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Corporate Participants

- Vernon J. Nagel - Acuity Brands, Inc. - Chairman, CEO & President
- Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP
- C. Dan Smith - Acuity Brands, Inc. - Senior VP, Treasurer & Secretary

Conference Call Participants

- [Jeffrey Todd Sprague - Vertical Research Partners, LLC](#) - Founder and Managing Partner
- [Timothy Ronald Wojs - Robert W. Baird & Co. Incorporated, Research Division](#) - Senior Research Analyst
- [Ryan James Merkel - William Blair & Company L.L.C., Research Division](#) - Research Analyst
- [Jeffrey David Osborne - Cowen and Company, LLC, Research Division](#) - MD and Senior Research Analyst
- [John Fred Walsh - Crédit Suisse AG, Research Division](#) - Director

Presentation

- Operator - -

Good morning, and welcome to Acuity Brands Fiscal 2019 Third 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 third quarter results are Vern Nagel, our Chairman, President, and Chief Executive Officer; and Ricky Reece, our Executive Vice President and Chief Financial Officer. We are webcasting today's conference call on our website 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 & President

Thank you, Dan. Good morning, everyone. Ricky and I would like to make a few comments, and then we'll answer your questions. Our results for the third quarter were very solid despite continuing inflationary cost pressures, the impact of tariffs and further uncertainties caused by U.S. trade policies. We implemented several programs to address these cost issues, including additional price increases, product and freight cost reductions and further actions to improve productivity. We believe our top line growth this past quarter was negatively impacted by the pull forward of orders from customers into the first half of the year, as they acted to avoid announced price increases as well as reduced shipments in the retail channel due to efforts initiated this year to eliminate products within our portfolio that do not meet our profitability hurdles, primarily in the retail channel. I will provide greater detail on our sales mix later in the call. Additionally, we are pleased that our adjusted gross profit margin exceeded 40% for the first time in the year and improved sequentially for the third quarter in a row. Our adjusted diluted earnings per share of \$2.53 was a third quarter record. I know many of you have already seen our results, and Ricky will provide more detail later in the call, but I would like to make a few comments on the key highlights for the third quarter of 2019. Net sales were \$948 million, a slight increase over the year ago period. Reported operating profit was \$120.3 million compared with \$107.4 million in the year ago period. Reported diluted earnings per share was \$2.22 compared with \$1.80 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 Ricky will explain later in the call. In adding back these items, one can see adjusted operating profit for the third quarter of 2019 was \$135.5 million, a 14.3% of the net sales, compared with adjusted operating

profit of \$137.3 million in the year ago period, a 14.5% of net sales. Adjusted diluted earnings per share was \$2.53, a third quarter record, up 7% from the year ago period. Results this period were benefited by lower effective tax rate, as Ricky will explain later in the call. Net cash provided by operating activities was a strong \$312 million for the first 9 months of the year, up nicely over the year ago period. And our cash position at the end of the quarter grew to \$334 million leaving us with plenty of liquidity to execute our growth strategies. Looking at some specific details for the quarter. Net sales were essentially flat when compared with the year ago period. Overall, net sales volume grew more than 1%, which was mostly offset by unfavorable foreign exchange rate and the adoption of ACS 606 (sic) [ASC 606]. Changes in product prices and the mix of products sold were essentially flat compared with the prior year as higher pricing was offset by changes in the mix of products sold and customer mix within certain channels. We estimate the realization from recent price increases contributed low single-digit growth to overall net sales for the quarter. From a channel perspective, the increase in net sales in our independent sales network was largely offset by lower net sales in the retail channel compared with the year ago period. The decline in net sales in the retail channel was primarily due to the impact of efforts initiated this year to eliminate certain product categories that do not meet our expected profit margin profile. We believe our growth in net sales this quarter was also muted by the impact of customers, primarily in the independent sales network channel, pulling forward orders into the first half of the year in advance of announced price increases. We -- while we noted this activity in our previous 2 earnings calls, we were unable to determine the precise impact of the sales shift between quarters. Looking more closely at the details of our net sales this quarter, net sales through our independent sales network were up almost 3%. Our growth in this channel was benefited by implemented price increases, market share gains in certain lighting categories, particularly for Lighting Controls and growth of our building management solutions platform at Distech, which again performed exceptionally well this quarter. We believe the growth rate of our C&I business within the independent sales network channel was more than double the overall rate of growth for this particular market. Our growth in C&I was primarily due to greater shipments of certain high-volume, more basic, lesser featured LED fixtures primarily for applications on smaller and mid-sized commercial projects, significant growth of our Lighting Controls platform and light and the benefit from our implemented price increases, all partially offset by prolonged delays for larger nonresidential lighting projects as well as continued product substitution to lower-priced alternatives for certain lighting products. Additionally, net sales in our corporate accounts and direct sales channels were down slightly compared with the year ago period, primarily due to the completion of certain large projects in the year ago period and to a lesser degree slower releases for certain renovation projects. Net sales in the retail channel declined approximately \$12 million this quarter compared with the year ago period. As I noted earlier, the decline was primarily due to the

