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AYI - Q2 2019 Acuity Brands Inc Earnings Call

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OVERVIEW:

Co. reported 2Q19 net sales of \$854m, reported diluted EPS of \$1.67 and adjusted diluted EPS of \$1.99.



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PRESENTATION

Operator

Good morning, and welcome to Acuity Brands Fiscal 2019 Second 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*

Good morning. With me today to discuss our Fiscal 2019 Second 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 risks and uncertainties, such that actual results may differ materially. Please refer to our most recent 10-K and 10-Q SEC filings in 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 will answer your questions.

Our results for the second quarter were very solid despite continuing inflationary cost pressures and the impact of tariffs. We implemented several actions to address these cost issues, including price increases and additional productivity improvements. We believe our top line growth this quarter was impacted by the pull forward of orders by customers into the first quarter, as they acted to avoid announced price increases. Nonetheless, we grew our top line by almost 3%.



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Additionally, we improved our adjusted operating profit margins by 50 basis points over the year-ago period and delivered adjusted diluted earnings per share of \$1.99, a second 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 second quarter of 2019.

Net sales for the second quarter were a record \$854 million, an increase of almost 3% compared with the year-ago period.

Reported operating profit was \$95.9 million compared with \$89.5 million in the year-ago period. Reported diluted earnings per share was \$1.67 compared with \$2.33 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 second quarter of 2019 was \$112.4 million compared with adjusted operating profit of \$105.3 million in the year-ago period, an increase of 7%.

Adjusted operating profit margin was 13.2%, an increase of 50 basis points compared with the prior year.

Adjusted diluted earnings per share was \$1.99, a second quarter record, up 5% from the year-ago period. Results in the year-ago period were significantly benefited by the adoption of the new tax law as Ricky will explain.

Net cash provided by operating activities was \$188 million for the first half of this year, up nicely over the year-ago period. And our cash position at the end of the quarter grew to \$232 million even after we repurchased \$49 million of the company's stock during the first 6 months of the year, leaving us with plenty of liquidity to execute our growth strategies.

Looking at some specific details for the quarter. Net sales increased almost 3% over the year-ago period. Overall, net sales volume grew more than 3% while the price mix of products sold was unfavorable by less than 1 point this quarter, as gains from recently announced price increases were more than offset, primarily by changes in channel mix and to a lesser degree, changes in the mix of products sold. The small benefit of acquisitions net of divestitures was essentially offset by the negative impact of changes in foreign currency and the adoption of the new accounting standard, ASC 606.

We believe our growth in net sales this quarter was muted by the impact of customers, primarily in the independent sales network channel, pulling forward orders into the first quarter in advance of announced price increases.

While we noted this activity in our first quarter earnings call, we are unable to determine the precise impact of the sales shift between quarters. However, if we look at first half sales compared with the year-ago period, we grew our net sales by almost 7%. Our rate of growth over this time period was far in excess of the overall growth rate of the lighting industry in North America, which we believe was up low single digits.

We believe our channel and product diversification as well as our strategies to better serve customers with new, more innovative and holistic lighting and lighting controls and building management solutions as well as the strength of our many sales forces have allowed us to continue to gain overall market share in North America this quarter.

Looking more closely at the details of our net sales this quarter. Net sales through our independent sales network were benefited by implemented price increases and growth from our building management team at Distech, which knocked the ball out of the park this quarter, partially offset by a decline in C&I sales volume, caused by the pull forward of customer orders into the first quarter.

Additionally, net sales in our corporate accounts channel were up 10% over the year-ago period, as we continue to expand the sales of our Atrius-enabled luminaires, particularly, in the retail vertical.

It is interesting to note that net sales in the C&I market, which is part of our independent sales network were up almost 5% for the first half of 2019 compared with the year-ago period. We believe measuring net sales for the first half eliminates the distortion caused by the pull forward of customer orders between quarters. The overall growth in C&I for the first half was primarily due to greater shipments of certain high volume, more basic



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lesser-featured LED fixtures, primarily for applications on smaller, mid-sized commercial projects as well as the benefit from our implemented price increases.

