to the factors I just discussed.

Moving on to the balance sheet and cash flow, if you would please turn to Slide number 9? Accounts receivable increased $20 million in the second quarter due to sales growth and collection timing. Inventory was $23 million lower sequentially in the second quarter. As Todd discussed, the decline reflects more effective inventory management.

Accounts payable decreased $4 million in the second quarter when compared to last year, primarily due to lower inventory receipts and payment timing around the quarter-end cutoff. Net debt, or total debt minus cash, declined $19 million in the second quarter, reflecting repayments on a revolving line of credit and term loans.

Turning now to Slide number 10. Net cash provided by operating activities totaled $26 million in the fiscal 2019 second quarter, an increase of $32 million compared with the same period last year. The increase clearly shows the result of improved inventory management, where the impact of our investment in this asset during the quarter was improved by $58 million when compared to the same period last year, while still supporting continued growth in our sales. The inventory-related improvement was partially offset by the timing of receivables and payables.

Free cash flow was $20 million in the fiscal 2019 second quarter, an increase of $28 million compared with negative free cash flow of $8 million in the same period last year. In addition to the comments I just made about operating cash flow, capital expenditures were $4 million higher in the second quarter than compared to last year, primarily due to increased Wesco 2020 investments. We continue to expect capital expenditures to be in the $20 million to $25 million range in fiscal 2019.

We still expect free cash flow in fiscal 2019 to be significantly higher than fiscal 2018, despite the increased rate of capital spending, with improvement driven by continued inventory reductions in the second half of the year.

Now I'll turn the call back to Todd for his closing remarks. Todd?

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

Thanks, Kerry.

Our second quarter results represent further progress, expanding our business and executing Wesco 2020. We grew the topline at a robust pace, with the strongest results seen in the Americas. We're winning new business and renewing contracts at a solid pace, reflecting Wesco's enduring robust value proposition. Our Americas business is gaining momentum, and we're confident in our ability to fix the issues in EMEA.

We quickened the pace of Wesco 2020 execution, which is driving greater benefits. We continue to expect benefits to increase in the second half of fiscal 2019 and into fiscal 2020 as our execution accelerates. We remain confident in our ability to generate at least $30 million in annualized pretax benefits through Wesco 2020, with full realization still expected during fiscal 2020.

Based on the strong sales momentum achieved in the first half of the year, we're now targeting mid- to high single-digit percentage growth in net sales in fiscal 2019. We expect that this growth will continue to be driven by new business and existing contracts as well as higher ad-hoc sales.

Increased sales volume, Wesco 2020 benefits and expense leverage still are anticipated to drive a high single-digit percentage increase in adjusted EBITDA in fiscal 2019. However, because of EMEA's performance, we're keeping our gross margin assumptions in the second half of fiscal 2019, consistent with the first half of the year.

As Kerry mentioned, we're confident that net cash provided by operating activities and free cash flow in fiscal 2019 will be significantly higher than fiscal 2018. We expect that our SIOP process improvements will continue and that the cash flow generated in the second quarter will accelerate in the second half of the year.

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

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

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Our first question comes from Myles Walton, with UBS.

Louis Harold Raffetto ***UBS Investment Bank, Research Division - Equity Research Analyst of Aerospace and Defense***

This is actually Lou Raffetto on for Myles. So just wanted -- the inventory drawdown, was there anything one-time in nature? You haven't seen that sort of number on a quarterly basis very often, especially not in the second quarter.

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

It's not one-time. It's not one-time. Our SIOP processes are improving and continue to mature. We are, like we talked about in the comments, strengthening the leadership. We refocused functions. We're improving our forecast accuracy, especially around receipts. We're using our tools better, we're improving inventory turns. And that's all led to lower inventory in Q2. And we are very confident that we can continue to build on the momentum and improve that even further, with a decline in inventory in the second half of the year, which will drive an increase in operating and free cash flow also in the second half of the year.

Louis Harold Raffetto ***UBS Investment Bank, Research Division - Equity Research Analyst of Aerospace and Defense***

And then, I guess with the EMEA weakness, are you guys actually spending more on Wesco 2020 than you originally, or is that sort of -- are those costs being absorbed elsewhere?

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

EMEA and costs in Wesco 2020 are kind of separate issues. What we're seeing in EMEA is really more about sales generation, supply chain management, completely internal issues that we're confident that we can fix, separate of Wesco 2020. The Wesco 2020 initiatives are actually more -- they're heavier and more complicated probably here in the U.S. than they are in EMEA right now. So we have work to do in EMEA, but it's outside of Wesco 2020.

