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WAIR - Q1 2017 Wesco Aircraft Holdings Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Wesco Aircraft Holdings first quarter fiscal year 2017 earnings call. My name is Adrienne and I will be your operator for today's call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session. Please note, this conference is being recorded. I will now turn the call over to Jeff Misakian. Jeff Misakian, you may begin.

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

Thank you, Adrienne. Good afternoon, everyone, thank you for participating in Wesco Aircraft's fiscal 2017 first-quarter earnings call and webcast. We've included slides with today's presentation to help illustrate some of the points being made and discussed during the call. These slides can be accessed by visiting our website at www.WescoAir.com and clicking on investor relations.

We are joined today by Dave Castagnola, President and Chief Executive Officer, and Rick Weller, Executive Vice President and Chief Financial Officer. Todd Renehan, Executive Vice President and Chief Commercial Officer, and Alex Murray, Executive Vice President and Chief Operations Officer, are also 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 would like to turn the call over to Dave Castagnola. Dave?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Thanks, Jeff. Good afternoon, everyone. Please turn to slide 3. As we've mentioned in the past, our focus in fiscal 2017 is about driving growth and improving margins. During the past five quarters, we have booked new business and renewed long-term agreements at an accelerated pace. This in turn is driving investment in people, systems and inventory to support our expansion. Major aerospace and defense companies are increasingly recognizing the value proposition Wesco provides, a value that we believe is unmatched in the industry. While the first quarter came in below our expectations, we are just beginning to see the benefits of these contract wins and investments in the first quarter and we expect this to increase over the rest of fiscal 2017.

Now that we've been operating together as a team for several quarters, and are able to track and measure our results on a consistent basis, we are more comfortable sharing some of the details of our recent sales success. New business awards under long-term strategic customer contracts in fiscal 2016 and in the first quarter of fiscal 2017 have an aggregate value of approximately $430 million. On an annualized basis, this represents approximately $130 million in net sales, about half of which we expect to contribute to fiscal year 2017 as implementations ramp. This continues to give us confidence in our outlook for sales growth this year.

These new business awards represent a broad spectrum of product and services that Wesco provides with significant wins across hardware, chemicals and electronics awarded by the top aerospace and defense companies in the world. The majority of these wins represent increased outsourcing from our existing base of customers as we expand Wesco's value proposition to cover additional customer sites and SKUs, along with some exciting wins at new customers. We also continue to renew business with large strategic account customers at a rate of approximately 98%. Major customer renewals in fiscal 2016 and the first quarter of fiscal 2017 totaled approximately $2 billion in aggregate value, or about $400 million on an annualized basis. We are very pleased with the progress our sales teams have made with these substantial new business wins and contract renewals.

As I mentioned a moment ago, we are already starting to see the benefits of these efforts through sales realization in the first three months of the new fiscal year. New win and renewal momentum is continuing into the second quarter. For example, we recently entered into a multiyear renewal with one of our larger strategic defense customers, supporting production on a fixed wing program that will drive growth in the coming years. And progress made to date further validates our growth strategy and the actions taken to align sales resources to market channels, and our teams are delivering results.

Please turn to slide 4. Fiscal 2017 first-quarter net sales included approximately $11 million realized from the new business wins. However, this was more than offset by external pressures that included foreign currency translation, temporary disruptions to certain customers' consumption from operational changes, extended site closures, and weather-related issues, and production schedule revisions by a major commercial OE customer, resulting in a decline in net sales compared to the same period a year ago. We expect the sales shortfall from temporary disruptions to reverse over the remainder of fiscal 2017.

Production schedule revisions made by the major OE customer to both its business and commercial aircraft platforms lowered both ad hoc and contract sales in the first quarter, and likely will affect the rest of the year. Wesco supports all of this customer's major platforms, and while some are ramping, we are not expecting to see meaningful growth on these key programs until fiscal 2018. These conditions impacted ad hoc sales in the first quarter, worsening the effect of the OEM inventory adjustments on the market, which we discussed last quarter. They also moderated the increase in long-term contracts from new business wins in the quarter. Rick will walk through the details in a moment.

