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Masco Corp. (MAS)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

David A. Chaika
Vice President, Treasurer & Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

- Our statements will also include non-GAAP financial metrics
- Our references to operating profit and EPS will be as adjusted, unless otherwise noted
- We reconcile these adjusted metrics to GAAP in our earnings release and presentation slides, which are available on our website under Investor Relations

Keith J. Allman
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- I hope everyone out there is safe, healthy and managing through this difficult time
- I'll begin my comments by discussing the actions we are taking in response to the COVID-19 pandemic
- I'll then touch on our strong first quarter results and conclude with how we're looking at our business through the remainder of the year and beyond

Safety and Well-Being

- Please turn to slide 4
- Our top priority is the safety and well-being of our employees during this unprecedented time
- In early March, we formed a cross-functional COVID-19 task force to coordinate our response across the organization
- We've employed best practices and have followed guidance from the World Health Organization and the Centers for Disease Control and Prevention, including working remotely, staggering shifts, modifying work areas to ensure proper social distancing, enhancing cleaning practices and taking measures to ensure that sick employees stay home

COMMUNITY OUTREACH

- We've also been focused on community outreach
- Supporting the communities in which we live and work has always been at the foundation of Masco's culture
- Several Masco business units have assisted local charities and frontline health care professionals by purchasing and donating protective equipment such as masks and sanitizers and by making in-kind product donations
- In addition, we've committed $1mm to non-profit organizations that are helping to meet the urgent needs of our communities near our business units

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- Other efforts include exploring the manufacture of face shields and coverings, and certain valves and brass components for ventilators and producing and delivering, in a matter of days, washing units and examinations enclosures to protect medical personnel treating COVID-19 patients for a 500-bed interim clinic in Germany
    - These are just a few of the many efforts and activities going on across our company
- I am extremely proud of our employees
- They have worked very hard to keep each other safe and to serve our communities

Customer Needs

- Our second priority has been to ensure we are meeting the needs of our customers and end consumers during this difficult time, while maintaining the highest levels of employee safety
- Our businesses continue to provide essential products, though certain facilities have been shut down for the month of April and will continue to be shut down to some extent in May
- Additionally, limits on the number of customers in big-box retail stores, restrictions on the sale of certain categories in various states and closures of distribution outlets will reduce sales for our products in Q2, but had limited impact in Q1
- Let me briefly discuss our first quarter results

Sales, Operating Profit and EPS

- Please turn to slide 5
- For the quarter, sales increased 5%, excluding the impact of currency
- Operating profit increased $22mm, principally due to strong volume leverage in North American plumbing and in our paint business, and EPS grew 24% to $0.46 per share

PLUMBING

- Turning to our segments, excluding currency, plumbing sales grew 3%, driven by Delta's record sales quarter as they drove strong volume across all channels of distribution
- During the quarter, we also invested in our connected home strategy that we spoke about at our Investor Day with a small acquisition of a technology company that has developed an interconnected showering system that monitors and controls the temperature and flow of water
    - This system is an adaptable solution for a wide range of showering products and is the featured technology in Hansgrohe's smart shower system that debuted at the ISH show in Frankfurt last year

DECORATIVE ARCHITECTURAL SEGMENT

- In our decorative architectural segment, strong paint volume drove both top and bottom line performance
- As shelter-in-place orders were issued throughout March, we saw a significant acceleration in the sales of BEHR paint as more and more do-it-yourselfers took advantage of the time at home to undertake painting projects
- Recently, BEHR's leading brand and quality position was reaffirmed by a third-party testing organization as we once again achieved the highest rating in two out of the top three spots with our BEHR MARQUEE and BEHR ULTRA paint brands
- Our leading paint quality and value, along with our partnership with The Home Depot, positions us well to continue to capitalize on this resurgence of DIY paint demand

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CABINETRY BUSINESS

- We also completed the sale of our Cabinetry business unit in the quarter, delivering on our portfolio transformation that we announced just over a year ago
- We actively deployed the proceeds of that divestiture through open market share repurchases and an accelerated share repurchase transaction for a combined total of just over $600mm at an expected average price of between $39 and $40 per share, depending on how many incremental shares we receive at no additional cost to us when the ASR concludes

Liquidity

- So let's now discuss how we're approaching the current environment and how it impacts our outlook
- Please turn to slide 6
- From a business standpoint, in addition to our commitment to the safety of our employees, we are focused on two things, maintaining our strong liquidity and ensuring we are positioned to win in the recovery
- Our liquidity remains strong at $1.8B at the end of Q1
- We are actively reducing our costs and conserving liquidity by cutting discretionary spending, implementing a hiring and wage freeze, delaying discretionary CapExs and suspending our share buyback activity indefinitely
- Our goal is to ensure we are able to support our customers in any scenario in the most cost-efficient way possible
- While we are focused on short-term cost control during this pandemic, we remain committed to driving long-term growth, and we'll continue to invest in brand, innovation and service to ensure we win in the recovery
- We are in dynamic and uncertain times, and accurately predicting the depth and duration of the impact of this pandemic is difficult at best

