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Masco Corp. (MAS)

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MANAGEMENT DISCUSSION SECTION

Philip Ng
Analyst, Jefferies LLC

Hello, everyone. I'm Phil Ng, Jefferies building products analyst. We're delighted to have Masco join us today, at a dynamic environment in housing in [indiscernible] (00:06:21) more broadly. Representing the company is Rick Westenberg, CFO of the company.

Rick, why don't you kick things off and just give us a little more perspective on Masco and what you're seeing?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

Sure. Thank you, Phil. And good morning, everybody. I really appreciate you joining this morning here in the room or those joining via webcast. Really excited to be here at the Jefferies Industrial Conference and talk a little bit about Masco. So, I'll just start with a couple of minute introduction and overview of Masco.

Masco is approximately an $8 billion building products company in the repair and remodeling or R&R segment of the industry. We were focused primarily on R&R. About 90% of our sales are in the R&R space, with about 10% in the new construction area.

We're organized in two distinct segments, one being Plumbing, which is anchored by our Delta, Hansgrohe and Watkins Wellness businesses. Delta is really our North America – biggest North America Plumbing business. Hansgrohe is really our international Plumbing business with sales in over 150 countries around the world. Watkins Wellness is our spa and sauna business. Combined, our Plumbing segment generated just under $5 billion of revenue in 2023 and generated 18% operating profit margins. And we've guided to 19% operating profit margins here in 2024, so continued strong margins and expanding margins at that as well.

Our second segment is our Decorative Architectural Products segment, which is anchored by our Behr brand and business, which is really focused on paint and coatings, just really an industry leader and particularly in the DIY, but also growing in the Pro space. We also have in our Decorative Architectural Products segment a couple of other businesses, a building hardware business as well as a lighting business. And I'll touch upon that in here at

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this time. Because as you probably noticed or read, we announced earlier this week that we entered into an agreement to sell our lighting business, the Kichler lighting business. And we can talk more about that, I'm sure, as we get into the fireside chat. The Decorative Architectural Products segment generated just over $3 billion of revenue in 2023 and generated 17.8% operating profit margins. We've guided to approximately 18% margins here in 2024, again, very strong margins.

Masco's portfolio of businesses really share a common thread and that is founded on industry-leading brands, products and innovative products, as well as service. And that's really the basis of what drives what we do and Masco, coupled with our execution, really looking to grow above market and expand margins, which we've done and I'm sure we'll talk more about.

The last thing I'll touch upon is our capital allocation framework. It's very consistent and disciplined. First and foremost, we reinvest in the business. We invest, from a capital expenditures perspective, about 2% to 2.5% of our top line into our business. And for 2024, we've guided to spend about $200 million. Second is a strong investment grade credit rating. We are currently a BBB or BBB equivalent, which is right where we want to be and very strong balance sheet and cash flows of the business. Third is a relevant dividend. So we have a payout ratio of 30% and we've increased our dividend 11 years in a row and running. And fourth is to return all available cash to shareholders through share buybacks to the extent we don't have any M&A activity. And we've guided that we would anticipate having about $600 million to return to shareholders through share buybacks this year and that is before the proceeds that we would receive as part of the Kichler sale, as I mentioned earlier.

So, that's a little bit of a summary of the business as well as kind of our expectations for the year. And I know, Phil, will get into some more specifics as we join the – and during the fireside chat.

QUESTION AND ANSWER SECTION

Philip Ng
Analyst, Jefferies LLC

Q

Well, Rick, this divestiture for Kichler was timely appreciated, doing it right before our conference, so we got something to talk about, more things to talk about, I mean. Why now? What was the strategic rationale for divesting? And I think more importantly, you guys have done a phenomenal job in pruning your portfolio into higher quality consumer facing products. Any avenues for you to kind of redeploy that capital for growth, whether it's a third leg or something larger out there?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Sure, Phil. Yeah. As I mentioned, we announced the agreement earlier this week. We still are subject to customary closing conditions and regulatory approval. But, effectively, as you mentioned, Masco has done, I think, a tremendous job with regards to honing this portfolio. We exited cabinets and windows and doors a number of years ago, and that was really designed to reduce our exposure to the new construction part of the business, and focus more and more on the repair and remodel segment of the industry, which is a lot less volatile. And as I mentioned earlier, we have about 90% of our sales in that space.

