

07-Dec-2021

Core & Main, Inc. (CNM)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, everyone, and welcome to the Core & Main Third Quarter 2021 Earnings Conference Call. My name is Victoria, and I'll be coordinating your call today. [Operator Instructions]

I'll now pass over to your host, Robyn Bradbury from Core & Main, to begin. Robyn, please go ahead.

Robyn Bradbury

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

Thank you. Good morning and welcome to the Core & Main fiscal 2021 third quarter earnings call. This is Robyn Bradbury, Vice President of Investor Relations and FP&A for Core & Main. Thank you for joining us this morning. We're excited to share our results with you.

Steve LeClair, our Chief Executive Officer, will lead today's call with a brief company overview and our third quarter execution highlights. Mark Witkowski, our Chief Financial Officer, will then discuss our third quarter financial results and revised full year guidance followed by a Q&A. We will conclude the call with Steve's closing remarks. For Q&A, please limit to one question and one follow-up. If you have additional questions, you may return to the queue. Thank you for your cooperation.

Some of the information you will hear today may include forward-looking statements. Forward-looking statements include all that are not historical facts. We may include statements regarding our intentions, beliefs, assumptions

or current expectations concerning our financial position, results of operations, cash flows, prospects or growth strategies.

Forward-looking statements are subject to known and unknown risks and uncertainties, many of which may be outside of our control. We caution you that forward-looking statements are not guarantees of future performance or outcome and that they may differ materially from those made in or suggested by the forward-looking statements contained on this call.

These forward-looking statements are made only as of the date of this call. We do not undertake any obligation to update or revise any forward-looking or cautionary statements to reflect changes in assumptions, the occurrence of events or changes in future operating results.

In addition to providing results that are determined in accordance with US GAAP, we present EBITDA, adjusted EBITDA, adjusted EBITDA margin, adjusted net income, and net debt leverage, all of which are non-GAAP financial measures. These measures are not considered measures of financial performance or liquidity under US GAAP, but we use them to assess the operating results and effectiveness and efficiency of our business. We present these measures because we believe investors consider them to be important supplemental measures of performance. For reconciliation to the nearest GAAP measure, please refer to the slides in the appendix of the fiscal 2021 third quarter investor presentation, which can be found on the Investor Relations section of our website.

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

Stephen O. LeClair

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

Thank you, Robyn. Good morning, everyone. Thank you for joining us today and welcome to our fiscal 2021 third quarter earnings call. I will begin today's call with a brief business overview, followed by our third quarter execution highlights.

Starting on page 5 of the presentation, I'll begin with an overview of Core & Main. Core & Main is a leading specialty distributor of water, wastewater, storm drainage, and fire protection products and related services, servicing municipalities, private water companies, and professional contractors across municipal, non-residential and residential end markets nationwide. Our specialty products and services are used in the maintenance, repair, replacement, and construction of water and fire protection infrastructure. We are one of only two national distributors operating across large and highly fragmented markets, which we estimate to be approximately \$27 billion in size.

With approximately 300 branches across the US, we play a critical role in driving the adoption of new products and technologies throughout our industry, and we offer the logistics of last-mile delivery and support for our customers.

We have diversified end-market exposure with an estimated 45% municipal, 37% non-residential, and 18% residential end market mix in fiscal year 2020. Furthermore, we had near equal exposure to construction and new projects and existing repair and replace projects in fiscal year 2020.

Our business is well-positioned for scaled growth, margin enhancement, and strong cash generation. We have a secular focus on water infrastructure with ESG at our core.

On page 6, I will now cover our third quarter execution highlights. Our teams delivered exceptional performance in the third quarter by capitalizing on strong end-market trends, proactively managing inflation, and continuing to execute on our margin initiatives, all while operating in a very dynamic environment. We achieved record net sales of just over \$1.4 billion, growing nearly 40% compared with the prior year. We continue to expand our market share through the execution of our sales initiatives and by gaining preferred access to products during a period of material shortages in addition to closing four new acquisitions during and subsequent to the quarter.

We delivered another solid quarter of gross margin rate expansion as a result of our margin initiatives, a favorable pricing environment, and by purchasing opportunistically ahead of announced product cost increases. We have a team of pricing analysts who use data to drive pricing decisions and proactively update our prices for market cost increases, which enhances pricing visibility for our branch network and has delivered sustainable gross margin rate expansion over the last several quarters.

As a result of our strong execution in the third quarter, we grew adjusted EBITDA by over 80% compared with the prior year to approximately \$189 million. We continue to experience rapidly rising material costs across several product lines in the third quarter, resulting from unprecedented demand, constrained manufacturing capacity, container shortages and port issues. But our teams are navigating the environment exceptionally well.

PVC manufacturing capacity has been limited throughout the year due to raw material shortages stemming from plant closures as a result of severe weather events and other factors. Our PVC pipe suppliers have been working to rebuild inventory, but the current levels of demand continue to create product availability issues. Some of our suppliers import raw materials or finished goods, and we continue to see an impact to the cost and supply of those products due to the declining availability and rising costs of imported shipping containers.

Despite these challenges, our associates have been working tirelessly to ensure our customers have access to products and solutions when and where they need them to complete their jobs on time and maintain our nation's critical water infrastructure. As a result of their dedication and execution, our associates had delivered tremendous value to our customers by mitigating the impact of these supply chain events, which we believe has allowed us to gain market share throughout the quarter.

