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- Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO
- Karen J. Holcom - Acuity Brands, Inc. - Senior VP & CFO
- C. Dan Smith - Acuity Brands, Inc. - Senior VP, Treasurer & Secretary

Conference Call Participants

- [Brian K. Lee - Goldman Sachs Group Inc., Research Division](#) - VP & Senior Clean Energy Analyst
- [Timothy Ronald Wojs - Robert W. Baird & Co. Incorporated, Research Division](#) - Senior Research Analyst
- [Joseph Amil Osha - JMP Securities LLC, Research Division](#) - MD and Senior Analyst
- [Christopher D. Glynn - Oppenheimer & Co. Inc., Research Division](#) - MD and Senior Analyst
- [Deepa Bhargavi Narasimhapuram Raghavan - Wells Fargo Securities, LLC, Research Division](#) - Associate Analyst
- [John Fred Walsh - Crédit Suisse AG, Research Division](#) - Director

Presentation

Operator - -

Good morning and welcome to Acuity Brands Fiscal 2019 Fourth Quarter Financial Conference Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time. Now I would like to introduce Mr. Dan Smith, Senior Vice President, Treasurer and Secretary. Sir, you may begin.

C. Dan Smith - Acuity Brands, Inc. - Senior VP, Treasurer & Secretary

Thank you, and good morning. With me today to discuss our fiscal 2019 fourth quarter and full year results are Vern Nagel, our Chairman and Chief Executive Officer; and Karen Holcom, our Senior Vice President Chief Financial Officer. We are webcasting today's conference call at acuitybrands.com. I would like to remind everyone that during this call, we may make projections or forward-looking statements regarding future events or future financial performance of the company. Such statements involve risk and uncertainties such that actual results may differ materially. Please refer to our most recent 10-K and 10-Q SEC filings and today's press release, which identify important factors that could cause actual results to differ materially from those contained in our projections or forward-looking statements. Now let me turn this call over to Vern Nagel.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

Thank you, Dan. Good morning, everyone. We had a solid fourth quarter given market conditions and look forward to providing you with further analysis of our results in a moment. However, before I start, I would like to introduce to you, Karen Holcom, as our new Chief Financial Officer. Karen is a 21-year veteran at Acuity and knows our business and strategy exceedingly well. More importantly, she is focused on helping to execute our strategy to optimize value for our key stakeholders. Please join me in welcoming Karen to her new role. Karen succeeds Ricky Reece as CFO, who was recently promoted to President of Acuity. We will leverage Ricky's experience and knowledge of our business with his primary focus to drive our commercial growth plans. So with those announcements complete, Karen and I would like to make a few comments, and then we'll be happy to answer your questions. 2019 was one of the most challenging years we've experienced at Acuity. The markets we serve were in a constant state of flux throughout much of the year. Inflationary pressures at the beginning of the year were exacerbated by a number of market shocks, including the addition of significant tariffs placed on Chinese-made components and finished goods, uncertainty created by the threat of further trade actions and labor shortages in key markets. These issues and more create a great economic uncertainty, tempering demand for lighting products in both the residential and nonresidential construction markets. Further, we and our many channel partners had to deal with multiple price increases due to rising costs and tariffs, which further whipsawed demand creating great stress and uncertainty for our supply chain. Obviously, these issues pose many significant challenges for us to manage, yet we

feel our performance was strong given this environment. We made the decision early on to focus on those opportunities that were within our control, optimizing where we could and reacting quickly with the best of our abilities to those market influences that were beyond our control, including tariffs and the continued threats of additional ones. Our many actions to optimize our performance in this environment included multiple price increases, introduction to new products and solutions and aggressive initiatives to drive company-wide productivity. Part of this effort included eliminating or reducing our exposure to certain products whose profitability was most negatively impacted by the tariffs and sold primarily through the retail sales channel. While these actions resulted in lower net sales, they serve to significantly enhance our adjusted profit margins and our free cash flow. I know many of you have already seen our results and Karen will provide more detail later in the call, but I would like to make a few comments on the key highlights. First for the fourth quarter. Net sales for the quarter were \$938 million, down almost 12% from the year ago period, certainly more than we originally anticipated. Reported operating profit was \$103.3 million compared with \$143.7 million in the year ago period. Reported diluted earnings per share \$2.42 compared with \$2.70 in the year ago period. There were adjustments in both quarters for certain special items as well as certain other add-backs necessary for our results to be comparable between periods, as Karen will explain later in the call. In adding back these items, one can see adjusted operating profit for the fourth quarter of 2019 was \$146.1 million or 15.6% of net sales compared with adjusted operating profit of \$156 million in the year ago period or 14.7% of net sales. Adjusted diluted earnings per share was \$2.75, a quarterly record, up 3% from the year ago period. Now for the full year. Net sales in 2019 were \$3.7 billion, essentially flat from 2018, despite the drop in net sales in the fourth quarter. Reported operating profit was 406 -- excuse me, \$463 million compared with \$461 million in the year ago period, while diluted earnings per share was \$8.29 compared with \$8.52 earned in the year ago period. Adjusted operating profit was \$528 million compared with \$534 million reported in the year ago period. Adjusted operating profit margin in 2019 was 14.4%, down 10 basis points from a year earlier. Adjusted diluted EPS was \$9.57, a record up 8% from 2018. In addition, we generated a record \$495 million in net cash provided by operating activities this year as we significantly reduced inventory levels primarily due to improved supply chain performance. Karen will provide more detail on this later in the call. We closed the year with \$461 million in cash on hand, even after repurchasing \$82 million of the company shares, spending \$53 million for capital expenditures and funding \$21 million in dividends this year, leaving us with plenty of capacity to execute our growth strategies. Lastly, I'm pleased to report, we estimate that our return on invested capital in 2019 was 800 basis points greater than our average -- weighted average cost of capital. We believe that our many return performance metrics are industry-leading, your own calculations will highlight these positive returns. Looking at some specific details for the quarter. Net sales were down 11.6%