elimination this year of certain products sold primarily through the retail channel as part of a comprehensive review of our product portfolio for those products that do not meet our margin profile expectations. While we expect these efforts to result in lower net sales in this channel over the next few quarters, we ultimately expect that these actions will be margin accretive as operating profit dollars are expected to remain fairly constant. With regard to the impact on net sales for changes in the price and mix of products sold, the overall net impact was essentially flat this quarter. While it is not possible to precisely determine the separate impact of changes in the price and mix of products sold, we estimate the impact of price increases contributed low single digits to our overall growth in the quarter. This positive price capture was offset by changes in channel and product mix. The change in channel and product mix this quarter was mostly influenced by changes in sales to certain customers within certain channels and to a much lesser degree the extent of product substitution 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 profitability measures for the third quarter were solid given these overall market conditions. Our adjusted operating profit for the quarter was \$136 million, down ever so slightly compared with the year ago period, while adjusted operating profit margin for the quarter was 14.3%, down 20 basis points from the year ago period. If one were to reconcile our adjusted operating profit and margin in both periods for the U.S. GAAP mandated accounting changes for ACS 606 (sic) ASC 606 and the pension accounting pronouncement in 2018, our adjusted operating profit this quarter would have exceeded the year ago period by approximately \$1.3 million and adjusted operating profit margin would have been the same compared with the year ago period. Our adjusted gross profit margin for the third quarter was 40.5%, a decrease of about 110 basis points compared with year ago period. Adjusted gross profit was \$384 million, down \$9 million from year ago period. The decline in gross margin was primarily due to our shift in net sales among key customers within the retail channel and the significant impact from the under-absorption of manufacturing operating costs as a consequence of our inventory reduction efforts this year compared with an increase in inventory in the year ago period. The inventory build in year ago period was necessary to serve a certain very large orders that were required to be shipped in the fourth quarter in both corporate accounts and retail channels. As we mentioned last quarter, our adjusted gross profit and margin were negatively impacted by a shift in net sales between key customers within our retail channel. Each of our key customers in this channel have different service requirements, which impact how we account for these differences under generally accepted accounting principles. We believe the impact of this customer shift within this channel accounted for approximately 1/3 of the decline in overall adjusted gross profit margin as a percentage of net sales in the third quarter compared with the year ago. However, it is important to note, we believe much of this decline was largely offset with lower

SDA expense. Next, our adjusted SDA expenses were down approximately \$7 million compared with year ago period. Adjusted SDA expense as a percentage of net sales was 26.2% in the third quarter, a decrease of 90 basis points from the year ago period. Again, the decline in adjusted SDA expense was primarily due to lower freight cost, caused primarily by the customer shift within the retail channel. Our adjusted diluted EPS was a third quarter record of \$2.53 compared with \$2.37 reported in the year ago period, an increase of 7%. The increase was primarily due to 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 Ricky, I would like to comment on a few important accomplishments this past quarter. 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. We continue to gain market share in many important product categories and sales channels. Our Tier 3 and 4 solutions continue to expand and now make up more than 20% of our net sales. Our new product introductions continue to be well received by the market, some winning various awards for innovation. From a commercial perspective, we continue to accelerate the number of Atrius-enabled deployments and increased active programs with several of the largest U.S.-based retailers. Our Atrius-based IoT luminaires and solutions are becoming the industry standard in the big box retail segment. We believe that over 20% of the floor space of big box retailers in the U.S. is now Atrius enabled. Additionally, we continue to expand these differentiated solutions into other verticals as awareness by customers grows as they come to recognize the full benefits of these solutions, including superior visual comfort and energy savings as well as the capabilities of our IoT solutions, providing them with the opportunity to transform their spaces from nothing more than expense items into strategic asset. As I mentioned in prior earnings calls, it is clear that certain Chinese-based lighting companies, many obviously being subsidized in some form, are influencing pricing for certain basic lesser-featured fixtures sold in certain channels. We will not yield this space for many strategic reasons. Besides we have continued to expand our Contractor Select portfolio and further enhanced our service platforms to profitably compete in this portion of the market. We believe our lighting and BMS controls capabilities continue to expand at more than double the overall estimated market growth rate for these solutions. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control systems available in the nonresidential market, and importantly, they are connected to our growing BMS solutions providing customers with even more functionality. Lastly, this year, we initiated comprehensive reviews 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 modification and enhancements to both programs. Specifically with regard to ESG, we believe these factors are important to the long-term success of Acuity Brands and our stakeholders. We

are very pleased to announce that we have updated our earthlike website, which highlights some of the significant efforts and results we have achieved to date that lessen our impact on the earth and benefit our business, associates, customers and communities. I encourage all of you to visit our website at www.acuitybrands.com/about-us/sustainability to view these impressive results. We've been able to create these capabilities, while providing industry-leading results because of the dedication and resolve of our 12,000 associates, who maniacally focus on serving, solving and supporting the needs of our key stakeholders. I will talk more about our expectations for the balance of 2019 later in the call. I would like to now turn the call over to Ricky. Ricky?

Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP

Thank you, Vern, and good morning, everyone. As Vern mentioned earlier, we had some adjustments to the GAAP results in the third quarter of fiscal 2019 and 2018, which we find useful to add back in order for the results to be comparable. In our earnings release and Form 10-Q, we provide a detailed reconciliation of non-GAAP measures for the third quarter and first 9 months of fiscal year 2019 and 2018. Adjusted results exclude the impact of amortization expense for acquired intangible assets, share-based payment expense, manufacturing inefficiencies directly related to closure of a facility, excess inventory adjustments, acquisition-related items, special charges for streamlining activities and an income tax net benefit for discrete items associated with the Tax Cuts and Jobs Act. We believe adjusting for these items and providing these non-GAAP measures provide greater comparability and enhanced visibility into our results of operations. We think you'll find this transparency very helpful in your analysis of our performance. In the third quarter of the prior fiscal year, we recorded a pretax special charge of \$9.9 million, primarily with actions to streamline the organization. We expect to continue to incur additional costs in future periods associated with these actions initiated last year. The additional cost will consist primarily of early lease termination and moving cost associated with the closing of certain facilities. During the third quarter of this fiscal year, we reversed \$100,000 of previously recorded special charges due to updated estimates. The effective tax rate for the third quarter of fiscal 2019 was 20.9% compared with 26.4% in the prior year quarter. The decline in the current fiscal tax rate reflects a lower federal statutory rate and certain research and development cost tax credits, including claims for prior periods recognized during the third quarter of fiscal 2019. We currently estimate that our blended effective income tax rate before discrete items will approximate 22% to 24% for fiscal 2019 and 2020. Shortly after the end of our third quarter, on June 20, 2019, using cash on hand, we acquired WhiteOptics, L.L.C., headquartered in New Castle, Delaware. WhiteOptics is a manufacturer of advanced optical components used to reflect, defuse and control light for LED lighting used in commercial and institutional applications. WhiteOptics product portfolio includes light guide plates,

optical diffusers and innovative microstructure lenses that provide a unique 3 dimensional appearance. WhiteOptics' transmissive products include optics that improve the quality of light to support a low-glare LED solution and superior luminary efficiency and energy savings. The acquisition of WhiteOptics is not expected to materially impact the company's fiscal 2019 consolidated financial performance. We did not disclose the terms of the acquisition. We generated \$312 million of net cash flow provided by operating activities during the first 9 months of fiscal 2019 compared with \$300 million for the year ago period. Operating working capital defined as receivables plus inventory less payables decreased almost \$21 million during the first 9 months of fiscal 2019. This decrease is largely due to greater cash collections as well as fewer inventory purchases year-over-year, partially offset by the timing of payments for trade payables. We reduced our inventory by \$22 million during the past quarter as our focus on improving inventory turns is yielding positive results. At May 31, 2019, we had a cash position of \$334 million, an increase of \$205 million since August 31, 2018. The increase was due primarily to the cash flow from operations, partially offset by cash used to repurchase common stock, to invest in plant and equipment and to pay dividends. We repurchased 400,000 shares for \$49 million during the first 9 months of fiscal 2019. We have 4.8 million shares remaining under our current share repurchase board authorization. Our investment in capital expenditures was \$40 million for the first 9 months of fiscal 2019, an increase of almost \$8 million compared with the prior year period. We currently expect to invest approximately 1.5% of net sales in capital expenditures in fiscal year 2019. Capital expenditures for fiscal year 2019 include tooling for new products; equipment; facility renovations; information technology, including enhancements and upgrades to our industry-leading lighting and lighting control design software, Visual, and our proprietary customer order portal, Agile, as well as normal ongoing property and equipment maintenance. Last year, we executed a new 5-year unsecured credit agreement with a syndicate of banks that provide us with a total of \$800 million of borrowing capacity of which \$795 million was available at May 31, 2019. Our total debt outstanding was \$357 million at May 31, 2019. Our debt to capitalization at May 31, 2019, was 15.9%, and net debt to net capital was 1.2%. 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. We clearly enjoy significant financial strength and flexibility to support our growth opportunities, which may include acquisitions, and we will continue to seek the best use of our strong cash generation to enhance shareholder value. Thank you, and I'll turn it back to Vern.