Additionally, net sales growth in our independent sales network for lighting was somewhat muted by prolonged weak demand for larger nonresidential lighting project as well as continued product substitution to lower-priced alternatives for certain lighting products.

With regard to the impact on net sales for changes in the price and mix of products sold, the overall net impact was negative by less than 1 point. While it is not possible to precisely determine the separate impact of changes in the price and mix of product sold, we estimate the impact of price increases contributed low single digits to our overall growth in the quarter. This positive price capture was more than offset by changes in channel and product mix. The change in channel and product mix this quarter was mostly influenced by changes in channel mix and to a much lesser extent, 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 profitability measures for the second quarter were solid given overall market conditions. Our adjusted operating profit for the quarter was \$112 million, up approximately 7% compared with the year-ago period, while adjusted operating profit margin for the quarter was 13.2%, up 50 basis points from the year-ago period. The increase in adjusted operating profit margin was primarily due to a decline in both SDA expense in dollars as well as in percentage of net sales, partially offset by lower adjusted gross profit margin, the dynamics of which I will explain in a moment.

Adjusted gross profit margin for the second quarter was 39.2%, a decrease of 100 basis points compared with the year-ago period. Adjusted gross profit was essentially flat between periods at \$335 million, as higher net sales volume, the benefit of price increases and productivity improvements were offset by higher input costs, including inbound freight and tariffs on imported Chinese-made components and finished goods as well as changes in the customer mix within the retail channel.

This next point is very important to understand. Our adjusted gross profit and margin were negatively impacted by a shift in net sales between key customers within our retail channel. While our overall net sales of products sold through the retail channel were up 4% in the second quarter, net sales by key customers within this channel changed significantly. 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 a large portion of the decline in overall adjusted gross profit margin in the second quarter compared with the year-ago period. However, it is important to note we believe this decline was largely offset with lower SDA expense. We expect this shift between gross profit and SDA expense to continue for the foreseeable future.

Next our adjusted SDA expenses were down approximately \$7 million compared with the year-ago period. Adjusted SDA expenses in percentage of net sales was 26% in the second quarter, a decrease of 150 basis points from the year-ago period. Again, the decline in adjusted SDA expense was primarily due to lower freight and commission cost caused primarily by changes in sales channel mix, the customer shift within the retail channel as well as certain cost containment and productivity improvements, partially offset by higher expenses added from recent acquisitions.

Our adjusted diluted EPS was a second quarter record of \$1.99 compared with \$1.89 reported in the year-ago period, an increase of 5%. The increase was primarily due to the growth in adjusted operating profit and lower average shares outstanding due to stock repurchases during the past year, all partially offset by onetime favorable impact of the new tax law enacted in the year-ago period.

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 continued to make significant strides setting the stage for what, we believe, will be strong 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 were up over 30% again this quarter.

From a commercial perspective, we continue to accelerate the number of Atrius-enabled deployments and increase active programs with several of our largest U.S.-based retailers. Our Atrius-based IoT luminaires and solutions are becoming the industry standard in the retail segment. Additionally, we continue to expand these solutions into other verticals, as awareness by customers grows, as they come to recognize the full



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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 assets.

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 the space for many strategic reasons. As such, we have continued to expand our Contractor Select portfolio to profitably compete in this portion of the market.

Also, as I mentioned last quarter, we introduced in late 2018 the next generation of our industry-leading lighting control system, nLight AIR, a wireless control system with a wide range of options and functionality for which there was strong customer demand this quarter. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control system available in the nonresidential market, and importantly, they are connected to our growing BMS solutions. Our growth in these areas is significant.

Lastly, we initiated many actions last year to further streamline our operations to reduce costs and improve our productivity. We believe these initiatives both enhanced our performance this quarter and will continue to benefit our operating and financial performance in the future as well as allow us to accelerate investments in areas with higher growth opportunities. Ricky will have additional comments on this in a moment.

We've been able to create these capabilities while providing industry-leading results because of the dedication and resolve of our many associates, who are maniacally focused on serving, solving and supporting the needs of our customers.

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 second 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 second quarter and first 6 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 the closure of a facility, acquisition-related items, special charges for streamlining our 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.