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

We are shifting some consulting resources to assist us and continue to accelerate our efforts of improvement in EMEA. So I guess the impact, if anything, would be it's not creating an upward bubble in cost, but it's shifting some costs from North America to Europe.

Operator

And our next question comes from Michael Ciarmoli, with SunTrust.

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

Maybe, Todd or Kerry, SG&A -- I know you kind of gave that normalized number excluding the one-time costs. I mean, that puts the SG&A at a percent of sales of 17.3%, which would be a multiyear low. How should we think about that going forward? I mean, you guys have a target in mind? Should we think that that number can keep going lower as the model continues to get optimized? Maybe just some color there?

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

We think we can continue to improve it from there. Like we talked about, we made our first change in headcount last week here in Valencia. We have another one to do over the summer. We're going to continue with our process efficiencies. And the next phase is around our warehouse management system, which will continue to get us more productivity and overall more optimized processes, and more efficient. So we do recognize that it's the nicest level we've had over the past couple years. But we also recognize that we've been lower in the past and can continue to improve that.

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

And then, you referenced the Poland facility being operational. I think one of your large defense prime customers had some pretty significant rotorcraft operations there. Is that going to be a bigger opportunity to expand that business in rotorcraft through the distribution of consumables, either in the manufacturing or after-market process?

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

I think our footprint optimization is going to help us from an overall market penetration standpoint all around the world. We have now a state-of-the-art facility in Texas that's over 300,000 square feet. We just finished a state-of-the-art facility in the Northeast corner of the U.S. that's going to be over 350,000 square feet. We've got a brand new facility in Poland. I personally watched the heavy equipment dig up the new ground for the U.K. We're going to end up with multi-commodity state-of-the-art facilities strategically positioned around the world to help take care of our customers and drive more growth for the company.

Operator

(Operator Instructions) Our next question comes from Gautam Khanna, with Cowen and Company.

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

Had a couple questions. First, I was wondering, you talked a lot about ad hoc. Can you disaggregate that any way to determine what was maybe commercial aerospace aftermarket and how that business has trended versus ad hoc with your OEM subcontract manufacturer customers?

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

Well, you know the bulk of our business is more around the OEM base and not necessarily MRO. It's still a small percentage of our business. So it's hard to break that out. Most of the ad-hoc growth that we saw was with our biggest customers. And those biggest customers are not the MRO aftermarket customers. We are seeing some growth in ad hoc with those customers. But again, the majority of it is the business that we already have.

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

So is aftermarket still around single digits, 6%, 7% of the total?

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

Yes, 5% to 6%.

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

You also in your opening remarks talked about a contract renewal with a big defense prime. I was wondering if you could also just lay out for us any big re-competes, contract renewals coming up over the next year, like what it is in terms of percentage of sales, or any way to ballpark it?

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

Yes. I mean, obviously, for a lot of competitive reasons, we would never lay out too much detail on what's coming up for renewal. You do know, I think, from past conversations that our average terms are between three and five years. So 20% to 25% of the business comes up for renewal any particular year. We have had a big renewal year this year, and we've had a tremendously successful time at it so far through the first half of the year on our renewals. So future years are no spikes or no troughs, no different than any of the other years.

Operator

And our next question comes from Michael Ciarmoli, with SunTrust.

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

Maybe, Todd, just new business. You said it was a phenomenal quarter. Can you just elaborate in terms of what you think is driving that? Obviously, we've got a lot of commercial rate increases on the aircraft programs. DoD, it seems like a lot of money's flowing. I don't know if there's any that's attributed to KLX and just market disruption or more opportunities in the marketplace. But any color around what you think is driving a lot of that new business?

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

Yes. I think it's both internal and external. I think we definitely have some wind in our sails from what's going on in the marketplace, with lead times stretching out a little bit, commercial rates improving on some platforms. And we have some fantastic positions on big platforms out there that are growing. Defense spending and budgets are up. So we're definitely -- and I think, because we're doing a much better job from a performance standpoint, we're able to capitalize on those tailwinds more than maybe we have done in the past.

I also firmly believe that internally, we're doing a better job with an overall go-to-market strategy, both internal and external sales, to proactively attack the marketplace, capitalize on the disruption that's going on out there, especially with our largest competitor. So there's a lot of good things happening right now, some in the market and more for us.

