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KLXI - Q3 2017 KLX Inc Earnings Call

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CORPORATE PARTICIPANTS

Amin J. Khoury *KLX Inc. - Chairman & CEO*

Michael F. Senft *KLX Inc. - CFO, VP & Treasurer*

Michael Perlman

CONFERENCE CALL PARTICIPANTS

Michael Frank Ciarmoli *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Myles Alexander Walton *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Richard Tobie Safran *The Buckingham Research Group Incorporated - Research Analyst*

Sheila Karin Kahyaoglu *Jefferies LLC, Research Division - Equity Analyst*

William Daniel Ledley *Cowen and Company, LLC, Research Division - Associate*

PRESENTATION

Operator

Good morning. My name is Candace Griven, and I will be your conference facilitator today. At this time, I would like to welcome everyone to the KLX Third Quarter 2017 Earnings Call. (Operator Instructions) As a reminder, ladies and gentlemen, the conference is being recorded on this day, December 6, 2017. Thank you.

I would now like to introduce KLX's Director of Investor Relations, Michael Perlman. Mr. Perlman, you may begin your conference.

Michael Perlman

Thank you, Candace. Good morning, and thank you for joining us. Today, we're here to discuss our financial results for the third quarter ended October 31, 2017. Company's earnings news release, which was issued earlier this morning, presents our third quarter 2017 results. If you haven't received it, you'll find a copy on our website.

We will begin with remarks from Amin Khoury, Chairman and Chief Executive Officer of KLX. Also on the call this morning are Tom McCaffrey, President and Chief Operating Officer; and Mike Senft, Vice President and Chief Financial Officer.

For today's call, we have prepared a few slides to help you follow our discussion. You can find our presentation on the Investor Relations page of the KLX website at klx.com. In addition, copies of the slides will be posted on our website for you to refer to after the call.

Any forward-looking statements that we make are subject to risks and uncertainties. And as always, in our prepared remarks and our responses to your questions, we will rely on our safe harbor exemptions under the various securities acts in our safe harbor statement and the company's filings with the Securities and Exchange Commission.

We will address questions following our prepared remarks. (Operator Instructions)

Now I'll turn the call over to Amin Khoury.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Thank you, Michael, and good morning, everyone. We are pleased with the third quarter operating results at both our ASG and ESG businesses. Our Aerospace Solutions Group segment delivered solid revenue growth, margin expansion and free cash flow. We are also pleased to report that ASG continued its market momentum with 3 new contract awards and market share gain valued at approximately $125 million in the aggregate supporting the F-35 Joint Strike Fighter, Pratt & Whitney's new GTF engine and Bombardier's C-Series commercial aircraft. With respect to our ESG segment, the business recorded very strong third quarter revenue growth and operating performance, generating positive EBITDA and reinforcing our expectations for achieving positive operating earnings in the fourth quarter of this year. We've also raised our guidance by $0.10 to approximately $3.10 of adjusted net earnings per diluted share. The improved outlook is based on a lower share count as a result of our share buyback program, together with the true-up of our tax-deductible goodwill. On today's call, we will review the current market environment for each of our ASG and ESG segments and discuss our guidance along with our 2018 outlook.

Let's now review the aerospace market environment. Strong global air traffic demand continued in the third quarter, growing 6.6% year-over-year despite the impact of the 3 hurricanes on U.S. air traffic. In October, air traffic bounced back and was essentially in line with the more than 7% year-to-date increase, which is well above the 10-year average growth rate of 5.5%. This increase in air traffic has helped push load factors to a near-record 81.6% for the 10-month period ended October 31, 2017, contributing to a seventh consecutive year of record airline profitability.

Commercial aircraft delivery rates are expected to remain healthy, up low single digits for the full year 2017 as compared to the same period of the prior year and are expected to grow at an approximate mid-single-digit percentage rate for the next few years. Aftermarket heavy maintenance activity is expected to pick up as a larger portion of the approximate 11,000 aircraft delivered since the beginning of 2009 begin to require mandated heavy maintenance. This increase in aftermarket activity is expected to result an increase in demand for our aftermarket business.

