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PRESENTATION

Operator

Welcome to the Wesco Aircraft Holdings Fourth Quarter and Fiscal Year 2017 Earnings Call. My name is Ellie, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded. I will now turn the call over to Jeff Misakian. Jeff, you may begin.

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

Thank you, Ellie. Good afternoon, everyone, and thank you for participating in Wesco Aircraft's fiscal 2017 fourth quarter and full year 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're 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, is 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'll turn the call over to Todd Renehan. Todd?

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

Thanks, Jeff. Please turn to Slide 3. Our fiscal 2017 fourth quarter results reflect lower sales and gross profit compared to the same period last year primarily due to production declines on certain programs we support in our hardware contract in ad hoc business. Lower gross profit in the quarter was exacerbated by higher SG&A expenses, which we have not yet reduced enough to compensate for the decline in our sales over the past 2 years. In many respects, our fourth quarter results were similar to trends seen all year. We are clearly not satisfied with these results. They're not acceptable to us or our shareholders. Despite the poor financial performance in the fourth quarter, we believe we have stabilized the business and begun to turnaround our operations. Unfortunately, this operational improvement has not been reflected in our financial results to date.

Our first priority was to return our customer focus and service back to the world class levels for which Wesco has been known. As I'll explain, we've successfully improved operating metrics and received positive feedback from customers as a result. Now we are turning our focus to improve income generation as quickly as possible without harming the long-term health of the business.

Despite realizing more than $80 million in new contract business in fiscal 2017, we have yet to see aggregate sales growth. New business revenue has been more than offset by declines in our hardware business both in ad hoc and contract sales. This decline was primarily driven by lower volumes with existing customers, which reflects changes in their build rates from slowing production on certain legacy programs, content loss at some Tier 1 customers and a fairly typical rate of lost business during the contract life cycle process that's an ongoing part of the market and our operations.

We continue to win new business, which we expect to begin flowing into fiscal 2018, and renew more than 90% of contracts. The new rate of wins and renewals speaks to the value proposition that customers continue to find in Wesco's offering. As I'll explain later, we believe new business revenue will be the primary driver behind our return to modest growth in fiscal 2018. We expect the decline we saw in fiscal 2017 with certain customers to moderate next year as customer portfolios stabilize and work increases on ramping programs. We believe our revenues have stabilized and will return to modest growth in fiscal 2018 but gross margins are still being impacted by high-cost inventory that was purchased in prior periods. It will take some time to work these costs down before the benefit of our improved purchasing is fully realized.

We recognize that SG&A expenses are not where they need to be given our current level of sales. Higher SG&A reflects resources we added to improve customer service and on-time delivery and to support new business, but we recognize this higher level of SG&A relative to sales is not sustainable. The necessary corrective actions are already underway.

While we're making progress executing the improvement plan laid out on our last quarterly earnings call, these initiatives take time to translate into better financial performance. We're starting to see positive trends emerge and a recovery in key leading indicators, which we believe will drive stronger financial results. We've seen improvement in many areas, including on-time delivery, warehouse efficiency, ad hoc bookings and purchasing performance, and I'll talk about each of these areas in more detail.

With the support of our valued lenders, we also restructured our debt covenants to provide substantial flexibility while these actions begin to drive improved results.

Please turn to Slide 4. As you may recall, we outlined our plan to drive improved results on our last earnings call. We talked about 4 focus areas and the initiatives we're executing to achieve our improvement goals.

Please turn to Slide 5. In the area of profitable growth and improved margins, we made progress in both ad hoc and contract sales. As we mentioned last quarter, we focused significant effort on improving ad hoc bookings and sales through increased market-based pricing, training and audits. As a result of our efforts, ad hoc bookings in the second half of fiscal 2017 were 9% ahead of those in the first half of the year and 3% higher than the second half of fiscal 2016.

Ad hoc bookings were higher year-over-year for the second quarter in a row, which makes us cautiously optimistic that we're seeing an improving trend. This is a critical leading indicator for us; an increase in bookings will result in higher sales, but they can take time to materialize depending upon inventory availability among other factors.

In addition, as I'll explain shortly, on-time delivery rates have improved and as a result, we're hearing comments like, "It's nice to see Wesco back," from our strategic customers. I personally met recently with one of our largest customers, who had us in the penalty box for service issues in the recent past and is now giving us more business because of the improvements we've made. This is a big step forward, but we need to continue performing at a high level to sustain sales growth. Because of these improvements, ad hoc sales and margins in the fourth quarter were essentially stable with the third quarter. This is good progress, but we need to pick up the pace and do more work to sustain our momentum in the new fiscal year.

