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IDEX Corp. (IEX)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the IDEX Corporation Earnings Conference Call Second Quarter 2023. At this time, all participants are in a listen-only mode. A brief question-answer-session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Allison Lausas, Vice President and Chief Accounting Officer. Thank you. You may begin.

Allison S. Lausas

Chief Accounting Officer & Vice President, IDEX Corp.

Good morning, everyone. This is Allison Lausas, Vice President and Chief Accounting Officer for IDEX Corporation. Thank you for joining us for our discussion of the IDEX second quarter 2023 financial highlights. Last night, we issued a press release outlining our company's financial and operating performance for the three months ending June 30, 2023. The press release, along with the presentation slides to be used during today's webcast, can be accessed on our company website at idexcorp.com.

Joining me today are Eric Ashleman, our Chief Executive Officer and President; and Bill Grogan, our Chief Financial Officer. Today, we will begin with Eric providing an overview of the state of IDEX's business. Then Bill will discuss second quarter financial results, an update on segment performance in the markets they serve, and our outlook for the third quarter and full year 2023. Lastly, Eric will close the call with his final remarks.

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Following our prepared remarks, we will open the call for your questions. If you should need to exit the call for any reason, you may access a complete replay, beginning approximately two hours after the call concludes by dialing the toll-free number 877-660-6853 and entering conference ID number 13734463, or simply log on to our company homepage for the webcast replay.

Before we begin, a brief reminder, this call may contain certain forward-looking statements that are subject to the Safe Harbor language in last night's press release and in IDEX's filings with the Securities and Exchange Commission.

With that, I'll now turn this call over to our CEO and President, Eric Ashleman.

Eric D. Ashleman

President, Chief Executive Officer & Director, IDEX Corp.

Thank you, Allison, and good morning, everyone. I'm on slide 6. IDEX delivered record sales and adjusted earnings per share in the second quarter along with strong free cash flow. Our Fluid & Metering and Fire & Safety/Diversified Products businesses delivered exceptional performance on strong market fundamentals, both posting strong organic growth and profitability, with FMT delivering an all-time high EBITDA margin.

Our Health & Science Technologies segment continue to face challenges impacted by inventory destocking in our analytical instrumentation, life sciences, biopharma and semiconductor markets. Our teams within the segment drove double-digit organic growth over the last two years, admirably executing for customers in the business in very difficult conditions.

Now, on the backside of the post-pandemic recovery, our OEM partners are aggressively reducing higher inventory levels, beginning with those suppliers that have demonstrated the quickest returns to pre-pandemic lead times. Our teams are appropriately balanced as they execute targeted cost reductions to mitigate a portion of these volume declines, drive strong cash flow overall, and continue to innovate for our customers.

During our last earnings call, a revised outlook for the year assumed our industrial businesses would slow moderately in the second half, while our HST segment would experience a modest rebound. While our view on the industrial markets has not changed, we are no longer projecting a recovery in HST volumes in the second half of the year. Our outlook is based on revised forecast from our key customers who are reevaluating their end market demand alongside their current inventory levels. They're considering many factors overall, including supply chain improvements, lower than expected growth in China, and overall macro pressures within their market verticals. This is a complex and rapidly evolving context, which played out for us in Q2 with a 27% year-over-year organic drop in HST orders.

This moderating demand profile net of our incremental cost containment actions drives an additional $0.45 of EPS pressure at the midpoint versus our previous guide. With that, as we noted in our press release, we are revising our full year 2023 adjusted EPS guidance to $7.90 to $8 per share. Bill will discuss the specifics in greater detail during our segment and guidance updates.

In the second quarter, we also closed on the Iridian Spectral Technologies deal we announced earlier this year, adding another market leader in custom optical filter solutions serving the space, life science and telecommunications markets. We continue to focus on driving strong operational performance regardless of business environment, delivering and innovating for our customers. We're driving speed and agility within our businesses, taking out inventory and driving world-class lead times, positioning us best for growth cycles to come.

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We remain committed to managing through the short term, while not losing focus on critical investments in the development of our people, in capital deployment, and in our differentiated technologies to enable our long-term growth path and deliver above-market performance over a cycle.

With that, I'll turn it over to Bill to discuss our financial results.

William K. Grogan

Senior Vice President & Chief Financial Officer, IDEX Corp.

Thanks, Eric. Moving on to our second quarter consolidated financial results on slide 8. All comparisons are against the second quarter of 2022 unless otherwise stated. Orders of $766 million were down 9% overall and down 13% organically, mainly driven by a 27% organic decrease in HST due to timing of project orders for next-gen sequencing equipment, as well as OEM pressure across the life sciences, analytical instrumentation, pharma and semiconductor markets.