During the second quarter of fiscal 2019, we recognized a pretax special charge of \$400,000, primarily related to move cost associated with the previously announced transfer of activities from a planned facility closure. In the second quarter of the prior fiscal year, we recorded a pretax special charge of \$600,000. We expect to continue to incur additional costs, primarily attributed to early lease termination and moving cost in future periods associated with the closing of certain facilities related to the streamlining actions announced in fiscal year 2018.

As a reminder, as part of adopting ASC 606 at the beginning of fiscal year 2019, we're providing in our Form 10-Q, disaggregated revenues by the major sales channels of: one, independent sales network, which includes C&I agencies, infrastructure utility agencies, system integrators and showrooms; two, direct sales network; three, retail network, which includes home centers and digital retail; four, corporate accounts; and five, all other, which is primarily OEM, international and catalog.

The effective tax rate for the second quarter of fiscal 2019 was 23.1% compared with the 23.1% tax benefit in the prior year quarter. The tax benefit in the second quarter of fiscal 2018 was due to recognizing a \$31.2 million discrete tax benefit of the Tax Cuts and Jobs Act. Additionally, last year's second quarter adjusted tax rate of 17% was unusually low, as it reflected a lower blended year-to-date effective rate following the passage of the Tax Cuts and Jobs Act.



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In other words, prior year's first quarter effective tax rate of 35.4% was lower due an adjustment to the tax provision in the second quarter. We currently estimate that our blended effective income tax rate before discrete items will approximate 24% to 26% for fiscal 2019. We generated \$188 million of net cash flow provided by operating activities during the first 6 months of fiscal 2019, compared with \$178 million for the year-ago period.

Operating working capital, defined as receivables plus inventories less payables, decreased almost \$36 million during the first 6 months of fiscal 2019. This decrease is largely due to reduced account receivable balance.

Our operating working capital days increased 16 days to 66 days, primarily due to higher inventory days at February 28, 2019 compared to August 31, 2018. The increase in inventory is primarily due to a buildup over the last several quarters of inventory ahead of the relaunch of our broader Contractor Select line and customer expansion in the retail channel. We are focused on improving our inventory turns, as we assimilate these newer products and customers.

At February 28, 2019, we had a cash and cash equivalents balance of \$232 million, an increase of \$103 million since August 31, 2018. The increase was due primarily to 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 6 months of fiscal 2019. We have 4.8 million shares remaining under our current share repurchase board authorization. Our investment in capital expenditures was \$25 million for the 6 -- first 6 months of fiscal 2019, an increase of almost \$4 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; facilities 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 provides us with a total of \$800 million of borrowing capacity, of which \$795 million was available at February 28, 2019.

Our total debt outstanding was \$357 million at February 28, 2019. Our debt-to-total capitalization at February 28, 2019, was 16.5%, and net debt to capital was 6.5%.

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'll 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 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-growth potential over the long term.

Our strong sales growth, significant cash flow and robust return on invested capital through the first half 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 market and items influencing costs have not really changed over the last 6 months. So let me reiterate a few of those key items that could influence our performance for the balance of our fiscal 2019.



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Many independent third-party forecasts continue to suggest the overall construction market, as measured in dollars, will grow in the low to mid-single-digit range. We still believe the lighting industry will lag the overall growth rate of construction market somewhat, primarily due to continued product substitution to lower-priced alternatives for certain products sold through certain channels, though recent industry pricing actions should have a favorable impact on growth as measured in dollars.

Additionally, we expect that labor shortages in certain markets could continue to negatively impact growth rates for both construction and lighting. While the U.S. government, once again, delayed the implementation of increased tariffs to 25% from the current 10% for certain imported Chinese-made finished goods, we believe the outcome of the entire tariff situation could have a dampening effect on overall demand due to higher component costs and finished good prices. Further, it is evident that the global trade issues as well as current rhetoric regarding the potential closing of the U.S.-Mexican border have certainly created greater volatility in demand in our various end markets, and we expect that to continue.

As previously mentioned, we believe 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 those portions of the market.

