Company Name: MSC Industrial Direct Co., Inc. (MSM)
Event: Stephens Annual Investment Conference | NASH2022
Date: November 15, 2022

<<Tommy Moll, Analyst, Stephens Inc.>>

Well, thanks, everyone, for joining us today. I’m Tommy Moll, analyst here at Stephens. We appreciate your interest in our conference as well as MSC Industrial Direct where I’m happy to introduce Kristen Actis-Grande, CFO of the company; John Chironna, Vice President, Investor Relations. Kristen, John, thanks for joining us. We appreciate your time today.

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

Thanks, Tommy.

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

Thanks, Tommy.

<<Tommy Moll, Analyst, Stephens Inc.>>

So, I’ve got questions to keep us busy for the full 45 minutes. Although just in terms of format, after we get about 30 minutes in, I’ll look up and we’ll be glad to take any questions directly from the audience.

But let’s just start with some very high-level overview kind of questions because some of the folks in the audience may be unfamiliar with your storey or may just want a quick refresh. But you’re one of the largest industrial distributors sub-bullet under that being there’s been this big emphasis on moving from a spot-buy supplier to a Mission Critical partner. Anyone who’s looked at any of your materials in the last year or so has seen that phrase regularly. But what does that mean? And what was the genesis of that initiative?

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

Sure. So starting with the genesis, if you kind of go back about 10 years in MSC’s history around the time that Amazon entered the B2B space, MSC really took a good look kind of inside of what our competitive advantages were and really decided at that point to strategically prioritize our high-touch solutions and services business. And what that means is everything from vending, VMI, implant solutions to how we leverage our metalworking expertise.

And then the Mission Critical nature of the phrase that Tommy alluded to is really about how we partner with our manufacturing customers, in particular, to help save them money and to help improve their productivity of their operations.

<<Tommy Moll, Analyst, Stephens Inc.>>

And metalworking is a key product category, and you mentioned it already, Kristen. But can you frame the rough contribution to revenue? And then also for those who may know MRO distribution generally or industrial distribution generally, what is different about metalworking, margin, competitive dynamics?

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

Yes. So metalworking for us, the revenue is about 40% to 50% of our total MSC revenue. And what sets us apart really is that we have the largest breadth and depth of metalworking SKUs and the largest degree of expertise in the metalworking space. And that looks like the people that we employ in roles we call metalworking specialists and the people that specialize in selling metalworking products and partnering with the customer to optimize their metalworking operations.

<<Tommy Moll, Analyst, Stephens Inc.>>

Last high-level topic I want to hit before we dive in on some of the specifics, Kristen, is the family ownership. So, I think the CEO’s – your current CEO’s family member started the business over 80 years ago. There’s still a significant ownership and control element that flows from that. So what do you want to make sure investors know about any impact on operations, capital allocation alignment with the public shareholders, et cetera?

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

Sure. So the CEO of our company today, Erik Gershwind. The company was founded by his grandfather, Sid Jacobson, back in 1941. He started selling metalworking tools out of the trunk of his car to the naval shipyards that were building ships in Manhattan for World War II. And there’s a couple of things that are, I think, unique to MSC because of that.

The first is really more to do with sort of the cultural elements of the company. Before this was even really kind of a cool thing for companies to focus on. We’ve always been very focused on the individual, whether that was the supplier, the customer, the associate or what we – that’s what we call our employees internally or the shareholder.

And then I think from an operations perspective, some things about the company probably segueing to capital allocation, too, the family is really the ultimate long-term shareholder. And that definitely influences how we think about capital allocation from an operations and a capital allocation perspective, we really tend to bias towards organic investment. And we’re very focused on growth over long periods of time. And from a capital allocation perspective, I would say a focus on the ordinary dividend and occasional specials is something that you’ll see happening inside of MSC.

<<Tommy Moll, Analyst, Stephens Inc.>>

So let’s go a little deeper on Mission Critical now. Starting with each of the core tenants and the execution against those. So, I just jotted down a three, starting from the top of your P&L, market share capture, grow profits faster than sales, high teens ROIC. But just give us a little bit more on each of those goals and what you’ve done to achieve that?

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

Sure. So Mission Critical has sort of two terms inside the company. One is what Tommy mentioned, which is like the whole relationship that we want to have with the customer, but then we also branded it in early 2020 around our program that we had externally communicated to return the company to more of its previous levels of share capture and growth. So what we had done is set out a target to grow above the IP index by at least 400 basis points over a cycle.

