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Core & Main, Inc. (CNM)

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, everyone, and a warm welcome to the Core & Main Q1 2022 Earnings Call. My name is Melissa, and I'll be your operator. [Operator Instructions]

I now have the pleasure of handing over to your host, Robyn Bradbury, to begin. Robyn, over to you.

Robyn Bradbury

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

Thank you. Good morning and welcome to the Core & Main Fiscal 2022 first quarter earnings call. This is Robyn Bradbury, Vice President of Investor Relations and FP&A for Core & Main. I am 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 a review of our growth strategy and an example of how we are targeting growth in underpenetrated product categories. Mark will then discuss our first quarter financial results and a full-year outlook followed by a Q&A session. We will conclude the call with Steve's closing remarks.

We issued our fiscal 2022 first quarter earnings release this morning and posted a presentation to the Investor Relations section of our website. As a reminder, our earnings press release presentation and the statements made during this call include forward-looking statements. These statements are subject to risks and uncertainties, and actual results may differ materially from those expectations and projections. Such risks and uncertainties include the factors set forth in the earnings press release and in our filings with the Securities and Exchange Commission.

Additionally, we will discuss certain non-GAAP financial measures during today's call, which we believe are useful to assess the operating results and efficiency of our business. A reconciliation of these measures can be found in our earnings press release and in the appendix of our fiscal 2022 first quarter earnings 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 and welcome to our fiscal 2022 first quarter earnings call. Starting on page 5, I'll begin with a brief business update. We delivered an extraordinary start to fiscal 2022, as we achieved strong growth in both net sales and adjusted EBITDA. This marks our 25th consecutive quarter of average daily sales growth.

Growth in the quarter was driven by strong demand across each of our end markets, higher average selling prices as we passed along rising material cost, execution across our sales initiatives to drive market share gains, and acquisitions.

Inflation remained elevated, and supply chain challenges persisted through the first quarter, but our resilience and execution delivered remarkable results. We achieved another quarter of solid gross margin rate expansion relative to the prior year. When combined with our 52% net sales growth in cost leverage, we delivered over 101% adjusted EBITDA growth for the quarter.

Market demand continues to be strong and broad based across the country. We are encouraged by the strength in residential land and lot development, despite rising interest rates and inflationary pressures across the residential building sector. We saw nonresidential construction activity accelerate through the first quarter, and municipal repair and replacement activity remained very strong.

Bidding activity, backlog, and pace of orders all trended favorably through the first quarter, giving us confidence in demand through the end of the fiscal year. Product shortages persisted through the first quarter, and continue to impact lead times and material cost. We continue to benefit from our size and scale by maintaining industry leading product availability, a testament to our value proposition.

We are focused on maintaining the right inventory to stay efficient, while also ensuring we have access to products to support our customers and their installation schedules. We have been increasing our inventory to maintain fulfillment levels, but we are closely monitoring bidding and project activity to be prepared for any changes in the market. Most of the inventory we have on hand is either reserved for a job or is a commonly used product that can be moved quickly. Our investments in inventory and supply chain strategies are generating significant returns for the business.

We remained active in M&A during and subsequent to the quarter, highlighting our commitment to drive sustainable growth through acquisitions. We closed on the Dodson Engineered Products and Lock City Supply acquisitions and signed a definitive agreement to acquire Earthsavers Erosion Control. Dodson Engineered Products is a single branch, full service distributor of water, wastewater, storm drainage, agricultural and irrigation products based in Western Colorado. Lock City is a single branch, full service distributor of water and wastewater products based in New York. With almost 50 years of industry experience, Lock City Supply has proven itself to be a distributor of choice in its local market.

Earthsavers Erosion Control operates three branches in California and is a full service distributor of geosynthetics and erosion control 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 California, Nevada and Arizona markets and surrounding areas. We look forward to combining forces and expanding our expertise to further serve our customer base in the Western region. Each of these businesses are great examples of what we look for in acquisitions, offering an expansion into new geographies, access to new product lines, and the addition of key talent. The integrations are progressing according to plan. Employee engagement is positive and feedback from customers and suppliers has been great. Our acquisitions are performing considerably well and we're working to optimize the synergy potential from each business. We maintain a large and highly diverse acquisition pipeline, which we will continue to pursue to position ourselves for sustainable growth.

In addition to our focus on M&A, we also remain focused on attracting, developing, and retaining top talent in a tight labor market. Our associates are our most valuable asset and are essential to our success. We offer a pay per performance culture to attract and retain high performing teams. This is especially important for our customer facing and support roles within our branches. We believe that our people first culture, consistent investment in the health, wellbeing, and the development of our people, and competitive compensation programs result in lower turnover rates among our associates.

Sales associates and branch management have the opportunity to earn competitive pay through our performance-based compensation structure. Our local business nationwide philosophy incentivizes both our sales force and our operations team to be entrepreneurial, making decisions grounded in customer centric approach. We have a resilient business model and a leadership team with a history of navigating through various economic cycles.

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. The municipal, residential, and non-residential construction markets have historically operated on different cycles and benefit from varied demand drivers. Additionally, roughly 40% of our business consists of non-discretionary municipal repair and replacement activity, which has proven resilient during the previous economic downturns.