GUIDANCE

Sales and Margins

- However, I'd like to share with you how we are currently thinking about Q2, understanding that we have withdrawn our formal guidance for 2020 and 2021
- With the numerous shutdown and shelter-in-place orders, we anticipate second quarter sales to be down in the range of 20% to 25%
- This assumes that in the United States and Europe, our closed facilities begin reopening throughout the month of May, and that there are no further restrictions enacted in additional states or geographies
- With the sudden nature of the shutdowns and restrictions on distribution, our decremental margins will likely be in the 40% to 45% range in Q2 and will improve throughout the year to a full year decremental of roughly 35%
    - These decremental margins are a result of the inefficiencies of the rapid shutdown and operating in reconfigured plants, due to safety precautions we have enacted
- Additionally, we anticipate healthy demand upon reopening

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Supply Chain

- Transitioning now to our supply chain; at the beginning of the quarter, the main concern about COVID-19 was its impact on our Asian supply chain
- While our factory and third-party suppliers in China were shut down for the majority of Q1, our factory and nearly all of our third-party suppliers are now operating at or close to 100%, which we hope is a good sign for the rest of the world

CLOSING REMARKS

- As we manage through the near-term, ever-changing environment, we are working closely with our leaders across the organization to assess the impact on 2021
- And we are determining how to best position Masco to win as we move through the recovery
- We believe our work over the past few years to refocus our portfolio on lower-ticket, less cyclical, repair-and-remodel-oriented products and our strong position in DIY-oriented products positions Masco particularly well to weather this storm and to outperform during the recovery

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John G. Sznewajs

Chief Financial Officer & Vice President

FINANCIAL HIGHLIGHTS

Sales and Foreign Currency Translation

- As Dave mentioned, most of my comments will focus on adjusted performance, excluding the impact of rationalization and other one-time items
- Turning to slide 8; we had a solid first quarter, and sales increased 4% and grew 5% in local currency
- Foreign currency translation unfavorably impacted our first quarter revenue by approximately $9mm
- In local currency, North American sales increased 8% in the quarter
- This performance was driven by strong volume growth in our paint and plumbing businesses
    - This was partially offset by lower volumes in our lighting and hardware businesses
- In local currency, international sales decreased 3% in the quarter, driven by lower volumes and unfavorable mix, partially offset by pricing actions

Gross Margins, SG&A, Operating Income and EPS

- Gross margins were 34.8%, up 30BPS
- Our SG&A as a percent of sales decreased 50BPS to 20.4%
- We delivered solid bottom line performance as operating income increased 11% to $228mm, with operating margins expanding 80BPS to 14.4%, despite the increased tariff costs that we discussed last quarter
- Our EPS was $0.46 in the quarter, an increase of 24% compared to Q1 2019

Tax Rate and Expenses

- Turning to the remainder of the year; as Keith mentioned, we have withdrawn our guidance for 2020 and 2021

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- However, to be as transparent as possible given these dynamic times, we've provided our key assumptions such as our normalized tax rate, general corporate expense and share count, along with other items on slide 22 of the earnings call deck posted on our website
- More importantly, to help you better understand the status of our business, I will provide additional color on the sales trends we are seeing in April as I walk through each segment and wrap up with more detail on our liquidity position, before I turn the call back over to Keith

Sales and Operating Profit

- Turning to slide 9
- Plumbing sales increased 3%, excluding the impact of currency
- Foreign currency translation unfavorably impacted this segment's sales by approximately $9mm in the quarter
- North American sales increased 6% in local currency as we experienced strong demand across our wholesale, retail and e-commerce channels
- As Keith mentioned, Delta delivered another record sales quarter with low double-digit growth through increased volumes in their faucet, showering and bathing products
- North American sales growth in the quarter was unfavorably impacted by approximately 2% as a result of facility closures at our spa business in California due to the state order
- International plumbing sales decreased 3% in local currency
- Hansgrohe had mid-single-digit growth in its home market of Germany
    - This growth was more than offset by an approximately 20% decline in China and declines in other European markets, including the UK, France, Spain and Austria as a result of the impact from COVID-19
- Operating profit in the quarter increased 4%, driven by incremental volume and lower spend, partially offset by the full impact of tariffs

Plumbing Markets

- Let's turn to the trends we have recently seen in our plumbing markets
- While we typically do not discuss intra-quarter trends as results from only a few weeks in a quarter can be misleading due to short-term sales fluctuations, we feel that any data points in this unprecedented situation are helpful

SEGMENT SALES

- In aggregate, our expectation is that plumbing segment sales in Q2, excluding currency, will be down between 30% and 35% over prior year
- And segment sales in April will be down approximately 35%
    - This decline is being driven by closure orders affecting our spa business and lower demand in several other businesses in this segment
- We anticipate our spa sales will decline by approximately $100mm in Q2 as Mexico and California, our principal spa manufacturing locations, issued shelter-in-place orders in late March and early April
    - These orders caused us to cease production
- Our expectation is that we will begin limited production by the end of May and ramp up thereafter
- Interestingly enough, demand for spas, both through our specialty dealer channel and through our online customers, remains robust