As Tommy mentioned, to grow profits faster than sales, and one of the ways we’re doing that is really heavily focusing on the operating expense cost inside the business. And then to return ROIC to the high teens, which is more aligned with sort of historical levels ROIC for the company. And we’re about two years in on that journey today. And I think you asked me a second part of that question, too, do you want me to touch on anything within Mission Critical?

<<Tommy Moll, Analyst, Stephens Inc.>>

Well, I was just going to go a little deeper on share capture. If you can hit on some of the signature initiatives, what levers you’ve pulled there? Give us a little insight on how you index against what do you index your share? It can be a tricky exercise in your business.

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

It can be, yes.

<<Tommy Moll, Analyst, Stephens Inc.>>

And then just aggregate to the extent you can, any of the price versus volume dynamics as you’re benchmarking that share over the time?

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

Sure. So, we index against the industrial production index. That’s kind of what we’re benchmarking our basis points of growth against. We have a focus inside the company really on five growth levers, which is metalworking as we kind of discussed previously, it’s solutions, which includes vendor – vending machines, vendor managed inventory and implant resources. It’s our digital efforts and end market diversification with a specific focus on public sector. And I’m missing one, what’s the fifth one. Okay. All right.

And then you asked, I think, about price and volume, Tommy. So the other thing, when we communicated those targets, there was some element of price that was inherently contemplated in the 400 basis points of growth. We didn’t really specifically size it. But if you look back over time, we usually have about 100, 200 basis points contribution of growth from price. So that would have been sort of the rough average we had put in that 400 basis points. We've, of course, been running higher than that and a good reason for that is the contribution from price, particularly in the last year.

<<Tommy Moll, Analyst, Stephens Inc.>>

Right. Moving on to cost or rather cost out. You mentioned focus OpEx as part of this initiative to grow profits faster than sales. I just jotted down some numbers. I think 73 out of 98 branches were shuttered. There was a facility of 170,000 square feet that you sold if I remember, maybe it was a sale leaseback or you consolidated footprint in some way. There's also been some adjustments to headcount through the pandemic. So let's just step through each of those and your and the company's thinking behind that?

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

Sure. So broadly, we mentioned growing profits faster than sales. The goal that we had set for operating expense reduction was to remove $100 million of fixed costs over three years. We're $85 million into that $100 million right now. And as Tommy pointed out, we're kind of attacking all of the areas of the P&L. I'd say early on, we executed what I would call some of our big rock projects. You mentioned the sales branch shutdowns, for example. So one thing to point out is that our sales branches are not stocking locations. So they're really just sort of physical places where our salespeople or outside or inside sales people will be located.

Of course, we don't really want our outside sellers there hardly ever. So even before the pandemic has started, we have been investing in technology to allow really calls to be fielded anywhere nationally, while still maintaining that sort of local feel and touch when the customer had come to expect by having a local presence. And then the pandemic really proved to be the sort of perfect – how about I say perfect cautiously given that it was a pandemic, but really good test case for actually pulling the trigger on that. And it has been seamless ever since.

You also mentioned some things around footprint optimization with the CFCs. We've done a little bit of that. The biggest facility we probably shut down there was the one you mentioned. We've always been really asset-light. Our main distribution footprint that we have now is really our five CFCs or distribution centers that are located in the states. We have some other smaller customer-specific inventory locations or smaller warehouses that serve sort of geographic masses of customers, but largely, it's our five national distribution centers.

<<Tommy Moll, Analyst, Stephens Inc.>>

And you mentioned, I think, $100 million of cost, and that's a net number, right?

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

That is the gross.

<<Tommy Moll, Analyst, Stephens Inc.>>

So that's the gross?

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

Yes. Yes.

<<Tommy Moll, Analyst, Stephens Inc.>>

Okay. So that's the gross. And then there is a net because there's some reinvestment that you've identified as well. Some of that's on personnel, I think, on the sales force side. But just give us the overview on the buckets of that reinvestment, the timing?

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

Sure.

<<Tommy Moll, Analyst, Stephens Inc.>>

Give us the latest.

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

Yes. So the – I guess one thing I should probably back up and mention when we announced these Mission Critical targets, one of the reasons that we implemented the program was really in response to kind of our performance sort of lagging for several years. So Mission Critical was sort of revitalizing inside the company, how we executed. And as we talked about, bringing the company back to those more consistent levels of share gain, profits growing faster in sales, the higher ROIC. So, when we did the reinvestment, one of the things that was kind of fundamentally different to the company was just the concept of making sure that we were funding our growth through generating productivity on a regular basis. And while it sounds really simple to say, it's not something that the company had historically done every year.