We have a long and established track record of strong cash flow generation. Our working capital optimization provides both counter-seasonal and countercyclical stability, allowing us to invest and build working capital during periods of growth, yet remain agile in the event of an economic decline. Our variable compensation structure also allows us to quickly take cost out of the business in times of economic declines.

We are sharing these characteristics because certain market uncertainty is common discussion topic right in the market right now. However, as mentioned earlier, we are very confident in the current demand environment. The resilience of our business and in the end markets in which we operate. While our current expectation is though we may not see incremental volume from the infrastructure bill until 2023 or beyond due to constrained supply chains and labor shortages, we believe those funds could be accessed sooner in the event of an economic downturn. Materials and labor utilized on private construction projects today could likely be redeployed and accelerate projects in the municipal water sector.

On page 6, we outlined the levers that enable us to drive sustainable growth. Over the last several years, we've invested in people and capabilities to strengthen our ability to drive growth. As we look ahead, we see multiple avenues to continue pursuing. We have demonstrated that we can grow faster than our underlying markets and believe that our competitive advantages allow us to continue gaining share at the local level. We continue to drive organic expansion into underpenetrated geographies through new greenfield locations.

We have meaningful runway to increase our share through strategic accounts, which include large private water companies and national contractors. Our size and scale position us to continue accelerating the adoption of products and technology in our industry, such as geosynthetics and erosion control solutions, smart meters, fusible HDPE technology and a number of other developing product categories. As I mentioned earlier, acquisitions are a key component of our growth strategy and we have a long runway to consolidate our fragmented industry.

Finally, we have opportunities to continue enhancing gross margins, including private label through global sourcing and pricing and procurement initiatives. We have an opportunity to transition ancillary spend to internally-sourced products. We have a team of pricing analysts who have been able to enhance product margins using data to drive pricing decisions and by proactively updating price changes to increase visibility to our branch network. Additionally, our category management team has the opportunity to continue shifting spend to suppliers with the best pricing and payment programs to optimize gross margins. We are in the early innings of executing on many of these initiatives and see a long path of growth ahead.

On page 7, we highlight an example of how we are constantly valuing opportunities to expand our addressable market and drive sustainable growth. We have recently increased our presence in the geosynthetics and erosion control market, which is large, highly fragmented, and estimated to be roughly \$5 billion of our \$32 billion addressable market. Geosynthetics and erosion control products are used to prevent soil erosion and storm water runoff.

Geotextiles, geogrids, erosion control blankets, and other related products come in both earth-friendly and biodegradable options. They are primarily used to reduce environmental disruption during construction. Land development tends to increase soil erosion risk, but geosynthetics and erosion control products reduce the likelihood that soil erosion will cause pollution and displace native wildlife. We estimate that our current share in this market is only 1%, but we have a long runway of organic and inorganic growth opportunities ahead.

We developed a platform for growth in this market after our successful acquisition and integration of Erosion Resources Supply in 2019 and L&M Bag and Supply last fall. Our recent agreement to acquire Earthsavers Erosion Control illustrates our ability to consolidate this large and fragmented market. We maintain a large pipeline of high priority geosynthetics targets and we see meaningful bolt-on opportunities ahead.

In addition to growth through M&A, we have multiple avenues of organic growth to pursue in geosynthetics and erosion control as we pull these products through our national branch network and into the hands of our existing customers. We have the ability to increase our private label offerings from the fabrication capabilities brought to us in our recent acquisition of L&M Bag & Supply.

Environmentally conscious regulations for storm water runoff prevention are becoming more prevalent. And we are aligning our sales efforts nationwide to capitalize on that locally regulated driven demand. Our sales associate is taking a consultative approach using their knowledge of the local regulatory requirements and specifications, provide customer specific product and service solutions. We are deeply involved in our customers planning process and our ability to support our customers by enabling them to comply with local regulations provides us with a significant competitive advantage. We are utilizing our acquired talent and expertise, trainings and incentives to drive cross-selling with our existing customer base. Lastly, we are benefiting from our sourcing consolidated buying capabilities to enhance the margin profile of certain geosynthetics and erosion control product categories. Our roll-up strategy is underway. We have a highly experienced team working to expand our product portfolio and service capabilities nationwide.

To wrap up my remarks, I continue to be impressed with how our team has come together to deliver these great 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. We acknowledge the amount of uncertainty associated with inflation, rising interest rates, and the war in Ukraine, but we have not yet seen this translate into lower demand.

Furthermore, we expect to continue gaining market share as we deliver high value to our customers and execute on our product, customer, and geographic expansion initiatives. We remain focused on our operating priorities and delivering a best-in-class customer experience.

I will now turn the call over to our Chief Financial Officer, Mark Witkowski, to discuss our first quarter financial results and full-year 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 first quarter operating results. Net sales in the first quarter were nearly \$1.6 billion, an increase of approximately 52% over the prior year. The increase was driven by higher average selling prices as we passed along rising material costs, strong volume growth, and acquisitions. Our sales benefited from volume growth across each of our end markets. We've

continued to see strength in residential land and lot development. Nonresidential construction activity continues to accelerate, and municipal repair and replacement activity has remained strong.