Record sales of $846 million were up 6% overall and up 3% organically. We experienced 10% organic growth within FMT, 8% organic growth within FSD, and 6% organic decrease in HST. Gross margin of 44.7% decreased by 10 basis points compared with last year. This was driven by lower volume leverage in HST, the dilutive impact of acquisitions and unfavorable mix, partially offset by strong price cost and favorable operational productivity across the segments.

Adjusted EBITDA margin was 28.4%, up 90 basis points. I will discuss the drivers of adjusted EBITDA on the next slide. Our second quarter effective tax rate was 22.4%. It was comparable with our prior year effective tax rate of 22.1%. Net income was $139 million, which resulted in an EPS of $1.82. Adjusted net income was $165 million, with an adjusted EPS of $2.18, which was up $0.16 or 8%.

Finally, cash from operations of $141 million was up 26%, primarily due to lower investments in working capital versus last year. Free cash flow for the quarter included higher CapEx and was $120 million, up 24% versus last year, coming in at 72% of adjusted net income. We drove over $20 million of inventory out of the business in the quarter through our targeted reduction efforts, and we saw inventory turns improved versus last quarter.

Moving on to slide 9, which details the drivers of our second quarter adjusted EBITDA. Adjusted EBITDA increased by $22 million compared to the second quarter of 2022. Our 3% organic growth included over 4% of price placing volumes negative for the quarter. This lower volume unfavorably impacted adjusted EBITDA by $9 million flowing through at our prior year adjusted gross margin rate.

Price cost was accretive to margins and we drove operational productivity that offset employer-related inflation. Mix was unfavorable by $3 million, mainly centered in HST due to continued volume declines in our analytical instrumentation and life science components.

Resource and discretionary spending was approximately flat versus last year. We have executed tight cost controls given our volume pressure, and we continue to identify reduction opportunities for the balance of the year. Reductions in variable compensation expense based on our updated outlook contributed $5 million of benefit in the quarter. These results yielded a 60% organic flow-through.

Muon and KZValve acquisitions net of the Knight divestiture and FX contributed an additional $9 million of adjusted EBITDA. Inclusive of acquisitions, divestitures and FX, we delivered 43% flow-through. Excluding the impact of variable compensation, flow-through was about 35%.

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And with that, I'll provide a deeper look at our segment performance. In our Fluid & Metering Technologies segment, we experienced strong sales performance with organic growth of 10%, but orders did contract by 4% organically, mainly driven by the slowing industrial landscape. Adjusted EBITDA margin expanded by 340 basis points versus the second quarter of last year, driven by strong price/cost performance and volume leverage.

We saw our industrial day rate decline early in the second quarter remained steady at that lower level. Customers are taking a cautious view of the second half as they process a variety of economic factors that influence their demand.

Our water business performed well. The North American market continues to be positive with extreme weather, necessary technology and infrastructure upgrades, and improved funding all fueling growth. Our energy markets remain mixed. Improved chassis availability is driving strength in our mobile applications, and the teams continue to work down pass-through backlog, but lower oil prices look to slow the pace of investment in the second half of the year.

In the chemical market, we saw positive results across the US, Europe and Asia, with battery markets providing additional opportunities for growth. The agricultural demand landscape remains mixed. Farm fundamentals are positive overall, and our OEM business remains strong. However, distributor inventory levels remain high, and we have not seen a material bleed-down as we progressed through the planting season.

Moving to the Health & Science Technologies segment. Organic orders contracted 27% in the quarter, driven by analytical instrumentation, life science and biopharma customers inventory destocking, timing of next-gen sequencing orders, soft semiconductor and slowing industrial demand. Sales were down 6% organically, and adjusted EBITDA margins contracted by 420 basis points, driven by unfavorable volume, leverage and mix, as well as higher employee-related costs, partially offset by strong price/cost performance.

As Eric noted, our life science and analytical instrumentation businesses are being impacted by customers' inventory destocking and reduced demand. This was driven by a combination of improved supply chain conditions, macroeconomic factors and lower than expected China demand. We expect this pressure will remain throughout the balance of the year.

The semiconductor market continues to experience softness resulting from memory oversupply, as well as customers feeling the impact of US export controls. We have exposure in multiple parts of the semiconductor value chain and expect demand will stabilize in the third quarter with recovery in the fourth quarter.

Our material processing technology business continues to experience softness across pharma, biopharma and nutrition markets driven by tighter capital availability and customer hesitancy due to recession concerns. We are seeing some strength in aftermarket and positive impact from our battery market opportunities, and we see some signs of improved quotation activity, but these are early days. Industrial markets in HST slowed in the quarter, in line with FMT results.

Finally, turning to our Fire & Safety/Diversified Products segment. Organic orders grew by 2% versus last year, mainly driven by favorable fire and safety and dispensing results. Organic sales growth was strong at 8%, with double-digit growth in both fire and rescue and BAND-IT. Adjusted EBITDA margins expanded by 300 basis points versus last year, largely driven by strong price/cost performance, operational productivity, favorable volume leverage, and positive mix. The paint market remains mixed with positive North America results, offset by delays of Europe and Asia customer investments.