when compared with the year ago period. Overall, net sales volume declined slightly more than 16%. Changes in price/mix were favorable by approximately 5% compared with the prior year. This improvement was primarily due to implemented price increases and changes in channel mix, partially offset by changes in the mix of products sold. We estimate the realization from recent price increases contributed low single digits to our positive price/mix performance this quarter. Other items influencing the change in net sales this quarter were not collectively or individually significant. These next few points are very important in explaining the movement in our top line. From a channel perspective, while we experienced declines in most channels, there were 3 key areas of significance. First, lower shipments to the retail channel accounted for more than half of the total decline in net sales this quarter compared with the year ago period. The largest portion of the decline in this channel was primarily due to the impact of load-ins in the year ago period for certain new customers, which did not repeat this year. The remaining portion of the decline in this channel was due in part to actions taken by the company to perform a comprehensive review of our product portfolio to eliminate or significantly reduce shipments of those products whose profitability was most negatively impacted by the additional tariffs. As we mentioned in previous earnings calls, we expected these efforts to result in lower net sales primarily in the retail sales channel. Second, net sales through our independent sales network and our direct sales network were off by approximately 4% this quarter. Our performance in these 2 channels was impacted by some pull-forward of orders into the third quarter to avoid an increase in product prices due to additional tariffs, continued weak demand, primarily for larger commercial projects and the completion of certain larger infrastructure projects in the year ago period, partially offset by implemented price increases, market share gains in certain lighting categories, including Lighting Controls and our Contractor Select portfolio as well as growth of our building management solutions platform at Distech, which again, performed exceptionally well this quarter. While shipments in the C&I market, included within our independent sales network channel were down slightly, we believe that our performance was reflective of overall market conditions and not specific to Acuity. Lastly, net sales in our corporate accounts channel were down 20% this quarter compared with the year ago period, primarily due to the completion of certain projects in the year ago period that did not repeat this quarter and to a lesser degree, slower releases for certain renovation projects. As we have noted in previous earnings calls, while we expect net sales through this channels to be very lumpy based on the nature of the construction cycle of the customers served, primarily big-box retailers, we continued to add to the total square footage covered by our connected lighting Atrius-based IoT solutions. I'll speak more about the advancements in this channel later in the call. With regard to the impact on net sales for changes in price/mix, the overall net impact was significantly positive this quarter. While it is not possible to precisely determine the separate impact of changes in price and mix, we

estimate the impact of price increases contributed low single digits to our positive price/mix performance this quarter. This positive price capture was further enhanced by changes in channel mix, partially offset by the mix of products sold. The positive change in channel mix this quarter was mostly influenced by the decline in net sales of lower-margin products sold through the retail channel, partially offset by product substitutions to lower-priced alternatives, primarily for more basic, lesser-featured LED luminaires sold in certain channels as well as a modest decline in shipments for larger commercial projects. Our adjusted operating profit for the quarter was \$146 million, down approximately \$10 million compared with the year ago period. While adjusted operating profit margin for the quarter was 15.6%, up 90 basis points from the year ago period. This was the highest adjusted operating profit margin posted by the company in the last 7 quarters and meaningful improvements on both a sequential and year-over-year basis. Furthermore, there are some additional points for you to consider as you evaluate our financial performance in the quarter. First, our adjusted gross profit margin for the fourth quarter was 42.1%, an increase of 320 basis points compared with the year ago period, a huge improvement. Adjusted gross profit was \$395 million, down approximately \$18 million from the year ago period. The decline in adjusted gross profit was primarily due to lower net sales within the independent sales network and corporate accounts, the impact from the under absorption of manufacturing operating costs as a consequence of our inventory-reduction efforts this year compared with the year ago period and to a much lesser degree, the drop in net sales through the retail sales channel. We estimate the negative impact on gross profit due to the under absorption of manufacturing operating cost was approximately \$10 million this quarter. Further, if one were to compare the change in adjusted operating profit this quarter compared to the year ago period, excluding the impact of under absorption of manufacturing operating costs in both periods, the decline in adjusted operating profit this year would have been only approximately \$5 million on a decline in net sales of \$123 million. The really important point here is that our efforts to prune our product portfolio and reduce our channel exposure to those products that did not meet our profit profile and to capture price as well as improve our supply chain performance, all had a positive impact on our adjusted profit margins this quarter, while not unduly impacting our profitability. Also, our adjusted SDA expenses were down approximately \$9 million compared with the year ago period. Adjusted SDA expense as a percentage of net sales was 26.5% in the fourth quarter, an increase of 230 basis points from the year ago period, primarily due to the decline in net sales. The decline in SDA expense was primarily due to lower freight expense as a result of the drop in net sales and productivity improvements. Our adjusted diluted EPS was a quarterly record of \$2.75 compared with \$2.68 reported in the year ago period, an increase of 3%. The increase was primarily due to the higher adjusted net income, which was benefited primarily by a lower effective tax rate this quarter as well as lower average shares outstanding. Before

