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Core & Main, Inc. (CNM)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to the Core & Main Q2 2022 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. Robyn, please go ahead.

Robyn Bradbury

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

Thank you. Good morning, everyone. This is Robyn Bradbury, Vice President of Finance and Investor Relations for Core & Main. I'm joined today by Steve LeClair, our Chief Executive Officer; and Mark Witkowski, our Chief Financial Officer. Steve will lead today's call with a brief business update, followed by an overview of our recent acquisitions. He will then discuss our confidence in the resilience of our business and the demand for our products and services. Mark will then discuss our record second quarter financial results and full year outlook, followed by a Q&A. We will conclude the call with Steve's closing remarks.

We issued our fiscal 2022 second quarter earnings this morning and posted the presentation to the Investor Relations section of our website. As a reminder, our press release, presentation and the statements made during this call include forward-looking statements. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. Such risks and uncertainties include the factors set forth in our earnings press release and in our filings with the Securities and Exchange Commission. Additionally, we will discuss certain non-GAAP financial measures which we believe are useful to

assess the operating results of our business. A reconciliation of these measures can be found in our earnings press release and in the appendix of our fiscal 2022 second quarter investor presentation.

Thank you 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. If you're following along with our second quarter investor presentation, I'll begin on slide 5 with a brief business update. I am pleased to report another record quarter as we continue to build on our momentum, achieving strong growth in both net sales and adjusted EBITDA. This is a remarkable accomplishment considering the challenges we faced from weather and flooding during the quarter, continued supply chain challenges, and our strong performance in the same period last year. Our teams are leveraging our best-in-class capabilities and executing at a high level to support our customers, suppliers, and communities. We continue to execute our strategies to drive above-market growth, while navigating ongoing supply chain constraints and inflation.

Strong demand and constrained manufacturing capacity supported elevated prices and caused continued project delays during the second quarter. Supply remains constrained for many of our product categories. However, we are beginning to see capacity free up for certain products. And while it is possible that commodity prices could moderate at some point, we expect the demand for our products to remain resilient, causing market prices to moderate at a slower pace than other industries.

In addition to strong pricing in the quarter, we continue to drive growth from both higher volume and M&A. Our customers remain busy and we continue to experience healthy demand across each of our end markets and product lines. Municipal repair and replacement activity remained strong and continues to benefit from healthy municipal budgets. Bidding, backlog, and order activity are all trending favorably across municipal end market, giving us confidence in demand through the end of the fiscal year. As a reminder, municipal repair and replacement activity makes up roughly 40% of our net sales.

We are encouraged by the strength in many pockets of non-residential development as suburban communities expand, which increases the demand for our waterworks, storm drainage and fire protection products on these projects. We have continued to experience softness in certain metro areas in both the East and West Coasts, which has impacted our volume of fire protection products and we expect that to remain the case for the balance of this year. Despite the softness in these metro areas, we expect non-residential activity to be positive given our backlog and bidding activity.

Residential volume was healthy through the second quarter and our bidding activity and backlog remain positive. Recently, we are beginning to see a few geographies where residential lot development project scopes are becoming smaller in size as developers assess the current market environment and the reduction in housing starts. As we look across the balance of the year, we believe the trend could continue, particularly if the Fed takes additional actions to combat inflation. As a result, we believe we could see softening in residential lot development at some point.

While the near-term prospects for the residential end market remains uncertain, we continue to believe the current undersupply of housing relative to household formation provides for a multiyear secular growth trend. As you can see, our teams are delivering strong results in a dynamic environment. We have a resilient business model and a leadership team capable of navigating through various economic cycles. We remain confident in the long term stability of our business and the end markets as roughly 50% of our net sales is driven by non-discretionary repair

and replacement activity. The diversified nature of our end markets, customer base, product offerings and geographic footprint provides better stability for our business relative to other distributors operating on a smaller scale.

Lastly, we remain active in M&A, driving sustainable growth through acquisitions. During and subsequent to the quarter, we closed the Earthsavers Erosion Control and Inland Water Works Supply acquisitions, and signed a definitive agreement to acquire the municipal waterworks division of Trumbull Industries.

