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AYI - Q1 2018 Acuity Brands Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 net sales of \$843m, reported operating profit of \$118.6m and reported diluted EPS of \$1.70.



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PRESENTATION

Operator

Good morning, and welcome to Acuity Brands' Fiscal 2018 First Quarter Financial Conference Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, please 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 first 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.

While our results for the first quarter were below expectations, we believe we continued to outperform the markets we serve. As we will explain later in the call, our results were driven by a few key factors, including continued weak demand in the U.S. nonresidential construction market and, more specifically, sales declines in certain channels and markets, partially offset by continued productivity improvements in our supply chain. I



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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 first quarter of 2018.

Net sales for the first quarter were \$843 million, a decrease of 1% compared with the year-ago period. Reported operating profit was \$118.6 million compared to \$126.6 million in the year-ago period. Reported diluted earnings per share was \$1.70 this quarter compared with \$1.86 in the year-ago period. There were adjustments in both quarters for certain special items as well as certain other add-backs necessary for our results to be comparable between periods as Ricky will explain later in the call.

In adding back these items, one can see adjusted operating profit for the first quarter of 2018 was approximately \$134 million compared with adjusted operating profit of \$143 million in the year-ago period, a decrease of more than 6%. Adjusted operating profit margin was 15.9%, a decrease of 90 basis points compared with the margin reported in the prior year. Adjusted diluted earnings per share was \$1.94, down 3% from the year-ago period.

A positive for the quarter was net cash provided by operating activities where we generated a solid \$140 million this quarter compared with \$56 million in the year-ago period. We closed the quarter with \$429 million of cash on hand, leaving us with plenty of liquidity to execute our growth strategies.

Looking at some specific details for the quarter. Net sales declined 1% over the year-ago period. This was our first quarterly decline in 7 years. At a high level, net sales volume declined approximately 1%. The price/mix of products sold reduced net sales by approximately 1% and was essentially offset by positive changes in foreign currency. While it's not possible to precisely determine the separate impact of changes in the price and the mix of products sold, we estimate the impact of price/mix was primarily due to changes in product price primarily for more basic, less-featured LED luminaires sold in certain channels.

There were 2 key areas that negatively impacted our sales, certain international markets we serve and the home center/showroom channel. Excluding these 2 items, net sales grew approximately 2% in the quarter over the year-ago period. Overall, this increase in net sales was reasonably broad-based along key product lines and sales channels in the U.S. and Canada with some variability within throughput.

Sales in certain international markets such as the U.K., Mexico and certain Latin American countries, which make up more than 3% of our total sales, declined approximately 35% this quarter compared to the year-ago period. Each of these countries are dealing with various economic and/or political headwinds.

Sales through the home center/showroom channel, which made up more than 10% of our total net sales, declined approximately 11% this quarter compared with -- to the year-ago period. While price and product mix have a disproportionate impact in this channel due to the nature of the more basic, lesser featured products sold through this channel, 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 expect this shift to continue in the near-term, potentially impacting our future results in a similar manner as this quarter. As such, we continue to accelerate the expansion of our product portfolio for this channel, creating solutions that we believe will have great appeal to both the commercial pro and the residential consumers for their new construction and renovation projects.

The key to positioning our portfolio in these channels is to further add solutions that incorporate differentiated technologies at attractive price points for various product categories and to offer customers in this channel that prefer our innovative and affordable Juno and Lithonia Lighting branded solutions even more choices. Also, we continue to evaluate additional strategic opportunities, including expanding channel access to profitably grow our sales in this important channel.

With regard to the overall market demand for luminaires in the North American market, we believe demand continued to decline once again this quarter. To add a bit more color on this, 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 down low single digits when compared with the year-ago period. We believe this is the second quarter in a row where demand for luminaires in North America was down compared with the same quarter one year earlier.



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Nonetheless, our specific issues in the home center/showroom channel and certain international markets, we were still able to grow our net sales in the U.S. and Canada by approximately 2% this quarter, far 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.

Sales of LED products account for approximately 2/3 of our total net sales in both periods, which as you know, includes the sale of non-fixture-related products and solutions as well.

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 of the North American market this quarter, particularly against the current backdrop of the soft market environment. Our profitability measures for the first quarter were solid, but impacted by continued tepid market conditions and the decline in revenue for reasons noted earlier.

Our adjusted operating profit for the quarter was \$134 million, down approximately 6% compared with the year-ago period, while our adjusted operating profit margin for the quarter was 15.9%, down 90 basis points from the adjusted margin in the year-ago period. The decrease in adjusted operating profit margin was primarily due to a lower adjusted gross profit margin. Gross profit margin for the first quarter was 41.6%, a decrease of 80 basis points compared with the adjusted gross profit margin reported in the year-ago period.

Gross profit and gross profit margin were negatively impacted by the decline in sales volume noted earlier, unfavorable price/mix and higher input costs for certain commodity-related items, particularly steel. This was partially offset by lower costs for certain components, primarily for LED fixtures, and productivity improvements within our supply chain. We continue to aggressively address items impacting our margins by accelerating programs to reduce cost, particularly for certain basic, less featured product families to enhance our overall competitiveness and to improve our profitability.

Next, adjusted SD&A expenses were down \$1.7 million compared with the year-ago period. Adjusted SD&A expense as a percentage of net sales was 25.7% in the first quarter, an increase of 10 basis points from the year-ago period. The decrease in adjusted SD&A expense was primarily due to lower sales commissions caused by the decline in net sales, partially offset by greater salary expense.

Our adjusted diluted EPS was \$1.94 compared with \$2 reported in the year-ago period. The decrease was primarily due to the decline in operating profit in the quarter, partially offset by the lower average shares outstanding due to stock repurchases in the third quarter in 2017.

Before I turn the call over to Ricky, I would like to comment at a few important accomplishments this quarter. On the strategic and technology front, we continued to make positive strides, setting the stage for what we believe will be strong revenue growth and profitability over the long-term. We continue to introduce new products and solutions supporting customers' preferences along the entire value chain, expanding our industry-leading portfolio of cost-effective, innovative, energy-efficient luminaires and Lighting Control solutions as well as our building management capabilities. Many of these solutions are connected to our IoT software platform as innovation continues to be at the forefront of our tiered solutions strategy. While sales data for our tiered solutions is still imprecise and expanding off a small base, we believe sales in our Tier 3 and 4 categories encompassing our holistic integrated solutions were up almost 10% this quarter and represent approximately 15% of our total sales.

We continue to expand our building management and Lighting Control platforms, which allows us to provide and enhance our comprehensive set of Atrius-enabled IoT business solutions built on our unique capability to collect extensive and valuable sensory data through intelligent luminaires, lighting and building management controls, software platform services and development tools. These solutions deliver connectivity and intelligence to a space via an expansive network of smart LED lighting and controls and a software platform that gathers, unlocks and transforms raw data to enable a broad range of software solutions addressing critical business challenges, all while delivering a superior visual environment and significant energy savings.

The deployment of our Atrius-based solutions continued to expand and, today, have been deployed across nearly 160 million square feet of indoor spaces, up significantly from one quarter earlier. Additionally, while not an immediate focus, the installed base of Acuity Brands' network lighting systems encompassing more than 1 billion square feet can now be upgraded to a more multifunctional Atrius sensory network that can supply IoT data for this robust platform.



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From a commercial perspective, we have accelerated Atrius deployments and increased active programs with several of the largest U.S.-based and certain European-based retailers as well as other key vertical applications, including airports. We believe these commitments and orders from both 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 the Atrius-enabled systems over the next 12 to 18 months. And this does not include the potential growth opportunities for new customers and partners, again, from which there is great interest in deploying our light-enabled Atrius platform and solutions.

We've been able to create these capabilities while providing industry-leading results because of the dedication and resolve of our approximately 12,000 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 fiscal 2018. Ricky?

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

Thank you, Vern, and good morning, everyone.

I will add some further insights into our financial performance for the first quarter. Additionally, I will discuss our current expectations of the impact to Acuity of the recently passed U.S. Tax Cuts and Jobs Act of 2017.

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 first quarter of both fiscal year 2018 and 2017. Adjusted results exclude the impact of amortization expense for acquired intangible assets, share-based payments expense, special charges for streamlining activities, manufacturing inefficiencies related to the closing of a facility and a gain on the sale of an investment in an unconsolidated affiliate. We believe adjusting for these items and providing these non-GAAP measures provide greater comparability and enhanced visibility into our results of operations. We think you 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 first quarter was 35.5%, essentially flat with 35.3% in the first quarter of last year. We expect the recently passed U.S. Tax Cuts and Jobs Act of 2017 to favorably impact our net income, earnings per share and cash flows in the future, due primarily to the reduction in the federal corporation tax rate from 35% to 21%, effective for periods beginning January 1, 2018.

We currently estimate that the company's blended consolidated effective income tax rate, which encompasses federal, state and foreign income taxes, will approximate 26% to 28% for the full year fiscal 2018 before discrete items compared with nearly 35% for the prior year. We also anticipate that the tax rate for the second quarter of fiscal 2018 will be significantly lower than the estimated full year blended tax rate to adjust for the 35.5% tax rate recorded for the first quarter of fiscal 2018. Additionally, we currently estimate the second quarter tax expense to be reduced by approximately \$30 million for discrete items, primarily due to a noncash income tax benefit from the remeasurement of the company's net U.S. deferred tax liabilities, partially offset by an unfavorable impact related to the taxation of the company's accumulated unremitted foreign earnings. We currently estimate that the fiscal 2019 effective income tax rate will approximate 23% to 25% before discrete items.

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

A highlight for the quarter is that we generated \$139.8 million of net cash flow provided by operating activities in the first quarter of fiscal year 2018 compared with \$55.8 million for the year-ago period, an increase of \$84 million. This significant increase in cash flow compared with the year-ago period was due primarily to lower operating working capital requirements, the timing of payments for income taxes and lower variable incentive compensation payments.

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Income taxes paid during the first quarter of fiscal 2018 were \$26.3 million lower than the prior year, which is primarily due to the timing of income tax extension payments, and will reverse in the second quarter. Our fiscal year 2016 federal and state extension payments were due during the first quarter of fiscal year 2017, while our fiscal year 2017 federal and state extension payments were not due until the second quarter of fiscal 2018.

Operating working capital, defined as receivables plus inventory less payables, decreased approximately \$14 million during the first 3 months of fiscal 2018.

We invested \$10.3 million on capital expenditures during the first quarter of fiscal 2018 compared with \$19.5 million last year. This reduction in capital expenditures compared with the prior year is primarily due to timing. We currently still expect to spend approximately 2% of sales in fiscal 2018 on capital expenditures.

At November 30, 2017, we had a cash and cash equivalents balance of \$428.6 million, an increase of \$117.5 million since August 31, 2017. Our total debt outstanding was \$356.9 million in November 30, 2017. So our cash at the end of our first quarter of fiscal 2018 exceeded debt. We had additional borrowing capacity of \$244.7 million at November 30, 2017 under our credit facility, which does not expire until August 2019.

We currently have authorization to repurchase up to 2 million shares of our common stock.

We clearly enjoy significant financial strength and flexibility and we'll continue to seek the best use of our strong cash generation to enhance shareholder value.

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

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

Thank you, Ricky.

At Acuity, we are optimistic regarding our long-term future despite recent market softness, which has impacted our short-term financial performance. We continue to see significant long-term growth opportunities that are ever-changing and evolving in a positive direction for our company.

We are often asked about the vitality and conditions of the key end markets we serve. Market data suggests that the overall growth rate of the U.S. lighting market over the last 2 quarters was down low single digits compared with the year-ago periods. This was considerably different from the growth rates anticipated by various forecasting organizations at the start of calendar 2017. Many reasons have been cited for this softness including, among others, lack of skilled labor, uncertainty over tax regulations and trade policies and pricing pressures in certain end markets for certain less-featured products. While we believe all of this is true to varying degrees, we continue to poll our vast customer base 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 Ricky pointed out earlier, the passage of the new U.S. tax bill will have a meaningfully positive impact on lowering taxes paid by Acuity, thus enhancing our future cash flow. We further believe the benefit of the immediate expensing provision for certain investments contained in the new law could have a favorable and significant impact on end customer demand for energy-efficient lighting fixtures, particularly for renovation projects.

As for our market expectations for the balance of 2018, while we have not seen nor heard of any new information from the market or forecasting organizations that would cause us to change the views expressed in our last earnings call, we believe many of these forecasters have not yet adjusted their models to incorporate the potential favorable impact of the just passed U.S. federal tax law on both the growth rate of the overall economy and then specifically on the construction industry, which we believe can and will be meaningful.

So with that as the huge caveat, let me just highlight some of those key points we made last quarter. Our current belief is growth in the lighting fixture market could remain sluggish for the next quarter or so and then rebound in the second half of 2018. This suggests that the overall market for luminaires in North America could be up low single digits for our fiscal year.

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Additionally and most importantly, we expect to continue to outperform the overall growth rate of the markets we serve, primarily in North America. We do not foresee a meaningful rebound in demand in the international markets we serve in the near-term. We expect certain headwinds noted earlier in the home center/showroom channel to continue in the near-term that potentially give way to 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.

Next, we expect the price of certain LED components to 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 further investments in associate headcount, wage inflation and health care costs, all to increase somewhat. We expect to mitigate some of the impact of these rising costs through certain pricing initiatives, productivity improvements and product cost reductions, though the timing of these initiatives might lag the timing of these increased costs.

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

Next, we believe the pricing environments for certain portions of the lighting market will continue to be challenging, particularly for more basic, lesser featured products sold through certain channels. Additionally, while our gross profit margin is influenced by several factors, including sales volume, innovation, components and commodity cost, market level pricing and changes in the mix of products and sales channels, we expect our annual gross profit margin to improve over time as volumes grow, our mix evolves as we execute our tiered solutions strategy and as we realize typical gains in manufacturing efficiencies.

So to be very clear, our focus is to guard our 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 Atrius IoT platform and software solutions. As 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 facilities. As we noted earlier, while we are very early in this game, we are seeing positive results in our growth rates for our Tier 3 and 4 categories as well as the acceptance of our Atrius IoT-enabled smart platform solutions.

Our company-wide strategy is straightforward, expand and leverage our industry-leading product and solutions portfolio, coupled with our extensive market presence and our considerable financial strength, to provide our customers with unmatched value and our shareholders with superior returns. 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 growth opportunity.

As I have said before, we believe the lighting and lighting-related industry as well as the building management systems market has 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. 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 questions.



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is from Josh Pokrzywinski from Wolfe Research.

Joshua Charles Pokrzywinski - *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

Ricky, maybe a follow-up on some of the cash flow benefits from the lower tax rate. I guess, in the context, you already have a pretty tidy balance sheet. What is the plan around capital allocation? Clearly, the outlook is a little different now from a fundamental perspective, but does this change at all how you guys view capital deployment, particularly buyback, coming off of 2017 where you've done a little bit and still have plenty of room to go?

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

Fundamentally, it does not. Our priorities have remained -- will remain consistent that our first priority is to grow the business, both organically and inorganically. We will continue to invest in the business. CapEx, as we've indicated, at 2% and then we'll invest in some expense categories as well. The other is in acquisitions. So we've been relatively acquisitive over our last 7, 8 years and see that as still a fundamental part of a way to deploy this excess cash flow.

But then, you do mention stock buybacks. We did buyback 2 million shares last year and we have the authorization from the board for another 2 million shares. So we have used that as a way to deploy the cash and we'll continue to look at that opportunistically as a way to deploy cash. And then, of course, no intent to change the dividend at this time, but the board as well as management reviews that on a regular basis.

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

If I could just make a comment on your comment about the industry forecast. It's interesting to us as we sit here and look at our business from a broad standpoint and then listen to our customer base, it's clear to us that the words and the music don't necessarily match. We see consumer confidence improving. We see the stock market going up. We see employment rates improving. We see unemployment coming down. We see the Architectural Billing Index improving. In front of me, I have the Dodge Momentum Index, which clearly showed a drop in the 2017 period with a sharp rebound.

Our view is, is that there is pent-up demand out there. We're just not able, as a company, to say precisely when is that going to turn. I am optimistic, but it's just my personal optimism that the change in the tax law is going to allow people, small business owners, to look at their businesses in a different way. One of the greatest opportunities for quick return is to go to more energy-efficient lighting solutions. And so when you think about now the opportunity for these things to be immediately expensed, it will have a significant impact on the cash flow of these businesses. So I have optimism. I just can't say when is it going to turn. We believe strongly that there is pent-up demand out there, but as we said in our prepared remarks, we don't see that in the next quarter or so. But all of these things are trending in a favorable way and I would expect there to be, over the longer-term, a meaningful rebound in our industry.

Joshua Charles Pokrzywinski - *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

But this doesn't represent like a sea change in your own capital deployment strategy. I guess, for all the changes it had in the market and your own cash flow, it doesn't sound like you guys are really pulling any more tools out of the box just yet.



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

No. But again, our expectation is that as customers see the benefits of this, we are expecting and I think we're starting to see broader forecast, though I expect there to be a wave of new forecast coming out with economists and different groups that do this forecasting to say that they expect the economy to benefit from the tax change. And assuming that happens, it would be our expectations to participate in that surging, if you will, economic growth.

Joshua Charles Pokrzywinski - *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

And then just one follow-up on the home center commentary. You mentioned it might linger a few more quarters, but is this 10% of the business, down low double digits, the right cadence or was there an inventory de-stock or some other shift that says this quarter was maybe on the higher end of the decline and then the go-forward trajectory is a little more subtle?

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

No. I think that given what we know now, this is more of a strategic decision by certain customers in the channel to do different things and take different approaches. So what we're seeing, I think, it's a bit more by strategy. It's not necessarily a de-stocking. It's really -- it's a branding strategy being executed by a few folks there that are having an impact. I would expect the impact to continue, but there are a number of actions that we're taking to help stem the tide of that and actually turn the channel into a growth channel for us.

Operator

Our next question is from Brian Lee from Goldman Sachs.

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

Just had a couple here. Maybe first off, on the pricing pressure, Vern, you alluded to. Is there any way you can kind of take a stab as to how much you would attribute to that coming from Chinese suppliers? And I know you mentioned mostly on the lower end, but can you also comment on the competitive dynamic you're seeing in Tier 3, Tier 4 solutions? There seems to be a pretty decent derating in growth from the 30% to 40% year-on-year rates you had been doing up until now and the 10%, nothing to sneeze at, but seems to be down ticking here quite a bit. So if you could put that into some context?

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

Sure. Let me take the latter portion first. As you know, our tier -- a large portion of the growth in Tier 3 where it is Atrius IoT-enabled is in the retail space. Retailers are seeing the significant benefits of not only having quality of light energy savings, but the ability to use that ceiling as a sensory network to collect data. And as you all know, retailers essentially say by the end of October, you don't touch anything to do with their stores because they're entering their largest season for selling. And so it was absolutely expected.

We still grew significantly. The amount of square footage, I think, went from roughly 90 million to 100 million square feet put in place in the fourth quarter of last year. And now we're up to about 160 million square feet. So it's our expectation that you'll continue to see that ramp in our second quarter simply because many of the retailers are now saying we're back to investing, if you will, in our stores. So don't view that as somehow a trend.

We are very bullish on the opportunities to continue to grow our Tier 3 and Tier 4 solution sets. And the mix, over a longer period of time, changed when it's not just retailers or certain airports. It now expands into the commercial space. So we're seeing that, but at a bit of a slower pace.

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More broadly on the pricing side, our view is, is that if you look at where the competition is coming in, it's really on what we'll call the more basic, lesser featured type products. These are -- I will call them commodity type products, but they're just basic and lesser featured. There are certain channels, and it's not just a single channel but channels, where they would sell those types of products. And so when we look at the overall Acuity, if you will, business model, I would guess to say that probably in the neighborhood of 20% of what we sell is through channels or areas where it might be subject to more of a competitive foreign-sourced competition. But I would tell you that while that -- those prices leak into the marketplace, most of the customers that we deal with, they're far more interested in selling branded quality products even for basic, lesser featured products. And yes, the price does influence that somewhat in that portion of the market, but when we look at our overall price/mix for our entire business, in this quarter, Ricky, it was approximately a point.

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

Right.

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

It actually was down slightly from some previous quarters where price/mix had been in the 1.5% range. So we are -- this is -- while it's happening, if you will, in this portion of the LED market, this happened in the more traditional fluorescent market 6, 7, 8 years ago and we know well how to do this. It has short-term impacts on some of the things that we're doing, but what we do is we reevaluate the products that we have in the marketplace, take costs out, bring new products to market to compete against that. So I don't see it being -- it's an issue, but not a major issue from my perspective.

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

Okay. Okay. And so just to be clear on Tier 3 and 4 specifically, it wasn't a competitive issue that impacted the growth rate this quarter?

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

No.

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

Okay. And then just my second question, and I know you guys don't necessarily look at the business this way, but investors increasingly are doing so as you provide more disclosure around the Tier 3 and 4 growth and mix. And if we do try to sort of segment out the LED business between your higher tiered solutions and sort of what we would consider sort of your core LED, it does imply that the core LED revenues are sort of down into the low single-digit growth category now. I guess the question would be, is that the right read? And then secondarily, what gives you visibility or confidence that the LED revenues outside Tier 3, Tier 4, where there's still a lot of growth opportunity ahead, that you can see growth accelerate in that portion of your business again?

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

I believe that in the Tier 1 and 2, if you look at, again, those certain channels, what's the percentage and so I gave you that previously. I think the rest of the balance of Tier 1, Tier 2 and Tier 3, other than say non-retail-oriented stuff, I think that's always been, if you will, a big business, but we're not seeing -- look, we're seeing the ability to differentiate the value of our solution set. It's still a competitive bid business, but we're seeing that ability to do that.



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Our view is, is that it's more of a volume-related issue. The marketplace has just slowed down. And I can tell you that while I talked to many customers, whether it's electrical distributors, electrical contractors, architects, engineers, at different points in different geographies, they have a story and the story is slow growth for right now. We have a number of projects that have simply been put on hold and by places where you wouldn't expect that. So our expectation is, is that you're going to start to see some of these projects released. I am encouraged by the tax law, particularly the expensing provision for renovation. So I believe that you'll see the benefits of that.

And again, you look at the same data that we all do. I mean, this Dodge Momentum Index has really taken a very sharp uptick and one of the sharpest upticks that we have seen really since probably going back to 2004, '05 and '06. So anyway, we'll all figure out together whether this is a longer term trend, but as I said earlier, the words and the music around the strength of the markets, the optimism of the people and then how that's translating into the broader electrical industry where things have been flat.

It's interesting. We keep bringing technology into the marketplace. And I believe that as people move from the sidelines back into the game, you're going to see an uptick in this. Don't expect that to happen next quarter, but I do expect that over the longer term, or it to be possible.

Operator

Our next question is from Chris Glynn from Oppenheimer.

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

Just wondering, when things kind of fell off, I think last quarter you noted pretty steady linearity, lack of a plus or minus inflections month-to-month and, clearly, that gave way a bit after the first month of the fiscal first quarter. So just wondering what you saw there as things developed?

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

Chris, it's interesting to me. In front of me, I have from the Census Bureau the electrical lighting equipment the U.S. total. And this is for value of shipments. Four of the last 5 quarters have been down. The only quarter that was up was Q3. It was 3%. All the rest of them were kind of in the mid-2s down. So I sit there and, again, I look against the backdrop of broader economic activity and say this just doesn't seem like it's sustainable. The Dodge Momentum Index, which is -- it's just an index and I think that it's reasonably accurate, actually showed this downtick really in the 2017 period. And now the uptick that it just recently showed has meaningfully outpaced what '17 gave back.