We continue to execute on our growth strategy by opening a new greenfield location in Austin, Texas, and by completing four acquisitions during and subsequent to the third quarter: Pacific Pipe, L & M Bag & Supply, CES Industrial Piping Supply, and Catalone Pipe & Supply. Our new branch in Austin, Texas is our third greenfield location this year, and it offers the opportunity to expand our fire protection product lines in a large and growing market. It also allows us to lower our logistical costs by not having to service the area from our surrounding branches. Our two other new greenfield locations, West Phoenix, Arizona and Logan, Utah, which opened in the first and second quarter of this year, demonstrate our commitment to driving growth and expansion in underpenetrated and attractive geographies.

Despite our wide geographic footprint, there's significant remaining whitespace across the country, and we use a data-driven strategy to identify and evaluate these markets. We have a pipeline of priority markets that we are targeting for the greenfield expansion, some of which had already been improved and will likely convert in the coming quarters. These new locations will offer us the opportunity to expand into new geographies and strengthen already existing market positions. We've had a great success with our greenfield strategy as we have the ability to capitalize on our scale and talent pool because our greenfields have an attractive financial return profile.

Turning to our recent acquisitions, the Pacific Pipe acquisition highlights our focus on expanding into underserved geographies. Pacific Pipe is a significant player in modernizing and expanding water infrastructure in Hawaii, the state we had no presence in previously. Pacific Pipe has been in operation since 2011, serving municipalities and contractors in the water, wastewater, storm drainage, and irrigation industries with a broad waterworks product offering. Pacific Pipe operates four locations spanning the islands of Hawaii, Maui, and Oahu.

L & M Bag & Supply acquisition highlights our focus on expanding our presence in underpenetrated product categories. It provides a sizeable growth opportunity in the large and fragmented geosynthetics and erosion control market, which we estimate to be roughly \$5 billion in size. Over the past three decades, L & M has built itself as one of the nation's leading manufacturers and suppliers of geosynthetics and erosion control products, complete with seven locations across the country. By joining our teams together, we will expand our expertise to better serve our customers nationwide, have a larger reach for our products and services, with a dedicated team of specialists serving the rapidly growing and highly specialized geosynthetics and erosion control market.

The CES Industrial Piping Supply acquisition expands our fusible HDPE product and service offerings in the Midwest. CES Industrial Piping and Supply (sic) [CES Industrial Piping Supply] (00:10:10) is a single branch distributor located near Kansas City, Missouri, who offers a full line of fusible HDPE pipe, fittings, and fusion machines. The team serves various markets, including industrial, oil and gas, water, wastewater, landfill, mining, environmental, and power plant industries. We are excited to grow our team in that area of the country and provide customers with added expertise in fusible pipe applications.

Catalone Pipe & Supply is a single branch distributor in Pennsylvania, who offers a spectrum of water, wastewater, and concrete catch basins, among other products, and distinguishes itself on supplying its customers with custom solutions to minimize installation time and costs. Group at Catalone Pipe & Supply works hard to exceed their customers' expectations and deliver high-quality products, which aligns with the dependable expertise we offer throughout the waterworks industry. We're excited to have them join our team and expand our waterworks footprint in the Northeast.

On a combined basis, these four acquisitions generated roughly \$145 million of net sales for the fiscal year ended December 31, 2020. Each acquisition will be additive to our sales and earnings growth in the fourth quarter. The integrations of these acquisitions are progressing according to plan. Employee engagement is very positive, and the feedback from our customers and suppliers has been great. We are continuing to execute on synergy opportunities through our combined sales expertise and sourcing strategies.

We have a strong and highly experienced integration team in place to seamlessly tuck in acquisitions as we've been able to do historically. We continue to maintain a robust pipeline of hundreds of identified actionable acquisition targets that provide a long runway for future growth, which we pursue through our disciplined approach. We prioritize complementary businesses that help us consolidate existing market positions, expand into new geographic areas, acquire key talent, and offer new products.

As we move into the fourth quarter, we enter our robust virtual and in-person training season. Last year, thanks to the agility of our learning and development team, we remained committed to the development of our associates despite obstacles created by the COVID-19 pandemic. Our learning team quickly developed a comprehensive, academy-based virtual training program, known as Core & Main University, that provides our associates with instructor-led and role-specific training.

This year, associates have the option to enroll in both in-person and virtual training courses created to develop skills and build leaders from within. Our investment in our people through best-in-class training and career

development is a true differentiator for us. We are deeply committed to the development of our associates, whether virtual or in-person, as it offers us the opportunity to attract and retain top talent and fuel future growth. Our associates, customers, and industry partners can learn and grow with Core & Main. We are training the industry's next generation of leaders, and we foster a diverse talent pipeline to our industry.

We have continued our evolution towards developing more robust environmental, social, and governance strategies and goals. We recently developed an ESG oversight committee, which will be responsible for governing and driving our ESG initiatives forward. We have an independent board of directors that champions the importance of ESG, and we are in the process of adding a new position to our organization that will be focused solely on sustainability. We are building on the foundation we established in our inaugural 2020 ESG Report, and I'm excited to share our progress with you in our next report, which we expect to publish by the middle of next year.

Lastly, subsequent to the end of the quarter, the Infrastructure Investment and Jobs Act was signed into law, a once-in-a-generation bipartisan infrastructure bill that makes transformational investment in our nation's infrastructure. I'll now discuss our anticipated benefits of the infrastructure bill on page 7. Among other things, the infrastructure bill makes historic investments in clean water infrastructure, an infrastructure that provides resilience to the changing climate. It sets aside \$55 billion to expand access to clean drinking water for households, businesses, and schools.