Foreign currency exchange rates may continue to be volatile adding further uncertainties. Excluding the impact, if any, of those factors just noted, we remain cautiously optimistic for the balance of fiscal 2019. Our wide and varied base of customers generally remain positive about their current year growth prospects. Many customers continue to have record backlogs, though they too are concerned about the timing of releases, particularly, for larger projects and the potential impact of tariffs and inflation on overall demand. However, and most importantly, we expect to continue to outperform the overall growth rate of the markets we serve, primarily North America. Further, we believe the sales of our lighting control solutions as well as our Atrius-based luminaires, all within our Tier 3 and 4 categories, will continue to expand, though I would like to 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.

As we have noted before, our gross profit margin is influenced by several factors, including sales volume, innovation, components and commodities costs, 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. However, we believe, for any meaningful gross profit margin improvement to occur, we will need to continue to capture our implemented price increases as well as experience an acceleration in market demand for more technology-enabled lighting solutions, particularly, for larger commercial projects, where our contribution margins are more favorable due to the complex nature of these types of projects. This illustrates the influence of products and sales channel mix on our margin profile.

Also, as I noted earlier, we expect changes in net sales volume sold through certain customers in the retail channel will have a dampening effect on adjusted gross profit and margins. But we believe will be largely offset with lower freight and commission costs within SDA expense.

Additionally, we have initiated a review of a small portion of our product portfolio and services offering with the objective of eliminating those items and activities that do not meet our return objectives. These efforts could modestly impact our future top line growth rate, but we expect that any actions taken in this effort will be accretive to our margins and return on invested capital. More information to come in the future on the impact, if any, from this initiative.

Lastly, the implementation of our integrated tiered solutions 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.



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As I've 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 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 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.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Joseph Osha with JMP Securities.

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

Two questions. First, your business continues to generate pretty solid cash flow. I'm just wondering if maybe Ricky could amplify, maybe a little bit more going forward, what the thoughts are about deploying that in buybacks? And then also what we might see in terms of leveraging the balance sheet? And then I have a follow-up.

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

Sure. As we mentioned before, Joseph, our use of cash are really in 3 areas. One to continue to invest in capital, through capital expenditures, IT and so forth. And you see that level at the 1.5% of revenues. We've been between that and 2%. Second, is to return to shareholders in the form of dividends and share buybacks, which we've done fairly aggressively over our careers or over the last decade, I should say. And then thirdly, it is acquisitions. I would say acquisitions after our normal capital CapEx spending is probably our preferred use. We've -- see opportunities to continue to fill in areas of product gaps as well as to expand our technology, and we'll continue to look at opportunities whether it's acquiring people or partnering or minority investments. And it's an active pipeline out there. So that's an area that we continue to see opportunity, and we'll use our cash flow to create shareholder returns in that way. When the M&A activity isn't as robust or we opportunistically see a benefit to repurchase shares, we'll do that, and as you know, we have a fair amount still left under the board authorization to buy back shares. We bought back 400,000 this -- so far this year. So we'll continue to do that as well. So those are the primary plans for our use of capital.

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

Okay. And just as a quick follow-up, you had, in the past, indicated the willingness to lever the business to a certain multiple of EBITDA. Do you still see that kind of debt-to-EBITDA number going up over time?

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

You could argue we're underlevered today. So I could see our leverage going up even through M&A or share buybacks. We do want to maintain our investment grade rating, which would suggest a 2.5 turns of EBITDA or probably less. Not to say that on a great opportunity for M&A or something, we might not hit that or exceed it, knowing we could quickly pay it back down. But we do want to maintain our investment grade rating, and that would dictate a ceiling probably in that 2.5 turns of debt as a ceiling.



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Joseph Amil Osha - JPM Securities LLC, Research Division - MD & Senior Research Analyst

Okay.

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

And we continue to see an active pipeline of M&A as Ricky points out. And as you know, M&A is never something that you can precisely predict. They have to be both doable and desirable at the same time, meaning, from a financial perspective. So again, interesting in terms of technology opportunities as well as niche based lighting companies.

Operator

And our next question comes from Brian Lee with Goldman Sachs.

