

Holley, Inc.
First Quarter 2024 Earnings Results Conference Call
May 8, 2024

Presenters

Anthony Rozmus, Investor Relations
Matt Stevenson, President and Chief Executive Officer
Jesse Weaver, Chief Financial Officer

Q&A Participants

Christian Carlino - JPMorgan
Brian McNamara - Canaccord Genuity
John Lawrence - The Benchmark Company
Martin - Raymond James
Joe Feldman - Telsey Advisory Group
Sabrina - William Blair

Operator

Good morning, ladies and gentlemen, and welcome to the Conference Call to discuss Holley's First Quarter 2024 Earnings Results.

At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions for asking questions will be provided, at that time. We ask that participants limit themselves to one question and one related follow up, during the Q&A period.

Please be advised that reproduction of this call, in whole or in part, is not permitted without written authorization of Holley. As a reminder, this call is being recorded and will be made available for future playback.

I would now like to introduce your host for today's call, Anthony Rozmus with Investor Relations. Please go ahead.

Anthony Rozmus

Good morning, and welcome to Holley's first quarter 2024 earnings conference call. On the call with me today are President and Chief Executive Officer, Matt Stevenson; and Chief Financial Officer, Jesse Weaver. This webcast and the presentation materials, including non-GAAP reconciliations, are available on our Investor Relations website.

Our discussion, today, includes forward-looking statements that are based on our best view of the world and our businesses as we see them today and are subject to risks and uncertainties, including ones described in our SEC filings.

This morning, we will review our financial results for the first quarter and share our guidance for the second quarter and full year 2024. At the conclusion of the prepared remarks, we will open the call up for questions.

With that, I'll turn the call over to CEO, Matt Stevenson.

Matt Stevenson

Thank you, Anthony, and good morning to everyone on the call. We appreciate you taking the time to join us.

It's our pleasure to share the latest on Holley's transformation and the exciting developments we have in store. As I approach the one year mark with Holley, I'm proud of the many improvements we've made. Even as the market finds its new normal, it's important to recognize the significant progress happening behind the scenes at our company. We're elevating the level of professionalism and enhancing the capabilities within our organization.

Our efforts have yielded substantial improvements in a remarkably short timeframe. We've also been diligent in eliminating nonvalue-added costs which has, meaningfully, impacted our bottom line. At the same time, we're building a robust growth engine to secure Holley's future success and to leverage the strength of our brands.

To achieve this, we welcome top talent with expertise from premier companies who share our enthusiasm for the automotive performance aftermarket and have the vision and know-how to take Holley to the next level.

During our call today, we'll also discuss the key developments in our transformation, show you some of the recently launched innovative new products and give you a sneak peek at the ones to come later in the year.

Let's move on to Slide 5, which shows some of the key highlights for the quarter. Despite a year-over-year decline in sales, we've maintained robust margins, showcasing our team's skill in managing costs, while still investing in growth areas.

Our strong free cash flow has allowed us to reduce our debt by an additional \$15 million, totaling \$65 million since September, reaffirming our dedication to lowering leverage.

We've also observed notable EBITDA contributions from our cost-to-serve program, which is an internal continuous improvement program launched, last fall. This program's success directly results from the extensive collaboration happening across various functions, within our organization.

Additionally, the quarter saw a reduction in past dues and continued improvement in inventory management, underscoring our advancements in forecasting, inventory planning and other operational improvements. As I mentioned, we significantly strengthened our leadership team with new members who will be instrumental in driving the development of our organic growth engine.

Let's turn to Slide 6 and delve into the quantitative highlights for the first quarter. Net sales decreased 7.9%. This was due to elevated inventory levels at the end of 2023, due to the modest holiday demand and a weakening consumer environment, which Jesse will discuss in more detail in his remarks.

Despite the dip in sales, we generally maintained our adjusted gross margins with a slight decrease of 40 basis points from the prior year, ending the quarter at 38.9%. Our adjusted EBITDA followed suit at 19.3%. Free cash flow continues to remain strong, as we instill greater discipline in our operations.

We also launched several impressive products, this quarter. We've kept our focus on growth areas, specifically in the modern truck and off-road segments. The midsize truck market is on fire, with the latest models offering the performance and price points that full-size trucks did a decade ago. We're seizing this opportunity by rolling out a comprehensive performance exhaust lineup within our Flowmaster brand for midsize trucks, starting with the Chevy Colorado.

The Ford Bronco has been a success, and as more hit the road, owners are getting bolder with their modifications. We're meeting this demand with advanced suspension and chassis components from our ADS brand.

Furthermore, the off-road trend extends beyond trucks and SUVs to UTVs, and we respond by introducing a new line of robust safety seats for these vehicles, through our Simpson brand. Later in the call, we'll delve into additional exciting products we're preparing for the market.