So that's sort of a fundamental operational difference that Mission Critical is driving. The reinvestment, the two biggest buckets they're focused on was in the sales personnel and in sort of digital investment, which covers everything from some of the less sexy back-office stuff, the tech stack to what the customer does see, which is designed to make their experience with MSC better and more frictionless.

<<Tommy Moll, Analyst, Stephens Inc.>>

So you have the cost to pull out, some of which is then reinvested. What's your philosophy on how those are aligned across quarters, across fiscal years, across this multiyear journey?

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

Yes. So, we’re trying to be very balanced about making sure that the savings is obviously ahead of the investment. So that’s balancing out in our levels of profitability. We’ve largely been successful with that. I think the more – I don’t know to say the more interesting thing, but for me, the longer-term capability that Mission Critical is enabling is just the idea that we are going to generate productivity year-after-year. It’s going to be enough to cover inflation and ideally to fund some of that investment, too. So when we’re looking at our pipeline of projects inside the company, we are looking at the timing of those things coming online and then the timing of the things that we could choose to invest in and how those things balance out each other.

<<Tommy Moll, Analyst, Stephens Inc.>>

Kristen, I should remember this, but Mission Critical was rolled out after you became CFO, is that correct?

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

Yes, it was the first earnings call I did.

<<Tommy Moll, Analyst, Stephens Inc.>>

First call. Okay.

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

Yes, yes.

<<Tommy Moll, Analyst, Stephens Inc.>>

So play this forward for us. There’s this signature and branded initiative that’s communicated very publicly to investors internally, et cetera. But there may be some more permanent philosophical changes in how the business is managed where you have more of an ongoing program rather than a consultant blessed slide deck that then permeates through the organization one time, and it’s more – this is just part of how we run the business every year. So walk us through that evolution if there is one.

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

Yes. It definitely has been an evolution. It’s really part of what we’re trying to change. I don’t know if that’s a cultural change, but sort of the DNA or the fabric of how we operate inside the business. One of the things that we’ve been working on very heavily that’s sort of behind the scenes in Mission Critical is really just what the performance management process is inside the company. That’s everything from how we handle our strategic planning, to handle – how we handle strap deployment and then how we execute within a given month or quarter. That’s been something I’ve been very focused on. And I think that the Mission Critical savings we’ve talked about is really just one element within that operating system for how we're running the company and want to run the company going forward.

<<Tommy Moll, Analyst, Stephens Inc.>>

And if you think about ongoing productivity savings, just give us some examples of repeatable versions of that? I mean, with Mission Critical, your base that you're starting from allows for some onetime items consolidating the number of branches, consolidating footprint, et cetera, but there's a limit to which you can do that.

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

Yes, absolutely.

<<Tommy Moll, Analyst, Stephens Inc.>>

So what are some repeatable examples on productivity?

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

Yes. And it's actually really the pivot we're making right now. So, we talked about some of the big rock projects earlier. But as you pointed out, Tommy, you can only go so far with those. So what the kind of intended future productivity generation looks like really is hundreds of hundreds of small projects that we execute every day. And I came from the manufacturing industry where it's a lot easier to identify ongoing productivity takeout.

I mean just if you think about the complexity of the manufacturing operation, there's tons of different ways you can save money every year. Distribution is a little bit trickier. But we're focused on attacking the company through every function, leveraging lean, leveraging OpEx principles to identify those programs and really democratizing that change, because if you're going to drive productivity every year and you're doing it in a business that doesn't really have the same levels of like ways that a manufacturing operation does.

You need all the associates inside the company to be engaged in that and ideating from the bottom up. So that's the pivot that particularly in this last year, Mission Critical we've been making. There's still going to be some big rock projects in there, but it's going to be more dependent on lots of little projects that deliver that productivity.

<<Tommy Moll, Analyst, Stephens Inc.>>

So let's pivot to market share for a few minutes. MillMax, I don't think has come up today, but it's one of the capabilities that you can deliver under the metalworking umbrella. It's the one that gets mentioned most frequently by yourself and John and others, so we have to ask about it. What is it and how do you sell productivity, if that's the right way to put it to a customer? And when you kind of pierce through the strategy here, how does that unlock other pieces of that customer wallet when done well? I think that's part of the strategy, but how does that work?