We remain focused on winning new business to drive growth in long-term contracts as well as streamlining the process of implementations. New business revenue was in line with expectations for the year but as I mentioned earlier, this has been offset by volume declines that were at a higher level than we anticipated at several large customers. While some of the large OEMs report strong deliveries in narrow-body commercial jets, other customers have had tough years dealing with production declines in a number of legacy commercial and defense programs, including those for which we supply product.

At the same time, many customers are tied to business jet platforms and as you know, the business jet market continued to struggle last year. However, in spite of these customer challenges, we generated year-over-year growth in contract sales in the fourth quarter, an improvement over flat performance in the third quarter.

Our second focus area is procurement and inventory management. We've been actively managing inventory, aggregating demand, accelerating remaining supplier LTAs and instilling greater discipline in our buying processes. We invested in inventory to provide more parts where they're needed to continue supporting new business. We expect to make an additional investment in the first quarter of fiscal 2018 to make more parts available for ad hoc demand and provide additional support for certain contracts. However, through active inventory management, we're planning to maintain our inventory investment at relatively flat levels for the remainder of the year. We put more SKUs on long-term agreements in the fourth quarter, moving closer to our target of 75% by the end of fiscal 2018. This should help maintain better back-to-back margin protection where we have provided fixed prices to customers by reducing future cost increases over time. This is a critical component of expected gross margin expansion in the coming year.

We're also improving local management oversight processes to focus on mitigating supplier price increases and reduce higher cost gap buys while driving greater accountability to the regions.

In customer service and on-time delivery, we're tracking well to metrics that we've developed. Over the past several months, we've improved weekly fill rates by 13% in our largest hardware warehouse in Valencia, which has led to an improvement in on-time delivery back to the levels of performance that customers used to enjoy with Wesco.

We also reduced overtime by 45% and cut total labor cost per transaction by 20% in the Valencia warehouse. We still have more work to do to drive these process improvements into our culture, but we believe the warehouse today is delivering to customer expectations and is much more stable and ready for long-term process improvement and growth.

Based on the achievements in our Valencia warehouse, we're implementing these new operational processes and training at all major warehouse sites. We're also expanding the scope of our process improvement to address procurement and sales operations, which we believe will lead to an additional savings and efficiency.

Improvements in operating metrics are helping drive greater efficiency and lower costs in our fourth focus area. In terms of addressing our overall cost structure however, we've not made enough progress. We took cost actions towards the end of the quarter to reduce corporate SG&A by approximately $6 million on an annualized basis, removing some senior level and other back-office functions, staying away from functions impacting the customer. We eliminated redundancies and management layers and reduced the executive leadership team by 4 members. This was merely the beginning of what needs to be done to right-size our costs and return Wesco to the level of profitability we all believe is possible. We need to do a lot more to reshape and resize our organization based on the new level of sales we have today. Please turn to Slide 6.

While these operational trends are encouraging, it's taking too long to produce financial improvement. In an effort to accelerate the process and deliver more tangible improvement, we recently engaged AlixPartners, a well-known business consulting firm to assist us with a comprehensive business review. Initial work will be a deliberately broad-based assessment of where the most significant opportunities exist to improve Wesco's profit generation. While the cost structure of the business relative to our current position and size in the market certainly will be assessed, we also have asked AlixPartners to evaluate other aspects of how we operate. This process is only in the early days. As both the scope and results of the evaluation develop over the coming weeks, our next steps will be to prioritize and pursue actions to maximize improvement. We expect this review to result in even better service for our customers, a lower cost structure and most importantly, increased shareholder value. We'll provide you with an update on our next earnings call.

I'll now turn the call over to Kerry Shiba to discuss our fourth quarter results. As you know, Kerry recently joined Wesco as our CFO. He brings a strong financial background at major Tier 1 and OEMs as well as a deep expertise in operational turnaround and restructuring situations. He's already brought greater discipline to Wesco's finance organization and made an impact on our company's financial and business processes. After Kerry reviews the quarter, I'll provide our outlook for fiscal 2018. Kerry?

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

Todd. As Todd just mentioned, I'm going to focus on the fourth quarter. So, if you would please turn to Slide 7. Overall, you can see that net sales for the fiscal fourth quarter declined $4 million or about 1% from the prior year. The size of the Q4 sales decline was lower than experienced in the first 3 quarters of 2017. Fourth quarter 2017 sales also were reduced by provisions for customer claims, which totaled about $2 million. The aggregate decline primarily reflects $5 million of lower ad hoc sales, offset partially by a $3 million increase in sales under long-term contracts. As just mentioned, the accrual for customer claims also affects this comparison. Now let's go just a level deeper.