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Within our Fire business, we continue to gain share with North American mid-tier and China OEMs through our integrated system strategy. Underlying truck demand remains positive and OEMs continue to improve their output. Rescue markets are stable overall, with some distributors burning off excess inventory being balanced by growth in our E3 products. BAND-IT results remain positive. We continue to gain share in an otherwise flat automotive market, which is partially offset by slowing energy and industrial markets.

With that, I'll provide an update for our outlook for the third quarter and the full year 2023. I'm on slide 11. In the third quarter, we are projecting GAAP EPS to range from $1.60 to $1.65, and adjusted EPS to range from $1.84 to $1.89. Organic revenue is expected to decline 7% to 8%, and adjusted EBITDA margins are estimated to be approximately 27%.

We project sequential volume declines across HST and FMT, with relatively flat FSD sales. On a year-over-year basis, we expect negative mid-teen organic sales decline in HST, negative low-to-mid single-digit declines in FMT, and low-single-digit growth in FSD.

Turning to the full year. As Eric mentioned, we have reduced our full year revenue guidance in response to our softening HST second half outlook. We now expect organic revenue declines of 1% to 2%. This implies high-single-digit revenue contraction in HST with low- to mid-single-digit growth in FMT and FSD.

At the midpoint, we have reduced our EPS guidance by $0.45 with approximately $0.60 related to lower volume and the associated leverage and unfavorable mix. We offset $0.15 of this pressure with additional cost containment actions related to targeted restructuring and lower resource investment, and variable compensation along with discretionary spending.

In summary, we estimate full year organic revenue contraction of 1% to 2%, GAAP EPS of $6.80 to $6.90, and adjusted EPS of $7.90 to $8. Adjusted EBITDA margin will be approximately 27%. Capital expenditures are anticipated to be about $70 million, and free cash flow is expected to be 100-plus percent of adjusted net income.

With that, I'll turn it back over to Eric for his closing remarks.

Eric D. Ashleman

President, Chief Executive Officer & Director, IDEX Corp.

Thanks, Bill. I'm on slide 12. As we've said in the past, our IDEX leadership will not allow short-term economic fluctuations to alter our foundational objectives, delivering strong execution for our customers, building great global teams, and deploying our capital with discipline.

We've always invested in our best growth opportunities across our well-positioned, diverse franchises. Over the last 10 years, we leveraged 80/20 to optimize business performance and fine-tune our portfolio towards faster, growing application sets. We're now adding power and next level potential to our best advantaged businesses and platforms through thoughtful and aggressive capital deployment.

Our Muon business acquired last year supports the most difficult applications within high quality semicon. Just like our businesses in sealing solutions and optical technologies, those optics businesses also play a critical role within space broadband markets, now complemented by our most recent acquisition of Iridian Spectral Technologies.

Our acquisition of KZValve opens the door for our Banjo franchise to play even deeper within fluidic handling for precision agriculture solutions. Our Nexsight business brings more software intelligence and channel assets into

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the water platform. Airtech opens doors with an alternate energy gensets. ABEL Pumps helps customers mine deeper to find the minerals required to power the e-mobility revolution.

The reality is that IDEX products are everywhere, playing close to the core of the world's most advanced technologies. Our components orientation allows for maximum tunability and flexibility to pivot resources to the fastest growing megatrends. None of this is possible without talented people and teams who thrive in an outstanding entrepreneurial culture. This aspect is a source of competitive advantage for IDEX.

We knew this was going to be a year of transition and dynamic recalibration with a course that would be hard to predict. We're managing the near term urgently and appropriately, but with an enthusiasm that recognizes the potential for great things ahead.

With that, I'd like to turn it over to the operator for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now conduct a question-and-answer session. [Operator Instructions] One moment while we pool for our first question. Our first question comes from Mike Halloran with Robert W. Baird. Please proceed.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Hey. Good morning, everyone.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Hi, Mike.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

So a couple questions. First, let's talk about the – obviously, the biggest piece in the quarter, the analytic instrumentation, life science, biopharma, et cetera, pressure points. Not overly surprising given what your customers are saying publicly as well. Maybe talk about a couple of things here, how you look at this bottom curve? When you think we can get back to maybe a little bit more normalized environment in the context of some of the funding, the oversupply, overinvestment, et cetera? I know you don't feel any differently about the long-term growth curve, but would love to get a sense for internally how you guys are thinking about the recovery curve.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yeah. Well, thanks for that. So, okay, I think if we step back and kind of think about this traversing over the course of the year, we go back to kind of the end of Q4, that's where we went from virtually unbounded demand, essentially only capacity and capability, entering the mix as a constraint.