I'll discuss each of these businesses in greater detail on slide 6. Earthsavers Erosion Control operates three branches in Northern California and is a full service distributor of geosynthetics materials including straw wattles, erosion control blankets, and a broad array of geotextile products. For over a decade, Earthsavers has been a leading and preferred resource in the California, Nevada, and Arizona markets and the surrounding areas.

Inland Water Works Supply is a single branch full service distributor of water and wastewater products based in Southern California with a focus on personal service and attention to detail. Inland Water Works Supply has proven itself to be a supplier of choice in its local market for 70 years. The strategic acquisition will allow us to better serve our combined customer base alongside a highly experienced and passionate team.

The municipal waterworks division of Trumbull Industries is a distributor and private label provider of specialized branded accessories and tools in the water and wastewater industry. Operating for more than 100 years and with four branches in Ohio and Pennsylvania, this team has built a long lasting customer relationship through their industry expertise and unparalleled service.

We expect that the acquisition of Trumbull will accelerate our private label initiative as we look to broaden their reach throughout our existing branch network. Each of these acquisitions provides us valuable talent and unmatched capabilities in their respective markets, collectively adding approximately \$95 million of annual net sales.

We remain active on the M&A front this year and we expect to continue acquiring and integrating companies in the coming quarters. As an experienced integrator and with a respected reputation as the acquirer of choice in our industry, we are well-positioned to grow sustainably through acquisitions for many years to come.

Now turning to page 7, I'd like to spend a few minutes discussing our confidence in the resilience of our business and the demand for our products and services. Our nation's water and wastewater infrastructure is aging, and the need for maintenance and repair is growing. Municipal repair and replacement demand has exhibited stable growth over the long term due to the consistent and critical need to replace aged water infrastructure. However, due to the limited availability of funding, the pace of investment has lagged the need to upgrade water systems throughout the US.

In 2020, the average age of water and wastewater pipes was 45 years, up 20 years from 1970. There are approximately 300,000 water main breaks every year, representing the equivalent of a water main break every 2 minutes. On average, municipalities lose approximately 16% of their treated water on an annual basis due to leaks. An estimated \$2.2 trillion is required for repairs and upgrades over the next 20 years to close the growing water infrastructure gap, which would more than double the historical growth rate in water and wastewater investment.

In recent years, access to capital, increased utility rates, and necessity have increased municipal investment in water. Municipalities appear to be taking a more active role in repairing and upgrading their water and wastewater

systems, and our business is well-positioned to benefit from these dynamics. We expect that funds from the infrastructure bill will begin to strengthen investments in municipal water infrastructure repair in 2023 and beyond.

Another demand trend we anticipate persisting through the next economic cycle is growing response to extreme weather events. Cities across the country are investing to mitigate the impacts of extreme weather events like those we've seen this summer related to tragic flooding across the US. As the frequency and magnitude of flooding events increases, our customers continue to demand more robust storm drainage infrastructure and treatment plant solutions. Our national distribution network and access to specialized products makes us well-positioned to support these growing needs.

To wrap up my prepared remarks, I am proud of how our team has come together to deliver these fantastic results. Earlier this year, we talked about our focus areas for fiscal 2022, executing on our key growth strategies, deepening our competitive advantage, and building on our foundation of long-term profitable growth. We've made great progress in each of these areas and continue to position the company for success.

I will now turn the call over to our Chief Financial Officer, Mark Witkowski, to discuss our second quarter financial results and full year outlook. Go ahead, Mark.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Thanks, Steve. I'll begin on slide 9 with some highlights of our second quarter results. We reported a net sales increase of 43% to \$1.86 billion for the quarter. The increase was due to price inflation in response to rising material costs, mid-single digit volume growth driven by a combination of market growth and share gains and contributions from acquisitions.

We outperformed our end markets in the second quarter due to our industry-leading product availability and the execution of our product, customer and geographic expansion initiatives. Acquisitions continued to perform well, contributing approximately 5% to our second quarter net sales growth.