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INTERNATIONAL BUSINESS

- Additionally, our international business is being impacted by shelter-in-place orders in many European countries, including the shutdown of our UK operation
- In April, we are seeing high double-digit sales declines in the UK, Italy and France, and approximately 20% declines in Germany, our largest market
- China appears to be rebounding nicely from both a supply chain and demand perspective as their economy begins to reopen
- To illustrate this, China sales were down approximately 20% y-over-y in Q1, but we currently expect April to be flat to up slightly from last year
- Due to shelter-in-place orders in many states in the US and Canada, many plumbing wholesalers and plumbing showrooms remain closed, impacting our North American plumbing sales
    - Some of this demand has shifted to the e-commerce channel
- And based on what we are hearing from customers, we believe there will be additional pent-up demand as the economy reopens

Decorative Architectural

- Turning to slide 10; decorative architectural grew 9% for Q1
- This performance was driven by high teens percentage growth in our paint business with strong double-digit growth in DIY and mid-single-digit growth in PRO
- Our outstanding DIY paint results benefited from a resurgence in DIY painting as states issued shelter-in-place orders beginning in March
    - While it is too early to call this a trend, we are well-positioned with BEHR's compelling quality and value proposition and a strong partner with The Home Depot to capitalize on any potential shifts in consumer behavior

INVESTMENTS AND SALES

- In addition, we remain committed to our investments in the PRO and are pleased with the performance in the quarter
- Strong paint sales were partially offset by lower sales in our lighting and builders' hardware businesses
- As we mentioned on our fourth quarter earnings call, lighting sales were impacted by approximately $15mm due to the loss of a portion of a private-label program and inventory rebalancing at a customer
- Similar to our plumbing segment, we experienced strong increase in online orders in all three businesses in this segment as consumers shifted their purchasing habits

OPERATING PROFIT

- Operating profit in the quarter increased by 17%, driven by incremental volume, partially offset by the tariff impact on lighting and builders' hardware
- We took steps to strengthen our lighting business during the quarter by closing an East Coast distribution center and consolidating that activity into our other facilities

April Trends

- Turning to April trends; we expect segment sales in April will be down approximately 10% over prior year and anticipate segment sales in Q2 will be down in the range of 5% to 10%

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- As a reminder, second quarter lighting sales will also be negatively impacted by approximately $15mm due to the loss of a portion of a private label program and inventory rebalancing at a customer

BALANCE SHEET

Net Debt-to-EBITDA and Covenants

- And turning to slide 11; our balance sheet remains strong with net debt-to-EBITDA at 1.6 times and we ended the quarter with approximately $1.8B of balance sheet liquidity, which includes full availability of our $1B revolver
- Borrowing on our revolver is subject to two main covenants, both of which have plenty of cushion
    - The first covenant is a net debt leverage covenant of less than 4 times and at the end of the quarter, we were at 1.6 times
    - The second covenant is an interest coverage covenant of no less than 2.5 times; at the end of the quarter, we were at 8.5 times

Debt Maturities

- Turning to our debt maturities; we are in good shape as our next maturity of $400mm is not due until April of 2021
- In the past month, both Moody's and Fitch reaffirmed their investment-grade ratings, with Fitch reaffirming its positive outlook due to our improved portfolio of businesses following the divestitures of our Cabinetry and Windows segments
- We are pleased that we closed the Cabinetry sale in February for $1B

Cash Proceeds and Working Capital

- As a reminder, we received $850mm of cash proceeds or approximately $630mm in net cash after taxes and expenses
- We also received preferred stock of the buyer with a liquidation preference of $150mm
- Working capital as a percent of sales improved 130BPS vs. prior year to 17%
- We now expect full year working capital as a percent of sales will be in the range of 16% to 17%

Share Buyback Activity

- Lastly, during the quarter, we continued our focus on shareholder value by deploying approximately $600mm to repurchase roughly 14.2mm shares
- As Keith mentioned, we are suspending our share buyback activity indefinitely, and therefore, estimate our 2020 average diluted share count will be approximately 266mm shares

Keith J. Allman
President, Chief Executive Officer & Director

CLOSING REMARKS

- The COVID-19 pandemic may have lasting effects on the economy, consumer behavior and homeownership, all of which we will continue to assess

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- There could be increased interest in single-family housing with more space in the house and more distance from neighbors
- Increased remote working could lead to lower home turnover, but also increased remodeling spending
- Homeowners may take on more do-it-yourself projects themselves, especially easy-to-do projects such as painting as opposed to having other people in their homes
- And consumers could increase their preference for trusted brands, particularly in products such as ours that touch water
- What we do know is that our actions over the past six years to create a less cyclical, more resilient portfolio, together with our strong brands and innovation pipeline, positions Masco extremely well to outperform the competition, be outstanding partners to our customers and create shareholder value through a recovery
- Our lower-ticket repair and remodel products performed well in a downturn and only declined 15% peak to trough in the 2008 to 2009 housing-led recession
- Many of our products are DIY-focused, particularly paint
- And we have invested in and are well positioned in all channels of distribution, including the rapidly growing e-commerce channel
- We have strong liquidity and generate significant cash flow in good times and bad, allowing us to gain share by investing in new products and programs even in slower times
- We have positioned our balance sheet to be a tool that will allow us to take advantage of opportunities that may arise, such as share buyback or attractive M&A.

QUESTION AND ANSWER SECTION

Stephen Kim
Evercore ISI

Q

I hope you guys are all doing well. I wanted to ask a question regarding your outlook, particularly on the decremental margins.

