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EDITED TRANSCRIPT

AYI - Q4 2018 Acuity Brands Inc Earnings Call

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OVERVIEW:

Co. reported FY18 net sales of $3.7b, reported operating profit of $455m and reported diluted EPS of $8.52.

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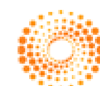

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PRESENTATION

Operator

Good morning, and welcome to the Acuity Brands Fiscal 2018 Fourth 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 fourth quarter and full year 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 at acuitybrands.com.

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

Now let me turn this call over to Vern Nagel.

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

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

While our results for the fourth quarter and the full year were records, we had higher expectations coming into 2018. Market conditions for growth were far more subdued than most had originally anticipated, especially for larger commercial projects, and deflationary pricing persisted throughout the year while cost pressures were far more significant than most had forecast, particularly in the fourth quarter. Our results for the quarter and the full year reflected solid performance given these market conditions, while our strategic accomplishments this year were very significant, as I will describe later in the call.

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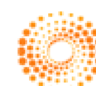

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I know many of you have already seen our results, and Ricky will provide more detail later in the call, but I would like to make a few comments on the key highlights.

First, for the fourth quarter. Net sales of almost $1.1 billion for the fourth quarter were a record, increasing approximately 11% compared with the year-ago period. Reported operating profit was $142 million compared with $153 million in the year-ago period. Reported diluted earnings per share was $2.70 compared with $2.15 in the year-ago period.

There were adjustments in both quarters for certain special items as well as certain other addbacks necessary for our results to be comparable between periods, as Ricky will explain later in the call. In adding back these items, our adjusted operating profit for the fourth quarter of 2018 was $154 million compared with adjusted operating profit of $176 million in the year-ago period. Adjusted operating profit margin was 14.5%, a decrease of 390 basis points compared with the prior year. We will provide important detail in the change in operating profit and margin in a moment.

Adjusted diluted earnings per share was a quarterly record of $2.68, up 5% from the year-ago period. For the full year, net sales in 2018 were a record $3.7 billion, up 5% from 2017. Reported operating profit was $455 million compared with $519 million in the year-ago period, while diluted earnings per share was $8.52, up 15% from a year ago.

Adjusted operating profit was $528 million, down 11% from the year-ago period. Adjusted operating profit margin in 2018 was 14.3%, down 260 basis points from a year earlier. Adjusted diluted EPS of $8.84 was a record, up 5% from 2017.

In addition, we generated a record $353 million in net cash provided from operating activities this year. We closed the year with $129 million in cash on hand, even after repurchasing $298 million of the company's shares, investing $163 million to acquire 2 great businesses, spending $44 million for capital expenditures and funding $21 million in dividends this year.

In addition, we entered a new 5-year $800 million credit facility, leaving us with plenty of financial firepower.

Lastly, I am pleased to report that we once again earned much more than our cost of capital. Our adjusted cash flow return on investment for 2018 was over 33%. We believe this level of return is far greater than others in the electrical industry.

For those who follow EVA, we generated over $168 million in positive EVA, a great accomplishment.

Looking at the key highlights for the fourth quarter. Net sales for the quarter exceeded $1 billion for the first time ever and were up approximately 11% over the year-ago period. Overall, net sales volume grew approximately 13%. This was offset by approximately 3 points for changes in the price and mix of products sold. Acquisitions and changes in foreign currency added another 1 point of growth. Our significant sales growth was due in large part because of our continued efforts to expand our customer base and the introduction of new products and solutions, which allowed us to gain overall market share.

Overall, we experienced solid growth in net sales in most channels and geographies. The largest contributors to the increase in net sales volume were greater shipments of certain high-value, more basic, lesser-featured LED fixtures primarily for applications on smaller commercial and residential projects; greater demand for our Atrius-based luminaires; and growth in our infrastructure and utility channel, primarily through our Hall of Fame team. The increase in sales of more basic, lesser-featured products was driven in large part by the successful relaunch of our Contractor Select portfolio as well as gains in certain other brands sold through numerous channels, including home centers and electrical distributors where we posted strong sales growth.

Sales through our C&I channel, which have historically made up more than 60% of our total sales, were down slightly again this quarter in dollar terms as well as a percentage of our total net sales compared with the year-ago period, primarily as demand for larger, nonresidential projects remained soft.

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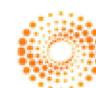

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Further, overall net sales were impacted by changes in the price and mix of products sold, primarily due to lower pricing in certain luminaires, reflecting increased competition primarily for more basic, less-featured products and changes in both product mix, which included substitutions to lower-priced alternatives, and channel mix, which includes declines in shipments for larger commercial projects noted a few moments ago.

While it's not possible to precisely determine the separate impact of changes in the mix and the price and mix of products sold, we estimate the impact of price/mix was more due to changes in product pricing and, to a lesser degree, mix primarily due to product substitution.

Based on information from various data collection and forecasting organizations, we believe the overall growth rate for the fourth quarter, as measured in dollars for lighting in North America, was flat to slightly down, continuing the sluggish trend over the last several quarters.

