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Masco Corp. (MAS)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. Welcome to Masco Corporation's Fourth Quarter and Full Year Conference Call. My name is Lester and I will be your operator for today's conference call. As a reminder, today's conference is being recorded for replay purposes. Following the presentation, we will conduct a question-and-answer session. [Operator Instructions]

I will now turn the call over to Renee Benedict, Director, Investor Relations and FP&A. You may begin.

Renee Benedict
Director-Financial Planning, Analysis & Investor Relations, Masco Corp.

Thank you, operator, and good morning. Welcome to Masco Corporation's 2023 fourth quarter and full year conference call. With me today are Keith Allman, President and CEO of Masco; and Rick Westenberg, Masco's Vice President and Chief Financial Officer.

Our fourth quarter earnings release and the presentation slides are available on our website under Investor Relations. Following our remarks, we will open the call for analyst questions. Please limit yourself to one question with one follow-up. If we can't take your question now, please call me directly at (313) 792-5500.

Our statements today will include our views about our future performance, which constitute forward-looking statements. These statements are subject to risks and uncertainties that could cause our actual results to differ

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materially from the forward-looking statements. We've described these risks and uncertainties in our risk factors and other disclosures in our Form 10-K and Form 10-Q that we filed with the Securities and Exchange Commission.

Our statements also include non-GAAP financial metrics. Our references to operating profit and earnings per share will be as adjusted unless otherwise noted. We reconcile these adjusted metrics to GAAP in our earnings release and presentation slides, which are available on our website under Investor Relations.

With that, I'll now turn the call over to Keith.

Keith J. Allman

President, Chief Executive Officer & Director, Masco Corp.

Thank you, Renee. Good morning, everyone, and thank you for joining us today. Before I get started, I'd like to share with you that we have appointed Robin Zondervan as our incoming Vice President of Investor Relations. Robin is currently our Controller and Chief Accounting Officer and will be transitioning to lead Investor Relations at the end of this month.

I have full confidence that with Robin's leadership, we will continue to have a world-class investor relations function at Masco and provide the investment community with the information and transparency you have come to expect from us.

Now, on to our results. I'll start this morning with some brief comments on our fourth quarter and full year results. And I'll finish with our view on 2024 as well as our long-term margin expectations.

Please turn to slide 5. We delivered a strong finish to another dynamic and successful year. In the fourth quarter, our top line decreased 2% with volumes down across most categories partially offset by favorable pricing, currency and our acquisition of Sauna360. The smaller decline in volume relative to the first three quarters of the year supports our view that many of our markets appear to be stabilizing.

Operating profit increased $38 million in the quarter due to a favorable price-commodity relationship, as we continued to recover the significant inflation that we have experienced over the past two years and due to our continued efforts to drive efficiencies across our operations. Operating profit margin improved 230 basis points to 14.5%. With our strong execution, our earnings per share for the quarter increased 28% to $0.83 per share.

Turning to our segments. Plumbing sales were in line with the prior year in local currency with lower volumes being offset by favorable pricing and our acquisition. Plumbing performance in the quarter was led by Delta Faucet's mid-single-digit sales growth driven by strong performance in the wholesale channel.

International Plumbing performed better than expected in the fourth quarter as demand in Europe and China, while still challenged, appears to be stabilizing. Investments in our leading global plumbing brands, innovative products and customer service are producing results and we will continue to capitalize on these initiatives.

Turning to our Decorative Architectural segment. Sales declined 7% primarily due to a soft DIY paint market with DIY paint sales declining high single digits. While our PRO paint business declined slightly in the quarter, we are very pleased with our three-year PRO paint stacked comp of approximately 60%.

This significant growth in share gain demonstrates the strength of our Behr brand and the quality of our products that continue to resonate with pro painters. We will continue to invest in this business to expand our services and

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build upon our successful collaboration with The Home Depot to capitalize on the large opportunity in the PRO paint market.

Now let's review our full year performance. Please turn to slide 6. Masco executed extremely well in 2023 and improved nearly every operating metric for the full year. Gross margin improved 360 basis points to 35.2%. Operating margin expanded 120 basis points to 16.8%. Plumbing margin expanded 210 basis points to 18%. Decorative margin expanded 10 basis points to 17.8%.

Earnings per share grew 2% to $3.86 per share, up from $3.77 per share in 2022. We delivered a return on invested capital of 36%. And our free cash flow conversion was approximately 122%, which allowed us to return $610 million to shareholders in the form of dividends and share repurchases in 2023 and to complete the bolt-on acquisition of Sauna360 for approximately $136 million.

Importantly, we have achieved compound annual earnings per share growth of 14% from 2019 to 2023, delivering on our commitment of double-digit EPS growth through cycles and demonstrating the power of our brands, innovation and portfolio of lower-ticket repair/remodel-oriented products. I want to thank all our employees for their strong execution, focus on the customer and their continuous improvement mindset that delivered this tremendous performance.

Turning to slide 7. As we look to the future, we are well positioned to achieve strong profitable growth over the next few years through top line growth, market share gains, margin expansion and disciplined capital deployment. Our current market assumptions for 2024 are as follows. For the North American repair and remodel market, we expect the market to be flat to down low single digits.

For our international markets, we expect the markets in aggregate to be down low to mid-single digits. For the paint market, we expect the DIY paint market to be down low single digits and the PRO paint market to increase low single digits. We expect to outperform the market and for Masco's overall sales to be approximately flat in 2024. Despite this flat top line assumption, we will continue to improve margins through disciplined pricing, selective cost reductions, innovative product introductions and operational efficiencies across our business.

This margin expansion will not be without its challenges as freight and shipping costs have recently increased. Other commodity inputs remain elevated and other costs such as people-related expenses and insurance are increasing. We are up for the challenge and have demonstrated our ability to execute in dynamic times. We expect to deliver increased Plumbing margins of approximately 18.5% and Decorative margins of approximately 18% in 2024 resulting in a Masco operating margin of approximately 17%.

Turning to capital allocation. Our strategy remains unchanged. Firstly, we will reinvest in our business to maintain and grow our leadership positions and win in the marketplace. This includes continuing to invest in our growth initiatives such as growing our share in the domestic plumbing wholesale channel, continuing to expand our international plumbing share and continuing to gain share in PRO paint. It also includes investing in our facilities to ensure we have the capacity to support future growth by completing our European faucet and shower facility and our Midwestern paint manufacturing and distribution center.

Secondly, our capital allocation strategy is to maintain a strong investment-grade balance sheet with gross debt to EBITDA levels of below 2.5 times. Our balance sheet remains extremely strong with gross debt to EBITDA of 2 times at yearend. Thirdly, we have a targeted dividend payout ratio of 30%. I'm pleased to share that our board declared a 2% increase in our dividend for 2024, which will bring our annual dividend to $1.16 per share and marks the 11th consecutive annual increase.

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And fourth and finally, we expect strong free cash flow conversion in 2024 of approximately 90% and will deploy that free cash flow after dividends through share repurchases or acquisitions. Based on our projected free cash flow, we expect to deploy approximately $600 million through share repurchases or acquisitions in 2024.

Our M&A strategy has not changed. We continue to review and selectively pursue opportunities that have the right strategic fit and the right return for Masco with the goal of adding 1% to 3% top line growth through acquisitions annually. Based on our expected operating performance and capital deployment actions, we anticipate earnings per share for 2024 to be in the range of $4 to $4.25 per share.

Now looking out over the next three years. We will continue our strong execution and deliver margin expansion through 2026. For our Plumbing segment, with our industry-leading brands including Delta and Hansgrohe, we expect to expand margins to 20% in 2026, up from 18% in 2023. For our Decorative segment, led by our industry-leading Behr brand, we expect to achieve margins of 19% to 20% in 2026, up from 17.8% in 2023.

This would result in overall Masco operating profit margins of approximately 18.5% in 2026. We believe we can achieve these margins with normalized 3% to 5% repair and remodel industry growth in 2025 and 2026 through leveraging incremental volume, exercising pricing discipline and executing operational improvements.

While 2023 clearly saw a reduction in demand, we believe that our markets will stabilize in 2024 and return to typical growth rates in 2025 and 2026. Structural factors are supportive of increased repair and remodel activity in several ways. Many homeowners have taken advantage of low mortgage rates and are likely to remain in their homes longer. 1.7 million more homes will reach the prime remodeling ages of 20 to 39 years old over the next three years. And home equity levels remain high.

All of these structural forces provide tailwinds for our business and increase our confidence for a strong repair and remodel market. We will continue to invest in our brands, capabilities and people to outperform the competition in both the near and long term. With favorable fundamentals and our continued focus on executing our growth strategy together with our strong free cash flow and capital deployment, Masco is well positioned to continue to drive shareholder value over the long term.

Now I'll turn the call over to Rick to go over our fourth quarter, full year and 2024 outlook in more detail. Rick.

Richard Westenberg

Chief Financial Officer & Vice President, Masco Corp.

Thank you, Keith, and good morning, everyone. Thank you for joining. As many of you know, I joined Masco as a CFO in mid-October. I'm excited to be part of this strong performing company and team. And I'm happy to be sharing our results with you this morning. As Renee mentioned, my comments today will focus on adjusted performance excluding the impact of rationalization charges and other onetime items.

Turning to slide 9. Sales in the quarter decreased 2% or 3% excluding favorable currency impact. In local currency, North American sales decreased 3% or 4% excluding acquisitions. In local currency, international sales decreased 3%. We continue to drive operational efficiency and price/cost performance in the quarter, which helped lead to gross margin expansion of 560 basis points to 35.1%.

SG&A as a percent of sales was 20.6% and was impacted by higher employee-related costs such as incentive compensation. Our operating profit grew 16% in the quarter and margin expanded 230 basis points to 14.5%. This strong operating profit and margin performance was due to pricing actions, lower commodity and freight

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costs and cost savings initiatives partially offset by lower volumes and higher employee-related expenses. This resulted in EPS growth of 28% to $0.83 per share.

Turning to the full year 2023. Sales decreased 8% over the prior year, slightly better than our expectations given sales performance in our Plumbing segment. FX and acquisitions did not have a material impact on full year results. In local currency, North American sales decreased 9% and international sales decreased 6%.

SG&A as a percent of sales was 18.4% in line with more normalized levels. Operating profit for the full year was $1.3 billion and operating margin expanded 120 basis points to 16.8%. Lastly, our EPS increased 2% year-over-year to $3.86. This figure assumes a tax rate of 24.5% versus the previously guided 24%, which unfavorably impacted full year EPS by $0.03.

Turning to slide 10. Plumbing sales in the fourth quarter increased 1% and showed signs of stabilization. Lower volume and mix decreased sales by 4%. This was more than offset by favorable pricing of 2%, the impact of acquisitions of 2% and FX of 1%. In local currency, North American Plumbing sales increased 1%, however, decreased 1% excluding acquisitions. In local currency, International Plumbing sales decreased 3% as demand continued to be soft in Europe and in China.

Segment operating profit in the fourth quarter was up $50 million or 34% year-over-year and operating margin expanded 400 basis points to 16.4%. This operating profit improvement was driven by pricing actions, lower commodity and freight costs and cost savings initiatives partially offset by lower volume and higher employee-related expenses.

Turning to the full year 2023. Plumbing sales decreased 8%, slightly better than our expectations. Lower volume and mix decreased sales by 12% partially offset by net pricing which favorably impacted sales by 4%. Acquisitions had a favorable impact of 1% and FX was immaterial for the full year. In local currency, North American Plumbing sales decreased 8% net of the 1% impact from acquisitions. And International Plumbing sales decreased 6%. Full year operating profit increased 4% and margin expanded 210 basis points to 18%.

Turning to slide 11. Decorative Architectural sales decreased 7% for the fourth quarter. Paint sales declined mid-single digits with PRO paint sales down slightly against a mid-single digit comp in the fourth quarter of 2022. Operating profit was $100 million in line with 2022 performance and operating margin expanded 90 basis points to 14.8%. Operating profit was impacted by lower volumes and pricing offset by cost saving initiatives and lower material costs. As expected, we did experience relief in certain paint input costs with modest low single-digit deflation in the fourth quarter.

Turning to the full year 2023. Sales decreased 9% driven by a high single-digit decline in our DIY paint business and a mid-single digit decline in our PRO paint business. This performance was in line with the expectations we set at the beginning of 2023 as we cycled over 25% PRO paint growth in 2022. Additionally, over a three-year period, PRO paint sales have grown by over 60% demonstrating our ability to gain and retain share. Full year operating income was $557 million in the segment and operating margin expanded 10 basis points to 17.8%.

Turning to slide 12. Our yearend balance sheet was strong with gross debt to EBITDA at 2 times. We ended the quarter with $1.6 billion of liquidity including cash and availability under our revolving credit facility. Working capital improved by 6 days to 59 days or 16% of sales. With this improvement in working capital, our adjusted free cash flow for the year was $1.1 billion, an improvement of over $500 million compared to the prior year driving our free cash flow conversion to 122%. Given our strong cash performance, we were able to return $610 million to

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shareholders through dividends and share repurchases including the repurchase of $227 million of stock in the fourth quarter.

Now let's turn to slide 13 and review our outlook for 2024. For Masco overall, we expect 2024 sales to be flat but with operating margin growing to approximately 17%. Currency is projected to have minimal impact in our 2024 results. We will continue to invest in our business for future growth while also maintaining cost discipline. As a result, we expect SG&A as a percent of sales to be in the range of 18% to 18.5% in 2024. As always, we will take appropriate actions to address our costs as the year develops based on market conditions.

As we think about the cadence for the year, we expect sales to be down slightly in the first half of the year with modest growth in the back half of the year. Also, as it relates to operating margins, with a softer sales outlook in the first half of the year, we anticipate Masco margins will be roughly flat in the first half of the year with expansion expected in the second half.

In our Plumbing segment, we expect 2024 full year sales to be plus or minus low single digits. We anticipate the full year Plumbing margin will be approximately 18.5%, up from our 2023 margin of 18%. Margin expansion will primarily be driven by pricing discipline, operational efficiency and continued cost savings initiatives. In our Decorative Architectural segment, we expect 2024 sales to also be plus or minus low single digits.

Looking specifically at our paint business in 2024, we anticipate our DIY business to decrease low single digits and our PRO paint business to increase low single digits. We anticipate the full year Decorative Architectural margin to be approximately 18%, up from our 2023 margin of 17.8% driven by cost savings initiatives. With regards to capital allocation, we expect to reinvest approximately $200 million through capital expenditures, pay a dividend of $0.29 per share per quarter and deploy approximately $600 million towards share repurchases or acquisitions in 2024.

Finally, as Keith mentioned earlier, our 2024 EPS estimate is $4 to $4.25. This assumes a 221 million average diluted share count for the year and a 24.5% effective tax rate, which is consistent with our 2023 effective tax rate. Additional financial assumptions for 2024 can be found on slide 16 of our earnings deck.

With that, I'd like to open the call for questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, we will now conduct the question-and-answer session. [Operator Instructions] Your first question comes from John Lovallo. Your line is now open.

John Lovallo
Analyst, UBS Securities LLC

Q

Good morning, guys. Thank you for taking my questions. The first one is your R&R is expected to be flat to slightly down in 2024. It seems like you expect flattish sales for both Plumbing and Decorative Architectural. So seemingly, basically in line, maybe slightly above the overall market. How are you thinking about Masco's ability to outgrow its markets longer term?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

John, thanks for the question. I haven't changed my opinion on our ability to gain share, which is that we expect as a company to both outperform the market and to expand margins. And we expect to continue to do that. So we will outperform the market. And that's driven primarily by our brands which have developed over the years, as you know, to be leaders in their spaces. So there is both consumer pull as well as trade pull where we're well recognized by plumbers and pro painters as a quality brand. Our service proposition as it relates to our channel partners to be able to help them drive profitable growth with minimal inventory positions due to our repeatable delivery and service. And our people and our teams around the globe. So our expectation is to outperform the market. Now in some spaces that we compete with, there'll be greater share gains. In other spaces where we already have substantial leading market share, those share gains will be more modest. But we definitely expect to outperform the market going forward.

John Lovallo
Analyst, UBS Securities LLC

Q

Okay. That's helpful. And then maybe just help us with the cadence of the planned margin expansion across Plumbing and Decorative Architectural to your 2026 targets. Is the improvement expected to be fairly linear in 2025 and 2026 or how should we think about that?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Well, I think 2024, we believe, is going to be flattish on the top line and probably more modest as it relates to margin improvements. And when we think about our innovation pipeline and our projects that will drive efficiency and cost reductions which will lead to that margin improvement, those happen more towards the outyears. And it will take some time to settle in and to be realized into the P&L. So I would say there's a bit of that margin acceleration in 2025 and 2026.

Primarily, when you think about it, John, the biggest drivers will be the dropdown in incremental revenue. And we have very strong, let's call it, [ph] 2025 (00:27:39) in Plumbing, it's knocking on 30% dropdown on the incremental volume. And our plan, as we said, is to – our belief is that we'll be relatively flat in 2024. And then in 2025 and 2026, when we think about the health of the consumer when we see what's happening and we believe what will continue to happen with regards to stabilization as it relates to rates, et cetera; that we're expecting more of a typical growth rates in 2025 to 2026 causing that 3% to 5% growth in R&R.

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Now we look at the same analytics and we listen to a lot of the same people as it relates to analytics around expectations. And a lot are calling for significantly more than that. We're not. We're just basing our 2025 and 2026 on more of a historical 3% to 5% R&R growth rate. So that will be a significant contributor to margin expansion as well.

John Lovallo
Analyst, UBS Securities LLC

Q

Thanks, Keith.

Operator: Your next question comes from Matthew Bouley from Barclays. Your line is now open.

Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

Good morning, everyone. Thank you for taking the questions. On that margin cadence into 2024. Looking at the past three quarters, your year-over-year margins have expanded, actually kind of improved the past three quarters. And it sounded like you're saying that that kind of margin expansion will flatten in the first half and then go back to expanding in the second half. So I'm just curious if you can kind of touch on that a little bit. Why wouldn't the recent improvements in margins continue to flow through on a year-over-year basis into the first half of 2024? Thank you.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Hey, Matt. Good morning. I think when you think about the improvement rate that we've seen this year, we've had some pricing catchup that we had to do against some, as you know, fairly significant cost inflation. So that was a component of it. When we think about 2024, we have operational improvements that we're going to continue to drive.

Probably when we think about the benefit of pricing, we'll see I would say a little bit of a headwind in our paint business. We've talked consistently about our relationship with our channel partner as it relates to price where we keep our operating income dollars whole and match commodities with price. But that affects margin and it affects it both ways where you go up or go down.

So there will be a slight headwind in pricing in our Decorative business and probably a slight tailwind in our Plumbing business. So to your direct question in terms of the rate of margin improvement, I think that really points to – it really answers your question as it relates to pricing and where we will see margin improvement despite calling for a flat top line in 2024 is in the efficiency improvements that we're going to continue to drive with our projects that we have in flight.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah, Matt. The only thing I would add is from a timing perspective, our margin performance is going to be aligned in terms of the expansion in line with our sales growth. And as we indicated, we expect a bit softer in the first half of 2024. As growth starts to pick up, we believe, in the second half of the year; we'll get that dropdown that Keith referred to. And then as we roll into 2025 and 2026 as growth returns to more normalized levels; that dropdown impact in terms of margin expansion, we'll see that manifest itself more prominently.

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Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

Got it. Really helpful. Thanks for that. And then second one just actually kind of coming off that last point there, Rick. The cadence to the top line in 2024, obviously, there's been a lot of volatility in R&R end markets probably more recently year-to-date, maybe some noise around weather and all that. Can you just kind of put a finer point around that early 2024 expectation? How is demand tracking year-to-date? Any kind of color on some of the volatility or improvement as you get into Q2 and beyond? Thank you.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Matt, in terms of the year-to-date demand or the current demand, I'd characterize it as stabilizing. I would say in terms of what was favorable to our expectation in 2023 was a combination of both our execution and the timing and impact of our cost reduction projects or solid pricing, et cetera. And then also a little bit better demand than we anticipated.

There's certainly some volatility out there. But we're seeing signs of stabilization. Had a nice quarter in wholesale plumbing as it relates to top line demand. While still challenged, certainly, in Europe, we have seen some stabilization and starting to see some positive signs coming out of China as well. So that's how I'd characterize the demand in general.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah. And what I would say is it's in line with what our guidance is indicating. So there's nothing inconsistent with that, which is we do expect some stabilization as Keith mentioned. But a bit softer, so down slightly in the first half of the year. That's kind of what we're seeing in the markets today. But we are seeing some stabilization globally.

Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

All right. Thanks, Rick. Thanks, Keith. Good luck, guys.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Thank you.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Thank you.

Operator: Your next question comes from Stephen Kim from Evercore ISI. Your line is now open.

Stephen Kim
Analyst, Evercore ISI

Q

Yeah. Thanks very much guys. Appreciate all the info here. Could you talk a little bit more about the trends you're seeing in hardware and lighting within the Dec Arc business and how that figures into your fiscal 2024 guide and maybe also your long-term margin targets for Dec Arc?

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Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

These businesses were impacted by market softness in 2023. No question about it. We've talked consistently about it. Both businesses and I'm talking about our lighting and hardware business, Kichler and Liberty, took pricing and cost actions to offset the inflation they experienced partially offset the volume loss in 2023. In 2024, I'd expect these businesses to perform more in line with how we're seeing the overall R&R market, which is flat to down low single digits. Did you have a second question there, Stephen?

Stephen Kim
Analyst, Evercore ISI

Q

Yeah. Well, within the hardware and lighting – no, that was pretty much what I was looking for. And then as I think more broadly about your guide for next year, I think Matt touched on it; but I just wanted to take a finer point. Could we see sales and margins on a year-over-year basis be down in 1Q or is that not what you're envisioning?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

They could be. I'm thinking more kind of flat to maybe slightly down in 1Q, first half. And then better performance both in sales and margin in the second half.

Stephen Kim
Analyst, Evercore ISI

Q

Okay. That's very helpful. Yeah, appreciate it. Thanks very much.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Thank you.

Operator: Your next question comes from Michael Rehaut from JPMorgan. Your line is now open.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Thanks. Good morning. It's Mike Rehaut. I wanted to first ask about the 2026 targets. Appreciate the kind of laying some of those out. And thinking about the margins, I think, Keith, you kind of laid out a framework of in 2025 and 2026 getting to those targets kind of thinking about a sales growth backdrop of 3% to 5%. So I just want to make sure that I'm understanding that the margin expansion off of 2024, how much of that would be driven by volume leverage or incremental margins off of the volume leverage as opposed to perhaps other initiatives around either productivity or discrete cost efficiency measures around manufacturing or SG&A, et cetera?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Yeah. Our margin improvement expectations and frankly, the history of it has been driven by a basket of initiatives that we drive. Certainly, there's the incremental margin improvement that comes from the incremental volume. So that drops down at, call it, 25% to 30% and that's certainly above our fleet average of the company. So that's the significant driver in our margin expansion. But it's also part of the benefits of our continued investments in innovation. So we have an innovation pipeline and an expectation over those years to be launching margin-

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accretive products and products that both contribute to our market outperformance on the top line as well as margin improvements.

Very excited about the momentum we have in terms of the Masco Operating System and what that's been able to produce in terms of leverage in our factories in terms of variable overhead in addition to the new product launches and our brand building in addition to the benefit to the top line, that gives us also pricing power. And we're confident in that and being able to have that be a contributor to margin expansion as well. So the big driver would be the dropdown in the incremental volumes. But we also have a pipeline and defined initiatives around labor productivity, variable cost productivity, et cetera, to drive the margin expansion.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah. And Mike, the only thing I would add to that is, as Keith mentioned, the big driver is the dropdown on the volume. But as we're growing, as we're introducing new products and getting the price for that from innovation, we continue to stay disciplined on price and disciplined on cost. So as we grow, we do see that 25% to 30% dropdown. So although pricing and cost initiatives may not be as significant of a contributor, they will contribute both directly as well as indirectly in terms of continuing to leverage that incremental dropdown.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Okay. No, that's helpful color. I appreciate it. I guess maybe secondly, kind of staying on this topic for a moment. You look at the Decorative margins on average between 2015 and 2021, the segment averaged 19.5%, 19.4%. So it kind of seems like you're getting back to that midpoint, whereas maybe Plumbing, you're getting a little bit above that, which kind of more speaks, I think, to the volume leverage.

So I just wanted to kind of make sure I'm thinking about this right in that – is the right way to think about this is that the operating leverage, the incremental margins much more so comes through on the Plumbing side over the next couple of years, whereas Decorative, it kind of seems like it's kind of getting back to that historical gross margin and maybe there's some perhaps even deflation that is a margin benefit over the next couple of years as more recently, when you had an inflationary environment that was margin dilutive? Just trying to think about kind of returning to that historical average and what's assumed in Decorative because if I'm thinking about this right, it does seem like the incremental margins on sales leverage more so apply to Plumbing than Decorative. And love any thoughts on that if I'm not thinking about it the way you are.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

No, I think simply said, you got it. I think that's right. We have a higher dropdown on incremental margins in Plumbing, a little bit lower, call it, in the 25% range in Deco. In Deco, specifically thinking about paint, we have a different pricing dynamic which we talked about. I won't get into the details on that. But no, I think you've got it right, Mike.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

All right. Perfect. Thanks so much. Appreciate it.

Operator: Your next question comes from Anthony Pettinari from Citi. Your line is now open.

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Anthony James Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Good morning.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Good morning.

Anthony James Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Can you discuss price/cost spread in Plumbing and DA in 4Q and maybe any updated expectations around brass carryover? And then just thinking about COGS maybe more holistically, what level of cost inflation does the full year guidance contemplate?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah, Tony, thanks for the question. So from a Q4 perspective, we did see some favorable pricing, low single digits in the Plumbing, both for the quarter and for the calendar year. For DA, it was a lot more muted. And as we look into 2024, we're expecting in the Plumbing segment, low single-digit pricing as a tailwind. But for the Decorative Architectural products, we're expecting a bit of a headwind from a pricing perspective, modest price giveback.

Anthony James Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Okay. That's very helpful. And then this is maybe just a minor point. But in terms of the DA margin target in 2026 being a range versus Plumbing and company targets, single points; is that the pricing mechanism you discussed or just any background there?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

I think we'll give point estimates and range estimates in terms of our guidance and this we felt a little more appropriate just given some of the uncertainty. As I think Mike articulated, we've got a little bit more of a dropdown dynamic in terms of the volume dropping down the margins on Plumbing. And so we felt pretty confident with regards to our 20% margin target in 2026. On Decorative, we just have a range of 19% to 20%. And as Mike pointed out, it's more consistent with kind of where we ranged historically.

Anthony James Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Okay. That's helpful. I'll turn it over.

Operator: Your next question comes from Susan Maklari from Goldman Sachs. Your line is now open.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good morning, everyone.

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Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Good morning.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

My first question is thinking about the macro and what that could imply for the business this year. There's increasingly an expectation that rates will move down as we get later into the spring and the summer. And as we think about that perhaps driving that existing home sales coming back, how should we think about the timing of those events relative to how you could start to see that coming through in the business? And what are the segments that could be most benefited by that?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Susan, good morning. When you think about the correlation to our top line drivers, existing home sales is certainly an important factor but not nearly as important as really how the consumer feels and how the consumer confidence is developing. That confidence driven by the amount of equity in their home, for example.

So if you think about – let's say the existing home turnover, pick a number, say it's, let's call it, 5 million. So if we have 5 million units turnover, that's on a 130 million unit base. So roughly, what is that? 3%. And we know – we estimate that a newly purchased home in that year will spend approximately 30% more on home improvement. So if you take 3%-ish spending 30% more, you start to see how that minimizes the impact of that. Or said differently, for every $1 million of existing home turnover increase, it only drives 0.2% of overall top line volume in the market. So a 25% increase in existing home turnover drives 0.2% in the overall market roughly.

So it's important to us and particularly when you look at something like DIY paint that tends to be a little bit more sensitive to existing home sales. But more important, I think, is the correlation to R&R spend as it relates to home price appreciation and consumer confidence. So as rates decrease and the consumer becomes more confident, that's really a driver of what we think will really be pushing the R&R market.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. And then shifting to the working capital, you made a lot of really impressive progress there over the last year. As you think about 2024 and just the go forward, what's the ability to continue to drive benefits from that? And anything you'd highlight there?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah, Sue, it's Rick. Good morning. Yeah, so I appreciate the question. As you noted, we did, as a business unit really across the business, drive working capital efficiencies and improvement. We brought it back down to 16% of sales in 2023, which is more in line with historical levels. And it really was a big contributor to our cash flow in 2023, contributed over $200 million in terms of cash flow in terms of our free cash flow number, which was very beneficial.

I think going forward, we plan to really hold working capital in a disciplined manner, make sure we've got enough inventory to keep up our service levels, which are important from our customer perspective, but to stay disciplined on that. And our guidance for 2024 is that we'd have working capital as a percent of sales of 16.5%. So a modest

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increase. But we'll calibrate that based off of the timing of when the market comes back and starts to grow. But we'll as a business stay disciplined now that we've got the working capital kind of back to where we'd like it to be.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you and good luck with everything.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Thanks, Sue.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Thank you.

Operator: Your next question comes from Adam Baumgarten from Zelman. Your line is now open.

Adam Baumgarten
Analyst, Zelman & Associates

Q

Hey, good morning, everyone. I believe you mentioned on the call that paint pricing is lower in 2023. I guess a couple of questions. One, when did that occur throughout the year? And is the outlook for 2024 that you mentioned down based on just the carryover maybe from some of the movements in 2023? Or do you expect incremental pricing pressure beyond kind of what you maybe recently saw?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Yeah, Adam, maybe just to clarify. For the calendar year 2023, we saw very modest price increase. It actually corresponded with commodities. So we saw material costs down in Q4 in the paint sector. But for the full year, we saw appreciation overall. And so we saw a slight price increase in terms of the 2023 numbers. As we look into 2024, as we indicated, we do see some price-downs in 2024. And that's really a reflection of what we expect to see, which is kind of modest low single-digit deflation in the inputs. So kind of keeping that price/cost relationship in check.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

To your point, Adam, there would be some carryover obviously with there being a little bit – the price giveback a little bit later in 2023.

Adam Baumgarten
Analyst, Zelman & Associates

Q

Okay, got it. That's helpful. And then I guess for you, Rick, now that you've been at Masco for – I believe it's almost four months now. Where do you see the biggest opportunities for Masco from a cost side going forward?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

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Yeah, no, appreciate the question. And yeah, as I mentioned, first of all, as I mentioned in my opening comments, really excited to be part of the Masco team and the strong business and operations and portfolio that we have. I'm really excited about the portfolio of brands and products in the business. I've had the opportunity to really get out and meet all of the business unit leaders. And I've been out to many of the business units. I was actually in Germany at Hansgrohe last week. Really impressed with the team and really impressed with the mindset in terms of the Masco Operating System and the mindset of continuous improvement, operational efficiency and cost reduction.

So I think we need to continue to kind of exercise ourselves in that regard. I think with regards to opportunities, it's really leveraging the mindset that we have here at Masco and across the business units as well as leveraging our scale as we continue to grow the business and drive that productivity and that efficiency really across all of our business but particularly on the Plumbing side as we look at our global business.

Adam Baumgarten
Analyst, Zelman & Associates

Q

Great, thanks. Best of luck.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Great. Thank you, Adam.

Operator: Your next question comes from Mike Dahl from RBC Capital Markets. Your line is now open.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Hi. Thanks for taking my questions. I wanted to ask again about cost. I think a question was asked earlier around price/cost spread and I heard the comments around price. I didn't hear specifically your expectations for input costs for both segments that are embedded within the 2024 guide. So could you address that, please?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Sure, Mike. I'm happy to do that. So as it pertains to 2024, we're expecting for input costs not to be a material impact, not to be significant in 2024. Obviously, we'll see how the year plays out. In Plumbing specifically, we expect to see some modest decline in input costs but offset with some freight and some other inflation. Obviously, as I think we all know, given the dynamics in the Red Sea, freight cost is a little bit volatile and is a bit of a headwind in the first half that's baked into our outlook as a contributor to our expectations in the first half of the year. But that's a little bit of the dynamic on Plumbing. In terms of Decorative Architectural products, I think we mentioned a couple of times we expect relatively modest input cost decrease in 2024.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Mike, we're thinking – specifically, we're thinking in Plumbing, relatively flat commodities, sort of staying where they are now. And for paint inputs, they've moderated sequentially. When you look at resins, we are seeing a little bit of deflation in those input costs. But other costs including copper, zinc, TiO2; they will moderate a little bit more but not significant benefit.

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Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Got it, okay, thanks. And then my second question just back on the free cash flow. The conversion rate, obviously, 90% is still high. I think your business typically targets 100% conversion on net income. When I looked at the moving pieces, it doesn't seem like working cap is that much of an incremental usage. And then you've got CapEx, I think, down year-on-year. So just any other drivers in terms of things we should be thinking about level of investments or non-working cap line items? Any other moving pieces there?

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

So Mike, those are the two really – so working capital, as I think Sue had asked in terms of that dynamic; we do expect a little bit of build in working capital in 2024. We'll watch that obviously. But we've got it down to a pretty balanced level right now. So as the market returns, we expect some build in working capital. Capital expenditures, as you noted, will be down year-over-year from 2023 to 2024. But it's still higher than our depreciation and amortization. So our CapEx guidance for 2024 is $200 million. Our D&A is $160 million. So that CapEx versus D&A is another contributor to the 90% guide.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Okay. That's helpful. Thanks.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Sure.

Operator: Your next question comes from Truman Patterson from Wolfe Research. Your line is now open.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Hey. Good morning, guys. Rick, looking forward to working with you going forward. First question for me. In your Plumbing segment, your supply chain is heavily reliant on shipping products to the US and Europe. I'm hoping you can give an update on some of the Red Sea shipping issues currently. Any supply chain issues or incremental costs embedded in your 2024 guidance?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

We are seeing, as you might expect, Truman, elevated costs for the containers that normally would be routed through the Red Sea that now have to go around. And you're exactly right. It's primarily for our European business. So those container costs have increased and we've contemplated that in our guide. And that's all part and parcel of how we think next year is going to shake out. But we are seeing an increase in those costs.

Richard Westenberg
Chief Financial Officer & Vice President, Masco Corp.

A

Truman, to your other question. Although we're seeing elevated costs, so far our service levels have been able to be retained. And so we're not having disruptions per se. But we're watching, obviously, the dynamics closely.

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Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay, got you. And just thinking through your 2024 revenue guidance of flattish versus a flat to down low single-digit R&R market. First, are you all expecting kind of your smaller ticket portfolio to outperform big ticket? And then second, you all mentioned some incremental market share gains this year specifically. Could you just elaborate on that a little bit, product categories, geographies, channels, et cetera, of some of these kind of near-term gains?