Demand for new business jet aircraft remains depressed. However, it is promising to see an increase in aircraft usage and lower levels of used aircraft inventory. In addition, a number of new business jet platforms are set to enter service in 2018. Consequently, there is growing confidence that 2017 represents the bottom of the market for business jet manufacturing with the expectation that conditions will begin to improve in 2018. With respect to military manufacturing activity, we are also seeing some encouraging signs of growth and expect that 2017 marks the bottom of the market. This is due to a change in attitude regarding defense spending by the administration in Washington. This should bode well for new-build activity as well as for maintenance spending on the existing installed base of military aircraft.

Shifting to the oilfield services market. U.S. land-based rig count, which stood at 909 as of October 27, is over 60% higher than the 557 active oil and gas rigs a year ago, driven by a substantial increase in year-over-year exploration and production of E&P capital expenditures. U.S. land, oil and gas production expenditures are expected to continue to shift from drilling to completions as E&P companies bring onstream a substantial portion of the approximate 7,000 drilled but uncompleted wells. In fact, during the third quarter, completion activity significantly outpaced drilling activity. This bodes well for KLX's energy services business as this is the portion of the well life cycle on which KLX's energy service business is most focused.

Let's now turn to Slide 2 and discuss our third quarter 2017 consolidated results. Third quarter 2017 revenues of $456.7 million represented 17.4% organic revenue growth as compared to the same period in the prior year. Consolidated results reflect an increase of 5.4% in ASG revenues and a more than 100% increase in ESG revenue. Operating earnings of $60.5 million increased 56.7%, reflecting an approximate 330 basis point improvement in operating margin. Third quarter growth in operating earnings was driven by a 10.4% increase in operating earnings at ASG and an approximate 90% reduction in operating loss at ESG. Adjusted net earnings and adjusted net earnings per diluted share were $44.9 million and $0.88 per diluted share and increase 55.9% and 60%, respectively, as compared with the same period in the prior year. Included in our adjusted net earnings per diluted share an incremental approximate $0.05 x benefit as a result of the true-up of our tax-deductible goodwill. As a result, we now expect the amortization of tax-deductible goodwill will offset approximately $42 million per year of domestic tax expense, which is somewhat better than our earlier estimate.

Let's now turn to Slide 3 and review our ASG results for the third quarter. Our ASG segment reported revenues of $367.6 million, an increase of 5.4% as compared to the same period in the prior year. The increase in revenues was driven by a mid-single-digit percentage increase in sales to commercial aerospace manufacturing customers, including initial revenue contributions from new business awards and market share gains, which we announced in 2016. That was partially offset by a decrease in demand from business jet manufacturing customers. Aftermarket revenues increased by approximately 3.6% as compared to the same period of the prior year. ASG operating earnings of $62.4 million were up 10.4%, and operating margin of 17% expanded approximately 80 basis point. ASG adjusted EBITDA of $73.9 million was 20.1% of revenues and was up 10.1% as compared to the prior year period.

Let's turn to Slide 4 and review third quarter 2017 results for our ESG business. As compared to the prior year, third quarter 2017 ESG revenues of $89 million increased by 121.6%. Prior year operating loss of $17.9 million improved by $16 million or 89.4% to a loss of $1.9 million for the quarter. Adjusted EBITDA was $9.4 million and improved by $16 million as compared to the third quarter of last year. As compared to the second quarter of 2017, revenues increased by 21%, operating loss improved by 75% and EBITDA improved by 147%.