Brian K. Lee - Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst

Just had a couple here. I guess first off on the mix shifts here in retail, it seems like you would have less control on the sales channel for this part of the market, hence the lower SD&A expenses if I'm reading it correctly. How should we think about what that means for growth potential? Is this the part of the business, as a part of your mix that just grows in line with the industry, given the competition in this channel? So maybe if you could help walk through the growth, sort of, puts and takes for that particular channel?

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

Okay, Brian. Sounds like there's a food fight going on at Goldman Sachs. Not certain that we heard all of that question. But when we think about our retail channel, we see opportunities for continued diversification and growth. But you know, again, we have to look at the trade-off in terms of, are those solution sets that we are providing appropriate returns on our own business? But we see the retail channel as an opportunity for us, again, to continue to diversify our customer base. We're doing that. And obviously, that has some impact because these customers are -- all have different service requirements, which as I mentioned in my previous or my prepared remarks, do have an influence on how we, basically, account for some of these things, some of the items are above the line so they enhance gross profit. Some of the things, such as freight, I mean this is a really simple issue. It's just depends on whether we provide freight of the material or that end customer provides freight, and then the adjustment is the price. So -- but again, our view around the retail channel is continued opportunity to leverage our brand and to leverage the supply chain that we have in place for profitable growth.

Brian K. Lee - Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst

Okay, great. Hopefully, it'll be a little bit better. On the -- maybe second question just on channel and product mix. I know these were issues for you guys that just, I guess, started to materialize, we've seen some shifts in the past couple of quarters. So wondering if it's the right assumption to anticipate that the revenue, going in 2019 is going see this impact in a similar range on a year-on-year basis e.g. offsetting the recent price increases like you saw here in fiscal '18?

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

Yes, the food fight is still alive and well at Goldman Sachs. I think the question was based around sales channel mix and its impact. First of all, let me make a comment on pricing, we were very pleased with the price capture that we were able to achieve in the second quarter, and really, there's still more to come as it rolls through. But just so everyone understands, while price capture for us we believe contributed low single digit to our growth, understand that probably 2/3 of our business is really bid business. And I think it's very different than some of our competitors. So that 1/3 that is subject to price lists and so on and so forth is really where the price increases were put in place. When it comes to our bid business, we are



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always looking to sell the value of our solutions and optimize our profitability as best we can. We were very pleased this quarter with how, again, the realization of price helped offset a great deal of the cost that we had. Some of the channel mix discussion that we bring up really is the fact that this quarter had what, we believe, was an anomaly because of the pull forward within the C&I market, as the people are trying to avoid price increases placing their orders early. And so therefore in Q2, we saw a drop in sales volume in the C&I market. But when we look at our overall business, it grew over 3% sales volume. So it was other channels that allowed us to show growth. So again, our Distech, BMS just knocked the ball out of the park in Q2, and they've been doing that. They're doing a great job. That's within our independent sales network, if you will, channel. We also had growth in our infrastructure and utility. We had growth in our corporate accounts channel. So all of these have varying dynamics of both gross profit margin profile as well as then below the line, the gross profit line, the service requirements. So when we talk about all of the sales channel mix, it's alive and well for Acuity. I think the bottom line on all of this is the 50 bps of operating profit improvement that you saw in the quarter. So we're doing the right things of raising prices, differentiating our product solutions, getting after productivity improvements within our organization, Again, price increases, all of this is to drive -- and I'm really pleased with how our folks drove improvement on our operating profit margins. We didn't talk about variable contribution margin, but variable contribution margin this quarter was like over 30%. So we're focused on the right things, we're looking to improve stuff. We made commentary that we're looking at certain portions of our portfolio. This is small, it's not big. But just to say, hey, are we getting the right kinds of returns, both on sales and on our return on investment that are appropriate with the objectives that we have. So I think you'll continue to see channel mix, but if we're coming into historically our second half, which is as larger volumes in the first half, some of those mix shifts should result in some more favorability to us.

Operator

And our next question comes from Christopher Glynn with Oppenheimer.