Our net sales growth rate of approximately 11% 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.

Our profitability measures for the fourth quarter, while solid given overall market conditions, were below our expectations and prior year performance. They were impacted by changes in the price and mix of products sold noted earlier and significantly higher costs, particularly for certain commodities and components, as well as freight and wages, which I will address in a moment.

Our adjusted operating profit for the quarter was $154 million, down approximately 12% compared with the year-ago period, while adjusted operating profit margin for the quarter was 14.5%, down 390 basis points from the adjusted margin in the year-ago period. The decrease in adjusted operating profit margin was primarily due to the decline in adjusted gross profit margin. Adjusted gross profit margin for the fourth quarter was 39%, a decrease of approximately 350 basis points compared with the year-ago period.

It is critically important to understand the underlying factors that drove the decline in our margins this quarter and the actions we took to counter those factors as well as the timing and financial impact of those actions. Adjusted gross profit increased $7 million over the year-ago period, driven primarily by higher sales volume and productivity improvements, partially offset by changes in the price and mix of products sold and higher input costs. We estimate the impact of price/mix reduced our adjusted gross profit margin by 280 basis points this quarter.

Another significant factor impacting our adjusted gross profit and margin was higher input costs for certain items, including electronic and certain oil-based components, freight and certain commodity-related items, particularly for steel. Many of these items experienced dramatic increases in price in the fourth quarter due to several economic factors, including enacted tariffs and wage inflation due to the tight labor markets. We estimate the inflationary impact of these items reduced our adjusted gross profit in the quarter by more than $20 million, lowered our adjusted gross profit margin by 200 basis points and reduced adjusted earnings per share this quarter by $0.38.

We took significant actions in the quarter that we believe will offset these and other cost increases, including wage inflation, as well as the impact of currently enacted increases in tariffs. These actions included announced price increases and other measures to improve productivity and reduce other costs. We believe that the timing of the price increases and other actions implemented will begin to offset these and other cost pressures midway through our first quarter of 2019. Therefore, we expect to continue to experience some drag in margins in our first quarter of 2019.

Next, our adjusted SDA expenses were up approximately $29 million compared with the year-ago period. Adjusted SDA expense as a percentage of net sales was 24.4% in the fourth quarter, a very slight increase over the year-ago period, demonstrating the leverage of our SDA investment as net sales volumes grow.

The increase in adjusted SDA expense was primarily due to higher freight and commission costs to support the increase in net sales, greater employee-related costs and, to a lesser degree, costs for marketing and outside services, partially offset by actions taken in prior periods to streamline the organization. Excluding the impact of higher freight and commission expense due to the increase in net sales volume, more than half of the increase in SDA expense, compared with the prior year, was due to greater employee-related costs. While our salary headcount remained flat

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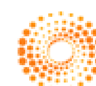

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year-over-year even after acquisitions, we expect employee-related costs will continue to rise as we enter fiscal 2019 as markets for certain skills remain tight, contributing to a rise in wage inflation.

Our adjusted diluted earnings per share was $2.68 compared with $2.55 reported in the year-ago period. The increase was primarily due to the favorable impact of 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 in the quarter. As I noted earlier, we believe the spike in certain input costs reduced our adjusted EPS this quarter by $0.38.

Before I turn the call over to Ricky, I would like to comment on a few important accomplishments this year. On the strategic and technology front, we continue to make great strides, setting the stage for what we believe will be strong revenue growth and profitability over the long term. Let me briefly mention a few of our accomplishments in 2018.

We introduced almost 100 new product families this year, expanding our industry-leading portfolio. We gained market share in many important product categories and sales channels. Tier 3 and 4 solutions grew by 30% this year and now make up more than 15% of our total revenues. Our Atrius-based IoT luminaires and solutions are becoming the industry standard in the retail segment. Additionally, we are expanding these solutions in other channels as awareness by customers of our meaningful points of differentiation and the capabilities of our IoT solutions increases significantly, providing customers with the opportunity to transform their spaces from expense items to strategic assets. It is now evident that certain Chinese-based lighting companies, many clearly being subsidized in some form, are influencing pricing for certain basic, lesser-featured fixtures sold in certain channels. We will not yield this space for many strategic reasons. As such, we aggressively reintroduced our expanded Contractor Select portfolio to profitably compete in this portion of the market.

We acquired 2 excellent companies this year, Lucid and IOTA, as part of our strategy to expand our portfolio and access to market. Also, we introduced in late 2018 the next generation of our industry-leading lighting control system, nLight AIR, a wireless control system with a wide range of options and functionality for which there is strong customer interest. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control systems available and, importantly, are now connected to our growing BMS solutions.

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

We have been able to create these capabilities while providing industry-leading results because of the dedication and resolve of our many associates who are maniacally focused on serving, solving and supporting the needs of our customers. I will talk more about our future growth strategies and expectations for 2019 later in the call.

I would like to now turn the call over to Ricky. Ricky?