Let's briefly review our financial position on Slide 5. For the 3-month period ended October 31, 2017, net cash flow provided by operation was $87.2 million. Company generated free cash flow of $62.2 million or approximately 241% of net earnings and 138.5% of adjusted net earnings. Capital expenditures were $25 million, reflecting investments related to the company's new 550,000 square foot ASG Miami global distribution and operations center as well as discrete investments within the ESG business. As of October 31, 2017, cash on hand was approximately $288 million and total long-term debt of $1.2 billion less cash resulted in net debt $912 million and the company's net debt to net capital ratio was approximately 29%. There were no borrowings outstanding under the company's $750 million credit facility. Over the past 3- and 9-month periods, the company repurchased approximately $50 million and $80 million of KLX common shares at an average price of $47.46 and $48.09 per share, respectively.

Let's now turn to Slide 6 and briefly review our 2017 guidance and our initial 2018 outlook. We are raising our 2017 adjusted net earnings per share guidance by $0.10 per share to approximately $3.10 per diluted share. The improved outlook is based on a lower share count as a result of our share buyback program, together with an approximate $0.06 per share full year benefit from taxes. For the full year, we expect revenues to increase approximately 17% to approximately $1.75 billion and operating earnings to increase approximately 72% to approximately $222 million. Adjusted net earnings and adjusted net earnings per diluted share are both expected to increase approximately 70% to approximately $159 million and approximately $3.10 per diluted share, respectively. We remain optimistic about the outlook for both our ASG and ESG businesses. Within ASG, we expect the revenue contribution from new program awards and market share gain will continue their initial ramp in the fourth quarter and into 2018. Furthermore, we will continue to press our advantage of superior service, of quality and on-time delivery to gain additional new business in the coming quarters. Our ESG segment continues to benefit from the increase in capital expenditures by our oil and gas exploration and production customers.

Let's now turn to Slide 7 and review our 2018 outlook. Revenues are expected to increase approximately 10% to $1.95 billion as compared to the same period in the prior year. Operating earnings are expected to increase approximately 30% to approximately $290 million. Adjusted EBITDA expected to increase approximately 23% to approximately $385 million. Adjusted net earnings and adjusted net earnings per diluted share are both expected to increase approximately 23% to approximately $194 million and $3.80 per diluted share, respectively. Included in our 2018 outlook is approximately $20 million of moving costs, lease buyouts, asset write-offs for abandoned equipment and other similar items related to the consolidation and relocation into our new ASG Miami global distribution and operations center. On a segment level, we expect ASG revenues to increase approximately 5% to approximately $1.5 billion and ESG revenues to increase approximately 40% to approximately $450 million.

With that, I will now turn the call back over to Michael for the Q&A portion of this morning's call.

Michael Perlman

Thank you, Amin. I will now turn the call over to Candace for the Q&A portion of today's call. Candace will provide instructions on how to ask a question. Candace?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And it looks like our first question comes from Myles Walton, Deutsche Bank.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

I was wondering if we could talk a bit about the margin expansion at -- ESG is pretty phenomenal. The incremental margins you're seeing there, somewhere in the 40% range in the quarter, is that sort of the incremental margins that you're planning on into '18, the 30% to 40% range?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

We haven't given any margin guidance for the ESG business in 2018, but we expect the performance of our ESG business, which has been outstanding over the past few quarters in terms of the turnaround, to continue to show very substantial improvement in 2018.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

I'm guessing -- the other end of the question is in terms of the implied margin expansion, I imagine that ASG -- you're not planning on much of the '17 level into next year because you've got -- even x the $20 million facility move, you probably got some integration or transition transaction costs that you have to absorb in the number.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Yes. As I just said, Myles, we're really not giving any guidance as to the operating margin for the ESG business for next year. Sorry, I can't comment on it. What we can do is we will think about that a little bit and think about whether we can give more specific guidance about the 2 businesses sometime over the next month or so. And when we do so, we'll do it publicly and then we'll be able to talk with you about it, okay?

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

That's fine. And then on the implied 5% growth in ASG, it sounds like you're -- I mean, you're sounding pretty positive or at least looking for some level of growth for military biz jet. I imagine OEM and aftermarket are already in that mid to high single-digit range. Are you anticipating biz jet and military to be in that mid-single-digit range or all 4 are roughly the same? Or do you have a...