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

Just following up on the price topic. Just wondering how you'd mark -- where you might be along the expected price capture and realization ultimately, as you worked through some of those -- the bid business "protections"? You think you're kind of halfway there? A couple of quarters out from what you see is kind of steady state based on the dynamics you've addressed so far?

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

You know, Chris, it's a good question. And it's just -- it's a educated guess so take it for what it's worth, I would say that we probably still have another quarter of just a little bit of noise on that. But as I said earlier, really pleased with the price capture on that portion of our business that is off of a price -- based off a price sheet. I think others have said the same thing. So we'll see. on the project side. Again, projects, we are always looking to differentiate our value proposition taking into account all aspect of that, including costs, to drive a difference.

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

Okay. And with expected continued mix pressure within the retail dynamics, can price offset that and get you to gross margin positive over the next few quarters? Or is there just too much contention there with the mix dynamic?

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

So don't use the word contention. What it is, is just how different people, different customers in that channel handle different aspects. The easiest one to understand is freight. Some people provide their own freight, and so they take that off, if you will, the sales price. So that has a gross profit dynamic. Some people ask us to provide the freight, and therefore, it's a higher priced consultant. So it's -- the dynamic is really not problematic, maybe the accounting treatment goes for that. We expect that dynamic to continue. So it's a reset, if you will, of your -- the notion of what historical margins for that channel may have been at gross profit and on operating profit. And operating profit is -- essentially will offset the difference. It's just that it influences the gross profit, and our SDA expense, primarily freight and commission. And you saw that this quarter, as our SDA expense



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was down pretty significantly. And so that, as you think about your models, all of you think about your models going forward, I would say that historically, our freight and commission is operated between say 11% and 12% of sales, the way we do our accounting. You know we'll probably be at the very low end of that range on a go forward basis. So if you're going to see overall SDA be down a little bit because of that phenomenon on a go-forward basis, but the margin profile will also be down as a result of that.

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

Okay. And then you mentioned in the press release focus on improving mix of products and solutions. Just want to clarify exactly what that means because, I think, your of steadiest growth is the large enterprise solutions customers that may, in fact, have the opposite effect within mix from the perspective of margins?

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

Yes, so we are very excited about the growth rates that we are experiencing in our corporate accounts. Again, as I mentioned -- call, those corporate accounts have been different. I mean it's all part of the same type of fixture, but they're driving the ability for us to ultimately sell an Atrius-enabled solution, more of the SaaS revenue kind of thing. So laying the track has really been a very positive thing. And it's growing our business very nicely. We're well over 2 billion square feet of Atrius-enabled fixtures, which is just a staggering number, and continuing to grow at an unbelievable pace. While the gross profit margin profile of that is below, if you will, what is the C&I channel. So when we talk about channel mix, our focus is to -- a key portion of our team is to drive and improve the C&I overall mix, particularly, around larger projects, those things continue just to be sluggish in terms of their release. Backlogs continue to be, for these types of projects, favorable. But they're slow to release. Lots of people tell us it has to do with labor shortages in certain markets. So what people are doing is amping up their education, trying to recruit more electricians so on and so forth. So we believe that this problem gets solved because the overall market dynamics, employment, rising commercial rental rates and industrial rates, vacancy rates, all these things are flashing big green signs. That usually means that if there's now an uptick coming in the build of that type of real estate, backlogs of customers would suggest that, that is true. But we haven't seen the releases of some of these larger projects. So that's what we mean by improving our channel mix.

Operator

(Operator Instructions) Our next question comes from Deepa Raghavan with Wells Fargo Securities.

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

Vern, just some commentary on how the quarter progressed month wise? That will be helpful. And if you can talk about any improved momentum or not well into March, now that March is under the belt?

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

Yes. The quarter was lumpy in terms of orders. Again, it's always difficult to quantify exactly why. Certainly, early into the quarter, so the December month for us was influenced by the pull forward. I also believe that January was impacted to a degree by weather in key parts of the country. We had a little bit of a government shutdown, so I'm grasping at straws to try and explain why there was this lumpiness. We are starting to see improvements in the overall order rate. And we would expect that because, again, you're coming out of seasonally, for us, our second quarter is always our softest quarter. And then we have the build going into Q3 and Q4. So probably a little bit too early to say that, oh, let's declare victory, and this is the way it's going to be. But we see favorability, and we continue to hear favorability.