I turn the call over to Karen, I would like to comment on a few important accomplishments this year. On the strategic and technology front, we continue to make significant strides, setting the stage for what we believe will be solid growth in revenue and profitability over the long term. In 2019, we introduced almost 100 new product families, expanding our industry-leading portfolio, partially offsetting the impact of our pruning efforts to reduce the sale of lower-margin products sold primarily in the retail channel where price capture was a challenge. Our new product introductions continue to be well-received by the markets, some winning various awards for innovation. We gained or maintained our market share in many important product categories and sales channels. Tier 3 and 4 solutions grew approximately 15% this year and now make up approximately 20% of our total revenues. From a commercial perspective, 2019 brought continued success of our connected lighting Atrius-enabled solutions. Our products and services enjoy strong market acceptance in retail applications, now deployed in over 5,000 retail stores in North America, getting over 5,000 million square feet of sales force space under our connected lighting sensory network. We have several large retailers with our Atrius SaaS applications now deployed or in detailed evaluation. Initially, we received feedback that our retail clients found that the energy and maintenance benefits of our intelligent luminaires to be a strong economic value proposition, while also seeing embedded future-proof sensors as a nice-to-have. Currently, those early technology adopters are now activating Atrius services as part of their customer engagement, customer insight and associate productivity enhancement programs. Increasingly, we see data analytics and data science opportunities generated by our connected lighting Atrius platforms as critical areas of investment, allowing retailers and now others to garner valuable insights about their businesses from our services. Additionally, we expanded our connected lighting Atrius-based solutions into other verticals as awareness by these customers of our meaningful points of differentiation and the broad capabilities of our IoT solutions increased significantly, particularly as they realize the opportunity to transform their spaces from expense items to strategic assets. Today, we have nearly 10 million square feet of connected lighting, Atrius-enabled space in passenger terminals at 4 of the top 10 airports in the United States, including Atlanta, Denver, Las Vegas and Seattle, which handle approximately 125 million passengers per year, with more projects on the way. Net sales of our Contractor Select portfolio grew nicely in 2019, particularly in the C&I market and now makes up approximately 10% of our net sales. Contractor Select is our fighter brand in response to the Chinese-based lighting companies, many of which we believe are clearly being subsidized in some form that are influencing pricing for certain basic, lesser-featured fixtures sold in certain channels. Again, we are very pleased with the growth and profitability of this product portfolio and will not yield this portion of the market for many strategic reasons. We made significant strides in expanding our industry-leading lighting control platform and light as well as our building management

system business, Distech, where both units grew double digits in 2019. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control systems available and importantly, are connected to our growing BMS solution, providing customers with even greater functionality. Further, we initiated many actions this year to further streamline our operations to reduce cost and improve our productivity. We believe these initiatives will enhance our future operating and financial performance as well as allow us to accelerate investments in areas with higher growth opportunities. Also, as I noted in our previous earnings call, we initiated comprehensive reviews this year in 2 key areas of our company: compensation; and environmental, social and governance or ESG. These reviews, which included feedback and insights from our shareholder base, resulted in important modifications and enhancements to both programs. Our ESG program is helping us to identify further opportunities to drive efficiencies, reduce cost, increase our positive impact on the environment and increase associate engagement and satisfaction. And lastly, we continue our efforts to complement our solutions portfolio with strategic acquisitions and investments, including the acquisition of The Luminaires Group in mid-September. The Luminaires Group is a leading provider of specification-grade luminaires for commercial, institutional, hospitality and municipal markets, all of which complements our architectural platform. We are pleased to welcome the 350 associates of The Luminaires Group to the Acuity family. Our solid performance this year is a result of the dedication and resolve of our 12,000 associates, who are maniacally focused on serving, solving and supporting the needs of our key stakeholders. I will talk more about our expectations for fiscal year 2020 later in the call. I would like to now turn the call over to Karen. Karen?

Karen J. Holcom - Acuity Brands, Inc. - Senior VP & CFO

Thank you, Vern, and good morning, everyone. I am happy to be on the call with you today. As Vern mentioned earlier, we had a few adjustments to the GAAP results in the fourth quarter and for the full year of fiscal 2019 and 2018, which we find useful to add back in order for the results to be comparable. In our earnings release, we provide a detailed reconciliation of non-GAAP measures for the fourth quarter and full year of fiscal 2019 and 2018. Adjusted results exclude the impact of amortization expense for acquired intangible assets, share-based payment expense, manufacturing inefficiencies and excess inventory adjustments directly related to the closure of the facility, acquisition-related items, special charges for streamlining activities, a gain on the sale of our former Spanish lighting business and an income tax benefit for discrete items associated with the Tax Cuts and Jobs Act. We believe adjusting for these items and providing these non-GAAP measures, provides greater comparability and enhanced visibility into our results of operations. We think you will find this transparency very helpful in your analysis of our performance. Recall that during the fourth quarter of fiscal 2018, we reversed pretax special charges of \$5 million as certain

previously planned streamlining activities were no longer expected to occur primarily because we were successful in selling our former Spanish lighting business for a gain during the quarter. During the fourth quarter of this fiscal year, we recorded net pretax special charges of \$0.5 million, related primarily to certain streamlining activities. Additionally, in the fourth quarter of fiscal 2019, we incurred \$1.3 million of expenses related to acquisition and investment activities. The effective tax rate for the fourth quarter of fiscal 2019 was 20.2% compared with 21.1% in the year ago period. The decline in the current fiscal tax rate reflects a lower blended federal statutory tax rate and certain research and development cost tax credit, including claims for prior periods recognized during the fourth quarter of fiscal 2019. Prior year's fourth quarter tax rate benefited from \$3.4 million of discrete income tax benefit, resulting from the TCJA. We currently estimate that our blended effective income tax rate, before discrete items, will approximate 23% for fiscal 2020. Shortly after the end of our fourth quarter, on September 17, 2019, we completed the acquisition of The Luminaires Group, headquartered in Montréal, Canada. The Luminaires Group, which is comprised of 5 distinct brands, is a leading provider of specification-grade luminaires for commercial, institutional, hospitality and municipal markets. TLG generates annual sales of approximately \$100 million and employs over 350 associates, located across 5 locations in the U.S. and Canada. Management expects that the acquisition will be immediately accretive to fiscal 2020 adjusted earnings. We did not disclose the terms of the acquisition. We generated a record \$495 million of net cash flow provided by operating activities during fiscal 2019 compared with \$352 million for the year ago period, an increase of \$143 million. We reduced our inventory by \$71 million during fiscal 2019 as a result of our efforts to improve inventory turns, which we have accomplished, while also improving customer service. At August 31, 2019, we had a cash position of \$461 million, an increase of \$332 million since August 31, 2018. The increase was due primarily to record net cash flow from operations, partially offset by cash used to repurchase common stock, invest in plant and equipment and pay dividends. We repurchased 650,000 shares of the company's common stock for \$82 million during fiscal 2019. We have approximately 4.6 million shares remaining under our current authorization. Our investment and capital expenditures were \$53 million for fiscal 2019 or approximately 1.4% of net sales. We currently expect to invest approximately 1.7% of net sales in capital expenditures in fiscal year 2020. Last year, we executed a new 5-year unsecured revolving credit facility and term loan with a syndicate of banks that provides us with a total of \$800 million of borrowing capacity, of which \$796 million was available at August 31, 2019. Our total debt outstanding was \$357 million at August 31, 2019, and our debt to capitalization at August 31, 2019, was 16%. Our \$350 million senior unsecured notes mature in December 2019. We intend to refinance these borrowings using availability under our \$400 million unsecured delayed draw 5-year term loan facility. Our record cash flow performance in fiscal 2019 has afforded us with significant