We're also allocating resources to elevate brand recognition for our company and the distinguished brands in our portfolio. Last quarter, our public relations efforts resulted in over 786 million media impressions, highlighting the impact of our communication strategies.

The significant rebranding from Holley Performance Products to Holley Performance Brands was a key milestone, better representing the wide ranging and in-depth offerings of our portfolio. This strategic move has resonated, positively, in the market.

We also recently inaugurated our event season with LS Fest West in Las Vegas. Throughout the year, we aim to engage with over 500,000 enthusiasts through various events, fostering grassroots connections with our enthusiast community.

Our operational focus continues, particularly through a comprehensive cost-to-serve program. This initiative has already yielded over \$3 million in savings for the quarter, primarily by optimizing our freight policies. We also improved our in-stock rate for the top 2,500 SKUs by 5% and have, strategically, removed approximately 12,000 slow-moving or low revenue SKUs from our portfolio. These actions help relieve a strain on our resources and streamline our business operations.

On the left of Slide 7, we present the three core steering principles that guide our company. These principles are the foundation which drive our focus on the four main areas depicted on the right.

The first area emphasizes our commitment to our team, ensuring Holley is an exceptional workplace. The second area is dedicated to refining our operations, not only to eliminate nonvalue-added activities that inflate costs, but also to improve product availability and drive appropriate inventory levels that align with market demand.

Furthermore, it is imperative that our operations offer enthusiast consumers and distribution partners the premier omnichannel customer experience in our industry. The third critical area is optimizing acquisitions.

Holley has integrated several remarkable brands and businesses in recent years, each with its own unique attributes. Fostering these distinctions is essential to ensuring their success in their respective categories.

Lastly, our focus on, steadfastly, prioritizing our customers, encompassing both our value consumer base, as well as our devoted distribution partners. We're exploring avenues to expand and enhance our sales channels, aiming to connect with and serve a broader spectrum of enthusiasts.

In this call, we'll share our latest achievements on the path towards our transformation goals. Since our last earnings call just two months ago, we have made significant strides, particularly in cultivating a high-performing team.

Slide 8, which we previously discussed, illustrates our transformative journey and the four building blocks that are instrumental in making this transformation a reality. Initially, we established the core elements of accountability and empowerment, such as enhanced communication and functional KPIs. We implemented a daily rhythm of reporting and reviewing results and harmonized major projects and program reviews.

We also outlined the fundamental expectations of our leaders. Subsequently, we refined the organization's focus by segmenting the market and prioritizing opportunities with the highest growth potential.

We introduced more discipline into our operations and leveraged various data points to pinpoint straightforward wins and concentrate on key opportunities. Specific projects and programs were initiated to capitalize on these areas. We also began collaborating with our distributors to expand our mutual business and introduce an initial wave of new talent to facilitate change.

Now, we are currently at the crux of the transformation. As discussed in the previous quarter, we executed a restructuring event that positioned us to elevate our organization. This restructuring created the bandwidth to recruit key expertise in vital leadership roles, essential for driving our transformation and unlocking elements of our growth strategy. Today's call will showcase that the significant progress we've made in this domain, including the introduction of exceptional leadership talent.

Growth remains a focal point of our endeavors and, shortly we'll discuss advancements in four key growth elements. But first, let's examine the remarkable progress we've made on a foundation component for driving growth, a high-performing team.

So let's turn to Slide 9. We are experiencing an exciting period, and the aspect that excites me the most is the leadership team we are assembling. We have cultivated a dynamic executive team renowned for their expertise in fostering growth and implementing best practices. These individuals are not only skilled in their respective functions, but are also hardcore enthusiasts. Their passion for our daily endeavors is infectious and the vigor they have infused into our organization is truly remarkable.

Allow me to highlight Jordon Musser, a former professional race car driver who, intimately, understands the perspective of our customers.

Following his racing career, Jordon excelled in the electronics and lighting sectors, scaling businesses as the entrepreneurial leader within global organizations. He will spearhead our Safety division, encompassing the brand Simpsons, Stilo, HANS and RaceQuip, as well as our Electronics segment, which includes fuel injection, ignition and tuning.

Chet Baker is our newly appointed Head of Sales, overseeing all of Holley's B2B sales, which includes our distribution partners, national retailers, OEM and international markets. Chet's background features experience in executive sales roles with prominent companies like Ocean Spray and Abbott.

A hands on leader, Chet has also immersed himself in the startup space in recent years. Coming from a family of hardcore automotive enthusiasts, Chet has a lifelong connection with cars. He is well acquainted with our brands and products, and his passion for our industry is so deep that he describes his new role as his dream job.

Now, digital engagement is a critical component of our organic growth strategy, encompassing not only direct to consumer platforms and third-party marketplaces, but also the enhancement of data and content quality for our valued distribution partners. We required a leader with a profound digital transformation background, and we are fortunate to secure Charlie Taylor to spearhead our digital initiatives.