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

That's the commentary for March?

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

We don't give commentary on individual. I'm just saying that what we saw as we departed Q2, we saw an improvement. We saw lumpiness in Q2. And we're now starting to see favorability relative to that lumpiness.

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

Understood. My second question is what are your thoughts on recent lighting industry M&A? I mean you're seeing this Cree fixture business being sold to a private family business, GE's current business gone to a PE, and now that Eaton has announced the spin as well. What does it say about the lighting industry as such? And secondly, is there an interest for you to participate in this?

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

My comment on the lighting industry is it's not going anywhere. I mean it's a robust industry, it's growing. It brings a lot of value. I think that some of the smaller bit players like Cree, they didn't make the right investments and they misstepped. And so they didn't win. Acuity has been investing heavily for the last decade, building out a controls platform, building on an IoT platform. I think that with Eaton's announcement that they're going to spin their lighting business, I think that, that was the portfolio decision. Lighting was a very small part of Eaton's overall portfolio and so they made a decision. But Eaton's lighting business isn't going anywhere. It's going to become its own public company. And so I don't see the notion of people making investment decisions as somehow being indicative of the lighting industry. When Eaton came out and said, "Here are our performance requirements, and our lighting business doesn't quite meet those." Acuity far exceeds those types of performance requirements. Our operating profit margin, yes, this quarter, 13.2%, improving. Our top line, we continue to grow. Our controls business continues to add improvement there. Yes, we're dealing with the notion of product substitution from -- to lower-priced alternatives so we're fighting, if you will, that trend. But we believe that we will be able to improve our margins, both gross profit as well as operating profit over time. I'm bullish on the lighting industry and where it's going to go. I think that some of these competitors that are -- again, the M&A has been with relatively minor players so far. The spin of Eaton's lighting business is not an M&A event, they're alive and well.

Operator

And our next question comes from Ryan Merkel with William Blair.

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

So first question from me, may be discuss in more detail what products and services you're reviewing? And what the impact could be to sales and margins?

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

So as part of our normal course, we look at product life cycle management. In the past, where product life cycles have been much longer and more traditional or conventional lighting. With the LED -- the advent of LED, it's no longer a new technology, it's around -- product life cycles have become shorter. The ability to be more innovative with form factors and how you put technology inside, those luminaries, it just shortens up the product life cycle. So what we're doing, in my view, is nothing more than a normal review of product life cycle management and making decisions around why are we going to continue to offer something that is no longer, in our view, effective relative to new form factors or new capabilities. I don't perceive that it's going to have a significant impact on our top line. If there, any impact to us, I expect it to have a offsetting positive impact on our



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margins and our return on investment. So to me, the reason we're mentioning it, is because we want people to understand that we're doing this, but the expectation is well, I don't think it'll be significant on our top line. It will have some impact, but we also believe it will improve our operating profit margins as well as our return on invested capital, which by the way is quite robust.

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

Okay, that's a helpful clarification. And then secondly, when do you expect the higher margin part of the Atrius solution to begin impacting the P&L? Because it feels to me that we're still not really selling a whole lot of the Tier 4, but maybe help us with that?

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

Yes, no, it's interesting, it's a great question. Against the backdrop of Acuity Brands, which is almost a \$4 billion business, it's hard to have an activity that is growing nicely spice the stew so significantly that you say, oh my gosh, I can now see the difference. We are getting great growth in our corporate accounts because people want the benefit of the Atrius-enabled capability. When they buy that, they usually wait till they have enough critical mass before they start to, if you will, drive the Ferrari. But for the early adopters, we are seeing interesting activity. It is positive to what we're doing. Where we're getting the growth so far is in our corporate account, as we continue to push the technology, enhance the technology, hone the technology, all the words that you want to use, once we're able to now more specifically control it, and once we have the opportunity to put it in the hands our agents -- and I still think, we're probably 12 to 18 months out where we could actually sell solutions into various verticals through that sales force, it will be a powerful capability and profit generator for Acuity.