The ad hoc sales decline reflects the impact of production schedule changes at a regional and business jet manufacturer that we have previously disclosed. The $3 million increase in contract sales resulted from a mix of new business for the quarter, adding $21 million, partially offset by an $18 million reduction due to declines on major contracts and lost business. Looking at major product categories, lower hardware sales principally reflected slowing legacy programs and commercial end business jets. Increased chemical sales, which more than offset the hardware decline, occurred in the defense sector particularly related to the F-35 production.

While sequential sales comparisons can be affected in the aggregate by seasonal and workday differences, the Q3 to Q4 comparison was relatively flat except for the impact of the claims provisions that I just mentioned. The daily sales rate improved slightly on a sequential basis, reflecting progress that Todd discussed earlier. Please now turn to Slide #8.

Lower gross profit and higher SG&A cost drove lower income from operations and related margin in Q4 when compared to the same period last year. I have a few comments regarding both areas. Gross margin was 190 basis points lower year-over-year in the fourth quarter. The largest items in the comparison were the customer claims provision just noted in the sales discussion, higher negative inventory-related adjustments and a weaker hardware sales mix, which reflects a lower ad hoc component and changes in the contract portfolio since last year. More broadly, the change in mix between hardware and chemical sales also had a negative impact on gross margin in the quarter. On a sequential basis, gross margin essentially was stable in both hardware and chemicals, excluding the impact of the claims-related accruals.

SG&A expense increased $12 million year-over-year in the fiscal 2017 fourth quarter. The most significant items in the comparison include an increase in personnel-related costs, including $4 million to support new business and improve customer service, $2 million of severance expense and an incentive compensation comparison that was $3 million negative. As a percent of sales, SG&A was 360 basis points higher year-over-year.

On a sequential basis, SG&A was slightly higher than in the third quarter primarily due to a $1 million increase in personnel costs to support both new business and improve customer service. In addition, Q4's severance expense was $1 million higher than in Q3.

Adjusted diluted earnings per share fell by $0.22 in Q4 of fiscal 2017 when compared to the same period last year. Approximately $0.14 of the decline primarily reflects lower income from operations that I described previously. The remaining $0.08 was tax-related, primarily the result of discrete items recognized during the quarter.

Our effective tax rate in Q4 of fiscal 27 (sic) [2017] was significantly higher than in the same period last year, primarily due to a $37.5 million non-cash charge on accumulated foreign earnings. This item obviously is significant, so please allow me a minute to describe what happened here.

Like many international companies, Wesco's historical position has been that foreign earnings were permanently reinvested offshore. We reassessed the potential need to repatriate foreign earnings in the fourth going within the context of a longer-term outlook. Key factors considered include an expected imbalance between cash generated and used in the U.S. as well as an increase in excess free cash flow that will be used to repay debt as required under the recent amendment to our credit agreement. Based on the reassessment, we determined that it is likely that we will, in future years, repatriate previously earned and undistributed foreign earnings of almost $127 million. The related deferred tax liability for U.S. taxes becomes payable in the future years when these foreign earnings are repatriated.

The reassessment is performed periodically. The Q4 tax charge reflects a decision based on the current facts and circumstances. Our current view is that the historical foreign earnings to which the tax charge relates will be sufficient to address the projected U.S. cash flow imbalance. As a result, we don't believe the 2018 effective tax rate will be impacted negatively. While future tax reform could affect the accounting in this area, we, of course, can only reflect the impact of laws and regulations that are currently in place. If you would now please turn to Slide #9.

Accounts receivable declined in the quarter primarily due to an improvement in collections and timing. Net inventory increased $25 million in the fiscal 2017 fourth quarter as we continue to invest to support customer service and new business. Approximately 1/2 of the overall increase was a one-time investment made in conjunction with a key customer securing new upstream business.

Total debt of $864 million was slightly higher at September 30 compared to the previous quarter. We borrowed $17 million against our revolving credit facility during Q4, which was offset partially by term loan repayments of $15 million.

As previously disclosed, with support from our lenders, we recently amended our credit facility to increase leverage ratio requirements beginning with the fourth quarter of fiscal 2017. The amendment provides us with the flexibility to focus on our business and long-term value creation. Our leverage ratio was 4.59x EBITDA at September 30 compared to the amended requirement of 6.25.

