Company Name: MSC Industrial Direct Co., Inc (MSM)
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<<Dave Manthey, Analyst, Baird>>

All right. Good afternoon everyone. I'm Dave Manthey. I'm the senior analyst on the industrial distribution team with Quinn Fredrickson. And today we have MSC Industrial. This is a leading distributor of industrial products cutting tools, also abrasives, measuring instruments, machine tool accessories, safety products, et cetera, MRO products.

The company markets through e-commerce channels, inventory management solutions, call centers, et cetera. They have five primary distribution centers in 26 branches now, down from, what, almost a 100, I think at one point.

<<John Chironna, Vice President-Investor Relations and Treasurer>>

Yeah.

<<Dave Manthey, Analyst, Baird>>

And serves customers throughout North America. So well – I'll leave it to the management team here to outline the details on that. But we have with us today, Kristen Actis-Grande, who's the Executive Vice President and Chief Financial Officer, and John Chironna, who's the Vice President of IR and Treasurer.

What we'll do is, I'll turn it over to management for some brief overview, and they'll go through the slides afterwards. I'll come back and we'll talk about the email address, and then we can do Q&A a relatively small group. Just, we'll probably just go with raise your hand if you have any questions, but we'll tackle that at that time.

So with that, I will turn it over to Kristen.

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Thank you, Dave. I'll say a little bit about the company to start. Just a few prepared remarks and then looking forward to any questions about all of you have. And so as Dave mentioned, we're industrial distributor. We're about $3.7 billion in revenue. We operate in a fairly fragmented market, and we have a leadership position in metal working. And one of the things that makes us unique is that we offer a variety of high touch services and solutions that we combine with technical expertise to help our customers save money and to improve their productivity.

Several years ago, we began a program internally that we call Mission Critical, which was designed to help us return to above market levels of market share capture and to improve profitability. We just end our fiscal 2022 recently, and we ended with 11% average daily sales growth and adjusted operating margin of 12.9%.

We also generate high levels of cash. We use a balanced capital allocation strategy, return that cash to shareholders through a combination of share repurchases, a pretty healthy ordinary dividend, and the occasional special dividend.

Few remarks on the fragmented market that we operate in that I touched on earlier. So on the left hand side of the slide; you can see our total addressable market, which is about $215 billion. About a third of that market is made up of the top 50 industrial distributors. The balance of that is comprised of small, local mom-and-pop distributors and other regional distributors. These companies are typically offering one or two product categories with a very small footprint where they compete. But these are the companies that we go up against pretty much every day.

On the right hand side of the slide, hop back for one second. Thanks. You can see a little bit about the customer landscape. So roughly two-thirds of the addressable market is made up of less than 5% of the customers. These customers tend to want a more complex solution, and this is where we really play very nicely because it allows us to leverage those high-tech solutions and services to help the customer save money, help them increase their productivity.

I mentioned at the start of the presentation, our Mission Critical program. A little bit more on that covered here in this slide. I won't go through the whole thing, but basically there's two goals with Mission Critical. The first is to return to more of our historic level of performance. Two measure measuring that. One is outgrowth of the market as measured by the industrial production index. And then the second on the right hand side of the slide is to improve our return on invested capital to the high-teens. At the time we launched the program, which is about two years ago, we were in the mid-teens, and I'm happy to be able to say that as of the end of our fiscal 2022, we've actually met both of those goals already. But we're definitely not done yet. This is a long journey if by no means ends this year or next year.

But I will close the prepared remarks with a quick glance at what we've given for guidance. And so we're just starting our fiscal 2023. Simply put, we're targeting ADS sales growth of 5% to 9% and adjusted operating margin of 12.7% to 13.3%. Within that, we have a 40 basis point headwind coming from two things. 20 bps of headwind from acquisition, 20 bps from a fewer number of selling days and our fiscal 2023 as compared to our fiscal 2022.

And then again, not going to go through everything on here, but the other thing I'll touch on is within gross margin, we do have a headwind coming to 40 to 70 basis points, and there is a somewhat different profiling of that margin throughout the year. We expect Q1 to be our low point improving sequentially thereafter. And Dave, I appreciate the opportunity to share a few things and looking forward to questions.