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

Thank you, Ricky. While current market conditions in the lighting industry continue to be challenging, we continue to be optimistic regarding our long-term future. We believe our

many actions to improve our market reach, enhance our customer solutions and capabilities and to 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. Our above-market sales growth, significant cash flow and robust return on invested capital through the first 9 months of the year are reflective of our very positive operating performance despite some of these current industry headwinds. Our views on overall market demand for the lighting industry and items influencing costs have not really changed over the last few quarters. So let me reiterate a few of those key items that could influence our performance in the fourth quarter and for the balance of the calendar 2019. Many independent third-party forecasts continue to suggest the overall growth rate for the North American construction market as measured in dollars will be in the low to mid-single-digit range. We still believe the lighting industry will lag the overall growth rate of the construction market, primarily due to continued product substitution to lower-priced alternatives for certain products sold through certain channels, while recent industry pricing actions should have a favorable impact on growth as measured in dollars. Additionally, we expect that labor shortages in certain markets will continue to dampen growth rates for both construction and lighting. The U.S. government increased tariffs on certain imported Chinese-made finished goods to 25% from 10% in May. This action resulted in many lighting companies, including Acuity, implementing a price increase in late May. The U.S. has threatened to increase tariffs on additional Chinese-made products and now, Mexico as well. Though the administration recently backed off on these threats, the turmoil caused by this almost daily rhetoric in the press regarding global trade issues has certainly created greater volatility in our various end markets impacting demand. We believe the outcome of the entire tariff situation could have a dampening effect on overall demand due to higher component cost and finished good prices. As previously mentioned, we believe the other announced price increases and other actions taken will help offset the increase in cost for various items noted earlier. While increases in some input costs, such as steel have leveled off for now, we expect other costs and expenses, such as imported electrical components and finished goods, freight and wages will continue to rise. These potential cost increases could have a negative impact on our financial results due to the timing and nature of any mitigation efforts, including potential future price increases and other actions to reduce costs. Further, we believe that product substitutions to lower-priced alternatives for certain products in certain portions of the lighting market will continue, particularly, for more basic, lesser-featured products sold through certain channels, potentially pressuring both top line growth and profitability. The relaunch of our Contractor Select portfolio and other actions taken were done to enhance our opportunities for profitable growth in these or those portions of the market. Excluding the impact, if any, of those factors just noted, we remain cautiously optimistic about overall market conditions

for the balance of 2019, though some leading indicators of future market demand, such as the Architectural Billing Index and the Dodge Momentum Index show current softness. Our wide and varied base of customers generally remain positive about their current year growth prospects. While many customers continue to have healthy backlogs, they too are concerned about the timing of releases, particularly for larger projects and the potential impact of tariffs and inflation on overall demand and the current softness in some of these leading indicators. However, most importantly, we expect to continue to outperform the overall growth rate of the markets we serve primarily in North America. 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 emphasize, it will be lumpy at times because of the unpredictability and timing of customer's renovation and new construction schedules as well as the volatility in demand caused by global trade and political issues. This 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 modestly in this coming fourth quarter compared with the year ago period. The primary reason for this was that net sales last year were significantly benefited by shipments to new customers in the retail channel as part of initial stocking programs. Those initial stocking orders will not repeat this year. The potential of this top line decline notwithstanding, we believe our adjusted operating profit margins will exceed those reported in the year ago period as well as continue to improve on a sequential basis. I'd like to reemphasize those points because it will be particularly important as one thinks about their models going forward and I believe it's a favorable outcome. Additionally, as I noted last quarter, we initiated a review this year of a portion 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 will continue to impact our top line growth rate, however, we expect that the actions taken in this effort will be accretive to our margins as a percentage of net sales and return on invested capital. As we have noted before, our gross profit margin is influenced by several factors, including sales volume, innovation, components and commodity cost, market pricing dynamics and changes in product and sales channel mix. Additionally, we are always striving to improve our profitability through our continuous improvement efforts. Lastly, the execution of our integrated tiered solution strategy, including the expansion of our Tier 3 and 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 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 have said before, 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, as importantly, the conversion of the installed base, which is enormous in size through 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 well positioned to fully participate and lead these exciting and growing industries. Thank you. And with that, we will now entertain any questions that you have.

Question And Answers

Operator - -

A. (Operator Instructions) And our first question comes from the line of Tim Wojs with Baird.

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

Q. So maybe just, again, going back to your last comments there, Vern, just on the profitability improvement that you're expecting in the fourth quarter. You mentioned that you expect EBIT to be -- EBIT margins to be up year-over-year and sequentially. Should we think the same for gross profit? Just there was that headwind from the load-in on the sales line, but I also think there was a headwind not only from that load-in but also just some negative operating costs that hit the gross profit line, the COGS line in the fourth quarter last year. So any commentary you can give us on just gross margins being higher year-over-year in the fourth quarter would be helpful?