To those first signs, okay, we're going to have to tune this thing and get it to something more sustainable long term, more normal. So we saw that play out initially. There's a lot of focus on inventory. Just too much inventory

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all over the place. I think over time and here especially in the second quarter, we saw a view of – as people start to attack that with analytics, and we got a lot closer to our customers. You could see kind of the depth of it, where it was accumulated, how much it was – how long it was going to take to burn that off. That became kind of a secondary component for us in Q2.

And then I think the piece that's really played out and we saw a lot of this calibration in the second quarter was another assessment of end markets and where they really are on the customers' part. So you kind of had markets clicking along kind of at the top end of high – high-single digits, I think, in the pandemic kind of move back down to an assumption that they would be more normal, let's say, more mid-single digits, and I think closer now to – yeah, in the near term, at least, balance of the year in that low-single digit with those factors that I talked about in the opening remarks. And I think – and probably maybe strength of China being the one that was the most pronounced and started to really pop out of the page for – in the conversations that we had in Q2.

So we sort of backed up, took a look at those forecasts, that situation. And as you can see here, it essentially cleared the deck for the rest of the year. I think we bottomed out from an orders perspective. We've seen kind of the levels that we're at now hold here through July. Even with all of the analytics that we have and inventory, you can see the two kind of working together.

So then I think all of the visibility shifts to probably the real spirit of your question, which is when does the start to get back to something that's more traditional for – in terms of growth rates. For us, I think, honestly, we see that past – certainly past the six months that are ahead of us. Somewhere probably out in 2024, obviously, the comparatives would get a lot easier. But I think we're still going to all have to watch. We're going to have to watch and see what's the long-term call on China. Is this a trough of a cycle there and there's ultimately an uptick? We'll be listening for that intelligence as well.

The funding environment, how are people leaning in to kind of approving projects and outfitting plants and things. And we've seen the CapEx intensive sides of our business, probably the semicon piece of it I feel the best about. I mean, that's tracked by everybody. And we can kind of see everybody pointing to better days ahead starting in kind of – for us, probably beginning of Q4 and certainly leaning into the year.

So I think the arrow up in 2024 probably still with some variable rates, coming out of it, and a lot more assessments that we've got to make as we go through a period that we think now has been de-risked and sort of laid out there in a way that we can all get comfortable with.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Great. No. That's super helpful. And maybe the exact same conversation on short cycle industrial piece is the weakening side of things. Obviously, Bill in the prepared remarks gave a lot of context on where some of that softening is. But just would like to understand how you think that bottoms out and how that recovery curve plays out in the context of there are clearly a lot of moving pieces out there.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yeah. And I want to emphasize that that side of the business has kind of run its course exactly the way we thought it would.

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Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

So, you've seen here, order rates declining. That's the normalization of backlog. I want to make it clear to everybody that, you all recognize how close to normal we actually are now. So our backlog, when you net out sort of the compounded price – the aggressive price that's happened over the last couple of years and compare it to sort of pre-pandemic levels, we're basically pretty close. We're a little higher than normal, but we'll get there soon, certainly in the back half of the year. That's on the industrial side of the business.

Our quarterly coverage that we have, if you're familiar with us, we typically talk about half the quarter covered and the other half we have to go find, we're there now. And so, really, now, we're able to see into these markets and understand, and think a lot more about the future than the past. And that's where as you kind of – reexamine the list of markets that Bill went through. Now you're seeing, I think in many ways, kind of an absence of catalysts, unless it's really, really tied to, identifiable megatrend with a bunch of funding sources like the water space for us.

You're seeing kind of that same story of, hey, hesitancy, I wonder where things are going, a little reticence to go ask for big funding of large capital projects. So I think we're well-positioned for what inevitably, at some point, we'll start to move up. And I do believe that next cycle is going to be a good one. But I think here in the near term, it's still going to be kind of a story of watching the rest of the world catch up and kind of get to the same point of calibration that we are. And then I think it's going to be a much bigger, broader kind of macroeconomic conversation as we head into 2024, of which catalysts will be out there. The good news from an IDEX perspective is – I know you know, Mike, we do really well on the entry point.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Once we kind of hit this point and are ready to go, short lead times, rapid recovery out there at the tip of the spear with innovation. So, that's kind of my take on where things are now with an emphasis on how close to normal the company's actually positioned.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

That's great. If I could just squeeze one more in. You mentioned the confident in the cycle you had in slide 12 where you're talking about how well you're positioned for growth. Could you just give some context to what you think that growth algorithm looks like for you? What are we talking about in terms of what the sustainable organic growth profile looks or the relative outperformance you can get versus whatever the markets are doing? Maybe just put that in context on a longer horizon, please.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

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Yeah. I think the examples I cited there, particularly now that they've been augmented with some really, really strong capital deployment gets us closer to that 300% outperformance that we've been shooting for in terms of potential and delivery. So, let's say, we enter a world that has kind of a 2% nominal floor, we would be expecting to drive with a combination of solid price capture, innovation and the assets that we have something closer to that 5% level, and then continuing to deploy capital on top of that, which then ultimately if you kind of run it through the algorithm of contribution margins and the compounding nature of what we have as a company, that sets up the double digits earnings growth that, I think, everybody kind of expects and is looking forward to from an IDEX.

