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Core & Main, Inc. (CNM)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to the Core & Main Q4 2021 Earnings Call. My name is Alex, and I'll be coordinating the call today. [Operator Instructions] I will now hand over to your host, Robyn Bradbury, with Core & Main to begin. Over to you, Robyn.

Robyn Bradbury

Vice President-Financial Planning and Analysis & Investor Relations, Core & Main, Inc.

Thank you. Good morning and welcome to the Core & Main Fiscal 2021 Fourth Quarter and Full Year Earnings Call. This is Robyn Bradbury, Vice President of Investor Relations and FP&A for Core & Main. Thank you for joining us this morning. We're excited to share our results with you.

Steve LeClair, our Chief Executive Officer, will lead today's call with our fourth quarter and full year execution highlights, followed by a discussion on recent topics of interest. Mark Witkowski, our Chief Financial Officer, will then discuss our financial results and fiscal 2022 outlook, followed by a Q&A session. We will conclude the call with Steve's closing remarks.

For Q&A, please limit to one question and one follow-up. If you have additional questions, you may return to queue. Thank you for your cooperation.

Some of the information you will hear today may include forward-looking statements. Forward-looking statements include all matters that are not historical facts. We may include statements regarding our intentions, beliefs, assumptions, our current expectations concerning our financial position, results of operations, cash flows, or

growth strategies. Forward-looking statements are subject to known and unknown risks and uncertainties, many of which may be outside of our control.

We caution you that forward-looking statements are not guarantees of future performance or outcomes and that they may differ materially from those made in or suggested by the forward-looking statements contained on this call. These forward-looking statements are made only as of the date of this call. We do not undertake any obligation to update or revise any forward-looking or cautionary statements to reflect changes in assumptions, the occurrence of events, or changes in future operating results.

In addition to providing results that are determined in accordance with US GAAP, we present certain non-GAAP financial measures to assess the operating results and effectiveness and efficiency of our business. We present these measures because we believe investors consider them to be important supplemental measures of performance. For a reconciliation of the non-GAAP measure to the nearest GAAP measure, please refer to the slides and the appendix of the fiscal 2021 fourth quarter investor presentation, which can be found on the Investor Relations section of our website.

Thank you for joining us this morning and for your interest in Core & Main. I will now turn the call over to Chief Executive Officer, Steve LeClair.

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Thanks, Robyn. Good morning, everyone. Thank you for joining us today, and welcome to our fiscal 2021 fourth quarter and full year earnings call.

Fiscal 2021 was a remarkable year for Core & Main. We delivered record financial performance, while delivering on our pledge of dependable service to our customers and suppliers in challenging market conditions. The strength, flexibility and resilience of our business model was exemplified as we fulfilled unprecedented levels of demand. We continue to execute in our strategies to grow the business and strengthen our operational capabilities while delivering value to our customers, supporting our associates, and achieving strong financial performance. We navigated through supply chain challenges while continuing to deliver extraordinary service to our customers.

Infrastructure solutions are localized and must meet product specifications and engineering standards that vary from one municipality to another. Our customers count on us to provide the right solutions to meet these local requirements. Equally important, access to specialty products is critical to our customer success and completing a project on time and on budget. We have maintained industry-leading product availability during a period of unsurpassed scarcity, a testament to our value proposition. Our customers choose us for the breadth of our products, extensive industry knowledge, familiarity with local specifications, convenient branch locations, and reliable delivery capabilities. Throughout the year, we strengthened our connections with existing customers, and developed relationships with many new customers across the country.

Our success is linked to the quality of our team, the depth of their expertise and their commitment to overcome any obstacle to achieve our goals. When confronted with a difficult operating environment, our associates adapted and continued delivering on our promise of providing local knowledge, local experience, and local service nationwide. I would like to express my sincere gratitude to all of Core & Main's 4,100 associates for their unwavering dedication, determination, and resilience. Our associates are the best in the industry, and I'm inspired by their exceptional service to our customers, suppliers, communities, and to each other.

In fiscal 2021, we delivered just over \$5 billion of net sales, up 37% over fiscal 2020; and \$604 million of adjusted EBITDA, up 77% over the prior year. Our sales growth was driven by strong demand across each of our end markets, higher average selling prices as we pass along rising material costs, solid performance across our sales initiatives to deliver market share gains and acquisitions. We also achieved share gains from having preferred access to products during a period of material shortages. Our teams leveraged a strong sales growth through the expansion of our margin enhancement initiatives and disciplined cost management to achieve record profitability in fiscal 2021. Our focus on pricing analytics and operational execution at both the corporate and local levels produced solid margin results despite the intensifying inflationary pressures we faced.

We finished the year strong from an M&A standpoint, adding five extraordinary businesses to our team in fiscal 2021 and acquiring Dodson Engineered Products subsequent to year-end. Each of the acquisitions fits well within our M&A strategy, offering expansion in new geographies, access to new product lines, consolidation of existing market positions, and the addition of key talent.

Dodson Engineered Products is a single-branch, full-service distributor of water, wastewater, storm drainage, agricultural and irrigation products based in Western Colorado. Founded in 1970, Dodson has a long history as a trusted and reliable partner to its customers, suppliers, and associates. The opportunity to bring in companies such as this in the Core & Main family provides strategic value and will allow us to expand our reach to better serve customers in Central and Western Colorado.