Charlie brings a wealth of experience from his tenure at Volkswagen, where he led their digital efforts, and from Publicis, where he accelerated digital engagement for numerous clients. A longtime tuner and installer of parts from our APR brand, Charlie is yet another valuable addition to our team.

Innovation remains at the heart of our growth and our continued leadership in the industry. Will Robbins joins us from Bridgestone, where he was the Head of Consumer Product Strategy. Will's extensive experiencing in harnessing consumer insights and market data to drive innovation positions him, perfectly, to lead our product strategy across our entire portfolio. His team will collaborate closely with business unit leaders to introduce platform solutions to the market.

Will's background and world-class product strategy is complemented by his personal passion for modifying and racing cars on the weekends, making him a seasoned user of our products.

We have assembled a formidable leadership team poised to unlock growth through their vast experience and serve a leadership approach. Their expertise is matched only by their enthusiasm for our industry, ensuring that our company remains at the forefront of innovation and customer engagement.

The keys to unlocking growth that we highlighted in our previous call are detailed on Slide 10. These keys include product innovation; promotional excellence; strategic pricing; and targeted M&A. Let's examine the progress we've made in each of these areas.

In terms of product innovation, we have conducted a thorough market segmentation to identify growth verticals and categories. We're now focusing on developing consumer insights by category, pinpointing key product features and benefits and identifying unmet needs.

Rationalizing SKUs is paramount as it removes nonvalue-added items that distract from driving innovation. Significant strides have been made in SKU rationalization, not only through one-time initiatives, but also by developing a detailed process for the ongoing pruning of our portfolio. This will minimize the need for extensive rationalization exercises in the future.

It is important to ensure that our innovations receive the necessary support and acceleration, within our organization. Aligning resources with a robust development process is essential, and we have successfully implemented a comprehensive Phase Gate System now that is in daily

practice, within our organization. All business units are engaged in this rigorous process, which we will continue to refine, over time.

To ensure the success of our exceptional products, it is imperative to foster market awareness. This endeavor requires meticulous coordination across our consumer engagement channels, encompassing events, websites and social media platforms, as well as collaboration with our distribution partners.

Presently, we're in the formative stages of an overhaul of our product launch process. This strategic move is directed at hastening the adoption curve of our products, guaranteeing that they swiftly resonate with and captivate our target audience. By refining this process, we aim to bolster the speed and efficiency with which our new products are introduced to the market, thus propelling them towards rapid acceptance and success.

Regarding promotional excellence, our goal is to be industry leaders in all facets, particularly in the realm of digital marketing. We made significant strides under the guidance of Philip Dobbs, our Head of Marketing, who has now been with us for over six months.

Our recent advancements include launching a new cloud-based product information management system that ensures a single source of truth for our data. This system not only feeds content to our digital platforms, but also our distribution partners, enhancing consistency and accuracy, across channels.

Additionally, in the quarter, we implemented HubSpot across our business, a leading CRM solution, which will allow us to optimize our customer engagement and outreach efforts. We have also made significant progress in our organic and paid search strategies to increase top of funnel awareness of our products.

We recognize the importance of third-party marketplaces in driving promotional excellence and ensure that our products are well-represented on these platforms. This is a part of a broader strategy to make our products readily available and visible to consumers, wherever they shop.

Consumer engagement, whether online, at events or through our customer experience center, remains a core aspect of our business as the leading consumer platform in aftermarket performance. We are committed to making incremental improvements in all these areas to expand our customer reach.

Furthermore, we are dedicated to partnering closely with our distributors on key promotions and product launches. We value their partnership and are working to develop even closer relationships to ensure mutual promotional success for our brands.

These initiatives are part of an ongoing effort to maintain and enhance our position as a frontrunner in the industry, ensuring that our promotional strategies are as effective and far reaching as possible.

Next, strategic pricing is critical to our organization's growth. It involves setting prices based on our products value propositions to consumers and the competitive dynamics rather than solely on production costs. We are enhancing our resources and analytical tools to further develop this competency within the organization.

Lastly, progress has also been made in shaping our future M&A strategy, which is guided by our consumer market segmentation and target growth categories, where we see gaps in our portfolio.

One of our top near term priorities is reducing leverage. We know that the M&A cycle can be lengthy. Therefore, we must ensure we stay active in the market, should the right targets become available.

Now, as you can see, in the brief span of two months since our last earnings call, there has been notable advancement across the company in the pivotal areas that are instrumental in driving growth.

Before I hand it over to Jesse, I'd like to spend a few more minutes on product innovation and highlight some of our exceptional products.

As a reminder, please refer to Slide 11, where we have strategically aligned our growth functions including product strategy, product management, sales and marketing around our consumer verticals.

