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# EDITED TRANSCRIPT

AYI - Q2 2018 Acuity Brands Inc Earnings Call

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## OVERVIEW:

Co. reported 2Q18 net sales of \$832m, reported operating profit of \$88m and reported diluted EPS of \$2.33.



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## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

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## PRESENTATION

### Operator

Good morning, and welcome to Acuity Brands' Fiscal 2018 Second Quarter Financial Conference Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time.

And I would like to introduce Mr. Dan Smith, Senior Vice President, Treasurer and Secretary. Thank you. Sir, you may begin.

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

Good morning. With me today to discuss our fiscal 2018 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](http://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.

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### **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.

While we made progress on improving our top line growth in the second quarter, particularly against the backdrop of a continued weak nonresidential construction market, our profitability performance was below our expectations. 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 2018.

Net sales for the second quarter were \$832 million, an increase of over 3% compared with the year-ago period. Reported operating profit was \$88 million compared with \$108 million in the year-ago period. Reported diluted earnings per share was \$2.33 compared with \$1.53 in the year-ago



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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 2018 was \$103.8 million compared with adjusted operating profit of \$123.9 million in the year-ago period, a decrease of 16%. Adjusted operating profit margin was 12.5%, a decrease of 290 basis points compared with the margin reported in the prior year. Adjusted diluted earnings per share was \$1.89, up 7% from the year-ago period.

For the first 6 months of fiscal 2018, net cash provided by operating activities was \$178 million compared with \$90 million provided in the year-ago period. During the quarter, we spent \$194 million to repurchase 1.2 million shares of our stock. Nonetheless, we closed the quarter with \$230 million in cash on hand.

Looking at some specific details for the quarter. Net sales grew 3.4% over the year-ago period, driven by an increase in net sales volume of over 6% and an approximate 1% favorable impact from foreign exchange rates, partially offset by a 3.5% -- by 3.5% for unfavorable changes in product prices and the mix of products sold.

The increase in sales volume was primarily driven by greater shipments of our Atrius-based luminaires to certain customers in key channels as well as growth for certain high-volume, LED-based fixtures with popular form factors, primarily for applications on smaller projects. Sales of LED luminaires make up more than 2/3 of our total net sales, which, as you know, includes the sale of non-fixture related products and solutions as well.

There were 2 key areas that negatively impacted our net sales volume this quarter. We experienced declines in shipments in the nonresidential construction market, primarily for larger projects where demand remains soft and lower shipments through the home centers -- home center/showroom channel. Net sales through the home center/showroom channel, which made up more than 10% of our total net sales in the year-ago period, declined approximately 11% this quarter.

While changes in price and product mix impacted net sales in this channel due to the nature of the more basic lesser-featured products sold through these customers, we believe the decline in net sales was primarily due to changes in the in-house branding strategies being deployed by certain customers for select products in certain categories. We believe this shift will continue over the next few quarters, potentially impacting our results in a similar manner.

Further, overall net sales were impacted by unfavorable price/mix, primarily due to changes in both product mix, which included substitutions to lower-priced alternatives, and channel mix, which included declines in shipments to larger commercial projects noted earlier, which generally have a mix of higher-priced solutions. Price/mix was also impacted by lower pricing on certain LED luminaires, reflecting the decline in certain LED component cost as well as increased competition, primarily for more basic lesser-featured products.

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 on net sales due to price/mix was due more or less equally to changes in product and channel mix as well as changes in product prices. As such, we continue to accelerate the expansion of our product portfolio to more effectively and profitably compete in that portion of the market where features and performance are less important.

We will relaunch our Contractor Select portfolio, which will include many new products incorporating certain attributes of differentiation but at competitive price points that we believe will have great appeal to both the commercial pro and the residential consumers for their new construction and renovation projects. While this expanded portfolio, we believe, can offer even more choices to customers served in these markets that would prefer our innovative and affordable Juno and Lithonia lighting branded solutions to products offered by others, we will begin shipping these solutions in early summer.

Regarding overall market demand for luminaires in North America, we believe demand declined once again this quarter. While available market data does not line up perfectly with our quarters, initial information from numerous forecasting organizations, while varied, suggest shipments of lighting fixtures in the United States were flat to down low single digits when compared with the year-ago period.



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We believe this is the third quarter in a row where demand for luminaires in the U.S. was down compared with the same quarter 1 year earlier. Nonetheless, excluding our specific issues within the home center/showroom channel, we were still able to grow our net sales in the U.S. and Canada by more than 4% this quarter, outpacing the negative growth rate of the overall lighting industry. I will comment more on our expectations for the balance of 2018 later in the call.

Lastly, we believe our channel and product diversification as well as our strategies to better serve customers with new, more innovative and holistic lighting and building management solutions and the strength of our many sales forces have allowed us to continue to gain overall share in the North American market this quarter, particularly against the backdrop of the soft market environment. As I noted earlier in the call, this is particularly true in certain key verticals where demand for our Atrius-enabled luminaires continues to grow rapidly.