As part of our sales initiative to deliver above-market growth, we opened three new greenfield locations throughout fiscal 2021. These new locations will allow us to expand into new geographies and expand underpenetrated product lines. Despite our vast geographic footprint, there is significant remaining white space across the country, and our team uses a data-driven strategy to identify and evaluate these markets. We have a pipeline of priority markets that we are targeting for greenfield expansion, some of which could convert in the coming quarters as we align sales, talent, and operating facilities.

Turning to page 6. I'd like to highlight an example of how we deliver significant value to our customers and their projects. In February 2021, sewage poured into the streets and across the yards of Ventnor Heights, New Jersey residents due to a major pipeline leak. After inspecting the job site, county engineers consulted with our local team when they discovered the diameter of the pipe was unusual and inconsistent with today's standards.

They needed product expertise and an innovative repair solution. Our local product specialists were able to provide our customer engineered drawings and a quote within 24 hours to let them know exactly what was needed to repair the rupture in the line. We produced and delivered a custom retrofit solution with specialty fabricated fusible HDPE pipe and fittings. With our HDPE fusion equipment and technician on the job, the solution we provided was a success. Our local New Jersey team embraced the responsibility to their community and their environment to keep our water infrastructure up and running, while leveraging our regional product specialists and resources. We do work like this every day. Our associates live and work in their local communities, and partner with them to ensure the best solutions for any water or wastewater infrastructure needs.

Product availability challenges persisted through the fourth quarter and continue today. But given our long-standing relationships with our suppliers and leadership position in our industry, we have been able to gain preferred access to products to continue serving our customers. Although we believe supply chain disruptions will continue to impact lead times and project cycles through at least the first half of fiscal 2022, our overall sentiment remains positive and our strong backlog is indicative of future demand.

If supply chains normalize, we expect to release products reserved for jobs held in backlog. Throughout the course of the year, our inventories and backlog have grown as a result of us holding inventory for customers until we can secure all the necessary parts and components to ship the complete solution and support our customers' installation schedules.

Material cost inflation. We continue to experience rising material costs across nearly all product lines in the fourth quarter due to strong demand, constrained manufacturing capacity, shipping container shortages, and port congestion that has impacted our suppliers. Our teams continue to navigate the inflationary environment exceptionally well by partnering with our customers to give them timely notice of market price increases, and locating the products they need so they can complete their projects as scheduled.

PVC pipe prices have inflated more than any of our other product lines and have remained at an all-time high. While it's possible to PVC pipe prices could decline at some point, there are a number of factors that are keeping prices high in the near term, like strong demand, continued supply constraints due to raw material shortages, and tight manufacturing capacity. It's important to note that every piece of pressurized PVC water pipe has to undergo pressure testing to pass American Water Works Association Standards, which is unique to our industry and can cause PVC pipe pricing to move in different cycles in general purpose resin use for other applications.

Additionally, we continue to experience price increases across many other product lines that could offset any potential future deflationary pressure from our commodity-based products like PVC pipe. During the fourth quarter, we continued purchasing inventory ahead of supplier cost increases, resulting in gross margin rate expansion. If procurement costs stabilize in fiscal 2022 or we don't receive advanced notice of material cost increases, we would expect to continue passing along the higher selling prices, although gross margin rates may contract as we lose the benefit of lower cost inventory. Through the first few months of fiscal 2022, we have seen prices remain high and even increase across most product categories.

M&A pipeline. We have a strong track record of acquiring and integrating businesses, and we continue to cultivate a solid pipeline of targets for the short and long term. We have closed 17 acquisitions since becoming an independent company in 2017, adding more than \$650 million in annualized net sales. We have a streamlined process of identifying attractive bolt-on opportunities and we are well-positioned to source, acquire and integrate new businesses. We believe we are widely viewed as the acquirer of choice due to our longstanding relationships and entrepreneurial culture and our investment in the development of our people. Our industry is large and highly fragmented. Our pipeline continues to be robust. And as we look ahead, we see a long runway for growth through M&A.

Capital allocation priorities. We have significantly improved our financial flexibility as a result of debt repayment from the proceeds of our initial public offering. We have a stronger balance sheet, lower cash interest payments and substantially reduced net debt at the end of the fiscal year. The reduction in net debt leverage provides us with greater optionality to invest in value-creating growth opportunities moving forward.

Our current capital allocation priorities continue investing in organic and inorganic growth opportunities, although we will evaluate other capital allocation options as we generate strong cash flow over the next year and beyond. Over the course of the last few years, we've been able to successfully execute in our growth and M&A strategies, while also paying down debt using our cash flow. We are comfortable operating in the 2 times to 3 times net debt leverage range, while making investments to grow the business.

Infrastructure bill. We are optimistic about the opportunities provided by the Infrastructure Investment and Jobs Act, a once-in-a-generation bill that makes transformational investment in our nation's infrastructure. An infusion

of funds of this magnitude has immense implications to accelerate the repair and replacement of aging water infrastructure; and it will lead to a more sustainable future for our communities.

While we believe that the new infrastructure bill will provide multi-year tailwinds for the municipal water sector, we also believe it will take time before we see those funds flow through to our business as a result of constrained supply chains and industry-wide labor shortages. It's likely that we may not see incremental volume from the bill until 2023 or beyond. However, we are well-positioned to capitalize on the favorable tailwinds due to our market leadership position and competitive advantages.