Currency translation and lower sales volumes pressured margins and profitability in the quarter as our current SG&A expenses have been planned to support the new business ramp we are experiencing. We will continue to manage SG&A expenses, aligned with sales and in support of business growth. We also continue to make progress with strategic sourcing initiatives. We are working closely with our supplier partners, signing more to long-term agreements, which we believe will further support margin improvement. As sales increase in fiscal 2017, we expect the mix of business and operating leverage to improve profit performance.

As I mentioned, new business is being added by Wesco at an accelerated pace with complex implementations. We have reassessed our assumptions about inventory investment in fiscal 2017 to make sure we are able to deliver the level of service that our customers deserve. As a result, we are buying more inventory in support of our new programs at a faster pace than originally planned, including some recent wins with immediate material acquisition needs. While we might have forecasted the inventory investment timing better, we are taking the actions necessary for growth which will benefit the Company in the long-term.

Now, Rick will walk you through the details of our third-quarter results. Rick?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

Thanks, Dave. Please turn to slide 5. Net sales in the fiscal 2017 first quarter were $339.4 million, decreased 6% compared to the same period last year. Foreign currency translation had a negative effect of approximately 4% on fiscal 2017 first-quarter sales primarily from the British pound. As we mentioned in the past, we are taking steps to address the effect of the pound's decline, which I'll talk about -- more about in a few minutes. Constant currency sales were down nearly 2% compared to the same period last year, primarily due to a decrease of approximately 4% related to the temporary consumption disruption and weather-related impacts and a 1% decline from the commercial OE customer production schedule changes, partially offset by a 3% increase from new business.

The temporary consumption disruption and commercial OE production changes affected both ad hoc and contract sales, given that most of these customers purchase both product types from us. Ad hoc was impacted to a greater extent, adding to an ongoing OEM inventory effects. Long-term contracts increased in the fiscal 2017 first-quarter primarily through the new business wins, though the temporary disruption and OE production change impacts partially offset this growth.

Please turn to slide 6. Income from operations was $26.3 million in fiscal 2017 first quarter compared to $37.1 million in last year's first quarter. Operating margin of 7.7% declined 260 basis points from the first quarter of last year. Margin was primarily impacted by a 210 basis point increase in SG&A expense as a percent of sales, resulting from lower sales volume and the planned investment in SG&A to support growth, and to lesser extent by lower gross margin. SG&A expenses were $4 million higher in the first fiscal 2017 first quarter compared to the same period last year primarily reflecting planned, higher people-related and systems costs, which included investments to support new business of approximately $2 million.

Gross margin was down 50 basis points in the first quarter compared to the same period last year, primarily due to changes in mix. Net income was $0.13 per diluted share in the fiscal 2017 first quarter compared to $0.21 per diluted share in the same period last year. Adjusted net income of $0.19 per diluted share in the fiscal 2017 first quarter decreased $0.06 from $0.25 per diluted share in the same period last year. Our effective tax rate in the fiscal 2017 first quarter was reduced by discrete tax items. We continue to expect our effective tax rate for fiscal 2017 to be in the range of 28% to 30%. Adjusted EBITDA was $34.3 million or 10.1% of net sales in the fiscal 2017 first quarter. This compares with $45.6 million or 12.7% in the same quarter last year.

Please turn to slide 7. Sales in North America were down 6% in the first quarter compared to the same period last year, primarily due to a decline in ad hoc sales. Contract sales were also lower in the quarter. North America was affected by temporary consumption disruption issues and commercial OE schedule changes that we described earlier. The decline in contracts was partially offset by sales from new business wins. Operating margin in North America was 6.4% of net sales in the first quarter compared with 10.1% in the same period last year. North America's decline was primarily due to sales volumes and mix and a planned increase in SG&A expenses for new business and IT investments. Gross margin was down 90 basis points in North America while SG&A as a percent of sales was up 280 basis points.