Finally, please now turn to Slide #10. Cash provided by operating activities was $6 million in the fourth quarter of fiscal 2017, an improvement over the third quarter. Free cash flow was about $4 million in the fourth quarter, which compares to $2 million negative in the third quarter.

With that, I will now turn the call back to Todd for closing remarks and our fiscal 2018 outlook.

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

Thanks, Kerry. Please turn to Slide 11. Fiscal 2017 was a challenging year for Wesco and our shareholders. As we discussed, the business struggled with sales, margin and expenses throughout the year. Since the change in leadership at Wesco however, we've been actively engaged in turning around the business. Through our improvement plan initiatives, we're starting to see necessary improvements in our operational metrics for the first time in several quarters. We expect this trend to continue in fiscal 2018 with further progress planned in our 4 focus areas as we work across multiple fronts to achieve better performance. With the help of AlixPartners, we plan to accelerate the process and deliver more tangible and sustainable improvement.

We still don't have clear visibility to the pace of change in our financial results for the coming year, but we expect to recover some of the lost earning power of our company through better execution. In fiscal 2018, we expect to see a low single-digit percentage increase in net sales primarily based on the ramp-up of new business and ad hoc sales and a low double-digit percentage increase in adjusted EBITDA, primarily through higher sales and gross margin and stable SG&A as a percent of sales.

Our operational metrics are improving and although it will take time for them to fully materialize in our financial results, we expect them to gain traction throughout the year, leading to a better second half than first half of fiscal 2018. As a result, we're planning to exit the year at an adjusted EBITDA margin run rate of more than 10%.

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

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

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

QUESTIONS AND ANSWERS

Operator

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

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

Just a couple of questions. I wondered if you could give us, Todd, a better sense on the pace of declines, or the change in pace of the declines in sales associated with lost business or reduced scope. I know you said in your plan for 2018, you expected 90% renewal rates. Can you maybe give us a sense of what that number was last year, or maybe give us a sense of the quarter-over-quarter movements in some of those lost business metrics?

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

Yes. Let me answer the first part of the question. When we looked at the forecast for new business this year, for 2018, versus the build rate declines in churn, we're starting to see a turn. And if you looked at what happened last year, we had a big decline in ad hoc and then we had a one-time sale to a major OEM that did not happen. We're going to stabilize ad hoc. We won't have that one-time year-over-year bad guy. The new business should have more traction versus the build rate declines. Our churn or our retention rates have been fairly consistent in the mid-90s over the past 2 years plus going forward in 2018.

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

Okay. And then with respect to the process rollout from Valencia to the other spots, are you anticipating changing any incentives there in terms of driving behavior? Also, in terms of that process improvement, are there 2 or 3 central points of focus that you're looking to drive above the others?

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

Yes. I'll start with that, and then may be let Alex add some color if we need to. We have not had to change any of the incentives in the Valencia warehouse where we've already made tremendous improvement. The fill rates are up, the overtime is down, the receiving backlog is down, the quality holds are down, the gap buys are down; the on-time deliveries, up. And we've been doing that with just better management oversight, better metrics, better visibility and a lot of focus. And we're going to simply take those processes and learnings that we had in Valencia out to the other warehouses around the country. And as I said also now, take that into procurement and into sales ops, but we haven't had to change any incentives necessarily.

Alex Murray - *Wesco Aircraft Holdings, Inc. - President and Chief Operations Officer*

Sure, Carter. Just in terms of the question about the process and the process focus. For the most part, it's hand in hand with the consultants that we engaged then, DeWolff, Boberg and Associates. And their niche is really on first-line supervision and making sure the gap between your best and your least effective employees is reduced. And that's where we saw the improvement within our Valencia warehouse, really where we were bringing our lower performing employees through better supervision, discipline and understanding what might be holding them back from performance and making changes to improve that situation. And that's the same focus that we'll be taking to other functions and other buildings.

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

And was that a function of -- just as a follow-up, was that a function of employee turnover to have less experienced workforce in Valencia? I mean, that facility has been there for a long time.

Alex Murray - *Wesco Aircraft Holdings, Inc. - President and Chief Operations Officer*

Yes. The employee turnover was a significant dynamic. There are a lot of new people in that building to -- and bringing extra staff in to improve the customer service situation and just through the natural turnover that we experienced in the warehouse.

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

And to add, Carter, I think when we made the last cost-cutting moves, Valencia got hit hard. And it took a lot of labor out of there that was, like we've said in the past, too close to the customer.