financial strength and flexibility to support our growth opportunities, which may include additional acquisitions. We will continue to seek the best use of our strong cash generation to enhance shareholder value. Thank you, and I will turn it back to Vern.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

Thank you, Karen. This is probably the most important portion of this call, our outlook and our focus for 2020. While current market conditions in the overall lighting industry continue to be challenging, we are optimistic regarding our long-term future and that of our key markets. We believe our many actions to improve our market reach, enhance our customer solutions and capabilities and drive company-wide productivity will help optimize our financial performance in the future while affording us the opportunity to continue to invest in areas we believe have high profitable growth potential over the long term. That notwithstanding, we believe current market demand for lighting is sluggish. We believe the catalyst for these tepid conditions is primarily due to continued concerns over key economic issues, including global trade policies and the potential for future tariffs. We expect these market conditions to continue for the foreseeable future and until such time as there is more clarity and certainty regarding these key economic issues. In addition, we believe there are a few other factors that will continue to influence the lighting market, including continued product substitution to lower-priced alternatives for certain products sold through certain channels, labor shortages in certain markets and continued cost increases, particularly for imported electronic -- electrical components and finished goods, freight and wages, though recent pricing action should help to mitigate some of these factors. Given this market environment, we can only focus on those areas within our control and react to the best of our abilities to those influences beyond our control. We believe that maniacal focus on a few key areas coupled with precise execution of our plans will afford us the best opportunity to produce favorable results for our key stakeholders. So in 2020, our primary focus will be on 2 key areas: growth through market share gains, and margin improvement. Let's start with our growth initiatives. Our focus will be on the following: number one, leverage our leading access to market with continued new products and solutions based on our tiered solution - or tiered strategy approach. Similar to the last few years, we are, again, planning to introduce over 100 new product families in 2020, many with embedded Controls technology as well as further leveraging our architectural brands with the acquisition of The Luminares Group. Number two, accelerate the expansion of our connected lighting Atrius IoT solutions platform, both in retail, where we continue to have great success and into new verticals, including transportation, healthcare, warehousing and distribution and commercial office. To do so, we are adding additional resources and capabilities with the creation of our applied technology team to focus on these additional verticals and to build on the success we are having in the retail vertical. As I noted earlier, our initial efforts into these new verticals is

encouraging. Number three, accelerate our efforts to capture additional market share for discretionary renovation projects in multiple channels. The installed base continues to represent a huge opportunity for profitable growth. And number four, build on the success of our Contractor Select portfolio to drive further growth for certain basic, lesser-featured fixtures. With regard to margin improvement initiatives, our focus in 2020 will be in the following key areas: number one, capture profit and margin growth through the introduction of new products and solutions; number two, continue to reduce our product cost through the redesign -- through redesign efforts; number three, finalize the consolidation and closure of 2 distribution locations by the end of the first quarter to reduce our cost base; number four, drive further company-wide productivity gains through our lean deployment processes; and lastly, manage our fixed operating cost by exploring opportunities to further leverage our supply chain footprint and our SDA investment. These growth and margin improvement initiatives in 2020 are part of our long-term growth strategy to fulsomely leverage our market leadership position with technology-enabled solutions that are differentiated and valued by customers so we can gain further market share and to appropriately structure our business to the current opportunities to enhance our profitability and cash flow. Further, we believe the sales of our Lighting and BMS Control solutions as well as our Atrius-based luminaires, all within our Tier 3 and 4 categories, will continue to expand, though, and I would like to again emphasize, it will be lumpy at times because of the unpredictability and timing of customers' renovation and new construction schedules as well as the volatility in demand caused by global trade and political issues. The next point is very important. While as a matter of policy, we don't give earnings guidance, we feel it is important for all investors and analysts to understand that we believe our net sales could be down again this coming first quarter compared with the year ago period. The primary reason for this is that net sales last year were significantly benefited by the pull-forward of orders from customers attempting to avoid implemented price increases due to inflationary pressures and the impact of tariffs enacted on certain components and finished goods manufactured in China and to a lesser degree, the continued load-in to a new customer in the retail sales channel, which resulted in a combined 11% growth in net sales in the year ago period. At that time, we acknowledged it was impossible for us to quantify the precise impact of the pull-forward of orders due to the then implemented price increases. Because we do not expect either of these situations to repeat this quarter, it makes our ability to quantify the changes between the first quarter of 2020 to the year ago period a significant challenge. The situation is further exacerbated by continued pruning of our product portfolios noted earlier. Nonetheless, our best guess is that net sales could be down in the first quarter of 2020 compared with the same period in 2019 in the mid- to high single-digit percent, partially offset by the addition of The Luminaires Group. Additionally, as we noted earlier, we initiated a review in late 2019 of our product portfolio and services offered primarily through the retail channel with the objective of