Turn to slide 8. Sales in the rest of the world segment declined 5% in the first quarter, but were up approximately 13% on a constant currency basis, with higher ad hoc and contract sales. Operating margin in the rest of the world was 13% of net sales compared with 11% in the same period last year, primarily reflecting the increase in the sales volume and mix. We continue to make progress towards the establishment of a new UK legal entity combining legacy hardware and chemical entities. This will allow for operational efficiency, leverage, and improved customer service across multiple commodities. The appropriate functional currency for the new entity remains under review when it will be determined prior to its establishment. We still expect this to occur in the middle of fiscal 2017.

Please turn to slide 9. Net inventory increased $38 million in the first quarter of fiscal 2017. As mentioned earlier, this is primarily to support the substantial increase in new business. We expect to make similar investments in the second quarter with the pace slowing in the second half of the year. Total debt was $843 million at December 31. We drew down $25 million from our revolving credit facility in October to fund our inventory investment and costs of the term loan A refinancing. We repaid $11 million in debt in the first quarter, including $5 million toward the revolver.

Please turn to slide 10. Net cash used in operating activities was $28 million in the fiscal 2017 first quarter compared with net cash provided by operating activities of $11 million in the same period last year. Free cash flow usage was $29 million versus a source of $10 million in the first quarter of last year. Changes in operating and free cash flow primarily reflect the timing of inventory receipts.

Please turn to slide 11. We continue to expect constant currency sales growth to be in the range of 3% to 5% in fiscal 2017, driven by an increase in long-term contracts through new business expansion, partially offset by a decline in ad hoc sales. We expect sales to increase sequentially in each quarter of the fiscal year, subject to the timing of new business implementation. Our experience with implementations to date has led us to plan for a heavier phasing of quarterly sales to shift to the fourth quarter.

Higher sales and improved operating leverage, coupled with strategic sourcing benefits, are expected to support margin improvement later in the year and we'll continue to manage SG&A expenses in line with sales growth. As a result, we continue to anticipate adjusted diluted earnings per share to be in the range of $1.15 to $1.20 in fiscal 2017. The increased acquisition of inventory and supporting new business growth has reduced our outlook for free cash flow for the year, with a further impact in the second quarter before moderating later in the year.

In addition, the shift to greater sales in the fourth quarter means that some of these sales won't be collected until fiscal 2018, which impacts total receivable collections timing for the year. As a result, we are now targeting a free cash flow conversion ratio of approximately 50% in fiscal 2017 to reflect these changes. This target is driven by implementation timing, which is subject to change as we continue through the process. We will continue to manage our investments appropriately to support new business growth and may update you on our progress.

Now I will turn the call back to Dave for closing remarks. Dave?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Thanks, Rick. Please turn to slide 12. Our focus in fiscal 2017 is clearly about driving growth and improving margins. Our first-quarter results included a number of items highlighted today that we do not believe are representative of our underlying business performance. We are taking actions to address the translational effect of the British pound and the temporary disruption to the customer consumption issues are recovering. Sales related to the commercial OE customer production schedule changes are expected to be lower this year, but we believe this impact will be more than offset by an increasing contribution from new business wins.

As we mentioned, we are booking new business and renewing long-term agreements at an accelerated pace. We've been talking about our growth strategy for several quarters, and while the first quarter was weaker than expected, we believe we will see the benefits in our results as the year progresses. The new business wins and renewals validate the actions taken in fiscal 2016 to align our sales force to distinct market channels, and they are driving results through increased sales and continued momentum in long-term contracts. We expect the pace of sales realization to quicken as we further implement the new wins, which should lead to stronger overall results.