Operator

Our next question comes from Tim Wojs with Baird.

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

Just 2 follow-ups for me. So the first is on inflation, the last couple of quarters, you had, kind of, called out a headwind to gross profit, I think, last quarter, it was \$16 million, and in Q4, it was \$20 million. Any color on what that was in the February quarter? And then secondly, just to kind of -- put a little finer point on this, mix issue, as you look forward, it's not unreasonable for us to think that all in, you should actually start to see margin improvement on an EBIT basis despite some of the mix issues with gross margins?

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

Sure, and you saw on an EBIT basis, the improvement in Q2.

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

Exactly.

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

50 basis points. Our expectation is that we will continue to drive improvement at the operating profit level. So to me, our -- coming back to your previous question on cost, our costs continue, like when we started to imagine that we're getting closer to where we're anniversary some of that cost, those numbers, the difference isn't as great. But yes, you would say okay, it has a deteriorating impact on your margin. This is where the price increases were very helpful in helping to lessen that and as we said, we believe that our price increases contributed low single-digit to our overall growth, which when you then further imagine that it really applies mostly to about a 1/3 of our business. We did get pretty solid capture.



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So a little bit of that sales channel mix this quarter noise because of the pull forward through the C&I channel or the C&I market, I should say, because of the price increases implemented on that, that caused a bit of a distortion. We still saw a great growth in our corporate accounts and again, just a big shout out to our Distech, BMS team. It really put some big points on the board, so and we expect that to continue. Those are -- that actually is margin accretive to us. So cost was an issue, tariffs issue, price increases benefited that. The mix -- the channel mix had to do with the pull forward in the Q1 from the C&I side.

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

Okay, great so EBIT margins, that expansion should continue going forward?

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

Well, we're not providing guidance. But as you might imagine that is going to...

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

I tried.

Operator

And our final question comes from Jeffrey Sprague with Vertical Research Partners.

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

Just wanted to come back to one of your earlier questions that might have been less about whether the lighting industry is going away and more about does it make sense in this environment for you guys to explore being a consolidator in an environment where arguably there's too much capacity? Or is that, kind of, country to your strategy and you'd rather just try to pull away from the pack organically?

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

Yes, so we continue to look at all types of M&A, whether it's technology, technology within lighting, technology within BMS, technology within Atrius, as well as lighting businesses that could enhance our portfolio. The Juno acquisition, that was a great example of a company that fit very nicely and filled a gap with us. The Juno team, fantastic opportunity, but also we acquired Lucid. Again, a fantastic company to help us drive more of our SaaS opportunities. So we are looking at a broad playing field, businesses that the most recent transactions that have been announced, where there's been M&A, not spin out. Those businesses, there was really no reason for us to participate in that. We believe that we have a robust portfolio, talented people, and as you point out, we would go at that and look to grow organically in the marketplace to tidy up a competitor or buy something like either of those 2 businesses, I think, would have been really dilutive to our returns and our attention. So we are active in the M&A world on all aspects like Ricky pointed out, but for us to drive consolidation with some of the companies that were available, that would not have been a benefit to Acuity shareholders.

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

And then a separate question. Totally understand your comment about the price increases and list price going through that 1/3 of your business, but does that activity significantly influence your ability to capture price on bids? Is there a kind of element of some sort of price umbrella or just kind of general tone in the market around positive price that would feed into your bidding activity?

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

Yes, still once we bid, and the bid has been accepted, this is where some of the previous jobs that have been either part of our agent's backlog or now a part of our backlog, a lot of that was price protected. As we look forward, we're looking at how do we continue to differentiate our solution set. This is where our controls platform is very helpful to us in adding differentiated value, and we are looking at what our cost structure is. But we price to the market opportunity, not to our cost structure. We look to improve our cost structure to drive margin influence, but higher cost in the marketplace does find its way into the project side of the world on future bids.

Operator

And ladies and gentlemen, that concludes our question-and-answer session for today's call. I would now like to turn the call back over to Mr. Vern Nagel for any closing remarks.

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

Thank 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. And thank you for your support.

Operator

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

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