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Core & Main, Inc. (CNM)

Q3 2022 Earnings Call

CORPORATE PARTICIPANTS

Robyn Bradbury

Vice President-Finance & Investor Relations, Core & Main, Inc.

Stephen O. LeClair

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

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

OTHER PARTICIPANTS

Matthew Bouley

Analyst, Barclays Capital, Inc.

David John Manthey

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

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Mike Dahl

Analyst, RBC Capital Markets LLC

Keith Hughes

Analyst, Truist Securities, Inc.

Vivek Srivastava

Analyst, Goldman Sachs & Co. LLC

Patrick Baumann

Analyst, JPMorgan Securities LLC

David Ridley-Lane

Analyst, BofA Securities, Inc.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, welcome to the Core & Main Q3 2022 Earnings Call. My name is Glenn and I'll be the moderator for today's call. [Operator Instructions]

I would now hand you over to your host, Robyn Bradbury, Vice President of Finance and Investor Relations, to begin. Robyn, please go ahead.

Robyn Bradbury

Vice President-Finance & 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 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 business update and an overview of our recent acquisitions. He will then highlight an example of how we help build sustainable water resources for the communities we serve, followed by a discussion on the resilience of our end markets. Mark will then discuss our third 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 third quarter earnings press release this morning and posted a 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 third 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 are following along with our investor presentation, I will begin on page 5 with a brief business update. I am pleased to report another strong quarter as we continue to build on our momentum achieving double-digit growth in both net sales and adjusted EBITDA. This marks our eighth consecutive quarter of double-digit net sales growth with third quarter net sales exceeding our expectations due to healthy end market demand, robust performance across our growth initiatives, and continued price realization. It is an impressive accomplishment considering the 39% sales growth we achieved in the same period last year.

Our teams continue to execute at a high level to grow the business and support our customers, suppliers, and communities. We achieved strong volume growth in the third quarter, driven by a combination of end market growth and share gains from the execution of our product, customer, and geographic expansion initiatives. Municipal repair and replacement activity was strong. We expect it to remain positive through the end of the year and beyond. Municipalities continue to benefit from healthy budgets, allowing them to invest in improvements to their aging water infrastructure. Additionally, we believe the funding available through the infrastructure bill will start to flow to municipalities at some point in 2023.

During the quarter, we saw non-residential construction activity strengthen as suburban communities expand which increases the demand for our waterworks, storm drainage, and fire protection products. Historically, non-residential construction activity has lagged residential housing development by roughly 12 to 18 months. We believe we are currently seeing non-residential construction strengthen due to the growth in residential development we experienced in late 2020 and 2021. We expect continued strength and resilience for both our municipal and non-residential end markets.

Shipments for residential projects were healthy throughout most of the quarter. However, we began comparing against very strong volumes at the end of the quarter both year-over-year and sequentially. Residential bidding activity varies across the country. Many areas remain positive, but in some areas, project scopes are shrinking in size as developers assess the evolving economic environment and the recent reduction in housing starts. Over the long term, we believe homebuilders will continue developing lots and that the lack of home supply will continue to drive growth in the residential market over a multiyear period.

Supply remains constrained for many of our products. Certain products continue to have long lead times or lead times that are inconsistent, which has made it difficult to fully optimize our inventory levels. As the quarter progressed, we began to see product availability and lead times improve for certain products, including PVC pipe. We saw PVC pipe prices stabilize and remain elevated during the quarter despite the improvement in lead times and availability. We believe the specificity of our products to our industry has provided resilience against price volatility, but we are monitoring closely to assess the impact of improving product availability and slowing demand due to normal fourth quarter seasonality.

As product availability improved and lead times became more predictable for certain products, we began to reduce inventory levels for those products as the quarter progressed. In such cases, we no longer need to carry as much inventory to maintain service levels with our customers. We expect to continue optimizing inventory levels in the fourth quarter and into the next year as supply chains improve for other product categories.

On the M&A front, we welcomed four new companies to Core & Main during and subsequent to the quarter, strengthening our product lines, geographic footprint and talent while highlighting our ability to drive sustainable growth through M&A. We have now surpassed \$800 million in combined annualized historical net sales from acquisitions since becoming an independent company in 2017. Acquisitions are a key source of new talent and expertise, and they continue to enhance our competitive position as we grow. Our pipeline remains robust with significant opportunity for continued growth through M&A.

We also opened a new location in Fort Collins, Colorado, our second greenfield this year. This new location extends our waterworks product offerings in Northern Colorado and Southern Wyoming, building on our commitment to make our products and expertise more accessible in every region we serve.

We issued our 2022 Environmental, Social and Governance Report in October. At Core & Main, ESG and sustainability is an integral element of our business. We are focused on supporting our nation's critical water infrastructure needs while delivering long-term value to our stakeholders. Our approach to ESG is holistic strategy that spans from our vision to our core principles and policies to how we meaningfully engage with our associates, customers, suppliers, shareholders and communities. As we continue to make progress toward our ESG priorities, I am pleased to share Core & Main's accomplishments in our second ESG report, which demonstrates the impact of this important work and the goals we strive to achieve in the coming years.