Current market events. There are a few recent themes in the global macroeconomic backdrop I'd like to address. First is the conflict in Ukraine. Core & Main does not have any direct business exposure to either Russia or the Ukraine, but it's still difficult to determine what supply chain or demand impacts could arise from the ongoing conflict. Given the recent ban on Russian imports, we could see further impacts to our supply chain, and we will most likely be impacted by inflationary pressure on fuel costs. We may also see inflationary pressure in certain product categories linked to supply chain shortages. We are confident that we remain well-positioned to navigate any environment due to our size, scale and ability to access products.

We have not seen a slowdown in demand related to economic inflation or rising interest rates. Demand has continued to be strong. If inflation or interest rate increases continue, it is possible we could see affordability challenges across our end markets, which could impact demand. We are not seeing anything like this currently. But if we do, we believe we are well-positioned given our mix of repair and replacement projects in the municipal end market.

As I look ahead to fiscal 2022, I am confident that Core & Main is investing in the right areas and at the right time. We are deepening our competitive advantage and building on our foundation of long-term profitable growth. We have multiple levers for organic growth, continually cultivating ways to grow faster than the market and gain market share. We are poised to benefit from favorable industry trends. We have an attractive and resilient financial profile with strong return characteristics. We have gained significant market share, built robust capabilities, and are in good position to deliver strong performance this year and many years to come.

I will now turn the call over to our Chief Financial Officer, Mark Witkowski, to discuss our fiscal 2021 fourth quarter and full year financial results followed by our fiscal 2022 outlook. Go ahead, Mark.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Thank you, Steve. Good morning, everyone. Turning to page 9. I'll begin by covering our fourth quarter operating results. Net sales in the fourth quarter were \$1.2 billion, an increase of approximately 50% over the prior-year period. The increase was driven by higher average selling prices, strong volume growth, and acquisitions. Sales benefited from volume growth across each of our end markets, in addition to more moderate weather this year than last year. The municipal market continued to experience strong demand due to growth in water and wastewater infrastructure spending.

Residential land and lot development continued to be robust in the quarter. We've also started to see growth accelerate across the non-residential market, as demand continues to catch up to pre-pandemic levels. We experienced strong volume growth across each of our product lines in the fourth quarter, except for our meter products due to shortages of semiconductor chips that are components of certain smart meter products. Our sales initiatives and our industry-leading product availability allowed us to outperform our end markets and deliver above-market growth during the quarter.

Roughly two-thirds of our net sales increase in the fourth quarter was due to higher average selling prices, which was much more than expected and driven by our team's ability to pass along rapidly rising material costs. We continue to experience rising material costs on nearly all product lines due to unprecedented demand and constrained supplier capacity. Despite these challenges, our teams navigated the inflationary environment well, working closely with our suppliers to secure products and giving advance notice of price increases to our customers.

Acquisitions contributed approximately five points of sales growth in the fourth quarter. Gross profit in the fourth quarter increased 60% to \$327 million. Gross profit as a percentage of net sales was 26.2% compared with 24.5% in the prior-year period, an improvement of approximately 170 basis points. The increase was primarily attributable to strategic inventory investments ahead of announced price increases, a favorable pricing environment, and the execution of our gross margin initiatives such as expanding private label, achievement of growth-based supplier incentives and accretive acquisitions.

Similar to the third quarter, our gross profit was positively impacted by our inventory purchases ahead of supplier cost increases, which results in a lagging, weighted average cost of goods sold relative to current market prices. We're also operating in a significantly less sensitive pricing environment due to industry-wide product shortages which we benefited from due to our investments in inventory. We continue to make great strides across our pricing and private label initiatives, delivering sustainable gross margin rate expansion relative to the prior year. We also achieved gross margin synergies from our recent acquisitions, which we expect to benefit from on a go-forward basis.

Selling, general and administrative expenses for the fourth quarter increased 33% to \$183 million. SG&A as a percentage of net sales was 14.7% compared with 16.6% in the prior-year period, an improvement of approximately 190 basis points. The decrease in SG&A as a percentage of net sales was due to our ability to leverage our fixed costs, partially offset by higher variable compensation costs, higher costs from acquisitions, and increases in other variable costs due to volume inflation.

Adjusted net income increased \$72 million to \$73 million in the fourth quarter. The increase was due to strong sales growth, gross margin rate expansion and SG&A cost leverage. In preparing adjusted net income, we exclude the effects of non-controlling interest as we evaluate and manage the business as a whole.

Adjusted EBITDA grew 113% to \$151 million, improving adjusted EBITDA margin by approximately 360 basis points. The increase in adjusted EBITDA margin was due to strong net sales growth, gross margin rate expansion and leveraging our fixed cost structure on the sales and gross margin growth.

Turning to page 9 (sic) [page 10], I'll now cover our fiscal 2021 full-year results. Net sales for fiscal 2021 were just over \$5 billion, an increase of nearly 37% over fiscal 2020. The increase was driven by higher average selling prices due to rising material costs which contributed approximately half of our net sales increase, strong volume growth, and acquisitions. Our sales benefited from volume growth across each of our end markets throughout the year. We estimate that the residential end market experienced low-double digit volume growth due to robust land and lot development activity to support housing demand.