These verticals encompass Domestic Muscle, Modern Truck and Off-Road, Euro and Import and Safety and Racing. While Holley boasts a significant presence in the Domestic Muscle segment, it is also important to note that we have acquired exceptional brands and product lines in recent years. These acquisitions provide robust platforms for expansion in each respective vertical.

Slide 12 provides a small glimpse into some of the innovative products we have recently launched or slated to release in the upcoming quarters. In Domestic Muscle, we expanded the leading Sniper 2 platform by introducing a new Bluetooth module. This baseline kit offers full control from a user's phone, enhancing convenience and lowering costs.

We also launched Baer Classic Brakes, a direct bolt-on for early GM, Ford and Mopar applications, allowing owners to enjoy modern braking capabilities, while retaining their original 13-inch wheels.

Furthermore, the Holley EFI Terminator X2 marks the next generation of Holley's class-leading EFI system, boasting enhanced features and an approved customer interface. This evolution of our Terminator line includes a more modern and readily available microchip set.

Moving to Modern Truck and Off-Road, we introduced the GM Mid-Size Truck Exhaust by Flowmaster, catering to the growing midsize truck market. Then there's the PredatorX Tuner, our new Bluetooth OBD-II tuning module for trucks that is accompanied by a complimentary phone app for seamless tuning. Additionally, the Baer Big Claw brake kit offers improved braking performance for modern trucks, featuring a simple installation that utilizes OE calipers with a relocation bracket to accommodate larger rotors.

In the Euro and Import sector, we're proud to present APR Ultralink and DinanConnect. These are OBD-II tuning solutions that enable VW, Audi, Porsche and BMW drivers the luxury of tuning at home, without the need to visit a dealer.

Then in our Import brand AEM, we released an EV Vehicle Control Unit that represents a significant leap in integrating EV systems, unifying the tuning and conversion experience with a modern high feature and customizable interface.

And finally, in Safety and Racing, we've unveiled the new Simpson Prima Printed Suits, employing next-gen printing technology that enables full customization of premium automotive racing suits. In addition, we launched Off-Road Simpson seats for UTVs, prioritizing comfort, containment and safety in a convenient package.

Lastly, there are two new Simpson helmet offerings, the Devil Ray, which is the next evolution of one of our workhorse motorsport helmets and the exciting new Adventure Motorcycle helmet series, the brand's first dedicated helmets for the popular on/off-road segment.

Now, this is just a small glimpse of products to come from all our great brands in the future.

I would now like to turn the presentation over to Jesse, who will discuss our Q1 results in more detail and reiterate our outlook and guidance for 2024.

Jesse Weaver

Thank you, Matt, and good morning, everyone. Turning to Slide 14. Early last year, we set four main financial goals for the full year: restore historical profitability; improve free cash flow; optimize working capital; and reduce debt. As we ended the year, we advanced in '23 on all four fronts and continue to be focused on achieving these goals in '24.

I'd like to start by sharing the progress we made on our financial goals in the first quarter, despite a difficult environment. First, we continue to remain focused on restoring Holley profitability and making progress towards our long-term goal of 40% gross margin and at least 20% EBITDA margin on an annualized basis.

As we laid out in our original guidance, efficiency gains from cost-to-serve efforts are expected to deliver at least \$5 million within the year, and we were able to, successfully, capture more than \$3.7 million in the first quarter.

Our next financial priority is to improve our free cash flow. We demonstrated progress on this initiative in the first quarter by delivering approximately \$18 million of free cash flow, a \$15 million improvement versus the same period, a year ago.

Over the last year, we've seen significant improvements in free cash flow through the optimization of inventory and during the quarter, we continued to support our initiative to optimize working capital with our transformative SKU rationalization of approximately 12,000 finished goods SKUs, representing 23% of our SKUs and only 1% of sales.

As a reminder, the objective of the SKU rationalization efforts is to reduce complexity and focus internal development and management resources on high turn SKUs that will drive long-term growth in growing consumer categories.

And finally, we remain committed to reducing our debt position and deleveraging our balance sheet. We reduced our net leverage ratio once again this quarter to 4.16x and prepaid an additional \$15 million on debt in March.

So as you can see, we are making excellent progress on both the operational initiatives Matt highlighted earlier, as well as our financial priorities, and our team continues to deliver strong results, despite a challenging environment.

As you all know, inflation remained elevated in the first quarter. We believe higher inflation, combined with increasing credit card debt, climbing household auto loan balances and declining wage growth led to a pullback in consumer spending on goods in the quarter.

So while the economy is expanding, consumers are feeling the pinch and are showing discretion when spending, particularly on goods, as they tend to shop deals more often in this environment.

With that backdrop, I'd like to spend a few minutes discussing our financial results.