Michael Patrick Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Thanks. Really appreciate, Eric.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Thank you.

Operator: Our next question comes from Deane Dray with RBC Capital Markets. Please proceed.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

I want to follow up on some of the commentaries, both on the HST and industrial side. And on HST, and we agree this has been well-vetted in terms of the public company, analytical instrument companies discussing the destocking and we're getting the sense that the bottoming is coming. But just share with us, you're one step removed as a supplier to these OEs. So, what is your level of visibility, and how has that changed, and what has happened with lead times now that you've had much of this destocking happening?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yeah, Well, you're absolutely right. I mean, it's important that people understand, the typical IDEX solution here is a component which is going into some system or device that then is out there – goes out into the market, and then there's a whole bunch of other revenue streams that come with it, service and consumables and things. We don't participate there. And so, we're talking primarily with people in factories and supplying and purchasing chains, obviously, engineering on the innovation side, but typically not the first person that they're going to talk to on a commercial conversation about kind of where they're sitting.

So, that's always been a little harder for us as a conversation to have. And so, you can kind of think of the way this has played out is we've kind of crawled up from the factory floor into front and center commercial

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conversations mainly because of our criticality. We're in a place – we get there where others probably don't because of the essence of what we're making and what it does for the end device.

So, I will absolutely tell you that one of the benefits of what we've come through here is we have a lot deeper relationships. We're in different conversations than we've been able to be into. And our understanding of kind of inventory positions and philosophy is better now than it's ever been before because it has to be.

Your second question then was related to lead times. I mean, we are in really, really good shape, and that in some ways is why you're seeing and have seen kind of the rapid degradation of order rates when any – but we do the same thing. We're thinking about taking inventory out of the system. You essentially do 80/20. You line up dollars of supply and your secondary factor is always assurance, supply, OTD and capability. When those two things come together, you essentially hammer the order book.

And so, in many ways, we've seen that play out probably the most aggressive given who we are and what we do. And it's an indication of where we are from a lead time. Our ultimate backlog position for the company, quarterly coverage of order rates is also a validation of where we are, because it's right back to very, very typical levels for us.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

All right. That's really helpful. And just to flip over on the industrial side. What we're trying to do is connect the dots here about your commentary about slowing industrial orders and slowing industrial landscape. And I'm trying to parse out how much of this is just a result of a normalizing supply chain and release of buffer inventories and shortening lead times, which in itself is kind of a normalized process. But it doesn't sound like there's anything disturbing on the end market – the sell-through side, the end market demand. But I just want to get clarification on that. So, how much of this is strictly from a normalizing supply chain on the industrial side versus any deterioration on the end market demand?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yeah. No, I think you're thinking of it right. I mean, the predominant driver here is normalization of the cycle. Absolutely. It's just – I said this in these calls a couple last couple of times that eventually you run into physics. There's no need to keep all this backlog around unless you're going to alter permanently the capability of the system. And nobody wants to do that. So, a lot of this is playing out.

If you look at our last quarter here, particularly on the industrial side, we posted double-digit organic growth. It's not necessarily indicative of the environment that's out there. That's us eating the last of the backlog and the past due, and getting our own lead times where we want to get to. As we're doing that, it's telegraphed through to the customer who's then dropping their order rates exactly the way you'd expect that they would.

Underneath all of that, this allows us to, as I said before, really see, okay, what is this environment that's out in front of us both today and tomorrow? And you're right, I don't see a lot of things in there that are overly negative. In fact, I see kind of a lot of the same behavior that we saw before this. In many ways, still some continued reluctance to make big capital purchase bets and all of those things. But to be honest, those really weren't here over the last couple of years either. So, there's not a lot of negative noise that's behind that recalibration curve that's happening there.

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I would also say, though, there isn't a lot of tons of super positive things there as well, where people are saying, well, now that this is behind us, we're ready to go on Project A, B and C. But I don't know if that's actually different from where we've been. So I don't know. I hope that's helpful. But I think it your opening statement is pretty close here that the major driver is a cycle playing out and then fundamentally underneath it, there's not a ton of noise in terms of what's going on market-to-market.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

All right, Eric, that was exactly what we were looking for and appreciate all the color. Thank you.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Thanks, Deane.

Operator: Our next question comes from Allison Poliniak with Wells Fargo. Please proceed.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Just on the HST. Thanks for the color on your – how to think of organic decline in Q3. On the EBITDA margin, obviously down – down year-over-year this quarter. Does that take another step down or are you stemming sort of the decrementals now just given your aggressive approach to cost? Just any color of how we should think about it, just given the sharp decline in organic next quarter. Thanks.