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

Thank you, Vern, and good morning, everyone. As Vern mentioned earlier, we had some adjustments to the GAAP results in the fourth 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 fourth quarter and full year 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 and credits for streamlining activities, manufacturing inefficiencies and excess inventory adjustments related to the closure of a facility, gain associated with the sale of the company's Spanish lighting business, gain associated with the sale of an investment in an unconsolidated affiliate and an income tax net benefit for discrete items associated with the U.S. Tax Cuts and Jobs Act. We believe adjusting for these items and providing these non-GAAP measures provide greater comparability and enhanced visibility into our results of operations. We think you'll find this transparency very helpful in your analysis of our performance.

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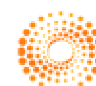

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In addition, many of our peer companies, especially as we become more of a technology company, make similar adjustments, so it will help you as you compare our performance to other public companies in our industry.

During the fourth quarter of fiscal 2018, we reversed pretax special charges of $5 million as certain previously planned streamlining activities were no longer expected to occur, primarily because we were successful in selling the Spanish lighting business for a gain during the quarter. We recorded a pretax charge of approximately $10 million in the prior year fourth quarter, which included planned streamlining activities associated with the Spanish business that were no longer necessary due to the successful sale of the business.

During the fiscal year 2018 and 2017, we recorded net pretax special charges of $5.6 million and $11.3 million, respectively, related primarily to streamlining activities. We expect to incur additional cost in future periods associated with the closing of certain facilities, primarily attributed to early lease termination and moving cost. We expect the annual savings from the fiscal year 2018 streamlining actions, once fully implemented, to exceed the amount of the special charge. The savings will be reinvested in activities to support higher growth opportunities as well as drive improved profitability.

We reported net miscellaneous income of $4 million in the fourth quarter of fiscal 2018, which reflected a $5 million gain associated with the previously mentioned sale of the Spanish lighting business. This gain was primarily due to the recognition of favorable accumulated foreign currency translation adjustments previously recorded in comprehensive income.

The effective tax rate for the fourth quarter was 21.1% compared with 36.4% in the prior year quarter. The fourth quarter of 2018 tax expense included a onetime tax benefit of $3.9 million related to reduction in estimated taxes on undistributed foreign earnings. Excluding this onetime benefit, the effective tax rate on adjusted earnings in the fourth quarter of 2018 was 25.5%. The lower effective tax rate and toll charge adjustments were 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 25% for fiscal 2019. As these lower rates reflect the passage of the new U.S. tax law, we'll have a meaningfully positive impact on our future earnings and cash flow. The impact of the tax legislation may differ from current estimates, possibly materially due to, among other things, changes in interpretation or assumptions the company has made, guidance that may be issued and actions the company may make as a result of the tax legislation.

We primarily manufacture our products in North America. However, we source certain components in approximately 15% of our finished goods from China that are subject to the recently enacted import tariffs. We are aggressively seeking to mitigate the impact on our profitability of these added costs. Our mitigation efforts include a variety of activities such as finding alternative, non-Chinese suppliers; insourcing the production of certain products; and as Vern mentioned earlier, raising prices. Effective September 17, 2018, we raised prices up to 6% on the majority of our products to cover cost increases we had experienced that are not directly related to the tariffs. We have announced 2 additional price increases of 6% on the majority of our products and 10% on our China-sourced finished goods, which are directly related to the increased tariffs. And these price increases will be effective October 15, 2018. Based on our mitigation activities, including the announced price increases, once fully enacted, we believe we can offset the added cost and tariffs. There is a delay in when we see the benefits from our mitigation activities and our cost increases that could continue to negatively impact our margins in the first quarter of fiscal 2019.

We generated $353.2 million of cash flow provided by operating activities during fiscal year 2018 compared with $336.6 million for the year-ago period. Operating working capital, defined as receivables plus inventory less payables, increased almost $92 million during fiscal 2018. This increase is largely due to higher inventory, primarily due to the customer expansion in the home center channel, new product launches and a buildup of finished goods to support committed projects in the corporate accounts channel. Our operating working capital days increased 6 days to 50 days primarily due to higher inventory in August 31, 2018, compared to the prior year.

At August 31, 2018, we had a cash and cash equivalent balance of $129.1 million, a decrease of $182 million since August 31, 2017. The decrease was primarily to cash used to repurchase common stock, to fund acquisitions, to invest in plant and equipment and to pay dividends, partially offset by cash flow from operations. We repurchased 2 million shares for $298.4 million during fiscal year 2018. We have 5.2 million shares remaining under our current share repurchase board authorization.

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Our investment in capital expenditures was $43.6 million for fiscal 2018, a decrease of $23.7 million compared with the prior year. We currently expect to invest approximately 1.5% of net sales in capital expenditures in fiscal year 2019.

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 $356.4 million at August 31, 2018. Our debt to capitalization at August 31, 2018, was 17.2%, and net debt to capital was 11.7%. We had additional borrowing capacity of $794.7 million at August 31, 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 support our growth opportunities, which may include acquisitions. And we'll continue to seek the best use of our strong cash generation to enhance shareholder value.

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

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

Thank you, Ricky. Current market conditions in the lighting industry continue to create challenges for management to drive improvements in short-term financial performance while continuing to invest in attractive long-term opportunities. Shorter-term issues notwithstanding, we are optimistic regarding our long-term future. Our many actions taken in 2018 to improve market -- our market reach, enhance our customer solutions and capabilities and to drive company-wide productivity were done so we can optimize our financial performance while continuing to invest in areas we believe have high growth potential over the long term.

The following are a few observations regarding our fiscal 2019. Many independent third-party forecasts continue to suggest the overall construction market, as measured in dollars, will grow in the low to mid-single-digit range. We believe the lighting industry will continue to lag the overall growth rate of the construction market, primarily due to continued product substitution to lower-priced alternatives for certain products sold through certain channels.

From a pricing perspective, we expect the market to be competitive, though announced price increases by many in the industry should abate some of these pressures. Additionally, labor shortages in certain markets will continue to impact growth rates for both construction and lighting.

We believe the outcome of the tariff situation could have a dampening effect on overall demand due to higher component cost and finished good prices, particularly if the proposed increase in tariffs to 25% from 10% on finished goods made in China takes effect on January 1, 2019. It is not possible for us to precisely determine what the potential impact tariffs will have on demand as it is a very complex situation impacted by numerous factors, including currency fluctuations and political outcomes.

Excluding the potential impact of future tariffs and other changes in the economic or political environment, we expect the overall growth rate of the lighting market, as measured in dollars, should be up low single digits in 2019, which is a departure from the negative growth over the last 1.5 years. As previously mentioned, we believe the announced price increases and other actions taken will in time offset the spike we experience in current cost for various items noted earlier. However, we believe costs for many inputs could continue to rise due to the inflationary impact on certain commodities, particularly steel and oil; the impact of tariffs on imported electrical components and finished goods; freight and wages, primarily due to tight labor markets. These potential cost increases could have a negative impact on our financial results due to the timing and nature of any mitigation efforts, including future price increases and other actions to reduce costs.

Further, 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, potentially pressuring both top line growth and profitability. The relaunch of our Contractor Select portfolio and other actions taken were done to enhance our opportunities for profitable growth in this portion of the market.

Foreign currency exchange rates will continue to be volatile.

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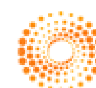

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Excluding the impact, if any, of those item -- factors just noted, we remain cautiously optimistic for fiscal 2019. Our wide and varied customer base generally remains positive about their growth prospects. Many have record backlogs, though they, too, are concerned about the timing of releases, particularly for larger projects, and the potential impact of tariffs and inflation on overall demand.

However and most importantly, we expect to continue to outperform the overall growth rate of the markets we serve, primarily 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 I would like to emphasize, it will be lumpy at times because of the unpredictability and timing of customers' renovation and new construction cycles.

As we have noted before, our gross profit margin is influenced by several factors, including sales volume, innovation, components and commodity costs, market pricing dynamics and changes in product and sales channel mix. Additionally, we are always striving to improve our profitability through our continuous improvement efforts. However, we believe, for any meaningful gross profit margin improvement to occur, we will need to experience an acceleration in market demand in the C&I channel, particularly for larger commercial projects where contribution margins are more favorable due to the complex nature of these types of projects. This illustrates the influence of product and sales channel mix on our margin profile.

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 strategy and to leverage our fixed cost

Infrastructure to achieve targeted incremental margins to improve our overall bottom line profitability.

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

As we have noted in our last several conference calls, the implementation of our integrated tiered solution strategy and our opportunities to meaningfully participate in the interconnected world is an integral part of our overall long-term profitable growth strategy to meaningfully expand our addressable market by adding significantly greater, broad-based holistic solutions that will allow our customers to transform their connected intelligent buildings and campuses from cost centers to strategic assets. This all takes focus, resources and time. We are investing today to enhance and expand our core competencies, affording us the opportunity to excel over the longer term in our fast-changing industry because we see great future opportunities.

As I've said before, we believe the lighting and lighting-related industry as well as the building management systems market have the potential to experience significant growth over the next decade because of continued opportunities for new construction and, more importantly, the conversion of the installed base, which is enormous in size, to more efficient and effective solutions. As the market leader in lighting solutions and a technology leader in building automation, along with our Atrius platform, we are positioned well to fully participate in and lead these exciting and growing industries.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Ryan Merkel with William Blair.

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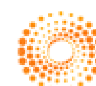

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Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

Couple of questions from me. First, I wanted to ask about pricing. How much price did you capture in the quarter from the summer price increases? And then now that we're approaching the middle of your fiscal first quarter, can you comment on whether you're starting to recover the 200 basis points of gross margin that you lost this quarter?

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

Sure. Ricky, why don't you start?

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

Yes. The price increase that we did earlier in the summer was on selected items and was not across the entire product family. The broader ones didn't come effective until after the end of the quarter. So we got pretty good capture on that, but I want to stress that it was largely on the legacy non-LED products. And therefore, that's a minimal amount of what we're selling today and therefore didn't have as big of an impact as the price increases that became effective on middle September and then the other 2 that will become effective here in the middle of October.

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

And Ricky, I would also say that as we see our order rates, they continue to be robust. And so those orders that are being placed have in effect the increase that was announced on August 9. So I would say that we are seeing capture in a robust way on net price increase. And we expect to have the same type of capture on the other price increases as well.

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

Okay, very good. And then secondly, on gross margins, I think your view has been that we should be finding a bottom soon. You've got pricing, new product introductions and cost takeout. So I guess I'm just trying to gauge your confidence, Vern. How confident are you that the fiscal fourth quarter could be the bottom for gross margins?

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

Ryan, while we don't prognosticate going forward, as I look at the fourth quarter, the spike increases of costs were a little north of $20 million. These are very discrete items that we track, and we just didn't see those increases really in Q3 anywhere near to the extent that we did. So when I look at our business and really try to understand the very elements of your question, I believe that 200 bps of margin degradation because of these spike costs, we will recapture these. If I look at the price/mix, which was probably a 280 bp drag on margins compared to the year-ago period, again, we're seeing -- we continue to see that, if you will, price degradation, but we also see a shift in products to, if you will, lower-priced substitutions. And it doesn't mean that they're less effective. It doesn't mean that we make less margin. It just may mean that we make less margin dollars around that. Having said all of that, I believe that the price increases will have an influence on that price/mix as well as we go into the market. So confidence level of trying to understand where we are and then the base going forward, we are -- our view is that 2019, we'll see growth in dollar terms driven by, again, price increases. We're assuming that the economic environment continues to be favorable. Again, our customer base gives us pretty solid input that while they have record backlogs, yes, they're a little concerned about releases of larger products, they still see the notion of stock and flow in those types of projects being favorable. So we have a positive yet cautiously optimistic view coming into 2019. And we're pretty good at extracting margin as volumes improve. So as I mentioned, mix does have an impact on our business. Mix did have an impact this quarter. When we look at our C&I business, we don't look at it as a business, but when we look at the C&I channel, typically, that's north of 60% of our total revenues. Well, it declined this quarter because the revenue growth in other aspects of our business, whether it be the electrical distribution channel, the home center channel, the infrastructure and utility channel, our enterprise solutions, which are really selling our Atrius-based luminaires, those are the folks that brought us the lift, and larger projects were left behind, if you will. So we are optimistic that these larger projects will continue to

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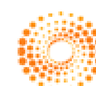

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come back, and that adds spice to our margin stew, if you will, because the variable contribution off of those more complicated projects are favorable to us.

Operator

The next question comes from Tim Wojs with Baird.

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

I guess maybe, first, just on inflation. You talked a little bit about beginning to offset the inflationary pressures kind of midway through Q1, which I guess we're kind of at today. So I mean, are you starting to see that pricing start to recapture the inflation? And then second, I guess, is your message that kind of by the time you get into the second quarter, that you should kind of be fully offsetting inflation? Just some color on these 2 questions will be helpful.

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

Sure. We do believe that the price increase that was effective for 9/17 on those inflationary items, as Ricky had described earlier, that we are seeing full capture and we are starting to see the offset to that. But again, as you know, we have costs in our inventory that need to roll through, and the way that inventory turns in -- less than a quarter, it will influence Q1. Our expectation is that as we get into our full Q2, we will have full capture of both price increases that will offset the inflationary effects of costs that we saw earlier as well as the significant tariff increases on component parts that are rolling through and, then to a lesser degree, on finished goods. So our expectation is that we will cover these costs. I do believe that we are experiencing continued wage inflation because of tight labor markets. Our expectation is that, that will continue. We do hope to offset some of those with productivity improvements and then, to a lesser degree, the pricing increases that we have put in place.

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

Okay, okay, that's helpful. And then just on the large projects side, I mean, any change you've seen kind of sequentially as you kind of just talk to your agent base or talk to your customers just about the release of some of those large projects?

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

Yes. Again, I believe that folks continue -- and when I say folks, I'm talking about contractors, electrical distributors, if you look at people who are in the specification world, architects, engineers, lighting designers, people continue to be busy. Contractors and electrical distributors, many of them are operating with record backlogs. So the question is, how and when do these release? I do believe in certain markets that labor shortages continue to be a problem, and so people are picking and choosing which jobs they release. I do think that some of those labor shortages will continue to influence our industry. But I also believe that some of these larger projects that people had on the books are starting to release. And so our expectation is that as we get into 2019, some of these more interesting projects will release. And we're starting to see that. We've had some really nice releases of both commercial spaces as well as street and roadway things starting to release. For all of those of you who come through Atlanta, when you walk outside, you'll see a fantastic overhang or a bridge, if you will, between parking structure and the terminals, and that's all Acuity. It looks just outstanding. So we're starting to see these types of projects released. So again, cautiously optimistic around that, and our market channel partners have a similar view.

Operator

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

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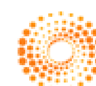

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Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

On the price increases, have you seen any prebuy in those -- well, prebuy, I imagine that wasn't all that substantial maybe in the quarter that just got reported. But so far, as you're seeing in the F Q1, any significance on the volumes side that you're seeing?