Material costs continued to increase throughout the quarter, though we are starting to see the frequency and magnitude of cost increases slow. As a result, we expect price contribution to moderate in the second half of the year as we anniversary the rapid price increases from a year ago. Gross profit increased 54% to \$501 million in the second quarter, and gross profit margin increased 190 basis points to 26.9%. Gross margin was positively impacted by strategic inventory investments ahead of announced price increases, a favorable pricing environment, our gross margin enhancement initiatives, and accretive synergies from acquisitions. As we've discussed for the last several quarters, we have targeted initiatives in place to continue driving sustainable gross margin expansion, including private label through global sourcing, pricing initiatives and procurement optimization. We're in the early innings of executing on these initiatives and we see a long path of sustainable growth ahead.

Selling, general and administrative expenses increased approximately 20% to \$230 million in the second quarter. SG&A as a percentage of net sales declined 240 basis points to 12.4%. The decline was due to our ability to leverage our fixed costs on the increase in net sales in addition to the timing of one-time costs in the prior year associated with the accounting for equity awards.

Interest expense in the second quarter was \$17 million compared with \$37 million in the prior year. The decrease was primarily due to the redemption of the 2024 and 2025 senior notes. Our effective tax rate in the second quarter was 17.3% compared with 24.6% in the prior year. The year-over-year reduction reflects certain fixed tax

expenses and permanent differences decreasing as a percentage of pre-tax income. The effective tax rate for each period reflects only the portion of net income that is attributable to taxable entities.

We recorded adjusted net income for the second quarter of \$169 million compared with \$61 million in the prior year. The improvement was due to our strong sales growth, gross margin improvement, SG&A cost leverage and lower interest expense, partially offset by an increase in income taxes.

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 increased approximately 79% to \$277 million, compared to \$155 million in the prior year. Our adjusted EBITDA margin improved 300 basis points to 14.9% due to our strong net sales growth, gross margin improvement, and leveraging our cost structure on the increase in net sales.

Now, I'd like to provide a brief update on our cash flow and balance sheet on slide 10. Net cash used to fund operating activities during the quarter was \$23 million, an improvement of \$32 million compared with the prior year. The improvement was primarily due to higher profitability and lower cash interest, partially offset by higher receivables from our strong sales growth and an increase in inventory, reflecting supply chain uncertainty, inflation, and strategic investments ahead of supplier cost increases. We continue to carry portions of our inventory longer than expected due to elongated project timelines and to ensure product availability to support our customers.

These dynamics could reduce a portion of the working capital unwind we typically expect to see in the second half of the year.

Net debt at the end of the quarter was \$1.627 billion. Increase in net debt from the prior year reflects higher borrowings to fund the increase in working capital and our recent M&A activity coupled with lower cash balance. Despite the increase in net debt, our leverage improved to 1.9 times, attributable to an increase in adjusted EBITDA. As part of our debt refinancing in July 2021, we correspondingly entered into a five-year fixed interest rate hedge on our senior term loan with a notional value of \$1 billion to lock-in the LIBOR rate at 74 basis points. As of July 31, the cash value of the hedge was \$65 million.

On July 29, we amended the terms of our credit agreement governing the ABL facility to increase the aggregate amount of commitments by \$400 million to \$1.25 billion. And at the end of the quarter, we had nearly \$1.1 billion of liquidity consisting of excess availability under the asset based lending facility, which is net of \$142 million of borrowings and approximately \$9 million of outstanding letters of credit.

While we expect to generate strong operating cash flow over the next six months and beyond, we believed it was prudent to expand the borrowing capacity of our ABL to support anticipated business growth and to give us additional flexibility to pursue growth opportunities as they arise.

We have a capital allocation plan that consists of balanced investments and growth. Our priority is to maintain our financial strength and flexibility without sacrificing long-term organic and inorganic growth opportunities. We will continue to invest in greenfields and acquisitions to grow our market share or enhance our operating capabilities. We will also evaluate other capital deployment options as we generate strong cash flow, including the potential for share buybacks and debt reduction.

I'll wrap up on slide 11 with a discussion of our outlook for the remainder of the year. We sustained great momentum through our spring and summer selling seasons and our customers remain busy with healthy

backlogs. We expect overall end market demand to remain positive, even as rising interest rates, inflation, supply chain disruptions and labor shortages persist.

As Steve mentioned previously, we are beginning to see a slowdown in new residential construction in certain geographies. With rising interest rates, we could see a slowdown in lot development more broadly. However, our residential bidding activity and backlog currently remain positive.