You had suggested that you're assuming a reopening in May, no resumption of second wave effects that might result in significant shutdowns. And you suggested that the decremental margin would be 40% to 45% in Q2 and then improve, I think you said, to 35% for the full year. I just want to make sure I heard that right.

And if you could give us a sense for how those decrementals may look between the two divisions, just to make sure that we're thinking about it clearly. And then also, when you eventually go to incremental margins when that happy day arrives, can you give us a sense for where you think the incremental margins will be as a result of your comments with the decrementals in the near term?

Keith J. Allman
President, Chief Executive Officer & Director

A

Stephen, thanks for the question. I talked in my prepared remarks a little bit about the sudden nature of the shutdown and some inefficiencies that we're experiencing operating our plants as we improve social distancing and address our number one priority, which is the safety of our employees. So there are some inefficiencies there that are affecting the decrementals. We are holding on to some cost at this point to be able to better prepared to serve our customers in the rebound, if you will.

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Keep in mind that prior to the pandemic, we were guiding towards low incremental margins, lower than we typically would in plumbing due to high tariff headwinds and even lower incrementals in decorative architecture due to tariff headwinds and some loss of the private label business in lighting that we called out last quarter as it relates to Q1, Q2 and Q3 volume losses.

So our decrementals will be higher in Q2. And we do expect to improve them throughout the year, and you are right, in terms of full year decrementals, in that 35% range.

When we anticipate how our cost takeouts will flow and the way we'll look at – looking at our comps, we would expect to see strong improvement in our decrementals in Q4 to get to that full year range of roughly 35%. Admittedly, there is a lot of variables in there. But that's some more color in terms of how we're thinking about the decrementals. In terms of the incrementals, John, do you want to provide a little more color there?

John G. Sznewajs
Chief Financial Officer & Vice President

A

Yes. In terms of the incrementals, Stephen, I wouldn't expect them to be materially different from our decrementals. I mean, I think as volume comes back, I would think that you would see them in that 30% to 35% range, which we've traditionally enjoyed on volume as we've grown our business over the years.

Michael Wood
Nomura Instinet

Q

You gave the impact of the spa business shutdown on sales in Q2. Are you able to give us any information in terms of the profit impact that that will have?

Keith J. Allman
President, Chief Executive Officer & Director

A

I think if you think about those – our typical decrementals, I think that's a good way to look at it.

John G. Sznewajs
Chief Financial Officer & Vice President

A

Yes. And to Keith's point, because those plants are shut down, we are carrying some extra cost mix. So it is probably – that's one of the reasons we're driving higher income decrementals in Q2, because we do view the shutdowns as short-term in nature, and so we have kept a fair number of employees around. So we are able to produce when that plant comes back – those plants come back up online.

Michael Wood
Nomura Instinet

Q

And in terms of the...

Keith J. Allman
President, Chief Executive Officer & Director

A

Mike, I'd like to – go ahead.

Michael Wood
Nomura Instinet

Q

I'm sorry. Go ahead.

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Keith J. Allman
President, Chief Executive Officer & Director

A

I was just going to highlight a comment we made which is really a testament to the strength of that business in that what we're seeing in our demand patterns for our spa business – and this is definitely in the e-commerce channel and most definitely in our specialty retail channel – is a continued demand, strong demand for our products in that the issues that we're facing in this particular part of our business relate to shutdown of our manufacturing capabilities in our plants because of shutdown orders in Mexico and California.

I think that's an important nuance to point out, more than a nuance. I think it's an important fact that this is more of a supply-related, short-term issue that we're addressing and we'll come out of as these state orders and, in the case of Mexico, country order lift.

Michael Wood
Nomura Instinet

Q

Understood. Thank you. And in terms of Q2 guidance that you provided, I understand how you tried to incorporate when facilities may reopen and that no additional shelter-in-place orders could go into effect. How are you thinking about the impact that this has in terms of paint gallon sales? In terms of – you called out consumers increasingly painting because they're at home and they're pulling forward maybe some of those honey to-do list projects. Are you expecting that that continues? If you can just talk about what you might think is temporary or permanent in terms of consumer behavioral trends related to this, thank you.

Keith J. Allman
President, Chief Executive Officer & Director

A

When we think about the impact of COVID-19 on buying patterns on psyche of our consumers, it's difficult to say what will be a structural change and what will stay and what maybe is a change that is more fleeting. For sure, we're seeing a move to online. And we're seeing that even in our rough plumbing business where pros buy. How much of that sticks remains to be seen.

With respect to our paint business, well, we've worked really hard from a mix perspective to more or less neutralize the mix impact of PRO to DIY. There's a little bit but we've worked hard and we're leveraging the volume on our PRO business so that – those are both good businesses for us. But we are definitely – we had about 75% mix skewed towards DIY. And there's no question that we are seeing a resurgence of DIY demand for those reasons that we all know and that I talked about in my comments.

So do we anticipate that to stick? Yeah. I think that's going to stick through Q2. If that is a longer-term structural change, I think, realistically that remains to be seen. But we like our positioning definitely with our strong partner and our strong brands and our quality in DIY. And we also like our positioning and how we've been able to manage the profitability of the business on the PRO. So not sure if this trend towards DIY will stick indefinitely. But the way I see it, it's going to stick through Q2.