<<Dave Manthey, Analyst, Baird>>

Okay. So, if you have any questions, feel free to raise your hand and we can just go that route. Otherwise, you can send an email to session2@rwbarid.com, and we'll get them up here. And I will relay them to the management team here. So, I guess to start with I seem to remember that at the very beginning of Mission Critical, Eric kept using that as a phrase, we needed to be the Mission Critical partner on the shop floor. He kept saying that, and then it became this margin and return thing, but I think there's one and the same. Can you talk about what does it mean that MSC is trying to be the Mission Critical on the shop floor? What type of solutions are you referring to there?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Sure. So, broadly, when our CEO refers to that he's speaking about the pivot that the company has made away from being a spot buy catalog supplier into being a more solutions focused distributor. And so, very specifically what we're talking about is a variety of solutions we offer that includes vending, it includes vendor managed inventory, it includes implant resources that we'll put at the customer's location to provide inventory services, inventory management. And then it's also referring to the expertise we bring, not just to the solutions discussion, but also to metal working, where we have a leadership position.

And we employ about 150 technical metal working specialists that allow us to go into our customers and to run what we call a business needs or customer needs analysis that basically helps us to identify opportunities to save that customer money. So we really want to be of Mission Critical partner on the plant floor for the customer, and it's really that technical expertise combined with the solutions that allows us to do that. And oftentimes through this BNA and CNA process that we run business needs and customer needs analysis. We can identify cost savings and efficiency opportunities for the customer that sometimes outnumbers what the customer actually spends with us.

<<Dave Manthey, Analyst, Baird>>

Okay. And second, when you were showing the inverted triangle and the customers and the market and that sort of thing, it's pretty clear that the types of solutions that you can provide a complex, large manufacturing entity, that seems pretty logical. So that would be the high end of that of the triangle there. But it's, as you move down, clearly the biggest part of the industry is with the smaller, the local mom-and-pop, machine shop or manufacturer. Does the – do those generate enough of a profit pool to allow you to target them with various solutions? Or do you tailor your solutions differently? Can you talk about the differences? Because clearly these solutions resonate at the top. What do we do at the bottom?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Yeah. So does that resonate with the very small customer, you mean?

<<Dave Manthey, Analyst, Baird>>

And can you afford to offer it to them?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

So not every customer would – it would not make sense for every customer to have certainly VMI necessarily or In-Plant. It's a little bit of a lower barrier from a profitability perspective to be able to offer vending to a customer, I would say. But one of the things that's so important to servicing that total population of customer is the ability to leverage the e-commerce platform to support them. So it's a – we're going for is a frictionless customer experience, low cost to serve that customer. And then ideally, as we get them in, we can start to increase our share of wallet with the customer to a point where perhaps if they're big enough or become big enough, we can leverage solutions or other forms of expertise to create stickiness with the customer.

<<John Chironna, Vice President-Investor Relations and Treasurer>>

Dave, I would also add in that. Those smaller customers are able still to tap into our technical expertise, because those people really understand manufacturing, they understand metal cutting applications, so those smaller customers might have questions on, should we be using water cutting machines or laser cutting or traditional manufacturing techniques. And they look to us to be experts in this field, and certainly our small army of 150 technical metal working experts are very important, but even our 200 to 300 metalworking sales people have a tremendous amount of knowledge towards that end. So that's also helpful. They can still tap into that even if they're not doing the volumes that might be required of a vending or an In-Plant solution.

<<Dave Manthey, Analyst, Baird>>

And you price those customers appropriately to encompass the cost of that expert's time, I would imagine.

<<John Chironna, Vice President-Investor Relations and Treasurer>>

Yes.

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Yes. Although I'd say it's a low, it's relatively low overhead to support that transaction.

<<Dave Manthey, Analyst, Baird>>

Yeah. Okay. Fair enough. Maybe we could talk about the key cost saving aspect of the program. So, you've got sales and service supply chain and G&A, and could you just maybe give us some examples of each one of those to give us an idea of what those look like?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Sure. So, we talked about the component of Mission Critical that's contributing to increased ROIC. More specifically within that, we set out a target to take out a $100 million of cost over three years that we're starting the third year of the Mission Critical program. This year we've taken out $85 million of costs so far. And then today's point, or as we show on the slide here, we've been targeting kind of all three categories of our operating expenses to drive out that cost.

Couple examples across the area, so sales and service, and actually, Dave, you touched on this at the start of your remarks about the decrease that we've seen in a number of branch locations. So even before COVID had started, we were already looking at the physical footprint of our sales branch locations, Our sales branches then, or the remaining ones that we have now were never stocking locations. They were more of like a physical place for our sales people to have a desk, which ideally, we don't even want them at that desk to begin with.