The bill also provides funding to make our infrastructure more resilient to the impacts of climate change with an investment of over \$50 billion aimed at protecting against droughts, floods, heat, and wildfires. The bill additionally provides for a major investment in weatherization. We expect these areas of the bill to benefit our business directly.

The bill also appropriates funds to other construction verticals we would expect to benefit from such as investments in roads and bridges, which could benefit our storm drainage product line and investments in airport upgrades and expansions that could benefit our fire protection product lines. While we believe that the new infrastructure bill provides multiyear tailwinds for the municipal water sector, we also believe it will take time before we see those funds flow through to our business as a result of the current constrained manufacturing capacity and industry labor shortages.

It's likely that we may not see incremental volume as a result of the infrastructure bill until 2023 or beyond, but we believe we are well-positioned to capitalize on the favorable tailwinds due to our market leadership position and operational capabilities. Once the funds from the infrastructure bill begin to flow and supply and labor shortages are resolved, we believe the investments from the infrastructure bill could drive roughly 1 to 2 points of additional municipal end market growth each year.

I'm extremely proud of the strong performance we delivered throughout the third quarter, especially given the supply chain uncertainty, the unprecedented demand, resource constraints, and inflationary trends that continue to exist. While these challenges may persist through the fourth quarter, our branches and leadership teams remain dedicated to working with our suppliers to provide consistent, reliable products and services to our customers nationwide.

I will now turn the call over to our Chief Financial Officer, Mark Witkowski, to discuss our fiscal 2021 third quarter financial results and revised full year guidance.

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 third quarter operating results. Net sales in the third quarter were approximately \$1.4 billion, an increase of nearly 39% over the prior-year period. The increase was driven by higher average selling prices, strong volume growth, and accretive acquisitions. On an organic basis, our net sales growth was approximately 35%.

Our sales benefited from growth across each of our end markets. The municipal end market continued to experience strong demand trends resulting from growth in municipal water and wastewater infrastructure spending. Residential construction continued to benefit from single-family housing demand and new lot development, though, growth in the third quarter was more moderate compared to what we experienced in the first half of the year due to supply chain constraints across the residential building sector. The non-residential end market, which contains a mix of project types, experienced strong volume growth as demand continues to catch up to pre-pandemic levels.

The execution of our sales initiatives and our leadership position within our industry have allowed us to outperform our end markets and deliver solid market share gains by ensuring our customers had access to the products where and when they needed them, despite the ongoing supply chain constraints and product availability challenges.

We believe roughly two thirds of our net sales increase for the quarter was due to price inflation, which was much higher than expected and driven by our team's ability to communicate rapidly rising material costs to our customers and locate the products they need, so they can complete their projects. We continue to experience rapidly rising material costs across several product lines resulting from unprecedented demand, constrained manufacturing capacity, container shortages and port issues. Despite these challenges, our teams have navigated the inflationary environment well and are working closely with our customers to give them advance notice of market price increases.

Pipe, valves and fitting sales increased 38% compared with the prior year due to a mix of volume gains and price inflation from rising material costs, along with contributions from recent acquisitions. The same factors drove growth in our storm drainage product line, which increased 52% compared with the prior year. Our fire protection product line grew 46%, and growth was also attributable to strong volume gains and price inflation from rising material costs. Our metering product line grew by 17% compared with the prior-year period. Metering growth has been tempered recently due to semiconductor chip shortages, which are necessary components in certain smart metering devices.

Gross profit in the third quarter increased approximately 52% to \$371 million. Gross profit as a percentage of net sales was 26.4% compared with 24.1% in the prior year, an improvement of approximately 230 basis points. The increase in gross profit percent was primarily attributable to the execution of our gross margin initiatives, accretive acquisitions, strategic inventory investments ahead of announced price increases and a favorable pricing environment.

Our initiative to get better visibility of cost increases from our vendors to our field teams has resulted in gross margin rate enhancement during the quarter. Additionally, we continue to make great strides in our private label initiative, increasing the amount of internally sourced products relative to the same quarter last year. Our performance across each of these initiatives has continued to deliver year-over-year gross margin rate expansion, which we believe will be sustainable over the short and long term.

Given our size and scale, we've been able to make opportunistic inventory purchases ahead of announced price increases, which results in a lagging weighted average cost of goods sold during inflationary periods. Industry-wide product availability challenges have also created an environment, where products are significantly less price sensitive than what they typically are, which we have been able to capitalize on due to our market leadership position and our preferred access to products. Opportunistic investments in inventory, coupled with a favorable pricing environment, have allowed us to generate considerable year-over-year gross margin rate expansion, though, a portion of this increase may be temporary. We believe our defined gross margin initiatives will continue to drive long-term sustainable gross margin expansion.

Selling, general and administrative expenses for the third quarter increased approximately 30% to \$188 million. The increase was primarily due to an increase in personnel expenses driven by higher variable compensation costs resulting from higher sales volume and stronger profitability, increased head count from acquisitions and lower discretionary spending in the prior year in response to COVID-19. SG&A as a percentage of net sales was 13.4% compared with 14.3% in the prior-year period, an improvement of approximately 90 basis points.

Interest expense in the third quarter was \$13 million compared to \$35.6 million in the prior-year period. The decrease was attributable to the redemption of the 2024 senior notes, the redemption of the 2025 senior notes, and lower interest rates on the new senior term loan due to the refinancing transactions completed in connection with the initial public offering.

