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Fastenal Company (FAST) CEO Daniel Florness on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-11-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $0.37 beats by $0.01 | Revenue of $1.38B (7.76% Y/Y) beats by $1.62M

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Fastenal Company (NASDAQ:FAST) Q3 2019 Earnings Conference Call October 11, 2019 10:00 AM ET

Company Participants

Ellen Stolts - Financial Reporting and Regulatory Compliance Manager

Daniel Florness - President & CEO

Holden Lewis - EVP & CFO

Conference Call Participants

David Manthey - Robert W. Baird

Nigel Coe - Wolfe Research

Ryan Merkel - William Blair

Robert Barry - The Buckingham Research Group

Joshua Pokrzywinski - Morgan Stanley

Chris Dankert - Longbow Research

Operator

Greetings, welcome to Fastenal Third Quarter 2019 Earnings Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] Please note, this conference is being recorded.

I would now turn the conference over to Ellen Stolts with Investor Relations. Ellen, you may now begin.

Ellen Stolts

Welcome to the Fastenal Company 2019 third quarter earnings conference call. This call will be hosted by Dan Florness, our President and Chief Executive Officer; and Holden Lewis, our Chief Financial Officer. The call will last for up to one hour and will start with a general overview of our quarterly results and operations, with the remainder of the time being opened for questions and answers.

Today's conference call is a proprietary Fastenal presentation and is being recorded by Fastenal. No recording, reproduction, transmission or distribution of today's call is permitted without Fastenal's consent. This call is being audio simulcast on the Internet via the Fastenal Investor Relations homepage, investor.fastenal.com. A replay of the webcast will be available on the website until December 1, 2019 at midnight Central Time.

As a reminder, today's conference call may include statements regarding the company's future plans and prospects. These statements are based on our current expectations and we undertake no duty to update them. It is important to note that the company's actual results may differ materially from those anticipated. Factors that could cause actual results to differ from anticipated results are contained in the Company's latest earnings release and periodic filings with the Securities and Exchange Commission, and we encourage you to review those factors carefully.

I would now like to turn the call over to Mr. Dan Florness.

Daniel Florness

Thanks Ellen, and good morning everybody, and thank you joining the Q3 Fastenal earnings call. Just a few observations on the business as I start out. This is no secret that the industrial marketplace has weakened in the last 12 months. The Blue Team has reacted. I'm impressed with the group I call friends and associates. They're talented group and they shined through this quarter.

My next comment isn't really a trade secret, the third quarter of 2019 had one additional business day. We generated about $21 million per day in revenue, this helped our quarter. I was -- the sarcastic side of me was thinking that perhaps everybody on this call could petition our respective governments about modifying the global calendar to add one business day in every quarter going through would probably do more for our economy than all the silliness that we typically see coming out of our respective capitals, and I'll leave it at that and no political party has a monopoly on ridiculousness. All kidding aside, the supply chain for our customers has become more expensive in the last year and a half and more volatile.

Our job is really straightforward. We provide Supply Chain Solutions. We challenge the status quo with both our customer and with our supplier, and trust me, they reciprocate. That's a good constructive balance, a good friction balance. Challenge sometimes means considering a different product. Our business model has an advantage here over many of our local competitors. Sometimes it means a different solution. As you know from what you've learned about Fastenal over the years and prior quarters, we have many to offer.

Fortunately for us, many of our competitors are one trick ponies, and this helps us win in this type of environment. I never lose sight of the strength of an organization where our team -- 75% of our employees have intimate knowledge of our customers operation. They have knowledge of their local and global business culture, and the scale to stitch it together. This is more powerful than an abstract server study at customers' keystrokes that can only do fulfillment. I believe we can win, but we have to figure out where we win with that strategy.

And I think the things that we do with our growth drivers play very well into understanding that advantage. All that technology, though does bring in tremendous productivity wins. We are slowly introducing technology in our business, and I believe you see it shine through in our ability to manage the labor side of our business.

Getting to Holden's flipbook, we've reported earnings of $0.37. There were just some discrete tax items in the quarter, actually in both years; but adjusting for these, the EPS remained at $0.37. Pleased to see our pretax profit growth accelerate from frankly a disappointing second quarter.

Two things stood out. First, the team executed nicely on pricing, which produced a better gross margin. Does it mean that that we're not behind on the price cost, and the goal isn't about who wins on the price cost because this is a supply chain relationship between supplier,

between our supplier, our business, and our customer, and we need a supply chain that works for all . So it's not about who wins, it's about who provides the best value to our customer.

Secondly, our team adjusted really well to the slowing business, kind of just as fast in the second quarter, we're just a little bit faster in the third to provide nice incremental margins while at the same time, we continue to invest in the growth drivers of our business. That's one of the most important aspects of this as we still have the resources to invest in growth. Business conditions remain sluggish and our customer tone remains cautious, very pleased with the cash generated during the year-to-date, the improvement during the period, my compliments to our team in the field, my compliments to Holden, Sheryl, and their respective teams, performed really well on managing our working capital.