So, we had put technology in place to be able to leverage our inside sellers across the whole country while still maintaining sort of a local feel to that what was a physical office, but it basically allowed us to remove all the physical, all the costs associated with having these 100-ish physical sales branches. That was one of the first projects we did, and still one of the projects that delivered the most fixed savings reductions at one time.

In supply chain, a couple examples I would give you there are that we've continued to invest into robotics technology in the plants – excuse me, in the CFCs or what we call our distribution centers. So, we have five main distribution centers that service most of our customers. We've been putting robotics investment in place there, probably over the last 10 or 15 years, but we've accelerated that pace of late and particularly given the labor challenges that everyone is facing.

Another example in supply chain is, we've looked at freight optimization. So, when do we cluster replenishment shipments for our vending machines? How often are we shipping to our national account locations? All designed to optimize the outbound freight costs that we incur to service those customers? And then on the G&A side, this is probably the area where you have like the most little projects that have been executed and will continue to be executed, but there's really no area we haven't touched there. But I mean, I guess a couple tangible examples I would give you, even in my own space in finance one of the first things we did was a big lean project to reduce cycle time and month end close.

So you can take time out of month end close, and you can introduce linearity in the process. You don't need as many accountants to support the close cycle. So that was just an example of a way that we were able to remove some costs from the G&A functions. Other versions of that and other functions looking at insourcing versus outsourcing, probably some of the more obvious levers in the G&A space.

<<Dave Manthey, Analyst, Baird>>

Well, listening to you talk about all these initiatives and these programs that you're working on it's great. I know when you came to the company from Ingersoll Rand, we had very high hopes that you have this sort of knowledge and experience and you're bringing all this to bear. And the great thing is it sounds like you're – you've been given enough latitude, enough of your team, enough resources to make this all happen. How do you feel about that? In the time since you joined the company, how do you feel about the support that you've received to implement some of these, what I think sound like really great programs?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

I've had plenty of support. I think it's been great unit, when you make a decision to change companies. And I was, as Dave mentioned ran for 17 years before I jumped over to MSC, you hope that you're getting the whole story when you make that commitment. And I definitely was, everything that they brought me in to do turned out to be true, and I was given the leeway to do all of those things. I actually run our transformation office now in addition to my traditional CFO responsibilities, and I also picked up M&A and I run our international P&L. So it's been a really good chance to impact the company in multiple areas.

And the great thing is the receptiveness to implementing those changes, whether it's lean, whether it's changing our kind of operating system that we leverage inside the company. All of that's been fair game. And it's been exciting to see other leadership changes that have happened along the way that are only accelerating the company's willingness to transform both to achieve everything here in Mission Critical. But, there's also a cultural element to that too, to like embedding that ability, desire and drive to be world-class.

<<Dave Manthey, Analyst, Baird>>

Well, this might be a good time to talk about Martina McIsaac who I guess she's coming in as Chief Operating Officer, and a lot of what you just talked about sounds like some of that Chief Operating Officer role. So could you talk about, as this is, as she's coming in and as you're thinking about dividing and conquering the world here, what does that look like?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Well, first of all, I'm thrilled to have her on board. She is, it's early days, but we've actually been talking to her for quite longer than her start date would reflect. I'm really excited about what she adds to the company. And so we're bringing in Martina from Hilti, which is a tool company, and there's a few things about her profile that made her particularly interesting to us. I'd say one is she really has helped, not just in her role at Hilti, but in prior roles, kind of one of her areas of expertise is figuring out what's the right organic growth formula? What is that kind of magic, number or recipe, and how do you continue to repeat that over and over and over again?

The other thing I would mention is she really in particular at Hilti helped figure out what opportunities were available to continue to add value for the customer in the services space, which is something that we're very interested in MSC and doing at MSC. And then the last thing, like we just talked about, she has a great Lean and Six Sigma background. And I'm probably, amongst all the things I'm excited about her coming here for is I'm very excited that she speaks that language because we need more of our leaders in the company that speak the Lean Six Sigma language and can coach our associates that way. So that's what I'm excited about.

<<Dave Manthey, Analyst, Baird>>

That’s all really good news. John, anything to add to that?

<<John Chironna, Vice President-Investor Relations and Treasurer>>

I would just say, you think about the two of them Kristen came in a couple years ago maybe picked off some low hanging fruit, drove home additional savings through lots of little wins and hits, if you will. And then Martina now comes in as the COO with that Lean and Six Sigma background, and it’s just going to… yes, our targets officially end in 2023, but they don’t really, I mean, to the street they do, but we’ve set our sites already on 2024 and 2025, and we need – we know we need to continue to find cost savings and productivity improvements to continually expand operating margins. And Martina comes in with that background and she’ll be able to drive home even more, I would say over the coming years. So, we’re all excited about it.