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

It absolutely is. So MillMax is a tool that we have that basically is one of the ways that we partner with the customer to help them be more productive and to help them save money. What MillMax is specifically, it actually looks like this tiny little hammer. And if the customer has a milling operation, we'll send in a salesperson, partner with a metal working specialist, and they're literally tapping this hammer against the – it's the actual cutting tool or the milling tool. And it's spitting back tons and tons of data into our software about the efficiency of that operation. So it's looking at how efficiently the machine is running, how it's configured, are the specifications set tightly enough, and then we, in a matter of 20 minutes, can basically come up with a plan to help that customer run that line differently.

And that results in labor savings, it results in utility savings, scrap reduction. It's actually really incredible how, first of all, how cool it is when you tap it and all the data shows up. But it's a really great way that we're able to partner with the customer. And beyond that I think you had asked part of this in your question, Tommy, but when we're going in to partner with a customer in that way, MillMax is just one of the ways we do that. So there are two processes that we run with our customers called a business needs analysis and a customer needs analysis.

MillMax is one of the things we may offer to that customer to identify savings to them, but really what we're doing is we're going in. We're looking soup to nuts at the customer's operation. Everything from how the product is received in, how it's stocked, how it's withdrawn, the customers metal working operations, what they're buying, how many skews they're buying, and we basically come up with a plan to commit to cost savings for that customer that's documented in the B&A or the CNA. And we review that every quarter with the customer.

<<Tommy Moll, Analyst, Stephens Inc.>>

So that goes right to my next question, which was on pricing. I don't think your go-to-market is based on the lowest product price so much as a total cost of ownership perspective, which you've kind of already hit on. But when you talk about that in your materials selling on total cost of ownership, guaranteed savings, what does that mean in simplest of terms, and maybe more importantly, what incentives do you put around your sales force to sell on those terms? Are – is there more of a margin component that's in their incentive compensation, or how do you get the buy-in from those who are actually meeting the customer?

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

Yeah, so latter part first. Yes. More weighted to margin from an incentive perspective. And then from a total cost of ownership and how we sell that, it really is exactly what we talked about with the B&A and the CNA process. We're sort of holistically looking at, yes, we may be slightly higher on a piece part basis, but we're delivering savings to the customer through all other forms, not even just what the customer is buying from us. And that's really how the seller is facilitating that conversation on total cost of ownership with the customer.

And I think there's good buy in. I mean, it's probably been from a capability perspective, one of the harder parts of like making a pivot to be a Mission Critical. Like even if you look way back in 2013, I think one of the reasons that we would say it didn't gain traction as fast as we would've wanted and probably contributed to some of that lackluster performance in the late 10s. I don't know, we call that decade. But it would be really, it does take a different capability. It takes a different skillset inside the company to get your sellers comfortable having that conversation. And we feel really confident about where we are there now. And some of the work that we've done even culturally through Mission Critical has contributed to that. It's been a really strong focus on capability development.

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

I would just say add in that. When you think about us going in there and doing these business needs analyses and saving them money on not our MRO stuff necessarily, but the direct spend of the cost of goods sold of a manufacturer, that's basically 85% to 90% of their cost of goods sold. So if we can impact that number by a small percentage, it's a huge dollar amount compared to what they're purchasing from us. And especially resonating well today with the high inflation, the wage inflation and product cost inflation. So it really helps our sellers talk about price if we have to come with price increases, which obviously everyone has over the last one to two years. But it's very helpful in discussing that.

<<Tommy Moll, Analyst, Stephens Inc.>>

So we've now heard the inflation word uttered. So let's move to today's operating environment. And we'll have a robust conversation on inflation. Generally, and then we'll talk about price costs specifically, but on inflation, I think for a lot of investors, there's an association of inflationary periods tend to be beneficial for distributors such as yourself. But are there limits around that? Is there more a reasonable range of inflation, but then if it's too far up into the right than it's not necessarily a tailwind to your business, how does this current cycle feel versus prior? And just to throw another question on to this multiparter.

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

Give me a lot of remember, Tommy.

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

Yeah. When you roll over how much risk is there from input cost deflation specifically around commodities?