Our profitability measures for the second quarter were certainly below our expectations. They were impacted by continued tepid market conditions and the impact from changes in price/mix noted earlier. Our adjusted operating profit for the quarter was \$103.8 million, down approximately 16% compared with the year-ago period, while adjusted operating profit margin for the quarter was 12.5%, down 290 basis points from the adjusted margin in the year-ago period. The decrease in adjusted operating profit margin was primarily due to no variable contribution margin earned on the higher sales and the increase in selling, distribution and administrative expenses, both in dollars and as a percentage of net sales.

Gross profit margin for the second quarter was 40.2%, a decrease of 150 basis points compared with adjusted gross profit margin reported in the year-ago period. Gross profit and gross profit margin were negatively impacted by unfavorable price/mix, foreign currency and higher input costs for certain commodity-related items, particularly steel and certain oil-based components. This was partially offset by higher sales volume noted earlier, lower costs for certain components, primarily for LED fixtures, and productivity improvements within our supply chain.

We continue to aggressively take actions to enhance our overall competitiveness and improve our profitability, including accelerating programs to introduce new products with more appropriate cost structures that we believe will lessen the impact of price/mix, efforts to reduce cost on existing products and to drive overall productivity improvements.

Next, adjusted SDA expenses were up \$19.2 million compared with the year-ago period. Adjusted SDA expense as a percentage of net sales was 27.8% in the second quarter, an increase of 150 basis points from the year-ago period. The increase in adjusted SDA expense was primarily due to higher freight cost to support the increase in net sales and greater employee-related costs, including higher compensation expense, rising health care and an increase in the number of associates compared with the year-ago period.

Greater employee-related cost accounted for more than half of the increase in total SDA expense this quarter when compared with the year-ago period. We expect this higher level of employee-related cost to continue in the second half of fiscal 2018.

Our adjusted diluted EPS was \$1.89 compared to \$1.77 recorded in the year-ago period. The increase was primarily due to the favorable impact on income tax for the new tax law, as Ricky will explain later in the call, and lower average shares outstanding due to the stock repurchases in the past year, partially offset by a decline in operating profit in the quarter.

Before I turn the call over to Ricky, I would like to comment on a few important accomplishments this quarter. On the strategic and technology front, we continue to make positive strides, setting the stage for what we believe will be strong revenue growth and profitability over the long term. While sales data for our tiered solutions are still imprecise, we believe sales in our Tier 3 and 4 categories encompassing our holistic, integrated solutions were up well over 20% this quarter and represent almost 15% of our total sales.

As a reminder, Tier 3 includes the sale of our network and IoT-enabled luminaires, while Tier 4 includes recurring revenues for services, including from our Atrius IoT solution set. The growth in our combined Tiers 3 and 4 was driven primarily by greater shipments of Atrius-based luminaires in key verticals, as demand for these lighting-based IoT solutions continue to expand.

From a commercial perspective, we have accelerated the number of Atrius-enabled deployments and increased active programs with several of the largest U.S.-based retailers as well as other key vertical applications, including certain types of public buildings.



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We believe these commitments and orders from customers, accelerating an expansion of their current platforms as well as customers moving beyond pilot programs to implementation, will afford us the opportunity to meaningfully expand our install base of Atrius-enabled systems in future quarters. And this does not include the potential growth opportunities from new customers and partners that began from what sure is great interest in deploying our lighting platforms, enabling the utilization of our Atrius-based solutions.

Also in the quarter, we completed the acquisition of Lucid, a data analytics software company to enhance our expanding portfolio of building management services. Lucid, based in Oakland, California, has approximately 40 associates who will be part of our Atrius team.

Lastly, our Board authorized a repurchase of up to 6 million shares or approximately 15% of the company's outstanding stock, reflecting our long-term optimism for the company's prospects. Additionally, our Board believes that the repurchases of the company's stocks supports our objective to maximize long-term shareholder value while continuing to fund investments to better serve our customers, grow our business and improve our operating and financial performance. Ricky will have additional comments on this in a moment.

We have been able to create these capabilities while providing industry-leading results because of the dedication resolve of our approximately 12,500 associates, who are maniacally focused on serving, solving and supporting the needs of our customers. I will talk more about our future growth strategies and our market expectations for the construction market later in the call.

I would like to now turn the call over to Ricky before I make a few closing comments. Thank you.

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### **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 fiscal 2018 and 2017, which we find useful to add back in order for the results to be comparable. In our earnings release, we provide a detailed reconciliation of non-GAAP measures for the second quarter of both fiscal year 2018 and 2017.

Adjusted results exclude the impact of amortization expense for acquired intangible assets, share-based payments expense, 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 of 2017.

We believe adjusting for these items and providing these non-GAAP measures provide greater comparability and enhance visibility into our results of operations. We think you will find this transparency very helpful in your analysis of our performance. In addition, many of our peer companies, especially as we become more of a technology company, make similar adjustments, so it will help as you compare our performance to other public companies in our industry.