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

We do think that how we have repositioned our portfolio, Truman, to be the lower priced, lower ticket repair and remodel focus is more resilient than the higher priced, higher ticket items that are oftentimes more associated with new construction. So when you compare our type of project that a consumer would execute with paint, plumbing, lighting, hardware, et cetera; those tend to be more resilient than the bigger tickets, say, cabinets and windows which I'm very familiar with.

So yeah, we think that bodes well. And that fits in with the strategy and how we aim to be attractive and who we aim to be attractive to as it relates to investors as it relates to a higher margin, more resilient, less cyclical portfolio. And that's really important to us. And we've demonstrated, as we said, the ability to meet our commitment of double-digit EPS growth through cycles. When you look at 14% EPS CAGR from 2019 through to where we are today, so 2023. So we're very pleased with that and we think that is partly driven – more than partly driven by the reconfiguration of our portfolio. So that's a significant part of it. Reminding me your second question, Truman, the second end of that.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Yeah, just the near-term kind of market share gains that's embedded in your guidance. Just hoping you could elaborate on kind of product categories, geographies, channels, et cetera.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Sure. We're going to continue to invest in our share gains and continue to outperform the market as we have up to 2023. To highlight a few of those, we're particularly focused on the showroom channel in Plumbing. And that involves our channel relationships with – and our programs to drive growth. Our innovation pipeline is certainly a part of that. Brand and the pull that we have, as I mentioned before, both from the trade and the consumers is part of that.

We've invested extensively in involving showroom associates and creating advocacy in the showroom market. So it's not just about products. It's also about capturing the hearts and minds of the folks in the showroom that sell our products as it relates to involving them literally in the design of our products. And we treat that as an operational type of exercise for us to create advocacy. And we measure it and we drive it.

Certainly, PRO paint. When you look at our PRO paint, Truman; on a stacked basis over the last three years, we've driven 60% growth, 6-0. And I know 1, 1.5 years ago, there was a lot of questions on the stickiness of that demand. And we've proven that we're not only able to maintain those share gains but also intend to grow those share gains. And that's through service, through having the right product [indiscernible] (00:57:54), obviously, but through our overall competitiveness as it relates to as-applied cost and jobs.

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We look at our net promoter scores that we're clocking on our new and existing PRO paint customers and it's industry-leading. So we feel really good about that. So there's a couple of areas there, Plumbing wholesale, PRO paint. But we're really driving across the board an expectation of market outperformance and margin expansion.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Great. Thank you and good luck in 2024.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Thank you.

Operator: Your next question comes from Garik Shmois from Loop Capital. Your line is now open.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Hi. Thanks for squeezing me in. First question is just on the 2026 margin targets. I was wondering if you could speak to maybe some of the levers you can pull more on the cost side if the remodeling market doesn't, say, recover to that 3% to 5% expected range.

Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Variable cost productivity, making sure that we're matching our shifts in our operating plan to the volume that we've had. Very hard to do. We've gotten very good at that for obvious reasons in the last couple of years with the volatility we've seen. Depending on where the overall market goes, there's fixed cost productivity that we would drive.

We continue, as Rick mentioned, to be disciplined in terms of both price as well as our ability to manage costs and to make sure that we are continuing to invest in those key areas that drive growth and nothing more. So cost of maintenance, variable cost productivity, direct labor productivity, matching our fixed footprint to actual demand. All those sorts of things are part of our Masco Operating System. And it's what we're measured on and what our teams across the company are compensated on in terms of the ultimate metric of how we perform is our ability to do that.

So it's about all those disciplines together. There's no one silver bullet. But we will hit those margin commitments in 2026. And just like we have hit our double-digit earnings per growth commitment through cycles. And I believe we've – that's something I value and we as a company value very much is the hard-earned credibility that we've developed with the investment community and our high say-do ratio.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Understood. Thanks for that. I wanted to follow up just on one of the bigger ticket item – big businesses that you offer. You said that the bigger ticket is likely to remain more volatile or perhaps underperform smaller ticket. And just wondering about the spa business and what you're assuming for that in 2024. Maybe if we exclude the Sauna360 deal, what are you expecting on an organic basis?

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Keith J. Allman
President, Chief Executive Officer & Director, Masco Corp.

A

Yeah. I like our spa business. It's a strong business with global market share. It's, on a percentage, one of our more global businesses. I like the tailwinds behind it as it relates to the overlay with an aging population and the importance placed on mental and physical health. And we have a tremendous team there. We're going to continue to drive market share and the business is growing and doing a fine job.

I'm not going to get into the specifics of how we parse out within the segment where it's growing. But I like that business and we're going to continue to invest in it. We have a great product offering that's recently launched that's performing well for us. We have industry-leading technology that make those devices very easy to use and monitor and interface with. And as I said, it's outstanding team out there. So that business is going to continue to perform very well for us in 2024 and beyond.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Sounds good. Thanks again. Best of luck.

Renee Benedict
Director-Financial Planning, Analysis & Investor Relations, Masco Corp.

We'd like to thank you all for joining us on the call this morning and for your interest in Masco. That concludes today's call. Thank you.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you for joining. You may now disconnect.

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