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

Yeah, it's interesting, if you probably asked me a year ago, was there ever a limit, I probably would've like contemplated a scenario where that was the case, but then we hit this crazy period that's happened for the past year, and my opinion would've definitely changed. So we do really like inflation from a distribution perspective, as you mentioned, it's very fairly easy for us to kind of turn around and pass on the price increases we get from our suppliers to our customers. There's a lot of transparency in that process which certainly helps us. And – so far we have not seen that limit. I think one of the reasons that we've really been successful over the last couple years is exactly what John articulated around the sort of this craziness of this environment. It does allow us to uniquely benefit the customer in a way that really pre – this crazy labor and product inflationary environment, it wasn't as obvious a conversations like coming from manufacturing.

Every year we start our budgeting, every plant manager gets a productivity target instead their four walls. And that might be anywhere from 3%, 6%, 7% depending on what the company's goals are for the year. And not surprisingly, the plant manager is going to their biggest category of spend to get that productivity, which is direct material typically followed by labor, typically followed by indirect material.

So that's the portion where we kind of lead in the relationship with the customer, but now all of a sudden we have a much captive audience to articulate how we can be supportive of their productivity efforts, not just in the indirect space, but in the direct space and also in the labor space, particularly in a metal working operation. So it's been good for us the last year for a number of reasons. Both the ability to pass price and then the ability to really have a captive audience on that productivity conversation. But I'd say the pace has continued probably more than we would've really ever contemplated if you asked me four or five months ago. And at this point, we will plan to continue taking price if the opportunity allows.

<<Tommy Moll, Analyst, Stephens Inc.>>

The pace of supplier price increases is what you were referencing specifically. So let's zoom in a little bit on price cost. Just walk us through some of the recent trends in this inflationary period and to the extent you can just because we all do this in any given quarter, distinguish on gross profit dollars and gross margin rate and how you think about when you say we're price cost positive, what that means?

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

Yes. Yeah. So on the sort of the inflation piece and the cost increases coming in with the metal working suppliers are probably the one where we're still seeing the healthiest sort of pace and amount of increases. So there is kind of an interesting dynamic between the MRO and the metal working sides of the business. When we think about the impact of price and cost inside the company the first quarter that, so we're in our fiscal first quarter right now, and this is where we would expect the maximum contribution from price on a dollar basis to happen. A lot of that has to do with the amount of increases we've taken really since January of this earlier this year.

On a cost side – so we use average costings that does create some complexity in how we model price and cost, which means that even though we've been taking all these cost increases, we won't actually peak on the P&L and cost until probably our fiscal third quarter in terms of total dollar basis. But from a margin perspective, we had a favorable price cost spread in 2022, and we would expect that to continue in 2023. The extent to which it continues and for how long will largely be dictated by the pace of increases that we see from our supplier base. But if the music were to stop sometime this year, then at some point you would have more of a headwind from cost as the price realization tapers, and we're still dealing with the tail end of the average cost coming on to the P&L.

<<Tommy Moll, Analyst, Stephens Inc.>>

And when you talk about a positive price cost spread, that means in gross profit dollars, gross margin rate of the above.

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

Both. Yeah.

<<Tommy Moll, Analyst, Stephens Inc.>>

Okay.

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

The only thing I guess I would add to that is for MSC, we have historically and continue to see a 30 basis point to 50 basis point headwind from customer mix and product mix and channel mix such that this year we're actually expecting gross margins to contract slightly in fiscal 2023. Because as the price cost spread, although it's positive, it's not as positive as it as it was in 2022. So in 2022, we actually expanded gross margins for the year. And that's because the price cost of spread was so positive, it also completely mitigated the 30 basis point to 50 basis point.

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

Yeah, that's a good point. So our guidance for the year is down 40 basis points to 70 basis points of gross margin, which was a combination of acquisitions from headwind, and then to John's point, the balance of that mixed dynamic offset by price. And then, 2024, if you do assume that pricing stops at some point this year, we're certainly not just like waiting for all the cost roll off the balance sheet. Part of the future of Mission Critical is really thinking about how can we apply some of the ways we've approached productivity generation into other parts of the P&L. So obviously, there's always a really heavy focus on product cost as you know, especially being a distributor. But we're looking at how we can attack other elements of cost within the P&L and apply some of that same thinking that we've been doing to OpEx into those areas.

<<Tommy Moll, Analyst, Stephens Inc.>>

So on OpEx, let's talk about the way up and then possibly the way down in a scenario of obsession. We talked earlier, Kristen, about some of the upfront one time, whatever you want to call it, big rock cost out items. But if you then rebase your OpEx run rate, however you want to do that, what's the philosophy on the rate at which you then start to grow that level of investment in any given quarter to continue to ensure you're leveraging there? Then in the context where your volumes are pressured, again, a recession scenario how do you try to mitigate the pain on the way back down?