The effective tax rate for the second quarter was a benefit of 23.1%. This benefit included \$31.2 million or \$0.75 per diluted EPS of net discrete items associated with the U.S. income tax cuts, primarily due to an income tax benefit from the remeasurement of the company's net U.S. deferred tax liabilities to a reduced federal rate, partially offset by an unfavorable impact related to the taxation of the company's accumulated unremitted foreign earnings. Excluding this discrete benefit, the adjusted effective tax rate was 16.9% compared with 32.6% in the second quarter of last year.

We currently estimate that our blended effective income tax rate before discrete items will approximate 26% to 28% for the remainder of fiscal 2018 and 23% to 25% for fiscal 2019. As these lower rates reflect, the passage of the new U.S. tax law will have a meaningfully positive impact on lowering taxes paid by Acuity, thus enhancing our future earnings and cash flow.

The impact of the tax legislation may differ from the current estimates, possibly materially due to, among other things, changes in interpretation or assumptions the company has made, guidance that may be issued and actions that the company may make as a result of the tax legislation.

On February 12, 2018, using cash on hand, we acquired Lucid Design Group headquartered in Oakland, California. Lucid provides a data and analytic platform to make data-driven decisions to improve building efficiency and drive energy conservation and savings.



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Its SaaS-based building OS platform enables owners, operators and occupants to find powerful insights in their building operations' data to make buildings more efficient and improve the performance of the people and businesses that rely on them. Lucid's operating results and preliminary amounts related to the acquisition accounting were included in the consolidated financial statements from the date of acquisition and are not material.

We generated \$178.3 million of net cash flow provided by operating activities during the 6 months ended February 28, 2018, compared with \$90 million for the year-ago period, an increase of \$88.3 million. This significant increase in cash flow compared with the year-ago period was due primarily to lower operating working capital requirements and lower variable incentive compensation payments.

Operating working capital, defined as receivables plus inventories less payables, decreased approximately \$26 million during the first 6 months of fiscal 2018.

At February 28, 2018, we had a cash and cash equivalent balance of \$229.8 million, a decrease of \$81.3 million since August 31, 2017. This decrease was due primarily to cash used to repurchase common stock, to fund acquisitions, to invest in plant and equipment and to pay dividends. We repurchased 1.2 million shares for \$194.3 million during the second quarter of fiscal 2018.

Our investment in capital expenditures was \$20.9 million for the first half of fiscal 2018, a decrease of almost \$15 million compared with the prior year. We currently expect to invest approximately 2% of net sales in capital expenditures in fiscal 2018.

As Vern mentioned earlier, our Board just authorized the repurchase of up to 6 million shares of common stock. The extent and timing of actual stock repurchases will be subject to various factors, including stock price, company performance, expected future market conditions and other possible uses of cash, such as acquisitions.

We believe the repurchase of all of the shares under the improved authorization within a 12-month period would require additional resources beyond our current available cash and borrowing capacity. Therefore, we may incur additional borrowings and increase our leverage to accommodate such repurchases.

The Board believes the repurchase of the company stocks supports our objective to maximize long-term shareholder value. We further believe, because of our strong cash flow and availability to additional financing, we should be able to continue to fund investments to better serve our customers, grow our business, both organically and via potential acquisitions and strategic partnerships, and improve our operating and financial performance.

Our total debt outstanding was \$356.9 million at February 28, 2018. Our debt to capitalization at February 28, 2018 was 17.9%, and net debt to capital was 7.2%. We had additional borrowing capacity of \$244.7 million at February 28, 2018, under our credit facility, which does not expire until August 2019.

Based on our cash on hand, additional committed borrowing capacity and our expected short-term cash flow from operations, less cash needed to fund operations as currently planned, make anticipated capital investments, pay quarterly dividends as currently anticipated, pay principal and interest on borrowings as currently scheduled, make required contributions to our employee-benefit plans and fund possible acquisitions, we anticipate over the next few months having approximately \$300 million available for share repurchase.

As I mentioned previously, to be able to purchase the full 6 million shares authorized over the next 12 months, we would need to obtain additional financing. The type of debt instruments, amount, terms and timing of additional borrowings will be dependent on the extent and timing of share repurchase activity.

Thank you, and I'll turn it back to Vern.



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

Thank you, Ricky. The current weakness in the lighting industry has created a challenging environment for management to drive short-term financial performance while continuing to invest in attractive long-term opportunities. Nonetheless, we are optimistic regarding our long-term future despite this persistent market softness, which has impacted our short-term financial performance.

We are often asked about the vitality and conditions of the key end markets we serve. On one hand, market data suggests that the overall growth rate of the U.S. lighting market over the last 3 quarters was down low single digits compared with the year-ago periods. Many reasons have been cited for this softness, including, among others, weak nonresidential construction activity, lack of skilled labor, previous concerns over tax regulations and current uncertainty regarding trade policies, substitutions to lower-priced alternative products and pricing pressures in some end markets for certain less-featured products.