eliminating those items and activities that do not meet our financial objectives. These efforts have and should continue to impact our topline growth rate and could be further exacerbated by future trade policy changes and potential additional tariffs. Further, the execution of our integrated tiered solutions strategy, including the expansion of our Tier 3 and Tier 4 holistic lighting, building management and our Atrius IoT platform and software solutions and our opportunities to participate in the interconnected world is an integral part of our overall growth -- long-term profitable growth strategy to meaningfully expand our addressable market by adding broad-based holistic solutions that will allow our customers to transform their connected intelligent buildings and campuses from cost centers to strategic assets. As I noted earlier, we intend to make additional investments in this area in 2020, including potential acquisitions and minority investments to drive our market-leading advantage in these emerging growth markets. Lastly, our goal is to outperform the growth rates of our key markets and channels. Within the retail sales channel, we expect to participate by servicing the needs of our customers in a mutually beneficial manner. In total, we expect to show positive growth in 2020. While the turmoil in the current environment is unsettling and impossible to predict when the uncertainty gives away to clarity, we believe the lighting and lighting-related industry, as well as the building management systems market, have the potential to experience solid growth over the next decade because of continued opportunities for new construction and more importantly, the conversion of the installed base, which is enormous in size to more efficient and effective solutions. As the market leader in lighting solutions and a technology leader in building automation, along with our Atrius platform, we believe we are positioned well to fully participate in and lead these exciting and growing industries. Thank you. And with that, we will entertain any questions that you have.

Question And Answers

Operator - -

A. (Operator Instructions) Our first question comes from Christopher Glynn with Oppenheimer.

Christopher D. Glynn - Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst

Q. Karen, welcome to the call. So just curious about maybe a big picture on some of the structural channel shifts, Vern, in the context of the top line pressure reported, just curious from a couple of perspectives about your base run rates in the channel mix evident in the fourth quarter versus go-forward? Is there any way to kind of define what you and the Board are talking about, about the right size of your run rates relative to the volumes? Because

clearly, you're trimming some areas of portfolio. And in particular, is pruning still the right word? Or are you doing something a little beyond what that word suggests?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. So, Chris, I think pruning is the right word. When these tariffs came through, they really created a great deal of turmoil within global supply chains. And so many of us in the industry had to evaluate where we played and why we put forth price increases to help offset that, we took other actions to mitigate component costs increases to mitigate finished good price increases. But to the extent that we were able or unable to get full capture on pricing in some channels, we made the decision to review that portfolio and understand where we needed to play and why. As I pointed out, our Contractor Select portfolio grew very, very nicely in Q4, and it's targeted directly at, what we'll call, competition for the basic, lesser-featured end of the market, which is important market to us. But there are certain channels where we feel we did not realize the type of financial profile that we're after. So we began to, if you will, prune those products and assess which products we could mutually benefit both our customers as well as our shareholders in terms of profit margin. So when we think about our business going forward, the turmoil that has been created in 2 ways, the price increases have created pull-forwards, almost illogical distortions of the market of people trying to avoid those price increases. So it's going to make it very difficult. It made it very difficult in 2019 to really understand period-over-period growth, what was truly happening in the markets. And we think that 2020, at least for the first half, will be exacerbated by the same types of things. We also have a little bit of noise around the fact that we had a load-in of certain customers within the retail channel. So that -- there's just a lot of noise around this. This is why -- again, we don't normally give guidance. We attempted to provide some guidance to the best of our ability by saying that we think that our top line will be impacted by mid- to upper single-digit decline in the first quarter of 2020 compared to 2019. I also said that we expect for the full year to show positive growth. So we're trying to balance off market dynamics with our own ability to drive opportunistic share gain in the marketplace. I think that the profitability improvement that you saw in the fourth quarter is reflective of the actions that we have taken to both protect our business and to grow our business. So you saw the margin improvement at the adjusted gross profit level of about 320 basis points. We're able to leverage that to about 90 basis points at the adjusted operating profit level. So I think you have some reasonable information and insights around margin profile. And I think that some of the commentary that we made around first quarter as well as what we expect for the first year growth to also be helpful to you in modeling.

Christopher D. Glynn - Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst

Q. Yes. Congrats on the gross margin and the free cash flow improvement noted as well. Just building off the last comment to the margin, you did build some momentum through the year on margins. But clearly most pronounced in the fourth quarter here, seemingly a springboard as the components of it seem to be from structural shifts as you evolved a few things during the year. So it is that a pretty clear set up for favorable tailwinds full year margins fiscal '20 comparing to the year just ended?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. I think we should. We expect that we will see favorable margin comparisons in 2020 to 2019. But we expect that to be for the full year. So if I could encourage everyone to not obsess over each quarter, we expect that the full year will be favorable. It's also very interesting to note, and I just wanted to point out again that the un-absorption -- or the under absorption of fixed manufacturing this quarter was almost \$10 million. In the year ago period, the under absorption was almost \$5 million. So when we think about how we're structuring our business and how we're managing that, we did a great job this year in managing our inventory levels down, improving our service, and you saw that in our tremendous cash flow. Part of that tremendous cash flow was the collection of receivables for the load-in of the year ago period. But we've done a great job managing our balance sheet, and I expect that we'll continue to see positive margin improvement in 2020 over 2019.