Net sales for pipe valves, fittings, and storm drainage products benefited from strong end market growth, acquisitions, and higher average selling prices across most product lines. Our fire protection products benefited from a strong commercial construction market and higher average selling prices. Our meter products grew at a slower pace primarily due to shortage of semiconductor chips, which are components of certain smart meter products. We've seen sequential improvement in meter volume since last quarter and expect that trend to continue for the remainder of the year.

We outperformed our end markets and drove above market growth in the first quarter due to our industry leading product availability and the execution of our product, customer and geographic expansion initiatives. Roughly, three-fourths of our net sales was due to higher average selling prices, driven by our team's ability to pass along rising material costs.

We continue to experience inflationary costs from our suppliers, and the conflict in Ukraine has further challenged our supply chain in recent months. Nearly, two-thirds of the pig iron imported by the US last year came from Russia and Ukraine, but the conflict has reduced shipments and created a global shortage of steel and iron. When coupled with rising fuel prices, we have recently experienced immediate surcharges imposed on certain product categories. Despite these challenges, our teams are navigating the inflationary environment exceptionally well, working with our customers to give advance notice of market price increases and added surcharges. Acquisitions contributed approximately 5 points of sales growth in the first quarter.

Gross profit in the first quarter increased 64% to \$421 million. Gross profit as a percentage of net sales was 26.3% compared with 24.3% in the prior year, an improvement of approximately 200 basis points. Similar to recent quarters, our gross profit margin was positively impacted by inventory investments ahead of supplier cost increases and gross margin enhancement initiatives. We're operating in a less sensitive price environment due to industry-wide product shortages, which we benefited from due to our supportive inventory levels. We continue to make great strides across our margin initiatives delivering sustainable gross margin rate expansion relative to the prior year. We also achieved accretive synergies from recent acquisitions, which we expect to continue benefiting from moving forward.

Selling, general and administrative expenses for the first quarter increased 34% to \$206 million. SG&A as a percentage of net sales was 12.9%, compared with 14.6% in the prior year period, an improvement of approximately 170 basis points. The decrease in SG&A as a percentage of net sales was due to our ability to leverage our fixed cost. Interest expense for the first quarter was \$13 million, compared with \$36 million in the prior year. The decrease was primarily attributable to the redemption of a 2024 and 2025 senior notes. Income tax expense for the first quarter was \$30 million, reflecting the effective tax rate of 18%, compared with \$6 million in the prior year at an effective rate of 18.2%. The effective rate for each period reflects only the portion of net income that is attributable to taxable entities.

Adjusted net income increased to \$127 million from \$27 million in the prior year. The increase was primarily attributable to higher operating income 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 grew 101% to \$219 million improving adjusted EBITDA margin by approximately 340 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.

On page 10, I'll now cover our cash flow and balance sheet highlights for the quarter. We have an operating cash outflow of \$37 million this quarter. We generally anticipate an operating cash outflow in the first quarter and this year was no exception as we continue to build inventory to support demand, and to ensure we have products available for our customers while navigating long lead times. The operating cash outflow for the quarter as a result of higher profitability and lower cash interest expense, that was more than offset by higher operating capital to support our growth both year-over-year and sequentially and higher cash taxes.

We've historically generated the majority of our cash in the second half of the year, and we expect the same trend this year, particularly as we work to optimize our inventory levels. Our net debt at the end of the quarter was \$1,545 million bringing our net debt leverage down to 2.2 times an improvement of 0.3 times since last quarter.

The improvement was attributable to an increase in an adjusted EBITDA, partially offset by \$57 million of borrowings under our Senior ABL Credit Facility to fund operations, meet our working capital needs, and execute M&A. Our term loan carries interest at LIBOR plus 250 basis points on the unhedged portion of the facility. We entered into a five-year fixed interest rate hedge with a notional value of \$1 billion to lock in the LIBOR rate at 74 basis points. The current cash value of the hedged stands at \$76 million.

At the end of the first quarter, we had \$785 million in total liquidity, excluding the cash value of the hedged. We expect that our current liquidity, combined with our anticipated operating cash flow will be sufficient in the near term to fund operations, and continue pursuing our growth strategies.

I'll now wrap up on page 11 with a discussion of our outlook for fiscal 2022. Despite the current macroeconomic backdrop, we have great momentum heading into the summer selling season. We expect end market demand to remain strong, and the pricing environment to remain stable for the remainder of fiscal 2022.

Project activity is robust, and we have not observed a slowdown in bidding activity or a rise in project cancellations. Material costs continue to climb through the first quarter due to sustained demand and little to no improvement in supply chain capacity. As a result, we now expect pricing to be higher in the second half of the year than originally anticipated. We expect residential and nonresidential demand to be positive for the full year, though we expect pressure in the second half as we anniversary strong volumes in the prior year. We expect to continue benefiting from stable municipal repair and replacement activity through the remainder of the year. Overall, end market sentiment is positive and we enter the summer construction season with a strong backlog.