And the nice thing about this page, in one page, we talked about two things that we haven't been able to talk about with confidence and maybe even some pride in recent years, and that is we performed well on gross margin and on working capital, but we still have work to do. Onsites, we signed 84 in the quarter, a little bit less than the second quarter. I think there's two things driving that; one, a lot of discussions during the quarter with customers centered on supply chain, challenging supply chain, some of those discussions were about pricing and also in an environment like this, and we see it in our vending as well, when there's uncertainty in an environment, a natural human reaction is sometimes it's easier to not make a decision at all than to worry about what decision is the right one. And so we're seeing, saw a little bit of a slow down, but we're still at up 30% over where we were a year-ago at 1076 Onsites, and the business continues to grow in low teens. And we believe we will still sign between 375 to 400. It's a little bit more difficult of a goal than it would have been three months ago or six months ago, only time will tell if that belief will be turned into a reality, but we believe that we can accomplish it.

The one thing might jump out at you is we closed 22 traditional branches during the quarter. That's not a surprising number. We've been doing similar numbers of that over the last four or five, six years, but we did close 35 Onsites. I'm a firm believer, some organizations sometimes not hide from the truth, but hold back the truth, and they won't acknowledge things challenging the status quo. And as a result, they don't do anything, don't do anything and all of a sudden do something big all at once. And then spend all their efforts adjusting for the numbers to explain it to what was going on in the world, we don't do that.

We challenge the business every day, and if our team feels along with their customer, there are some Onsites that don't make sense in today's environment, perhaps the business has slowed down, perhaps a plant's been consolidated, we want to understand why from the standpoint of trends of our business, but I consider it's a healthy thing. Vending, we continue to have a very good clip with vending. To me, the most noteworthy thing that stood out on our vending numbers, so our installed base is up 12.2%, Q3 to Q3, our product sales are up in the mid-teens. I'm not really good at numbers, but I do know that means our revenue per machine increased in the 12-month period.

I consider that a tremendous accomplishment in an economy where things have weakened and you would expect your revenue per machine to decrease a little bit. I think there's two things that are shining through there. One, vending is about a lot of the stuff that goes through our vending machines is about PP&E, so stuff people need.

We're in a high employment environment, so there's still plenty of employees and employees need stuff. I think that's part of it. I think the other part is our team has become really dialed in at managing their vending asset base, and utilizing that asset base to benefit their customer. And it means sometimes you pull parts out, you put new parts in, and that those two things drive the fact that that base of business actually expanded in a declining economy. E-commerce was up about 28%, Q3 to Q3, I consider that a weaker number. One thing that shines through and that for me is a chunk of that e-commerce is to larger customers and a chunk of that was economically weakened.

With that, I'll turn it over to Holden.

Holden Lewis

Great, thanks Dan. Good morning, let's just jump on to Slide 5, total sales are up 7.8% in the third quarter, adjusting for the one more selling day in the period, our daily sales were up 6.1%, which is a deceleration from the second quarter. September daily sales growth was up 5.8% which is fairly consistent with the July and August rates. But business activity has continued to soften, the leading Purchasing Managers Index averaged 49.4 in the third quarter, and it was 47.8 in September.

Those are levels that are consistent with modest contraction in industrial production. For its part, industrial production was up just 0.3% in the July-August period. The cautious tone is reflected in the feedback of our regional leaders and in the trends of our end-markets. Manufacturing was up 7.7% and heavy equipment was up 4.4%, oil and gas and industrial end markets are also softening while transportation and consumer linked customers are stable. Construction was up 2.9% in the third quarter with larger customers outperforming smaller ones.

We estimate the price in the third quarter contributed 90 to 120 basis points, which is slightly improved on the second quarter. However, we think the degree of price realization in the period is partially masked by the current period having to grow over last year's rising contribution from price because the third quarter 2018 marks the rollout of our pricing tool. We're pleased with the efforts of the Blue Team to mitigate the effects of tariffs and inflation during this period.

From a product standpoint, non-fasteners continue to lead but did decelerate with 8% growth in the third quarter, while our more cyclical fastener line was up 3%. From a customer standpoint, national accounts were up 10.2% in the quarter, with 62 of our top

100 accounts growing. Non-national account growth was less than 1% was roughly 57% of our branches growing in the third quarter. Our growth today is coming largely from the growth drivers which only reinforces our commitment to them.

Regardless of the market conditions, Fastenal provides a value to our customers. It has a financial model that allows us to invest as others pull back, and we intend to do so. Now moving over to Slide 6, our gross margin was 47.2% in the third quarter, down 90 basis points versus last year. The components of this decline are familiar, product and customer mix, price cost and transportation expense, plus the absence of the difficult comparison we had last quarter.

However, the third quarter was also up 30 basis points versus the second quarter, which bucks the more traditional flat to down sequential pattern. This largely reflects moderation in the variables that impacted the second quarter. Mixed drag was 70 to 80 basis points narrowing a bit as Onsite growth rates slowed, price cost improved through the quarter as pricing efforts to offset tariffs and inflation gain traction.

It's common for the fourth quarter gross margins to slip versus the third quarter as it's happened in four of the last five years typically by 20 to 40 basis points. With the momentum we built in the third quarter however, we anticipate being able to sustain our gross margin above 47% in the fourth quarter. Our operating margin was 20.4% in the third quarter down 10 basis points year-over-year. SG&A as a percentage of sales was 26.8% better by 80 basis points at a record low for the third quarter. We leverage operating costs despite the slowdown in sales growth, aided a bit by an extra selling day in the period.