I'll now discuss each of our acquisitions in greater detail on page 6. 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 has proven itself to be a supplier of choice in its local market for 70 years. This strategic acquisition will allow us to better serve our combined customer base alongside a highly experienced and passionate team.

Trumbull is a distributor of pipes, valves and fittings, storm drainage products and meter products with additional capabilities that will significantly expand our private label offerings. Trumbull operates out of three locations, two of which are distribution facilities and one of which specializes in private label products serving municipal and industrial end markets. Trumbull brand is well-known and trusted throughout the industry for their tools and accessory kits used in the maintenance and repair of water infrastructure products and facilities. We will leverage our scale, internal purchasing processes, sourcing network and distribution footprint to grow the Trumbull brand as we expand our product offering into new categories.

Distributors, Inc. is a full service distributor and fabricator of fire protection products located in Hawaii. Operating out of its facility in Honolulu, Distributors, Inc. provides fire protection contractors with quality products and services for new fire protection systems in the maintenance and repair of existing systems. Our recent acquisition of Pacific Pipe expanded our waterworks product offering into Hawaii for the first time. After more than a year of building our capabilities in this market, we are excited to now offer a complete line of fire protection products through the acquisition of Distributors, Inc.

Lanier Municipal Supply is a full service distributor of water, wastewater, storm drainage and meter products operating out of four locations across Florida and Georgia. They have spent the last four decades building a

reputation as a leading distributor in the Southeast. The depth of knowledge and expertise they bring to us strengthens our position as a leading specialty distributor in the region. This acquisition adds key talent and expands our product offering in an underserved market.

Each of these businesses align well with our core M&A strategy, offering expansion into new geographies, access to new product lines, and the addition of key talent while adding approximately \$115 million of combined annualized net sales.

On page 7, we highlight an example of how we build sustainable water resources for the communities we serve. The City of Waukesha, Wisconsin needed a new sustainable water solution to continue supplying clean water to its community of 72,000 residents. The area relies primarily on a local sandstone aquifer for their water, but the water levels in the aquifer were dwindling as time passed due to a growing population. The city formed a specialized task force to address this issue and completed thorough studies to find a sustainable solution that would serve the community's clean drinking water needs for the long term. It involved transporting water from Lake Michigan to the City of Waukesha and then transporting the water back after it was used and treated. Core & Main was selected to help address this infrastructure challenge.

Our local experts led trainings to educate project partners on potential solutions and supplied 26 miles of 30-inch ductile iron pipes including all the necessary valves, fittings and accessories to build a new pipeline from Lake Michigan to Waukesha. Our product expertise, combined with the lead contractor, provided an all-encompassing approach to developing a complete and environmentally effective water infrastructure solution.

We are proud of the work we do to support local communities, whether it be supporting access to clean drinking water, water conservation efforts, solutions to reduce the impacts from droughts and flooding, or through the safety provided by our fire protection systems. We believe that our people, products and services make a positive impact to communities.

Now turning to page 8, I'd like to spend a few minutes discussing our end markets and the resilient demand for our products and services. We have diversified end market exposure between municipal, non-residential, and residential construction markets nationwide. We maintain a balanced mix between new development and repair and replacement projects.

Our municipal end market, which makes up roughly 39% of our net sales, consists primarily of repair and replacement projects to existing infrastructure. 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, the pace of investment in our nation's water infrastructure has lagged the need for investment especially over the last decade, and an estimated \$2.2 trillion is required for repairs and upgrades over the next 20 years to close the growing water infrastructure gap. In recent years, access to capital, increased water utility rates, and necessity have increased municipal investment in water. We expect funding from the Infrastructure Investment and Jobs Act to strengthen investments in municipal water infrastructure in 2023 and beyond.

The first tranche of funding has been distributed to the state revolving funds, and municipalities are in the process of applying and evaluating whether their projects qualify. Once funds are awarded and allocated, municipalities will begin building them into their fiscal budgets. At that point, we expect they will begin spending these funds on new projects.

Our non-residential end market, which makes up roughly 39% of our net sales, consists of a balanced mix between new development and repair and replacement projects, and includes everything from commercial and industrial development to less cyclical road and bridge rehabilitation projects, which benefits our storm drainage product lines. This market also encompasses most of our fire protection projects, including the installation of fire protection systems in new buildings, along with the retrofit of existing systems to comply with changing regulations or redesigns.

Our residential end market, which makes up roughly 22% of our net sales, consists primarily of the water, sewer, and storm drainage products supporting new lot development for residential building sites. Land developers often purchase large tracts of land for development that were not previously connected to utility infrastructure. We supply our products to the underground contractors installing the infrastructure to support the community. Over the long term, we believe the lack of developed lots and the undersupply of new homes will continue to drive growth in our residential end market.

I am proud how our team continually executes. I want to thank our associates for their dedication and commitment to customer service. I also want to thank our customers and suppliers for their continued partnership. We continue to execute across our key growth strategies, deepening our competitive advantage, and building on our foundation of long-term profitable growth.