On the other hand, while we believe all of this is true to varying degrees, we continue to poll our vast customer base and channel partners. And from the majority, we continue to hear guarded optimism regarding the prospects for future growth. Generally speaking, the trades are busy and backlogs are favorable.

As for our market expectations for the balance of 2018, we continue to see favorable trends in certain leading indicators, continue to hear from customers that large projects are set to release and see some encouraging reports from third-party forecasting organizations. Nonetheless, we continue to be cautious and believe overall market conditions could continue to be challenging for the near future, suggesting growth in the lighting fixture market may remain sluggish for the balance of fiscal 2018.

However, most importantly, we expect to continue to outperform the overall growth rate of the markets we serve, primarily in North America. While we expect the headwinds noted earlier in the home center/showroom channel to continue to negatively impact our net sales in the near term, we believe there is an opportunity for growth later in the calendar year, as we bring additional solutions to key customers and take actions to expand our access to market in this important channel.

Further, we believe the sales of our Atrius-based luminaires within our Tier 3 and 4 categories will continue to expand, though this can be lumpy at times based on our various customers' renovation and new construction cycles.

Next, we believe that product substitutions to lower-priced alternatives for certain products in portions of the market will continue, particularly for more basic lesser-featured products sold through certain channels, pressuring top line growth and potential -- potentially, profitability.

Next, we believe the price of certain LED components will continue to decline, though at a decelerating pace, while certain other costs, including certain components and commodity costs, especially steel prices, as well as certain employee-related costs, primarily due to compensation inflation and other related costs, will continue to increase.

Our adjusted SDA cost as a percentage of net sales this quarter was 27.8%. We believe this percentage was at the high-end of the range, as our second quarter net sales are usually our lowest of the 4 fiscal quarters. We expect to mitigate the impact of some of these rising costs with certain pricing initiatives, productivity improvements and the implementation of programs to reduce product and other overhead cost, though the timing of these initiatives might lag the timing of these increased costs.

Additionally, our gross profit margin is influenced by several factors, including sales volume, innovation, components and commodities cost, market-level pricing and changes in the mix of products and sales channels. We are always striving to improve our profitability. However, we believe that for any meaningful margin improvement to occur, we will need to experience an acceleration in market demand, particularly for larger commercial projects.

Also, we expect our gross margins to improve once the introduction of our newest products and solutions become a more meaningful portion of our revenues over the next several quarters, our mix evolves as we execute our tiered solutions strategy, particularly for our Atrius-based solutions, and as we realize typical gains in manufacturing efficiencies.

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Next, we continue to be leery of the impact of foreign currency exchange rate fluctuations, which are always unpredictable.

So to be very clear, our focus is to garner additional top line growth, driven primarily by our ability to outperform the growth rates of the markets we serve, continue to improve the mix of products and solutions as we execute our tiered solutions strategy and to leverage our fixed-cost infrastructure to achieve targeted incremental margins to improve our overall profitability.

Lastly, we are focused on and very excited by the long-term potential of the many opportunities to enhance our already strong platform, including the expansion of our Tier 3 and 4 holistic lighting, building management and our Atrius IoT platform and software solutions. The world of data optimization, targeted by our Atrius platform, is in the early beginnings, and we believe we are uniquely positioned to take full advantage of these high-growth opportunities.

We have noted in our last several conference calls, the implementation of our integrated tiered solutions strategy and our opportunities to meaningfully participate in the interconnected world is an integral part of our overall long-term growth strategy to meaningfully expand our addressable market by adding significantly greater broad-based holistic solutions that will allow our customers to optimize the performance of their connected intelligent buildings and campuses.

This all takes focus and resources. We are investing today to enhance and expand our core competencies, affording us the opportunity to excel over the long term in our fast-changing industry because we see great future opportunity. 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 significant 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 these exciting and growing industries. Therefore, we remain bullish regarding the company's long-term prospects for continued profitable growth, particularly as we bring more value-added solutions to the market for both new construction and the conversion of the installed base.

Thank you. And with that, we will entertain any questions that you have.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Matt McCall with Seaport Global Securities.

### **Reuben Garner** - *Seaport Global Securities LLC, Research Division - Associate Analyst*

It's actually Reuben on for Matt. So a lot of moving parts with the margins right now. Can you kind of update us, I guess, if the current environment continues? I know you've got inflation in freight and steel and employee cost. Can you help us with maybe where you're expecting contribution margins to be over the next year or 2 with the current environment?