We've also discussed the complexity associated with implementing this level of new business and we've aligned our fiscal 2017 forecasting to reflect our recent experience. Given their complexity, the timing of implementations and associated sales opportunity remains a challenge to forecast, but we will continue to update you on our progress. The robust rate of new business wins is also driving higher investment in inventory to support our growth. While this is impacting free cash flow to a greater extent than we initially planned, we believe the investment will benefit the Company and our shareholders in fiscal 2017 over the long-term.

I'll now turn call over to Jeff to direct the Q&A period. Jeff?

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

Thank you, Dave. With that, we will open up the call to your questions. We ask that you limit your questions to one initially to allow everyone a chance to participate. We appreciate your assistance with this process. Adrienne, may we have the first question, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jason Gursky, Citigroup.

Jon Raviv - *Citigroup - Analyst*

Good afternoon, it's John Jon Raviv on for Jason here. Can you guys address on the faster purchasing, how much of the faster purchasing could you classify as strategic or opportunistic? And how much link to actual -- how much is linked to actual contracted sales with real visibility? And related to that, when and in what way does this faster purchasing manifest? Should we expect a higher growth in the out years, just where do we get the benefit from this? Thank you.

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

First I would say that everything we are strategically sourcing is contracted with our customers, and it's our largest volumes and -- of things that we procure and that we buy. It really is the scale and the ability to be able to provide to the suppliers planning windows to optimize their setups from running that product to provide the benefit to the supplier and to Wesco. We are probably about -- approaching about 40% to 50% along the way of the journey of rolling that out and we expect it somewhere in the 60% to 70% when it is fully implemented.

Operator

Carter Copeland, Barclays.

Carter Copeland - *Barclays Capital - Analyst*

Just a quick clarification, and then a bigger picture question on cash. As the sales on some of this stuff slipped, are there any unrecoverable investments in inventory? That's the first one. And just high-level fundamentally, you've maintained the sales growth guidance, but clearly the composition of those revenues appears a little bit different, and that's having some implications for the cash flow. When you take a step back and say -- when you look at the typical cash conversion of existing business versus the new stuff that you're out there winning and trying to win and ramp up, how should we think about the differences in those profiles? Because it seems from the change in composition here that that's pretty stark. Thanks.

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Well, I think on the last question first, in that the new business wins are really driving a higher front-end investment, as we need to be positioned with our customers to begin the pull. In other words we have to have the bins in a basically full production rate. And that's putting a lot of pressure on the timing and scale of our initial buys. And that's just being fueled by the success we are having on winning new business. We expect that to -- as the revenue comes in, that will even out over time, and that inventory that we are buying will end up going into a period of supply SIOP process moving forward.

Carter Copeland - *Barclays Capital - Analyst*

Dave, is there a regular payback period that we should think about that? You've got the initial stocking and then you earn returns on that initial inventory. Do you have a target for how we should think about those contracts in terms of -- from a cash standpoint, when that payback is?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

I would think about it as being a full bin turn of the inventory. And that really kind of varies based on the number of bins and how fast those bins are turning at a customer facility, but that could take anywhere from 9 to 12 months of duration until we get a full turn. But to build on Dave's point, getting enough volumes to enter strategic sourcing and into the SIOP process allows us to be able to optimize those turns once we've got all the bins and all the volumes included in our total inventory and production planning process.

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Yes, so just to build on that a little bit, Carter, again, we've got one customer we mentioned which was a Q1 win with immediate buy, and we are already turning inventory. We've got others where we've got full bin, and then they've had some delays due to some of their internal issues and we are sitting and waiting to go. So we have this (technical difficulty). There's a lot of variability in the front-end of this, but I think to Rick's point, and I agree with that, that as the year progresses you'll start to see the revenue pick up. And the cash conversion piece of it will improve accordingly, again, as the revenue picks up. But the front end of it has a lot of variability in it, and we can talk a little bit later about we are doing 100 implementations. So there's a lot of variability in what we are doing right now, given the scope.