I will now turn the call over to our Chief Financial Officer, Mark Witkowski, to discuss our third 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 page 10 with highlights of our third quarter results. We reported net sales of \$1.8 billion, an increase of 29% compared with the prior-year period. The increase was partly due to price inflation from passing along rising material costs to our customers, mid-single-digit volume growth driven by a combination of end market growth and share gains, and approximately 3 percentage points of contribution from acquisitions. We outperformed our end markets and gained share in the quarter due to our strong execution across our product, customer, and geographic expansion initiatives.

We continue to experience rising material costs across many of our product lines in the third quarter. As supply chains improve for certain products, we are beginning to see those costs stabilize, most notably in our municipal PVC pipe category. If prices hold steady from where they are today, we expect price contribution to moderate in the fourth quarter as we anniversary the price increases from a year ago.

Gross profit increased 35% to \$500 million in the third quarter, and gross profit margin increased 110 basis points to 27.5%. Gross margin was positively impacted by our margin enhancement initiatives, accretive acquisitions, utilization of lower cost inventory, and a favorable mix benefit.

Selling, general, and administrative expense increased approximately 23% to \$231 million in the third quarter. The increase was primarily due to an increase in personnel expenses, which was driven by higher incentive compensation costs from higher sales and profitability. In addition, distribution and facility costs increased due to higher volume and inflation. SG&A as a percent of net sales improved 70 basis points to 12.7%. The improvement was due to our ability to leverage our fixed costs on the increase in net sales.

Interest expense in the third quarter was \$16 million, compared with \$12 million in the prior year. The increase was due to our borrowings on the senior ABL credit facility and an increase in interest rates on the unhedged portion of our short term – our senior term loan.

Our effective tax rate in the third quarter was 18.3%, compared with 18.6% in the prior year. The reduction reflects certain fixed tax expenses and permanent differences, decreasing as a percentage of pre-tax income, partially offset by a higher percentage of income attributable to taxable entities due to the secondary offerings that were completed in January and September of 2022.

During the third quarter, a secondary public offering of 11 million shares of Class A common stock was completed, our largest current shareholder, Clayton, Dubilier & Rice. We did not issue any new shares in the offering and we did not receive any proceeds from the sale. Following the offering, CD&R affiliates' ownership in Core & Main decreased to roughly 65%.

We recorded adjusted net income in the third quarter of \$165 million, compared with \$105 million in the prior year. The improvement was due to our strong sales growth, gross margin improvement, and SG&A cost leverage, partially offset by higher interest expense and 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 46% to \$275 million, compared with \$189 million in the prior year. Our adjusted EBITDA margin improved 160 basis points to 15.1% due to our strong net sales growth, gross margin improvement, and leveraging our cost structure and the increase in net sales.

Now I'd like to provide a brief update on cash flow and balance sheet on page 11. Net cash generated from operating activities during the quarter was \$154 million, an improvement of \$121 million compared with the prior-year period. The improvement was primarily due to higher profitability and actions we took to optimize inventory, partially offset by higher cash taxes. We expect to generate stronger operating cash flow in the fourth quarter from normal seasonal working capital unwind in addition to our inventory optimization efforts if our supply chains continue to improve.

Net debt at the end of the quarter was nearly \$1.6 billion. The decrease in net debt from last quarter reflects a \$52 million reduction in borrowings under our senior ABL credit facility. Net debt leverage at the end of the quarter was 1.7 times, a 1.1 times improvement from the prior-year period due to an increase in adjusted EBITDA. At the end of the quarter, we had over \$1.1 billion of liquidity consisting of excess availability under our ABL credit facility.

Turning to page 12, we highlight our capital allocation priorities. Over the long term, we envision maintaining a balance sheet with significant available liquidity and a net debt leverage target of 2 to 3 times. Historically, we've had generated significant levels of cash flow from operations, and we have been able to make continued investments in organic growth and operational initiatives as well as acquisitions while simultaneously deleveraging our balance sheet. We expect to keep organic and inorganic growth as our top priorities for deploying cash.

In addition to these opportunities, we expect to continuously evaluate our capital deployment opportunities, including returning value to shareholders through share repurchases. While share repurchase programs are often utilized in such situations, our current float is modest relative to our market capitalization, and open market purchases would likely not be our initial path. Considering that CD&R is our current largest shareholder and is likely to monetize its ownership position over time, it may make sense to consider a repurchase directly from them

from time to time, which may be directly negotiated or in conjunction with concurrent secondary share sales to the market.

I'll wrap up on page 13 with a discussion of our outlook for the rest of the year. We've sustained great momentum through our summer and fall selling seasons, delivering impressive results despite the strong prior year growth we are comparing against. Demand indicators remain positive for our municipal and non-residential end markets. And our customers remain busy with strong backlogs. Municipal repair and replacement activity, which makes up roughly 39% of our net sales, continues to grow. This market has proven to be more durable than new construction and we expect it to remain positive in the fourth quarter.

We are seeing an acceleration of non-residential construction activity as suburban communities expand, which increases the demand for many of our products. Non-residential bidding activity and backlogs are both positive, and we expect demand to remain positive through the end of the year.