Turning to Slide 15, we've highlighted our first quarter '24 results and key financial metrics. Net sales in the first quarter of '24 were \$158.6 million, compared to \$172.2 million in the same period a year ago. This result is in line with the guidance we provided previously, and consistent with our previous expectations, these distribution partner inventory levels were elevated coming into the year.

During the quarter, we conducted our tax holiday promotion in Q1, which we estimate drove \$5 million in net incremental revenue lift for D2C. This was the first time Holley conducted a promotion during the tax refund season, which our data indicates is a prime buying opportunity for our consumers.

Similar to the promotion we ran during the holiday season, distribution partners were included in the program, support on the sellout of select products. As we continue the growth in our partnership with distribution partners, we expect that the participation in these promotions, going forward, will be an important contributor to our overall growth equation, as we work together to drive consumer demand.

Past due orders, which decreased for the 10th consecutive quarter, benefited our sales in the first quarter as they were reduced by \$1 million to \$8 million. This improvement in Q1 '24 is in line with the improvements we saw in '23.

Gross margin for the quarter was 32.8%, compared to 39.3% in the same period, a year ago. After adjusting for the transformative product rationalization of 9.7 in Q1 of '24, adjusted gross margin for the quarter was 38.9%, compared to 39.3% in the same period, a year ago.

Typically, sales declines show much greater compression on our COGS fixed cost, but through efficiency improvements, primarily in freight, we are able to, meaningfully, offset deleverage pressure and experience only 40 basis points of margin compression on an adjusted basis.

SG&A, including R&D expenses for the first quarter was \$37.8 million and slightly elevated versus the \$36.7 million from the prior year. The increase was primarily driven by a \$700,000 increase in equity compensation cost and a \$2 million reserve related to litigation settlements that were partially offset by lower outbound shipping and handling costs.

Despite our sales headwinds, we delivered strong first quarter adjusted EBITDA of \$30.7 million and adjusted EBITDA margin holding relatively stable at 19.3% versus a year ago.

As shown on Page 16, we once again delivered strong free cash flow of \$17.8 million in the quarter, roughly a \$15 million improvement, year-over-year. And then as you can see on Slide 17, our remarkable cash flow has enabled us to continue reducing our leverage.

We announced a prepayment of an additional \$15 million of debt at the end of March, which brings our total pay down of \$65 million in principal against our first lien term loan facility, since September of '23. This has allowed Holley to recognize up to an estimated \$2.5 million in annualized net interest savings.

With these efforts, we ended the quarter with a net leverage ratio of 4.16x, which continues to be, meaningfully, below the covenant outlined in our amended credit agreement of 5.75x in the quarter and below the original covenant of 5x. The covenant relief period is on track to expire

at the end of Q2, and we are confident in our ability to, successfully, exit the relief period, at that time.

Now, I'd like to turn to Slide 18 to discuss our outlook. For the full year '24, we are reiterating our previously provided outlook, which was net sales in the range of \$640 million to \$680 million, and adjusted EBITDA in the range of \$125 million to \$145 million.

We expect '24 results to include capital expenditures of \$8 million to \$12 million, depreciation and amortization between \$24 million and \$26 million, and interest expense, excluding the mark-to-market on the collar, in a range of \$50 million to \$55 million. As we remain focused on continued improvements in leverage, we are also providing a year-end net leverage target of between 3.5 to 4x.

I would also like to note the midpoint of our '24 sales and EBITDA ranges assume the exit of unprofitable business lines in the Q1 rationalization of non-performing SKUs, representing approximately 1% of annualized sales.

In addition, we continue to drive efficiency in our business and expect to save \$5 million to \$10 million in '24, above the savings generated in '23, from improvements in return handling and reduced shipping fees. These factors make us optimistic about improving the adjusted EBITDA margin, as shown in the full year guidance.

Moving on to our outlook for the second quarter, inventory levels at our distribution partners remained slightly elevated, over the prior year levels. Therefore, we are expecting net sales in the range of \$165 million to \$175 million and adjusted EBITDA in the range of \$34 million to \$40 million.

We believe that our sales and marketing initiatives, including distribution partner participation and quarterly promotions, along with efforts around clearance and overstock inventory and improvement in our product launch effectiveness, will help drive growth in the second half of the year.

As I mentioned in the beginning, we will continue to focus on increasing total profit, free cash flow and reducing debt as our main financial goals. We are confident in the resilience of this enthusiast-based industry and have made excellent progress on our organizational transformation to incubate our organic growth while, simultaneously, refining our cost-to-serve.

We remain very bullish in the free cash flow generation of this business and are firmly on track to achieve our long-term gross margin and EBITDA margin targets of at least, 40% and 20%, respectively.

This concludes our prepared remarks. We'd now like to open up the line for questions.

Operator

Thank you. Ladies and gentlemen, at this time, you may register your desire to ask a question by pressing “*”, “1” on your telephone keypad. Once you have been called upon, please make sure you are not on mute, and proceed with your question.