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

Yeah, so we've obviously been doing a lot of scenario planning. So the way we set the guidance, we sort of have a most likely scenario between how we're going to – how the timing and the Mission Critical savings comes online, and then how we reinvest that. But from a sort of scenario planning perspective, unsurprisingly, we've spend a lot more time on that than any other normal year, but we have really clear triggers that we set. So being a distributor, being relatively short cycle, like we don't have a lot of lead time for when the fall off happens. There are certain indicators that we look for in our data to give us a head start that the slowdown is coming. But we were really very structured and clear with these triggers because we don't want to wait too long to interpret a change in the data.

And we certainly don't want to let any emotions or sort of subjective opinions about what's happening with the data delay us from reacting. So we've got these triggers and it basically looks at trending on a short, as a rolling 14-day basis for all the different things that we track on the P&L. And if those happen, we automatically go to that chapter with the playbook and implement the actions or counter measures that we have in place. A lot of them are OpEx focused because you can do that. Not easily, but relatively easy, I suppose you could say and quickly. A lot of the stuff in there is not surprising, and it's like, not rocket science, it's how you would think about your discretionary spending, how you think about your staffing levels, how you think about which investments you might bring online given the environment that you're heading into. And then some other things that I won't go too much into the specifics of, but that's the general gist of it.

<<Tommy Moll, Analyst, Stephens Inc.>>

So let's walk through a few questions, I'll ask every company I host this week around the potential for recession. It's top of mind for a lot of the investors attending here. So you've already alluded to it a bit, Kristen, but just around the planning or the scenarios that you and John and Erik and the Board think through to what extent are you committing more time to scenario planning, to just thinking through the options versus before, because you're reading the same headlines all these folks are. At the same time and by contrast, you're putting up pretty robust numbers from a P&L standpoint each quarter. But you're still seeing the headlines. So how much of your mind space is that capturing these days versus baseline a year ago or whatever?

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

A lot more than a baseline a year ago. But it's really – I'd say the biggest change was in how we approached our budgeting cycle, which because we're on an August fiscal that was happening for us over the summer just a lot more scenario planning, making the playbook specific to what we thought those scenarios might look like through the budget cycle.

But I'd say probably the biggest difference, Tommy, is before we're scenario planning would be something we would really run our team through every quarter. We just run through scenarios literally every time we pulse, every time we forecast, every time we look at monthly results. So it's not – I'd say a scenario planning isn't like an additional part of the performance management exercise we would go through.

It's just in all of the reviews we're doing because we are hearing the same things that you guys are hearing, which would tell us that depending on how pessimistic or optimistic you are, I guess, it seems like people just expect everything to fall off a cliff pretty soon. So we want to be ready for that. And as our own assumptions and projections are changing, we just refresh the scenarios every time.

<<Tommy Moll, Analyst, Stephens Inc.>>

Right. From the CFO seat, you probably spent a lot of time thinking about inventory. So let's hit that again in a recession context. If volumes start to quickly decline, what kind of risk is there to any backlog or supply chain-driven investment you've recently made in inventory? I mean yours is higher than average, however you want to define average like that of almost every one of your peers and competitors. But if things quickly turn, what's the risk there?

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

Yes. So it is higher of late, of course, because of the amount of inflation we've been taking, but also as we've been reestablishing normal stocking positions coming out of the supply chain sort of constrained environment that we were in for quite some period there. The – I don't really see any risk necessarily to what's in inventory. And part of the reason for that is there's probably still some SKUs, particularly in the metalworking space that we would take more product if we could get it.

We're not by any means constrained, and we're not at risk of not fulfilling orders. But if you think about kind of what you'd have for a normal safety stock level, there are some SKUs we still haven't been able to bring all the way back up to sort of our preferred level. So there's actually within that inventory balance, still some things we would take more of if we can get it.

So I don't see a lot of risk when I think about the inventory balance and a slowdown. And then, of course, we throw off a lot of cash as things stabilize and especially as things slow down, we've been consuming a lot of working capital as the business has been growing for the past couple of years.

<<Tommy Moll, Analyst, Stephens Inc.>>

So maybe the risk level is low in your mind, but are you seeking more regular reporting from folks on weekly, monthly inventory levels? Is there an enhanced level of CFO scrutiny on check sizes that...