As Steve indicated earlier, we are beginning to comp against strong residential volumes in the fourth quarter of last year. And single-family housing starts have continued to weaken in recent months. We are gauging the health of residential market by assessing our bidding activity and by having discussions with our customers and field teams.

Based on these factors, we are expecting pressure in the residential market during the fourth quarter. Despite the potential for near-term pressure, we remain positive over the long term, believing that homebuilders will continue developing lots and the lack of available home supply and developed lots will continue to drive growth in this market. As a reminder, residential lot development makes up roughly 22% of our net sales.

In total, we expect our end markets to provide a solid foundation for us to continue driving above-market growth from the execution of our product, customer and geographic expansion initiatives while delivering tremendous value to our customers. As a result of strong demand and continued supply chain challenges for many of our products, we have experienced a better pricing environment for longer than anticipated. This has resulted in elevated prices through the third quarter, which we expect to persist through the remainder of the year, though price contribution will be sequentially lower as we anniversary the price increases from a year ago.

As supply chains continue to improve and demand softens, it is possible we could start to see the cost of certain products come down in 2023. However, based on our current demand and supplier indications, we expect cost increases to continue for many product lines, and we will work to pass them on accordingly. Potential inflation in these product categories are likely to offset a portion of the potential future deflation on certain commodity-based products.

With respect to gross margin, we delivered another strong result in the quarter, some of which was driven by a mixed benefit that is likely temporary. We could see a sequential margin rate decline in the fourth quarter as our inventory cost catch up with market prices and mix returns to normal. Given the continued benefits from our inventory investments, the favorable pricing environment, and our recent mix benefit, we now estimate that roughly 100 to 150 basis points of our year-to-date gross margins may be temporary in nature and could reset once supply chains and costs fully normalize. However, we expect continued margin enhancement from our gross margin initiatives, including private label and synergies from accretive acquisitions, which would help offset this potential reset in gross margin rate.

Taken all together, we are raising our expectations for fiscal 2022 net sales growth to be in the range of 31% to 33% and adjusted EBITDA to be in the range of \$910 million to \$930 million. Consistent with the expectations we

have shared since the beginning of the year, we anticipate normal fourth quarter seasonality this year. We had 50% net sales growth in the fourth quarter last year, which included a longer selling season due to unusually moderate weather.

Regarding operating cash flow, we saw a steady improvement in the third quarter and we anticipate stronger operating cash flow in the fourth quarter from normal seasonal working capital unwind in addition to our inventory optimization efforts. We expect to end the year with 40% to 45% operating cash flow conversion from adjusted EBITDA.

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, and we remain focused on executing at a high level and 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] We have our first question, comes from Matthew Bouley from Barclays. Matthew, your line is now open.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Hey. Good morning, everyone. Thanks for taking the questions and congrats on the results. I wanted to ask a question on – you mentioned in the prepared remarks around pricing kind of commodities versus some of your other product lines. I think I heard you say that you're expecting cost increases for many product lines and that could offset commodity-based deflation in other categories. I'm just curious if you can kind of expand on both of those. I know you mentioned a lot around PVC, but just kind of any specifics around what level of commodity deflation we could expect into the new year? And then where are you seeing those kind of offsetting product line increases? Thank you.

Stephen O. LeClair

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

A

Yeah. Thanks, Matthew, for the question. In the third quarter, we really saw some nice momentum in a lot of the non-commodity products. We saw some nice cost increases come through which our suppliers had indicated that they were working on and we were able to get those passed along to our customers. I'd say on the commodity side, those prices were fairly stable for the quarter and that was despite some improvements to supply chain there.

So, that was a positive, I'd say, development for us as we look forward and what could happen as we get into 2023. We're still expecting non-commodity products in those areas to see some additional cost increases and we'll work those through. As we mentioned, still too early to say on the commodity products and what could happen there, but I think the momentum we saw coming out of the third quarter and in the fourth quarter could help if there is any potential declines there as we go forward.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

All right. That's helpful. Thank you for that. And secondly shifting to the margin side, I think I heard you say that you now view potentially 100 to 150 basis points of temporary margin may have been achieved year-to-date which I guess would suggest sort of mid- to high-25% gross margins would be normalized. I guess, number one, how quickly do you think we reach that level? And number two, as you reach that normal level, should we kind of think of that as the new baseline after which your margin initiatives that you've been working on kind of organically could then see that margin expand from those levels? How should we think about all that? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Matthew. On the gross margin side, yes, we did increase that expectation from \$50 million to \$100 million, to \$100 million to \$150 million now. So I think the baseline you're looking at there from kind of 25%, mid – 25.5% up to 26% as a reasonable baseline to look at.

In terms of the timing of that, it does depend a bit on ultimately what we see on some of these other product categories. And if we continue to see some price opportunity, we still have a lot of, I'd say, low-cost inventory and a lot of the non-commodity products. So, if those market prices keep rising, that'll help defer some of that maybe into 2023. So, we'll keep an eye on that. But the timing of it, I'd say, is going to still depend on how that supply chain frees up.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

All right. Wonderful. Thanks, guys. Good luck.

Stephen O. LeClair

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

A

Great. Thank you.