Our first question comes from the line of Christian Carlino with JPMorgan. Please proceed with your question.

Christian Carlino

Hi, good morning, thanks for taking our question. Could you speak to how trends evolved over the quarter in terms of out-the-door sales and quarter-to-date? And just to the degree that you saw variability in out-the-door sales during February and March around tax refund timing? Thank you.

Jesse Weaver

Sure. That's a good question, Christian. So, out-the-door sales throughout the quarter improved. Certainly, January was a really tough month. I think part of that could have been impacted by what was going on with the storms. But we saw some improvement in out-the-door sales.

I think a bright spot here is, as we drive participation with our partners, one of the areas where we 100% participate in D2C, and we saw even better improvements in trends between January, February and March, which is extremely encouraging, overall.

Christian Carlino

Got it. That's helpful. And then, understanding there has been new products. But you've talked to, I think, over 40,000 in SKUs that you've rationalized over the past year to year and a half. Could you speak to maybe what the actual SKU count is now? I think you implied it's closer to 50,000.

And are these primarily legacy categories that are just turning too slowly because there's a limited car part for those types of modifications? Or is it more rightsizing some of the categories you've entered through acquisition, over the past couple of years?

Jesse Weaver

Yeah, so just to kind of put a finer point on it, yes, we're ending at around 40,000 SKUs. And I think the key metric here is we've reduced around 45% of our total finished goods SKUs, which is an important piece of this. And it's really only impacting about 3% of sales.

I think to your question on why and how, you really have to pay attention to the strategy that we've employed here. So, organizationally, the focus on large, growing segments of the population where we need to drive new product development wasn't as refined as it is, today.

And so, in a world where you're developing a lot of SKUs without a lot of good, strong end markets, you end up with this SKU proliferation, where I think you can do the math on this, average, these SKUs are doing \$600 a year. And as we've tightened that up, we look at the portfolio and we say the carrying costs, the working capital, all of the efforts on the distribution and R&D, it just does not make sense, particularly given the strategy.

Operator

Thank you. Our next question comes from the line of Brian McNamara with Canaccord Genuity. Please proceed with your question.

Brian McNamara

Hey, good morning, guys. Thanks for taking the questions. So maybe one for Jesse. Q1 orders looks like they're down about 12%. The midpoint of your Q2 guide implies minus 3% in sales, and then your H2 guidance implies a nice return to growth. For those of us maybe a little less familiar with the business, can you remind us how long orders typically take to convert to revenues and how you square the deviation?

Jesse Weaver

It really depends on the source of the orders. Obviously, D2C comes pretty quickly, the distribution partners, it's usually within four weeks of the order coming in, and a lot of that also depends on availability. So it's not going to be a perfect one-for-one on the orders, Brian, to the shipments. But we use it as a good leading indicator into kind of how those trends then would cascade into the P&L.

Brian McNamara

Great. And then on, I mean, H2 looks like it's a little more--the year feels a little more H2 loaded here in terms of growth resuming. I mean, clearly, this is a turnaround story. What gives you guys, if you could rank order the confidence that that growth will come back in H2 for maybe some investors that are doubting that?

Matt Stevenson

Hey, good morning Brian, it's Matt. There's--as I hope it came across in the prepared remarks, there's just a ton of great activity going on behind the scenes to put in place strong initiatives to drive growth, as well as onboarding new leaders to really fuel that.

And I think where you're seeing some of the upgrades in talent into the organization that have been here a little longer, you're already seeing those great strides, and Jesse talked about the trends in D2C.

That's under Philip Dobbs leadership, who's been here over six months and is really improving our go-to-market strategy around digital and data and third-party, etc. So, there's a lot of great activity going on and we're confident that will bear fruit later on in the back half of the year.

Brian McNamara

Then, I guess, finally, maybe I'll put you on the spot here, Matt, you've been here for about a little under 11, right around 11 months. I mean, what would you say to an investor considering an investment in Holley here? Like why step in here? Obviously, there's a ton of work going on behind the scenes that maybe investors can't really see, can't get under the hood for a forced pun there. But like, why step in now? Why is the future bright there? Thanks.

Matt Stevenson

Yeah, thanks, Brian, and a great question. We're all matching the breadth and depth of our brands and our products in all the consumer verticals we reach and how we're bringing better data and professionalism to drive the business forward to where the growth segments are in the market and really putting processes behind it to accelerate that growth.

And it's just--it's a different way than it's been done in the past. And we're just very optimistic, as we continue to improve our processes and as we talked about, bring on this talent that it's going to yield the fruit we're confident it will. So, overall, very resilient market. We've seen it through ups and down cycles and really, we're just getting going on the early innings of driving this growth engine.

Brian McNamara

Great, thanks a lot, guys.

Matt Stevenson

Thanks, Brian.