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

No, no, no, definitely not. We believe that both military manufacturing and biz jet manufacturing for new equipment have bottomed in 2017, and we expect that there may be some small improvement in 2018 in those 2 sectors. Our expectation for growth in the ASG business reflected in our guidance is primarily due to the OEM and aftermarket businesses, both of which have done very well in the quarter, here to be doing well in the fourth quarter so far and the new business awards, which we won in 2016, and our market share gains are really kicking in. And that is what is driving the growth and driving our expectations for next year.

Operator

And next, we have Gautam Khanna with Cowen and Company.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

This is Bill on for Gautam. Just had a couple of questions. First one, on the large ASG awards, can you give some background on those? Were they competitive takeaways? Are these the OEMs are outsourcing more to distributors? Can you just give some more color on the -- what drove the awards?

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Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Yes, they're all market share gains.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And then on the ASG margins, they were up nicely back to 17%. How much of that was mix? And -- or how much of it was Herndon integration savings? Can you just give some color around the margin improvement?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Whenever the aftermarket business makes a substantial growth, as it's the most profitable portion of our business, it helps our margins. So our expectation is at some point here that the aftermarket, it will account for more than 50% of our business. Now it accounts for about 40%. And a lot of the margin improvement that we expect in future years is as a result of our expectation of the aftermarket business being a larger share of our business. That's driven by the expanding size of the installed base of aircraft. So as the traffic grows and as the net increase in the size of the installed base on an annual basis continues to expand, demand for our aftermarket products and services expand. So while there are roughly 25,000 commercial airliners in the fleet now, we would expect that number to be closer to 50,000 airliners 20 years from now and for our aftermarket business to reflect that -- at least that kind of growth.

William Daniel Ledley - *Cowen and Company, LLC, Research Division - Associate*

Okay. And if I could just follow up one more, sorry. How was Herndon performing on the integration side? How is the margin targets progressing versus your prior guidance for improving your EBITDA?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Herndon has more or less been integrated. There is a little more work to go, so we're not 100% integrated yet. And I would say margins are close to our earlier expectation, not 100% there yet.

Operator

We'll move now to Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Just following up on Myles' question with regards to ASG's top line growth, the 5%. If I think about your commercial OE win, your prior wins that you announced, the $300 million earlier this January, and thinking about that as attributing to commercial OE growth, is it fair to say that the commercial OE business is at least growing 5% and you back into aftermarket growth of about 3%, 3% to 4%? Is that what your expectation bakes in?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

We're not giving guidance for 2018 growth for the individual portions of the Aerospace Solutions Group. What I can say is that we booked $500 million of new programs and market share, now another $125 million this year. The activity from those gains is only just beginning. I mean, it really is at a very, very early stage. There's very little contributing so far. Our expectation is that it begins to contribute substantially in 2018.

Michael F. Senft - *KLX Inc. - CFO, VP & Treasurer*

Sheila, we -- it's Mike, Sheila. I think we do feel very good at the moment with regard to the trends in the aftermarket part of our business as well. So as you think about the contributions in 2018 and beyond, I think we are -- we have been pretty consistent in our message with regard to the growth in the installed base of aircraft and the inevitability and the upswing in the aftermarket opportunity set. And I think, again, this quarter, we are hopeful, based on the trends that we've seen and how the fourth quarter is starting off, that, in fact, that aftermarket portion of our business will continue to get back to what we call the normalized relative part of the total revenue base.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Understood. And then just on -- staying on the topic of the win. You've taken so much market share already. Sort of what's left to win? Or is it -- this entire gamut of customer win, how are you going about these wins? Are they completely new contracts on certain programs? Or are they just additional? So if you could maybe give a little bit more detail there.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

They're both new program wins, but we haven't been involved before. And where we are a second source of supply in other, we are getting -- we're being awarded a larger share of those customer's spend and being given additional products to deliver as compared to what we were delivering before. So it's both. It's both new programs and increased share at customers where we are not the primary supplier.