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.

A

Yeah. So it's Bill. I think in the third quarter, you'll see a little bit of additional pressure as volume steps down in the third quarter. And, we've bottomed out in the order side here in Q2. Sales will bottom out in Q3. I think margins hit its low point and we'll start to build back up. Obviously, the additional cost actions we've taken have helped mitigate that and then the volume leverage will get – as we start to build back in the fourth quarter, we'll start to set our journey back to a 29%, 30% EBITDA-type margin as we progressed through the recovery.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Got it. And then just in terms of the dislocation here in the analytical instrumentation market, is that driving any incremental sort of M&A opportunities, just given the unusual nature of it or kind of steady as it's been? Just any color there.

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.

A

Yeah. Not really. I mean, I haven't seen anything there. I mean, that backdrop matters. It might prevent some folks from putting something out there because they want to let things clear and not be quite as noisy or something like that in the short term. But nothing that's really popped and set because this cycle is playing out a certain way, the funnel is now composed much different than it has been for us.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

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Got it. And then just one last quick one. The inventory drawdown on your side, Bill, did you say you guys were largely done with that or there's still more to go in the second half here?

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.
A

No. There's still more to go, I think. From absolute dollars, I think we'll continue to bleed. Inventory turns, there'll be a little bit pressure just with the decreased volumes within HST. But the teams continue to track and there's probably another $20 million to $30 million of inventory reduction here in the back half.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC
Q

Perfect. Thank you.

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.
A

Thanks.

Operator: Our next question comes from Vlad Bystricky with Citigroup. Please proceed.

Vladimir Bystricky
Analyst, Citigroup Global Markets, Inc.
Q

Good morning, team. Thanks for taking my call.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

Sure.

Vladimir Bystricky
Analyst, Citigroup Global Markets, Inc.
Q

So, I just wanted to ask within FSDP, a couple of things there. In terms of the durability of the strength you're seeing at Fire and Rescue, are you able to parse out sort of how much of that is better chances for availability with your traditional OEMs versus, your growing relationships with mid-tier OEMs and the retrofit offerings you now have available?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

I don't know that that particular fine-tuning is a big driver here. I would say that chassis availability and that the improving nature of it is a positive catalyst for that business. And it's something we knew when we saw that backlog extend, for frankly, a long period of time that as it would start to expand itself, we knew that would be pretty gradual, but ultimately positive for us for a business. The composition of who they are, in terms of suppliers inside it is interesting around the margins, but I would say it's going to be – it's going to be put it in the category of generally positive and probably positive for all.

Vladimir Bystricky
Analyst, Citigroup Global Markets, Inc.
Q

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Got it. Okay. That's helpful. And then just to follow-up within that segment. The strength in the North American paint dispenser business, I think, was a little surprising versus what I was expecting anyway. So were there any larger one-time type deliveries in there that contributed to that strength? And how are you thinking about the outlook for the named dispenser business going forward?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

No, I think dispensing had a couple large project orders that they're delivering on here as they progressed in the second quarter and within the third quarter. Then I think as we blew past into the year, the North American replenishment cycle will be for the most part over. And then we look for some of the opportunities to continue on the emerging market side. Europe was a little bit slower for us this year and see if there's a bit of a recovery going into next year to help offset that. But yeah, that business will start to decline, especially on the orders as we progress through the back half of the year.

Vladimir Bystricky
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Great. That's helpful. Thanks. I'll get back in the queue.

Operator: Thank you. Our next question comes from Joe Giordano with TD Cowen. Please proceed.

Joseph Giordano
Analyst, TD Cowen
Q

Hey. Good morning, guys.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

Hi.

Joseph Giordano
Analyst, TD Cowen
Q

Hey, Eric. I just kind of wanted to square your commentary about like a lack of catalysts in a lot of the markets is interesting. And how do you kind of juxtapose that with confidence around and optimism around CHIPS Act and Infrastructure Bill, and, manufacturing on or spending kind of like very high levels right here? How do you kind of square all those up?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

Well, look, I think those are all absolutely legitimate to the things we're planning on. It's what we're tuning the company to be. In some ways, try – helping people understand and that I'm describing we're at a position now where we can kind of see exactly the mindset of people in the current – in the next quarter in a way that for years we have not been able to.

And so, I'm with you, because I think many of the kind of big – broader trends that are out there are going to have nice runs as we go forward. Some of them are underway now. Some are going to be in the next period to come. But, I do think there's some noise in the system where, again, people are processing a lot of their own backlog and things like that. And then it – it's easier to sort of link that to those trends and say, well, there it is; that's

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validation. I just – this is a unique point that it's taken us a few years to get to that says, no, no, everything we see now is actually near term or talking about the world that's right in front of us.