Operator

And our next question comes from Jeff Bronchick from CSC Investment Management.

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

Jeff Bronchick, Cove Street Capital. I just have 3 quick ones, and then the real question. So on Page 7, it's says ad hoc was down $5 million, but yet in, I think, the speech, it was stabilized or up 8%. Help -- what am I missing there?

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

I think we're talking between bookings and sales. Bookings have improved in ad hoc for the first time in a long time over the prior 6 months. We've actually turned a decline that's been happening for several years. So the difference in those 2 one up, one down, bookings are up. Now bookings, remember, take up to 3 to 6, sometimes 9 months to materialize. So that's a good leading indicator for us of future ad hoc sales.

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

So bookings are up. Because ad hoc is ad hoc. A booking is in advance. So aren't they 2 separate things?

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

I'm not sure I'm following, Jeff. 2 separate things?

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

A booking is almost a contracted client looking out? Ad-hoc is "I need something in 15 minutes, what have you got?"

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

Oh, no, no. No, sorry. No -- you book ad hoc, Jeff. You book ad hoc in advance as well. So our branches around the world support our customers, either contractual customers or just ad hoc customers. And you make bookings for ad hoc sales but sometimes the customer needs it right away. Sometimes they need it 6 months from now.

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

Got it. And second question, so the customer claimed $2 million, was that sort of a performance give back? In other words, you did not perform and per contract, as the new way the world's working, that you had to basically refund them $2 million because you couldn't satisfy per contract?

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

No, it's not a -- well, first of all, it's not done. It was big enough that we thought it was important to disclose. It's a typical contract dispute based on -- yes, based on performance of what we say we did versus the customer thought we did. And we're still in discussions with this customer.

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

Does -- incentive comp costs were up with this performance, what's that?

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

So well, I'll start, and Kerry can add. Last year, we reversed the entire bonus accrual in the fourth quarter. And this year, we did not reverse the entire bonus accrual. We left a very small amount out where we are concerned about retention based on the amount of change that we're going through to keep for our employees and that's the difference. Last quarter was a full reversal, this quarter was a partial reversal.

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

Now I know that "this team has not been around and together for that long," but we have a new CEO appointed by the board with distribution expertise, good with clients. We have a very experienced CFO with all sorts of experience on the website of restructuring and financing and seems like the right guy for the job. Alex is probably -- grew up in that warehouse. Why in God's name does this group think it needs to hire outside consultants to basically seemingly block and tackle and run the business? I don't understand that at all.

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

Okay. Our blocking and tackling are focused around our 4 improvement areas: improve our way we buy, improve the way we sell, increase the margins, lower some cost that we can get at, and improve our on-time delivery. AlixPartners is going to do a much broader business review where we can build on the improvement plan, go deeper, go broader to substantially look at the way we operate the business and everything about it: the entire cost structure, the facilities, the go-to market strategy. And we need the knowledge, the experience, the focus, where 100% of what they do is this, and to do it quicker. So we made the determination that, that help would be the best interest of the company and the shareholder.

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

I would rephrase it differently. If -- I just truly simply don't understand why this team can't run this business. And if quicker and more capability is required, why don't -- and for the whole board, why don't we just put the company up for sale and let someone else do it? I just -- I have to say I'm blown away. And that would be my suggestion. Let's just do it and let someone else do it if you guys don't think you can do it.

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

I would say -- well, I don't want to just let that go. We are doing it. We're seeing it in the metrics. We're seeing it in the leading indicators. We believe that those leading indicators are going to lead to better financial performance. Certainly not happening as fast as we want it to, and this, again, is a broader, more comprehensive assessment of what are the things to do to unleash the true earnings power of the company, when can we make it hit, and then -- then we'll be in a better footing and a better platform to evaluate all the different alternatives which will be in the best interest of the shareholder. So with that, we'll take the next question.

Operator

Our next question comes from Jon Raviv from Citi.

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

Todd, when you talk about FY '18, what do your initial expectations assume regarding the outcome of this review? And for instance, you suggest that high SG&A is not sustainable but your FY '18 guidance assumes flat SG&A as a percent of sales. So in essence, why is the SG&A only flat as a percentage of sales next year?

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

Okay, 2 questions. SG&A is flat as a percentage of sales because it's, remember, offset by some of the increase in labor that we had to bring back initially to improve the level of service that we are providing for our customers. So through that, we're able to keep it flat. This 2018 plan doesn't have any initiative for whatever might come up with AlixPartners. It's too early for that. We're in the very early innings of that whole process and they're just evaluating what's going on right now. We do have some SG&A improvement in the plan based on the work that we've already done as part of our 4 focus areas driving out costs. So the $6 million annual reduction in overhead that we took, the reduction in overtime, the reduction in overall cost of transaction in the warehouse, those -- some of those things, based on traction, are built into the plan.