As a reminder, the residential end market makes up roughly 20% of our net sales. Municipal repair and replacement activity which makes up roughly 40% of our net sales has remained strong. Repair and replacement demand has historically been resilient through economic cycles, and we expect that to continue through the next cycle especially as funds from the Infrastructure Investment and Jobs Act make their way into our end markets.

Our expectation is that we may not see incremental demand from the infrastructure bill until 2023 or beyond due to ongoing supply chain constraints and labor shortages. Non-residential development which makes up 40% of our net sales also remained strong with healthy bidding activity and backlogs. We expect price contribution to moderate in the second half of the year as we anniversary the price increases from a year ago.

If demand softens providing relief to our supply chain, it is possible we could see the cost of commodity based products come off peak levels at some point in the second half of the year. Taken altogether, we now expect 26% to 32% net sales growth for fiscal 2022 excluding the contribution from acquisitions that have not yet closed.

We expect gross margins in the second half of the year to be sequentially lower than the first half, in part due to the moderating commodity prices and less inventory profits. With these factors in mind, we are raising our expectation for fiscal 2022 adjusted EBITDA to be in the range of \$840 million to \$890 million representing year-over-year growth of 39% to 47%. We expect to convert roughly 45% to 60% of adjusted EBITDA into operating cash flow for the full year. Our expectation for operating cash conversion is less than what we guided to last quarter due to strong demand and supply chain constraints resulting in our decision to continue investing in inventory.

In closing, we have a resilient business model and a leadership team capable of quickly adjusting to changes in the market. We are strategically positioned with multiple paths of sustainable growth. We remain focused on executing at a high level, delivering value to our customers, suppliers, communities, and shareholders.

At this time, I'd like to open it up 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.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Hello. You have Elizabeth Langan on for Matt today. Thank you for taking the questions. I just wanted to kind of touch on your updated guide. Would you be able to give us maybe a little bit more of a breakout of what you're embedding in price and volume? And if you have any details on the general cadence of that through the third and fourth quarter of the year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, sure. Thanks. Thanks for the question. As we're – as we've guided towards the second half, volume for the second half, we expect to be flat to slightly down, primarily coming off of really strong comps in the prior year. Second half price contributions I'd say would be in the low- to mid-teens with acquisitions contributing another couple of points. So, ultimately, full-year volume low- to mid-single digit, full-year pricing low to mid-20% range, and acquisitions approximate 3 points of contribution.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Okay. Thank you. That's really helpful. And would you be able to touch on what you're seeing in regards to inflation currently? And if there are any categories that are specifically seeing normalization or the ones that are kind of holding price?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, sure. I think, as we expected throughout this year, we did anticipate some of our commodity-based products would start to stabilize. We are starting to see supply chain and certain of those areas start to free up a bit. And at the same time, some of our non-commodity products that which we really saw kind of lagging and price start to come through during the quarter. And I'd say that non-commodity piece was really a surprise to the upside for us in Q2, and we really see that sustaining through the second half of the year, which is again part of the raise in the guide.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Okay. Thank you, sir.

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

Hi. Good morning. I guess my first question, you noted some slowdown on the residential side talking about lot development and I think some slowdown on the East and West Coast. Can you just sort of give a little more color on sort of what you're seeing there and how that's impacted, if at all, your sales forecast? So I guess that's my first question.

Stephen O. LeClair

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

A

Yeah, sure, Jamie. What we've seen generally is that some of the major metro areas in East Coast and West Coast have just taken a pause in some of the nonresidential and commercial construction. So, we're seeing that hit our fire protection products.

That's been -- we've seen that coming that isn't really new, but we've really seen strong performance in a lot of the other areas certainly in the Midwest that's kind of picked that up. So overall for the year, we still feel we've got positive outlook in regards to what we're seeing with commercial construction nonresidential.

From the residential piece, we've seen pockets where for the land and lot development phases are being put in place here, shortening the scope. And in terms of the land development that's happening in a lot of these areas, we're seeing that and certainly areas in the Sun Belt through Florida and Texas where that's starting to take shape.