Operator

Thank you. Our next question comes from the line of John Lawrence with The Benchmark Company. Please proceed with your question.

John Lawrence

Yeah, thanks. Good morning, guys.

Matt Stevenson

Good morning, John.

John Lawrence

So, when you look at the rationalization, can you take another step deeper, Matt? How long ago have some of these products been in inventory? And was--from looking at that rationalization, should it have been done a long time ago, obviously, with that many SKUs? Can you give us sort of a history? And what was the criteria? You mentioned \$600. What was basically the criteria to make that cut?

Matt Stevenson

Yeah, John. I mean, we take a very analytical approach to look at, really, what is driving value into the market like where there's clear differentiation in our products. We got to look at it by overall brand, by category, and understand are there SKUs that are adding value to the portfolio and to the brand, or are these things just done to be done without really a clear value proposition and direction.

And as Jesse talked about a few minutes ago, there was a lot of quantity over quality, right? And so, now we put in a very developed and diligent Phase Gate System where we then vet the opportunities based on the market potential, the value proposition, competitive pricing, etc., to make sure that then these things take off into the marketplace. So, it's just driving that level of professionalism in the business that wasn't there before.

And so, yes, these products should have been rationalized, a while ago. And I think we're in a good spot. The team did a great job about a year ago, starting in rationalization exercise. We thought that there was one more that was needed, and we feel the portfolio is in good shape now and it allows us to really concentrate on driving innovation.

John Lawrence

Great. And just last question for me. Just when you look at the process and you talk about the new products, can you give us just a sense of behind the scenes, how long this took to make the Bluetooth, etc.? Obviously, just some examples of how quickly the new team has assembled that data, gone to market with a new product and how that process, maybe from a timeline, is a lot different than it was in the past?

Matt Stevenson

Yeah, and one of the things, John, this Phase Gate System is elevating the biggest opportunities to the surface that then we can accelerate by putting in the proper resources. And I think a great example of that is that APR Ultralink. I mean, literally, John, this is a product that was talked about in the organization for years.

But really, the market segmentation and the appreciation for the data driving the business opportunities, because Euro is a large growth segment and there was a bias to Domestic Muscle previously, and we made sure we saw a great opportunity, worked collaboratively within the business. The functional areas and the business units drove the right resources that will accelerate that product.

So literally, it took it from something that had been in development for years and got it done in months. And those are the things we want to continue to do to highlight the large opportunities and bring them to market, faster.

John Lawrence

Thanks. Congrats and good luck.

Matt Stevenson

Thank you, John.

Operator

Thank you. Ladies and gentlemen, as a reminder, if you would like to join the question queue, please press “*”, “1” on your telephone keypad. Our next question comes from the line of Joe Altobello with Raymond James. Please proceed with your question.

Martin

Hey, good morning, this is actually Martin on for Joe. I was wondering if you can clarify your stance on M&A versus debt reduction in terms of capital allocation. In the near-term, is the bar fairly high for acquisitions? And is there a price you'd think about using stock?

Jesse Weaver

Yeah, so good question. I would say, right now, primary focus when it comes to free cash flow, as we've said, and we've committed to and consistently delivered on is to pay down debt. Now, I think, as Matt said a few times, it doesn't mean we're going to take ourselves out of the market when it comes to looking at M&A activities. But we're certainly very conscious of our leverage commitments and our path with free cash flow.

But I think when it comes to using equity, I think in my prior call, I know I said that that could be a tool, but definitely not at these price points on the stock, and certainly something well north of this. It's just kind of saying, hey, we've got--given to our public company, a lot of tools at our disposal, and we will be very conscious of driving shareholder value when it comes to formulating the capital structure on any acquisition.

Martin

Got it. Thank you. And just turning to the free cash flow conversion for the year. How should we think about that, particularly given that you had the relatively high level of interest expense? And I guess, a nice boost last year from inventory reductions. I think if we're using the this for our guidance, we get somewhere around 30% of adjusted EBITDA. Is that a good near-term run rate?

Jesse Weaver

I think just using what you've got there in terms of guidance on the EBITDA side, and just assuming, unlike last year, where we got well over \$40 million of free cash flow for inventory, there may be some modest improvements on free cash flow from inventory this year, but nothing to the level that we saw, last year.

Martin

Okay, great. Thank you very much.

Operator

Thank you. Our next question comes in line of Joe Feldman with Telsey Advisory Group. Please proceed with your question.

Joe Feldman

Good morning, guys, and thanks for taking the questions. Can you talk a little bit more about your promotional plans and what you've seen from the distributors? Because if I recall, you guys were trying to support the distributors a little bit more, and how effective that's been. Is that working how you'd like it? Thanks.

Matt Stevenson

Hey, Joe, thank you for the question. Yeah, regarding our promotional strategy, our goal is to lift all channels with the great products in our portfolio and that those are introducing. And our distribution partners are a key piece of that.