Carter Copeland - *Barclays Capital - Analyst*

Awesome. Thank you gentlemen.

Operator

Michael Ciarmoli, SunTrust.

Michael Ciarmoli - *SunTrust Robinson Humphrey - Analyst*

Maybe just to follow up and stay with the inventory here on Carter's topic, and maybe just a point of clarity. Was this win -- did this come after you guys reported the fourth quarter results? Just wondering when this win took place and -- in terms of the free cash flow downward revision. So is this something that occurred in the late November-December time frame?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

We have a combination of things. So what I was referring to happened after Q4. It was a Q1 win and it was immediate. The balance of a lot of the other investments were really timing. How well we planned that, we probably could have done a little bit of a better job, but the demands of the new business has really put a lot of timing pressure on when we buy, and a little bit more aggressively than we had planned. Again, for us, the Company has never dealt with this level of scope and success and variability relative to that. So that's why, given the experience of Q1, we're able to guide Q2 with a little bit more expertise given that we've got some learning in Q1 on the scale and scope. And we have a better idea in terms of the profiling of that investment as the fiscal year progresses.

Michael Ciarmoli - *SunTrust Robinson Humphrey - Analyst*

Got it, that's helpful. And then just on -- I just want to make sure I'm thinking about this. The OE productions changes, presumably rate reductions there, would that create an inventory drawdown for you guys? That you are not going to have to build up the volumes? And does that provide you with any sort of tailwind to cash flow?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Well, on this particular OE production schedule referring to, it was an OE customer who made production changes across the board. So in essence there was a rescheduled production rate changes on various business and regional jet platforms where we are at. We're at full bin positions. Actually, it takes a little bit more time to realize the impact of that. Q1 was actually a minor impact to that. We expect to see that as we go forward, so there will be a little bit of carrying on that inventory going forward.

On the flipside, two other production platforms of that OE customer is ramping up. So there will be a change over and utilization of that inventory as the year progresses. So balance year-over-year, we end up coming out the same as we migrate from a number of platforms to the other platforms in terms of rate, but it will be a year of the evolution of that inventory probably between the two to balance that out.

Michael Ciarmoli - *SunTrust Robinson Humphrey - Analyst*

Got it, that's helpful. Thanks a lot, guys. I'll jump back in the queue.

Operator

Ronald Epstein, Bank of America.

Mariana Perez Mora - *BofA Merrill Lynch - Analyst*

Good afternoon. It is Mariana Perez Mora for Ron today. Our question is related to $100 million sales win that you highlighted. Can you please discuss your expected margin profile for these contracts and how they compare with your existing business?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

Sure. The larger profile for the business that we are winning and securing, we're been experiencing that for the last for the last four quarters or so, of sequentially higher margins from the business we are winning. So we would expect that to continue and would expect, through the process of bidding and securing business, that we are going to be looking for business that's margin accretive going forward. The other thing I would also say is that as we build that, a lot of the cost that supports the businesses are relatively fixed, and so we also get leverage on that cost base that comes along with that. There's an increment to the actual reported margin on the contract.

Mariana Perez Mora - *BofA Merrill Lynch - Analyst*

Thank you. And does this $100 million contract win fully offset the revenue loss from the OEM production change?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

So on a broader term, full-year, the new wins in terms of that momentum in the business will overcome in the year the re-forecasting of the lower revenue associated with the OE schedule change.

Mariana Perez Mora - *BofA Merrill Lynch - Analyst*

Okay, thank you very much.

Operator

Gautam Khanna, Cowen & Co.