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

Got it. And then what about cash flow into FY '18? Any visibility to inventory stabilization?

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

Yes, yes. I think as both Todd and I had mentioned, we do expect another increment of investment in inventory in Q1 but from that point forward, we expect to be able to hold inventory investment relatively flat. So compared to, I think, the number's almost $130 million that we invested in inventory incrementally in 2017, we would expect the 2018 number to be a mere fraction of that. And that's the big difference in the cash flow story. It's basically all focused on the inventory area.

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

So you -- understood. And so are you prepared to give just some sort of a sense of what conversion might look like next year?

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

We're not providing any guidance on that metric. Again, the storyline is going to be in the inventory area, but it's -- this is one area we're choosing not to give a specific guidance right now.

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

All right. And then just very last one, the biggest driver of gross margin expansion next year, volume. Volume doesn't seem to mean much if it's only up low single digits. I think, Todd, you've mentioned inventory pricing. Can you just give us a better sense for what the moving pieces are for gross margin expansion next year?

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

Yes. I think there's probably -- there's a couple of key pieces. One is the improvement in ad hoc, so we actually turned ad hoc and showed some growth. And you know ad hoc has higher margins. And then two, its continued traction on the good work that the procurement team is doing with our average weighted cost of all of our buys. It's also supported by the work that the warehouse is doing because we're doing a better job of delivery, we have less gap buys. So it's probably those 3 keys that are driving most of the margin improvement.

Operator

And our next question comes from Gautam Khanna from Cowen & Company.

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

A couple of questions. First, I was wondering, the $2 million you mentioned, that was a pressure, that was a pressure to both the sales and gross profit or was it just one of them?

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

Yes, it was both. It was reflected as the reduction of sales and obviously, that drops through dollar-per-dollar to the gross line.

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

Okay. The -- you talked a little bit at the front end about losing some business within the Tier 1 customer base. Was that outside of the Alenia thing? Is that -- what explains it, and what sort of atrophy have you baked into next year, and is it BASN related -- what explains it? Loss as opposed to just declines in the end market, in the 747 or 777, or what is it exactly?

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

Right, right. There was smaller -- several smaller deals, less than $1 million, I'd say. And there was 1 deal that was over $1 million, which was a manufacturer in the U.S. that we were providing chemical services to. But several smaller deals, not necessarily -- didn't have anything to do with

BASN. Some, to some smaller competitors; some, we decided that the economics weren't good enough to hang onto; some went direct to manufacturer.

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

Okay. When you look at your customer base today, what level of sales do you have today that could go the way of BASN in the next 24 months if contracts don't renew or what have you?

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

A couple -- a little bit of color for that. We have been through -- the past couple of years, we've had higher revenue numbers of contracts being up for renewals than we've had in the past. This year and next year, we have much lower levels of contract volume that's coming up for grabs, if you will. If our retention rates again are in the mid to high 90s, we expect that to continue. We are not -- we are taking business from BASN more than we are losing business to BASN. We lost 1 small deal overseas to BASN, but we're not expecting any huge impact over the next 12, 24 months from BASN.

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

Okay. Spirit, not long ago, came to a master agreement with Boeing. Is there any risk there that they become a smaller customer of Wesco's overtime because of that contract?

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

Actually, they're one of our most strategic partners that we have, and we continue to grow with them and we're in discussions, 3 or 4 different deals that are on the table and working with Spirit. So they require broad-based consultative services and comprehensive supply chain solutions of multiple product commodities that we bring to the table. And they're a perfect example of somebody who recognizes that value.

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

Okay, great. And one last one, you mentioned ad hoc showing some light. Is this in the manufacturing -- subcontract manufacturing supply chain, or is that in the aftermarket with the MROs of the airlines? Where are you seeing that?

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

Yes. They're kind of stable and flat across all of the above, what you've just said. It's some of our largest customers who generate almost half of our ad hoc revenue are increasing bookings as well as the other portion of 50% of revenue. It's really across the board, not concentrated in 1 specific area.

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

Okay. But you are seeing the aftermarket actually start to stabilize as well? The airline MRO channel?

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

Yes, we are. That's been relatively stable for us right now, yes.