So – and again, some of those things are playing out. We have that in the walk. We talked about water. We talked about some decent things happened in chemicals. We just talked about some of the chassis availability that's building. So I don't want to diminish those in any ways, but in some ways, I'm just trying to show that we've really got solid visibility here and we'll be able to see them as they inevitably start to play in and layer in at different points along the curve as we go forward.

Joseph Giordano
Analyst, TD Cowen

Q

Yeah, I think that's fair. And would you just – would you categorize – it seems like most companies this quarter are kind of like – are certainly changing their commentary around like industrial distribution and things like that. It seems to be weakening in orders is getting worse. And you guys – maybe you feel like you were just kind of there first and this is...

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yes.

Joseph Giordano
Analyst, TD Cowen

Q

...what's playing out.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

I – I will be in a category now. I think actually we're in sync with distribution. We're out there with them. We're looking for new opportunities and we already live that. We were seeing that when others weren't talking about it, which is always the frustrating part of the beginning of one of these curves for us. So I knew this year I was going to have this element.

It puts us to the back side of it, which then says, I think you'll see that we'll be talking about other things, other catalysts in a – in a solid way that maybe it's going to take some time for others to kind of walk into. But that is a perfect example.

Joseph Giordano
Analyst, TD Cowen

Q

Fair enough. Thanks, guys.

Operator: Thank you. Our next question comes from Nathan Jones with Stifel. Please proceed.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Good morning, everyone.

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Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Hey, Nathan.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

I wanted to start with just putting a finer point on some of the inventory correction. Can you quantify what you think the headwind to growth or the dollars of inventory that are coming out of the business or coming out of your customers' businesses this year that will obviously, if we get that destock complete this year, won't it repeat next year?

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.

A

No. Nathan, let me take a crack at that. I think that's a reasonable amount of the current volume declines as the folks have calibrated on their months of supply pulling down. So that was really our expectation in the first quarter. As they looked at their end market demand and then their inventory positions at a second tier bleed down again here in the second quarter with – I think where our order patterns and our volumes are for the balance of the year, that's holistically true. And then any volume shifts are really going to be reflective of a true end market demand.

Really, what Eric talked about is us being in sync relative to our lead times with where they've calibrated around new expectations and their volumes. So it's a reasonable portion of the pressure we've experienced so far this year.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Then I'm going to ask a question on a metric that I don't think anybody out there has really talked about for the last three years, which is on-time delivery, because with all the supply chain challenges, everybody's on-time delivery metrics start blowing up. Now that you're talking about, lead times being kind of fairly back to normal. How much improvement have you seen in on-time delivery metrics? Where are they relative to where they were before COVID? And how much more improvement is left to go on that?

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yeah. So, I mean, that is a great question. Our on-time delivery is in really, really good shape. I mean, so think of this in the 90%-plus, that's where we need to be. A huge piece of that, when you think about it, is that's measured against lead time expectations that customers have. So, one of the things that's really changed here in the last couple of years is people have essentially put orders into one or two buckets, either as soon as you can do it, please, which really is there's no yardstick, or they've taken the cue from businesses like ours to say, well, what's your current capability? Okay, put it in my order for that level.

What's important is you start to get better. You have to communicate it to your customers so they understand it. That's how – that's kind of the one of the first things that we teach within our own operating model. Make sure people know where we are so that, frankly, they understand that they can start to dial that into their own requirements. We can plan a better factory that way. And so, you're – actually the improvement that I'm citing is against a moving bar that moves closer with lower lead times. That's a really, really interesting point that, we're always on the lookout for to make sure that we've kind of moved out of that world of promises to actual customer

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requirements and that our lead times are in sync with those. And then, the ultimate metric says, prove it with the OTD number. And so, we're in really, really good shape.

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.

A

And I think for a couple of businesses where we're still struggling with extended lead times or on-time delivery, those are the businesses that actually orders have still been fairly positive, because those behaviors haven't been able to calibrate on their customers. Exactly the point Eric highlighted earlier, where we have seen all those improvements, you've seen the order rates compressed. Those are aligned with shorter lead times.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

And just one last one on the cost actions that you're taking here. I understand you guys plan for the long term here and that you're probably not going to cut too deep, given that this might be a short, sharp correction; markets could recover next year. Can you talk about the type of costs that you're taking out and the type of costs that you're not taking out?

William K. Grogan
Senior Vice President & Chief Financial Officer, IDEX Corp.

A

Yeah. I mean, the first phase of cost reduction is obviously on the discretionary side, things that we've implemented broad-based across the portfolio. We talked about that last quarter even in the businesses that weren't as impacted as HST. They helped to mitigate some of the profit shortfalls. Then the second phase has been volume-related costs. We've done a little bit of restructuring internally. That's saved some of the economics.