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

So Rich, we saw some uptick in volume prior to, if you will, the 9/17 effective date. And then post the 9/17 date, we've continued to see the strong demand. I think some of that may have to do with the effective or the price increase effective 10/15. Because I think for all folks, from the things that I've read, everyone's saying that you have to take delivery on that. So I suspect that there is some of that, but that doesn't necessarily influence medium- to larger-sized projects as much. So we're seeing some of that, but I don't think that, that is really at the core of the overall growth that we're seeing in our order rate. It's a factor, but it's not the overall factor.

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

And then, Vern, on your comment about going -- if the rate goes to 25% effective 1/1, which is the plan, it seems like whatever price increases you've put through, you'd have to put through an incremental price increase to cover the move from 10% to 25%. Is that the right way to think about it?

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

It -- Rich, it is. I mean, yes, that is exactly the right way to think about it from Acuity's perspective. And I think even from a market competitive standpoint, 25-point increase in just costs because of tariff, the -- few would have the ability to absorb that. And so the question for us is, how much does that influence demand? And you know it gets really complicated when you start to bring in changes in foreign currency and what offsets what. But our expectation -- our strong expectation in our price increase in the release that we had, we identify that should the tariff increase on 1/1 go to 25%, that we -- the price increases that we would put in place would be effective immediately on that date. So we didn't announce what that price increase would be, but we said it would be effective at that date. So we gave our many, many channels way advance warning on this.

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

And then you're seeing good follow-through from your competitors? And I mean, it seems like imports are even raising pricing. So I mean, what's your thoughts around just realization?

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

Yes. We think overall, folks -- it's just -- it's too much for someone to absorb for too long. I think that there'll be some gamesmanship a little bit on the fringe around, how much inventory do I have at lower prices, and how long can I last, and what's going to happen there? But on the other hand, you should have folks saying, "Well, the industry is going to put through the price increase. It's going to go all the way to the end consumer. So do I use that as an opportunity to optimize my margin?" So of -- that's all of the noise out there. Our view is that the industry follows through on these price increases.

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

Okay. And then last one for me, just as a shorter-term question, but just since the margin dropped as much as it did here this quarter, typically, you go from F Q4 to F Q1, and it tends to vary, but it seems to be up a little bit, at least sequentially, in terms of gross margin. I guess is there any thoughts, any color you can provide us on how we can think about the nearer term in terms of, going back to one of the other questions around

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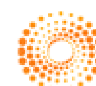

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the bottoming here on gross margin, is there any thoughts around the nearer term that -- anything you'd point out that we should really think about as we think about the November quarter?

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

Sure. Rich, we have -- as an industry, really, we've experienced over the last, I'm going to say, handful of years, deflationary environment. This quarter was really the first quarter where inflation reared its head in an aggressive way. Truthfully, I would say that Acuity, I'll put us into the big bucket, and the industry caught a little bit off guard on the significance. And some of it had to do with the tariffs. We just didn't know how those things were going to roll through, but that's [Atrius]. We were experiencing inflation in other areas as well. And so I think that the timing of how we put through our price increases, we were probably a little late. And so that's why I'm calling out, if you will, the spike increase in these costs because typically, we catch up, we understand how to do it, and we're now putting this in place. We're also looking at other measures to reduce our costs, but we always are doing that. So that's why I'm calling out this north of $20 million spike increase that impacted our margins a couple hundred bps. We knew that we were going to have some mix changes, particularly as we introduce Contractor Select into several different channels. The margin profile of Contractor Select is solid. But when I look at the overall average or compare it to larger projects, it's not there, and it never will be, but our cost to serve is also a lot less. So we like the dynamics, but I would just tell you that we missed the spike increase as did most of the industry. We caught up pretty quickly. So I think as you think about your margin sequentially going forward, we're still down year-over-year even if I add that back. And that had to do, again, more with mix and some of these product price substitutions and price. I think that will still -- the product substitution will still be with us. I think that the price increases are going to be addressing some of the price degradation that we've seen over the last probably 5 or 6 quarters.

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

To -- so to simplify it, think about the 200 basis points impact sticking here at least for the November quarter on a year-over-year basis, and then anything above that, we'd have to just think about overall volume assumptions and then go forward from there. Is that the right -- just if I simplify it?

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

It is. And -- that is and the fact that the price increases are going to kick in as well, not just to cover costs but also how will that influence different positions that people have. Acuity does have a strong position because of our North American manufacturing footprint, but we import a lot of components that we convert, if you will, in the process. So we're going to look to see how we can drive our productivity and our improvements to capture margin there as well.

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

I would just like to make sure that you remember that the price increase will be only for half of the first quarter. We'll get the full impact of that in the second quarter, of course, but the price increases related to the tariff aren't effective until the 15th of this month, October 15, which obviously is halfway through the quarter. So as you were doing your math there, Rich, I just want to sure you factored in we won't have the full quarter benefit of the price increases.

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

It's a good point. Unfortunately, there's noise around that. It's...