Income tax expense in the third quarter was \$24.9 million compared with \$7.5 million in the prior-year period, reflecting effective tax rates of 18.6% and 25.8%, respectively. The effective tax rate for each period reflects only the portion of net income that is attributable to taxable entities, and it declined in the current-year period due to certain fixed tax expenses decreasing as a percentage of income.

Adjusted net income increased approximately 400% to \$105 million. The increase was due to strong sales growth, gross margin rate expansion, and SG&A cost leverage. In preparing adjusted net income, we exclude the effects of non-controlling interest as we evaluate and manage the business as a whole. For a reconciliation of net income to adjusted net income, refer to the slides in the appendix of the presentation.

Adjusted EBITDA grew 83% to \$189 million, improving adjusted EBITDA margin by approximately 330 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 net debt and liquidity position at the end of the quarter. Our net debt at the end of the quarter was \$1,491 million, bringing our net debt leverage down to 2.8 times, which is half a turn favorable compared to last quarter. The reduction in net debt leverage was attributable to an increase in adjusted EBITDA. We expect to continue to reduce our debt leverage despite making strategic investments to grow the business.

At the end of the third quarter, we had nearly \$846 million in total liquidity. We believe that our liquidity and cash generation from operations will be sufficient in the near term to meet our working capital needs, anticipated capital expenditures, scheduled principal and interest payments on our term loan and to continue pursuing our growth strategies, including M&A.

Operating cash flow in the third quarter was \$33 million compared – approximately \$28 million lower than the prior year despite higher earnings due to continued investments in working capital to support growth. We have continued to invest in inventory to ensure availability and access to products for our customers despite the ongoing supply chain and product availability challenges.

Strong sales growth and inventory investments resulted in a larger working capital build than what we would typically see in the third quarter. Our inventory balance at the end of the third quarter was approximately \$721 million, representing nearly 88% growth over the prior-year period. We believe these investments are prudent and necessary to ensure our customers have access to the products they need. In some cases, we are holding products for our customers, while we locate those in short supply in order to ship products to align with our customers' installation schedule.

Historically, we have generated most of our operating cash in the second half of the year as we unwind working capital with reduced inventory spending and lower customer receivables. Despite the continued working capital investments in the third quarter, we still expect to see a strong seasonal generation of operating cash flow in the fourth quarter, though there's the potential that we may continue to opportunistically invest in inventory to lower then that cost of our products during this inflationary period and to ensure availability and access to products for our customers.

Turning to page 11, I'll now discuss our outlook for the remainder of the fiscal year. Our performance in the third quarter continued to be very strong despite ongoing supply chain constraints and product availability challenges. Demand and pricing trends remain favorable across each of our end markets and now look more positive than they did three months ago. Our supply chains continue to deal with capacity constraints across many of our product lines, which we expect will keep pricing at or above current levels through the fourth quarter.

Our gross margins have also continued to expand, and we expect continued year-over-year gross margin expansion in the fourth quarter. Based on current visibility, backlog of existing orders and business trends, we now expect fiscal 2021 adjusted EBITDA of \$560 million to \$580 million, representing year-over-year growth of 64% to 70%.

There are several uncertainties that exist for the balance of the year that could significantly impact our estimates and position us towards the lower or higher end of the range. Product availability constraints, labor shortages, declining commodity prices, inclement weather, and margin pressure resulting from the benefits associated with the opportunistic investments in inventory and the less sensitive pricing environment could position us towards the lower end of the range. Sustained pricing levels and gross margins, continued demand across each of our end markets, favorable weather, and suppliers' ability to meet demand could result in performance near the top end of the range.

We plan to provide guidance for fiscal year 2022 during our fourth quarter earnings call. As it stands today, we expect demand will remain strong in fiscal year 2022, as projects are delayed and pushed into next year. Strong demand and continued capacity constraints could result in sustained levels of high pricing, which we believe would benefit us through at least the first half of next year. As prices stabilize and supplier capacity returns to normal levels, we could experience difficulty sustaining a portion of our gross margin rate expansion that we have experienced during this past year.

As Steve mentioned earlier in the call, it is unlikely that we'll see incremental demand from the infrastructure bill prior to 2023. But given our performance in this challenging environment, we feel confident in our ability to execute at a high level during fiscal year 2022.

To close out our prepared remarks, we are very pleased with our strong third quarter financial and operational results. Despite the challenges we are facing right now, our teams continue to execute flawlessly to ensure our customers have access to products and solutions, when and where they need them to complete their jobs on time

and maintain our nation's critical water infrastructure. We continue to focus our efforts on increasing market share, improving profitability, and generating consistent 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: Great. Thank you. We will now start the Q&A session. [Operator Instructions] And the first question comes from David Manthey from Baird. David, please go ahead. Your line is open.

David John Manthey

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

Okay. Thank you. Good morning, everyone. First off, to bridge...

Q

Stephen O. LeClair

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

Hey. Good morning, David.

A

David John Manthey

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

...the EBITDA – yeah, to bridge the EBITDA guidance increase here, last quarter, you were at \$490 million for a midpoint. And this quarter that you just reported, most of us were at \$140 million, so you outperformed by, like, \$50 million, let's say. And I guess, when I think about the acquisitions, a couple of those were known, a couple unknown, but that's just adding marginally to EBITDA. So I'm coming up with about a \$30 million increase in core fourth quarter EBITDA guidance effectively. Could you just give us an idea, when you think through the list of things that are benefiting the company today, which are the primary drivers of that upside?