Operator: Thank you, Matthew. We have our next question, comes from David Manthey from Baird. David, your line is now open.

David John Manthey

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

Q

Thank you. Good morning, everyone. First question probably for Mark, a lot of distributors these days are flagging elevated variable comp expenses in the inflationary environment. Could you talk to us in dollar terms approximately by how much is your variable comp elevated relative to what you would consider normal right now?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Dave, I can talk to you about how that works. And as we generate higher product and gross margins, that's how we commission our sales reps. So as you see expansion in gross margins like we've had both through volume and margin expansion, you would typically see those types of variable plans expand at a higher rate than the sales that we've had. And then similarly, we've got other structures in place for bonuses based on profitability and return on investment, which have all performed very well. So we have seen some elevated incentive compensation costs that are flowing through SG&A.

And as – at the same time, if we were to see any kind of economic uncertainty happen or reductions in top line or margins, then that kind of cost comes out very quickly as well. So, we have seen some elevation there. It's flowing through SG&A, but given the overall performance, we've still been able to leverage that and deliver some really nice EBITDA percentage increase.

David John Manthey

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

Q

Yeah. Thanks. And I assume that's tens of millions of dollars. Is there any way you can put a slightly finer point on that or we could follow up also?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah, Dave, I'd say that's a reasonable way to think about it. It's definitely at those levels. It's a larger component of our personnel expenses, which makes up about 75% of our SG&A. And a good chunk of that is variable compensation.

David John Manthey

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

Q

Okay. Okay. And then second, you talked a little bit about the trends you're seeing in residential lot development. Could you discuss the Great Financial Crisis and some of the leads and lags you saw at that time? Obviously, it was a very overbuilt situation then. But are there any insights that that experience gives you relative to the current downturn that we're seeing?

Stephen O. LeClair

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

A

David, there's a couple things that we saw back during the Great Recession. Number one, our business was positioned very differently at that time as well to about 50% of our business was really geared towards new lot development in residential. So we were much more dependent upon that sector.

The other thing I'd share with you is, during that time period, lot development continued to happen after the recession really appeared. And so we continued to see a lot of vacant undeveloped lots that permeated through that entire sector that took years of work to finally work its way through the network.

And I think we're in a different spot now because lot development is almost hand to hand with new housing starts to some degree, and builders are trying to get ahead of that. They are also anticipating that, hey, at some point, whether it's next year or in 2024, they're going to need these lots ready to go to see the expansion again and the long-term needs for this housing development. So it's a much different profile that we have for our business, and it's a much different situation of where housing is, particularly lot development than where we were coming out of the Great Recession.

David John Manthey

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

Q

All right. Thanks, Steve. Mark, Robyn, thank you.

Stephen O. LeClair

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

Thanks, David.

A

Operator: Thank you, David. We have our next question, comes from Kathryn Thompson from Thompson Research Group. Kathryn, your line is now open.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Hi. Thank you for taking my questions today. Just – the first is just a cleanup from your guidance question or your guidance from today. And I appreciated all the color you've given. But what is embedded in terms of volume assumptions going for Q4? And then as you look into either the balance of calendar 2023 or for the next fiscal year, what are your high-level expectations of that balanced contribution of price versus volume?

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, Kathryn, it's Mark. I'll take that one. In terms of the guide for the fourth quarter, what we've got embedded in there, I would say, is kind of volume down kind of mid- to high-single digits, and again, primarily due to the really difficult comps we had last year. If you go back to Q4 of 2021, volume was up in the teens. And we had really, I'd say, unusually strong weather season for – in particular in our northern climate. So we're comping against a tough quarter there.

A

I think as you look forward, we do plan to issue guidance as part of our Q4 release, but recognize there's a lot of interest and what's going on in the end markets and volume. I'd say, as we mentioned in the prepared remarks, we are anticipating some near-term softness in the resi market, which is just about 20% of our mix. So it's too early to tell really the extent of that softness, but given the slowdown in single family starts, we believe that likely correlates into some softness in the lot developments.

On the non-resi side, we have seen strong construction activity and that should continue to benefit us, and certainly is a lagging end market relative to resi. So, I do expect non-residential to be a positive contributor, but that's an area we're watching pretty closely. And then from a municipal standpoint, that's been very steady and we'd expect that to continue.

So, as you kind of take those together, I think that sets us up to, again, pretty strong foundation as we go into 2023 from a volume standpoint. And I'd say beyond the market, we do expect to continue to grow in excess of the market by 200 to 300 basis points. And that's really a result of our organic growth initiatives that we continue to deliver on and then the acquisitions for another 100 to 400 basis points, similar to our historical results that we've seen there.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

That's helpful. A second question really is a bigger picture and more on material substitution. And Texas is allowing drainage with plastic and PVC instead of just concrete. And there's sort of widespread shortage of cement, which is obviously a critical component for concrete. So, this paves the way for greater use of your products versus concrete. How does this benefit Core & Main and how do you – are you – is this just a unique

Q

event to Texas or is there a push for change for other states? Really kind of what are the opportunities for that line of business and as you think broadly about material substitution, how that benefits Core & Main? Thank you.