Looking at the pieces, we achieved 65 basis points of leverage over employee related costs which are up 4.2%. This growth was largely due to 4.1% increase in FTE growth at the end of the period. We realized 20 basis points of leverage over occupancy related costs which were up 2.8% comprised of higher vending expenses as we expand the installed base and flattish occupancy expenses. Conditions remain challenging, so we remain focused on adding resources as necessary to finance our growth drivers and support our ability to take market share while tightly managing other costs and investments. If you put it all together, we reported third quarter 2019 EPS of $0.37, which is up 8% from $0.34 in the third quarter of 2018.

As Dan mentioned, we did have discrete tax benefits in both the current and prior year periods. And if you include a $3.6 million benefit in the third quarter -- including a $3.6 million benefit in the third quarter of 2019. If you adjust for these, third quarter 2019 EPS remained $0.37, up 7.3%.

Turning to Slide 7. Looking at cash flow, we generated $257 million in operating cash in the third quarter or 121% of net income. Higher earnings combined with lower working capital needs to produce the cash flow. Year-to-date cash conversion is 96.4%. Net capital spending in the third quarter was $60 million up from $35 million in the third quarter of 2018. This continues to reflect investments in hub property and vehicles that are necessary to support high service levels as well as investments in vending equipment to support growth in our installed base.

Our 2018 range for total capital spending is unchanged between $195 million and $225 million, with the same factors driving the third quarter increase impacting the full-year. We also paid out $126 million in dividends in the period and reduced debt by $55 million. We finished the quarter with debt at 14.7% of total capital in line with last year's 14.4% down sequentially and from year-end. Inventories were up 13.4% in the third quarter of 2019. Nearly half of this growth related to inventory to support new Onsites.

The remainder relates to higher hub inventories. We planned for growth in inventory to slow meaningfully in the fourth quarter as actions taken earlier in 2019 to reduce overseas purchasing in response to slower demand begins to be felt. Accounts receivable grew 5.8% in the third quarter of 2019. Receivables benefited from slower growth and the timing of quarter-end. If I try to adjust for the latter, we estimate that receivables growth would have been roughly 7.5% with roughly half day increase in DSO, the slowest rates have increased since the first half of 2017.

Our customers continue to aggressively pursue longer payment terms and withhold payment at quarters-end. We expect growth in our working capital assets to be more modest in the fourth quarter than it was in the third producing another strong cash flow quarter. That's all, we have for our formal presentation. So with that operator, we will take questions.

Before we switch over to questions, last time when I was flipping through Holden's book one thing that hopefully stands out in these calls is Dan is unscripted, which probably makes for a frustrating listen from an audience perspective. Holden is nicely scripted, so you get maybe the how from Dan, but you get the what and the meat from Holden.

And that's a good one-two punch. There was an item that I added into the notes of my flipbook last night that I didn't want to throw out there because I thought I might get a question on it. And I didn't want to give you an unsatisfied, unsatisfactory answer. I thought I'd preempt you. That is the one item in the quarter that kind of makes me scratch my head is our construction business. And we had enjoyed nice growth in construction over the last several years.

That growth has slowed dramatically as we've come into 2019. And in all honesty, we don't totally understand it, it's two worlds there, our large account business continues to grow well, our local business isn't growing as well. And some of that you can attribute to the fact that we've, we closed about 5% of our locations a year, so that but so that's going to take a toll on the local construction business. But that's not a new phenomenon. We've been doing that for four or five years.

There is some slowing in our local construction business as I pointed out to you, I've given the unsatisfactory answer that we don't completely understand it. I do know from talking to peers in other organizations and I know a number of folks and organizations that sell into this arena. In the large account business, we’re not really seeing it, but they are seeing it in the smaller account business as well.

And so it's more of an observation than a conclusion. I apologize for that but I thought I had pointed out anyway with that, we will turn it over to questions and not sure if Ellen preempts the group but we've asked for one question and a brief follow-up if you still need.

Question-and-Answer Session

Operator

Thank you. At this time, we will be conducting the question-and-answer session. [Operator Instructions] Thank you. Our first question today comes from the line of David Manthey with Robert W. Baird. Please proceed with your questions.

David Manthey

Thank you. Good morning, everyone. First off, can you talk about additional price increases that you may be thinking about in the fourth quarter to offset additional tariff-related COGS inflation?

Daniel Florness

Sure, as you know , there's going to be another round of tariffs that go into place in mid-October, and then there'll be another round in mid December. Our intention is, as we get into the latter part of this quarter that we will adjust our pricing and our pricing tools to reflect the changes that are coming because of those tariffs. So, I think you are going to expect us to take action on those, should they ultimately materialize in the latter part of this quarter.

David Manthey

Okay, thank you. And second, it's a small percentage, I know, but I'm hoping you can provide more details on the 35 Onsite closures, were these purely chance or cyclical customer issues rather than a bad fit or some sort of competitive loss? Is there anything you can share with us regarding that or is there anything you learned from those closures that helped you better that potential customers for Onsite implementations in the future?

Daniel Florness

Sure, yes, the quick answer is probably a little bit of all of the above. But you're right, Dave. I mean, we closed more this quarter than we've typically done. And I think there's a couple of things to think about here. One is simply the installed base has gone up, and as the installed base goes up, there's going to be a natural degree of churn that happens. And so, the fact that -- we're that it's a high number, but frankly the three or four quarters that preceded this quarter were higher than the ones before that. And so, there's an element simply of it's become a big part of our business, we have a lot of them out there, there's going to be a natural element of churn that goes up over time.