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, hey, Dave. Thanks for the question on that. Yeah, certainly, as we look back at our guidance last quarter and the performance here that we're now expecting through the end of the fourth quarter, certainly, the price levels was a major factor. We did anticipate prices might stabilize a bit. We've continued to just see increases across all of our product lines, and that's been a major contributor to the revised guidance. In that inflationary environment, we've also been able to capitalize on our inventory investments, and that's been driving our gross margin rate up higher than we also expected.

A

So between the higher price levels and our ability to capture that at the gross margin level, those have been the two primary factors. And when we do see inflation like this, we can really leverage our SG&A. So we saw really those two factors drive up the EBITDA result and the EBITDA guidance range increase.

David John Manthey

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

Okay. Thank you. And, second, you mentioned the chip shortage impacting AMR sales. How should we think about the dynamic of that market today? I would imagine, obviously, a meter has to go in of some sort to do – do customers just default to the traditional meters? Is there some kind of deferral? Are those sales gone forever?

Q

Can you just help us understand the chip shortage relative to the automatic meters and what that means for the future?

Stephen O. LeClair

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

A

Hey, Dave. This is Steve. So, a couple things I'd share with you regarding meters. There's definitely – we're definitely feeling the impact right now of chip shortages, particularly in a couple of segments of smart meters. And so when we look at how that product is used today, a lot of this – a good portion of those sales are refurbishment of new water meter projects. So, municipalities are investing in this technology almost for all of their endpoints as they do this and a replacement of the old manual read ones. So some of those projects are being delayed as we go through here, so we're seeing the backlog build in that.

Meanwhile, on the repair and replace of some of these, right now, a lot of the inventory is being allocated into the most critical needs that we're seeing for repair and replace or to finish out projects that are halfway through at this point. So we're going to continue to see pressure as we get into the back half of this year and likely into the first half of next year with these chip shortages. And it's going to be a continual thing we're going to have to work through – some of the manufacturers are working through alternative designs to help fill that void, but that's not an immediate or a quick solution for some of the projects that have already been slated and ready to go.

David John Manthey

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

Q

Got it. That's helpful. Thanks very much and good luck.

Stephen O. LeClair

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

A

Thank you.

Operator: Great. Thank you, David, for your question. And our next question comes from Jamie Cook from Credit Suisse. You can go ahead. Your line is open.

Jamie Cook

Analyst, Credit Suisse

Q

Good morning and nice quarter. I guess, two questions, one, short term, I know you're opportunistically building inventory to help your customers, but like, how do we think about inventory as we end the year, and is this a trend that you expect to continue into next year? And to what degree does this impact over the longer term sort of free cash flow conversion? And then my second question, just sort of longer term, with the market share gains that you've had and the infrastructure bill and some of these pricing dynamics you're talking about, does it make you more confident or optimistic about where EBITDA margins can go longer term relative to the objectives that you guys put out when you first went public? Thank you.

Stephen O. LeClair

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

A

Thanks, Jamie. I'll tackle these and then hand it over to Mark to talk a little bit more about the flow-through in working capital and the seasonality impact. So, certainly, right now, with demand as high as it is and product availability as limited as it is, we're trying to take positions in inventory that we typically wouldn't see. We generally see a seasonal downturn towards the back half of the year, particularly with the areas in the North that may have

more seasonal weather makes it difficult to do underground construction work. But we're going to continue to build that, seeing the demand profile that we have and the backlog, we're going to continue to try and capture the inventory we can to secure the projects and fulfill the backlog and release some of that.

If you look at the share gains that we've had, we're continuing to see our value proposition play out for customers – our existing customers and certainly newer customers that have come to us and unable to get their product needs fulfilled by our smaller competitors. So, we think that has a lot of opportunity for us to continue to build share, and continue to do that. And then given really the shortage in supply right now and given the role that we play with our size and scale, we're certainly encouraged by what we see with margin enhancement. As we go forward, some of this stuff, particularly right now, we're benefiting from the fact that we've been able to take big inventory positions at lower costs and then sell that through. And we've also been in a beneficial position of being able to get access to products right now, almost from factory to job site that have enabled us to get price and then much less price sensitive.

There's a portion of that which we think could be transitory as we get into next year, but we're really encouraged by what we're seeing with the margin enhancement, our ability to gain share and the value proposition that we play.

Mark, do you want to talk a little bit about the seasonality of the working capital?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah, Jamie, I think you were asking about cash conversion as we think about the inventory investments. And I would tell you, certainly for 2021, we're going to see slightly less cash conversion of that EBITDA due to those inventory investments. I do expect some of that to unwind into 2022 as capacity kind of normalizes, but I think, really, returning back to normal levels after that.

And then, from an EBITDA expectation, I would tell you that, certainly, if we see that infrastructure build flow through, like we said maybe in 2023, and that continues to be a lift for demand for us, certainly, that probably help sustain these pricing levels, which we're certainly able to leverage pretty significantly. And I think that certainly helps that EBITDA target that we were looking at as part of the IPO. So, more to come on that, but certainly a good environment for us given the current supply and demand characteristics.

Jamie Cook

Analyst, Credit Suisse

Q

Okay. Thanks. And nice job.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thank you.

Stephen O. LeClair

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

A

Thank you.