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

A. Sure. So you saw that this quarter our gross profit margin improved, well, sequentially to 40.5%. It was the first time in, I believe, the last 3 quarters that we have exceeded 40% the gross profit margin level, a key indicator for all of you and for us internally as well. We would expect to see improvement in Q4 as well. As you know, and we mentioned the last couple of quarters because of some of the intra-channel mix, customer mix within the retail channel and how we serve those customers, it is having an influence that lowers, if you will, based on historical standards, our gross profit margin, but it is made up in lower SDA. We estimate that in the third quarter that impact lessened our gross profit margin by approximately 30 basis points compared with the year ago period. So we are expecting improvements in Q4, particularly as we look at various products and product categories within our portfolio that really don't meet our margin hurdles or our return on investment hurdles. So we're looking to prune that back, which I view as a very favorable activity. And so what that should do in Q4, little bit of noise going out, it will contribute to most likely lower sales in Q4, but a higher

margin profile. And as Ricky and I said in our prepared remarks, we're expecting that to result in constant or consistent operating profit dollars.

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

Q. Okay. And then, I guess, just to be clear, you would expect gross margins to be up year-over-year in Q4 or sequentially as well?

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

A. I would expect them to be up sequentially. The headwind, well, oh, excuse me, for the year ago period, we would expect them to be up pretty meaningfully above the year ago period.

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

Q. Okay. Great. And then maybe just switching over to kind of the tariffs. What have you heard from your customer base in terms of the move from no tariffs to 10% and then just the incremental move from 10% to 25%? Have your customers or your channel partners being able to pass that on to customers? Is that what you've heard or have you heard any sort of pushback on that move to 25%?

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

A. So we sell-through 14 different sales channels and so I just comment on some of the broader ones. Certainly, the move from 10% to 25%, that was a situation, I believe, where the industry, not only the lighting industry but anybody who has product that's coming from China, that was a move too large for anyone to absorb or for the fluctuation in foreign currency to give some argument that you could absorb that. So the price increases, I think, are real and the end channels are passing those along to end customers because they can't absorb that either. I was very pleased with our price capture in Q3. We've implemented more pricing. We expect that to continue to benefit our results. And when I say benefit our results, to offset these significant tariff increases. I'll remind everyone that if you go back to early September, mid-September, that price increase had more to do with the cost dynamics in our industry, less to do with tariffs on finished goods. We then put in additional price increases, including the most recent price increase in May, reflective of the significant increase in tariffs on Asian-made finished goods.

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

Q. Okay. Okay, great. And then just kind of sneak last one in. We noticed you didn't buy any stock back in the quarter. Any thoughts on just stock down 11% here today, how you think about buybacks opportunistically, would be helpful.

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

A. Sure. So I'll take a stab at this first and then Ricky can comment. First of all, our stock being down 11% today is ridiculous. I mean the value of the business and the things that we're doing, we're enhancing the value of that. It's all the good things. We're really generating a lot of cash. We're doing great things within the key markets that we serve. We're looking to prune some of the things within our business that don't really provide the kinds of returns that we expect. We have a significantly high return on invested capital, cash flow return on investment and those are important metrics to us. So we're looking to make sure that we're a better business and a growing business. You might imagine that with \$334 million of cash, we are looking at all alternatives. The pipeline that Ricky has from acquisitions and strategic investments is robust, and we would expect to execute on those where we see really interesting opportunities to enhance our return. So as we have always said in the past, if you look at how we have used our capital, our free cash flow, 1/3 of it has gone to acquisitions, 1/3 of it has gone to stock buybacks and the other 1/3 has been split between CapEx and dividends. So I would expect us to continue to operate in that kind of environment. Ricky?

Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP

A. Yes, I would just add a few more comments on that. As Vern said, our first priority is acquisitions. We think that provides the greatest longer term value creation for shareholders. The pipeline is very long and very active, both for outright acquisitions as well as opportunities to invest in complementary technologies and operations. You saw after the end of the quarter, the small acquisition of WhiteOptics but strategically that will be very important to us as we continue to advance the optics capability in some of the new form factors that are going to the market today, taking advantage of the LED. So very excited about that, but clearly share buyback is on the table. We have the authorization from the Board and that certainly an opportunity we'll take good care of.

Operator - -

A. And our next question comes from the line of John Walsh with Crédit Suisse.

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

Q. I guess, the first question around pricing, and I think you've articulated that there's the general inflationary price increases and then the price increases that are related to the tariffs. But I'm just curious, if we were to see the tariffs disappear, what kind of industry

discipline has been instilled? Or do you think customers would allow you to continue to capture that nontariff inflation just because historically it has been a price down market?