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

I think we’re also excited about the ability it’s going to free up for Eric to be more strategic on a day to day basis too. I think that’s important.

<<Dave Manthey, Analyst, Baird>>

Yeah. And what are those 2025 goals?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Ha! To be communicated at a future date, Dave.

<<Dave Manthey, Analyst, Baird>>

Okay. We did get a question here. We’ve all heard about the supply chain challenges. How impacted were the mom-and-pop players that are the majority of the market? And then do you expect any changes as the supply chain normalizes?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

So they were definitely negatively disproportionately impacted. The ability for the larger distributors to take product and command priority in the line with our manufacturers is probably not surprisingly a very prominent thing that happened. And we also certainly didn’t hesitate to leverage our cash to flex inventory as an asset throughout that time to help us to continue to take share when the locals couldn’t supply product. It’s interesting, it really forced those distributors to compete more on price, which is not necessarily a sustainable model for them, even if they do tend to be more competitive on price on a regular basis, since they don’t have the degree of expertise or solutions that we can offer to the customer. The supply chain situation has been easy.

So, I think that’s certainly helping the locals to get their typical stocking levels back up. But I think we’ve taken advantage of that environment and the amount of time it’s sustained for to take share. And we typically see strong retention rates once we can get in there and once, especially once we assign an account to be managed by a seller.

<<Dave Manthey, Analyst, Baird>>

Okay. Another question here. First, anyone have a question? Go to the audience first. No. Okay. So MSC is a good barometer of the industrial economy. Can you comment on recent volume levels and outlook? You can just report it, so it's okay, right?

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Yeah. I'll repeat what we said in our earnings release. So, we had 13.5% average daily sales growth in September, and we have a very strange fiscal calendar. So at the time we've reported, even though it was October 20th, we were about a week into our October and seeing a similar rate of growth. So, I don't think we're too different than a lot of the market in this regard that we are hearing all the same things all of you are hearing. We're looking for signals of early indicators of a slowdown, but generally right now we feel very good about, what we're seeing, about what our sellers are telling us.

And for the most part it's just the feedback from the customer directly is the same thing that we're concerned about, which is they're hearing all the same things. Everyone's worried about when a slowdowns going to happen, but largely no indicators of that at the time.

<<Dave Manthey, Analyst, Baird>>

That's consistent with what we've heard from a lot of folks. There's sort of this belief that something is going to happen out there, but we're not seeing it right now today. And the next one is just a question about flatness of earnings over the past, say five years. I guess clearly you had, there was COVID in there and there's a bunch of safety products, and there's, maybe you should talk about just what's happened over the past five years. And I think the sentiment here is what happens to break us out of this earnings range that you've been in over the past, say, five years.

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Yeah. So, I think, it honestly probably starts longer than five years ago. So the company was found in 1941. We went public in 1995 after we went public. We kind of grew like hot kicks so probably like the 2013 time period that was a combination of expansion into different geographies, adding headcount, going into different end markets. And then around the 2013 time period the growth and sort of the historic performance levels of the company kind of stagnated.

And I'd say largely stayed that way until well really until COVID hit, at which time we were benefiting some ways from the sale of PPE products, but had largely seen depression in the rest of our product offerings to most of our end markets. And we had a few things about COVID that did negatively impact the earnings of the company, largely around write-downs on PPE. But we had already made a decision internally to commit to Mission Critical really before COVID started, but unfortunately the timing of COVID kind of delayed us from actually getting the ball rolling.

So, I'd say an Ernest, it started right before I joined the company, which was fall of calendar year 2020. I always have to check my fiscal calendar conversion fall of calendar 2020. And there was kind of just a, I mean, it's not rock, it's not like surprising how it happened. Everyone was disappointed in the performance, but there was really finally a willingness to say, we're going to have to do something fundamentally different to change that because, it's been kind of flat earnings growth, sluggish top line performance since 2013.

And the Mission Critical program has been the set of primary levers that are the catalyst for the outperformance now. And we talked about OpEx savings but obviously there's been really significant reinvestment back into the company to get that growth engine going. And that's creating a lot of the top-line growth that we've seen so far, but I'd say really are not fully benefiting from at this point, given the degree of reinvestment that we've made.