Operator: Great. Thank you so much for your question. And our next question comes from Matthew Bouley from Barclays. Please go ahead. Your line is open.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Morning. Thank you for taking the questions. Congrats on the results. Back on the gross margin of over 26%, apologies if I missed it, but any way to quantify what the benefit specifically from pre-buying was in the quarter? And looking forward, is 26% kind of a new baseline? Or just from this pre-buying dynamic, would you expect some kind of reset or reversal as we think about 2022? Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Matthew, for the question. As you look at gross margins for the quarter, I'd tell you, there's a lot that we are working on and have continued to benefit from that have resulted in that 26% gross margin rate. Certainly, our initiatives that we've talked to you a lot about in terms of our focus on price, both to get these inflationary prices into the market and stay ahead of those has been critical for us. Certainly, buying ahead and getting good procurement opportunities from our vendors has been a driver. The other area that we've talked to you about is really the data-driven exercises we've done on some of the non-bid items. And we've been able to get that price more aligned across the markets in the US. Our private label initiative, we saw a great expansion there in the quarter. And then certainly, the acquisitions that we've done, we continue to get synergies out of those.

So, there's been a lot of factors driving that, not necessarily breaking out in any one in particular. But as we look at kind of the sustainable gross margin rate, I would tell you, Matt, that we kind of look at it as year-to-date gross margins and our performance there. I feel like there's about 50 to 100 basis points of temporary benefit that we're seeing in there across the year. So, that'll be the amount we continue to look to offset as we go into 2022 and beyond with those gross margin initiatives that we have that are sustainable. So, that's probably the best way to think about in terms of the rate.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

No, that's great color. Thank you for that. Just second one on the topic of passing through inflation, I'm just wondering if there's any product categories or even end markets where you're starting to see any incremental pushback on pushing prices through just given the amount of inflation we've seen. Thank you.

Stephen O. LeClair

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

A

Yeah. Matthew, right now at this point, inflation has been ubiquitous across nearly all product lines that we have. We haven't really seen demand subside in this. So, as of the end of third quarter, everything still looks incredibly strong right now. The demand across all end markets is strong. Municipal is strong. So, we're feeling that the market is absorbing a lot of these cost increases. And kind of the challenge right now is being able to release this backlog, fulfilling all of the demand that's out there. Our customers are struggling with some labor as well, too. So, getting a lot of those things fulfilled is really the bigger constraints that we're seeing at this point rather than absorbing the inflation.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Great. Thanks for the color. Good luck.

Stephen O. LeClair

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

Thank you.

A

Operator: Great. Thank you, Matthew, for your question. We will now move on to Kathryn Thompson from Thompson Research Group. Please go ahead. Your line is open.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Thank you for taking my questions today. Follow up on IIJA, we've been speaking to a variety of state departments of transportation and other key officials just about the passage of this bill and what it means now, we're already hearing from a handful of states that are seeing an acceleration of letting schedules, and granted some of these may be for highways, but it could have a trickle effect for you.

Q

A two-part question on this. What are you hearing on a regional basis? And with the passage of – since the passage of IIJA, are you hearing a similar thing in terms of, I mean, acceleration of letting schedules? And then what, if any, changes do you anticipate on pricing quotes given the passage of this bill? Thank you.

Stephen O. LeClair

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

Thanks, Kathryn. I'll touch base really on two ways that we're kind of looking at this thing. Certainly, when we look at the water aspect of this and the \$55 billion there, there's still a pretty lengthy process for those funds to be allocated into the different states and the revolving funds. So, that's still yet to be seen exactly how and where those funds start flowing in. Those we anticipate will – we think are going to be constrained somewhat right now for the demand, just given the supply chain constraints and the backlog that's already existing in municipal. I mean, the demand has already been strong. So, we think that could be challenging to get anything incremental through 2022, but we think that's going to really provide a lot of sustained growth and opportunity for municipalities to continue to grow and to find the funding means necessary to grow that municipal piece, certainly through 2023 and beyond. So, we're encouraged by what we're seeing there, but probably not an immediate impact at this point from what we can see.

A

In regards to some of the other infrastructure aspects of this, certainly, DoT has always been quicker to get into the projects. And we see some pretty good opportunity there with storm drainage material, yet to be seen exactly how all that flows through. But we're encouraged by what we see there. We'll have certainly a positive impact on that aspect and we'll continue to monitor that at a state level.

So, in regards to those two things, those are the things that are immediate. When we look at the third piece here, which talks about kind of this resilient infrastructure and some of the things related to drought, that's going to be much more difficult to ascertain exactly how that plays into our – certainly short and medium term, but we'll continue to monitor that.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Okay. A topic of discussion that we've had with you in the past and granted you're newer to being on the public stage is the concept of best and worst branches in terms of market share, and it showed that there had been a pretty big differential in terms of market share between the best and worst. How is that gap expected to fare in

Q

2022 and maybe describe some of the steps to bring some of those laggards up, and importantly in bringing those laggards up how that contributes to margin expansion?

Stephen O. LeClair

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

A

Yeah, Kathryn, we always looked at – with 300 branches, we certainly have areas in the country where we've had really strong positions and continue to build on that, and other areas that we've been entering into over the last few years, really, for the first time. And so, working your way up from a distant number three or number four in a market up has great potential for margin enhancement, earnings performance and everything else.

So, I won't share specifically about areas in the country where we started to see a lot of improvement there. But this environment that we're in right now has really played to our strengths. So, certainly, when we look at some of these areas that we've been under penetrated in in the past, the fact that we got size and scale behind us to be able to get access to products has really helped us to continue to gain share in the space and gain margins over a lot of our smaller competitors that may have a more significant position in that individual market.

So, we're continuing to do that. This is a model that we continue to refine. So, we're always looking from a quartiling standpoint at our underperforming branches, and we'll continue to refine that through next year as well. And we're encouraged about what we're seeing in terms of margin enhancement and EBITDA growth through those branches.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Great. Thank you.