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

A. Yes, my observation around that is that the industry has been for -- the bulk of the industry, I won't say for some of these lesser-featured type products where they are subject to a bit more of global competition. I would say that the industry has generally been and I would expect it to continue to be disciplined around larger projects or what I will call specification-driven projects, where you're adding value by selling not only product feature differences but you're selling service and support differences and we're seeing that. We're raising prices on some of our controls platform, primarily because there is value there and we have experienced some cost. And I think that the industry recognizes that value and our competitors also recognize their own value. So I would expect that those types of price increases to stay in place, frankly.

Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP

A. I would just add, historically, we have seen the ability to pass on commodity price increases. So for a lot of the price degradation we've experienced over the last 8, 9 years was because we were seeing declines in LED cost, efficacy of LED and so forth and the market again was passing that on. So I would just reiterate, I do think the market is pretty rational when it comes to these kind of common commodity costs, both when they go up as well as when it goes down.

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

A. And John, I would also comment that one of the reasons that we have aggressively relaunched our Contractor Select portfolio where we have revamped the product portfolio, if you will, based on features and benefits, but also has been maniacally focused on the cost structure within that, and that is to effectively compete in that portion of the market where to the extent that tariffs go away, we still have a strong competitive advantage, not only in the product portfolio set, but in the service set. We're modifying our service platforms, making our transactional capabilities far more frictionless and easy to do business with to compete in that world. And it's an important element for us because I don't know that pricing, while we seem to debate somewhat, particularly on product substitutions, we would expect to continue to thrive in that marketplace, even without tariffs.

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

Q. Got you. And then maybe a follow-on here about the installed base opportunity. I mean, I feel like we've always talked about LED penetration rates through the installed base, but

given the very public field failure with Detroit that everyone was speaking about a LIGHTFAIR, you've seen kind of an increased amount of marketing around product quality, whether it's from yourself, your channel partners or competitors. Is there a potential to see an acceleration of, call it, Contractor Select or this kind of Tier 1 refocused product as some of this earlier imported lights fail in the field, is that a big opportunity? Or is that something people talk about, but you don't actually think it's going to amount to an increased installed base opportunity?

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

A. John, that's a great question. We, Acuity, have been and/or increasing our aggressiveness in communicating to our customer base both through electrical distribution to the end customer that there is a huge difference, just because something looks the same and they both say LED and they both say 5-year warranty, they're not the same. I call it internally selling the difference. And more and more, we are becoming even more aggressive at selling the difference. And this happened in the analog world. If you go back almost a decade ago, imports coming in, they didn't meet some of the standards and when you had failures that were highly publicized and more and more of these failures are on, I'll just call them, larger projects like the city of Detroit, that goes like wildfire through the industry. And now, we are able to sell our difference, but also sell the fact that Acuity is maniacally focused solely on lighting, lighting controls, building management capabilities and it's our quality that we sell and our ability to support those kinds of things. So we do see it as an emerging opportunity to really sell the difference and create greater sales and greater profitability for Acuity.

Operator - -

A. (Operator Instructions) And our next question comes from the line of Jeff Osborne with Cowen and Company.

Jeffrey David Osborne - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

Q. I was wondering if you could just put in perspective the pruning of the portfolio. You mentioned it was \$12 million year-over-year. If you annualize that, is that a good number of what you've done so far? And is there more room to go in terms of what you're looking to prune?

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

A. I would say that there is. The decline in our retail segment of \$12 million, that's a portion of the pruning activity, that's not all of it, it's not all in the retail channel, it's looking at various products. Just a little historical perspective. We got into some of these products by really

doing a service and accommodation to certain customer sets so on and so forth. It wasn't really core to our business but the customers were core to us. And so leveraging some of that capability and saying, yes, we'll do it, it wasn't really consistent with some of the value propositions of the brands that we have. So this pruning is really, it's been a long time coming, but it's an appropriate thing to do. My guess is that it will continue to influence the next couple of quarters, particularly, as we do year-over-year type comparisons, and we'll continue to give more insight on that. While we say it's modest, it could be 2 or 3 points of our top line, depending on how aggressively we pursue some of these things and look at alternatives. It's not just that we're going to stop doing some things, but do we want to commit resources to reengineer or engineer some new products in this area that, again, may or may not be consistent with the value proposition of our brands. So we're still evaluating those types of things. But again, I want to reemphasize really important that we expect at the operating profit level for these things to be fairly neutral in terms of the actions. That's reflective of the fact that we're not making really any money on doing some of these accommodating type things and there is no reason to burn up our factories or our balance sheet or our people servicing that portion of the business that is not accretive to what we're doing. So there is still, I think, more effort that we'll be putting into this. And while it will create a little bit of noise on the top line, we think that shareholders will appreciate the benefit on the bottom line and on how we return capital to shareholders.