Stephen O. LeClair

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

A

Yeah. Kathryn, Texas is a good example of where we're starting to see some of those specifications change. They were a heavy reinforced concrete pipe for their storm drainage needs. And one of the areas that you've seen is the use of alternative products along those lines, particularly corrugated high density polyethylene, storm drainage and retention systems that in many cases can be easier to install, easier to work with and have some additional benefits and characteristics for the flow of water through there.

So, what we're seeing is this has been part of what our team's been working closely with, with a couple of the key suppliers on getting these specifications modified and changed to allow that product in to be able to test it. Texas is a great example on a large scale where we're seeing entire states relook at some of those specifications. And we think it has great opportunity for us medium term, short term, and long term.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Great. And are there any other states where you would identify where you're seeing a similar trend?

Stephen O. LeClair

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

A

Certainly as you look at it at a state level, there are a number of bigger states on there that have been heavy RCP users in the South and the Southeast. And then as you get into some of the more refined areas, there's still a number of municipalities that on a local level we can continue to drive those specs and introduce them to the product and help to understand how that product can be utilized in some effective ways as a good alternative.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Great. Thank you very much.

Stephen O. LeClair

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

A

Thanks, Kathryn.

Operator: Thank you, Kathryn. We have our next question, comes from Mike Dahl from RBC Capital Markets. Mike, your line is now open.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Good morning. Thanks for taking my questions. My first question is just around kind of the inventory management and supply chain. It sounds like there's been a little progress and some improvement in the supply chain, which is allowing you to work down inventories a bit. Could you elaborate on just what products you've already seen it in? And it sounded like that might broaden out in the fourth quarter in terms of where you can start to strategically normalize your inventory level, so maybe if you could give some color on again which categories seem to be evolving in the right direction and allowing you to take down some of those inventory levels.

Stephen O. LeClair

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

A

Yeah, Mike. We saw some pretty good progress and availability of products and lead time reduction and many areas across multiple categories, although there are still pockets where lead times are extended out for some of these areas. So, certainly, we saw with PVC a normalization of flow in production and lead times getting back to near pre-COVID-type lead times, and many of the core products they're associated with that, the typical diameters of bread and butter type product has really gotten back into more traditional lead times and availability.

Prices have remained firm through the end of the quarter on that, so we're pleased to see that. We're going to be watching that one closely. The other areas that we get that are real specific to our sector, particularly when we get into valves, hydrants, ductile iron pipe, some of these are still dealing with extended lead times. Its capacity is still constrained to meet demand, so we're continuing to see some price increases coming in from those product categories.

And then we just have some irregularities and inconsistencies on a couple of different other product categories where extended lead times have just become the norm. And we see that with a lot of like large diameter type work specialty valves, specialty fittings, those things along those lines are still not only in short supply, but very long lead times. So, we've had to take a real active approach here and be able to manage our inventory where the lead times have gotten more consistent to be able to balance that and optimize our inventory levels to best serve our customers and then still where we're seeing items in short supply, making sure that we're stocked appropriately, getting access to that product.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

That's very helpful. Thank you for that color. And then as my follow-up, Mark, in response to Kathryn's question, I think you mentioned that maybe the initial expectation is that maintenance – or municipal remains fairly steady. When we think about potentially kind of budgets resetting and then infrastructure funds flowing in at some point, are there offsets to why we wouldn't see some improvement in municipal or is that just kind of conservative approach until you actually see the funds hitting or some timing issue? I know you explained the lag a little bit, but maybe just a little more color on why we wouldn't see better traction on municipal next year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Mike. Yeah, just to clarify, I would say what the expectation for muni is that we see steady growth and definitely has the potential for some incremental infrastructure spending at some point during 2023. So, that would definitely be upside on the kind of municipal steady growth that we've experienced historically. So, that's how we're thinking about it as we move forward.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Got it. Okay. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yes. Thanks.

Operator: Thank you, Mike. We have our next question, comes from Keith Hughes from Truist Securities. Keith, your line is now open.

Keith Hughes

Analyst, Truist Securities, Inc.

Q

Thank you. A question – well, you made some comments on PVC and some of the prices are coming down. Is PVC going to be down year-over-year in the fourth quarter or are you still dealing with some latent inflation on just a year-over-year basis?

Stephen O. LeClair

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

A

Hey, Keith, we said that pricing really normalized through the third quarter and remained at elevated level. So, we haven't seen a price decrease in PVC. We're watching it closely to see particularly how seasonality affects it and how we're dealing with the improved availability and lead times. But we have not seen a price deflation in PVC through the end of third quarter.

Keith Hughes

Analyst, Truist Securities, Inc.

Q

Okay. And I guess, switching over to the municipal business, you talked about some of the infrastructure spending coming in. Is there any sort of clarity at what time of 2023 that would really start to hit municipality projects?

Stephen O. LeClair

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

A

Yeah. It's difficult to tell. Most of the budgets have been set for a lot of the projects that have been scoped. So, we're just now seeing some of the funds trickle in. And in fact, we've seen a couple of projects that have popped that have been treatment plant expansion projects that are going to be utilizing those funds and some really early bidding activity. But that's a handful that we've seen so far. So, there is still – we're still watching that closely. We're looking at the bid activity that's coming in. We're looking at how those types of funds get allocated into the budgets and the project scoping. We'll start getting a real clearer picture, I think, as we get into spring and the bidding activity to see how that starts flowing. But up to this point, like I said, we've seen a handful of projects that have been utilizing those funds.