And again our backlog looks strong in there. The outlook looks good for us. And what we're seeing, we're just seeing some of the sizing and scoping of the development be scaled down as builders look, at some of the challenges associated with interest rates and the housing market itself is just -- they're looking at how that's going to shape our form.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Q

Okay. And then just a follow-up question. I think last quarter you talked about, 50 bps to 100 bps of temporary margin benefit in your guidance. I think it was tied to strong pricing but can you just provide an update on if that's changed at all like what your assumptions are? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Jamie. Now we've got another quarter in where we've been able to continue delivering on some of our gross margin initiatives that we've got in particular with, some of the private label work, our accretive acquisitions that we did, last year, we saw continued benefit come through there in particular with some of the erosion control products that we're now expanding. So, we've seen some nice increases associated with that. That 50 to 100, I think still is a temporary benefit, we believe, just due to the pricing environment. And this continued ability to buy ahead of these cost increases is still there. But I'd look at that kind of off the first half margins that we've been able to deliver just due to continued execution on the initiatives that we've got.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Q

Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thank you.

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. And not to beat a dead horse on guidance, but just a couple of clarifications and appreciate the color you've given so far. Three quarters of the top-line growth has been driven by pricing in the first half of the year. As you look at your second half guide, how much of that is driven by the favorable pre-buy price increases and mix? I mean, this is kind of on the pricing bucket. How much does that contribute versus some of your other core initiatives that you've been working along and really kind of part and parcel with that? What are the levers for the margins that we should take into account understanding that you had guided for sequentially lower? But what are the primary components for that understandable sequential deceleration of gross margins? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Kathryn, just try to impact out a little bit on the top-line as we look out into the second half. The guide is really to see continued stability with our non-commodity-based products. We do expect some softening of some of the commodities, in particular, PVC, that's been a pretty large element of the price increases that we've seen come through. So, we're assuming some of that kind of dials back as the supply chain frees up potentially here in the second half.

And then, from a gross margin perspective, again, no real major mix impacts there, but we do expect to see some of those inventory profits become less as we get into the back half of this year and I'd expect more of that pressure kind of later in the year just based on kind of what we're seeing to-date.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. And as far as the coast, once again, you noted that earlier and in the Q&A for non-res [indiscernible] (00:28:34). Is it more in bid activity or is it in projects that were slated to start that are now delayed or is it just – give a flavor of what that means? And then, based on your prior experience, how does this deal versus prior periods where you've seen a pause?

Stephen O. LeClair

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

A

Yeah. I would say most of what we're seeing are project delays that are happening and occurring right now, most part for the commercial construction piece impacting our fire protection projects. I would say this has not given us a lot of concern at this point just given the nature of the type of projects that we're seeing out there that are on the slate. So, we've been through this before. Certainly, went through some of this during COVID where some of these areas were impacted temporarily, where construction was paused. So, that's generally what we're seeing.

The condition across the rest of the country has been really quite strong so we're encouraged by that. And so we're not too alarmed. This was we've certainly been seeing that coming and bidding activity across the rest of the country still looks very strong.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Okay. Great. Thank you very much.

Q

Stephen O. LeClair

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

Kathryn.

A

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

David John Manthey

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

Yeah. Thank you. Good morning. First off, I was wondering if you could broadly discuss the relative growth rates of the municipal markets during the quarter and the momentum you're seeing there? You kind of touched on resi and non-res already.

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. David, thanks for the question. Just I would say in general as you think about our end markets for the quarter and the first half I'd say, municipal has been really strong relatively speaking. Just from a volume perspective I'd say kind of in that low- to mid-single-digit range. And munis typically an area that's kind of low-single-digit so really, really good volume coming out of that.

A

Non-resi I'd say next just, again good strength broadly speaking though there are some pockets where we saw some weakness and then, kind of residential third, just lower due to, some of the scoping.

David John Manthey

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

Okay. Thank you for that quick color there. Could you talk about the municipalities and how they're dealing with inflationary spikes? Is there some kind of a shift going on here from upgrades to chasing break-fix-type business? And what I'm getting at is do you think there's any sort of project deferrals because of budget limitations just stemming from these inflationary spikes that we're seeing?

Q

Stephen O. LeClair

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

Hey, David. We're not really seeing a lot of project deferrals due to the inflationary nature of the products themselves. We are seeing some projects being tabled due to availability of product and the long lead times associated, particularly large diameter-type water main replacement, things along those lines where the lead time for that pipe could be anywhere from six to nine months. So, we have seen some deferral of those projects until better availability of those specialty-type products are – becomes more available and timely.