And previously, I think we commented on the last earnings call, when Holley ran a promotion, we didn't include our distribution partners, and we felt that was a real miss, as they're an important part of our go-to-market strategy.

So now going forward, we support them and during this promotional time period and work together, and we're continuing to optimize that as we work on future promotions and continue to get more coordinated with our partners.

Joe Feldman

Got it. Thanks. And then just one more question on the leverage, just to be a little more clear. Are you guys--to get to the leverage target that you outlined for us, is that more the EBITDA, or will there be more debt pay down this year? I just haven't ran through the math yet, but maybe you could share some thoughts on further pay down, through the year. Thanks.

Jesse Weaver

Hey, Joe, I think to get there, I mean, just the cash generation just drives it, with the EBITDA hitting the midpoint of the guidance and actually generating cash in the interim to drive down the net leverage gets you there.

In terms of buying back debt, we look at that as--we did \$15 million in Q1. It's one of those things that I've been very opportunistic about and just kind of balancing our free cash flow forecast in any given quarter and really just making sure that, from our leverage covenant perspective, we don't get any credit for having cash on the balance sheet over \$50 million.

So, my objective there is just to make sure that we, based on our forecast, make sure that we stay under \$50 million in cash on the balance sheet by buying back the debt. But I'm not going

to give you a specific number on that. But just note that getting to that leverage target is really just hitting the guidance and generating cash in the process.

Joe Feldman

Got it. That's helpful. Thanks, guys. Good luck with this quarter.

Jesse Weaver

Thank you.

Matt Stevenson

Thank you, Joe.

Operator

Thank you. Our next question comes from the line of Phillip Blee with William Blair. Please proceed with your question.

Sabrina

Hi, this is Sabrina on for Phillip. Thanks for taking our question. Could you provide some color on the performance of Sniper 2.0 during the first quarter? And then any early signs on second quarter performance to date with new products, and then also just more broadly?

Matt Stevenson

Yeah, thank you for the question. Sniper 2 is, of course, a really important product for our business and has resonated extremely well in the marketplace. And we just introduced this new Bluetooth connectivity kit for your phone. So previously, when you purchased a Sniper 2, it came with a digital display.

So now, with this new Bluetooth module that hooks up to the phone, more price sensitive customers can get a great Sniper 2 product at a lower entry point. So, we're very optimistic in Sniper 2 performance. It's doing well, and it's the leader in its space, relative to this premium entry level EFI conversion. So, all things are looking strong for that product.

Sabrina

Great, thank you. And then a quick follow-up. Your team has made considerable progress working down past dues. So, how are you thinking about your plans for past due order fulfillment for the remainder of the year and that incremental margin impact versus last year?

Jesse Weaver

Yes, this is Jesse. So, I would say, Sabrina, that most of the past due fulfillment improvements happened in the back half. And so, we would expect, potentially, some improvement here in Q2. But largely, we see that happen in the back half. And I think we're probably getting close to what would be a standard run rate of past dues, which I would say is in the \$5 million range of

the business at its current size. The plan is to work as hard as possible to get down to that by the end of the year, but that's kind of where we expect it to level off.

Sabrina

Okay, great. Thank you so much.

Jesse Weaver

Thank you.

Operator

Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I'll turn the floor back to Mr. Stevenson for any final comments.

Matt Stevenson

All right. Thank you, Melissa. The Slide 21 underscores the compelling investment narrative surrounding Holley. This market, propelled by automotive enthusiasts, extends beyond a mere pastime. It is a passion and it is a way of life for our customers. Its resilience to economic cycles is notable, given that it is more than just a fleeting trend.

We command a vast addressable market approaching \$40 billion, which has demonstrated consistent growth, over many years.

Holley is at the forefront of the industry with a collection of storied brands that have a legacy of innovation. Additionally, our history is marked by successful acquisitions and value creation through strategic integrations.

Plus, we are presented with the unique opportunity to forge a new digital frontier that will transform how our consumers and distribution partners engage with our brands, providing us with a competitive edge and fostering growth.

This leads to a compelling investment case with a business committed to delivering stable organic growth of at least 6%, maintaining 40% gross margins, achieving over 20% EBITDA margins, generating sustainable free cash flow, and establishing a platform that facilitates the unlocking of value and strategic acquisitions.

The combination of the allure of the automotive enthusiast marketplace and Holley's distinguished brand portfolio presents an exceptional investment opportunity.

In closing, I wish to express my sincere appreciation to our team members for their dedication to serving our customers daily, to our remarkable consumers who support our brands, as well as to our distribution partners, many of whom have been integral to our success, for decades.

Also, thank you for your attention today and look forward to providing updates on our progress in subsequent quarters. I want to thank you, and wish you a great day.

Operator

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