But the second piece is, you're right. As we've achieved the degree of critical mass in that initiative, the reviews, we always review our business not only in Onsites but elsewhere, but we get more active in terms of reviewing the businesses that we have as we get critical mass as we have more aged facilities. And if I look at the 35 that we closed in this quarter, I was able to get a good explanation about 27 of them, just to let you know. And if I look at that, there's a handful where the plant closed. There's a handful where the model changed, right where we opened the Onsite because the purchasing manager liked the model and that purchasing manager has now moved on and new ones in place doesn't like the model as much.

And so, they've changed it. And so, there's a few of those. There are a few where we lost some business to competitors. Usually, that's because they decided to go for maybe a better pricing scheme or what have you, but those do exist…

Holden Lewis

Or somebody new in their procurement function.

Daniel Florness

Or somebody new in their procurement function, right. So those elements do exist. They've existed every quarter before this. Now, I will also say there were 11 Onsites that that frankly we closed them because maybe the financials didn't play out as we would have expected. In fact, if I look at those 11 Onsites, they're running at about 20K a month. That's well below what we need to have in order to make that model makes sense. And so, we wound up closing that Onsite, but in nine of those 11 cases, that business moves back to the branch that's nearby, right?

So it's not lost business even though it is a closed Onsite, but the financial decision is better at the branch than it was at Onsite in those cases. So, I think the perspective that you have to have here is, we always review our business and as the base goes up, I think closures would go up as well. But that said, I think that this quarter was pretty high. I don't expect to see that that level of closings in the fourth quarter. And even at that high level, we're talking about roughly 3% of our installed base, I mean not a big number. So, which I think you kind of commented, so that's probably how I'd respond to that.

Holden Lewis

I'll add just an item in there, Dave, and that is if you think about growth drivers, if you think about our business in general, we consider this a healthy part of the business, take our national accounts business as an example. I know based on history that when we come into a new year, I can assume that 5% of our national account revenue from last year will be gone not because we lost the customer, but because across those thousands of locations, there were special projects going on in 2019 that won't happen in 2020. And so if we want to grow our national account business and I'll just pick an arbitrary number, if we want to grow our national account business 15%, we have to go into the year with a plan to hit 20 because we know we're starting to downsize. When I think of our vending business, this year we will pull out about 13% of our vending machines based on our installed base.

And that's been true for years actually, if I go back five years ago, we were pulling out about 25% of our installed base every year from the prior year. Because we put in 10, we realized we needed eight; we put in two, we realized that wasn't a great place to put vending; and we improved the business over the last decade, we've pulled out north of 40,000 vending machines from locations where we've installed them. And what do we have to show for it, we have a business that went from zero to we will do about 1.1 billion through vending this year.

It helps our overall organization grow faster. It's a nice discrete business in and of itself. And but I know that every time we placed 10 machines are so likely we're going to pull a few of them back. And I love the business. And I love the fact that we're always rationalizing. I don't know ultimately like on the Onsite, what is the churn rate? But I don't know, maybe 5% a year is a number. I hope I don't see that number in the report that comes out now that Dan Florness do this. But I'm just saying it's, it's a business and you approach it from pragmatic business perspective. What's a win for your customer, what's a win for your team, and what's a win for the future of the business as well and we love the Onsite business and we think a healthy look at it as a good thing.

David Manthey

All right, very helpful color as always. Thanks very much.

Holden Lewis

Yes, thanks Dave.

Operator

The next question is from the line of Nigel Coe with Wolfe Research. Please proceed with your question.

Nigel Coe

Thanks. Good morning guys.

Daniel Florness

Good morning.

Nigel Coe

Good detail in the first couple of questions. Yes hi guys. So just want to maybe just address kind of what you're seeing out there in a bit more detail. It feels like September was a weaker month more broadly. Yet, you saw a nice uptick in September sequentially. So you didn't seem to see that, although you are talking about a great proportion of national accounts, customers are declining. So I'm just wanting to maybe just dig in to sort of feedback you're hearing from branch managers and then more specifically, you called out I think last quarter weakness in heavy industry and oil and gas. You didn't called that out this quarter. So I'm just wondering what you're seeing in those two areas? Thank you.

Daniel Florness

Sure. Yes, the September number was a little bit below where July and August was, I would agree that they were substantively in the same range. But we did do a little bit better with pricing in the quarter, obviously. And I think that that kind of moved through as the quarter went on as well. I don't think I'm going to get into disclosing month by month, kind of what we think the pricing was. But I think it's fair to conclude that it got better as the quarter progressed and that probably, don't you probably saw a little bit of a decline in -- or a backing up in volume growth filled in a little bit by improvement in the pricing side.

And I think that was probably an element of it because if I think about the markets, yes, they're getting softer. And that probably don't surprise anybody and you're right, I didn’t call out oil and gas and heavy machinery specifically, it feels like it almost goes out saying at this point, but those areas are weak. The industrial manufacturing sector broadly is weak and I kind of feel like volume for us outside of our market share gains is probably in the area flattish. And then that's where we've gotten to at this point.