Matthew Bouley
Barclays Capital, Inc.

Q

I wanted to ask back on Q2 revenue guide sort of what you're seeing out of end consumer demand. It sounded like you're seeing something perhaps better there relative to the discrete impact of the shutdowns, which you attributed as somewhat severe, particularly in the spa business. Are you able to sort of quantify or ballpark where the end demand feels like it's tracking relative to the discrete impact of those shutdowns across the business? Thank you.

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Keith J. Allman
President, Chief Executive Officer & Director

A

When you say end demand, Matthew, can you help me understand your question a little bit better?

Matthew Bouley
Barclays Capital, Inc.

Q

Certainly. So where consumer demand is relative to your sell-in demand with the customers? And then I'm speaking really specifically about the plants that were shut down, which is a little bit different than what the consumer demand is, of course.

Keith J. Allman
President, Chief Executive Officer & Director

A

So, in terms of how our demand from the consumer relates to, let's say, a change in inventory position in our channel, we're definitely seeing – this is consumer demand. We're not – due to some of the issues as it relates to some of the intermittent shutdowns of our facilities for employee safety and some of the longer shutdowns due to state orders, we have seen a little bit of our inventory – and I think in the channel, it's safe to say there's a little bit of an inventory reduction in the channel. So this is POS. This is good demand, particularly as we see it in paint.

John, I don't know if...

John G. Sznewajs
Chief Financial Officer & Vice President

A

Yeah. The other thing I'd point to is just, Matthew, is Keith's comments on the demand we're experiencing in spas, right? It's a high-ticket item. And the fact that demand for spas in both online channel and our specialty dealer channel remains very healthy. And we take that as a good sign that the higher-end consumer is out there shopping and looking to continue to improve their home. So I think both paints, as Keith just mentioned, and the spas is a pretty good indicative sign of where the consumer is.

Kenneth Zener
KeyBanc Capital Markets, Inc.

Q

Can you perhaps discuss the – obviously, the spa, you called that out specifically as it's related to a supply issue. But can you maybe talk about how different markets are responding in terms of demand? So obviously, plumbing is down a lot, but there's big variances within America. Northern California, where I am, is very severe in terms of being shut down.

But other places like Denver or Dallas, could you give us a feel for how stay-at-home orders is affecting kind of what you're seeing in both plumbing, which is less, I guess, DIY, perhaps than paint. If you could just explain some of that, the differences that you're seeing, that would be very much appreciated, thank you, in terms of demand.

Keith J. Allman
President, Chief Executive Officer & Director

A

Sure, Ken. Thanks for the question. I'll talk to demand as it relates to a couple parameters, geographical and then maybe talk a little bit about channel, which may be helpful for you.

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Let's just start east to west here. In China, we talked about that a little bit. The demand appears to be rebounding quite nicely. We were down, as we mentioned, about 21% in Q1. And we think in Q2, we should be flat to maybe even up a little bit.

In Germany, down in that 20% range in April, but we are seeing that starting to improve. Staying in Europe, we do see significant sales decline in UK, Italy, Spain and France. Those are due mainly to shelter-in-place and temporary closures of some of our distribution outlets, or our customers' outlets for plumbing.

Obviously, in the US and Canada, we've been impacted by shelter-in-place across many states. I don't really have a lot there to offer beyond what we all know that in Florida, it's been – in Texas, it's been hit a little bit less. And up in New England and the Northeast, it's been hit a little bit harder.

In terms of channels, many large retailers remain open and sales is only off modestly in those stores. Retail tends to skew a little bit towards DIY, as we've said. And that's helping it out a little bit. Paint sales, as I talked about, in retail have been very nicely positive y-over-y.

Plumbing wholesale, continuing here with the channels, by and large, plumbing wholesalers have closed their showrooms, but kept their counter, their backend open. Sales are impacted a little bit more since many homeowners are reluctant to have someone in their house. And sometimes, that tends to be more of a pro install. And we do see some construction being limited like states here in Michigan.

And then from a channel perspective, the e-commerce category is performing quite well and is up y-over-y really across the board. So I think our diversification, both in terms of geographies and channels, is helping the situation out and we're positioned to win really as these channels [Technical Difficulty] (39:20).

John G. Sznewajs
Chief Financial Officer & Vice President

A

Ken, what I would add to Keith's comments, yeah, we do think consumer demand is good. But the question that we're very closely watching is how long does this last. As you are well aware, stimulus checks hit a lot of consumers kind of mid-April, and that could temporarily boost things. And that's why we are going to be reluctant to get too far out there with how strong demand is until we really get a good sense over the longer term, and not short term over a couple of weeks, how demand is and consumers are going to react to things. So I just want to keep that in the back of your mind as well.

John Lovallo II
Bank of America Merrill Lynch

Q

The question is on CapEx. I think you mentioned that maintenance is about $75mm. So it seems like there's about $40mm or $45mm of sort of non-essential spend in your outlook. Can you just help us understand what that non-essential spend relates to and how quickly you could pull back on that if needed?