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

Yes. Yes, there is – there definitely is. And actually, the period where we're in right now, we're usually looking at different year-end buys, too. So we're looking at that through a different lens than we might normally look through it. And then just like everything else in the company where we've been changing the performance management processes, we've also implemented new things around inventory and operations planning process sort of how we build consensus and cross-functional alignment around those decisions.

<<Tommy Moll, Analyst, Stephens Inc.>>

Yeah. On pricing, are there any precedents you could cite from prior downturns on how pricing tends to react in your business?

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

Yes. So the – for us, when we think about the ability to price and price realization, it's really more about what's happening sort of in the economic environment from an inflationary perspective. We've never gone backwards on price in a downturn. I think certainly, you would want to think about the customer being more price sensitive, but we have not really had a challenge managing through that.

And I think even now with the work we've done on the pivoting to the high-touch solutions and services, the ability to save the customer money, I think we're even better positioned to weather that.

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

I think some of that's because a lot of products we're selling can be highly engineered like cutting tools and such as opposed to some other end markets, I don't know, maybe construction where it's more commodity focused. So they do see pricing declines.

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

It's a good point, yes.

<<Tommy Moll, Analyst, Stephens Inc.>>

So I've got one more question I want to make sure to ask and then I'll turn it to anyone in the audience to ask a question. But Kristen, it's been over two years, I think, since you've been in the CFO seat. So I want to reflect on your tenure thus far. There have been some cultural changes at the company, some of which you've initiated, some of which others have initiated.

There's been some senior personnel adds or realignment, I guess. You've got a new COO, I believe, first time ever in the company's history. I say new head of sales, although the individual is not new for your company, if I remember correctly There's a lot more robust planning and process, at least in what's communicated to the Street since you've been in the CFO role.

So maybe just cherry pick what's most impactful from that list that you want to make sure to highlight for folks is what's different today?

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

Yes. I think there's probably – if I only have to pick two, I'll pick the performance management process changes that we've made, which is one of the key reasons that I was brought in. We've been very successful at that. And I think one of the things that attracted me at MSC wasn't just sort of what they wanted in the job, but I did really see things that were unique about the culture and the values of MSC that was really what prompted me to make a move after 17 years in the same place, the values and the culture of the company that I came from were really important to me and having been there for so long, I felt like I had a chance to sort of positively impact what had changed about that company over that time period.

So joining somewhere that had things that were similar was very important to me. But it was also pretty obvious that there were things that were uniquely great about the culture that we wanted to keep. But things that we felt we could evolve and make sharper and more agile by changing the performance management process, which is really one of the main things I've been working on, and I touched on it earlier, but that's really everything from standard work for strategic planning all the way to standard work for how you review results and how you forecast. It's the whole end-to-end performance planning process.

And then probably the second thing I would point out, you mentioned a lot of the changes at the top. So I am with the exception of Erik now, the most tenured leader on the executive team some – all my two years in, which is saying a lot for a company like MSC, where you have some very tenured associates. But I am very, very excited about the executive team that we have right now.

It's my favorite thing to talk about lately, but we have had a new SVP of sales that was promoted internally. She is incredible. The depth of knowledge that she has and the way that she leads her team, I'm not sure I've ever met a leader who was – had more people that worked for her willing to literally run through a brick wall if she asked them to. It's pretty incredible. She's wonderful.

We've also brought in a new Chief Digital and Information Officer, John Hill. He has a really incredible background, and I love what he's been doing already in his first six months with the company. And then most recently, we added Chief Operating Officer, which we actually did have that role once before, and it was right before Erik became the CEO. So we have a COO now, Martina McIsaac that joined just about, I don't know, like a month or two months ago probably.

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

Yeah, two months.

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

I – it’s early days, but I am really, really excited about her and really excited to have a partner that has the same focus on culture and performance management and lean that I do, and I’m excited to have someone help drive that change through the company. So really, really excited about her.

And it also is going to allow Erik to focus more of his time on the strategy of the company. It will prevent him from getting less dragged into some of the day-to-day things. So I think we’re all very excited about what’s happening right now.

<<Tommy Moll, Analyst, Stephens Inc.>>

So we have a full room. I’m sure someone in the audience would like to ask a question or two. Just raise your hand if you’d like to ask anything. I’ve got a few more I can keep working through, but I want to give everyone a fair shot here. Going once, going twice. All right. Well, I’ll keep asking.

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

Fire away.