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

Well, as we've pointed out in our prepared remarks, our focus is to really adjust the portfolio through new product introductions, both at the, if you will, lesser-featured end of the market as well as to continue to bring out solution sets that support the higher end of the market. Our Atrius-based solutions are in high demand. We're seeing very significant growth for these types of products. So we're looking to manage, if you will, the business in this, if you will, challenging environment. And so I think you'll see our margins -- and as we've said again in our prepared remarks, probably not

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change a great deal unless we do see a pickup in some of the proportions of the market, particularly for larger projects where we typically enjoy higher margins because of the differentiated nature of those products. So we are expecting that, by the way, to happen. From an SDA perspective, I'd like to just make sure everyone understands that while our costs are up, not -- we've added headcount over the year-ago period. The increase in our headcount over the last few quarters has really flattened out, as we continue to leverage our structure. So we're seeing a period-over-period improvement. But SDA as a percentage of sale, on an adjusted basis, we were at 27.8%. Typically, we're in the upper 26s, call it, say, 27%. But the second quarter is typically our lowest volume quarter, our lowest sales volume quarter. So as a percentage, the numbers are a bit higher. As we look out to the third quarter and the fourth quarter, our expectation that SDA as a percentage of sales will come down more into the range that we typically have operated, which is in that, call it, 26% to low 27% range. I would also caution folks that our third quarter is typically our highest expense quarter because we have certain events where we have like our national sales conference, and we have LIGHTFAIR. These are expensive activities, and they typically occur in our third quarter.

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**Reuben Garner** - *Seaport Global Securities LLC, Research Division - Associate Analyst*

Okay. And Vern, just to clarify that the -- when you say you don't expect margins to change much unless you have an acceleration, is that from the Q2 levels? Or are you talking about on a year-over-year basis?

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

I think we're looking more on a year-over-year basis, though our Q2 margins, obviously pressured compared to the year-ago basis, were driven primarily by -- it's difficult for us to precisely gauge price versus mix, but we think in this particularly quarter, it was about half-and-half. If you go back and look at it historically, we have typically experienced price/mix in the 1% to 2% range. We have gone above that. But typically, that's been price-related. And so this quarter, we saw, again, compared to the year-ago period, a channel mix and a product mix movement that was in addition to, if you will, price. And that channel mix has to do again with the larger project portion of the world. And we hear from lots of people that backlogs are strong, activity is good and that these projects will release. They just haven't released. We have great market share there. We have great value propositions, but we're just not seeing the release. And so while, again, people are encouraged, until we actually get the order and then ship it, that's when we'll declare that the markets are moving back in a more favorable way.

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**Reuben Garner** - *Seaport Global Securities LLC, Research Division - Associate Analyst*

Okay. Great, very helpful. And then on the share repurchase program, can you help us with -- you kind of touched on it a little bit in your prepared remarks, but the -- how you view share repurchase versus M&A today? And maybe do you have an updated leverage target, given the extent of the potential share repurchase program?

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

Yes, let me take a quick answer, and then, Ricky, please chime in. If I look back over the last decade or so, Acuity has really done, I think, an excellent job of returning capital to shareholders in very shareholder-friendly ways. We've purchased over \$1 billion worth of our shares, almost 15 million shares over the last decade plus. We've done acquisitions totaling about \$1.1 billion, \$1.2 billion. We've returned dividends of probably north of \$300 million and CapEx of about \$700 million. So Acuity is always looking over the longer term for ways to optimize its return to shareholders. We are very optimistic about our long-term growth opportunities. We see the technology side of our business really being in its nascent beginning, but yet the optimism and the utilization is now starting to ramp up. We're very excited about that. So we're going to continue to invest in that because we see it as a huge potential for us. So we want to make sure that we're balancing off how do we invest in our business with the opportunity to take advantage of situations where the marketplace, in our view, is misjudging the, really, the long-term opportunities of this company. And so this is why we are saying that it is a -- we will continue to look to do share purchases because we see that as a long-term valuation creating opportunity for our shareholders. We are -- Ricky, if you look at our balance sheet, we have historically been underlevered relative to sort of our industry norms. And so this share repurchase really gives us the opportunity to have a capital structure that may be more consistent with industry norms.



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

Yes, I would add onto that. On the leverage side, we clearly want to maintain our investment-grade rating. We've had some preliminary discussions with the rating agencies and so forth around that. So leverage would still be in line with what you would expect for an investment-grade company, but as Vern said, higher than the very low leverage we've had in the past. So probably under 2x leverage would be what you would expect versus us being more close to half a turn of leverage in the past, so -- are willing to leverage up. I would say on the M&A, the pipeline continues to look good. We do have the capability and the desire to continue to be active in M&A. We will be likely accessing additional capital to make sure that we have the firepower should we purchase the entire 6 million, that we still have the firepower to be active in the M&A area. So I don't think our long-term allocation of capital will change dramatically in terms of M&A and buying back shares. But as Vern said right now, the share repurchase looks like an attractive way to enhance shareholder value, and we believe we can do that while continuing to be in the M&A market and seeking opportunities to increase value through M&A as well.

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

And let me just add one more comment. Ricky's intent would be to be opportunistic in the marketplace, to acquire shares and do that over time.

**Operator**

And our next question comes from Rick Kwas, Wells Fargo Securities.

**Richard Michael Kwas** - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Just a question on price/mix, Vern. So should we think about mix being this sort of headwind going forward? And in combination with price, the down 3 to 4 is the right way to think about it or at least over the next few quarters? It just seems to me that at least from a mix standpoint, it's going to be a little bit of a struggle to lessen that burden over the next few quarters given the comps you face and given the import competition out there. So I think considering that it's pretty important to gross margin and hence, how the stocks going to behave over the next several quarters, how should we think about this to rightsize our thought process around trying to model this?