Jeffrey David Osborne - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

Q. Make sense. And my second question and the last one is just on the Atrius. Can you touch on how you're capturing the value for that, in terms of any metrics that you can give, in terms of price, premium that you have for the product, either in a per unit or square footage basis? You've just been somewhat elusive on sort of the revenue model for Tier 3 and 4 in the past, and so it would be helpful just to understand how is that 20% of retail square footage evolves over time with the awards that you have? What the financial ramifications of that are?

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

A. Jeff, I don't know, if we've been elusive on Tier 3, we apologize and that must be miscommunication. Our growth in the corporate account world for us or that enterprise solution world has been really quite positive. We are gaining share, if you will, in that space as we convert these retailers. That's why we wanted to give you all a sense that our actions to date where we say we believe that in the big box world, more than 20% of that square footage in U.S. is now under Atrius-enabled luminaires. So we earn that business and we sold those luminaires. Now what we're doing is working with these customers to really help them drive the Ferrari that they bought in terms of what it can do to their business model.

And that's really been the Tier 4 opportunity for us to generate more SaaS revenues. They are, again, we're operating of the small base. But the reason that these retailers and other verticals are putting in our Atrius-based luminaires is because they are -- they believe in the future opportunity of the IoT-enabled capabilities. And so they're now experimenting with these apps. I think that if I had a learning that I would share with the group and I think Ricky and I would have said, boy, when someone transforms a single store, they're now going to start using it and putting an option, that's just not how things work. We were wrong in that premise. People want to get critical mass. Think of airports. These transformation of these airports are years in the making. While if they redo 1 terminal and you're a passenger going from that terminal to another terminal and its Atrius-enabled in the 1 terminal and then they lose you going to the other, they've created a horrible customer experience. So they are buying these luminaires, future-proofing because they know that over the course of, I'll call it, whatever their renovation cycle is, they're going to have that platform in place. So the Tier 4 revenues, the SaaS revenues, have been slower in coming relative to what our assumptions were 3 or 4 years ago. But we believe that the reason that they're buying these solutions, the fixtures themselves and the controls platform and all of this is because they believe strongly in the opportunity of what the Atrius IoT-enabled capability will allow them and that's why we're selling a lot of luminaires into that space.

Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP

A. And I would just add of our business model enabled us to capture that value over time, as Vern said, as they start driving that Ferrari or adding more and more applications and capability to it. Yes, we get a premium when we sell the hardware, but the further opportunity is once they start using the data that we're able to collect or collect additional data as we build out greater capability or other sensors or other companies want to use our network to transfer data and run applications and gather information that they can use to enhance the business or the productivity of the customer. So our business model allows us to continue to capture that along the way and grow the SaaS revenue and enhance their revenue on that network that we put on as they continue to use it more and more.

Operator - -

A. And our next question comes from the line of Jeff Sprague with Vertical Research Partners.

[Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder and Managing Partner](#)

Q. Just a couple things from me. Just back on the whole idea of kind of the influence of tariffs and pricing on buyers' behavior. So first, do you have a sense of what the pull forward actually was in the first half of your year? And secondly, I would have thought perhaps that this move to 10% to 25% may have actually created some sort of pull forward in the current period and

it seems like that didn't happen. So maybe just a little bit of additional color there would be helpful.

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

A. Sure. It's interesting and, unfortunately, to have precise data to answer your question, we don't have, but I have been to a number of industry events talking with distributors, contractors, different customer set. And in that dialogue with them and I'll just pick distributors here for 1 second, they've said, we've been inundated at bringing in projects now and having to consume more and more of our floor space, actually having to add space to house these projects that will be delivered over a more lengthy period of time. I believe that the move to 25%, while that may have created some pull forward, I think, you saw a lot of the pull forward kind of in that first half of the year. I think, what you could actually see is projects on the 25% side potentially being delayed. And the truth of the matter is that for a lot of the product that was hit by the 25% tariff, that actually is on the more smaller and more stock flow type projects. Usually, larger projects that require more sophisticated type luminaire, we're manufacturing those types of products in our North American footprint and so we're able to, through different types of sourcing so on and so forth, sell those luminaires without necessarily the pressure of -- the fulsome pressure of the tariffs. So I think, there, you didn't see more pull forward of those types of things. And then on the stock flow side, I believe that folks are sitting back saying, well, how long is this going to stay. A lot of distributors, they already have enough inventory. They're not going to pull forward more when they're running out of space. So I don't -- we did not see the same type of pull forward activity on the May increase, even though it was a significant increase. So it's just an interesting dynamic that's going on. And I wish I could give you real statistics but we just don't have them and a lot of our distributor customers are struggling with what is actually happening in their business, yet, they continue to be reasonably optimistic around their backlogs are healthy, they see some of these projects, but they too are concerned about larger projects. This is just simply taking longer, and I think that may have more to do with steel which fortunately has abated somewhat here so. We'll see how that plays out frankly.

Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder and Managing Partner

Q. Yes, so just maybe an additional color on large projects. So is it your view that it's just inflationary pressures? Or there is something going on with the end demand picture or some other dynamic that is kind of leading this kind of extended drawing out, for lack of a better term, in some of the large project activity?

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

A. Yes, it's a great question. No doubt that there are changes afloat on how people use space, use space differently so on and so forth. But I think that a lot of it has been influenced by, I hate to say this, at first, I didn't really accept that the notion of labor shortages were having an influence, but I think, more and more a lot of these contractors, they're comfortable with their backlogs, they're comfortable with their project and their activity as it currently is, and they're saying, well, I'll get to that project later. And so I think the delay has a lot to do with just the availability of labor and to a lesser degree than expectations. Dan, as you pointed out earlier, folks may be saying, well, if I wait, maybe these tariffs go away and pricing will come down back to pre-tariff levels and therefore, my project looks better. We hear that anecdotally but we don't really have good evidence around that yet.

Operator - -

A. And our next question comes from the line of Ryan Merkel with William Blair.

[Ryan James Merkel - William Blair & Company L.L.C., Research Division](#) - Research Analyst

Q. So first off on a low single-digit price capture. Has this been neutral to the profit line as it relates to the quarter? And then any reason it should change positive or negatively in the future?

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

A. So low-digit capture, we're spreading across the whole portfolio. We would say that it has been a slight positive, but we've had to really work hard to take cost out of cost components that we can control, not just componentry that's coming in from Asia and/or finished goods. There's still, I think, more to come on the finished good side. Again, price increase was put in place in late May. We still see input coming in at a favorable rate, positive rate for those types of smaller and medium projects but maybe that's slowed down just a tad. But I would expect that these types of activities to continue to be positive so long as they don't ultimately end up impacting overall demand. I think a bigger issue -- and I'll let Ricky comment, I think a bigger issue still continues to be just the volatility caused by all of the rhetoric that's in the marketplace. I think that that we see people who are busy but they're not really actually shipping product. I think people are, again, taking a bit of wait-and-see approach. Ricky, your perspective on...

Richard K. Reece - Acuity Brands, Inc. - CFO & Executive VP

A. Yes, I think the low single digit in the quarter for the most part offset the tariff increases we have. Of course, the last tariff increase came in very late in the quarter in mid-May. We announced the price increase extremely quickly but we do protect certain backlog. We had

certain customers, we had to negotiate the final amount with that are under a different scenario than just a distributor or someone who places an order on a daily basis. So I think, for the most part, we captured it in the third quarter, but I think, there will be further margin opportunity to capture more and then maybe go beyond here in the other quarters as we don't have to protect certain projects that had already been quoted and all once we get past that.

Ryan James Merkel - William Blair & Company L.L.C., Research Division - Research Analyst

Q. Okay, yes, that makes sense. And then just a follow-up on the fourth quarter sales, so down modestly. If I were to rank sort of the pieces there, would it be first the retail comparison that's pretty tough, I think it was 500 basis points of growth last year, I think that's what you quantified. And then secondly, eliminating some products maybe 2% to 3% negative impact, and then would the last piece just be the pull forward into the first half?

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

A. I would say that the first 2 are directionally correct. I would say that when you get into our fourth quarter and then imagine where projects pull forward all the way from the fourth quarter into the first half, I would say probably not as much. I don't know that I would influence that. We're still trying to handicap, as Ricky pointed out in answering the previous question, what impact is the May price increase having. Right now, we're not seeing that it's having a huge pull forward impact. So I would say as you think about the Q4, the first 2 were directionally correct. And again, I'd like to really emphasize because this is going to be important for how all of you write your reports. Our expectation is that we are going to continue to see our profit measures improve and will go a long way to offsetting some of that top line decline because of just the mix of it. So it's important that everyone understands that as they create some of their models.

Operator - -

A. And that does conclude today's question-and-answer session. I would now like to turn the call back to Mr. Vern Nagel for any further remarks.

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

A. Thank you, everyone, for your time this morning. I realize that some of the questions around top line for Q4 very important as you think about your models, but again, we are really focused on not only growing our business but profitably growing our business and making sure that we are doing it in areas that provide us with the kinds of return on capital and the margin improvements that we're after. So please understand that, know that we're focused

on it. I think as you do your models you'll find it to be a very favorable outcome. Anyway, 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 long term to deliver strong returns to our key stakeholders. Again, our future is bright. Thank you for your support.

Operator - -

A. Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect, and everyone, have a great day.