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

And then, just last one. Kerry, I know you expect free cash flow to be significantly better this year. I mean, you did $12 million last year. Can you maybe frame significantly -- I mean, $15 million, $16 million would be a big improvement. But can you give any color? Or are you just not prepared to kind of frame that with an actual range?

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

Yes, we are going to choose to not give you a quantitative range on that one, Mike. But we do feel very, very good about the progress we're making.

A little bit of a wildcard for us is with the amount of sales growth we continue to see, just the timing at the end of the year, what of that sales growth is sitting in receivables versus the continued progress we expect to see on our inventory. And a pretty good wildcard around a year-end cutoff. So that's why we tend to at this stage avoid that for you. And the rate of growth that we continue to see in the business will be one of those variables.

But we are still very, very confident, especially because of the progress we're making in our SIOP processes, as Todd described, that we're going to continue to accelerate momentum that you've seen us achieve as far as just nominal free cash flow in the second quarter. And we're looking forward to a good second half overall.

Operator

Our next question is a follow-up from Gautam Khanna with Cowen and Company.

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

Yes, I wanted to follow up on your comment of disruption in the marketplace. Could you elaborate on what you meant by that? Specifically KLX and Boeing.

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

Specifically on who, sorry?

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

Well, I don't know if you were referring to KLX and Boeing, or was it something else?

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

Well, that's certainly part of the disruption in the marketplace, along with the lead times that we talked about. They've got a lot going on over there. And we are capitalizing on it as much as we possibly can.

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

And does that show up mostly in the ad-hoc market? Or is it in taking competitive contracts away?

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

Initially, it showed up in ad hoc and just some of that volume there. And eventually, hopefully it'll show up in some contractual business shifting.

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

And just to expand upon your comments on EMEA. So what specifically is going on there that is within your control? Is it just a lack of pricing discipline? Or what specifically is the problem? And what specifically is the solution you're implementing?

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

Sure. So overall specifically, it's gross margin and, more specifically, hardware margin. We have had some strategic contract renewals that we retained and took lower margin to do it. It was the right decision to do. Along with that, we've had some volume declines with other customers. And then, maybe the third thing is there's been a decline in chemical distribution volume.

The issues and actions that we're taking broader are around sales generation and supply chain management. By sales generation -- but first, I'd say internal issues. Nothing wrong with the marketplace; all positive things for us that -- we can fix this. Temporary, and will be fixed.

From a sales efficiency and productivity standpoint, which will be a quicker fix, we're talking actions around process improvements, metrics, accountability, sales management, increasing activity, increasing pipelines, driving win rates both inside sales and outside sales. And we're already seeing bookings, which is a leading indicator, improving around the sales efficiency.

On the supply chain management side -- also fixable, but maybe take a little bit longer -- is improving the backlog that we have, the amount of backlog that's tied up with suppliers; continuing to improve our COGS savings and negotiate better long-term agreements with specific suppliers. And that will just -- those are maybe a lead time away from seeing that in the P&L.

So that's what's happened there. And that's what we are doing to turn things back around.

Operator

Our next question comes from Myles Walton, with UBS.

Louis Harold Raffetto ***UBS Investment Bank, Research Division - Equity Research Analyst of Aerospace and Defense***

Just quickly, the return of the ad-hoc business has definitely been encouraging, and the growth LTA as well has been solid. I guess, any way you could, though, sort of isolate what the pass-through is on chemicals? How much is that contributing to the overall growth? I'm just trying to isolate the sort of the inventory to support growth. But if the growth is actually just the pass-through, or some portion of it is just pass-through, then it's not . . .

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

Yes.

Louis Harold Raffetto ***UBS Investment Bank, Research Division - Equity Research Analyst of Aerospace and Defense***

There's a little bit of a difference there?

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

Yes. No, I get it. So just to put some of that in perspective, Kerry talked about the growth rates in the other products. Chemical sales were up 9% year-over-year in Q2. The pass-through revenue represented the largest part of the total chemical sales increase. Service fees also went up. But the biggest piece was pass-through.

So from an inventory standpoint, you also have to keep in mind that chemical inventory turns much more quickly than hardware inventory. So when we see inventory growth in chemicals, typically sales will follow, and very quickly. So it's not as much of a drain on ROIC in the chemical inventory world.

Operator

Thank you. And I am not showing any further questions at this time. I'd now like to turn the call back over to Jeff Misakian for any further remarks.

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

Okay, Daniel, thanks very much.

On behalf of everyone here at Wesco Aircraft, we'd like to thank you for your participation today. Thanks again, and have a great day. Bye now.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect.