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AYI - Q3 2018 Acuity Brands Inc Earnings Call

EVENT DATE/TIME: JULY 03, 2018 / 2:00PM GMT

OVERVIEW:

Co. reported 3Q18 net sales of $944m, reported operating profit of $105.9m and reported diluted EPS of $1.80.

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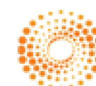

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PRESENTATION

Operator

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

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

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

Thank you, and good morning. With me today to discuss our fiscal 2018 third quarter results are Vern Nagel, our Chairman, President and Chief Executive Officer; and Ricky Reece, our Executive Vice President and Chief Financial Officer. We are webcasting today's conference call on our website at acuitybrands.com.

I would like to remind everyone that during this call, we may make projections or forward-looking statements regarding future events or future financial performance of the company. Such statements involve risks and uncertainties such that actual results may differ materially. Please refer to our most recent 10-K and 10-Q SEC filings and today's press release, which identify important factors that could cause actual results to differ materially from those contained in our projections or forward-looking statements.

Now let me turn this call over to Vern Nagel.

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

Thank you, Dan. Good morning, everyone. Ricky and I would like to make a few comments, and then we will answer your questions.

Overall, our performance this quarter was solid, particularly against the backdrop of current market conditions, including a continued soft lighting market. I know many of you have already seen our results, and Ricky will provide more detail later in the call, but I would like to make a few comments on the key highlights for the third quarter of 2018.

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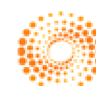

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Net sales for the quarter were $944 million, up almost 6% compared with the year-ago period. Reported operating profit was $105.9 million compared with $131.5 million in the year-ago period. Reported diluted earnings per share was $1.80 compared with $1.90 in the year-ago period. There were adjustments in both quarters for special charges 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 that adjusted operating profit for the third quarter of 2018 was $135.8 million compared with adjusted operating profit of $148.3 million in the year-ago period. Adjusted operating profit margin was 14.4%, a decrease of 220 basis points compared with the year-ago period. Adjusted diluted earnings per share was $2.37, up 10% from the year-ago period.

For the first 9 months of the fiscal 2018, net cash provided by operating activities was $301 million compared with $198 million provided in the year-ago period. So far this year, we have spent $164 million for 2 acquisitions and $298 million to repurchase 2 million shares of our stock. In addition, as Ricky will explain later in the call, we entered into a new $800 million credit facility with our bank group on June 29, further enhancing our financial flexibility.

Looking at some specific details for the quarter. Net sales were a third quarter record, up almost 6% over the year-ago period, driven by an increase in net sales volume of over 10% and an approximate 1% favorable impact from acquisitions and foreign exchange rates, partially offset by approximately 5% for unfavorable changes in product prices and the mix of products sold.

We experienced sales growth in most channels and geographies. The largest contributors to 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 in our infrastructure and utility channel and from 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 nonfixture-related products and solutions as well.

Sales through our C&I channel were down slightly this quarter compared with the year-ago period, primarily for larger nonresidential projects where demand remains soft. Further, overall net sales were impacted by unfavorable price and mix, primarily due to lower pricing on certain luminaires, reflecting increased competition primarily for more basic, lesser-featured products and 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.

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 this quarter was primarily due to changes in product prices for lesser-featured products and product substitution, and to a slightly lesser degree, changes in channel mix. To combat these market forces, we continue to accelerate the expansion of our product portfolio to more efficiently -- excuse me, to more effectively and profitably compete in that portion of the market where features and performance are seemingly less important.

We relaunched our Contractor Select portfolio this quarter, which includes 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 residential consumers for their new construction and renovation projects. With this expanded portfolio, we believe we can offer even more choices to customers served in these markets that would prefer our innovative, reliable and affordable Juno and Lithonia Lighting-branded solutions compared with products offered by others. Based on information from various data collection and forecasting organizations, we believe overall market demand for lighting in North America was slightly positive this quarter, a welcome relief after several previous quarters of negative growth.

Our net sales growth of almost 6% stands in stark contrast to the overall growth rate of the luminaire market in North America. 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 current backdrop of a soft and price-competitive 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.

Our profitability measures for the third quarter, while solid given the overall market conditions, were below prior year performance. They were impacted by continued tepid demand in certain portions of the market and the impact from changes in price/mix noted earlier.