Bill Ledley - *Cowen and Company - Analyst*

This is Bill Ledley on for Gautam tonight. I had a couple of quick questions. One, on these new business wins, are these takeaway wins or are you -- are these new wins taking over inventory from the OE customer? And did you have to purchase inventory, if they are takeaway win?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

We have a combination, Bill. In one win, the one in Q1, that was actually gaining market share. We displaced a competitor. The majority of our wins have really been coming from our existing customers that continue to outsource and go to our model, which has really been the momentum of this business for the last few years that we've really aligned to, to attack from a sales and support of our customers perspective. In some cases, we are adding sites and growth to them. In other cases we are working through inventory transitions; it really depends on the customer. We take that into account in our business analysis and in our contract dealings with them as we go. In essence, a combination, a multiple combination of all those things.

Bill Ledley - *Cowen and Company - Analyst*

Thanks. And then on the 777 rate cut, when do you suppose you'll start seeing weakness from that, if you are not already seeing it, and how long do you think that will take to work through the channel?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Yes, typically on a 777 rate cut, any of our Tier 1 customers who have a position of 777, if they begin to feel that production rate reduction, we'll feel that production rate reduction where we have JIT consumption supporting them. In most of our customers, though, we supply to everything they do. So it's a bit of a balancing act. So if they've got something ramping up, that could offset 777. Typically we will feel it as soon as they feel it and we will feel it in a much smaller level than they will feel it, based on what we provide. But because our consumption is so aligned with our customers, we will feel that right away. So if it has happened, we've felt it.

Bill Ledley - *Cowen and Company - Analyst*

Thanks. And then just one last one. Have you seen any payment terms stretching from your OE customers that might be impacting cash flow? I think you mentioned earlier on the call that some of the sales in Q4 won't convert. Is that typical or is that from stretching out payment terms?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

No, those are not payment term related. They are just timing related in terms of when we book the sale, and it comes in to the collection window. So we started the quarter with low sales, they build back through the quarter. And so those early misses, because of the consumption disruption we talked about, were not collectible in the quarter. And we've collected those subsequently here in Q2. Terms have stayed pretty consistent for us. Some customers at contract renewals work on extended terms, but we've done a pretty good job of staying close to the customers and really collecting inside the time and windows that we are allowed to, and that's given us an offset to extend the terms and hold our DSO pretty constant.

Bill Ledley - *Cowen and Company - Analyst*

Thanks, guys, and good luck.

Operator

Myles Walton, Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Just had one clarification and one question. So the clarification one, so the first quarter, it sounded like it came in below your expectations. And it sounded like ad hoc for the full year, you now expect to decline. And so I am missing the plug on maintaining the full-year EPS in particular and the confidence interval you have on the implied margin expansion that's pretty significant.

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

So I think on the OE side, the OE schedule change from that particular customer, they were a large ad hoc customer as well. So that is one of the key reasons. And there's also some indirect sales to the customer from other customers that we provide to. When you take those into account, those ad hoc sales we forecasted out of the year. We've also looked at our Q1 bookings, which were lower. A lot of it had to do with this particular OE customer as well. And we've also taken that forecast in. So that's what we've done on the ad hoc sales for the year.

That is being overcome by the robust nature of the new business implementations. Those margins, along with our strategic sourcing activities, where we are driving a reduction in transaction costs, both at Wesco and at our suppliers, and also leveraging those buys over LTAs and over longer terms, is also providing value. When you bring those together we'll be able to drive the margins that will enable us to achieve our guidance.

Myles Walton - *Deutsche Bank - Analyst*

Okay. And so you think adjusted EBITDA margins are going to expand year-on-year in 2017?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

Yes, we will see an expansion of EBITDA margins year-over-year and sequentially going forward. Primarily because of the sales growth that we're going to see from new business. Because our SG&A sequentially is going to be at or below levels we experienced in the first quarter. So we talked about the big impact of SG&A deleverage in Q1; that will turn back the other way when we start getting some sales momentum growth from new business.