In terms of feedback from the RVP groups, it's probably what you would expect most are talking about tone being cautious, much as they have been. They did call out, obviously oil and gas, heavy equipment. We've talked a bit before about some of the automotive, not a lot of direct exposure to automotive very little if any, but indirectly, some of the regions that are there have certainly called that out.

I'm not sure that I'm adding any market still list, that are soft, but I'm not seeing anything getting better either. And so it's still a bit of a challenge. What I will say is, I think some of the commentary from the RVPs what got added in the last month or two, a little bit more discussion about seeing some layoffs in their markets, a little bit more discussion about seeing people deciding or choosing to defer spending decisions. I would say those really begin to creep into the dialog in the last quarter or two. And again, I just think it feeds this, this narrative that that conditions they’re not spiraling out of control by any means, but they continue to soften up in our marketplace.

Nigel Coe

Great, thanks so much, great color. And then just on the gross margin, you kind of preemptively went out with (inaudible) number for 4Q, obviously that's top of our minds. I understand, just given your terms and the timing of tariffs, that is 25% List 3, start to filter into your P&L in 4Q. So I'm just curious, if you are seeing the incremental inflation, what could be the opposite to that?

Holden Lewis

Well, remember, the List 3 tariffs went into place. Initially, I think in December and the number in March of 2019. Those frankly, the cost of those actions were largely in our 3Q, I think I know what you're talking about, we have turns of two times. But remember tariffs are a little bit different and that it's not about when you purchase the products about when it hits the shores. And so if our six months, sort of supply chain lag is three months overseas on the water and three months domestically, then the impact from tariffs, you're going to feel that once it hits the shore, but from that period to the time that it flows through the network, that's really more like three months.

So the List 3 tariffs, those costs were largely in 3Q, I don't anticipate an incremental impact in 4Q from the List 3 tariffs. On List 4, those go into play in October and then again in December, if they ultimately go through. And I expected those costs would then roll forward into the first quarter of next year. And we'll adjust our business ahead of that to make sure that we're neutral on it. So, our intention is obviously not to fall behind based on sort of what the new tariffs are. But I think I want to emphasize as well, Nigel, when we fell behind, it had a lot more to do with general inflation in the marketplace than it did with the tariffs.

Now, I think general inflation was sort of goosed by the tariffs if you will. But it wasn't so much the tariff that presented the challenge to us as it was the generalized inflation. And I think, the change of approach that we've taken in recent months in three areas, one, the group has new information and new tools in the field that they didn't had 18 months ago. We have a new structure internally dealing with our pricing and our costing versus what we had 18 months ago. And I think that structure, the people involved in that structure and its oversight, I think are doing a phenomenal job. And then just the muscle memory that's been built up in the field, again very different from what existed 18 months ago.

And so I think our capabilities now versus what existed 18 months ago are far stronger. I think the execution speed of what you saw in 3Q reflects that and I think we can manage what comes as effectively today as we've been able to at any point in this period, but I don't anticipate tariffs being an incremental drag to 4Q relative to 3Q at this point.

Daniel Florness

As Holden was talking, I was just flipping through some stats here on components of our business just to shed a little additional light on the first question about heavy equipment. If I look at heavy manufacturing, now heavy equipment is a subset of that, if I look at heavy manufacturing as a business, that's about it's between 35% and 40% of our revenue, so it's a big swath of our revenue.

That was growing about 13.5% in the first quarter, that dropped a little over 8% in the second quarter and it was about 6% in the third quarter. So mirrors up pretty well with what our reported number is. If I look at heavy equipment subset in there, which is about two-thirds of that component, it's about 27% of our revenue, 13.5% in the first quarter. So in line with the overall heavy manufacturing, 7.5% in the second quarter, so we're starting to pull down that overall heavy manufacturing group. It dropped a 4.5% in the third quarter.

So two things jump out of that, that's lot of OEM fasteners in there, lot of production in there that weakened as we went through the year. The interesting thing is that there was a divergence between the two-thirds of the heavy manufacturing, that's heavy equipment and the one-third that is and there's a divergence and there's more resiliency in the other group. So the overall number isn't declining as much and I go into the weed and get a little wonky and only from the standpoint of that's that demonstrates what our team is doing, our national accounts team, our regional teams are doing, that's market share gains. We're picking up great market share because our customers are struggling right now. And it shines through in our heavy manufacturing, it shines through in some of the stats that Holden puts out as far as our top 100 customers, how many are growing with us? All that kind of information really sheds light.

Nigel Coe

Great color. Thanks.

Daniel Florness

Thank you.

Operator

Our next question is from the line of Ryan Merkel with William Blair. Please proceed with your question.

Ryan Merkel

Hey, thanks. Couple of questions.

Daniel Florness

Hey Ryan.

Ryan Merkel

Yes.

Daniel Florness

Before you start, congratulations on the new baby.

Ryan Merkel

Thank you. Lot of work but a lot of fun.

Daniel Florness

There you go.

Ryan Merkel

Thanks Dan.

Daniel Florness

You must be tired because usually you get into queue earlier than this.

Ryan Merkel

I will tell you what, three hours.

Daniel Florness

You’re a little bit slow.

Ryan Merkel

Yes, I’m a little slow. So on gross margins, just a follow-up. So if you do a little bit better than 47% in the fourth quarter, that would be a year-over-year decline of like 50, 60 bps. So how should we think about the components of mix, price costs and frame?