Michael F. Senft - *KLX Inc. - CFO, VP & Treasurer*

And Sheila, it's Mike again. I think it's important to emphasize that KLX is uniquely positioned in terms of our ability to service both our existing and new customers in terms of the resources we have to call on to both provision for new programs and with our new distribution facility coming onstream, the ability to do that both cost effectively for our customers and profitably for KLX. So when you consider the momentum that we continue to build in our Aerospace Solutions Group business, it's a pretty unique value proposition relative to, I think, what anyone else can deliver at this point, and we're just continuing to press our advantage.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then just one on ESG, if I may add. I don't know which one to pick. I have 2 questions. I'm going to stick with the 40% top line growth you gave for ESG. Kind of what gives you confidence behind that? I guess with the 40%, how much of that is customer CapEx expectations? Is it wins you already have in the backlog? What's pricing driven? If you could give any details on that.

Michael F. Senft - *KLX Inc. - CFO, VP & Treasurer*

Yes, I'd be happy to answer that, Sheila. It's Mike. Since the business, by its nature, is episodic, it's more about the organic trends in our customer's business. And as Amin noted in his prepared remarks, the buildup of inventory of DUCs or wells that need to be completed is, as he noted, in our sweet spot. Based on our customer feedback in terms of the CapEx budget for those completions in 2018, based upon the prices that we expect too see at current levels, which will support those CapEx budgets very comfortably, we would -- that we continue to anticipate this 2018 guidance to be readily achievable. And it's not based on any step function of incremental penetration. It's really a continuation of the block-and-tackle differentiation of our business and the service quality that we provide.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Sheila, it's a -- the forecast for the coming year is built on a bottoms-up basis, service and product line by product line in each geo region by the teams in each of the geo region, together with the product line manager. So it is very specific, customer-by-customer and service-by-service budget that is put together for us to be able to put out a forecast.

Operator

Now we'll hear from Richard Safran with Buckingham Research.

Richard Tobie Safran - *The Buckingham Research Group Incorporated - Research Analyst*

I wanted to ask you about another aspect of your 2018 guide that wasn't in the outlook in the release. I wanted to know if you'd be willing to discuss your expectations for cash flow in '18 and cash conversion. Can you discuss in your answer if you could highlight any working capital benefits you might be seeing in '18?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

We haven't yet put out a free cash flow guidance number. As you know, the company does generate a lot of cash, which is why we have stepped up our share buyback program. We raised it from $100 million to $200 million, and then we bought $50 million back this quarter. And our free cash flow generation -- I need to be careful what I say here because we don't have guidance. We don't have public guidance out yet. I think, Rich, what we got to do, similar to Myles' question, I think what we'll do is we'll think through how to guide for free cash flow for 2018 sometime during the next month or so. We'll address both your question and Myles' question publicly, and then we'll be able to talk about it with you.

Richard Tobie Safran - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. All right. Now next, I wanted to ask you about one aspect of those $125 million in share gains that you announced. I was particularly interested in the win on the Pratt Geared Turbofan. Amin, I believe you had made comments not too long ago that engines weren't necessarily a primary area for expansion here, different OEMs, that sort of thing. And here, we have what looks to be a nice win on the Pratt engine program. So is this a bit of an exception? Does this portend potentially more share gains on engines sometime in the future, that sort of thing?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Well, we haven't been -- this hasn't been a sweet spot for us or a strong business for us in the past, but we are steaming to make some headway as we speak here this morning. We were pleased with the win, obviously. And as we did say in our news release, we do expect to continue to press our advantage and to continue to grow market share over the 2018 time period. I can't be more specific than that at the present time.