Operator - -

A. Our next question comes from Deepa Raghavan with Wells Fargo Securities.

Deepa Bhargavi Narasimhapuram Raghavan - Wells Fargo Securities, LLC, Research Division - Associate Analyst

Q. Vern, Karen, welcome. Just dovetailing on that margin improvement question, Vern, can you talk about the drivers to the margin improvement in fiscal '20? I mean you mentioned all these actions, which I guess, it's pretty comprehensive, but can these actions lead you to, say, I'm just throwing a number out there, 41% gross margin improvement for the full year irrespective of volume performance? I guess that's the big question for me. How do we think about your resiliency in a weak volume environment? And on the flip side, how do I think about pricing because that was a big help to margins this time? If tariffs were to ease, I mean, will import competition pick back up and start to pressure margins again? So yes, 2 sides of the coin, so if you will, I'd appreciate it.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Sure. Channel mix was a significant driver to our improvement in margin. So as we ramped up or as our sales through our independent sales network, primarily the C&I market, that

became a larger percentage of the total sales in Q4 relative to the total percentage that retail or sales through the retail sales channel were. So that shift in channel mix had a meaningful improvement on the gross profit margin. I would like to point out, and I think it's really important, if you were to look at, again, the change in our operating profit between periods, excluding the unabsorbed overhead, it was a decline of \$5 million on a drop of almost \$123 million of sales. So I think what the shareholders should take from Acuity is that we are managing our business and our portfolio well to both optimize our profit but also to optimize our profitability and to return back that cash, if you will, in the form of great cash flow because we have deleveraged some of our exposure into some of those markets. From a growth perspective going forward -- from a margin perspective, I'm not going to prognosticate or give guidance around that. What I will say is that we expect the mix of our business to continue to a degree as it is or as we reported in Q4, and that should have a favorable impact on gross profit margins. The notion of the volume and demand in the marketplace to your question is really important. We still expect that the first quarter or market conditions which will impact our first quarter to still be sluggish. Order rates I think in the nearer term continue to be a challenge. I think there is a lot of economic uncertainty out there. So we're looking to not only have issues that -- not issues, but they have items that will impact our first quarter compared to the year ago period. Attempting to quantify that, we gave you some insights as to what we think the top line's going to be, and we'll have to manage our SDA accordingly. But for the full year, we would expect there to see positive improvement. I think a number of the forecast that I see out there are calling for growth in 2020. But those same forecasters are saying that they expect the back half of calendar year 2019 to continue to be flat to maybe even slightly down. I find it to be very interesting when I look at a number of indicators. As you might imagine, we collect all sorts of data. And that data has historically been -- has given us insight into the future. And just a couple that I would point out to everyone. When we look at, for example, the industrial market or the commercial office market, vacancy rates are at a significant low. And you see rising rents in both of these areas. Typically, that would instigate investment in the area, I personally believe that there's a lot of money sitting on the sidelines waiting to get clarity around some of these economic issues that will begin to attack this. I mean these rising rents when people look at that given the interest rate environment, I think it's a very positive opportunity. So I have a cautiously optimistic view of what the future holds. I just think that the shorter term is going to continue to have turmoil because of some of these economic uncertainties.

Deepa Bhargavi Narasimhapuram Raghavan - Wells Fargo Securities, LLC, Research Division - Associate Analyst

Q. Got it. I think a follow-up to the same question that you're talking about is, so if -- let's just say the tariffs start to ease a little bit here, when do you expect -- can a bulk of these projects

that we're talking about that are on the sidelines come back online pretty quickly? And I mean generally, how do we think about election year or actually throwing in some uncertainty on top of it? I appreciate that, and that will be my last question for the call.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Sure. So -- thank you. So our many sales forces continue to see and experience, if you will, record backlogs, which is that projects aren't releasing, and I think it is because of uncertainty around cost. Many of these projects are -- they're years in the making, they're not 1 month. And so, therefore, when they decide that they're going to build a commercial office building that's going to take 2 years from start to finish to come into place, they're trying to project their cost. So the uncertainty of tariffs has a meaningful impact on when they say go. I think as we get clarity around those things, you're going to see more of those projects come to fruition. Architects and engineers, even though the Architectural Billing Index has softened up a little bit here, continue to be very busy. We don't hear of anyone laying people off. So we still think that there's good activity out there. To the extent that our price capture has really gone mostly to offset the tariff increase, so to the extent that tariffs start to abate for whatever reason, I think that you might see some of the pricing readjust, but in our perspective it's been a -- it's been kind of a cost-neutral -- so I wouldn't expect us to see any significant profit profile change because of that, other than we would expect to see volume growth, which is hugely beneficial for Acuity because we have very solid variable contribution margins on an incremental sales dollar of growth.

Operator - -

A. Our next question comes from Brian Lee with Goldman Sachs.

Brian K. Lee - [Goldman Sachs Group Inc., Research Division](#) - VP & Senior Clean Energy Analyst

Q. Welcome, Karen. First one, maybe just on the volume growth, maybe drilling down a little bit, I know there's a lot of moving parts you're adding into 2020, Vern, but on new construction volumes, can you kind of give us a sense for where you think those are tracking at? I know in past quarters, it seemed like you guys have been mentioning sort of down, low single-digit, so if you could maybe update us as to how that, the trend in that particular vertical is looking right now?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Sure. So again, we're not economists, but when we look at information, I think the U.S. Census Bureau does it well. On an inflation-adjusted basis, seasonally adjusted, the overall market for electrical lighting equipment, it's been down like 8 of the last 9 quarters. On an

inflation-adjusted basis, when we look at some of the other items, nonresi has kind of been on a decline here, whereas nonresidential -- I'm sorry, I meant to say resi has been down, nonresidential has been flattish to slightly down. I think what's been popping up a lot of the stuff has been public nonresidential. So we continue to see an environment that is, again, I'll call it sluggish, with a lot of larger projects remaining on the sidelines and people's backlogs not being released. One positive thing that I think is important or -- is the fact that when we look at the Dodge Momentum Index, while it was declining, starting in kind of middle 2018, seems to have flattened out. So I think that when we look at the overall market, we continue to see new construction on an inflation-adjusted basis to be flat to slightly down. For those folks in that portion of the industry that have non, say, deflationary items, unlike the lighting industry, they're probably actually showing some growth.