We've recently seen an acceleration of volume growth across the non-residential construction market as local economies continue to recover and as demand returns to pre-pandemic levels. We estimate that our non-residential end market grew at a low-single digit rate this year. Municipal repair and replacement volume grew at a

low- to mid-single digit rate due to healthy municipal budgets and better access to low-cost capital. Overall, we believe our end markets delivered mid-single digit volume growth in fiscal 2021.

We achieved considerable share gains due to our sales initiatives and also from having preferred access to products during a period of material shortages which allowed us to acquire many new customers. Our product, customer, and geographic expansion initiatives delivered solid performance throughout the year. We've continued to accelerate the adoption of new products in our industry, such as feasible HDPE solutions to our waterworks customers like the projects Steve discussed earlier, fabrication and kitting assemblies for fire protection contractors, and new water retention and erosion control systems.

We've also increased our share with strategic accounts who typically pursue complex projects that require greater technical expertise and specialized procurement needs. The combination of our growth initiatives and winning new customers allowed us to achieve above-market growth well in excess of our historical average annual share gains.

Acquisitions contributed approximately 3 points of sales growth in fiscal 2021. Gross profit for fiscal 2021 increased 46% to approximately \$1.3 billion. Gross profit as a percentage of net sales was 25.6% compared with 24.1% in fiscal 2020, an improvement of approximately 150 basis points. The increase was primarily attributable to strategic inventory investments ahead of announced price increases, a favorable pricing environment, the execution of our gross margin initiatives, achievement of growth-based supplier incentives and accretive acquisitions.

We estimate that roughly 50 to 100 basis points of our fiscal 2021 gross margins may be temporary in nature as a result of our inventory investments, the favorable pricing environment, and resetting of certain growth-based supplier incentives. However, we have multiple margin initiatives in place to help offset this impact of temporary gross margin rate benefits.

Selling, general and administrative expenses for fiscal 2021 increased 29% to \$717 million, while SG&A as a percentage of net sales improved approximately 100 basis points to 14.3%. SG&A as a percent of net sales declined due to strong cost leverage, partially offset by higher variable compensation costs, \$21 million related to higher equity-based compensation expense due to accounting for equity awards, and \$5 million due to costs in connection with the IPO and secondary offering.

Interest expense for fiscal 2021 was \$98 million compared with \$139 million in fiscal 2020. The decrease was attributable to the redemption of the 2024 senior notes, the redemption of the 2025 senior notes, and lower interest rates on the senior term loan due to refinancing transactions completed in July.

Income tax expense for fiscal 2021 was \$51 million, compared with \$9 million in the prior year, reflecting effective tax rates of 18.5% and 19.6%, respectively. The effective tax rate declined in the current year due to certain fixed tax expenses and permanent differences decreasing as a percentage of pre-tax income.

During the fourth quarter, a secondary public offering of 20 million shares of Class A common stock was completed by certain of our shareholders. We did not receive any of the proceeds from the offering. In connection with the offering, approximately 7.5 million partnership interests were exchanged for shares of Class A common stock, together with the retirement of a corresponding number of shares of Class B common stock.

As a result of these exchanges, we acquired certain tax attributes held by CD&R and its affiliates. We expect that these tax attributes will reduce our future tax – cash tax payments to taxing authorities. Under our tax receivable

agreements, we recorded a payable that represents 85% of these anticipated tax savings while we retain the remaining 15% as cash tax savings.

A summary of each TRA is located in the appendix of the presentation. Because we only make TRA payments if we achieve the benefit of a cash tax savings, we do not consider TRA liabilities current or future to be debt-like items.

Following the offering of CD&R and its affiliates, ownership decreased to roughly 70%. Adjusted net income increased \$223 million to \$266 million for fiscal 2021. The increase was due to strong sales growth, gross margin rate expansion and SG&A cost leverage. Adjusted EBITDA grew 77% to \$604 million, improving adjusted EBITDA margin to 12.1% from 9.4% for fiscal 2020, and growing nearly 2 times the rate of our sales growth. The increase in adjusted EBITDA margin was due to strong net sales growth, gross margin rate expansion, and leveraging our fixed cost structure on the sales and gross margin growth.

On page 11, I'll now cover our cash flow and balance sheet highlights for the year. We had an operating cash outflow of \$31 million in fiscal 2021, with the increase in profitability more than offset by investments in operating capital required for strong sales growth and to ensure product availability for our customers. We made additional investments in inventory that we believe were prudent and necessary to ensure our customers could complete their projects on time. Additionally, our operating cash taxes were roughly \$47 million higher than the prior year period due to higher pre-tax book income. While we made substantial investments in operating capital this year, our after-tax operating profit, excluding intangible amortization relative to our year-end balances of accounts receivable, inventory, PP&E and accounts payable was just over 40% for fiscal 2021.

Our net debt at the end of the quarter was \$1.492 billion, bringing our debt leverage down to 2.5 times. The reduction in net debt leverage compared with the end of fiscal 2020 was attributable to debt repayment from the proceeds of our IPO, in addition to an increase in adjusted EBITDA. We expect to improve our – and maintain our net debt leverage in the near-term despite making strategic investments to grow the business. In the near-term, to fund operations, anticipated capital expenditures, scheduled principal and interest payments on our term loan and continue to pursue our growth strategies.