So our optimism -- we're not economists. We're in front of our customers. We're asking them how their business is and what they're doing. Again, we're starting to see positive comments coming from what I'll call the trades, whether it's architects, engineers, lighting designers and now, again, the electrical contractors. Some markets are impacted by lack of availability of labor for differing reasons. I just feel like there's an opportunity here for improvement. We've been in this funk for a while, we as an industry, not necessarily Acuity. We continued to outperform the growth rates of the market. I mean, what this thing shows is that they were down 2.5% and yet when I look at our apples-to-apples business, we were up 2%. So again, that's probably that 400 to 500 basis points spread that we've reasonably and consistently have been doing relative to the market.

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

Okay. And back to linearity, just to get the context of your full year or longer term comments right and help to try to get the second quarter in line with the 80/20 likely scenario there. Since things kind of tailed off in the quarter would sort of suggest the fiscal second probably gets worse before you get better in the fiscal second half rebound. Anything wrong with that thought process?



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

Well, as we said in our prepared remarks, we think that the sluggishness carries into the second quarter. I don't see -- the tax law, I think, will have a favorable impact. They just don't think it will be immediate, but I'm not an economist so don't quote me there. I am expecting some projects and certain portions of the larger project business to release. I think that will benefit the industry. But no, I think what we're expecting is, again, this continued sort of sluggishness. And then, you add on top of that our expectations where our business in the home improvement channel will probably still be impacted by the continuing shift of some of these branding strategies before it improves, which is second half-related. And Ricky, your two cents?

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

No. I agree with that, Vern.

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

Okay. And then on Tier 3, Tier 4, I just wanted to reconcile. I think you said near 160 million square feet. Last quarter, that was 90 million, but then year-over-year, the growth was only 10%. So those relative orders of magnitude, I can't conceptually reconcile them, the square footage versus the percent growth. Clearly, you're mixing apples and oranges here.

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

I know. Yes, you can. So we'll help you do that. The retail portion and where Atrius or the Atrius-enabled square footage is not the only activity that goes through our Tier 3 solutions capabilities. More and more, these solutions that we are selling, that first started out with energy savings, right? And now we're enabling those things to do more than just provide energy savings. So when we talk about the amount of square footage, we're focused on really only a portion of that market. So the Tier 3 base was larger than just the Atrius base. So the Atrius-enabled base improved correctly noted 160 million square feet from 90 million square feet, but that's only a portion of the base.

Operator

Our next question is from Cindy Motz from Williams Capital Group.

Cynthia Michelle Avella Motz - *The Williams Capital Group, L.P., Research Division - Analyst*

I just wanted to ask about the gross margins. I know that, Vern, you said that you expect them to trend upward over time. I mean, do you think that where we'll get back, maybe not next quarter, but latter part of the year, like the 42%, maybe 43% range at one point you spoke about?

And then also to just in terms of -- just following up on the showroom channel a little bit. You're talking about some customers' strategic branding. What makes that get better? Is -- I mean, what do you think you're doing some actions you're taking just in terms of new products or just a little more color there would be great.

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

Sure. Sure. So I'll answer the second part. Ricky, you can answer the first part.

In the home improvement/showroom channel, a lot of the activities -- a lot of the products that we're bringing to market we think will have an influence over how some of the branding strategy changes work where folks will be more interested in having our branded solutions because these products will have features and benefits that are interesting to them and that would include some of these more basic, lesser featured



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products all the way up through when you think about the resi market and how we want to leverage, if you will, the Juno brand through both the home center and showroom channel. So it's a product solution mix and there's a number of products that will be coming out at a pretty robust cadence. We've been working on those. And then number two, we believe that the channel, broadly defined, will continue to grow and we want to expand our access into those -- through those customers and into that channel. So we believe that, that will also have a very favorable impact on our growth rates later in the period.

With regard to margin, and then I'll let Ricky answer that, it's just interesting to us. Volume was a component of that and then certainly that point of price/mix flowed through, but I think we did some really good work offsetting some of the costs from a productivity standpoint. I'm pleased with where our supply chain is in terms of the improvements that they've made. Very, very significant in that regard. And then, Ricky, material costs.

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

Yes. I think as you look at the current trends, we got material costs going up, steel being the primary one, but you've got aluminum, you've got oil. You've got other of the commodities, which we haven't as an industry been able to really pass through in a large way. That, I think, will equal out. Historically, it has, so that will bode better for us as we look forward. Volume, as Vern highlighted, will be key. The incremental margins that we typically earn off of volume increases as we leverage our fixed cost will give us an opportunity to improve margins. The mix. As we continue to grow Tier 3, Tier 4, generally, those have higher margin percentages than the Tier 1, Tier 2, particularly as we get to Tier 4 and the recurring revenue, more SaaS type areas, so that will bode better for us. Again, these are longer term type trends and that's something we're predicting in the next quarter or so, but we do see opportunities on all of those fronts to help us improve margins going forward.

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

And Cindy, I would just add to this for the group out there. When we look at our cost structure and the things that we're doing to manage the business, while I don't normally compare a current quarter to some other quarter other than the previous year's quarter, if I look -- if I go back and I compare this quarter's performance just as it is, \$843 million of revenue, 15.9% adjusted operating profit and I compare that to the second quarter of 2017, we increased our revenues about \$38 million. Our OP was up about \$10 million. So our OP percentage over that quarter was up about 50 bps and our variable contribution margin compared to those 2 quarters was about 26%. So I'm not pleased that we had a negative comparison to the first quarter of the year-ago period, but when I think about where is our business structured and where are we making our investments and I compare that to a more recent quarter that probably had similar characteristics, we're still providing, if you will, value-add. And we are very focused on our margin dynamics, but it's really -- it's a bit of a volume-related game. If I look at our supply chain and I compare to our peak in terms of headcount, which would have been July, I mean, we're down probably about 15% in terms of the headcount, in terms of how we're managing that. So I think we're doing a good job on those things.

Our expectation still is that the markets will finally align to where the words and the music match. The enthusiasm of the marketplace and then how it spills into our overall industry and then Acuity's ability to outperform that, I think, will continue to show through. I do believe that the change in the Dodge Momentum Index is reflective of that opportunity.

Cynthia Michelle Avella Motz - *The Williams Capital Group, L.P., Research Division - Analyst*

Okay. So the 15% headcount reduction, I just was curious because this is separate, but SD&A was up a little bit too so -- and you had said that maybe it was going to trend around -- I knew it was low last quarter, and then you said it was going to go up. But I mean, would you expect it to still be in this 26%-ish -- or actually it was 27.5% this quarter, but any guidance on where that's going to go?

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

Sure. So let me be clear on the change in staffing, if you will. That's all supply chain. So that's up in the COGS area, not down in the SD&A area, okay? I'm just trying to give you all a sense of we are managing the business to the volume that we have.



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From an SD&A perspective, we have continued to invest in our business. Our headcount on our salaried headcount has been pretty stable here over the last 6 months. We haven't really meaningfully changed that. If I look at it on a year-over-year basis, we have increased our salaried headcount probably in the neighborhood of 7%, 8% on a true apples-to-apples basis, but we've had wage inflation and some of the mix of people are now just a bit more expensive. So that 25.7% number probably does get a little bit higher, but it only gets a little bit higher assuming that the volumes are there. And then, therefore, if the volumes are there, we expect our gross profit margins to be higher and the net is the -- it would be the increase in our adjusted operating profit margin. So you need to have both for that number to, in my view, grow. I hope that makes sense.

Operator

Our next question is from John Walsh from Vertical Research.

John Walsh - Vertical Research Partners, LLC - VP

Yes. Just 2 quick questions here. So wondering if you could talk a little bit about the price discovery you're seeing in the Atrius branded platform. I mean, it does sound like the number of pilots is broadening and this was -- when we thought about traditional relight renovation, it was about \$3 a square foot. And then, I think in the last year, you were out on the road making comments around \$3 to \$5. How should we think about that growing over time as you add more value? What are the conversations you've been having with customers there?

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

Yes. So the value, if you will, of retrofit renovation work varies widely, right? And so if you have very large big-box stores that are renovating, it's usually a single fixture type and so the value per square foot is different than if you're redoing a hospital or an airport or a commercial office building. So just know that what we gave you in the \$3 to \$5 was a range, but it's an average of a very wide range, so that's number one.

Number two, the value proposition that, whether it's retailers, whether it's public spaces, again, airports, convention centers and now health care facilities, the value is clear around both better quality of lighting and energy savings. So it is paying for the opportunity to now play and use that ceiling as a sensory network in a more robust way. As various customers are becoming more mature and experienced now utilizing this data, they're seeing other opportunities to use the data to do different things. And so the value in what we're seeing. Again, Tier 4 is a really small base. It's not enough to move the needle in the shorter term, but what we're seeing is that more and more people are finding use cases in their specific examples that are very exciting to them. So it's causing them to either expand or extend the base that they have and adding more feature sets to it, which is favorable to Acuity, or it's causing new customers to say, yes, I now see and understand the opportunity. I can see how I could use this capability to enhance my business model. So 2 things are happening. They're now saying how do I invest to upgrade my facilities, putting in and installing this capability. And then how do I get the recurring opportunities of that data.

And then, thirdly, folks that have, well, have pilots in place are now moving to more broader installations. And so our view of that is very, very favorable. And that's why we continue to report out square footage. I mean, at some point in time, it becomes really a bit of a nightmare to keep track of all that, but because we're in our infancy, we want to convey that to you so that you understand how others and people are starting to say this is really a very strong and robust value proposition.