John G. Sznewajs
Chief Financial Officer & Vice President

A

Sure, John. As Keith mentioned and I mentioned, one of the things that we intend to continue to invest in even through the recession is innovation. And a lot of that non-maintenance CapEx goes to tooling for new products, so jigs and fixtures and things for new plumbing products, new shower products, some new things that we're delivering in the paint area.

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So that's generally where that capital is going because we think it's important to continue to drive the consumer to our retail partners, our showroom partners, even though times may be tougher. Having new products out there continues to give us good shelf space with our partners and draws customer footsteps into their locations. And so whether that's on their online locations or whether that's on their physical locations, we think it's important to continue to drive innovation across the entire portfolio.

Keith J. Allman
President, Chief Executive Officer & Director

A

John, in terms of some of those projects that we will look at cutting, sometimes there's information technology upgrades, and those sorts of things that we can delay a little bit. So, those sorts of things and some are related to equipment that we can delay a little bit, that's really what we're talking about.

Mike Dahl
RBC Capital Markets LLC

Q

It's good to get so much of this detail out there. I had one follow-up on the plumbing business, and you've given some of the components and channel commentary.

When I think about the impact of the spa business, in particular, to a prior question, it looks like that impact alone is a 10% year-on-year delta in plumbing sales. And you highlighted some fairly severe declines in Europe. So I guess the question is really, can you break out then your core US business expectations for plumbing ex the spa business, because it seems like they assumed 30% to 35% for the segment with some of those other components would imply that core US plumbing may only be down something in the teens or so?

John G. Sznewajs
Chief Financial Officer & Vice President

A

Yeah. Mike, it's John. In terms of the math you've done, most of that, that's right. I'd say as we look at North American plumbing, we're probably down a little bit higher than that. We're probably down closer to that 20% range or so would be the way I would characterize, how we're currently viewing North American plumbing.

Michael Rehaut
JPMorgan Securities LLC

Q

And also just want to send my wishes, I hope everyone is healthy and safe out there across your organization. First question, I just wanted to circle back if I could to an earlier question around decrementals; and very much appreciate the commentary there. And obviously, in the initial stages, makes complete sense that you would have a higher than normal decremental.

As you look towards the full year at 35% that would then certainly point to something better than that by the time you get to Q4. Initially, or over time, we had thought of decrementals in a kind of a normalized basis, perhaps of 30% to 35% of the business where decorative was a little bit lower, plumbing was a little bit higher within that range. Just wanted to kind of circle back on those assumptions, and if given the full-year trend, is it correct to assume certainly that you'd be at a better position than that 35% or so, by the end of the year and that decorative would be a little bit lower than plumbing?

John G. Sznewajs
Chief Financial Officer & Vice President

A

First off, I'd like to just make sure we're clear, I think decrementals by segment or incrementals by segment, however you want to look at it, they're approximately the same. I don't think there's a material difference between

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how we look at the incrementals or decrementals between plumbing and decorative architectural. They're both in that 30% to 35% range.

The one thing that I would mention, and because of the nature of the circumstances we're finding ourselves through, it's not always a straight line quarter-to-quarter, right? And so what Keith and I were trying to point out is, obviously, we've got high decrementals here in the first part of things. But as things begin to normalize, they tend to revert back to our more typical incremental/decremental margins.

And so that's how we're seeing it for the full year. So if you think about the way that we see the progression through the year, I think that should help think through how that should work.

Michael Rehaut
JPMorgan Securities LLC

Q

Okay, appreciate that, I guess. I guess, secondly, I just wanted to circle back a little bit on paint, and there's been obviously a decent amount of press and coverage around room-by-room DIY projects, as you've alluded to, in the shelter-in-place backdrop and we all saw the strong US Census retail sales out of home improvement for March.

I was hoping to get a sense, if possible, around how the monthly trends occurred for the paint business in the US. It's an overall 9% segment growth for the quarter. I'm assuming that there was perhaps a particularly strong March. And then you're expecting a 10% decline in April. Any sense of how strong March was? And if you have any kind of sense from a triangulation standpoint around perhaps what might have been pulled forward or a certain jump in activity around those preceding week or two to as people lined up projects before shelter-in-place?

Keith J. Allman
President, Chief Executive Officer & Director

A

Mike, you're exactly right on the inside-the-quarter monthly trends. That's what we saw. We saw a nice, call it a single-digit pickup in January and then we got right up near that 20% range in March. So that is where we saw it come in.

In terms of, if that's a pull-ahead volume, or if there's more volume, if that's consistent, that's tough to say. Really don't know at this point. I think the key for us and the theme that John and I are trying to communicate across this broad geographies, broad channels with a lot of uncertainty is that we certainly are thinking about our estimation of where this overall market will land as we move through this pandemic.

But what's more important for us isn't so much the precision of our forecast, what's important for us is flexibility and having the capacity and the appropriate costs to get through this as effectively as we can, while being ready to win and position to win in the recovery. And that includes capacity and it includes investment in technology and R&D and brands.

So that's the way we're thinking about it. But specifically to that inside-the-quarter, you hit it, what we saw in there.

Philip Ng
Jefferies LLC

Q

I guess one more question on the decremental margin. Just curious, how much of that – does that account for any raw mat deflation, particularly in your paint business with oil down pretty dramatically? And any potential lift from any cost takeout initiatives that you might be pursuing down the road?