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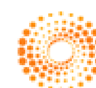

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Our adjusted operating profit for the quarter was $135.8 million, down approximately 8% compared with the year-ago period, while adjusted operating profit margin for the quarter was 14.4%, down 220 basis points from the adjusted margin in the year-ago period. The decrease in adjusted operating profit margin was primarily due to the impact of price/mix on gross profit margin and higher selling, distribution and administrative expenses, both in dollars and as a percentage of sales.

Adjusted gross profit margin for the third quarter was 41.6%, a decrease of 90 basis points compared with the adjusted gross profit margin reported in the year-ago period. Adjusted gross profit increased $14.1 million over the year-ago period driven primarily by higher sales volume and productivity improvements, partially offset by unfavorable pricing for certain products and, to a lesser degree, changes in channel mix as well as higher input costs for certain commodity-related items, particularly steel and certain oil-based components. These same factors contributed to the decline in adjusted gross profit margin as well.

Next, adjusted SDA expenses were up 20.6 -- $26.6 million compared with the year-ago period. Adjusted SDA expense as a percentage of net sales was 27.2% in the third quarter, an increase of 130 basis points from the year-ago period. The increase in adjusted SDA expense was primarily due to higher freight and commission cost to support the increase in net sales and greater employee-related cost, including higher compensation expense, rising health care and an increase in the number of associates, primarily due to acquisitions, compared with the year-ago period. We also experienced an increase in outside professional, product testing and certification fees associated with actions taken to address industry shortages for certain electronic components.

Excluding the impact of higher freight and commission expense due to the increase in sales volume, greater employee-related cost accounted for a little more than half of the remaining increase in total SDA expense this quarter compared with the year-ago period. We expect this higher level of employee-related cost to continue in the fourth quarter of fiscal 2018 as labor markets remain tight, contributing to a rise in wage inflation.

An interesting point to note, our adjusted variable contribution margin on a sequential basis this quarter compared to the second quarter was up almost 29%. Our adjusted diluted EPS was $2.37 compared with our $2.15 reported in the year-ago period. The increase was primarily due to the favorable impact on income with the new tax law and the lower average shares outstanding due to stock repurchases in the past year, partially offset by a decline in operating profit this quarter.

Before I turn the call over to Ricky, I would like to highlight 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, profitable growth over the long term. While sales data for our tiered solutions is still imprecise, we believe sales in our Tier 3 and 4 categories encompassing our holistic, integrated solutions were up over 40% this quarter and represent more than 15% of our total net sales so far this year.

As a reminder, Tier 3 includes the sale of our network and IoT-enabled luminaires, which -- while Tier 4 includes recurring revenues for services, primarily 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. We believe these commitments and orders from customers accelerating the expansion of their current platforms, as well as customers moving beyond pilot programs to implementation, will afford us the opportunity to meaningfully expand our installed base of Atrius-enabled systems in future quarters.

Also, we just introduced the next generation of our industry-leading lighting control system, nLight AIR. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control systems available. Also in the quarter, we completed the acquisition of IOTA, the industry leader in emergency lighting and power equipment for commercial and institutional applications. This acquisition will further enhance our market leadership in this important lighting category.

Lastly, we initiated a number of actions this past quarter to further streamline our operations to reduce costs and improve our productivity. These initiatives will enhance our operating and financial performance as well as allow us to accelerate investments in areas with higher-growth

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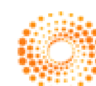

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opportunities. These actions were taken considering prevailing market conditions and are focused on driving initiatives consistent with our long-term growth strategies. Ricky will have additional comments on this in a moment.

We have been able to create these capabilities while providing industry-leading results because of the dedication and resolve of our 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 expectations for the construction markets later in the call.

I would like to now turn the call over to Ricky before I make a few comments regarding our focus for the balance of calendar 2018. Ricky?

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

Thank you, Vern, and good morning, everyone. As Vern mentioned earlier, we had some adjustments to the GAAP results in the third quarter of fiscal 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 third quarter of both fiscal year 2018 and 2017. Adjusted results exclude the impact of amortization expense for acquired intangible assets, share-based payment expense, acquisition-related items, special charges for streamlining activities and excess inventory adjustments related to facility closures.

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.

During the third quarter of fiscal 2018, we recognized a pretax special charge of $9.9 million, primarily related to the planned consolidation of certain facilities and associated reduction in employee workforce. The special charge consists primarily of severance and employee-related benefit cost.

We also recorded a $3.1 million charge during the third quarter to reserve for raw material inventory located at one of the facilities where production activities were ceased, because it will not be cost-effective to relocate that inventory. We expect to incur additional costs in future periods associated with the closing of the facilities primarily attributed to early lease terminations and moving cost. We expect the annual savings from these streamlining actions, once fully implemented, to exceed the amount of this special charge. The savings will be reinvested in activities to support higher-growth opportunities as well as drive improved profitability.

The effective tax rate for the third quarter was 26.4% compared with 34% in the prior year quarter. The lower tax rate was primarily due to the U.S. Tax Cuts and Jobs Act signed into law last December. 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 meaningful, positive impact on lowering taxes paid by Acuity, thus benefiting our future earnings and cash flow. The impact of tax legislation may differ from current estimates, possibly materially, due to, among other things, changes in interpretations or assumptions the company has made, guidance that may be issued and actions the company may make as a result of the tax legislation.

On May 1, 2018, using cash on hand and borrowings available under our line of credit, we acquired IOTA Engineering, headquartered in Tucson, Arizona. IOTA manufactures highly engineered emergency lighting products and power equipment for commercial and institutional applications, both in the U.S. and internationally. IOTA's operating results and preliminary amounts related to the acquisition accounting were included in the consolidated financial statements from the date of the acquisition and are not material.

We generated $300.7 million of net cash flow provided by operating activities during the 9 months ended May 31, 2018, compared with $198 million for the year-ago period, an increase of $102.7 million. This significant increase in cash flow compared with the year-ago period was due primarily to lower operating working capital requirements, lower variable incentive compensation payments and lower payments for income taxes.

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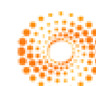

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Operating working capital, defined as receivables plus inventory less payables, decreased approximately $3 million during the first 9 months of fiscal 2018. The increase in inventory during the 9 months ended May 31, 2018, was primarily due to customer expansion in the home center/showroom channel, new product launches and build up of finished goods to support committed projects in the corporate accounts channel. The increase in inventory was mostly offset by a corresponding increase in accounts payable during this same period.

At May 31, 2018, we had cash and cash equivalent balance of $94.3 million, a decrease of $216.8 million since August 31, 2017. The decrease was due primarily to cash used to repurchase common stock, to fund acquisitions, to invest in plant and equipment and to pay dividends, partially offset by strong cash flow from operations. We repurchased 800,000 shares for $104.1 million during the third quarter of fiscal 2018. Fiscal year-to-date, we have repurchased 2 million shares for $298.4 million. We have 5.2 million shares remaining under our current share repurchase board authorization.

Our investment in capital expenditures was $32.2 million for the 9 months of fiscal 2018, a decrease of $23 million compared with the prior year. We currently expect to invest approximately 1.5% of net sales in capital expenditures in fiscal 2018.

On June 29, 2018, we entered into a new credit agreement with a syndicate of banks that provides us with a $400 million, 5-year, unsecured revolving credit facility and a $400 million, unsecured, delayed-draw, 5-year term loan facility. Our total debt outstanding was $358 million at May 31, 2018. Our debt to capitalization at May 31, 2018, was 18.3%, and net debt-to-capital was 14.1%. We had additional borrowing capacity of $704.3 million at July 2, 2018, under our new credit and term loan facilities, which do not expire until June 2023.

We clearly enjoy significant financial strength and flexibility to accommodate the current stock repurchase program, of which 5.2 million shares remain available for repurchase. 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. Current market conditions in the lighting industry continues to create 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. Our many actions taken this quarter to reduce costs and improve our capabilities were done so we can continue to optimize our financial performance while continuing to invest in areas we believe have high-growth potential over the long term.

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 improved slightly this quarter compared with previous -- the previous 3 quarters, which were 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, current uncertainty regarding trade policies, substitution 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 continue to be busy, and backlogs are favorable.

As for our market expectations for the balance of calendar year 2018, we continue to see favorable trends in certain leading indicators, hear from customers that large projects are set to release and see some encouraging reports from third-party forecasting organizations. Nonetheless, we remain cautious due to increasing inflationary pressures, including the impact from recent tariff actions.

However, and most importantly, we expect to continue to outperform the overall growth rate of the markets we serve, primarily in North America. Further, we believe the sales of our Atrius-based luminaires within our Tier 3 and 4 categories will continue to expand, though, and I would like to emphasize, this will be lumpy at times because of the unpredictability and timing of customers' renovation and new construction cycles.

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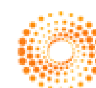

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Next, we believe that product substitutions to lower-priced alternatives for certain products in portions of the lighting market will continue, particularly for more basic, lesser-featured products sold through certain channels, pressuring top line growth and profitability. The relaunch of our Contractor Select portfolio and other actions taken were done to enhance our opportunities for profitable growth in this portion of the market.

Further, 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, which are being influenced by the recently enacted tariffs, as well as certain employee cost, primarily due to compensation inflation caused by tight labor markets and other related cost, we will continue to see increase.

Our adjusted SDA cost as a percentage of net sales this quarter was 27.2%. We believe this percentage is still a bit high but is reflective of the necessary investments that are driving growth in our Tier 3 and 4 platforms.

We expect to mitigate the impact of some of these rising costs through certain pricing initiatives which we announced this quarter, ongoing productivity improvement and the implementation of programs to reduce product and other overhead costs, including our announced streamlining actions, 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 commodity costs, market-level pricing and changes in product and sales channel mix.

Through our continuous improvement efforts, 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 and as our mix evolves as we execute our tiered solution strategy, particularly for our Atrius-based solutions as well as our nLight control systems; and lastly, as we realize typical gains in manufacturing efficiencies.

Next, we continue to be leery of the impact of foreign currency exchange rate fluctuations, which are 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 sold as we execute our tiered solutions strategies 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 Atrius IoT platform and software solutions. The world of data optimization targeted by our Atrius platform is in the early stages of development, and we believe Acuity is uniquely positioned to take full advantage of these high-growth opportunities.

As we have noted in our last several conference calls, the implementation of our integrated tiered solution strategy and opportunities to meaningfully participate in the interconnected world is an integral part of our overall strategy. 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 have 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 the 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. 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. With that, we will entertain any questions that you have.

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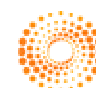

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Brian Lee with Goldman Sachs.

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

Maybe just to start off, big result in the Tier 3, Tier 4 sales, so kudos to you guys on that. The 40% growth that you mentioned, Vern, that was the best result we've seen in over a year in that particular category. Also, pretty big acceleration off the past few quarters. Was this mostly driven by the strength in large infrastructure and utility projects you mentioned in the prepared remarks? Just trying to get a sense for, as you alluded to, how lumpy this quarter's result was for that group of products. And then what you're thinking about the growth for Tier 3, Tier 4 sort of in the back half of the calendar year, if it moderates at all.

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

So Tier 3 and Tier 4 solutions really are part of our both Atrius-based luminaires as well as our interconnected energy management/lighting solutions. The growth that we continue to experience is really as more and more customers recognize the future potential benefit of what these solutions and capabilities can mean to their business. Really by transforming how they view their property and their assets -- building assets really as an expense, thinking them more as a powerful opportunity to be a strategic asset. They're taking advantage of not only the quality of light upgrades, the energy savings, but what the future potential of this is. So we see expansion in retail. We see expansion in other public spaces for these types of luminaires. The growth this quarter, as we continue to say, everyone and all of you analysts are looking at it on a quarter-by-quarter basis. We tend to look at these things more on an annual basis because the construction cycle for various customers varies greatly. And so yes, this quarter was terrific. But if I look at the full year, we are experiencing full growth or great growth in these categories. And we expect that overall growth rate to continue as we look at more annual increments, not necessarily quarter-by-quarter. But yes, this was a strong quarter. And the backlog continues to be favorable for Acuity.

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

Okay, fair enough. Maybe just quickly on that point, do you expect the large infrastructure and utility project strength that you saw this quarter to persist here in the near term? Or were those fairly concentrated in the quarter given the timing of the projects? And then just quickly on the balance sheet, wondering if you could, Ricky, give us some color on the -- on 2 moving pieces: The big inventory build, what the composition was there? What drove the increase? And how that should trend going forward. And then any commentary you have on the payables moving up as well.

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

So Ricky, let me take the infrastructure question. We're very pleased and excited by sales forces bringing solutions to the infrastructure and utility community. We have great products. We have great solutions, and we have great sales forces that are differentiating those capabilities to our customers. So we continue to see that as a positive growth area, and we would expect that to continue as we go forward.

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

Yes, and Brian, on the balance sheet, on the inventory increase, it's primarily in the finished goods area as we increased inventories, as we expand our customer base in home center and showroom channel. So we are building up inventory as we load in into some of these new customer bases. Some of the growth that we're seeing in these Tier 3, Tier 4 opportunities with some big corporate accounts has necessitated us to bring in some finished goods as they are managing their construction cycle and when we would anticipate going in and doing the installation and commissioning

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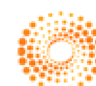

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of those products. And then the Contractor Select new product line, or revitalization of that existing product line, is taking off. It's some 200-plus new product families in that category. And as we're ramping up to and launching those products out into various channels, has caused the finished goods to come up. The payable increase is directly related to that. Much of this increase happened later in the quarter and, therefore, the payables have not yet matured and paid off. We would expect to see the inventory to gradually come back down as we launch these and then just get in a refurbishment, refilling type of endeavor. But that primarily was in the finished goods area and for the reasons I described.

Operator

The next question comes from Christopher Glynn with Oppenheimer.

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

Nice volumes. As the price/mix has gotten more negative -- the volumes have certainly picked up here. Are you seeing a real demand response to your kind of pricing at the low end and kind of seeking out a final remedy for the emergence of the offshores over the past year or 2?

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

So Chris, as we think about that portion of the market that favors more, let's say, less-featured, more price competitive solution sets -- and you're right. It's being driven, we think, by mostly illegal activity in terms of dumping of product onto the market, which various industry consortiums are looking to address. That notwithstanding, we are introducing -- relaunching, as Ricky points out, Contractor Select. And this portfolio of products and services and the way we're attacking the market in a little bit of a different way is directed right at the opportunity of serving this market. And we're in the early stages of introducing our Contractor Select capabilities, but we're already starting to see the benefits of that. We believe in the last quarter, we picked up a couple points of share in that portion of the market. We see our unit volumes continuing to tick up. But we're also seeing, from a pricing perspective, us attacking that with better margin products doing that.

I would expect the price in that portion of the market to continue to be challenging, but I think that we are in good stead to make that happen. I know that there's a lot of questions regarding the overall marketplace for larger projects. And is pricing in some of this moving into that world? I find it fascinating looking at various data points. If we look -- we use U.S. Census data a lot. If we look at private nonresidential construction over the last year, and even a little bit longer than that, that market's been flat to down. This is construction spend. This has nothing -- lighting is only a small portion of that. So we're fighting, if you will, this trend in the marketplace, which, by the way, to me, we're starting to see some positiveness. The last quarter, we saw an uptick from the U.S. Census data on private nonresidential construction.

So for us, it's really more about a volume game. We don't believe that pricing, if you will, has meaningfully moved into that market, or people who were dumping products have moved into that portion of the market. We see on our large jobs just -- that's what's contributing to the flatness, if you will. They're slightly down in the C&I channel. We're seeing a resurgence, which we hope is a harbinger of positive things, in that lower, less-featured area of the market where we think we have a real competitive advantage based on our ability, of the size of the portfolio, our ability to serve customers. We're trying to get our supply chains kind of linked up a little bit to the increase in volume, so we're having a little bit of noise around that. But I would tell you that we're favorable to where we've positioned the business to compete in that world going forward.

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

Okay. And it sounds like Contractor Select's more a go-forward driver. So we're assuming your volume successes in the quarter at the low end involving taking an upfront margin hit and flushing some of the product that wasn't cost sized to serve that market?

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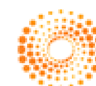

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Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

I wouldn't say that necessarily, no, no. We're moving product into that marketplace and introducing solutions. As Contractor Select's a relaunch, as Ricky points out, there's a number of new products. But we also have products in that space that are very cost-effective. I think it's really we're altering our service model a little bit. We're altering how we support our customers. And truthfully, our key customers are far more interested in having the preference of a Juno or a Lithonia-based luminaire because Acuity stands behind it. When we give warranties on these products, people know that they can count on us to deliver against them. And they're not sure about some of these other entrants that are into the market that are selling, if you will, over the Internet. There's a lot of training -- there's a whole lot of capability that goes along with what Acuity brings to the marketplace that is -- that are points of differentiation into the market, not just price. Obviously, price is important, but it's not the only thing that occurs. So I would say the answer to your question is no.

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

And last one, would you care to opine on what's been a bigger mix mover over the past few quarters between defending share at the low end versus the ebb in the higher value mix of projects in the marketplace?

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

Yes. I would say that as we looked at our price/mix this particular quarter, it was approximately 5 points price/mix, kind of the biggest number that we've seen there. But I -- when we look at it, it's hard to precisely analyze that. We think a little bit more of it is price and product substitution. But a big chunk of that is the fact that we're growing our Atrius-based luminaires in certain key channels. Now, those are fantastic products, but the standard margin of those things -- because often they're going into large projects that have lots of the same type of luminaire, the standard margin on those is just different than what we historically experienced on large commercial projects that have massive amounts of different types of luminaires.

So as a percentage of our total revenues, these are just approximate numbers. The C&I channel has historically represented about 60% of our total sales. This quarter, that number was probably more in the 56%, 57% and so -- of total sales. So there's a margin difference that we experience because, again, of the difference of products that we sell into that C&I channel, mostly for larger projects. If I look at larger projects, as we internally define them, that was the primary reason for, if you will, the slight decline in overall C&I. So for us, that channel mix really played a big part. And until we start to see, if you will, that larger project coming back -- and again, I look at this census data, the last quarter or so has started to turn positive on construction put in place. That's all construction in nonprivate, nonresidential construction. And that usually is a leading indicator 6 months down the road of positiveness on larger projects for Acuity. And we do well there. Because they're complicated, they require lots of support, and we're really good at it.

I'm also very excited about the introduction of our -- or the expansion of our nLight capabilities. The wireless solution that was introduced is massively comprehensive and will be a huge, I believe, opportunity for us to grow that larger project business. But also primarily in the renovation side, we're starting to see a great deal of interest on larger renovation projects that are coupled with our nLight wireless capabilities. So we're optimistic about what that holds for us going forward.

Operator

The next question comes from Joseph Osha with JMP Securities.

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

I've got 2 for you. First, I'm wondering if we could dive a little more into how much of an impact materials costs have had in the quarter.

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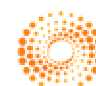

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Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Ricky, do you want to...

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

Yes. We are certainly seeing a bit of headwind in material cost, largely around the commodity metals, steel, aluminum, both of which -- more from a secondary impact of the tariffs. We don't purchase that much steel that are directly impacted by the tariffs, but we've seen steel costs go up regardless, the U.S. manufactured steel. So we are seeing a bit of a pressure there. There's some electronic components that we're seeing a little bit of pressure on based on shortages that currently exist in those areas and would expect in the future to continue to see a bit of pressure based on the tariffs that the administration has announced, the 301 tariffs that will be on some of the China areas. We're looking at ways to mitigate that, both in cost reductions, price increases as well as sourcing from areas that aren't as impacted by the tariffs. But it has had an impact. We haven't exactly quantified it in the public announcements. But I would say it's not a material number, but it is putting some pressure on our margins.

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

Okay. And then the second one for me would be, can we get some color in terms of what the uptake on this price hike that you announced back at LIGHTFAIR has been? How much of that would you say has stuck so far?

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

So Ricky -- I mean, just commenting on the impact of materials, completely agree, secondary impact rolling through. We announced our price increase on certain products, certain, if you will, more traditional, fluorescent-based products, but also certain LED products. Those price hikes, on average, were in the 6%-plus range. They were due to take effect, I think, June 11, I think was the date.

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

Yes.

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

Something of that nature. So those are starting to roll through. We're seeing the benefits of some of that. Our expectation, because everyone coming into this space on these types of products is experiencing cost inflation. So I have some optimism that we will -- that those price increases will stick into the marketplace. But it's obviously too early to impact our results for Q3, and our expectation is that it will help offset some of these costs as we get into Q4 and beyond.

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

Okay. So just to be clear, and then I'll get off the phone here. That you would expect some of these price increases to start rolling through your numbers for the August quarter?

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

Yes.

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Operator

The next question comes from Tim Wojs with Baird.

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

I just wanted to -- on the home centers, could you just give us a little bit of an update where you are in those 2 transitions from one customer to another? And just kind of how that ties into the inventory? I mean, will a lot of that product wind up shipping in the fourth quarter?

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

Yes. So to be extremely, extremely clear, we're not transitioning from one customer to another. We are expanding access into a number of markets, including the home center channel, and that's really important to draw the distinction in your question. The product portfolio of Contractor Select also supports, not only the home center channel, but it also supports the electrical distribution channel. So as we introduce the Contractor Select portfolio, as Ricky pointed out in answering the question on inventory, our expectation, as he said, it will support growth in the home center channel as well as the C&I channel. Home centers for us this quarter were up slightly after being down the previous 2 quarters. We still have, I think, tremendous opportunity in front of us to support our key partners in that channel as well as ED. So those folks will be seeing also new product introductions coming into their world. And I would expect that for us in the home center channel, it will be, like all of our channels, an opportunity for growth.

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

Okay, great. Yes. No, transition was probably a bad word. So sorry about that. Thanks for clarifying. And then second, just on the buybacks, you bought back some in Q2 and some in Q3. Now you have the expanded debt financing. Should we think that there's just kind of a gradual buyback cadence that you guys will have? Or does the debt refinancing accelerate some of the stock buyback?

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

So Tim, and to everyone out there, if you look at our organization over the last decade plus, we have done a really focused job of about 1/3 of our cash flow's repurchasing shares, about 1/3 of our cash flow's doing acquisitions, about 1/3 of our cash flow's doing both dividends as well as capital expenditures. If you look at the last quarter, we spent $160-plus million doing 2 really very interesting acquisitions for us. One expands some of our analytics in what we'll call our technology group, really allowing us to do more Tier 4 capabilities. And then the other acquisition was really to solidify our position in emergency and power backup capabilities within the lighting industry. So we've solidified our leadership. Those are 2 good examples of how we are deploying capital to bring value to shareholders. In addition to that, in the quarter, we spent near $300 million. I think, Dan, it was $298 million.

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

For the year-to-date.

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

Year-to-date, year-to-date, sorry. Year-to-date, year-to-date, excuse me on that. $298 million buying a couple million shares. But I believe that over the last 5 quarters, we have spent a little over $600 million purchasing 10% of our shares outstanding. So what we're doing is we're looking at all of these alternatives on a longer-term basis. So Ricky and Dan expanded our credit facility to give us more flexibility, because we do have authorization from the board, where we still have 5.2 million shares that we could purchase. So you're absolutely right. We're going to look at all of this as we

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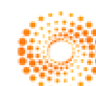

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have done over the last decade plus in a very strategic fashion. The M&A pipeline, Ricky and team continue to be busy seeing alternatives. So we're always looking for ways to deploy our financial strength and our balance sheet in ways that drive shareholder value.

Operator

The next question comes from Rich Kwas with Wells Fargo Securities.

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

Just a couple questions with regards to volume, Vern. Was there any significant benefit from volume with regards to getting out of the price increase? And then anything that would've -- how would you characterize the benefit from Contractor Select at this point in terms of the current quarter on volume? How should we think about it in terms of the benefit on volume?

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

Yes. So I think that in the stock-and-flow, smaller-project world, our volumes were up. And so volumes were up. Some of that also has price and product substitutions as part of that. So net-net, we were still positive in that portion of the market. When we look at what's happening with our Atrius-based luminaires through what we call our enterprise solutions group, those were favorable. Infrastructure and utility contributed. Again, as I said, most channels and geographies were favorable this quarter in terms of net sales dollars increase. So the unit volume, and if you will, the sales volume was favorable in not just one area versus another.

And then that would have been somewhat offset by the fact that larger projects were not there. We saw, again, a decline in that area. So I think we had a fantastic quarter from a volume perspective. And if we had just been normal -- if the market had been normal, sorry, on just larger projects, which again, I'm optimistic that those things will start to turn, we would have seen not only additional volume, less of an impact on price, less of an impact on mix and better margins. I was very pleased, by the way, Rich, to see our variable contribution margin on incremental sales sequentially from third quarter to second -- from second quarter. I think that's indicative of the current market conditions and our ability to, from the actions that we're taking, to get variable contribution on those sales growth dollars.

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

Okay. So the Contractor Select as well as -- I mean, the price increase, I mean, it probably helped volume. But it sounds like that benefit should -- Contractor Select should benefit volume on a go-forward basis. I mean, it's not going to be...

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

Going forward. I think -- Rich, I would say that it's more of a go-forward type thing than big impact on Q3. As Ricky points out, the big impact on Q3 from Contractor Select was just building up our inventories in anticipation of load ins, not -- I mean, both in the home center channel as well as the electrical distribution channel, which is meaningfully larger than just the home center channel.

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

Okay. And then the price increase really is not affecting much on LED, correct? It's only small pieces of the LED portfolio?

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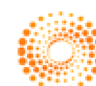

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Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Well, so imagine again what Contractor Select is meant to do. It's meant to have attractive price points, but also have a better margin profile for us. So we're moving the cheese a little bit, right? Price increases are on existing products, we're actually introducing new products that have better margin profile. But on existing products, where we have increased prices, that has been primarily for those luminaires that have high steel content. And that is more primarily driven off of florescent-based luminaires. The other thing that I would submit to you on price increases is the fact that 75% of our, if you will, lighting business is project based. So it's always been a competitive business, not necessarily that we say, here is a single widget at a price. And oh, by the way, we've decreased the price some percentage. So I would say that the price impact or the impact of price increases, it will have some impact. But it will only be in that portion of our business that is subject to more stock and flow. And we see more of that...