Taken all together, we now expect high teens net sales growth for fiscal 2022, consisting of stronger growth in the first half of the year, moderating in the second half as we annualize more difficult comparisons from both volume and pricing. Given the sustained price realization benefit from the rising material costs, we now expect gross margin rate to be roughly flat with the prior year. At the midpoint of our range, we expect to achieve SG&A leverage and we anticipate our full year adjusted EBITDA margin will be slightly above fiscal 2021.

With these factors in mind, we are raising our expectation for fiscal 2022 adjusted EBITDA to be in the range of \$710 million to \$750 million representing year-over-year growth of 18% to 24%. We expect to convert roughly 65% to 80% of our adjusted EBITDA and operating cash flow in fiscal 2022 as we work to optimize our inventory balances in the second half of the year. We typically convert 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 to

ensure product availability for our customers. Our expectation for operating cash conversion is less than originally anticipated due to sustained supply chain challenges and our decision to continue investing in inventory ahead of supplier cost increases.

To close out our prepared remarks, we are thrilled with our first quarter results. We have a resilient business model and a leadership team capable of adjusting quickly to changes in the market. We remain focused 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 today comes from Matthew Bouley of Barclays. Matthew, over to you.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Hi, this is Elizabeth Langan on for Matt today. Congratulations on the results. I was wondering if you could touch on, could you give us an idea of where you're seeing notable strength that's in your respective end markets and what's kind of driving those expectations higher and if you have seen a change in – within any of those markets given the uncertainty in the macro?

Stephen O. LeClair

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

Elizabeth, it's Steve. So, thanks for your question. What we've seen through first quarter had really been robust demand across all of these end markets. Municipal has continued to be very strong. You know, I think when we look at the demand in that area, it has continued to build for the last several quarters, and it's continuing to build, and bid activity looks very strong as well, too in municipal. Nonresidential has been strong, continues to really drive a lot of our fire protection sales.

And then residential. We've been watching it closely. Obviously, we're concerned about what happens with interest rates and all of the other dynamics that seem to be impacting residential. But land development continues to be really, really strong through the quarter and continues to be as we look forward.

So, yeah, I would say that we just saw all three end markets really performing extremely well as we got through first quarter and continue to see a lot of bid activity across all of them at this point.

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Thank you. That's really helpful. I was also hoping you could touch on how you're thinking about maintaining your market share gains that have been driven by your access to products. And do you expect those will be sticky or do you think that you'll see some reversion with the loosening of the supply chain?

Stephen O. LeClair

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

Yeah, what we're seeing right now is supply chain just continues to be tight, tighter than we anticipated. The capacity for a lot of our manufacturers, they've been challenged to try and increase that and any type of short- or medium-term timeframe.

So as that continues to be tight, we continue to get preferred access to product that many of our smaller competitors aren't able to get. We continue to serve them at a high level, and I think that's been the important part. As long as we can continue to get that opportunity to serve some of these newer customers that we've gained by getting access to product, we'll continue to support them when supply chains ease. So we're hopeful that we'll be able to continue that momentum even after the supply chain starts to ease at some point in the future.

Operator: [indiscernible] (00:27:31). Does that answer your question?

Elizabeth Langan

Analyst, Barclays Capital, Inc.

Yes. Thank you.

Stephen O. LeClair

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

Thank you, Elizabeth.

Operator: [indiscernible] (00:27:38) thank you. Our next question today comes from Nigel Coe of Wolfe Research. Nigel, over to you.

Good morning, everyone. This is [ph] Will Franco (00:27:53) on for Nigel.

Stephen O. LeClair

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

Good morning, [ph] Will (00:27:56).

I was first wondering if you could – good morning. I was first wondering if you could talk about the price cost contribution of the quarter and how you see it rolling through the rest of the year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. Thanks, [ph] Will (00:28:12). Thanks for the question. As you saw, gross margins for the quarter were strong, up about 200 basis points, really benefiting mostly from price cost spread. I'd say that's about, call it, 170- so basis points of that with another 30 basis points being contributed from accretive acquisitions and synergies there. So, we continue to benefit both with less favorable pricing environment, buying ahead of inventory, and then the gross margin initiatives that we've had in place and then [ph] continuously good response there (00:28:50).

Q

Got it. And I was also wondering if you could provide any color on how you're thinking about the seasonality of earnings this year and maybe any color on the second quarter set-up?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Yeah. Well, typically, what we'd see going into the second quarter would be a nice ramp up sequentially due to volume. I'd say, we're also continue to see pricing accelerate. So I would expect sequential growth at the top line and Q2. Typically, we'd see that kind of level off in Q3, and then Q4, typically sequentially would be down from those Q2 and Q3 levels primarily due to the colder regions that we have slowing down their construction season. So, we'd expect, I'd say, a return to kind of normal seasonality levels here through the remainder of 2022.

Q

Got it. That's very helpful. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah.

Operator: Thank you, [ph] Will (00:30:01). Our next question today comes from Joe Ritchie of Goldman Sachs. Joe, over to you.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Thanks. Good morning, everybody and congrats on the nice start to the year.