Operator

Our next question comes from Myles Walton from Deutsche Bank.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

I was wondering, it sounds like a lot of the margin expansion improvement you're counting on here is around mix, whether it's ad hoc or the hardware maybe not working against you as much as it has in the past. But in the past, we've counted -- or I think the company has thought about mix as being a source of getting better. And I hear you that the bookings are starting to improve. I'm just curious, how much of that low single-digit growth are you thinking is disproportionally ad hoc? And realistically, if it doesn't happen, can you still get margin expansion within your EBITDA's defined margins into next year if you don't have ad hoc come through?

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

Yes, the plan -- and we're not going to give specific growth rates by ad hoc/contract in hardware, but I can tell you that it is not predominantly based on ad hoc improvement. Overall, contract hardware improves, ad hoc improves, chemicals improves but not as much. So it's not reliant on ad hoc growth only.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Is there an underlying improvement in the chemical's gross margins assumed? And have you seen any of that happen as well?

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

No, there's not improvement in chemical margin assumed.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay, okay. And the other one, I guess, it would be for Kerry. But on the cash flow side, you mentioned that inventory investment will be a fraction of what it was this year. Obviously, this year was a pretty elevated number. But even in the prior few years before this year, inventory expansion was in the $40 million, $50 million range. Are you saying it wouldn't be anywhere close to that either?

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

I think it would be less than that amount. I don't want to give an absolute specific number, but I think the years prior to 2017 are going to be a little more reflective of the kind of the order magnitude that we're going to be in. I know it's a little bit of an ambiguous answer, but I think it's a reasonable benchmark for you to be thinking about.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay. So you're looking probably for a year-end '18 leverage ratio to be somewhere in the -- just under 5.5x, given everything you gave us today?

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

I would say, directionally, we would expect to be better than that.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay, all right. And then just the only other clarification, I guess, was around SG&A. Maybe I totally missed it. But the $6 million of improvement, that's 40 basis points of improvement in SG&A, what's the offset to keep SG&A flat as a percent of sales?

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

It's primarily -- it's the investment in the customer-facing side of the business, to restore our customer service as well as to support growth.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

That sounds like it's more of an ongoing, not a one-time investment. So the payoff for SG&A leverage -- how much -- I guess what's the targeted SG&A leverage or is that what AlixPartners is going to tell you?

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

I think in a large part, that's where we're looking to get help to both quantify and accelerate the efforts there.

Operator

Our next question comes from Ronald Epstein from BoA.

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

It's Kristine Liwag. Back to ad hoc, from my understanding, some of the lost ad hoc sales were because of poor performance in some of your existing long-term contracts. So I was wondering, when you think of next year and you're thinking about the drivers of ad hoc growth, are those going to be dependent on performance in order to get that business back?

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

That specific business, Kristine, yes, ad hoc is always dependent upon performance and that's where you see a lot of fluctuation in the marketplace where our competitors are falling down, we'll take the business; where we fall down, they'll take the business. So it's always based on performance. Those specific customers we mentioned in the past were already seeing improvement, that was one of my comments in the prepared remarks in terms of the -- in the penalty box, those specific customers are seeing that improvement. We're going to sustain that improvement, and then they'll continue to give us back that ad hoc business.

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

And so since you're just getting off the penalty box, when this business comes back, does it come at a higher margin? Or I guess, would it come at the previous ad hoc margin, or would you have to offer some discounts initially in order to incentivize them to give you back that ad hoc piece?

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

A lot of that depends on the availability. It depends on inventory, it depends on the competitive position. So we hope to bring it back at or -- at where we have been in the past.

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

But initially, it will not be at that level? Is that right?

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

It depends. Sometimes it's not at that level when we have to first come back, because yes, you've got to earn your way back in and sometimes, you do that with price. And then once you do and that confidence level comes back up, then we can start to see the margins we've had before in the past.

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

I see. And the decline in hardware margins in the quarter, is that attributed also to pricing pressure, or something else?

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

I think some of that has been -- as contracts have changed, the pricing levels in some of the new contracts that have replaced ones from last year were at lower pricing levels. But that can also be associated with specific content that shifted.

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

It's more -- Kerry's right, it's more around the content and the growth that we saw based on the product line versus competitive pressure.

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

And lastly for me, can you talk more about your decision to repatriate foreign earnings? And what are the metrics that we should monitor regarding your covenants?