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

Sure. We believe that the pricing environment has for that certain portion of the market that we'll call the lesser-featured, sort of lower-valued market, pricing competition there has remained fairly consistent. It's been aggressive. And so that is primarily where we're seeing, if you will, price. We have price in some other areas. There's a little bit of product substitution that's also influencing that. But I would say that it's more the channel mix side of it, we're guessing. I mean, it's really difficult for us to precisely pin down the difference between price changes as well as channel and product mix. That channel and product mix, which we guess to be approximately half of the 3.5%, so you can do the math around that. We think it's really the larger project side of the world just continuing to be soft. When I look at our projects and our shipments into projects, Q2-over-Q2, I mean, it represents the primary reason that we were down, if you will, in that area. So I see us competing very effectively, if you will, in the world of those lesser-featured, lower-value type products. Yes, we have to tweak our portfolio, but we're pretty good at that. When I look at our -- when we said that our volume was up about a little over 6%, and we look at our contribution margin off of that, it was consistent with what we've seen throughout our entire portfolio. So that's not the issue. It's that, it's in price/mix, half of it price, half of it mix. And in the mix piece, it's really more -- we're just not seeing the uptick yet in larger projects. We believe it will happen. But when will it happen, we're just being cautiously optimistic about it. We are very excited about the growth rates that we're experiencing for our Atrius-enabled luminaires. But a lot of those products are finding their way into very large, if you will, buildings, whether it's commercial retailers or whether it's large public facilities, airports, convention centers. And so what happens typically is that you're focused on shipping a lot of the very similar-type fixture. So the margin profile, the cost to serve that piece of business, by the way, is just less. It's not that it's bad, it's just less. It's less than these larger projects that we see in the commercial world where they're very complex. They are incorporating a great deal of different luminaires, control platforms and they're a beast to manage, and we're really good at it. And so that's just not happening. So that's the mix piece. On the price piece, Ricky, we're seeing kind of the same. I mean,



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we're not seeing lots of difference. We're seeing a little bit more substitution going on. But even in that substitution, while the price points may be lower, our gross margin profile as a percentage is still attractive. We're selling more of them and so we saw that in our world. So I hope I'm giving you some guidance that, for us, the opportunity to leverage our platform is really built around 2 things. One, continuing to move our product portfolio, to be competitive in that lower, less-featured product portion of the market. But being ready to serve large jobs, and these jobs would be \$50,000 and above kind of jobs that are important to us.

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

Yes, I would just add to Vern's comment that it's -- the price portion hasn't changed as much as I think it's the channel and product mix that got it to go up from 1 to 2 to the 3 to 4. And it's hard to predict, is that channel mix going to continue to be where it was this quarter or are we going to see the improvement, which Vern highlighted in these major projects and all, that better forecast where that price/mix may go.

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**Richard Michael Kwas** - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

And then do you feel you're losing share on the larger, more specified projects?

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

No, not at all. We do not. The solution set and portfolio is robust. The -- our access to that market through our agency partners is strong. It's interesting to us when we specifically look at geographies and markets. I mean, it's a handful of markets also that are experiencing fairly significant decline. And we know these markets, the Dodge Data supports declines, so on and so forth. And a lot of our agents in those key markets are, I mean, they're the 900-pound gorillas. And so they're saying, "Look, we're busy, but there's just nothing that's releasing right now."

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**Richard Michael Kwas** - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. And then just a real quick one on tariffs. I know it's early days, but what are your thoughts around tariffs, the impact on -- as it relates to the competition as well as on margins in your business? I don't know what percentage of your LED chips you source from China appears to be on the list in terms of being affected by tariffs. And then that would affect import players as well. So just curious on how -- I know it's early, but just any broad thoughts on how you think the impact could shake out over the next few quarters.

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

So Ricky, what is known, right, is the fact that steel and aluminum and we know that, that has not really had an impact on any of us when it comes to the specific componentry. I think that we're evaluating some of those things that again, we have a robust supply chain. What we're seeing from the administration are still positive signs. There's a lot of rhetoric around the relationship between Canada, U.S. and Mexico. We produce roughly 80% of what we sell. We import -- of that 20%, we import probably a little more than half of that, so that would be subject potentially to some opportunities for price increases. But we believe that our competition for those types of products are doing exactly the same. So the marketplace would be impacted almost equally. I would be encouraged by our supply chain in North America to fully leverage our capabilities should there be some differences that occur in how they interpret what components are. Yes, we purchased LED chips. But we purchase them from around the globe, not just, if you will, Chinese-based suppliers. So it -- we have other suppliers that we are -- that we consider partners that are in different parts of the globe than what is being discussed as potential targets for import fees, import duties.

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**Operator**

Our next question comes from Ryan Merkel, William Blair.



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

So first question I had was on launching the value lines to win back share in the stock and flow. On average, how much lower are the ASPs relative to the product you were selling before? And then are the gross margin rates similar or lower than before?