Stephen O. LeClair

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

A

Thanks. I appreciate that Joe.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

I guess my -- yeah, my first question is just around, I don't think I heard you guys say it, but the pricing commentary, what are you guys expecting for pricing as part of like your growth equation for the year? And then my follow-on to that is how should we be thinking about pricing in the second half of the year because obviously the comps get a lot tougher?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Joe. Yeah. On the pricing, I'd say within our guide, we were anticipating in our previous range that we gave pricing in kind of the mid-single digit range. We've increased that now to I'd say mid-teens for the full year, which, as you look at the back half assumes I'd say kind of low to mid-single digit pricing in the back half.

So, we've got it, I'd say, starting to stabilize and then potentially some of the commodities coming back later in the year. And just trying to reflect some of the uncertainty on the commodity side potentially later this year.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Got it. And then, Mark, I guess, what does that kind of mean for the gross margin equation then for the year? Because obviously, you guys are forecasting or embedding in the guide flat gross margins, but obviously great start to the first quarter. So is there – does that necessarily mean some pressure to gross margins naturally from those dynamics?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Joe, as we talked about, we do expect that we're benefiting from about 50 basis points to 100 basis points of some temporary margin benefit just given the environment we're in. Nothing really changing there in terms of our expectation. We've had now, I'd say several quarters and kind of this 26% -- north of 26% margin. So I think that 50 basis points to 100 basis points kind of coming off this run rate is that's how we're thinking about it. So as those prices potentially stabilize in the remainder of the year, I'd expect that temporary benefit to subside and [indiscernible] (00:32:28) really seeing that kind of back into that level that we were at in the prior year as we – as we finish off [indiscernible] (00:32:38).

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Got it. Okay. And if I could sneak one more in here. Steve, for you just the – you know, you mentioned that the infra bill, you are not expecting to see much of a benefit from that until 2023, some of it being supply chain oriented. Just -- can you just maybe provide a little bit more color? What's maybe holding up some of the spending? And then also, is there a risk at all that doesn't get spent or this is really truly just deferral into 2023?

Stephen O. LeClair

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

A

Joe, it's really looking right now that some of these projects are being tabled that would utilize these – those funds just simply because of the time constraints and the limited availability of product. So in the municipal world, some of the larger diameter projects that are out there, the lead time for some of this pipe – the pipe products and things like that can go out in some cases almost 52 weeks. So we believe until that capacity starts freeing up a little bit that we're just not going to see a whole lot of these funds being applied.

Now, things do change. If we start seeing maybe some residential start to soften in the back half of the year, I think that may be able to pull in some of this municipal demand and offset some of that. That's kind of how we're looking at it right now. But we're just seeing very robust pipelines today for our backlog and everything in municipal that these funds are just not needed at this point to continue the momentum that we – that we've been seeing for the last several quarters.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's great to hear. Thank you both.

Stephen O. LeClair

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

Thanks, Joe.

A

Operator: Thank you, Joe. We'll now move on to our next question comes from the line of Jamie Cook from Credit Suisse. Jamie, over to you.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Hey. Good morning. Nice quarter. I guess a couple questions. One, just the operating cash flow. You lowered your conversion rate to 65% to 85% – sorry, to 65% to 80% of adjusted EBITDA versus I think last quarter you were talking about 85% to 100%. So if you could give some color there, is it just inventory?

Q

And then my second question, back to pricing again. Can you just talk to what you expect or what you're seeing on pricing on PVC or other commodities and whether these moderate in the back half of the year and just pricing on non-commodities as well? Thanks.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Thanks, Jamie. On operating cash flow, it's really more of a factor on our growth that we expect now for the full year. We were expecting growth in the higher single digit. We've raised that now for the full year up into the high-teens. So, to support that kind of growth rate, we think the working capital need is higher, so that's what we reduced our guide for on the operating cash flow. I'd say our investments and inventory, we expect we'll maybe hold on to those a little bit longer, but more of its really related to the growth that we anticipate.

A

On the pricing side, really, we've continued to see accelerating pricing across the commodities through the first quarter. Non-commodities as well, we've seen price increases there. On our guide, we're assuming those prices kind of hold for the non-commodities, and commodities, we do have those coming back a little bit as we get through the end of the year. And, again, that's primarily reflecting some of the uncertainty in the macroeconomic backdrop if we do see some demand slowdown, which we haven't seen. But if we do see that, we've got that kind of reflected on pricing these through the remainder of the year.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Thank you.

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

All right. Thank you.

A

Operator: Thank you, Jamie. We'll take our next question today from Mike Dahl of RBC Capital Markets. Mike, over to you.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Morning. Thanks for taking my questions. Just on – a couple on the M&A side, you framed up M&A as contributing 5% to sales for the first quarter. Can you kind of give us a thought on just given what you've already closed or signed year-to-date, what's embedded in the full-year contribution for that?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Hey, Mike. Yeah, about 5% for the quarter price similar in the second quarter. We'll start to anniversary some of our larger acquisitions that we did last year primarily the Pacific Pipe and L&M Bag and Supply. So with the new ones that we've closed, we've got, I'd say in the low- to mid-single-digit range in the back half of the year. And that doesn't include our savers. That has not closed at this point.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

And just quickly on that. Is there any parameters you can give us to think about on, I know you said three branches in full service, but relative size I think of our savers?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. I'd say, we've provided in the past the average size branch kind of in the \$8 million to \$10 million range. So at three branches, you [indiscernible] (00:38:15) somewhere in that area.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

That's helpful. And my follow-up question, sticking on M&A, obviously, there's been a lot of capital markets disruption in the public markets. You're seeing rising funding costs and things like that. But just wondering what you're seeing in terms of M&A, whether some of this disruption has either shaken loose some assets, does it – has affecting competition for assets, how are you seeing incremental changes in your M&A pipeline today?