Myles Walton - *Deutsche Bank - Analyst*

And the only other one on debt covenants. I think 4.25 is for the second quarter where your amended covenant is. Is that still -- do you think you'll be in compliance with that? Or is that something you will go back to the banks on?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

The second quarter debt covenant is going to be tight. We've got a good line of sight to cash for the second quarter. We are continuing to monitor that, and really assess what our options are and what we -- best approach to address that in the event that we would need to do that. So we've been in contact with the bank and we are in active discussions about that as a contingency.

Myles Walton - *Deutsche Bank - Analyst*

Okay. All right, thanks.

Operator

Greg Konrad, Jefferies.

Greg Konrad - *Jefferies LLC - Analyst*

I just wanted to follow up around your commentary on outsourcing. You've obviously had good bookings recently. I was wondering how far along you think we are in this process, and maybe what the current bid pipeline looks like.

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

On outsourcing, let me give you some broader perspective. The industry that we serve has been going through a major consolidation really over the last decade. So where you had multiple aerospace companies, they've been all going through an M&A, and you really have larger companies who have been moving towards outsourcing to providers like us for these particular commodities. That has been working and that has continued. That market continues to be a significant market for us. I know that because I came out of that space and that's exactly what we were doing. We were looking for providers to Wesco to get economies of scale, reduce SG&A and improve working capital for inventory. So we've been very successful there because we fit that need very, very well. We see that demand sustaining itself for quite a period of time, and we've tapped into that very, very successfully because our value proposition really delivers that.

Greg Konrad - *Jefferies LLC - Analyst*

And then just a clarification question. You talked about working capital or inventories building in Q2 and then moderating. I know some of those new business wins don't come on until 2018; should we expect inventories to build through 2018?

Rick Weller - *Wesco Aircraft Holdings Inc. - EVP and CFO*

I would kind of say two things about that. First that we are going to continue to build inventory and stock to support new business. But I think if you look at strategic sourcing and the ability to be able to do better demand profiling with suppliers, aggregate our buys, do a better job of releasing quantities to suppliers closer into the pull requirement with a customer. That will help fund the forward inventory investment back into this year and into 2018.

Greg Konrad - *Jefferies LLC - Analyst*

Thank you.

Operator

Jason Gursky, Citigroup.

Jon Raviv - *Citigroup - Analyst*

It's Jon Raviv again. Thanks for the follow-up. Dave, can you just talk about what you guys have changed and what still has to change on the forecasting process there? And perhaps how to avoid some of these below expectation results going forward.

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Yes, I think the fundamental change that we've made coming out of Q1 is Wesco historically really planned to calendar days; Wesco calendar. And this business is a consumption-based business to our customers, like major distribution services providers in the world. So the big change that we've done now, given Q1, is we've realigned our forecast around customer consumption calendars. Alex has gone out with his team, surveyed all our major customers, looked every month in advance over the next eight months now or nine months as we did the re-forecasting, and try to understand what days they are and are not working, what shutdowns do they have planned, what holidays do they have planned, those types of things. And now we've realigned our forecast around their consumption.

That will give us a higher degree of accuracy. It's still a very difficult business to predict. I think that's on the production side. I think we can also be a little bit better and be closer to our customers on things like, if they are doing a planned shutdown, can we be forecasting that a little bit better? Holiday shutdowns. I think we had some seasonality in terms of the way the holidays fell this year that, using experience from last year, we actually experienced more disruption in Q1 than we've experienced before. These are things we are learning that we will utilize in our production moving forward.

On the new business side, we are learning very, very quickly based on the demands and speed of the material acquisition. That's playing into our Q2 and the balance of the year planning on material acquisition and cash flow, again, because that piece of the business was new to us in terms of scale and scope. I think those are the two biggest fundamental changes that we've made going forward in terms of continuing to drive to improve the forecasting accuracy of this type of business.

Jon Raviv - *Citigroup - Analyst*

And just given your background, do you get the sense that your customers are -- how is the behavior now different than, let's say, how you might have behaved in your previous roles?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Behavior in terms of what sense?