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

Yes. So the opportunity of relaunching Contractor Select, I mean, the portfolio is roughly in place, and some of those products are being sold today. So we don't see a meaningful, if you will, change in price. But what we do see is of the products that we are adding, what we're doing is we're -- those products are more appropriately featured, though there'll be some points of differentiation that we'll make that more appropriately feature for the market, and our cost structure will be more attractive for us. So really, it has more to do with us not, if you will, gaining share. We're not losing share. Yes, we could gain share. We expect to continue to grow in those areas, but it's really about attacking some of our profitability around those and to improve that price/mix, if you will, relationship.

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

So are the gross margin then similar to before?

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

Gross margin, I'm going to talk gross margin percentage. I think that our gross margin percentages will continue to improve on that, if you will, revamped product line. From a pricing perspective, we don't believe we've been losing any share in the marketplace. We think that there's actually opportunity to gain share. Data around that is hard to come by, but the data that we do have suggests that we're maintaining our share, even in the face of, if you will, some price degradation and substitutions going on in that end. We just want to improve our profitability margin percentages on those products that we sell. We're seeing nice volume growth, form factors are changing and so we expect that. We're actually driving some of that. So while the top line dollars are being impacted in that substitution, we think that we're actually improving our margin percentages. So it would be interesting to see. The installed base is massive, and that's where a lot of this stuff is going. So we believe it could be an incremental opportunity for sales growth, even though units will be up higher than sales dollars. But we want to continue to drive our sales dollars up as well, as well as our margin percentage with these types of more competitive value propositions for that portion of the market.

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

Got it, that's helpful. Okay, and then secondly, why have you needed to substitute to lower-priced products for large commercial jobs?

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

I'm sorry, say that again?

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

You mentioned you needed to substitute to lower-priced products for large commercial projects. I'm wondering what was the driver there? What's driving that decision?



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

Yes, if I said that, I didn't mean that. So I apologize. I think that on the larger projects, the opportunity there is to sell valued propositions that were priced -- price is always important. It's a competitive bid business, but it's not the same as, if you will, stock and flow where there is not really a specifier involved. Our pricing and our opportunities in that on those larger projects is really brought to bear by we're having a much better mix of products typically, we're adding much more controls into it and we're having the product or project manage those capabilities with our channel partners to bring value to that entire project. So I don't consider that to be a -- it's very different than what's happening, if you will, in that lesser-featured, individual, single product flowing to non-specified jobs. So if I said that somehow we're having to substitute product on larger projects, that's not what I meant. Ricky?

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

I was just going to say the substitution where we're more seeing that is in moving from troughers to panels or some downlights to wafers, not in the major projects as much.

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

Got it. I just misunderstood, I think, the press release. I read it wrong. Lastly, the price pressure you're seeing, is it still just impacting the 20% of sales that you defined as lesser-featured products?

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

Yes. Again, as we've said, project business by its very nature has always been a bid business. But typically, folks, when they're bidding, they're looking at the full value of their solution set. It's not just products, but it's how well can they project manage. It's how well can they tie in their more sophisticated control solutions, things of that nature. So again, while it's a competitive bid business, it's not someone coming in and saying, "I sent something over the Internet, and here's my price. Do you want to buy it?" It's very different than that, so -- and on the 80-20, I would say the 20% is more people who are interested in first cost. So price, more important -- price and availability, more important than features and functionality. For people who are interested in the total cost of ownership, they do have an ear towards how will this help me make my building smarter and more intelligent, how will it make my building do more things for me. So you have the opportunity to differentiate your value proposition. Sure, there's still substitution going on, as Ricky points out for some of these products, just because some of these new form factors are really cool and really interesting, some of them are at lower price points than the brethren that they're potentially displacing. But then there are other products that are coming to the marketplace that are higher priced than the products that they're displacing because they do more, and they're better luminaires.

**Operator**

Our next question comes from Sophie Karp with Guggenheim Securities.

**Sophie Ksenia Karp** - *Guggenheim Securities, LLC, Research Division - Senior Analyst*

I wanted to drill down a little more on the lack of large bid jobs that you have been referencing. This is actually quite kind of interesting because we don't see the same dynamic in other companies that are levered to the same construction cycle. And for example, we cover some HVAC names, and they've seen an increase in large jobs in the last quarter or 2. So I'm curious if maybe, are you seeing that maybe the agents are being disintermediated somehow? Because I'm assuming if the building is being built that needs HVACs, it also needs lighting, right? So why is that, that this discrepancy in these trends around similarly -- seemingly the same markets. Maybe you can comment on that?