Keith Hughes

Analyst, Truist Securities, Inc.

Q

Okay. Thank you.

Stephen O. LeClair

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

A

Yeah.

Operator: Thank you, Keith. We have our next question, comes from Joe Ritchie from Goldman Sachs. Joe, your line is now open.

Vivek Srivastava

Analyst, Goldman Sachs & Co. LLC

Q

Thanks. This is Vivek Srivastava on for Joe Ritchie. Maybe I wanted to understand the market share dynamics at play here. If you can provide some color how much market share you have gained year-to-date and maybe where you stand on the market share front. And then just follow-up on the same question is just during the last residential downturn, did the market see some kind of trade down to either lower priced or more private label products as bidding activity got more aggressive and what happened to your market share during that time?

Stephen O. LeClair

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

A

Hey, Vivek. This is Steve. So, I'd say that we've – it's difficult to quantify exactly what we've seen so far in terms of market share gains. But what we have experienced so far is that certainly with a lot of our smaller competitors that have been limited with access to product, we've been able to get preferential access along those lines given our size and scale. And that's allowed us to gain some good amounts of share certainly against a lot of the smaller competitors out there and the regional folks.

You talked a little bit about what we experienced through the downturn in the last recession. A very different dynamic back then as I shared on one of the earlier questions. And our business was positioned much differently. At that time, we were about 50% residential. Now, you look at it, we're about almost 40% municipal, 40% non-res, and just over 20% residential. So, our exposure was very different. We built a lot more sustainable opportunities and product categories that'll help to enhance that municipal sales and the non-residential sales. So, our business is just much more diversified than we were back then.

Certainly, through that downturn, things got very competitive particularly in the residential area. But that was a different environment than that was – it took a while for those lots that were way overdeveloped to be replenished once housing started to get back on its feet again through 2012 and the 2016, 2018, that timeframe. Right now, what we're seeing is a real shortage in lots. So, even as housing starts to build out and as we're starting to see a little bit of a pause, the medium- and long-term demand for lot development is still going to remain strong, we believe. And that creates a little different environment than what we've seen in that past in the deep recession that happened 12 years ago, 13 years ago.

Vivek Srivastava

Analyst, Goldman Sachs & Co. LLC

Q

Thank you. That's super helpful. Maybe my next question more focused on the strategic inventory investment and mix benefit this quarter. Any quantification you can provide on those two buckets? And then maybe more specifically on the mix side, what really was that mix driver, and how should we think about mix aspect of your business going forward maybe next quarter and a bit more medium term?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. I'd say, Vivek, on the inventory investments that we've made, I'd probably bracket that somewhere in the \$300 million to \$400 million of inventory where we've bought ahead a lot of these price increases more recently on some of these more non-commodity-type products that we'll work to continue to optimize as we get through the fourth quarter and into 2023.

In terms of the mix benefit, I'd probably give you – as you look at those gross margins sequentially from Q2 to Q3, we picked up about 60 basis points. I'd say a lot of that came from the mix benefit that we saw in the quarter. As we get through the fourth quarter probably back into 2023, we'll see that mix probably return back to more normal, which is part of that kind of 100 to 150 basis point reset that we expect to happen at some point.

Vivek Srivastava

Analyst, Goldman Sachs & Co. LLC

Perfect. Thank you.

Q

Stephen O. LeClair

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

All right. Thanks.

A

Operator: Thank you, Joe (sic) [Vivek] (00:52:27). We have our next question, comes from Patrick Baumann from JPMorgan. Patrick, your line is now open.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Hi. Thank you. Good morning. Nice to see the free cash flow in the quarter was positive. But it seems you've taken down the conversion guide throughout the year. Just wanted to see if you can update us on what you see as the normalized free cash conversion level for the company, and then how we should think about that into next year in light of what you're hoping to do from an inventory perspective. And maybe if you could give some color on how much inventory you think dollar-wise could come out to normalize things. I think you said \$300 million to \$400 million in response to the prior question. Is that that number that you're talking about or is it something else?

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, Patrick, thanks for the question. Yeah, as you saw, we had some nice operating cash flow conversion in Q3 and we'll look to expand on that as we get into Q4. I'd say, yeah, the \$300 million to \$400 million of inventory is the opportunity there that we think, as we get back to more normalized supply chain environment, that we should be able to release at some point.

A

I'd say, the way to think about it normally is probably 60% to 70% of our EBITDA we'd expect to convert into operating cash flow. So as you think kind of going forward, if we can capture some of that inventory, there should be some upside to that conversion rate into 2023.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Makes sense. And then last one is just kind of a mechanical question around the capital allocation discussion. Just curious how you go about evaluating potential share repurchases from a share owner that remains the largest holder and also has members on the board.