Stephen O. LeClair

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

A

Yeah. You know, Mike, what I'd share is that our pipeline has been pretty robust, certainly, going into the first part of this year and continues to be so. When we've seen this economic disruption and some of the uncertainty that's happened in the past where that really lends itself very well to the type of acquisition targets that we would typically be targeting in this and bring some of them to the table. So, we look at it as almost a favorable situation in our industry that when you start getting a lot of uncertainty along those lines it does really help aid the addition into the pipeline of some different assets in that areas. But, if you look at where we're -- the acquisitions that we've done, they've been just really good bolt-on acquisitions, whether they've been a waterworks branch in New York or in Colorado. You couple that with the consolidation we have underway and the erosion control and geosynthetics. It's just a very robust pipeline right now of opportunities out there for us to continue to consolidate. And we think any type of economic disruption probably helps us in some regard along those lines.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. That's helpful. Thanks, Steve. Thanks, Mark.

Stephen O. LeClair

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

Thank you.

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Operator: Thank you, Mike. Our next question today comes from Patrick Baumann of JPMorgan. Patrick, please go ahead.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Hi. Good morning. Can you give a little more granularity on the type of pricing you expect for commodity pipe this year that's embedded within that mid-teens pricing we expect for the total company. And then along those lines, in the first quarter versus the fourth quarter, what stepped up incrementally in price because the price contribution, it seems like improved a bit sequentially. Just curious, is that the commodity pipe? Or is that the other products that you saw that's other than the commodity pipe? Any color on that would be helpful.

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. Patrick. First, I guess on the Q4 to Q1, we did see an acceleration of pricing sequentially. I'd say PVC was a factor there. I wouldn't say it's rising as fast as some of the other product lines that we've had. PVCs had had a good run. So I wouldn't say that was necessarily the largest contributor in terms of the level of the increase. But, we have seen it really across a lot of the other non-commodities which have taken maybe a little bit longer to get priced than the commodity. So we have started to see a benefit coming out of there.

A

In terms of the guide going forward on commodity versus non-commodity, I'd say we haven't really broken it out that way. But embedded in our guide for the kind of full year mid-teens pricing does assume some of those commodities come back down. I think the non-commodities we really view as much, much stickier for the long term and continue to believe there's probably even some more opportunity there with some of those products as those suppliers look to try to recoup some of their costs that they've incurred. So that's probably the best way to think about that right now.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Okay. And then on the comments you made around, no benefits from infrastructure yet in kind of a demand that you're seeing. And then subsequent comments that if there was moderation in project activity in your other markets, non-res or resi that you could maybe see a step up in the ability to serve that. I'm just curious, has there been demand you're seeing from a muni perspective so far that you haven't been able to serve because you're just too busy with private, like the resi and the non-res stuff? Is that why you're making that comment? I'm just curious if you can give more color on the comment?

Q

Stephen O. LeClair

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

Yeah. More of the comment is really geared towards municipal projects that are out there, where a lot of the municipalities are just holding off at this point from further rehabilitation of their lines, just given the challenges associated to getting access to product. Pipes, not pipes. So there's a lot of different diameters of pipe that have different characteristics. Some may be more available than others.

A

And for some of these projects, particularly projects with larger diameter pipe, as the lead times right now are prohibitive from a lot of these municipalities from really aggressively pursuing some of these projects at this point. So we are seeing some of that happen. But for the most part, it's not a trade-off of which end market are we serving. And there's more so than, are we seeing some delay in some of these projects pending better availability of product and shorter lead time so they can execute them in a more consistent, predictable manner with the more predictable pricing.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Understood. Okay. Thank you.

Operator: Thank you, Patrick. We'll now move onto our question from Keith Hughes of Truist. Keith, the floor is yours.

Keith Hughes

Analyst, Truist Securities, Inc.

Thank you. Most of my questions have been answered, but I guess you talked about product availability issues continuing. Can you list off the top couple of problems out in terms of getting supply for your customers?

Stephen O. LeClair

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

Well, there's – I wouldn't want to give strong specific product detail or supplier details. But I think when you're looking at some of the demand that's out there, particularly for some of the basics like pipe, the lead times have [ph] extended out, fittings have extended (00:45:09) out. Those are obviously critical to being able to complete a lot of these projects. You get into some smaller components that may be out there in terms of restraints and gaskets and things like that that can sometimes slow a project down. Those are – those are primarily what we're seeing, and we're trying to balance a lot of that across all the country right now to fulfill projects along those lines.