Jon Raviv - *Citigroup - Analyst*

Just if you guys did not anticipate the scale and the scope, are customers just buying more faster than what you guys -- what you personally might have done in your previous role? And what do you think is driving that kind of change?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

I think on the new business side, really -- I think it was really -- we should have been a little bit more thoughtful about the size and the speed of having that material there for the customers than we did in our plan. Simple as that. I don't see really any change of any customer behavior in that.

For the ones that we had bought lower volumes in terms of our plan. For the customers that we won in Q1 with immediate plans, that just happened to be the nature of that particular deal. And we would've planned for that because we won it in Q1. So a bit of a balancing act; a little bit tighter knowledge about how to do the scalability of these going forward. I think is the real answer to that, and is really a Wesco forecasting, I think, more than a customer behavior change.

Jon Raviv - *Citigroup - Analyst*

Understood. Thanks so much.

Operator

(Operator Instructions). Michael Ciarmoli, SunTrust.

Michael Ciarmoli - *SunTrust Robinson Humphrey - Analyst*

Thanks for taking the follow-up, guys. Dave, could you just comment on some of the trends you are seeing maybe within the different end markets? Specifically I know your aftermarket is still more in the upstart phase, but the aftermarket and the defense end markets?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

I think you are right on where we are on the MRO side of our business. We are at the very, very beginning. So really we don't really feel the market, given our position. And we are really in a startup phase, growing opportunities, growing pipeline and putting the processes in place within Wesco in order to streamline the investments to serve that market. So the market doesn't come too much into play there.

The large strategic customers that we're being very successful with, regardless of the market, which is really in the low single digit growth rate, is where our customers stand. We are driving significant growth there because of their -- outsourcing patterns. So we are growing faster obviously than the market because of the nature of what we are serving into and the fact that they are outsourcing.

In terms of our military customers, we see commercial growing faster than military. We have very, very strong positions with the top defense contractors in the world. And we are on a number of high-performing rate-ramping platforms that those customers have. So it will be customer by customer. I think we are in a good position there in that regardless of how the military macro market moves, we will move with those top-notch customers who have marquee positions in defense.

Michael Ciarmoli - *SunTrust Robinson Humphrey - Analyst*

Got it, that's helpful. Thanks, guys.

Operator

Gautam Khanna, Cowen & Co.

Bill Ledley - *Cowen and Company - Analyst*

Thanks for taking the follow-up. Just had a question going back to I think Myles's question on the ad hoc sales. Is that largely due to business jet rate reductions? And can you talk about potentially how long that takes to work through?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

So a couple things on ad hoc sales. We talked in Q4 really about what happened in fiscal 2016 in terms of OEM inventory balancing. There was some destocking going on in the industry. I think the latter is starting to abate a little bit. Specific to the business jets, what we are experiencing really is more related to the OE customer rescheduling and production change mix. A combination of those platforms have reduced their near-term productions rates, while other platforms within that customer are ramping up. We feel the ad hoc associated with that lower production. A large portion of our ad hoc sales, I believe around 60% of our ad hoc sales, actually come from large customers that we have a position with. So when they reduce their production rate, it's actually normal for us to see a reduction in ad hoc that follows that.

Bill Ledley - *Cowen and Company - Analyst*

All right, got it. So it may not be business jet specifically; it may just be different rate changes across that customer's portfolio?

Dave Castagnola - *Wesco Aircraft Holdings Inc. - President and CEO*

Exactly.

Bill Ledley - *Cowen and Company - Analyst*

Cool. Thanks, guys.

Operator

(Operator Instructions)

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

Okay, Adrienne. Sounds like there are no more.

Operator

We have no further questions. I'll turn the call back over for final remarks.

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

Great. Okay, thanks. And on behalf of everyone at Wesco Aircraft, we want to thank you for your participation today. Have a good evening.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating and you may now disconnect.