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

Well, let's see. A couple of questions there. With regard to the covenants, as I have mentioned, where we are right now is 6.25 turns of EBITDA or adjusted EBITDA that says -- defined in the agreement. That covenant stays in place for the year-end and then 2 more quarters. And then it starts to drift down a bit, but it goes down relatively slowly. I think as Todd had mentioned initially, the fact that we got the support from our existing lending group, the improvement in the lifting, if you will, of the financial metric has been to a degree that we think we'll have plenty of comfort in operating going forward to execute our improvement plans in 2018. With regard to the repatriation, we believe that we accrued enough related to enough earnings that, as I mentioned, we don't expect to affect our tax rate, our effective tax rate in 2018. As far as bringing the actual cash back, I think that's going to be episodic. We'll just be looking at the balance between U.S. cash flows in and out over time, and we'll make the decisions as we need.

Operator

Our next question comes from Michael Ciarmoli from SunTrust.

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

Maybe just to go back to close this up on Myles' line of questioning. I mean, it seems like there's going to be a pretty big tailwind from lower inventory investment on cash next year. Anything else in the other working capital line items that would be a big consumer of cash next year or any other major cash consumers as you look out into '18?

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

We don't anticipate that, Michael. Our CapEx here is relatively -- it's quite modest relative to the size of the business and we don't see any big changes on the receivables or the payables side. The inventory is really the storyline.

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

Okay, okay, perfect. And then just on that inventory, I mean, obviously, it's up significantly, I think 16% year-over-year. The revenues are down. Do we have to be concerned, just given what you talked about some of the legacy headwinds? I mean, there's been certain programs that have come to a close completely. I mean, should we be concerned about any write-downs of the inventory? I mean, is all that inventory that you have on the books able to be moved granted some might have to be discounted?

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

We don't have any specific concerns. We have an ongoing reserve process based on the age and group of inventory. We have a large group of our inventory that is transferable, and we have a good eye on what's changing and what we have to do with specific inventory when programs start to decline. Some contracts have clauses in them, that if you buy certain inventory for that specific contract and you've exhausted all the other alternatives, then the customer's actually liable in some cases to take the inventory back.

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

Directionally also, for the last couple of years, our reserving policy, our book policy, if anything, has gotten a bit more conservative directionally going from 2016 to 2017. We're also looking at initiatives to try to, with more specificity, identify where stale inventory is at and figure out how to liquidate that also without upsetting the market that we're actively participating in.

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

Okay. Okay, that's helpful. And then just one more on the ad hoc. I mean, you talked about the bookings ticking higher. Have you been able to notice a material change in the market place or is this just a function of you guys coming out of the penalty box? I guess what I'm trying to get at, so are you seeing sort of a double bonus out there, the market's improving and you're coming out of the penalty box? Or do you think this is more or less just coming out of the penalty box?

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

It's not the market, but it's not all penalty box either. We're not in trouble with all of our ad hoc customers. We've mentioned a few but that, by no means, does that we're in trouble everywhere. We're doing a better job in the overall process in terms of quoting, turnaround, accuracy, getting the right product on the shelf, getting better pricing where we need to, training, and auditing. So it's a lot of -- what we said before in the past is these, some of these things were self-inflicted, and we're giving ourselves the cure. So we're operating better, some improvement in the penalty box, not a big change in the market.

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

Okay. And then just on the comprehensive review with the consultants. It sounds like you're already deploying the lessons learned from the Valencia facility. Have you guys already established that all of your sites, I guess, that you're sized correctly? Or is there the potential for this review to result in consolidation of some of your facilities? And just trying to think about the overall structure, whether or not you're kind of potentially spinning the wheels here, deploying best practices to facilities that might be targeted to get consolidated?

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

Yes. Well, we certainly wouldn't do that. But in terms of the process that we're going through with the business review is, we're way too early to make an assessment of our geographic footprint of facilities. But it's certainly something that we're going to look at.

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

Okay. Last one I had. You didn't really comment -- you talked about some of the legacy pressures, I guess, in the commercial market. Can you talk to the performance of what you're seeing from your military market? I know the overall aftermarket's small, but I mean, you're talking about low single-digit growth next year. Can you give us any color on how the markets perform?

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

We -- the military market that we've experienced in 2017 actually grew a little bit better than the commercial market. And that was fueled by some of the good progress around the F-35. And we expect that growth to continue but I don't have a specific percentage, military versus commercial, for '18.

Operator

And as we have no further questions, I would like to turn it back over to your host for closing remarks.

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

Okay, very good. Thanks, Ellie. Thanks, everyone, for joining us. On behalf of everyone here at Wesco Aircraft, we appreciate your time this afternoon and this evening. Have a good night.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. Thank you for participating. You may now disconnect.
