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Masco Corp. (MAS)

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MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

...Raymond James. We'd like to welcome you to the Masco Corporation presentation. With us today, John Sznewajs, Chief Financial Officer. This is a bit of a special day. I think this might be John's last conference of any kind certainly as Masco's CFO, as he is formally retiring and moving on for bigger and better things, no doubt. As well as Dave Chaika, Vice President, Treasurer and Investor Relations.

I think, John, your presentation is about 20 minutes or so. So we should leave enough time for questions from the field here. So with that, John, welcome. Welcome back.

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

Thanks, Sam, and good morning, everyone, and good morning to all those that are on the webcast as well. So thanks for joining us to learn a little bit about Masco this morning. So as Sam said, my presentation this morning will probably be a little longer than I would typically do in an investor conference only because my understanding is there's a fair number of international participants in the room, and for their benefit, go a little bit deeper on in who we are and what we're all about.

So we at Masco, we're one of the largest design manufacturers and distributors of home improvement products that's focuses on the repair/remodel segment of the housing industry. We had a good year the last year. We finished revenue with revenues of just over $8.7 billion, EBITDA of $1.5 billion, operating margins of 15.6% and we generate strong free cash flow. We've generated cash flow last year in the neighborhood of $600 million. And we report our earnings in two segments. One is our Plumbing segment, which is about $5.3 billion, with operating

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margins in the mid-teens, roughly 16% last year. And I'll dive into the segments a little bit deeper in the next couple of slides.

But then also our Decorative Architectural segment, which is largely our paint segment, we also have a lighting business and a builders' hardware business in that segment, but paint is the principal business in that segment. Sales of just under $3.5 billion and strong margins at just south of 18%. The thing that really distinguishes Masco from a lot of our competition, I think, are the three things that we really focus on for our – with our businesses, and those are our brands. We'll talk about our brands in a little bit. Innovation, because innovation drives customers not only to look at our websites, but also to our customers' points of distribution. And then service, to make sure we get our products in the hands of the appropriate channel partner at the right time. So we'll talk about each of those in a little bit more detail as we go through the presentation.

So, first, turning to our Plumbing segment, we believe we're one of the largest manufacturers of functional and decorative plumbing in the world. We've got two great plumbing businesses, one domestically here in the United States is Delta Faucet Company. And so we are one of the top three companies here in North America and arguably, the largest decorative plumbing manufacturer in North America.

And internationally, we've got a terrific business in Hansgrohe. Hansgrohe is a premium price point faucet and shower manufacturer, headquartered in Germany. And Hansgrohe has done a great job of penetrating the international and global markets. So Hansgrohe is really our one truly global brand. They serve not only the central European markets, but also they serve 140 markets globally.

As I mentioned, we've got a broad product range. We try to position ourselves with a good, better, best price point offering, and really with a focus on design and innovation. In addition to our two large plumbing businesses, our faucet and shower businesses, the third largest business in our segment, we have an outdoor wellness business, hot tubs. We're the largest manufacturer of outdoor hot tubs in the world. Watkins Wellness is the name of the company. They go to market under a variety of brands, Hot Springs is perhaps the most popular. And it's a broadly distributed product, both here domestically as well as internationally.

As you think about this business, which you can see here, the two charts on the right side of the page I think are pretty interesting. One, we're heavily focused on repair/remodel activity. And you can see here, about 85% of the business is repair/remodel activity. Only 15% or so is focused on new home construction, with a good chunk of that new home construction business with Hansgrohe internationally because they serve a lot of multifamily developments in Western Europe and in the Far East.

I think the other important thing to point out on this slide is the chart on the bottom right. A lot of people think that we are heavily focused on the retail channel with our Plumbing business. And as you can see on this slide, only about 20% of the segment sales are with our retail partners, be it either Home Depot or Lowe's. So really not that much of an impact on our business. The bigger impact obviously is our wholesale customers. And those will be people like Ferguson, Hajoca, Southern Pipe, down here in the Southern United States. So we've got a great presence with those customers.

And then you can see we've got a growing e-commerce presence with this channel – or with this segment as well and over 15% of our segment sales through the e-commerce channel. Okay. That's not direct-to-consumer from our website, but rather we go through channel partners, be it Home Depot or lowes.com, build.com, et cetera. Then finally, we do have a specialty dealer channel that we sell through and that's principally for our spa business.

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So turning to our Decorative Architectural segment. As I mentioned earlier, Behr Paint is the big company that drives this segment sales. And Behr has been a market leader in the DIY segment of paint for many, many years because we had a long and enduring relationship with our channel partner, the Home Depot. Over the course of the last 10 or 12 years, one of the most significant initiatives that we've driven through Behr and in collaboration with Home Depot is going after the pro paint contractor. And in that time, we've taken that pro business from approximately nothing in sales to just over $900 million in 2022. So a significant effort by both Behr and Home Depot to attract and retain that pro customer.

The way we got there was through the partnership. Both we and Home Depot invested significantly in making the experience for the pro customer better in the big box format as compared to a paint store format. And so if you go into many Home Depots now as a pro paint contractor, your experience will be very similar to that of going into a paint retail outlet, be it one of the major competitors. It's largely because of some of the staffing models that we've gone after, some of the financing models we've gone after. And we really took a look – a hard look at what it would take to attract those pro contractors into the store, [ph] giving them the (00:07:08) better shopping experience, and systematically over the last decade, we've knocked down each of those barriers to make it a really good shopping experience for them.

And so as you can see here on this slide, we are heavily focused on repair/remodel activities you might expect given paints – the nature of paint. And then we are heavily focused on the retail segment, given the nature of our relationship with Home Depot.

Turning to some of our key attributes. As I mentioned earlier, one of the things that we're really proud of at Masco is our – is the brands, the strength of the brands that we have in our portfolio. As I mentioned here, Delta Faucet Company was the one brand within the portfolio that was actually a greenfield. We started Delta Faucet Company back in the mid-50s as the first single handle manufacturer in the United States. We've acquired a number of businesses over the years, and you can see Hansgrohe, as I mentioned earlier, Hansgrohe founded in just 1901. Our first and only truly global brand in the premium price point into the shower market. It's done just a terrific job of penetrating numerous markets around the globe.

And then Behr Paint, another very strong brand for us, highly tied to the home centers and Home Depot, great with the DIY consumer. We continue to rank highly in the top of the quality reports for a variety of outside agencies that rate the quality of paint. And so the Behr team has just done a terrific job. And then, as I mentioned earlier, have also done a fantastic job of [ph] cording (00:08:40) the pro paint contractor.

The other attribute that I mentioned that I think is really important is talking – to talk about is our innovation because, again, we believe that innovation really fuels consumers going to our channel partners, going to our websites to transact. And so you can see here our Vitality Index is 25%. And what that means is that 25% of our sales in 2022 came from products that we introduced in the last three years.

So that – we place a high importance on that, and some of the innovation comes in a variety of different forms. For us, some of this is product innovation, and you see a lot of the product innovation here on the screen. So it's new styles and designs for our faucets or showers. In the case of Behr Dynasty in the kind of the middle right section of that nine box, it's a new paint line that we offer, a higher, more premium price paint offering. Our best quality paint ever that we've introduced at the highest price point. So think in the high 50s per gallon. And we didn't think there was much of a market, but as we and Home Depot looked at and evaluated the market, we did think that there was an opportunity to go after this higher portion of the market, and it's been an extremely successful launch. We are – in the first and second quarter, we are all setting the stores with Dynasty Exterior. So the launch last year was interior paints only.

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And then you can see, we continue to gain shelf space at Home Depot by going into more adjacent products such as aerosols that you see in the lower left corner and interior stains, which is a product category we had not been in before in the Home Depot. So good innovation, driving our business forward, driving our sales and bringing eyeballs to our products and our channel partners' store shelves.

So one of the things that we also like to talk about is the fact that we're broadly distributed. As I mentioned earlier, we try to set our products in a good, better, best price range, so we can hit all the price points that are important and relevant to the end consumer. And then we try to find ourselves wherever consumers are shopping. So I've talked extensively about our relationship with Home Depot, but we sell to all the major home centers, including Lowe's and Menards.

At the same time, our wholesale customers, both the plumbing side and the lighting side, we do a lot with electrical wholesalers as well as the plumbing wholesalers. E-commerce has become important for us over the course of the last several years, including during the pandemic, where we saw a significant rise in our e-commerce transactions. And so we're with homedepot.com, lowes.com, Amazon, Wayfair are some of our big customers.

And then an important thing I think to point out is that, that lower circle chart in the lower right column or right side of the chart, most people think we're heavily a DIY-focused business. And as you can see here, we think we're about half – just over half pro, just under half DIY with the sales of our products. So we think we've got a very good balance, both geographically through the channels and through the end customer, either pro or the DIY customer.

As we think about the prospects for the business over the long-term, we actually think the repair/remodel industry is a great place to be over the coming years. Generally, we've seen that R&R market in the United States grow at a rate of GDP plus 1% or 2%. And there's a number of factors on this screen that give us confidence as to why we believe demand will continue to be good over the coming years. Obviously, home price appreciation during the pandemic was exceptional. And in our mind, not only home price appreciation, but if you look at home equity right now in the United States, it's really at all-time highs.

The housing stock in the United States continues to age. Right now, the average age of the home is just over 40 years. And we know once the age of the house reached 20 years, it requires significant incremental investments just due to normal wear and tear. And as we look at the next several years, what we're somewhat optimistic about is if you consider the strong run-up in new home construction, just prior to the great financial crisis, those homes are about to turn in the age of 20 years old. And that should mean significant repair/remodeling demand coming into the market over the course of the next three to five years.

Household formations continue to be good, and millennials getting into home ownership. That was something that, pre-pandemic, we were not certain exactly how that was going to play out. We thought that generation might be a generation of renters. And what we've learned through the pandemic is that they act like just about any other generation just on a lag basis. And they got into home – new homes and home improvement very heavily during the pandemic. And then, fundamentally, what we look at is the strength of the US consumer. And many of you know, as you observe consumer, the US consumer continues to remain strong here in 2022 and 2023.

In terms of how we think about Masco through a cycle, this is how we like to look at it. Given the fact that we've got generally low-ticket repair and remodel products, we think there's a great degree of stability that we'll have through the cycle. As I mentioned, our brands and innovations will help drive it. And so our little growth algorithm

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is on the right side of this chart. So we think we can grow 3% to 5% organically, which is kind of in that GDP plus 1% or 2% for the R&R market. We do have an acquisition program and we are aspiring to add 1% to 2% in revenue via acquisition every year, and that will ebb and flow depending on the nature of the M&A environment.

And we have a challenge to our businesses. And as Keith Allman, our CEO, and I, as we talk to our businesses about their growth aspirations, really, there's two mantras that we give to them. One, growth above market; and two, expand margins. And given the strength of our market share positions and our margins, I'm not talking about hundreds of basis points of either share growth or margin expansion, but continuing to grind down tens of basis points of share growth and/or margin expansion.

And so you couple that with our share repurchase program, which we've been actively pursuing share repurchases over the course of the last seven or eight years. And generally speaking, what we target is any free cash flow after dividends, we redeploy back into the company either through share repurchases and/or the small M&A that I mentioned. And then, we do have a target of a small dividend, 1% to 2% return yield on that. We target a 30% payout ratio. And so we do see line of sight to kind of a 10% to 12% return on the stock if you include the dividend.

So just to kind of wrap things up here. I think there's a couple things to highlight about Masco that I'll reiterate. We have really focused the portfolio over the course of the last couple of years into the paint and the Plumbing segment of the markets, which we think are actually the two best portions of the R&R market because of the low ticket, brand-oriented nature of those products.

We continue to put the – invest heavily in innovation to continue to drive growth. We've got great fundamentals across, we think, the industry. We've got very consistent performance in terms of both sales and margin performance.

One of the things that we've done significantly, and I'll credit Dave Chaika, our Treasurer on this, is that we've done a great job of managing the balance sheet over the course of the last several years. And we've really put our balance sheet in an excellent position. We finished 2022 with net debt to EBITDA at 1.8 times. So even if there is a bit of a potential softness in the economy this year, we're well-positioned to weather that.