Holden Lewis

So I think at that point, so the freight comparables will get easier. Now obviously, our goal as a company is to not rest on comparables but actually execute the freight side better. But at minimum, the freight comparables get easier. And so I'm not expecting a big drag on freight. I think that will be that I think that impact will be diminished. The real question mark there is ultimately, there is a cyclical element, how much does our revenue go up or go down based on sort of the macro but that's the expectation right now, which means that most of what I would expect you to see is going to be related to the product customer mix, I think if you look at the cadence of price cost, it's one of those things where I think the number of the quarter isn't terribly meaningful, because pre-quarter and then post quarter were two very different numbers, depending on the timing of when you were able to enact the strategies that we enacted, but

by the time you finished up the quarter, you were approaching kind of balance, if you will on sort of the price cost side.

And our expectation is to kind of maintain something around neutrality. And as a result whatever we achieve in the fourth quarter, I think it's going to be heavily a function of mix.

Ryan Merkel

Okay, yes, that's really helpful. Especially the price cost getting neutral I think it’s really critical. Okay, and then next question and this is more theoretical, but based on what you're hearing from customers and seeing in the macro, what level of end market growth are you planning for in 2020?

Holden Lewis

So yes, it's very theoretical. What I would tell you is as you know, I've studied the PMI and its impact on our business for a long time. And I always viewed the PMI as being a bit of a leading indicator. And I think the PMI is probably signaling to us that the conditions that you're seeing today, which I think suggest very fairly flattish volumes, that we're going to roll into 2020 in a very similar position.

Now what the second half looks like, I have no idea, but we're going to roll into 2020 in a very similar position. And I think if volumes are flattish, I think that next year, we will get whatever we get based on market share gains and call that between 5% to 7%. There's probably a little bit of incremental price that flows in there just because we recognized for a full-year what we've put in as this year progresses. And I think that the -- you're looking at something in the 5% to 8% range based on where the PMI is today depending where the PMI is in December, ask the question again. So that might all change but that's probably how I would characterize how I look at the PMI and its impact on our business.

Ryan Merkel

Got it. Thanks so much.

Daniel Florness

Yes, thanks Ryan.

Operator

The next question is from the line of Robert Barry with Buckingham Research. Please proceed with your question.

Robert Barry

Hey guys, good morning.

Daniel Florness

Good morning.

Holden Lewis

Good morning.

Robert Barry

Congrats on the solid quarter.

Daniel Florness

Thank you.

Robert Barry

So just trying to get my head around this tariff related math a little more, just wanted to clarify with the full impact of tariffs on List 3 at 25% flowing through the P&L in this quarter, was that your earlier statement?

Holden Lewis

Yes, for all intents and purposes because again remember, our two times turns don't really apply where tariffs are concerned, right? Because the moment tariffs go into effect, the first container that hits our shores are tariffs at that point, and from that point, call it three months to move through our system from the ports through the hubs, through the branches to a customer, right. So we're not talking about a six month window in which it takes to sort of realize the tariffs to our cost. We're talking about something shorter than that.

And that's strictly based on the dynamics of the tariffs themselves.

Daniel Florness

I'll add one more. I'll add one more just twist to that. The dynamic, there's really a couple of things that come into play and a piece of it, I agree with Holden's comment, piece of it I disagree with Holden's comment. If you think about a customer, where we're bringing in, say OEM fasteners or we're bringing in, it's vending customers, we're bringing in. We do a lot of hand protection through our vending devices. So we are bringing in that kind of product, your visibility to need and supply chain are much more dialed in. So that element of the product turns faster because you're bringing in products that that you might, you might have a three month supply, four month supply, five months supply. So it turns a little faster. And the variability in that is dependent on not how quick it hits the cost impact but how long, how many months of, how many days of inventory have can change. If all of a sudden that customers business OEM fasteners are down 20%, what you thought was a five month supply just and six months supply, that means you have the legacy of that problem a little longer.

But it still hits relatively quickly. Same thing in a lot of our vending on our hand protection. Now if you went and visited a bunch of our branches and you looked at a lot of the MRO fasteners and a lot of the products that are in our branches, that's product where we have less certainty, less visibility to demand and we stock it a bit deeper because of that. There you have products that might turn once a year.

And so there are some elements of both, a lot of our discussions with our customers is on the former not the latter, because that's the product that's the product in their nose spin as opposed to their tailspin, it’s a tailspin that becomes a little more difficult from a turn standpoint. I hope I shed light there instead of that.

Robert Barry

Yes, I mean little bit perhaps. I mean, what I'm getting trying to get my head around is if you look at your sales, 34% is fasteners, I assume healthy chunk of that is subject to the tariffs and if you assume tariffs that is 25% on that COGS it seems like a much bigger number than the 1% price would cover. So I mean maybe some of the things you're talking about Dan are the reasons why price cost can be almost neutral even though that kind of headline math, I just did suggest a much bigger pressure, what are the other offsets?

Daniel Florness

Yes, keep in mind I'll let Holden to add in but there's a bunch of fastener products that we have moved out of tariff base country, the issue run into when you move it, it might be more expensive, but it's less expensive than a 10%, 15% and 25% tariff. And so there is some stuff that we've moved out, but I'll let Holden chime in.