I'll wrap up our prepared remarks on page 12 with a discussion on our outlook for fiscal 2022. Fiscal 2021 was a transformative and record year, and we entered fiscal 2022 with strong backlogs and great optimism. The underlying pace of demand appears favorable across each of our end markets. We expect residential housing tailwinds to continue given the undersupply of new homes and population shifts, despite homebuilders having to navigate ongoing labor and material shortages.

The macro environment for non-residential construction continues to be well supported. We saw an increase in non-residential construction in the second half of fiscal 2021, and we expect those trends to continue into 2022 as demand returns to pre-pandemic levels and as commercial construction activity expands to support growth and housing development. We expect municipal repair and replacement activity to remain strong, and we see favorable tailwinds leading into 2022.

Municipal budgets are healthy. Municipalities have access to low-cost capital and the need to repair aging infrastructure is growing in importance and significance. Municipalities have increased water and wastewater utility rates each of the year over the last decade, highlighting their ability to effectively increase revenue to improve their aging infrastructure systems.

While we're excited about the long-term positive impact the Infrastructure Investment and Jobs Act could have on our water infrastructure, we have not included any incremental benefits associated with the bill in our assumptions for 2022 guidance. We saw some projects scheduled for delivery in fiscal 2021 get delayed and pushed into fiscal 2022 due to supply chain constraints, which could provide tailwinds in the first half of the year.

We will continue to execute on our growth strategies and focus on the controllable areas of our business, including ensuring product availability for our customers, remaining ahead of inflationary or deflationary pressures and driving productivity gains and effective cost management.

We expect favorable impacts from higher average selling prices to continue through at least the first half of the year, potentially moderating in the second half as we approach more difficult comparisons. Even with the potential for price deflation if supply chains normalize or if demand softens, we expect to generate a favorable net sales benefit in fiscal 2022 due to the timing and magnitude of price increases in the prior year.

In terms of acquisitions, we currently have a strong pipeline of high-quality targets, and we look forward to adding more of these companies to our team throughout the year. Our recent acquisitions are performing well, and we expect them to contribute 2 to 4 percentage points of top line growth this year. Based on these factors, we expect fiscal 2022 net sales to grow in high-single to low-double digit range, with strong growth in the first half of the year but moderating in the second half with more difficult comparisons.

Regarding our gross margins, we do not expect to repeat the significant price realization benefits we achieved in 2021 during the rapid rise of inflation. I mentioned earlier that we believe our fiscal 2021 gross margins included roughly 50 to 100 basis points of potential, temporary one-time benefits. However, we have margin initiatives in place to help offset some of the potential pressure related to these one-time benefits. We expect first quarter gross margins to be weaker sequentially than our fiscal 2021 fourth quarter due to the resetting of growth-based supplier incentives and if inventory cost catch up with market prices.

While we expect to achieve SG&A leverage for the full year, we anticipate our adjusted EBITDA margin may decline modestly in 2022. With all of these factors in mind, we anticipate our fiscal 2022 adjusted EBITDA to be in the range of \$595 million to \$635 million. This includes only the contributions from acquisitions that have already closed. At the midpoint of our range, we expect 12-month adjusted EBITDA to be above our \$604 million of fiscal 2021 adjusted EBITDA each quarter throughout the year.

We expect that our fiscal 2022 results could be front-end loaded with stronger performance in the first half, slightly subsiding in the second half if supply chains normalize and commodity prices decline. Additionally, it will be challenged with tough year-over-year comparisons throughout the second half of the year.

We expect interest expense to be in the range of \$58 million to \$60 million for the year. Our term loan carries interest of LIBOR plus a margin of 250 basis points on the unhedged portion of the facility. In July of 2021, we entered into a five-year fixed interest rates hedge with a notional value of \$1 billion to lock in LIBOR rate at 74 basis points. We anticipate an effective tax rate of approximately 20% in fiscal 2022. This is slightly higher than our 2021 effective rate due to more Class A shares which result in more taxable income to Core & Main, Inc.

Regarding our cash flow, we typically convert roughly 60% to 70% of our adjusted EBITDA into operating cash flow, with fiscal 2021 being an exception, as we invested heavily in working capital to support growth and ensure product availability for our customers. We expect to convert roughly 85% to 100% of our adjusted EBITDA into operating cash flow in fiscal 2022, as we optimize our inventory balances in the second half of the year. We have

historically generated the majority of our cash in the back half of the year and as we unwind working capital, and we expect the same trend in fiscal 2022.

To close out our prepared remarks, we are very proud of our record fiscal 2021 fourth quarter and full-year financial results. Despite the challenges we faced this year, our teams continue to execute flawlessly. We continue to focus our efforts on delivering sustainable market share gains, improving profitability and generating strong operating cash flow.

That concludes our prepared remarks. At this time, I'd like to turn the call over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question for today comes from Matthew Bouley of Barclays. Matthew, your line is now open.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Hey. Good morning, everyone. Congrats on the results. Thank you for taking the questions this morning. So first one, I guess, on the gross margin outlook. I think, Mark, you said, Q1 might be down sequentially. But my question is, I mean a lot of your commentary is around sort of the continuation of tight supply chain and inflation continuing to rise which has obviously supported the gross margin over the past year. So kind of how are you balancing that? I mean, what's it going to take to really see gross margins to normalize assuming these positive drivers seem to continue to be in place? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Matthew for the question. As you look at the first quarter relative to the fourth quarter, I think we see a slight decline there just sequentially due to resetting some of the growth base supplier incentives. And then, you're spot on. I mean, it's really going to take some freeing up of this supply chain given kind of what we're seeing. So I wouldn't say, as we sit here today, that's necessarily the case. But certainly, as we get potentially into Q2, Q3 timeframe, if we see some of those prices start to stabilize, that's maybe when we start to see some of these costs catch up.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Okay. But it's a fair characterization that as supply chain and inflation sort of remain at this type of levels then that kind of abnormally high gross margin may persist?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Certainly, that could persist, Matthew. I think one thing that we're keeping an eye on is our ability to get advance notice. We're starting to see some of these price increases come even faster at this stage, so that'll be a potential headwind that we face if we are unable to continue to procure these types of products without advance notice like we've been able to in fiscal 2021.