And so we feel like we are in a great position to continue to drive growth to put our free cash flow back in the hands of our shareholders through share repurchases and dividends. And we think we've got great growth prospects in front of us.

So, Sam, with that, that concludes my prepared remarks. I'll turn it over to you for some Q&A.

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QUESTION AND ANSWER SECTION

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

Sure. We've got about maybe 10, 12 minutes or so questions for Masco from the room. In the back, yes.

Q

[indiscernible] (00:17:26-00:17:39)

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah. So the question was related to Plumbing margins. Since 2020, we've seen some margin compression in what were the driving elements of that. And so a couple of points. One, 2020 was perhaps our peak margins. If you recall, that was the first year of the pandemic. And so we pulled back significantly on expenses in 2020, not knowing where the economy was going. And then we also saw a pretty significant drop in commodity prices. So that was – that elevated our margins in 2020.

If you [indiscernible] (00:18:13) forward to 2022, to your point, we did see some margin compression and there was a number of things that went into that. Some of it was, to your point, commodities did hit us and we put through some pricing on that. And we're continuing to get some carryover pricing even here in 2023 as we were a little bit lagged in getting some pricing into the market. We did run into some operational headwinds in 2022, which we believe – we're very confident that we'll be done with here in – after the end of the first quarter of 2023. And so we think those will largely be behind us. So those are perhaps the two more and then a little bit of lower volume that we experienced – we expect to experience in 2023, that will keep our margins around 16% or so here in 2023.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

And the normalized margins, John?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Normalized margins for that should be a little bit higher than that, kind of in the high teens is where we've been before.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

Other questions? Talk about demand trends that you're seeing thus far this year in both your segments and in both US and internationally?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

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Sure. So a variety of things going on there. So let's start with our Plumbing segment. So this year, we've given some guidance to say that our Plumbing segment we expect to be down 10% to 14%. And that's against the backdrop of – we believe the R&R market will be down low double digits for our products. And why we may be down a little bit more than that is we do have our outdoor hot tub company that I mentioned in my prepared remarks. It's a big business. And we do expect that business had performed extremely well, grew 50% from 2020 to 2022, and we do expect the consumer to pull back on that high ticket item here in 2023. So that's going to drive our revenue down a little bit greater than our call on the market here in 2023.

Internationally, we're calling down for a high single digit, Sam. Our business in Europe has held up better than we expected through 2022 and part of that is we picked – Hansgrohe has picked up some share against some competitors that were – have been challenged in the marketplace, and they brought us some new products. And so they actually will be at a major trade show next week in Germany, launching a whole set of new products at Hansgrohe. And so that we think will continue to drive good demand. But outside of here in Western Europe, we've seen great demand in the Far East, China, India, some of the other tertiary markets for Hansgrohe, they have performed extremely well.

In terms of our Decorative Architectural segment for 2023, we've called that segment down 5% to 10%. We've called the DIY market down high single digits. We've called the pro market down kind of mid-single digits. So we do expect a little bit of a pullback in projects, but we feel confident that the Behr teams on it, the Home Depot team is on it and will continue to perform well. Did I miss anything?

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

I don't think so.

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

[ph] You covered (00:21:19) most of it. Talk about pricing versus volumes? Same sort of questions just...

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah. Yeah. So as we think about volumes, so as we call – if you look at – if you think about the 10% to 14% down for the Plumbing segment, the 5% to 10% down for the Decorative Architectural segment, you push those together, that means the company will be down about 10%. Volumes will be down a little bit more than that. We do have some carryover pricing that will offset some of that volume decline that we expect to have hit us here in 2023. And we're keeping a close eye on the market. We may put through additional pricing depending on how the market's developing in 2023. As a matter of fact, Hansgrohe already has put through pricing in early 2023.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

State of channel inventories.

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John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Channel inventories, as we came out of the fourth quarter, Sam, channel inventories were pretty good. We didn't see any significant destocking in the fourth quarter. So we think channel inventories here in the first quarter are, actually, in very good position, at least for our product categories. As you might expect, given the nature of our relationship with Home Depot and on the paint side, we very closely monitor those. And it's a seasonal product and so we know exactly kind of how the seasons ebb and flow in that product category. And so we do – we and Home Depot do a great job of managing the channel inventories there.