Holden Lewis

Yes, I mean the only other nuance I would add to that is it's certainly true that we import the great majority of our fasteners. But recall that we're as tight as one source, which as Dan indicated, we've actually reduced that source over this period of time. We also get a lot from Taiwan, and a handful of other countries out there that aren't subject, right. So don't overstate the impact of if fasteners are heavily tariffs, they are if they're coming from China, but we get a lot of our fasteners from Taiwan and other areas in Asia, as well as there's a major supplier in Canada they are not quite as effective as much. So those obviously aren't impacted the same way.

Robert Barry

Would you be willing to just tell us let your List 3 and List 4 exposures are?

Holden Lewis

No, I mean what we always said is substantially all of our products that we source from China is covered by List 3 and List 4. We have not disclosed historically what that number is specifically, what it was, when this all began 18 months ago, it's a little bit lower than that now, or 12 months ago, it's a little bit lower than that now, because of the works that we have done. Again as Dan pointed out to improve the supply chain cost of our customer supply chains, we have moved a material not a product out of China into other areas, usually within the region. But it's still a significant minority of our overall purchasing comes from China and what does come from China is going to be captured by List 3 and List 4.

Robert Barry

All right. All right, I'll leave it there. Thank you.

Holden Lewis

Thanks.

Daniel Florness

Thanks.

Operator

The next question is from the line of Joshua Pokrzywinski with Morgan Stanley. Please proceed with your question.

Joshua Pokrzywinski

Hi, good morning guys.

Daniel Florness

Good morning.

Joshua Pokrzywinski

Just maybe follow-up on some of the non-resi commentary. It looks like there was a nice uptick in momentum there in the September. Dan, I know you talked a little bit about some slowness otherwise it was a little bit of a head scratcher. But I think more broadly, construction markets had some weather issues impacting earlier parts of the year. Did the season just kind of go longer or have a bit more tail at the end as a function of whether push outs or any explanation for maybe why September was, was an uptick?

Holden Lewis

Yes, I hesitate to being a farm kid from Wisconsin. I'm always attuned to the weather and I'm appreciative what that means for this time of the year and people getting corn and soybeans in this part of the country out of harvested, I am hesitant to talk much about weather short of that because we're in a lot of jurisdictions and unless there's something major that really hits. It's a regional issue more than a company issue. The one you point out September, September did have a nice uptick in construction. We do 6.5% construction business versus the first couple of months, we are growing between 1% and 2%.

I like what I saw in September, one month is not a trend. I would love to see that that strength that strengthening we saw in September, shine through in October, November and time will tell if that happens. Right now I honestly don't know. But I did like what we saw on September.

Daniel Florness

The other thing I might suggest is if you look at just the comparables in August of 2018, our construction business was growing 18%, 19% in September of 2018, it was growing 13%, 14%. So little bit easier comp, I think also contributed to September looking better than the other two months in there. I would consider that as well.

Joshua Pokrzywinski

Got it. And then just a follow-up on pricing, obviously some good momentum there, getting kind of caught up after 2Q, any kind of institutionalized moves, I know there's a lot of discretion at kind of the branch and salesperson level on price movement and what it takes to win business or retain business? Has any of that discretion been lifted to higher parts of the organization to where maybe things like 2Q don't happen as often or did it just need to be a catch-up?

Daniel Florness

First off, one of the ways we circled the wagons, so to speak is we have a frank and honest discussion with our teams, and we talked to hear the facts at hand. Here's what we need to do and here's some of the discussions we need to have with our customers. And like I say you always lead the discussion with here are solutions that that makes some of the issue go away. Maybe there's a different widget that has a similar form and function that you've suggested in the past. But there hasn't been a willingness to change that all of a sudden now can effectively offset this impact. But you have a frank and honest discussion with your team, and they have a frank and honest discussion with our customers. And you challenge them and say, this isn't a mandatory thing. This is a need-to-do thing, which, frankly I think is more important than a mandatory thing.

We need to do this. And but we also need to have a mindset that this isn't a project. This isn't a three month thing, this isn't a 12-month thing. This is something you just do, just that right now. We need to reallocate a little more time to it because the urgency is high, because the volatility is high, and you need to have that conversation with your customer.

Unfortunately, when you reallocate some of that energy, maybe your vending drops off a little bit in your signings, maybe your Onsite drops off a little bit on signings, because something there's always a finite amount of energy in the air.

Holden Lewis

Yes, so I mean I would say, we really didn't fiddle with any elements of our culture, right with the elements of allowing people in the field to make decisions because they're the ones that know the customer far better than anybody and it does. And so we really didn't fiddle with elements of culture, if that's what you're asking. But we have fiddled with, as I said before is the information tools that are available to people in the field, the structure internally by which we attack sort of price and cost questions. And then obviously, just again, building up that muscle memory in the field getting used to having these conversations, and that sort of thing. We fiddled with those elements, but we didn't fiddle with fundamental culture, payroll, anything or pay plan or anything like that to achieve what we've done. And the good news is, I think that means that it should be more sustainable.

Joshua Pokrzywinski

Understood, good color. Thanks a lot.

Holden Lewis

We are at 9.50, so I think we are running to the end or leave a full hour now.

Daniel Florness

Full hour, Holden we will make it full hour.

Holden Lewis

Makes my call afterwards easier.

Operator

Thank you.

Holden Lewis

Keep on going, operator.

Operator

Thanks. Our next question comes from the line of Chris Dankert with Longbow Research. Please proceed with your question.