Stephen O. LeClair

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

A

Thank you.

Operator: Great. Thank you, Kathryn, for your question. We will now move on to Nigel Coe from Wolfe Research. Nigel, please go ahead. Your line is open.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Thanks. Good morning. Thanks for the question. So, taking out the price impacts, it looks like 25% or so price, so 14% volumes. How do we think about how that 14% look by your three end markets? And how do you think your share is trending? And I'm particularly curious if you're – it's kind of your inventory strategy and availability, whether that's kind of leading to share gains in whatever end market you think you are gaining share.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Thanks, Nigel, for the question. Yeah, when you look at volume performance for the quarter, I would tell you across each of our three end markets, it was very strong. So I'd say, pretty steady across all three of those end markets. No real major differences there. And that's really the biggest contributors there.

In terms of the inventory position, yeah, I would tell you, certainly our ability to access product right now has been a nice driver for share gains for us. We do believe that was a contributor, and again, those share gains really across all three of those end markets. So I wouldn't say any one in particular was much stronger than the other. Resi continued to benefit from new lot development. We've seen a nice comeback with non-resi, which was certainly pretty depressed last year. And then the municipal spending has continued to be strong. So, those end markets combined with those share gains are really the major contributors to the volume in the quarter.

Nigel Coe

Analyst, Wolfe Research LLC

I mean, if you had to rank the end markets, would you say resi would be at the higher end of that curve, which again, in reference to the volume number, the 14%?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. I'd say if I ranked them, it was – probably resi is slightly higher than non-resi and then muni kind of right on the heels.

Nigel Coe

Analyst, Wolfe Research LLC

Okay, great. And then just on pricing, obviously, a lot of [indiscernible] (00:48:47), but how do we think about core price? So obviously, you got commodity price swings. But if you had to think about just core price, how did that look? How has that been trending for the year?

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah, Nigel. I'd tell you on pricing, it's really been a unique year for us. Typically, we would see more volatility with commodities. This year, I would tell you, we've seen the price increases coming across all product lines. Similarly, I'd tell you if I would rank them, I'd probably put PVC at the top of the commodity price increases, but then really, the non-commodities have seen inflation, and then those manufacturers are continuing to try to get price into the market to offset some of their manufacturing costs, labor shortages, and everything else. So I think there's probably more to come in some of those areas as well, but we've really seen it across the board.

Nigel Coe

Analyst, Wolfe Research LLC

Okay. I'll leave it there. Thank you very much.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah.

Operator: Great. Thank you so much for your question, Nigel. And we will now move on to Mike Dahl from RBC Capital Markets. Mike, please go ahead. Your line is open.

Mike Dahl

Analyst, RBC Capital Markets LLC

Hi. Thanks for taking my questions. Just to follow up on the share gain, because it's something we've seen across distribution, just players of scale, this environment is really playing to the strength and leading to accelerated share gains. I know it's tough to pin down in any one quarter, but when you look back over the past few quarters, any way of sizing up how much share you think you have gained year-to-date?

Stephen O. LeClair

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

A

It's hard to tell right now, Mike. I think these things tend to be market specific in a lot of these areas. When we look at the volumes that we're seeing over here compared to what we think the industry volume is, we get some level of estimate on that. What I would share with you as we get into these, how stickier those share gains, and we feel pretty comfortable that given the value proposition that we have right now and the opportunity to serve some of these newer customers that we haven't been able to before, we have a very high retention rate with our customers today, 84%, 85%.

So, we feel pretty good about the opportunity to be able to serve some of these new customers, in addition to holding our own. And so we're pretty encouraged by what we see that we think this could be good sustainable share gains going forward, but difficult to really put a number on it at this point.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. Got it, but still helpful. And my second question is around the supply constraints, are there any regions or any product lines where you've seen an inflection and started to see any easing of the constraints, or conversely, are there product categories where you're still seeing constraints incrementally worsen?

Stephen O. LeClair

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

A

I would share right now that it's – across the board, we've seen challenges. Geographically, given our national footprint, I wouldn't say there's anything specific geographically we're seeing, but by certain product categories, we should start seeing an easing of maybe some of the import product that has been really challenged through the third quarter with some of the port issues, things like fittings, for example, that could be imported. Some of those are starting to ease, but there is still significant challenge and still a very empty pipeline right here in this channel.

So, a lot of what we're seeing as we ended third quarter was almost in some of these product categories, factory to job site was that – that was that immediate. They were really being put right to the projects themselves and very little inventory building in the channel as we go. So, what we are seeing as well, too, is some of these projects are waiting to release some of this backlog, waiting on a couple different products and materials. So, most of the projects that we're dealing with at this point involve not just one or two types of products, but have a pretty lengthy product list, then when one is short, if we can't substitute it, we often have to wait and we see delays going in the release of some of that material.

So that's kind of what we're experiencing as we ended third quarter, and encouraged by demand characteristics, encouraged by what we're seeing right now with maybe some easing in a few of these product categories, but it is still incredibly tight.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. Got it. Thank you.

Stephen O. LeClair

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

Thank you.

A

Operator: Great. Thank you. And our next question comes from Patrick Baumann from JPMorgan. Please go ahead. Your line is open.

Patrick Baumann

Analyst, JPMorgan Securities LLC

Hi. Good morning. Thanks for taking my questions. Can you talk about the acquisitions you did in the quarter outside of L & M and Pacific Pipe? And any color on size of the deals, revenues, margins and multiples that you're paying? And then, when you look at the pipeline, what are you currently seeing on valuation multiples?