A

But for the most part, municipal has just been incredibly steady as we've gone through here. We've seen a lot of work being done on repair and replace. We're seeing a lot of good treatment plant being done, new expansions of water and wastewater treatment plants as well, too. So, it's really been across the board and been very strong outlook and bidding activity has been incredibly strong.

David John Manthey

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

Okay. Thank you very much.

Q

Stephen O. LeClair

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

Thanks, David.

A

Operator: Thank you. Our next question comes from Joe Ahlersmeyer from Deutsche Bank. Joe, your line is now open.

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

Yeah. Thanks very much and nice results.

Q

Stephen O. LeClair

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

Thanks, Joe.

A

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

So, I just wanted to be clear on the municipal end market commentary. I think implicit in a lot of what you're saying is that you're not seeing any benefit yet from the infrastructure bill. I know on the last quarter call, you mentioned the potential to see earlier benefits from that as the supply chain eased. But given the prepared remarks and the answer to the prior question, it sounds like it's definitely not going to be a benefit until 2023 and that doesn't explain the increase in the guide, correct?

Q

Stephen O. LeClair

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

Yeah. Correct. I think that's the way we're looking at it right now. We're just not seeing a lot of projects utilizing those funds at this point. Again, through second quarter, everything has been pretty strong. We believe that if something were to happen, where residential, should start seeing some type of decline that some of that, we may see more capacity being allocated into municipal and that could drive and support some of the residential declines. But up to this point, we just haven't seen that yet.

A

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

Okay. Great. And then just shifting gears to geo erosion. I know you've said it's roughly a \$5 billion market subsegment within your addressable market. What kind of CAGR could that grow at? And do you have a share target in mind, something maybe in-line with your overall company average? And if it's maybe more or less what would contribute to that difference?

Q

Stephen O. LeClair

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

A

Well, we just see a lot of avenues to continue to grow that model. We are very underpenetrated in that in our business overall is a very complementary product to our existing customer base as well and fits in really strongly with what some of our core strengths are with local expertise and local specifications. So, we're going to continue to grow that. We see multiple avenues to do that organically and continuing to expand the capacity of our distribution network on this. In addition to, as you saw, with our most recent acquisition this last quarter continue to fill out a lot of the geographies out there to increase the supply. So, just some really nice acquisition for us that helps complement our prior ones [indiscernible] (00:35:34) supply and it's been primarily through the East Coast up and through the Midwest. And now having these three locations out in the West Coast really help support that business and we'll continue to grow it.

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

All right. Thanks very much.

Stephen O. LeClair

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

Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from Patrick Baumann of JPMorgan. Patrick, your line is now open.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Oh, hi. Good morning. I just want to dig into that 50 to 100 basis points of temporary benefit in the gross margin I suppose. Now, you're saying it's off of the first half run rate, which is around 26.5%. And I'm just curious, what gives you confidence that the temporary benefit isn't more than that? Can you talk about your visibility to I guess your core performance improvement since I guess pricing really took off versus kind of what you've seen in terms of inventory profits over that period? I think you were kind of run rating at 24.5%, 25% type gross margin before this inflationary period. So, any additional color, that would be helpful.

Stephen O. LeClair

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

Yeah. Thanks, Pat. Thanks for the question. Yeah. In terms of some of the margin initiatives that we've talked to you about previously, I mean, we've seen a continued improvement in those areas here now for several quarters. So, we've got those well tracked and we've continue to see expansion there in particular moving more product now through private label and then now having really full – four full quarters now of sustained gross margin accretion that we've seen come from some of the acquisitions that we've done, and then the related synergies associated with those. So, recognizing that we still have benefit in there associated with buying ahead of some of these cost increases that have come through, but we've also seen some product categories where we've actually seen pricing start to stabilize a bit and have seen the margin reaction associated with those.