Q

Stephen O. LeClair

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

Yeah, Patrick, obviously as part of our governance, we've got independent directors, we've got independent audit committee. So, to the extent we look at a transaction like that, we would obviously go through and apply the appropriate governance to any potential transaction there. But yeah, I understand the question, but that's how we would – that's how we'd look at that.

A

Patrick Baumann

Analyst, JPMorgan Securities LLC

Understood. Okay. Thanks a lot. Best of luck.

Q

Stephen O. LeClair

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

Yeah. Thank you.

A

Operator: Thank you, Patrick. We have 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. I wanted to go in a little bit on the non-resi revenue strengthening. We did see some indicators suggesting potential future weakness in non-residential, like the Architectural (sic) [Architecture] (00:55:31) Billings Index fell below 50, and ConstructConnect is forecasting non-res starts to climb for 2023. Do you think you're gaining market share? Is it a regional mix that you're benefiting from here, something else, to explain the strength in non-res?

Q

Stephen O. LeClair

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

Yeah, David, I think what we've seen is that while there's been some pressure in a couple areas in the East Coast and West Coast, we've really strengthened our position in the Sunbelt, certainly strengthened our position in the Midwest over the last several quarters. And I think that's paid off in some share gains for us. We're continuing to see a lot of work as well, too, which we bucket in the non-residential in the storm drainage world.

A

So, we shared a little bit earlier about some of the conversion of specs from RCP into polyethylene and other storm drainage products. We've been helping to lead that effort in a lot of areas and continuing to see prolonged growth there. So non-residential has been a real good mixed bag for us with a lot of different areas with fire protection products and storm drainage products where we've been able to accelerate some growth there and gain some share.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Got it. And how does the macro backdrop sort of change the way sellers are thinking? Is potential residential weakness ahead of them making them more willing to transact? How are sellers thinking these days?

Q

Stephen O. LeClair

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

Well, I think we've certainly seen from an M&A pipeline, as you've just seen in this last quarter, we've had a healthy pipeline. We continue to do that. We've been able to tuck in some great businesses almost across the spectrum on us. From a fire protection distributor to waterworks distributors, it continues to be a very robust and healthy pipeline.

A

Sellers have been through quite a bit over the last several years between COVID, between getting through this whole supply chain challenge and everything else that's been encouraged. And now you look at a potential, many

are worried about what could happen with residential. It just plays well to our strengths as the acquirer of choice in the space. And we continue to see just a robust pipeline of opportunities for us from the M&A front.

David Ridley-Lane

Analyst, BofA Securities, Inc.

Thank you very much.

Q

Stephen O. LeClair

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

Thank you, David.

A

Operator: Thank you, David. We have our questions, comes from Anthony Pettinari from Citi. Anthony, your line is now open.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

Hi. This is Asher Sohnen on for Anthony. Thanks for taking my questions. Just following up on a previous question around share, as availability of PVC and some of your other products kind of normalizes, do you expect to cede a portion of that share back to competitors or is share kind of a little bit more sticky than that?

Q

Stephen O. LeClair

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

Well, certainly, as we look at one product category, another with availability, what we generally see with the projects that we execute are a series of different types of product categories that go into each project. So, as you can imagine, there's pipe, valves, fittings. There's hydrants. There's – you name it. So having access to be able to complete a full project is really the strength that we provide. And we still have what I'd say a pretty significant competitive advantage right now and the ability to gain share by doing complete projects along those lines.

A

So, while we may see one product category or a couple become much more available and lead times get back to normal, we still see the opportunity with a lot of these specialty products that have limited availability right now and extended lead times to have an advantage for us. And beyond that, we're obviously working to continue to share our value proposition with all of our new customers as we go through here and continue to win their business on a go-forward basis.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

Right. And that makes a lot of sense. And then my next question is sort of just specifically on the residential end markets. As that market slows, do you see prices kind of slipping there or maybe prices for across your end markets kind of – set across the end markets and maybe the demand from public will kind of buoy that pricing?

Q

Stephen O. LeClair

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

Yeah. Certainly what we anticipate is that for a lot of the products that go into new lot development are essentially used in the municipal space as well too. So, the prices tend not to be swayed by one sector or another. And I think we're in – we're watching closely to see how this Infrastructure Bill and those funds start flowing. So, there's some – we would like to see that as if residential does get soft, the ability for municipal to pick up and that

A

Infrastructure Bill will help support some of that volume, we may see that could be reallocated into the municipal world as those budgets increase and we start seeing those funds flow.

Asher Sohnen

Analyst, Citigroup Global Markets, Inc.

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

Stephen O. LeClair

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

Thank you.

Operator: Thank you. And we have no more further questions on the line. I will now pass back to Steve for closing remarks.

Stephen O. LeClair

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

Well, thank you all again for joining us today and your interest in Core & Main. We are very proud of our third quarter performance and our ability to drive profitable growth and operating cash flow. We are confident that our underlying demand trends and impending investment in the US water infrastructure paired with our robust M&A pipeline and key growth initiatives will position us to achieve sustainable growth for the remainder of 2022 and beyond.

Thank you for your interest in Core & Main. Operator, that concludes our call.

Operator: Thank you. Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines.

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