[Brian K. Lee - Goldman Sachs Group Inc., Research Division](#) - VP & Senior Clean Energy Analyst

Q. Okay. No, that's fair enough. Helpful. And then just a second question here and I'll pass it on. I know you've done this in past quarters as well, clearly, some company-specific issues for you guys are doing the comparing here, but how would you say you compare to the industry growth rate during the quarter? And then I know you traditionally don't give the guidance, but you're giving guidance for Q1. What are you expecting kind of the baseline to be for that quarter and really the reason I ask is there's been a few quarters here now where you've underperformed the market it would seem, so trying to gauge when you think in fiscal 2020, you sort of get back to the, let's call it, trend of being able to outgrow the market?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Yes. So if I look at the overall growth rate of the market as I just commented, the market for the last, again, 7, 8 quarters has been down anywhere from 1.5 to almost 4 points on an inflation-adjusted basis. So Acuity's growth during each of those quarters or performance against that still has outperformed the overall growth rate of the market. I think we've had a couple of things here that are specific to Acuity when we decided to again look at our portfolio and determine the profitability of those items relative to what our expectations are. Yes, we did take some actions that were specific to Acuity around those products in certain channels. But when I look at overall C&I, which is the nonresidential portion of our world sold through agents commercial/industrial, I would say that our performance there is still positive relative to the market. Some of the lumpiness that we have seen in our corporate accounts world has been more due to the timing of releases. As you know, Acuity was the vendor of choice to relight all of the Target locations, and we've completed that. And we have expanded our customer base to now add many, many additional customers, not all of whom has moved as quickly or as large as Target. So we're having, if you will, some lumpiness, that's

what I call it. But yet, our expansion and the amount of footprint that we cover with our connected lighting, Atrius-enabled solutions continues to grow at a formidable rate and now we're expanding that capability into other verticals. So when I look at Acuity's growth and I compare it to the market, I'm looking at various channels and I'm looking at various segments of the market. And where we have participated in the same way, we continue to believe that we are either maintaining or growing market share when we look individually, for example, at our Lighting Controls solutions, we believe we are gaining significant market share. When we look at Contractor Select, it went from being, really a very small portfolio less than 18 months ago, to now almost 10% of our total revenues. And we like the profit margin capabilities off of that. That growth has come in the C&I channel primarily. So I think we are well-balanced, positioned well to continue to outperform the growth rates of the markets we serve. And to the extent that there is business out there that we feel is not mutually beneficial, we're not afraid to look for other channels to serve.

Operator - -

A. Our next question comes from Joseph Osha with JMP Securities.

Joseph Amil Osha - JMP Securities LLC, Research Division - MD and Senior Analyst

Q. Welcome, Karen. I have 2 questions. First one, we think about this free cash flow, which is formidable, and if we were to look forward 12 months and maybe sort of think about how that pie is segmented between additional acquisitions and buybacks, I'm wondering how you're thinking about that, that free cash flow deployment? And secondly, not to harp on, I think the point everyone's harping on, but it seems to me that you could have grown this business more, and taken, call it, a 40% gross margin and the fall through to the operating line probably would have been better. At what point do -- does topline growth begin to become more important than moving this gross margin higher than where it is now?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Sure. So Karen, maybe you take the first question on cash flow, and then I'll answer the second.

Karen J. Holcom - Acuity Brands, Inc. - Senior VP & CFO

A. Sure. Historically, we have spent about 1/3 on acquisitions, 1/3 on share repurchases and 1/3 on CapEx and dividends. So I think we're always looking for ways to optimize shareholder value and surely, share repurchases and acquisitions and dividends and CapEx are part of that. So I think that's where you'll see the use of our cash flow over the next year.

Joseph Amil Osha - JMP Securities LLC, Research Division - MD and Senior Analyst

Q. So no change really, in terms of the...

Karen J. Holcom - Acuity Brands, Inc. - Senior VP & CFO

A. Correct. No change. Yes.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. And I would say that we continue to be opportunistic. We have a very robust pipeline of acquisitions. We just completed the acquisition of The Luminaires Group. We continue to look at not only traditional lighting businesses to complement our portfolio, but also really interesting technologies to complement our connected lighting, Atrius-enabled solutions. Just want to tell everyone, we are making really solid progress in implementing our strategy around Atrius in the connected lighting space. I wish that the SaaS revenues could start to meaningfully move the top line. But as a \$3.7 billion business, there -- it's just -- it's still in its early stages, but it's really encouraging. To your second question on top line growth and letting the margins flow through, I really think it's important that when you do your analysis of Acuity's results, that you consider again the \$123 million change in year-over-year growth or decline in top line. And yet, on an adjusted basis, excluding the unabsorbed overhead in both periods, it impacted our profitability by a drop of only \$5 million. So I think Acuity is really focused on growing its top line to in fact grow its bottom line and improve our profitability. But the moves and the actions that we've taken to adjust our portfolio, I think are really in the best interest of our shareholders and that free cash flow was really powerful and it shows you the power of Acuity. So we balance off how do we have profitable growth and the definition around that, and we define profitable growth at Acuity based on the returns. Our return on invested capital this year was 18%, 800 bps greater than our weighted average cost to capital. We look at other things, like cash flow return on investment. It was almost 35% this year. Our returns are robustly huge. Having said that, we are about growth. And I think 2020, to get growth, it's going to be about market share gains in every channel that we focus on.