We could see some pressure there, but we do expect to continue to get those passed along as timely as we can. But certainly, we did see some very strong gross margin expansion in 2021 and just don't expect kind of at those levels.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Okay. That's fair. And then, second question just on the guide. Maybe just focusing on the revenue guide, curious if you could sort of break out the assumption of price versus volume in that? Because, obviously, you're speaking to some normalization in price perhaps in the second half, so it'd be sort of helpful to understand what you're really assuming on the pricing side as we kind of model the cadence through the year. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Sure. No problem. As you look at volume in the 2022 outlook, we've got to kind of low- to mid-single digit with market and our above-market growth initiatives that we've got, pricing in kind of a mid-single digit and then acquisitions contributing about 2 points on top of that.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Perfect. Well, thanks, everyone, and good luck.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

All right. Thank you.

Operator: Thank you. Our next question comes from Jamie Cook of Credit Suisse. Jamie, your line is now open.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning and nice quarter. I guess two questions. One, I think you talked about some projects that were delayed that could potentially be challenged into the first half of the year. I'm just wondering if that's embedded in your guidance and if you could sort of size that? And then understanding some of the near-term issues that are sort of pressuring or – that could potentially pressure margins in 2022. Can you talk about sort of some – some of the structural initiatives you guys have put in place to improve margins and what's embedded in the forecast for that for 2022? Thanks.

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

A

Jamie, I'll start with some of the projects that we're seeing. For the most part, all of our projects are continuing. Bidding activity continued and remain incredibly strong through the fiscal year end. A couple of areas where we're seeing real product shortages and exceptionally long lead times in the six-to-eight-month range get to be large-diameter projects that require PVC pipe or large-diameter ductile iron where those lead times can stretch out four to six months.

So, those are some of the ones. They're kind of – I don't want to call anomalies, but they're projects that are starting to see a push that we're going to continue to see a push on those as we go forward. They continue to be

on the table. They continue to be in the backlog. But due to the timing constraints of being able to get some of that specialty-type large-diameter product, it's been very difficult.

Mark, do you want to talk a little bit about margins?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Jamie, in terms of the gross margin initiatives that we've got that we believe are going to offset some of that temporary pressure, certainly our private label initiative continues to expand. We continue to add more capabilities and products there to roll out through our branch network. Our acquisition of L & M Supply really expanded our abilities on the erosion control products, which is a higher-margin product for us, and we believe we can continue to expand that through our branch network. So, that is an area that we'll see a pretty good expansion in 2022.

And then, we continue to work on our pricing initiatives not only to get the pricing into the market and make sure that we're current with that, but also looking at ways to optimize price especially on some of our non-bid and ancillary-type products. Locally, given some of the pricing data that we see across the country, we've been able to optimize that and really get those products priced accurately and at the right levels.

So, between those three, we typically expect, I'd say, 20 to 30 basis points of gross margin expansion in any given year. And, yeah, we think that helps offset some of the benefits that we've achieved in 2021, but we said could be temporary.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you. Yeah.

Operator: Thank you. Our next question comes from David Manthey of Baird. David, your line is now open.

David John Manthey

Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. Thank you. Good morning, everyone. Just wondering if you could break down by segment and stack rank from strongest to less strong growth rates in fiscal 2022 and the relative impact of price in those assumptions?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah, Dave. Thanks for the question. And in terms of breaking out the end markets, I'd tell you that we feel really, really strong on the residential end market, kind of in that mid-single digit and that's coming off of a low double-digit growth in 2021. So, we still see a lot of demand there with lot development. As I mentioned, non-residential is starting to follow and then kind of return to those pre-pandemic levels. So, it's a slightly – slightly lower than the resi growth, but kind of right in that mid-single digit range. And then, the muni segment still kind of strong and steady, but kind of low – low single-digit range. And again, that's coming off of a really strong growth rate in 2021.

And in terms of price, no major differences across the end market as it relates to price. Think about, like we said, mid-single digit range in terms of the price benefit, with more of that kind of front-loaded and then coming up against more difficult comps, given the pricing levels as we get towards the end of the year.

David John Manthey

Analyst, Robert W. Baird & Co., Inc.

Q

Okay. Thanks. And then to follow up on that, maybe I misheard this, but did you imply that second-half pricing could actually be negative after being more positive in the first half and then that nets out to mid-single digit? Did I hear that correctly?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah, Dave. That's how we're looking at it right now. And again, that assumes the supply chain does free up at some point kind of middle of the year, and that's the impact of that is some decline in commodity prices. Haven't necessarily seen that yet, but that's kind of how we're looking at it just given some of the uncertainty in the back half.