On the Plumbing side of the business, because it's a huge repair element to plumbing, faucets and showers break and need to get replaced on a regular basis, there's very consistent inventory. There's not a lot of spikes up and down. There's not a lot of great deal of seasonality to that business for us. And so, again, I think channel inventories are in very good spots [ph] there, I should say, Sam. (00:22:56)

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

Educate folks here in terms of which inputs are most important to your business, what trends you're seeing there and how you procure them?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Certainly. So I'll break it down by the two segments. So the two major inputs on the Plumbing side of our business are copper and zinc, which form brass. And copper has come off its highs in, call it, the second quarter of 2022, but still relatively elevated compared to where it's been over the course of the last several years. And we've seen a little bit of a tick up in – here in the first quarter in copper from its kind of, call it, mid-fourth quarter lows, but nothing that we're particularly concerned about. And so we watch those closely. And to the extent that copper or zinc runs, well, we will put through additional pricing.

Switching to the paint side of the business, the big inputs there are engineered resins and TiO2. And we haven't seen much movement in those. Both of those have been pretty consistent in terms of pricing. We might see some modest deflation this year across the portfolio. Most of that would be in the Plumbing segment. We don't expect much deflation in the paint side of our business this year or at least we're not seeing at this point. And even though oil has come down a little bit from its as high as earlier or maybe late in the fourth quarter, we're not seeing much compression in the pricing of the inputs on the paint business right now.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

Talk about M&A a little bit more...

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Sure.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

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...succinctly perhaps than what we had in the prepared remarks. What sorts of things are you attracted to? And then when you balance it versus share repurchase, would you only do something that would be at a synergized multiple below where your stock is trading? Or how do you balance likely M&A with share repo?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Sure. So M&A is an important part of our growth algorithm, as I mentioned. As we think about M&A, really what we're looking at are either bolt-ons to our paint or our Plumbing business. Let me be clear, we are not looking to add a third leg to the business at this point. That's not in the cards. We won small bolt-on acquisitions. We did four of them in late 2020.

So to give you an example, we bought a paint applicator business for our Behr Paint Company, which is a great adjacent product for Behr to get into. We bought a steam shower business for Delta Faucet Company. Here in the United States, it sells through the wholesale channel. So if you think about higher end consumers renovating their bathrooms, often times, they'll put in a steam shower. And so we bought a small company, we're rebranding it, Delta. And so we're seeing good growth with that business.

We bought an on – the largest digitally native brand in Plumbing in 2020, it's called Kraus. So they've only sold through the online channel since their founding. It's been another great addition for us to help protect us on the downside and the lower end of our market as consumers look to shop online. It's a protector brand to protect the core of the Delta brand.

So those are the types of transactions that we continue to look for. In terms of the return profile, our internal mantras are simply this. It's got to have the right strategic fit and the right returns. And if we can't generate those, then we will look to deploy our excess capital to share repurchases.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

So a realistic hurdle rate then to that degree would be what?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

It depends, Sam, on the transaction. Some of them get more synergies than others, and so it depends. But – well, we look at it well above what we call our risk-adjusted weighted average cost of capital. So we had a risk premium to our weighted average cost of capital when we look at M&A activity.

Sam Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

Final question I would have and then we have maybe only 30 seconds for any other follow-ups, but the CFO search. What sorts of capabilities or skill sets do you imagine the board will be looking for your replacement?

John G. Sznewajs
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah. So the search is on and we're looking both at internal and external candidates. And as you might expect, I mean, the attributes of the CFO that they're trying to find are someone that can be a strong leader within the organization, both internally and externally, have some operational experience in their past. Given the nature of our operations, have some M&A experience in the past. I mean that will be beneficial just given the fact that we

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continue to look at M&A and be a strategic thinker and thought partner for Keith Allman, our CFO. I mean, I think those are perhaps the key elements and the attributes that we're looking for.

Sam Darkatsh

Analyst, Raymond James & Associates, Inc.

Any final questions here from the room before we move to the breakout? Then we'll move to the breakout. Thank you, John.

John G. Sznewajs

Chief Financial Officer & Vice President, Masco Corp.

Thanks, Sam.

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