Richard Tobie Safran - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. And then just finally here, on capital deployment, would you care to make any comment on what you're thinking about next year? I mean, do you think there could be some bolt-on -- small bolt-on M&A next year, still expecting the buybacks, comparable levels of stock, that sort of thing?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

We are seeing some interesting opportunities to expand our product line breadth. And while we may not do any significant acquisitions, large acquisitions, we may, in fact, license or buy some product lines, some way to expand our product line breadth. And that's really being driven by our customers asking us to do so. So our expectation is that we will continue to buy back shares, but that we will also amplify our growth by adding product lines as -- in order to satisfy customer demand.

Operator

Next, we have Michael Ciarmoli with SunTrust.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Maybe Amin, just to really continue on that. What product lines do you guys you need to potentially penetrate into to expand some of those opportunities with customers?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Yes. Michael, we would not talk about that in advance of actually doing it. I think we can answer that question maybe in the second or third quarter of next year.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. What about -- can you just elaborate a little bit more on the $125 million of business, basically, from a financial standpoint, how they phase in? Is there any upfront inventory investment that we should think about in the near term here impacting cash? Are the margins going to be kind of similar to segment or similar to your kind of OE? Or are they a little bit dilutive out of the gate? Just trying to get some more color on how these programs ramp up here over the next, call it, 12 to 24 months.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Yes. I think it'll take at least 12 months to begin to see any revenues in the program announced today. So that's more of a 2019 impact. But on the programs announced in 2016, we'll see the nice revenue improvement in 2018, those programs. That's embedded in our guidance. With respect to the margin, I think that the -- we expect our margins to continue to expand for all the reasons that we mentioned, the aftermarket becoming a larger portion of the total, the move to our new 550,000 square foot operations center, the initiation of our new warehouse management system and inventory management system. So we're expecting for profitable operations on both -- on the OE side and then overall because of the improvement in the aftermarket mix. And so while we don't comment on the margins in any specific program, we would expect the margins to continue to expand in the out-year.

Michael F. Senft - *KLX Inc. - CFO, VP & Treasurer*

Michael, it's Mike Senft. Just to reiterate on the concept of investment in these programs, it's -- they are not upfront payments, number one, which is the most important part of this. And number two, with regard to the overall concept of asset base management, if you will, as you continue to drive revenue growth, the advantage we're going to have in this new distribution facility is just increasing all facets of the efficiency of the way we serve our customers. And that includes our ability to even more effectively manage our inventory levels, manage every aspect of working capital. And so we believe we can continue to grow without a simple linear function of growth in assets to support the growth in revenues. I think that's a really important part of the calculus of a lot of this new business that we're bringing on is we're going to get incremental leverage out of our footprint.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. Do you have to take on any existing inventory at some of these new customer wins that might create headwinds in the beginning of the programs?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

We don't take on the existing inventory, but we do manage our customer's inventory if they ask us to. And we -- and only when those inventories are utilized do we begin to sharing revenues. So we don't buy the inventories, and we don't make upfront cash payments, which other competitors in the industry do, but it does result in an extended period of time before we can actually begin to benefit from the new program.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. Last one for me, maybe going all the way back to Myles' question. I get it, you're not going to give guidance at the segment level on operating margins, but we can sort of back into ESG. Should we think -- it seems like it's going to be solidly profitable at an operating income level. Should we think about the operation sort of steadily improving throughout '18 from a cadence perspective? Is that how we should think about the trajectory of that business?

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

I think that that's fair. I mean, we are expecting to report breakeven operations or slightly profitable operations in the fourth quarter. So we're starting at just above 0, and I think you can think about small increases on a quarterly basis as we go forward.

Operator

And at this time, I'd like to turn it back to Mr. Perlman for closing remarks.

Michael Perlman

Thank you to everyone participating on this morning's call. We look forward to speaking to you again next quarter. Thank you.

Amin J. Khoury - *KLX Inc. - Chairman & CEO*

Good morning, everyone.

Michael F. Senft - *KLX Inc. - CFO, VP & Treasurer*

Thank you.

Operator

And this concludes today's conference call. Thank you again for attending, and have a good day.