David John Manthey

Analyst, Robert W. Baird & Co., Inc.

Q

And just to level-set that, if we think about guidance you've given previously, you've kind of done the same thing, right? You sort of assumed that commodity prices come down, whether they do or not. Is that the case?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. I'd say it's fairly consistent with how we've looked at it in the past, Dave. We've got pretty good visibility as we get three to six months out just in terms of the backlog and then the supply chain. And just given that uncertainty, with that, kind of making those assumptions in the back half that at some point that's going to come down.

David John Manthey

Analyst, Robert W. Baird & Co., Inc.

Q

All right. Yeah. Okay. All right. Thanks very much.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

All right. Thank you.

Operator: Thank you. Our next question comes from Nigel Coe of Wolfe Research. Nigel, your line is now open.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. [ph] Best (00:46:04) quarter. So just on the outlook, I think your EBITDA margins, if I'm not mistaken, are, I think, about 100 basis points lower year-over-year at the midpoint. I'm – again, if I'm mistaken, please correct me, but I was wondering if you can maybe bridge that. And then within that, I think you've talked about the price cost favorability representing about a 40 basis points in that range headwinds into 2022. I'm just wondering how that looks right now based on what you see?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Nigel. Yeah, I think as you look at the guide for 2022, we've got EBITDA margins coming back in that kind of 80 to 90 basis point range, with most of that coming from the gross margin line. We do expect to see a little bit of SG&A cost leverage coming into 2022 as we anniversary some of the IPO-related one-time costs in there. So, that's kind of resounding. It's coming down a full 100 basis points, but I'd say a majority of it, obviously coming from the gross margin rate line. And then, could you ask that second question again, Nigel?

Nigel Coe

Analyst, Wolfe Research LLC

Yeah. Sorry. The price cost impact, obviously, you've got some variability coming through this year. How does that shake out into 2022?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. I think the – as we think about the price cost benefit, certainly in the first half, we expect if prices continue to stay high and accelerate, we see a similar opportunity there with some potential headwind, just given the timing of when we get those price increases. But I think, as we get into Q2, Q3, certainly Q4, we start running up against much more difficult comps, and we'll see that. That's really where I see the gross margin benefits starting to get – as we start seeing some pressure there year-over-year.

Nigel Coe

Analyst, Wolfe Research LLC

Okay, okay. And then my follow-on is, with all these price increases, I understand that piping is not a huge proportion of the project values, but do you have a sense on how the overall kind of projects inflation is looking for these sort of the end customers? And is there any concerns on some demand destruction, given the inflation wave on products and labor availability? And I'm just wondering, on top of that, if the similar funding coming through in 2023, that's causing maybe some of the starts to maybe push to the right?

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Yeah. Nigel, this is Steve. I'd share with you right now, we haven't seen any demand deterioration whatsoever in regards to pricing or inflationary activities. The projects all seemed to be absorbing this at this point. And one of the key aspects of the value of these projects and the materials themselves is that what's on the mind in most of these contractors in municipalities is being able to complete the projects and being able to keep their labor fully active in this. So, I think that's the primary concern right now. And bidding activity and everything else continues to remain very, very strong.

When I look at the funding characteristics, we haven't just – we just have not seen much of the funding get through to the state revolving funds at this point or cause any type of delay along those lines. I think that's still a work in progress, but everything's still working through the backlog right now of all the existing projects that are out there, looking at the new bidding activity. So, I can tell you, as we stand here right now, there really hasn't – we haven't seen any impact whatsoever or a delay awaiting state revolving funds and infrastructure package making its way through.

Nigel Coe

Analyst, Wolfe Research LLC

Great. Thank you very much.

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Thank you.

A

Operator: Thank you. Our next question comes from Pat Baumann of JPMorgan. Pat, your line is now open.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Oh, thank you. Hi. Good morning, guys.

Q

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Hey. Good morning, Pat.

A

Patrick Baumann

Analyst, JPMorgan Securities LLC

On the acquisition environment, I think you said 2% is embedded in the outlook for sales growth. Can you talk about the pipeline and whether the volatility we've seen in the market year-to-date has delayed any deals from happening? And then you also mentioned something about evaluating additional capital allocation opportunities. Maybe you could kind of talk a little bit more about what you meant by that?

Q

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Sure. I'll talk a little bit about the M&A outlook, and I'll let Mark talk about capital allocation. We just see a very strong, robust pipeline still in M&A activity. And if you look at what a lot of these business owners have gone through between COVID, supply chain challenges, and all that environment, it's been very difficult for them, and it's really created a good opportunity for us.

A

From the standpoint of being able to look at a lot of the different areas where we drive value from M&A, where we look at either consolidating in certain markets or we look at expansion opportunities and even look at product opportunities, looking at everything from erosion control products, being able to expand in that area, there's just a robust pipeline out there, and we'll continue to work through a pretty strong pipeline out there and are encouraged by what we're seeing as we go into 2022.

Mark, do you want to talk a little bit about capital allocation?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, Pat. Nothing really there to read into. We'll continue to look at where we allocate capital. But more of it is just timing and opportunities on the M&A side. We're going to continue to focus on our growth strategy there, so nothing really additional to add there.