Meters have been a big one as well too. So we're still continuing to be challenged with getting access to all of the meters that we need for a lot of the smart meter installations that we have, where they're still struggling to get the proper chips and everything they need to produce at the quantity that we need. So those are – those are couple of the areas, Keith, that we're seeing some of those constraints still.

Keith Hughes

Analyst, Truist Securities, Inc.

Those are not just commodity areas you're seeing in some of the more engineered product there's – there's problem there?

Stephen O. LeClair

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

Yeah, correct.

Keith Hughes

Analyst, Truist Securities, Inc.

If I hear what you're saying?

Stephen O. LeClair

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

Yeah, correct. Yeah, absolutely.

A

Keith Hughes

Analyst, Truist Securities, Inc.

All right. Thank you.

Q

Stephen O. LeClair

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

Yeah.

A

Operator: Thank you, Keith. Our next question comes from David Manthey of Baird. David, over to you.

David John Manthey

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

Thank you. Good morning. And, Steve, you mentioned the land development trends. What are the other key datasets that are on your dashboard today?

Q

Stephen O. LeClair

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

We're watching that closely. We're obviously watching our bid activity in a lot of these areas, David. So, when we're looking at whether it's a municipal bid or a residential land development, we're watching the pace at which these are happening. We're watching the execution of these projects. Obviously, time to execute a lot of these projects has been prolonged in some cases given labor shortages and supply constraints.

A

So, we watch a lot of those aspects to make sure that projects are moving along. We've seen our backlog age a little bit as we try and fulfill, and execute the fulfillment through these. So, those are a couple of key things that are on my daily and weekly look at I – and how I assess what's happening out there. And as we've gone through that, we've been able to relook at how we're looking at the rest of the year, how we're looking at pricing. And I think you've seen that reflected in the guidance that we provided, and the confidence that we have, and what we're seeing in our end markets at this point.

David John Manthey

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

Okay. And I'm not a big fan of comparing every cycle to the GFC, but HDS Waterworks was down in 2007, 2008, and 2009 more than 50% peak to trough. And that may have been [ph] tax rolls in that unstable mini-market (00:48:02), and things like that, but can you discuss the mix of the business and the overall economic environment today versus the predecessor company in that environment which is clearly unusual?

Q

Stephen O. LeClair

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

Yeah. Certainly if we go back to the Great Recession and what happened back in that timeframe, our business was nearly 50% residential at that time. We focused a lot of our effort and resources on that. Since that timeframe, one of the things that we were challenged with, it's about the time when Mark and I came on board to

A

really try and reposition the business for long-term sustainable growth. And we built out a number of new opportunities within municipal. We started aggressively going after smart meters, going after other products to better serve that new municipal sector. And, now you're seeing a much different shift with where our business is positioned on how residential plays into it.

So, in addition, what I would say is back then as well too, we were also going through an integration of two different sizable integrations of two players, National Waterworks and Hughes Supply Waterworks. So there was a lot – there was some internal consolidation that was happening as well, which just lent itself with some of the challenges that we face out. What we have seen is we really positioned ourselves in so many different ways from a product standpoint, from a market standpoint, from a sales standpoint, to better drive a lot of the adoption in that – of those and to continue that sustainable growth.

Secondly is even during that downturn, we generated an immense amount of cash that we were able to use to reinvest back in the business. And that's been one of the cornerstones of how we've really endured through a lot of these different economic size cycles as between our ability to adjust our SG&A and adjust our investments and how cash spins off, and we look at it some type of downturn. Does that help at all, David?

David John Manthey

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

It does. Yeah. It's very good. Thanks a lot, Steve.

Stephen O. LeClair

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

Thank you.

Operator: Thank you, David. We'll take our next question from Anthony Pettinari of Citigroup. Anthony, please go ahead.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

Hi. This is Asher Sohnen on for Anthony. I think you pointed to strong demand in residential and – but I think on your last call, you talked about expecting demand from residential end markets to sort of decelerate from low double-digit growth to sort of mid-single-digit to high single-digit growth in 2022. Is that still the case?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. Asher, the way to think about it is we have really strong demand last year, so especially as we got later into the Q3 and Q4. So going up against those comps, I'd say, we expected a lower growth rate in terms of residential demand. But we're still seeing the strength there and a lot of development just not at the at the rate coming off of kind of double digit increases that we saw last year.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

Great. Thanks. And then just as a quick follow up, just on your comments around product availability, with some of these projects, these municipal projects on hold as product availability remains tight, is there a risk that the sort

of IJJA funds don't even flow through meaningfully in 2023 is sort of like product availability challenges persist throughout the year?

Stephen O. LeClair

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

A

There's a chance, I guess, that could happen. But I would say, given the demand that we've seen and the desire to be able to do a lot of these projects, I think you're going to see those funds start flowing through in 2023. I think it'll replace a lot of the self-funding that's happened with a lot of the municipals, a lot of the bond markets, and the bond funding that has happened with some of the existing projects. So, we anticipate it'll be utilized and that demand and momentum will continue into 2023.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

Q

Great. That's really helpful. I'll turn it over.

Stephen O. LeClair

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

A

Thank you.