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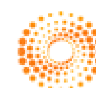

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Operator

The next question comes from Joseph Osha with JMP Securities.

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

Two questions for you. First, given the extent to which you've been willing to lever the business and buy back stock, work with the balance sheet, I'm wondering at this point, would you be willing to go out and explore the idea of acquiring smaller competitors and exploiting additional efficiencies there in an effort to maintain market share? I'm wondering what your thoughts are about that.

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

So 3 elements of our overall, if you will, shareholder value creation strategy is to continue to drive the financial performance of our business, acquisitions and return of capital through stock repurchases. I thought that 2018 was a pretty solid reflection of that balanced strategy. We picked up almost $300 million -- or invested almost $300 million in share repurchases. We spent about $160 million, slightly more, in acquiring 2 small businesses, and dividends and CapEx were probably another $60 million or $70 million on top of that. So the answer to that is yes, we continue to explore different opportunities that are both share expansion opportunities, the ability to extend into our -- or expand our access to market, to expand our technology capabilities. I think Lucid and IOTA were 2 good examples. IOTA expanding our SaaS model around bringing more Tier 4-type solutions to Acuity, and I thought that the acquisition of IOTA was just, as you described, a beautiful business that expands both our access to market and our product portfolio. So Ricky and team have a pretty active pipeline of acquisitions that they're looking at. And so I would expect us to continue to do the things that we've demonstrated that we've done in the past around these types of acquisitions.

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

Okay. And second question. It's interesting, operating expense is 25.5% of revenue. That's as low as it's ever been. Might -- your comments about wage pressure notwithstanding, might we be seeing that OpEx line perhaps sort of in the mid-20s percentage of revenue going forward? Some commentary there would be helpful.

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

So when I look at the dollars and put freight and commissions aside, which are pretty truly variable based on the type of revenue that we have, our fixed investment in our SDA, our salaried headcount, was stable year-over-year at about 3,100 folks, 3,200 folks. But that was also -- we did acquisitions where we brought in salaried headcount, but we also took some streamlining actions. My expectation is that we will see wage inflation more than we have, say, over the last handful of years. But generally speaking, we feel that the investments that we have in our human capital are pretty solid right now. So we would expect, as our volumes grow in dollar terms because the price increase will impact dollar terms, that we will see some leverage on our SDA expense. It's interesting, our unit volumes continue to expand at a more rapid rate than our dollar volume. And so that has an influence on many things. We measure everything in terms of dollars as a percentage of sales. So when we see our freight costs going up, when you have product substitutions that are putting lesser-valued items on a truck, it doesn't necessarily mean that the box is any different. So you're experiencing freight -- more freight costs as a percentage of sales. And then you add on top of that the fact that oil's going up, you can't find enough truck drivers, and so freight rates are going through the roof right now. So anyway, long way around the barn to answer your question. Yes, we would expect leverage on our SDA line going forward. And then just to finish off real quickly on that, you -- everyone looks at it quarter-to-quarter. We look at it on a full year basis because a lot of that SDA is fixed, and it goes -- if volume changes as we have seasonality in our business, for example, our second quarter is typically our lowest seasonal quarter, you would expect SDA as a percentage of those sales to be higher. So you have to just look at it over the course of a full year.

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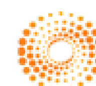

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Operator

The next question comes from Christopher Glynn with Oppenheimer.

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

Yes. So just want to look at the gross margin volatility here, moving away from the year-over-year frameworks. That goes down about 260 basis points sequentially. Putting aside inflation and the timing of price, you did say price/mix was a 280 basis point drag, but price/mix was better than it was in the third quarter. You moved from a minus 5 to a minus 3. So that 280 magnitude seems a little surprising. Maybe you could help clarify why or why not that's sort of a incongruous kind of number, that magnitude of 280 given that the minus 3 improved from the third quarter.

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

Sure. So Chris, I just did a little math, and maybe my math is wrong, but our adjusted gross profit was about $414 million. And so if I add the 30 back to that and compare it to the $1,061,000,000 sales, I get a 41% -- or excuse me, I get a 43.8% margin. So well, I get a 41.8% margin, sorry. So that's the 280 bps if I exclude the spike cost in that. It's just math.

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

Well, I'm wondering, we didn't have such gross margin impact called out from price/mix in the third quarter, but you had, in fact, a minus 5 price/mix on the top line in that quarter.

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

I just -- I guess I looked at it just a little bit differently this time. We felt, as we were looking at and analyzing our business, the price/mix, primarily price but with product substitution a little bit and mix going in there, that's -- that was the number, and that's about a 280 bp impact if I look at it on this quarter's result. I don't have third quarter in front of me, so I'm a little bit at a loss. I can get back to you.

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

Okay. On a separate tact, inventory spiked last quarter for purpose-built finished goods. We certainly saw that in the volume this quarter. Inventory still remains up here at year-end. Is that still a story of kind of purpose-built finished goods you -- that's kind of a bullish kind of positioning for the channel volume throughput you're seeing?