A

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Okay. And then, follow-up is on the commodity pipe product. How big is that as a percentage of sales now, given the strong environment you saw for price there in 2021? And then on the non-commodity pipe product, what kind of product cost inflation did you see there last year and what are you seeing so far this year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Pat. On the commodity side, now with PVC, ductile, steel pipe, some of those categories, represents about 32% of our overall net sales. And what I would tell you on the non-commodity side is, we've continued to see very strong pricing on that side as well. I'd say, it's slightly under the average with the commodities being slightly above the average.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Okay. And for that piece of the business, I mean are you seeing that less tied to kind of like the volatility in steel, PVC, et cetera, so you should see price from that part of the business continue this year? Or is that still going to be moving up and down with those commodities, like the commodity pipe?

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

A

Pat, we'll see. It's pretty typical around this time of the year to get price increases coming in in lot of the non-pipe related products. And so, we'll see if there continues to be more price increases and what that frequency is. Right now, if you look at the demand profiles that are out there and the supply constraints, it's pretty favorable for a pricing environment out there. But it's too early to tell yet whether we'll see that through – continue on all the way through first quarter and second quarter for the non-commodity products.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Understood. Okay. Thanks for your time. Appreciate it.

Operator: Thank you. Our next question comes from Kathryn Thompson of Thompson Research Group. Kathryn, your line is now open.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Hi. Thank you for taking my questions today. I know there's been a lot of focus on pricing today, but a little bit more of a conceptual question as we head into 2022. Strategic buys were an important part of – in addition to a favorable price environment were an important part to driving top line. It's been two-thirds of your top line gain for the past two quarters. But as we head into 2022, are you doing the same type of strategic buys and does that strategy really work in this market? And how do you think about those strategic buys on that versus favorable 2021? And how does that really stack into 2022?

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

A

Yeah. Kathryn, we have a couple of different ways when we look at this. We look certainly at our backlog of existing projects that we've closed that are due to ship at some point over the next several months. We also factor in what we're seeing in bidding activity and the price sensitivity associated with the bidding activity. So, we look at

this thing very closely about whether to take longer positions in certain product categories and what the capacity constraints are.

And if you do look at – understand that many of our suppliers are really dedicated to this sector and this sector alone. We have pretty good feel for what the capacity constraints may be. It allows us to take a position depending on what we're seeing in those internal metrics that we're looking at for backlog and for bidding activity.

So, right now we see a very favorable demand environment. We see tight supply constraints. It looks similar to where we ended fourth quarter, for sure. So, I think we're encouraged by that and we'll continue to take positions where we think we can continue to find that margin enhancement opportunity and get access to products and be able to pass that price through.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

I don't know if it's really post-COVID world, but a world – in a COVID world. The feedback that we're getting consistently from a wide variety of industry contracts along the industrial value and construction value chain is just a different approach to carried inventory. With all the supply chain shortfalls and growing the globalization trend, there's just a greater propensity to carry more inventory, really more simply put, and a greater value on business models that do – that inherently carry more inventory. What is your position and thought on that concept versus how you've operated your business pre-COVID and how you intend to operate going forward?

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

A

Kathryn, one of the things that we saw really coming out of COVID is – well, going into COVID, we really felt that demand was really starting to increase. While supply was still wide open, I think you saw some suppliers that took some capacity out [indiscernible] (00:57:41) given some of the uncertainty. We've always seen and feel like we have a really good outlook at what the demand profile is going to be and also what the bidding activity means and the closeness that we have with our customers to understand what the appetite is and when we're going to start seeing demand either slip or capacity in our area fall or increase as well, too.

So, I don't know if we necessarily have changed our approach in how we operate. We certainly see the value of inventory, and has been able to capitalize on that. We continue to see it today. And just given our size and scale in this area, it's really a benefit of ours to be able to do that to support our customers on where we can allocate inventory, get access to it, or find alternative materials for our customers.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Helpful. And then just looking forward, when you look at your four major operating segments and you look at what's in the pipeline, no pun intended, in terms of jobs in the future, what order patterns are you seeing today that may be different versus a year ago?

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

A

I think we continue to see really strong municipal demand, a lot of repair/replace work in that area, that aging infrastructure, and the ability to fund it for these municipalities continues to be very strong and robust. Residential in land and lot development continues to be really strong. I think the non-residential construction, and particularly

for commercial construction for our fire protection products is – we saw really good signs of life last year. We're encouraged by what we're seeing in that sector.

And then, you look at what's happening with DOT with the infrastructure bill, we support that with storm drainage and erosion control products, and I think that's an area that we're excited about as we get into 2022 as well.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Great. Thank you very much.

Q

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Thanks, Kathryn.

A

Operator: Thank you. That concludes the Q&A today. So, I will hand back to Steve LeClair for any closing remarks.

Stephen O. LeClair

Chief Executive Officer & Director, Core & Main, Inc.

Thank you all again for joining us today to participate in our fourth quarter earnings call. Fiscal 2021 was record-setting year for Core & Main. We are thrilled with the resilience of our business and our teams. Since becoming an independent company in 2017, we've unlocked our ability to grow well in excess of our end markets, acquire and integrate businesses, and enhance our margin profile. We are entering fiscal 2022 with a strong team, positive market tailwinds, and extraordinary momentum. We remain confident in our ability to deliver strong results to our stakeholders in 2022 and beyond, and are committed to providing our customers with local knowledge, local experience, and local service nationwide.

Thank you for your interest in Core & Main.

Operator, that concludes our call.

Operator: Thank you for joining today's call. You may now disconnect.

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