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

So that's 25% or so of the sales is the -- okay. All right. That's helpful to clarify. And then just one clarification. I think it was on Chris Glynn's question on the C&I piece. So you said it was -- usually it's about 60% of the business. This quarter, it was 56% to 57%. And then you were differentiating Atrius on standard margin versus large projects, large commercial projects. Can you just run through that again? It wasn't clear to me what you were trying to get across with regards to Atrius and then large C&I projects on the margin.

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

Well, okay. So if I look at our total business, typically -- or historically, I should say -- C&I has represented 60% of our total sales, roughly, and it fluctuates. This quarter, it was down probably 4 -- 3 to 4 points. So other portions, other channels, sales through other channels, had a higher percentage. The higher percentage sale portion was through what we call our enterprise solutions, which is primarily the sale of Atrius-based luminaires. And so those luminaires, because of where they're going, they're a lot of the same type of luminaires. So the standard margin at the gross profit level of those is typically less than what we would experience in larger projects, where we sell a much broader range of luminaires. And those jobs in the large construction market through C&I are usually very, very complicated.

And so the ability to service them, to commission them, to do all of the things that are necessary, there's a higher -- we typically extract a higher standard margin. But there's also a higher cost to serve, which is a bit different than what we would experience maybe selling through large retailers for use in their facilities or at airports, where you sell thousands of this exact same luminaire type. So that's -- and the cost to serve on those is typically not as significant as the cost to serve on large commercial projects.

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

Okay. That's helpful. Just real quick clarification on that. I thought Atrius had more software content. So wouldn't that help the margin a bit versus your traditional large C&I projects?

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

So it would the help the margin relative to large former florescent-type products in that particular channel. So the answer is, you have to look at it by channel and the opportunity to get higher margins because of it being Atrius-enabled. And the higher margin is really the use of data off of that solution set, but it's compared into that channel. We don't really compare one channel to another as to what the margin profile is, primarily because they're just so different. When you're selling 1,000 of the same fixture into a single location, it's very different than when you're selling 20 or 30 different luminaires into a similar-sized space. They're just different profiles.

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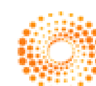

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Operator

The next question comes from Jeffrey Sprague with Vertical Research Partners.

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

A couple for me. First, just on the Contractor Select, we've heard from some of your competitors that they plan to, or are thinking about maybe pulling back a little bit from the low end to kind of address the margin pressures in the industry. I wonder if you're seeing that at all. What the competitive response has been to what you're doing with Contractor Select, if anything is visible at this point?

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

No, we're not seeing our competitive -- our competitors, including our traditional competitors, backing off, no.

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

And then on the inventory build in the quarter, would there have been an absorption benefit in your margins? And if so, how significant would that have been?

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

I wouldn't say there was a benefit. Clearly, we capitalized the conversion cost and so forth, as you would expect. But we had higher conversion costs because we had a lot more freight bringing the products in that we source, a lot more production. Production exceeded sales and so forth. But the whole purpose of capitalizing that is to match it to then when the sale is. But we did capitalize a lot more of the freight and the conversion cost. But then again, we expensed or incurred a lot more because we were bringing a lot more product in and producing a lot more as well. So it's designed to get the better matching. So it should keep the margins consistent quarter-to-quarter, everything else equal.

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

And understood. Then one -- just one last one. On the capacity moves, obviously understandable, you need to take cost actions in this environment. But you're taking capacity out at a time that you're growing volume. I just wonder if you could give us, say, a little bit of sense of the magnitude of the capacity reduction. And if you're doing something different on sourcing or automation or some other element of your supply chain to kind of accomplish and to balance that juggling act there.

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

Yes. So without providing absolute specifics, the ability to absorb one facility's -- it was a smaller facility -- its productive capabilities, we had -- we felt excess capacity -- or the capacity, if you will, to absorb those into other locations. Driving efficiencies, driving connectivity around those products into the locations where they ended up. So it's part of our lean process. We adopted lean manufacturing principles probably 15 years ago. And our supply chain continues to really do an excellent job of driving productivity. So we took advantage of the opportunity to consolidate some of these things to help us improve our cost profile and our productivity to be competitive, more competitive, and drive better financial results in the current environment that we find ourselves in.

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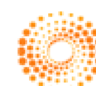

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Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

And I would add, Jeff, that several of these facilities are not large manufacturing, as Vern said. It came about as part of these acquisitions that we did. So it's now opportunity for us to consolidate some of the recent acquisitions, facilities that we acquired to get greater efficiencies than having a bunch of tiny facilities that came with some of the acquisitions.

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*

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

Operator

That concludes today's conference. Thank you all for participating. You may now disconnect.

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