Operator: Thank you, Asher. We'll take our next question today from Kathryn Thompson of Thompson Research Group. Kathryn, over to you.

Kathryn I. Thompson

Analyst, Thompson Research Group LLC

Q

Hi. Thank you for taking my questions today. I'm focusing on inflation outlook and on inventory. First, how much of the raised outlook is driven by volumes versus pricing and putting some year-over-year perspective on both of those metrics?

And then the second on [ph] really (00:52:48) on the inventory side, given the shift from a just-in-time to just-in-case strategy in a post-COVID world, how are you managing inventories going forward? Some color on fill rates today versus year-ago period would be helpful? And why bring this up is simply because even though inventories carry a greater value overall in a post-COVID world, we're starting to see some companies that are getting a little over their SKUs in terms of inventory. So, any color in terms of how you plan on managing inventories effectively. So, you also don't get over your SKUs. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

All right. Thanks, Kathryn. It's Mark, I'll take the inflation question first. On the – yeah, in terms of the raise on the guidance, I would tell you most of that is pricing. Like we said, we saw a lot of that accelerate and continue to accelerate through Q1. So, that top line raise, I'd say is primarily pricing. And in terms of the full year, on that, I'd say it's in kind of the mid-teens that we expect and that's at a lower rate than what we had in the first quarter. Obviously, as we continue to anniversary some of those inflationary metrics that we had in 2021. So, we expect that rate of acceleration would slow down throughout 2022.

Steve, you want to take the inventory?

Stephen O. LeClair

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

A

Sure. So, Kathryn, we talked a little bit about just-in-time and just-in-case inventory, one of the things I'd share with you that we watch closely is so much of our business is project-based. And so, when we're looking at bringing in inventory, the majority of that inventory is essentially allocated to a specific project for the most part. We do do some speculative buy and some items that obviously would be stock for ready to serve type inventory. Those tend to be very transferable across our network in different branches. So, now it is something obviously we watch and watch closely to make sure that our inventory doesn't get out of balance with what we're seeing both with our backlog and our bidding activity. So we're very conscientious of that. As you saw in the last several quarters, we've been able to invest in inventory and show a real strong return and we predicate a lot of that based on being able to understand what's coming at us in terms of these projects that we're yet to fulfill that are in our backlog and what the bidding activity looks like in these end markets.

So we do watch it closely. We're obviously very aware of some of the challenges that particularly some of the retailers have gone through with writing down inventory, et cetera. But all of our inventory is either allocated or fungible to other – other projects across our network to be able to be utilized along those lines.

Kathryn I. Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Great. That's helpful. And then, in terms of what visibility you have for volumes, which is really more, let's say, backlogs, but the projects that are upcoming, what type of or what types of changes are you seeing in terms of type of projects? How has that changed today versus a year ago and even from the start of this year? Thank you.

Stephen O. LeClair

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

A

You know, from a year ago, I think probably the one area we're seeing some continued growth in is certainly in non-residential construction and commercial construction. So we're seeing our fire protection product pull through been a lot stronger as we started this year. That was an area that was recovering after COVID. And we're starting to see some strength in that area, which has been encouraging. Residential and municipal have just been pretty steady and stable for the most part from what we've seen compared to last year.

Kathryn I. Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Great. Thanks very much.

Stephen O. LeClair

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

A

Thank you, Kathryn.

Operator: Thank you, Kathryn. We have our last question today from Andrew Obin of Bank of America. Andrew, please, go ahead.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Q

Thank you. I think this is David Ridley-Lane on for Andrew Obin. Mark, I just want to clarify something that you said earlier. So last year, you got a 50 to 100 basis points gross margin benefit from sell through [ph] or (00:57:26) lower cost inventory. Is your expectation that that is flat for this full fiscal year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. So the way I would think about that is that 50 to 100 basis points would be off of what our margin rate has been over the last, I'd say, three quarters, which has been in a kind of low 26% range. And when you apply that for the remainder of the year, you end up with gross margin rates that are about flat with 2021.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Q

Got it. And then the other question that [indiscernible] (00:58:05) have you seen – I absolutely hear you on the [indiscernible] (00:58:10) pipeline and so forth. Have you seen any indicator [indiscernible] (00:58:12), Mike, maybe the time from bidding to project start or anything happening? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. No -- thanks for the question. Really, we have not seen any indicators at this point that there's any softness. And we continue to talk to our suppliers, our customers, look at all of our internal data that we've seen and really nothing at this point that points to any kind of a slowdown in those times.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Q

Got you. Thank you very much.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks.

Operator: Thank you, Andrew (sic) [David] (00:58:53). That was our final question today. So I'd like to hand back to Steve for any closing remarks.

Stephen O. LeClair

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

Thank you all, again, for joining us today. It's a pleasure to have you on. We hope you're doing well. We are extremely pleased with our first quarter performance, continue to focus on the controllable areas of our business. While there are many external factors that continue to impact the global economic backdrop, we remain confident in our ability to deliver strong results to our stakeholders in 2022 and beyond. We 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, Steve. This concludes the call today. Thank you all for joining. You may now disconnect your line.

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