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John G. Sznewajs
Chief Financial Officer & Vice President

A

Yeah. Phil, I mean, the decremental margins are all inclusive of what we see and what we anticipate in our business across the board. So in terms of raw materials, let me just – I think you touched on that. Let me just give you a sense of how we're looking at raw materials now across the portfolio.

So copper and zinc are down more than 20% y-over-y. Most of that decline took place here in Q1. But that will probably help offset some of the tariff impact that we've been feeling, particularly in H2.

To your point, oil prices have declined here recently. Clearly, that will help our freight costs out. But as I think you're pretty well aware, freight is a relatively small piece of our overall cost structure.

In terms of the commodity basket for paint, the TiO_2 producers have announced price increases. And obviously, in this environment, we'll see how that plays out. Though there has been strong demand across the paint industry, so those could stay in place. And oil prices do impact the raw material basket in paint. Specifically, resin prices follow oil to some extent. But to date, we have not yet seen a material movement in our resin costs or other costs as a result of the decline in oil prices.

Propylene is fairly downstream from crude, and it's held up pretty well so far. And so oil and resins are definitely not a one-for-one relationship by any means. But if oil stays at these levels for a sustained period of time, our guess is that we would anticipate some easing on resin prices, particularly in the back half of the year.

Philip Ng
Jefferies LLC

Q

Perfect. And then just one more for me, Keith and John, you guys have seen a few cycles. Can you kind of give us a sense how you're thinking about the depth and perhaps the duration of this downturn, how you're positioned coming out of it? It seems like it's more of a shock rather than anything real long term, you seem to pretty positive about the outlook. But just kind of walk us through how you're thinking about this cycle vs. the last? Thank you.

Keith J. Allman
President, Chief Executive Officer & Director

A

Yeah, I think it's a little bit of a reprise of a prior comment I made. And that is that the depth and duration of the impact of this pandemic is unknowable. And that while we certainly are working hard to understand and to look at both trailing and leading indices and metrics to give us the best color that we can, most importantly, we're talking to our customers and our consumers to try to understand how they feel about the nature of demand, but it's unknowable.

So our focus is on flexibility and being able to win in any shape of the recovery and any length of duration and that goes back to managing our cost structure in the short term. And then when we move into the recovery period to focus on winning and taking market share through our leading brands and continued investment in those brands and innovation and having the capacity to support it and that's exactly what we're going to do.

Susan Maklari
Goldman Sachs & Co. LLC

Q

I just wanted to follow up on the capital allocation side of things. Recognizing that the uncertainty has caused you to pull back on your repurchase activity. But given the liquidity position in your cash balances and things, what

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would you need to see to start getting back in the market again? And any updates that you can give us along with that on the M&A pipeline and any changes there.

John G. Sznewajs
Chief Financial Officer & Vice President

A

Yeah. Sure, Susan. As we said in our prepared remarks, we're watching the situation closely. But fundamentally, our long-term capital allocation objectives have not changed, right? We want to be disciplined and balanced in how we approach it.

And as we discussed, we're going to be conservative on our liquidity here in the near term. We have suspended our share repurchase activity and we'll continue to evaluate our liquidity and market conditions before we resume it. So we have to have some sense that things are starting to get a little better.

With respect to M&A, the situation may produce some attractive opportunities in the near term. Don't know. Oftentimes, it takes sellers some time to readjust their expectations to market conditions. And so you might not see as many, but we continue to evaluate M&A though we'll be highly selective. It's got to be the right strategic fit, right return.

And then we're committed to our dividend. We do view our current payout as reasonable considering our level of liquidity and our cash generation. So given our strong cash flow, we'll be conservative in the near term and continue to evaluate market conditions and continually reevaluate how we want to proceed.

Justin Andrew Speer
Zelman & Associates

Q

I know it's not an easy time, but just a few more questions. What is the typical incremental volume – or incremental margins on volumes for your business in a normal type of environment?

John G. Sznewajs
Chief Financial Officer & Vice President

A

Typically, it'd be 30% to 35%, Justin.

Justin Andrew Speer
Zelman & Associates

Q

So most of the disruption associated with, like, distancing efforts and supply chain disruptions are the things that explain, I guess, the delta there?

John G. Sznewajs
Chief Financial Officer & Vice President

A

Correct. Yeah. Here in the near term, yes.

Justin Andrew Speer
Zelman & Associates

Q

Okay. And then in terms of the – we know that the raw material basket, in general, has been favorable. I know that you mentioned maybe some partial offsets to the negative. But in terms of price dynamics across your portfolio, including your coatings business or your paint business as well as your plumbing business, across your

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portfolio, how do you expect price trends to hold up in this kind of air pocket kind of environment where you do have raw material tailwind but recognizing also volume headwind.

John G. Sznewajs
Chief Financial Officer & Vice President
A

Yeah. I think pricing dynamics across the portfolio will vary. Our European business is different. They generally have put – and they had put price in earlier this year. It may differ by channel here. From time to time, we may put some price points in the trade or wholesale channel. With respect to paint, just given the nature of our relationship with one customer, we don't discuss our pricing, our conversations with that individual customer.