<<Tommy Moll, Analyst, Stephens Inc.>>

We haven’t talked about capital allocation. You did reference regular dividend. There have been specials paid over time. Then obviously, you’ve got repurchase and M&A as well.

But maybe first, let’s just hit on the dividend piece. How do you think about the pace of increases for the regular when a special is appropriate? What the history on the special is for your company because a lot of companies, it’s less common, I think, across the street. So any context there would be helpful for investors.

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

Yes. So I think right now, a lot of the conversation has really been on focusing on around how can we commit to a regular kind of steady increase in the ordinary dividend. We have – if you look back over kind of the history of the company, capital allocation really is relatively well balanced between organic investment, dividends, share repurchases and M&A.

But if you look in the last couple of years, there has been – there was a stronger slant towards specials for a period there. On average, if you go back further than that, the company paid a special roughly every four years really as the cash built up, they would pay out a special and roughly averaged out to every four years.

I think given the environment that we’re in now, obviously, the interest rates being higher is changing our perspective on certain levers within capital allocation. But we have been doing a little bit more on share repurchasing of late. We think the stock is really cheap right now. We’ve been trying to take advantage of that. We did increase the ordinary dividend announced at our last earnings release, and then we have been a bit more acquisitive in the past quarter or so to sort of pace of interest from local distributors has increased, and we've taken advantage of a couple of companies that we've had our eye on.

But I think this environment is definitely going to change how we look at things. And I – our priority has always been organic investment. I don't see that changing, but anything that requires debt is going to be a little more heavily scrutinized.

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

Yes. And I would just add that on the ordinary dividend, we – the philosophy for the company has been to continually increase it, which we've pretty much done since we implemented one 25 years ago, I think it was. With the exception of the pandemic where we didn't cut it, we kept at the same level. Obviously, we'd like to see earnings growth and continued increase in ordinary dividends and then everything else is still true.

<<Tommy Moll, Analyst, Stephens Inc.>>

You mentioned rising interest rates, which I would think may have an impact on relative priorities for capital allocation. So maybe obviously, it would make you less likely to lever up for an acquisition, for example. But at a higher level in an environment where the risk of a recession is increasing, the cost of capital is increasing. Based on what you know now, how does that impact capital allocation?

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

Everything has to look a lot better for us to choose to invest in it right now. I mean we're – so kind of stepping back, we're in a pretty good position from a leverage perspective. We are – we've been hovering between 1.5 and two for the last, I don't know 18 to 24 months, probably. Before that, more like one to 1.5. We tend to feel pretty comfortable going up to three, philosophically. But obviously, with the criteria for what we would be willing to do that for right now is a lot higher. The criteria is a lot higher, a lot stronger, paybacks have to look a lot better. I don't really contemplate any sort of significant requirements from an increase in debt perspective, but we'll continue to scrutinize everything.

And the philosophy has always been to put the dollar to its best and highest purpose, and that's an area where having a family ownership element certainly and the long-term focus certainly ensures that, that happens.

<<Tommy Moll, Analyst, Stephens Inc.>>

Yes. Last question from me before we wrap it today on end markets, which we shouldn't wrap before we at least hit a couple of your large ones. But heavy and light manufacturing, respectively, are 50% roughly and 20% of your sales. There are some components of those, I'm thinking specifically about aerospace and automotive, where in recent quarters, you've called out, I'll say a delayed recovery or a recovery that has lacked out of the broader industrial ecosystem.

But what more recent commentary can you give us on some of those end markets? And what do you want to make sure investors know about your big exposures in those two that I mentioned?

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

Yes. So broadly, direct exposure to aero and auto is 10% each, so 20% combined. And we have seen sort of a delayed recovery there. So we think about that as a tailwind opportunity for the company. Indirectly, we have more exposure than that. So if you look at kind of our end markets, the way we'd articulate it is roughly half of our end markets, we can really cleanly attribute to sale to.

The other half, we have to kind of indirectly make some assumptions around where that product goes. And if you think about like a machine shop, they're machining for all different types of customers. So it's hard for us to point to that customer and say, okay, they map to aero or – so it's larger than that indirectly, but we see that as a tailwind for the company right now.

<<Tommy Moll, Analyst, Stephens Inc.>>

Great. Well, that's all we have time for today. But again, I want to thank everyone for your interest in our conference and this fireside with MSC Industrial Direct. Kristen, John. We appreciate your time.

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

Thanks, Tommy.

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

Thank you, everyone.

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

Thanks, everyone.