<<John Chironna, Vice President-Investor Relations and Treasurer>>

So, I would just add to that… our fiscal 2022 was obviously the first year that we expanded operating margins and earnings in quite a few years, and we intend to continue doing that over the next number of years and that we're aiming for 20% incremental margins.

Q&A

<Q>: You've got a lot in the major investment and receivables and inventory, it's the nature of your business. But with short term rates of, 400 basis points at the government level with 450, how does that affect your competitive positioning?

<Q – Dave Manthey>: Repeat the question.

<A – Kristen Actis-Grande >: Yeah, so the question was with investments in accounts receivable and inventory how does the increase in interest rates impact our, was earnings levels? Was that the…

<Q>: [Questions-Inaudible]

<Q – Dave Manthey>: Competitive position.

<A – Kristen Actis-Grande >: On competitive position. Yeah. So, we will continue to flex inventory in particular as an asset if we think it strengthens our competitive position. Despite the increase, the increase in short-term interest rates or variable interest rates, that's not something we're going to hesitate to do. Particularly if there's a sequence of things that impacts the local mom-and-pops that allows that to be advantageous to us.

On the receivable side, that's more of, I'd say probably an outcome of sales growth. But we will flex extended terms if it's a benefit, but it's not something that we like to do. It's something that's kind of organically happening as we pivot more into national accounts, they tend to ask for and receive longer terms, which we can afford to give because of our balance sheet. But the thing that I'm excited about internally on both of those fronts, or I'd say working capital in general is, we haven't done a lot to optimize working capital inside the company really ever.

We've always had a strong cash position, but we've had lean projects running now that focus on the order to cash and procure to pay value streams, and we will be more aggressively targeting lean projects on inventory. None of that is yielding any kind of benefit yet. So it will allow us to continue to flex our working capital as a strategic advantage while off, – while also allowing us to pay down debt more aggressively, amongst other potential things that we could do with the capital.

<Q>: Thank you.

<A – Kristen Actis-Grande >: You're welcome.

<Q>: Is that working Capital initiative sort of like embedded into your free cash flow guidance?

<A – Kristen Actis-Grande >: Yeah. The question was, is that working capital guidance embedded in the free cash flow guidance? So basically the way we did the guidance on EPS for this year is we assumed a constant debt level into 2023. So anything that we do that's more aggressive around value stream optimization or working capital burned down would be advantageous to that guidance.

<Q – Dave Manthey>: Okay. And then with a couple minutes remaining here, talk about the percentage of your sales coming through vending and implant and your total solution selling, I think you said it was 56%, but could you just talk about those components and recent growth that you've seen?

<A – Kristen Actis-Grande >: Yeah. So we have three components of solutions. We have vending, we have vendor manage inventory, and we have implant solutions. And all three of those have been part of the levers. We've been pulling on Mission Critical to drive top-line growth. The one that has been benefiting us the fastest has been the implant growth, which when we started, we wanted to go from about, it's a little bit more than 5% to 10% of revenue coming from implant solutions. We closed 2022 at like around 11% of revenue.

And so we're probably most excited about the progress that implant is making, but really all of the solutions has been growing nicely and the reason I would cite implant probably is being the one I'm most enthusiastic about is the ability to gain further share wallet from those customers. And the ability to retain that customer is significantly higher than we see in the broader portfolio of customers once we have an implant resource in place. So, you want to add anything on solutions?

<A – John Chironna>: No, just in terms of numbers. So sales to customers with Vending today is about 30% of our sales, In Plants are 11%, Kristen mentioned, and then the VMI is the remainder.

<Q – Dave Manthey>: Okay. With one minute to go. Maybe you could talk about opportunities within the government and other non-manufacturing customer verticals.

<A – Kristen Actis-Grande >: Sure. So one of the levers that we articulated on the top-line for Mission Critical is end market diversification, which we've largely been targeting public sector growth up until now. We've had a few really big contract wins in that space most recently to serve the marine basis. But we've also seen a lot of success with state government, local municipalities some hospitals, schools, universities.

We've invested strategically to add to the public sector team. And that has been paying off for us quite nicely, although you don't always see it in the numbers because there's some weird comps happening there with PPE where that end market did purchase quite a bit of PPE post during COVID and post-COVID.

<<Dave Manthey, Analyst, Baird>>

Okay. Right on the number. Kristen, John, thank you very much for the presentation.

<<Kristen Actis-Grande, Executive Vice President and Chief Financial Officer>>

Thanks Dave.

<<John Chironna, Vice President-Investor Relations and Treasurer>>

Thank you, Dave.