So, it's allowed us to better really identify what we think that benefit is on a product category, which, ultimately, gives us confidence to know how these other products could react if they're – the cost side starts to stabilize a bit and we don't have that same level of opportunity to pass that price through. So, that's the best estimate at this point, but given the sustained quarters we've now had with those margins, we think that still 50 bps to 100 bps holds pretty firm.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Yeah, that's encouraging and helpful. Appreciate the comment. And then can you provide some additional color on the pipeline for acquisitions like the types of multiples you're seeing, the types of prospects? I mean, should we continue to expect bolt-on type deals? And then, in terms of that \$95 million of M&A revenue you highlight on slide 6, is that all now added to the guidance or just a portion? And if it is just a portion, just curious kind of, in rough terms, what percentage of that is now included in the guidance?

Stephen O. LeClair

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

A

Yeah, I'll start first with the M&A pipeline. So, as you've seen, we continue to find really strong businesses out there. It is still an incredibly fragmented market. We do consider ourselves the acquirer of choice. And we've got a lot of experience integrating in a lot of these businesses whether they're traditional water works distributors or certainly the work that we're doing now in geosynthetics is ripe for consolidation. And we continue to see a really strong pipeline. The multiples we're paying have been in line with everything we've done so far, 6 to 9 times adjusted EBITDA on a pre-synergy basis, and we typically provide two terms of improvement on that post synergies with cost reductions. And certainly, with our size and scale and purchasing arrangements, help us to really bring in post-acquisition synergies. So, the \$95 million, Mark, I don't believe that was in...

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

So, yeah, the Earthsavers and Inland, which are both closed, are in the guide. Trumbull has not yet closed and our practice on that has been to not include those in the guide until we get the closing which we expected...

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Should we assume...

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

... quarter.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

...should we assume, since it's like – could we just assume kind of a percentage of sales based on branch count or something like that?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

That's a fair way to do it. Yeah.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Q

Okay. That's helpful. I appreciate the time. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

All right. Thank you.

A

Stephen O. LeClair

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

Thank you.

A

Operator: Thank you. Our next question comes from Andrew Obin from Bank of America. Andrew, your line is now open.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Good morning. This is David Ridley-Lane, on for Andrew. Did supplier delivery times get better as you went through the quarter? And I'm asking broadly, I know there's still shortages or as you mentioned, the large-diameter pipes and the [indiscernible] (00:41:14) for water meters.

Q

Stephen O. LeClair

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

David, it's been kind of interesting. We certainly see some lead times improve pretty significantly over this last quarter as supply has firmed up. One thing I would share with you though, there's still a lot of extended lead times out there for many of our products. But I think nearly all of the manufacturers at this point have become more reliable in terms of their lead times and the accuracy of those which has helped us to manage this process much better with our customers and all the way through the whole system. So, I think we've kind of – we're kind of getting into a new normal here of normalizing some of these lead times, being able to have them be more reliable to support our projects and support our customers in this timeframe. We've really started seeing that improve certainly in the second quarter.

A

David Ridley-Lane

Analyst, BofA Securities, Inc.

Got it. And then I know you reiterated your view on when the US infrastructure-related funds will show up. Just not to split hairs, but are the lead times stabilizing the continued municipal demands, is that making it more or less optimistic about the impact for that in calendar 2023?

Q

Stephen O. LeClair

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

I would say we'll probably get a better feel for that in the next quarter here on how that firms up. It's just too hard to tell right now. We're just not seeing those infrastructure dollars really flowing through at this point. So, whether it's lead time concerns or inflation, which we haven't seen just yet, that's causing some of these delays or those funds not to be utilized, we'll have a better feel probably for the next quarter. And then we do believe this is going to be a tailwind for us, particularly in 2023, and we'll just see how that shapes up in the next quarter.

A

David John Manthey

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

Got it. Thank you very much.

Q

Stephen O. LeClair

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

Thank you, David.

A

Operator: Thank you. We currently have no further questions. So I will hand back to Steve LeClair for any further remarks.

Stephen O. LeClair

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

Well, thank you all again for joining us today. It's a pleasure to have you on and we hope that you're doing well. So, we're extremely pleased with our second quarter performance and continue to focus on the controllable areas of our business. While the near-term environment remains dynamic with inflation, supply chain challenges, and broader economic uncertainty, we are confident that the underlying demand trends, our robust M&A pipeline and strategic initiatives will position us to achieve sustainable growth in 2022 and beyond. 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 your line.

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