But to your last point, fundamentally, we're leveraging 80/20 in our resource allocation model to preserve a vast majority of our growth resources, as to Eric's point. I think we are going to be through this phase at some point in time next year and the investments that we're making now will drive results into the future.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

And, Nathan, this is – Bill mentioned it, but this is where 80/20 really helps us as a company. I mean, essentially, if you think of this in its simplest form, it says take your existing people that already work here and know the company and leverage them as powerfully as possible so you don't have to hire incremental head count at a time that you're pressured. And we use 80/20 to guide that. So, just make sure you're at a point with maximum power and impact, and you'd be surprised how much work people can do, and then you kind of get through this and that maintains the base.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great. Thanks very much for taking my questions.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Yes.

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Operator: [Operator Instructions] Our next question comes from Robert Wertheimer with Melius Research. Please proceed.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Thanks. Good morning, everybody.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

Good morning.

Rob Wertheimer
Analyst, Melius Research LLC

Q

You've touched on this throughout the call, and I think you've been pretty clear. But if the issue is trying to figure out how channel inventory dynamics in HST relate to the rest of the business or whether there's a risk of that happening. I wonder if you could step back a little bit and talk about how the channel in HST differs from your other two segments. And then, I assume the analytic process that you put in, kind of focus in your comments on HST is applied broadly throughout the business. So, I wonder if you can just sort of help with that understanding and that risk of the channel destocking.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

A

That was a great question. It's important that people understand. So everything we talked about generally in those HST markets with the massive change, those are direct relationships. And they're some of the most concentrated customer sets we have. So, not a lot of names and we're very directly linked to them.

So, your first point where it's very different is when you go over into kind of the FMT world and even the industrial side of HST, those are typically distribution environments. Not a lot of stocking that happens there. But think of it, the more important element is there's just a lot of people. So, numerous markets, lots of positions, lots of partners, and so it's just fragmented. And you just got a natural buffer there against any real swing either on the way up or the way down. You just don't typically see it that dramatically. And you've got optionality. I mean, even some people out there will choose to carry more inventory through all of this. They're going to make differentiated calls. But that concentrated OEM set does tend to move like a pack. And here we've seen them move the most aggressively.

Your last point was on analytics. We've always had great distribution analytics. It's a participative model. It's not this kind of stocking model, where there's a curtain between us and the end markets. We're partners in this. We've known each other for a long time and we actually need to participate in the sell. So, because of that, we've got – we both long had good analytics on inventory positions, who we're selling it to, how they're thinking about things. So, that's been a staple. I'd say that the move forward to something more positive I referenced earlier was getting even closer to the nuts and bolts of those OEM relationships where we have that direct line of sight.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Perfect. That was educational. Thank you. And just because I don't know and I'm not sure you say, but what is the China mix within HST? And is that weakness in China – obviously, China is weak. I don't know if that general economic slowdown or something industry-specific that accentuated it for you there.

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Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

Well, it's – it really doesn't ping for us with a China sale, because we're – we're typically selling to...

Rob Wertheimer
Analyst, Melius Research LLC
Q

Yeah.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

...North American partners or something like that. We're reading through their commentary about in-placement of instruments and things.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Perfect. Okay. I'll stop there. Thank you.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.
A

Thanks.

Operator: Thank you. There are no further questions in queue at this time. I would like to turn the call back to Mr. Ashleman for closing comments.

Eric D. Ashleman
President, Chief Executive Officer & Director, IDEX Corp.

Thank you very much. Thanks for everybody joining today. Just a couple of summary takeaways here. I mean, we said from the beginning this was going to be a year of, aggressive recalibration. That's certainly proven out. But I think this is truly the final economic phase of this pandemic. It's going to play itself out here through the balance of the year, and we'll be done with it. And for us, that means, look, our backlog is almost back to normal. It will be here soon. Our quarterly order coverage is normal now. I don't think we've got a lot of abnormal pandemic-induced order trends that we're going to be processing and talking about. And I could not be looking more forward to that, I assure you.

And then really, I'll just go back to kind of what I talked about on that last slide in the intro here. The future is going to be really good. We will accelerate quicker than others, as whatever the next cycle is, plays out positively for us, we'll see that. We're good diagnostic there. And because of the strength and resiliency we built over the last couple of years here, we're going to perform very, very well when that happens. All the things we talked about in terms of capital where we deployed it, the work we've done intensively around strategy, it's going to take us up another 100 basis points in that outperformance. And I referenced that earlier, too, as we're thinking about outgrowing our core markets.

And, just last, I know a lot of our team members listen in on this call. So I really want to thank them for just solid, solid execution through all of it, in particular, our teams in HST. As you might imagine, to kind of go from as fast as you can go to slowing down in the amount of time to short duration, that has been really challenging for them,

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and they have absolutely stood up in the way that we know IDEX employees do all over the place. So thanks for that.

Have a great day. We'll talk to you soon.

Operator: Thank you. This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a great day.

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