Q

Stephen O. LeClair

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

Sure. Thanks, Patrick. Yeah. The two acquisitions we did were what we'd call relatively small tuck-in acquisitions with CES Piping Supply (sic) [CES Industrial Piping Supply] (00:54:22) in Kansas City, and then Catalone in Pennsylvania. So, combined, their revenue was somewhere around \$13 million, so single-branch operations. Multiples were – typically, what we have done historically particularly for branch of that size, relatively low multiples.

A

We're encouraged by what we see. Pipeline looks really strong right now. As far as multiples go, we continue to operate within our strike zone that we've had anywhere from 6 to 9 pre-synergy is kind of what we've been looking at historically. We haven't seen that move a whole lot in our space. So, we'll continue to refine and look at the pipeline that we have, a very active pipeline as we speak. And excited that there's still a lot of opportunity there to continue to consolidate.

Patrick Baumann

Analyst, JPMorgan Securities LLC

That's helpful. And then on L & M and Pacific Pipe, what kind of synergies are you expecting out of those both at the businesses themselves and anything you can take to the rest of the portfolio? Because I know those are a little bit higher multiple than the 6 to 9 pre-synergy.

Q

Stephen O. LeClair

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

Yeah. For Pacific Pipe, in particular, they have a really strong foothold in Hawaii. So, we definitely have some purchasing synergies we can provide there. We're continuing to look at how we can expand out there as well through some other product line enhancements. For L & M, this is really an underserved product category for us. When we look at erosion control and geosynthetics, we're carrying that in less than 10% of our branches today. So, we're really encouraged by our ability to not only enhance that product category, but be able to pull that through many of our other branches that we have all across the country. And that gives us a really good substantial footprint. They have seven branches out there that move from the East Coast all the way out to Texas and Colorado. So, that's given us a really good footprint on which to expand on organically and inorganically as well.

A

Patrick Baumann

Analyst, JPMorgan Securities LLC

Thank you. Helpful color. Appreciate the time. Best of luck.

Q

Stephen O. LeClair

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

Thank you, Patrick.

A

Operator: Great.

Stephen O. LeClair

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

I believe we have time for...

A

Operator: Thank you, Patrick. And our last – okay. Should we take last question?

Robyn Bradbury

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

Yeah. Go ahead.

A

Operator: Great. So, our final question comes from Joe Ritchie from Goldman Sachs. Please go ahead.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Thanks for putting me in and nice quarter, everybody. Couple of quick ones for me. So, just in terms of your guidance, your EBITDA guidance for the year, I'm curious, what's the implied growth framework for the fourth quarter?

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

Yeah. Joe, I would tell you, in terms of the guidance on that for the growth, we'd see pricing, kind of, at these similar levels in Q4, we think pricing, kind of, stays where it is. We have, I'd say, built in into the guidance – last year was a really good weather year for us. So, I'd say we have a little bit of conservatism in for the volume for the quarter in the outlook to reflect, kind of, a good weather environment last year in there. But that's, kind of, the way to think about it. And then from an acquisition standpoint, I'd tell you the ones we've completed will contribute probably 4 to 5 points of growth for Q4.

A

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Got it. And then there's nothing in terms of, like, extra days or less days or anything like that to take into consideration for 4Q?

Q

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

No, not for the fourth quarter this year.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. Last quick one, just on pricing, so, pricing for some of your key commodities had – or the cost curves come down pretty significantly. Clearly this was a bit of an abnormal year in terms of how much pricing you were able to put through. How do we start to think about whether there's a, like, significant potential top line headwind next year, whether that be mitigated by some pricing stickiness, just any thoughts around that would be helpful for 2022. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah. Sure, Joe. I think the way to think about 2022 right now is given the demand and supply characteristics that we're seeing, we do expect pricing will hold at fairly high levels, at least through the first half of next year. And given where they're at, we'd expect a pricing benefit in the first half, possible that those prices start to subside more on the commodity side in the second half. And you could see a little bit of pressure in the second half. But, I think on the non-commodity side, like I said, we're still seeing some price increases and some opportunities for increases there. So, some of that may offset even what we might see on the commodity side.

So, we're feeling, I'd say, more confident about where pricing is and where it's headed than probably what we did last quarter. But, those are good situations for us. If prices stay high, again, that's a – it gives us a strong ability to leverage that ultimately down to profitability.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you.

Mark R. Witkowski

Chief Financial Officer, Core & Main, Inc.

A

Yeah.

Operator: Great. Thank you, Joe, for your question. And this concludes our Q&A session. I'll now pass over to Steve for final remarks.

Stephen O. LeClair

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

Thank you all, again, for joining us today to participate in our third quarter earnings call.

To close it out, I would like to share a few key items that make Core & Main a leading specialized distributor. We are a market leader with size and scale in an attractive and fragmented market. We have a strong value proposition playing a pivotal role in shaping our industry. We have multiple levers for organic growth, continually cultivating ways to grow faster than the market and gain market share. We have a proven ability to execute and integrate acquisitions with a large pipeline and additional runway. We are poised to benefit from favorable industry trends in each of our end markets. We have an attractive and resilient financial profile with strong return characteristics.

I'm incredibly proud and want to thank all of our associates for their continued commitment to our customers and our communities, especially given the disruption related to COVID-19, the product availability challenges and labor shortages. 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: Great. Thank you, everybody, for joining today's call. You may now disconnect your lines.

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