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

That's a great question. Yes, I can. It is very encouraging to us that the HVAC and other folks like that are seeing pickups in their business because the last people into larger projects are the lighting people, the furniture people, the carpet people. So we're the last 20% of any project. So this is why I said in my prepared remarks and why we feel that there is going to be this uptick because we are seeing improvements in the steel people, in the HVAC people in some of these things. But I would tell you that we are not forecasters, and I want to be really clear about that. We use data that you all see. If I look at the Census Bureau, private nonresidential spend, which is a key market for us, it's been down low single digits or flat for 9 months in a row. That's not our data. That's Census data. Private resi has been -- it went from being kind of low double digits. Now it's kind of flat -- or excuse me, now middle single digits. And then when we look at lighting equipment, also from the U.S. Census Bureau, it's been down 5 of the last 6 quarters. In the most recent quarter, it was down 3.5%. So I don't think that the channel is being disintermediated, particularly for larger projects. The channel may be under -- or channels, I should say, may be under pressure or different ways of conducting business over the Internet, things of that nature, on those lower-end, lesser-featured type products. But I think on the larger projects side, I think we're positioned incredibly well for that uptick. So I would submit to you that the positiveness that you're seeing in some other folks who are earlier in the construction cycle should bode well for the overall lighting industry for larger projects.

**Operator**

Our next question comes from Tim Wojs with Baird.

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

Maybe just -- I just had a couple of cost questions. So I guess on the SD&A line, I think absolute SD&A might have been up about \$20 million year-on-year in the second quarter. And I know it's a weaker quarter from a percentage basis. But on an absolute basis in the back half of the year, would you expect it, SD&A to continue to be up in dollar values? And I guess, what's the flexibility that you have internally to take cost actions to maybe reduce that SD&A line if you have to?

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

Yes, we would expect dollars to be higher in the back half and understand why. So a portion of our SDA is truly variable, freight commissions. It's roughly between 11.5%, 12% of sales. And so as sales in the back half of this, everyone knows, we are more of a back half-oriented company; third quarter, fourth quarter sales are typically higher than first and second quarter, with second quarter typically being our lowest sales quarter. So that variable dollar is going to take it up. Number two, the headcount, while it's been fairly stable for the last few quarters on a period-over-period basis, it's still going to increase. Wage inflation is alive and well. We provided merit increases effective November 1, Ricky, I think it was?

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

Correct.

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

And so, a range there. And we've -- so we've added wage increases, headcount to a degree. We're enhancing the incentive compensation based on full year opportunity, cash flows being very robust, which is one of our elements, and we've been incurring some additional cost because we are expanding access into a couple of different channels that are requiring incremental investment. The third quarter is typically always higher because we have LIGHTFAIR, and we have our national sales meeting, which are millions of dollars to pull these things off. Those are period expenses, but yet, we expect our revenues to increase even in this, if you will, somewhat tepid environment. So as a percentage of sales, we would expect our adjusted SDA to come back down. It's interesting, when I look back over the last handful of years, we have had SDA in the second quarter of 27.8% before. I mean, I'm not saying that it's a good or bad thing, but these are investments. Now to answer your question around taking cost out.

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We are always looking for ways to improve our structure, our cost structure. I'm very pleased with what our supply chain people are doing. We've seen real productivity gains. If you all go back to the fourth quarter of 2016 where we had some issues related to the stability of the workforce in a couple places because of dynamics that were happening beyond our control, we've now really found stability there. So we are looking at areas where can we stop doing some things so that we can continue to invest in areas that have long-term promise. This has been one of the most challenging environments that I think this management team has had to deal with because the markets, in theory, if you look at the stock market, if you look at the overall economy, you see things that are positive, but yet when you look at the real underlying factors relative to nonresidential construction in our world, it's almost as if we're in a bit of a recession. And yet, we see tremendous attractive long-term opportunities, particularly as we think about what Atrius can be. So we're managing the heck out of it, making tough decisions about what we're not going to do so that we can invest in things that we're going to do. The things that we're going to do take a little bit longer to come to fruition. But if I look at Atrius and our Atrius-enabled luminaires and our building management platform, these businesses continue to add to our top line growth. So we're excited about the prospects of the previous question. If HVAC is now picking up, that should have a positive contagion to Acuity on a go-forward basis.

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

Okay, great. That's very helpful. I appreciate all the color. And then I guess relative to pricing and maybe managing some of the commodity increases that you might be seeing in raw materials and freight, would you -- are you comfortable getting like-for-like pricing increases just given maybe some of the competitiveness in the market? Or do you -- would that come through new product introductions that might have a higher ASP or a despec product?

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

Yes, we are looking to -- we have increased prices on certain fixtures and solution sets that are directly impacted by some of these increases in raw material costs, but we're also looking to continue to drive cost outs through new product designs that allow us to maintain the margin percentages and even grow the margin percentages off of those products, as new form factors come into the marketplace. So I think it's a combination of both and Ricky, we're also looking at just our overall, if you will, total business structure. Can we do things in our business and be more efficient, and that's part of what our ABS process is. How do we continue to use Kaizen events to take cost out of our business so that we can reinvest it in other areas.

**Operator**

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

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

Everyone, thanks for your time this morning. 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. We believe strongly our future is bright. Thank you for your support.

**Operator**

That concludes today's conference call. Thank you for participating. You may disconnect at this time.



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