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

Yes. We're seeing our inventory investment in a couple of different areas to support growth through, if you will, our electrical distribution channel, our home center channel, our enterprise solution folks, these are all investments that we're making because we expect to see increases in revenues through those channels. I would also say that we've had some component issues, so we've wanted to make sure -- if you recall, a couple of quarters ago, we mentioned MOSFETs and other types of resistors and other types of electronic components that were just a challenge to get. So we pulled those in, probably have converted some of those, but I think that our inventory levels are reflective of what we expect in future sales.

Operator

Our last question comes from Brian Lee with Goldman Sachs.

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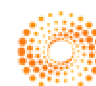

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Brian K. Lee - *Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst*

I just had maybe a couple of housekeeping ones. Could -- I think you might have alluded to this, Vern, but can you update us to what percent of sales T3 -- Tier 3 and Tier 4 were in the quarter and then what the growth rate was? I think it was 40% year-on-year last quarter, so just trying to get a sense for what the trend line is looking like. And then similarly, on LED as a percent of sales, roughly 2/3 is what you've been tracking at. If there's an update on that number you could provide as well.

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

Sure. I think that LED relative to our total percentage of sales, we're probably going to stop reporting that because as a percentage of our luminaires, it's just such a significant portion of that. Just assume that it's all LED. It will be the exception when it's not LED. And we do sell non-LED products, but that's not really the focus. So we've really stopped, actually even internally, accumulating that data because it has -- it doesn't mean anything to us anymore. So relative to our lighting business and lighting in general, as you know, we sell many other products beyond just lighting. The predominant share is now LED. As to Tier 3 and Tier 4, so for the full year, sales of Tier 3 and Tier 4 were up 30%. And if I look at our fourth quarter, we are up about 25. Again, a little bit lumpiness. That's why I'm talking to make sure people understand that we will have continued lumpiness as we deliver those solution sets, particularly with our Atrius-based luminaires. So we're up about 25 points. And if I did that, based on the quarter, we will probably be a 17% or 18% of total sales would be in that 3 and 4. But understand also that mix influences that, right? So as we introduce -- and our Contractor Select portfolio and the introduction was received very well in numerous channels. Well, those aren't Tier 3 and Tier 4 solutions, so don't be concerned about percentage-wise. We feel robustly strong that our investments in the things that we're doing in 3 and 4 are paying off. When I look at our enterprise solutions business, which is really what we're selling our Atrius-based luminaires through, that business was up huge on a year-over-year basis. And we're now introducing our nLight AIR solution set, which is really Tier 3-enabled capabilities, and we're seeing really strong interest there. So our expectation is that Tier 3 and Tier 4 in 2019 will continue to grow at really quite a significant rate and improve our capabilities as we go forward.

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

Okay, great. No, appreciate that color. Just the second question on margins here. The $20 million and 200 basis point impact from wage inflation and also costs and tariffs, I know may be difficult, but is there any rough ballpark delineation you can provide as to how much was wage related and how much was other costs related? And then I know there's been a few questions around the gross margin trajectory. I just want to clarify, are you inferring that gross margins in fiscal Q1 will be up versus fiscal Q4, i.e., Q4 is the trough? Or are we to assume that things are relatively flattish, and then you get an up quarter where you get the full recapture in fiscal 2Q?

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

Sure. So let me be clear on the slightly more than $20 million of spike increases. Those spike increases were for various types of material whether it's commodities like steel, component parts, electronic component parts. We also experienced an increase in freight. What we -- and there are other items, but when we say wages, what we're really meaning, wages are in the SDA area for us. So that does -- in fact, $20 million is not including wages. But what is important in the $20 million is if you look at freight and some of these other things, freight's a meaningful part of our business, whether we're shipping product to our customers or people are shipping components to us. These folks are having a difficult time finding enough truck drivers, and so wage inflation is driving up their rates to us. It's because of the tight labor markets that we're experiencing some of these inflationary items that are coming through. So at the gross profit level, I'm not calling out our wages. I'm calling out the tight labor market that's driving other costs, other input costs for us to be higher. So that $20 million doesn't include our SDA wages. Our SDA wages, as I said, while headcount's flat, if I look at the increase on a year-over-year basis of our SDA, excluding freight and commissions, a little bit more than half was due to employee-related costs. And that's the wage inflation item that we see there. So I hope that adds a little bit of clarity to the point.

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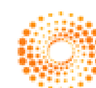

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Brian K. Lee - *Goldman Sachs Group Inc., Research Division - VP & Senior Clean Energy Analyst*

Yes, that's helpful. And just on the gross margin trajectory?

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

Oh, sorry, forgot that one. I think on the gross margin trajectory, as Ricky described, our expectation is that the price increase that is effective 9/17 for a portion of what we have will have a positive impact, and then the price increase that's effective 10/15, we will absorb some costs prior to that. So our expectation is that we will claw back at a portion of this $20-plus million. Our expectation is that we'll see some positive price in some of the other areas. So we're hopeful that we will see a lift from the fourth quarter in terms of margins, but it's a fluid situation, as you might imagine.

Operator

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

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

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

Operator

And that does conclude today's conference, all participants may disconnect.

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