Chris Dankert

Hey good morning guys, thanks for all the color thus far. I guess from our perspective, I saw you guys stepped up the IT and technology investment in the quarter by several million bucks, just anything worth home about there, any kind of major projects you'd highlight?

Daniel Florness

When I stepped into this role, one of the things that I thought was important, looking at the landscape out there, we decided to make a meaningful move and I started talk about this with our shareholders back in that timeframe. We decided to increase our relative IT spend, about a half a percent of sales. So I think what our business today is a half percent less profitable relative, so 50 basis points less profitable because we decided up that spend.

Now my gut believes that that 50 basis points. We are I don't know if we've clawed it all back but we're clawing it back because it brings productivity and it improves our business. I'm always talking to John Soderberg, our leader in the IT area, John's been in that area now about three and a half years leading that team, he's done a wonderful job, we have great talent. He's done a wonderful job better connecting our IT group with our business and so the talents, the inherent talents of our IT team really shine through. If I think of some, some recent wins. Just yesterday with our board of directors, I was chatting with him about two days ago, we rolled out and some of you are going to roll your eyes at this comment because companies have been doing this stuff for a long time, we haven't. We started talking earlier this year about the implementing a bot within our business to improve and our safety team, we've developed an incredible safety business over the last decade, obviously helped by vending, 55% of our vending revenue is safety products.

And our safety team is looking for added resources because they get bombarded with thousands of questions from the field. And it just takes away a lot of their energy. And to me the two things, couple of things jumped out there. Boy, that's, I'm glad to hear they're getting bombarded with questions. But I'd rather not add resources to answer questions because the ultimate is surface the information for our team.

So they so they have it 24 hours a day, seven days a week in the field. So we created our first chat bot, it rolled out two days ago. It's a safety bot, we've loaded it with common questions that our safety team gets. We've loaded it with information, all that and I'm going to start spilling things I know nothing about. But information that our field needs to address customer questions. We rolled it out the 50 branches couple of days ago. I'm pleased to report the first morning it was out, there were 29 questions asked and 22 responses with 76% hit rate on responses as far as satisfactory responses to the questions.

And that's something we couldn't have done two years ago. We are doing some things with rolling out some mobility. That's a slow walk. We're but what we're rolling some things out. To me, I fundamentally believe the wins are a better partner with our customer. A more productive, productive business which means we can inherently be more competitive in the marketplace and still provide better value. And but that's something a couple of quick examples. Again, you might roll your eyes and say, boy, those are pretty small steps. I think they're huge steps. And I'm really proud of our team for doing it.

Holden Lewis

And you're right. I mean, we're looking at IT spending this year, just from P&L standpoint, probably being up 10%, 15%. It’s an area that we continue to invest in our business because we can do so, even though if things are slowing down. That's not necessarily an area that we're looking to restrict, restrict our spend.

Daniel Florness

We invest where we get a return.

Chris Dankert

Yes. Got it, thanks for the color. It really helped kind of level set things and kind of how the growth goes there. And just the last one from me from a very high level. We talked about Onsite already, but just again thinking about total opportunity in the past, you guys have highlighted maybe 4,000 embedded addressable opportunities today. That's still kind of what you see as the opportunity out there?

Daniel Florness

Yes, and I will say at that way. I believe that that number has upside from the standpoint. Earlier we were talking about the 35 Onsite closures and to me, the reason I believe it's okay to have what you could arguably call failure is it means we're testing the fringes, it means we're, we're constantly trying things that maybe we haven't done before, to see if it work. I remember a trip I did with Troy (inaudible) who leads our business here in the Upper Midwest, we're down in Milwaukee area and we were visiting an Onsite and there's nobody in our organization that knows more about Onsites than Troy. He's been successful with a lot of them over the years, and he's talking about what he's doing. And he's kind of he is kind of shrugging and he said that I'm not sure if it'll work. But here's why I did it, boom, boom, boom.

He laid out his reasons. I'm like, that's awesome. And so I think there's an upside to that number but yes, that's where our number sits now, but I think we become more creative because Bob Kierlin created an organization that trust people to try things and be willing to make mistakes.

Holden Lewis

And Dan you can correct me if this is wrong, because that number is put together before I necessarily was here, but I believe that number also didn't include construction, government education opportunities, right?

Daniel Florness

Correct.

Holden Lewis

So we're actually finding opportunities to be Onsite in environments like that as well which to Dan's point is kind of expanding the envelope for what's possible within an Onsite environment.

Chris Dankert

Got it, got it. That's really helpful. Thanks, guys.

Daniel Florness

Sure. With that, it's five minutes of the hour. I'm going to call short of five minutes. Sorry about that. I'm a big believer in obligation. One thing I constantly talk to my team loud is obligations. We chat to each other, to our customer, to our shareholder, and to our supplier. And the one obligation I have to this group is be around answer calls. Today, I won't be here for that obligation. I'm leaving in a few minutes. A friend and brother, he's technically my brother in law, but a friend and brother passed away from pancreatic cancer here in September, David Gustafson down in Madison and going down to support my wife, my sister in law and my nephew and so I won't be around for any questions, if you have any of me, give me a holler next week. Thank you.

Holden Lewis

Thank you.

Operator

Thank you. This will conclude today's conference. You may disconnect your lines at this time. Thank you for your participation.