John Walsh - Vertical Research Partners, LLC - VP

Got you. And then I guess as a follow-up, as we think about this transition to a technology company, I mean, one of the questions I get a lot is if you look at your R&D, right, so your absolute dollars have been between call it \$40 million and \$50 million, about 1.5% of sales, how do we kind of reconcile that level of investment with what you're building out here with your platform? And is there other engineering spend that might be embedded somewhere else in the P&L so we're not capturing everything when we look at just the pure R&D number?



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

Sure. So Acuity is really -- we're not in the R&D game. We're taking, if you will, more or less known technology and we're applying that known technology in ways that allows us to take advantage, if you will, of this sensory network. I mean, anybody can take a sensor and, I guess, put a battery on it. People do it all the time and put it up in the ceiling.

The opportunity that Acuity uniquely has is to embed this capability, if you will, technology. We -- Acuity did not invent the LED chip, right? It's been around for 30 years. But how we now deploy, if you will, LED chips into our luminaires as well as incorporating software and how to use that and optimize its utilization in the most energy-efficient and visual efficacious way is really our skill set. So that's a human, capital-intensive business or a human capability. And most of that spend is embedded, if you will, in our SD&A. I mean, frankly, if you were to compare our SD&A to other, if you will, lighting companies, you would find that our investment in there is significant and formidable, and that is all engineering and human capital capabilities that are there.

So again, Acuity is not necessarily out trying to create the next LED chip. What we're doing is spending a great deal of capital, our human capital, in understanding how we can deploy those technologies to bring greater value. So if you think about that 26% SD&A number, a big chunk of that is really for the development of solutions, whether they be lighting, building management or Atrius, but they're all software-enabled and there's all significant technology inside that didn't exist in this industry even a short decade ago.

Operator

And we do have one last final question for today. It is from Tim Wojs from Baird.

Kai Shun Chan - *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

This is Josh Chan filling in for Tim. So my question is on the second half rebound within the core C&I business. I guess we are reading the similar economic data points, but I'm wondering if you have any color on what your agents are telling you in terms of projects in the pipeline? Any anecdotes in the business that gives you confidence that the second half could improve the way you think it DOES?

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

Yes. I think that there is really a couple of focuses that our agents are excited about in their local markets. One is the service and product capability of our architectural businesses that give them the opportunity to go out and win.

Number two, the product portfolio from some of our core products incorporating, if you will, other software technology into projects that are, I'll call it medium and larger term projects. Those folks feel that some of the stuff that is in their backlog should begin to release. It's been aged a little bit and I think people are saying we're going to do this project, we're going to do this project. And it's not that they have money. They have really all of the capabilities to do it. I don't know if some of them were because of labor shortages or whatever, but our agency network is feeling more bullish about the releasing of that.

And then thirdly, our stock and flow business. Acuity -- we're the leader, if you will, in the stock and flow business in North America, but we see great opportunity to really drive a differentiated value proposition both from a product portfolio capability as well as the service capability. So I think we all have a bit of optimism around our ability to execute irrespective of what the market does. I personally believe and it's only a personal belief that the markets are going to see some rebounding here. And I'm using Dodge. I'm using the voice of the customer. I'm not an economist. I don't have a crystal ball, but I do believe that we have the opportunity to see an uptick. And then into that uptick, our ability both with our agency network as well as our partnership with our agency network and our internal ability to execute to make some good things happen.



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Kai Shun Chan - *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

All right. And then my second question is on pricing. The pricing pressure that you've seen in some of the basic products, you said you've dealt with it before in the conventional side. So just wondering what Acuity's strategy is to combat that and how do you think it will ultimately settle out?

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

Yes. So I believe that product differentiation, demonstrating the difference, having the service model to do it and then tying that together with how people actually do projects and the ability to support that. Anybody can walk in with a price, but when you start to actually do some of these things in most of the channels that we serve, people are looking for more value-add than just a price around a particularly luminaire. So our view is, is that we will continue to innovate. We will also create solution sets that give us the type of margin profile we are after that also allows us to be even more price-competitive and preserve our margins. So you'll see some of these types of products continue to come out into the marketplace and then that breadth and that strength of capability is a compelling value proposition to the folks who buy that. Many of these distributors, they're really not interested in adding more vendors. There are e-mails every day flying all over the place. They don't need more vendors. So those prices sometimes leak into the marketplace, but the value proposition and how you're able to serve and leverage that is really what Acuity and others by the way, not just Acuity, but others who have more established channels to market, access to market, I think, will continue to win the day.

Operator

And this will conclude the question-and-answer session.

I would now 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. We strongly believe we are focusing on the right objectives, deploying the proper strategies and driving the organization to succeed in critical areas that have the potential, over the longer term, to deliver strong returns to our key stakeholders. Our future is bright and thank you for your support.

Operator

And this does conclude today's conference. You may disconnect at this time.

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