Operator - -

A. Our next question comes from John Walsh with Crédit Suisse.

[John Fred Walsh - Crédit Suisse AG, Research Division](#) - Director

Q. Maybe following on that market share gains questions. Some of the levers there that are going to allow you to do that, obviously, the DLC, very important for kind of incentive programs at utilities. I think they're coming out now or just talked about higher, more stringent qualifications to get those and the terms they're using are controllability and quality of light, which should fit very well with your product portfolio. Is that something that can

actually be meaningful? Is that a help to kind of the Tier 1 domestic OEMs versus the imports coming from overseas?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. I think it's a huge impact or can have a huge impact. DLC is very important and in terms of what they require. And so companies that are really focused on quality of light, who have invested significantly in understanding what controls mean. It's not just saying, I can dim a light or turn the light on or off, it's really how does it work in space. And too often, these lesser quality suppliers, people experience tremendous flicker. And so the experience that one has in that space is not good, as DLC points, there's significant influence towards quality of light as well as competitive cost. I think it's going to benefit those manufacturers that have really invested in, on quality of light. So yes, I do. I think it will have an impact.

John Fred Walsh - Crédit Suisse AG, Research Division - Director

Q. And then maybe just another question around the free cash flow, and just thinking about the inventory dynamics. I mean last year, you missed, kind of that 100% conversion that we typically use as a benchmark. This year, you kind of overdrove that. I mean, how should we think about the free cash flow conversion rate going forward? And is there is still any kind of working capital goodness as we think about our next year free cash flow number?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Yes. It's a great question. So our objective is to, as you point out, to have free cash flow in excess of net income. This year, coming up, may be a slight challenge. I think as Karen pointed out, we're expecting to spend between 1.7% and 1.8% on CapEx, that's slightly higher than our depreciation. So that -- just note that as a fact, I think from an operating working capital perspective, we're probably right now, doing this from memory, about 13% of sales, maybe even a little slightly higher than that. I think our total days, our net days are about 56 or 57 days. We brought our payables down, probably a little bit further than what we normally would expect. So I would think that our total days will come down from an operating working capital perspective. We're at about 56 or 57 days for inventory. We have areas to improve there. Our teams are doing a great job. It really depends on what percentage of our business is coming from offshore into North America as we look to really drive performance of our supply chain here in the North American market. We see opportunities to improve our inventory days. So I think you should expect from Acuity a continuation of attempting to meet that goal of 100% conversion of net income to cash flow

Operator - -

A. Our next question comes from the line of Tim Wojs with Baird.

Timothy Ronald Wojs - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Q. Two quick ones for me. I guess, first on the under-absorption, Vern, would you expect that to continue into the first quarter, just given the revenue guidance? That's one. And then second, how should we think of just leverage of SD&A in fiscal '20? I think you did leverage SD&A a little bit in fiscal '19. If you expect modest growth on the top line in 2020, should we expect SD&A to grow similarly? Or can it actually maybe be flat to down?

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. So on the absorption issue, we would expect there to be probably some negative or under-absorption in Q1 versus the year ago period. I haven't done any analysis to know how much that will be. It really depends on the order rate in our ability. We know we can service your order rate, but how does that order rate going to manifest itself? Orders continue to be somewhat sluggish, though we do see some bright spots and we hear encouraging words. Words don't mean much, orders mean everything. So we'll focus on that. But yes, I think you will see a bit of unabsorbed overhead. Not to the significance of what was in Q4, where that number was \$10 million. In the year ago period of Q4, it was \$5 million. I think you'll see a smaller number, less than both of those. But I don't know that, actually. On your SDA question. So here's the challenge, as you might imagine. We're trying to manage SDA and all cost, not just SDA, but all cost. All of our spend, in a way that allows us to be consistent with what the demand is in the current period. But also holding out knowing that we have an expectation that there'll be future improvements in demand. So we're trying to balance off all of those things. As I mentioned, we have a couple of warehouses that we were able to shut down and consolidate, so we could reduce our cost. But we continue to look at all aspects of our business to drive further leverage. We prefer to get the leverage because we have top line growth, but we will manage our fixed cost structure and our variable cost structure based on the environment that we find ourselves in. Our headcount is down approximately 9% on a year-over-year basis. So we've had to manage our business while experiencing these huge spikes, and then, in orders because of people trying to avoid price increases and then boom! The volume or the business falls off. So it's been quite a challenge to manage, but our expectation is to further leverage our SDA. Our costs are up because of wage inflation. It's been a tight labor market out there. And so we'll continue to experience those. We have made some investments in some areas, but we've also deinvested in some other areas. So we will -- I think, Dan, we finished the quarter at about 26.5% SDA as a -- I have it here someplace.

C. Dan Smith - Acuity Brands, Inc. - Senior VP, Treasurer & Secretary

A. Yes, correct.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. So 26.5%, but I think the bigger, or the more important aspect of it is, what will the spend dollars be? We could see a little bit of an increase, it just depends on what the drop off in volume's going to be in Q1, knowing that we have -- we're carrying a little bit more expense from Q4 into this coming Q1 compared to what occurred last year. So probably have a little bit of a challenge there in Q1. But I think for the full year, we will -- you will see leverage in our total fixed cost opportunities.

Operator - -

A. I would like to turn the call back over to Mr. Vernon Nagel for closing remarks.

Vernon J. Nagel - Acuity Brands, Inc. - Chairman & CEO

A. Thank you, everyone, for your time this morning. Again, we strongly believe we are focusing on the right objectives, deploying the proper strategies and driving the organization to succeed in critical areas that have the potential, over the longer term, to deliver strong returns to our key stakeholders. Our future is bright. Thank you for your support.

Operator - -

A. Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.