Justin Andrew Speer
Zelman & Associates
Q

Okay. And then last question for me is just the cash conversion of the model, just maybe the way we can kind of think about it is you can look at it as FCF as a percentage of revenues or FCF as a percentage of net income. How do you think that holds up in this type of environment as you sensitize your model?

John G. Sznewajs
Chief Financial Officer & Vice President
A

Yeah. I think it holds up reasonably well, Justin. I mean, we were – at the beginning of the year before any of this really emerged, we were talking about 100% FCF conversion on net income. And given the way our CapEx comes down, our working capital can come in, we believe we can maintain that 100% FCF conversion on net income through this period of time.

Garik Shmois
Loop Capital Markets LLC
Q

Just wanted to follow-up on the spa business; your commentary sounded like the demand is pretty encouraging. I'm just wondering, if you look back on how that business performed in past recessions, so how did that hold up given the more affluent nature of the target market? I'm just trying to get a sense of how sustainable some of that pent-up demand could be right now or if there is any lag effect in the downturn?

John G. Sznewajs
Chief Financial Officer & Vice President
A

Yeah. In past cycles, Garik, as you might expect, and particularly in the last cycle, because it was a housing-led recession, this unit saw some pretty significant volume declines in the 2008-2009 recession. And so I'm not certain this is an apples-to-apples comparison today vs. what we experienced last time. We would expect there to be some softening, just given the impact to the broader economy.

But we feel pretty good about how this company is positioned, because you may recall in the last recession, a fair number of their competition fell by the wayside or went bankrupt. And so they picked up a fair amount of share. Now that we have them as the market leader, we'd expect them to maintain that position even through this cycle.

Yeah, and I think an important piece to note there, Garik, is this company never lost money, even in the worst of the 2008-2009 recession.

Keith J. Allman
President, Chief Executive Officer & Director
A

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We like the fundamentals of this space as well. When you think about wellness and health benefits of spas, it's pretty incredible. I'm a new spa owner, relatively new, about a year. And I can count on one hand the times where I've been home and haven't taken a spa. It's great for the social aspect of the family. It's great for health, particularly for aging people. It helps you sleep better. It is a great product that's positioned well for the demographics of the United States. And it's our most international – or second most international business.

So I think that geographic dispersion is real strong. And we have 1,000-plus of the best dealers out there and we have a leadership team that is very strong at developing those leaders. So all-in-all, we like this business very much.

Seldon Clarke Q
Deutsche Bank Securities, Inc.

Appreciate the color on quarter-to-date trends and sales guidance, but could you just give us a sense of what this assumes as it relates to volume growth and price/mix and whether the current environment has changed your pricing strategy at all, just given the impact of tariffs on Q2?

John G. Sznewajs A
Chief Financial Officer & Vice President

So Seldon, you may remember that we put most of our pricing in related to the tariffs early in 2019. And so we really covered that and feel we're covered off on that last year. The balance of the pricing dynamics, yes, we're really not going to talk about future pricing actions on this call.

Truman Patterson Q
Wells Fargo Securities

So big picture, you have $1.8B in liquidity. You have defensively positioned businesses that drive a lot of cash flow. Could you just discuss your thoughts on maybe pulling forward some of the investments in your hub stores for the BEHR contract or maybe go out, get a little bit more offensive, try and gain more share in that channel during this downturn?

Keith J. Allman A
President, Chief Executive Officer & Director

We're committed to the growth in the PRO. It's a segment, as I talked about, that with the leverage we're getting has improved in profitability over the years. So it's a good business for us. And we have a good sales pitch, if you will. We have a good value proposition for the PRO there, particularly the PRO that's already shopping at The Home Depot. So we like that business. We're going to continue to invest in it. We're going to continue to invest in both people, technology, hub stores. We're going to continue to work and understand where the best investment is to make at any given time.

In terms of the specifics, we're not going to talk about that. But in a more general sense, we're going to continue to invest in that. And we think we have a very good reason to do that, both in terms of value and ability to win.

Steven Ramsey Q
Thompson Research Group LLC

Just wanted to discuss Kichler for a minute; can you maybe discuss how the current impact the adjustments you have to make in the near term impacts the longer-term cost structure reductions and changes you're making to that unit?

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Keith J. Allman
President, Chief Executive Officer & Director

A

Well, we're continuing to work as we are across our entire portfolio to optimize our cost structure, understanding that there is a short-term hit that we're taking as we're in, what I would call, the crisis. But we want to have our capacity and product development capabilities, et cetera, in place for when we have the recovery.

So we're looking individually across our portfolio at what that means. And we're continuing to evaluate it. And I think we're going to learn a lot over the next quarter or two, as we really see what happens as states open up. So we're looking across the business at our cost footprint at all of our business units.

Keith J. Allman

President, Chief Executive Officer & Director

CLOSING REMARKS

- I think we're going to conclude the call
- We tried to make this a little bit of a different call, given the fact that this is a different situation to dwell into as much detail and with as much transparency as we can as it relates to how we're thinking about this business
- I want to encourage everyone to stay safe and be healthy
- And I hope that you and your families are getting along as well as you can in this crisis. Thank you very much for giving us your time. Bye-bye

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