As it pertains to Kichler, in particular, it was – the strategic rationale was really fit. We felt that the business would have a lot more success and be able to focus on growth with a partner, with an owner that has a more concerted focus on lighting, and that's Kingswood Capital is the buyer. And they own Progress Lighting. So they've got a

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growing portfolio with regards to the lighting segment. And we think it's a really a win-win-win for all parties involved, including Masco with regards to being able to continue to focus our capital and our assets towards our core businesses, which is plumbing, coatings and wellness. And so, that's really the strategic rationale and the focus.

And so, we're really excited about the transaction. And the why now? The team has done a tremendous job at Kichler in terms of restructuring the business, making some tough decisions in terms of exiting unprofitable or low profit lines of business, taking price where appropriate and where possible, and particularly reducing costs. And it really positioned the business to be in a position where it is today, to be an attractive asset for a new owner.

Philip Ng
Analyst, Jefferies LLC

Q

What's the margin profile of Kichler? Is it kind of mid, low teens EBITDA range? And once you exit that hopefully by next year, does your segment get a nice bump from a margin standpoint?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. So we don't disclose margin performance by business unit. It is part of the Decorative Architectural Products segment. And I guess what we do this was [indiscernible] (00:13:34) a couple of data points, is we do disclose the rough top line size of the business and that's 3% of our overall business or 3% of $8 billion is the size of the business. Again, we don't talk about margin profile, but it is margin that is below our Decorative Architectural Product margin, which is about 18%. And so we would expect that to be – the transaction ultimately to be accretive to margins. It's pretty modest in terms of overall magnitude and that's not really the strategic rationale for the transaction, but it will be helpful for margins, at least modestly going forward.

Philip Ng
Analyst, Jefferies LLC

Q

And in terms of growth, where do you see the best opportunity to kind of grow whether it's organic or inorganic?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. I would say, it's really a combination. Organic is really more of where we can control our investment. And as I mentioned before, in terms of our capital allocation framework, we're focused first and foremost on reinvesting in the business, and that is in the tune of about 2% to 2.5% of sales. A big chunk of that goes into new product development and really focused on improving our technology, the design style of our products. We've got a metric that we track very closely, which is called the Vitality Index, and that is measured as the percent of our revenue that is attributable to products that we've introduced, new products that we've introduced over the last three years. And our target is about 25%. And we've been consistently at that level over the last few years, and that's where we're focused.

So there's some really great organic opportunities, both in terms of our core business as well as some adjacencies as well. So, just to name one in particular is the Delta faucet company business is currently launching a reverse osmosis water filtration system. That is, we think, very consistent with the Plumbing platform approach and very accretive to the business.

Overall, our focus is, again, across our plumbing, coatings and wellness businesses and that's where we're going to focus our investment organically, as well as inorganic.

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In our inorganic strategy or approach is really to focus on bolt on acquisitions. Acquisitions that are complementary and consistent with one of our three core platforms, that being plumbing, coatings and wellness. We've had a couple of acquisitions over the last couple of years that I would reference as good examples of that. The Steamist transaction, which was a steam shower business that we acquired in early 2022, was a bolt on to our Delta faucet business. And about a year ago, we acquired Sauna360, which is a Finnish-based sauna company that bolted on to our Watkins Wellness business. And both of those have been very successful and very consistent with our approach going forward. So I think they're representative transactions.

Philip Ng
Analyst, Jefferies LLC

Q

Super. Some of the big [indiscernible] (00:16:54) retailers that have reported results fairly recently have talked about the consumer weakening, particularly big ticket, larger projects and actually DIY as well. Any recent color in terms of point of sales trends? It felt like as you exited 2Q Plumbing in the US felt like was bottoming maybe at a good spot to inflect and Europe was stabilizing. So just give us a little color what you're seeing out there and how your customers are managing inventory in their business?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Sure. So how I would describe it is, is what we – how we often describe it in the current status is really a stabilization in the business. And that's really across really most of our lines of business. And I would say, although that isn't inflection to growth yet, it's progress relative to where we saw the market, let's say, 18 to 24 months ago. And really for our business, a couple of data points that I'd reference is the first three quarters of 2023, we saw a decline in our top line of about 10%, so that was Q1 to Q3 of 2023. In the last nine months, for the last three quarters [ph] stemming (00:18:00) from Q4 of 2023 through our most recent quarter, Q2 of 2024, we've seen a decline in our top line of about 2% to 3%, so real stabilization and consistency. And we saw some encouraging signs with regards to particular our North America Plumbing business in Q2 where actually volumes were up for the first time in a couple of years. And our Watkins Wellness business actually grew for the first time in a couple of years.

Now, we are getting out ahead of ourselves. We – our guidance or our expectations for the second half of the year is to be roughly flat, and that's in an environment where we see the North American R&R industry at flat to down low-single digits. So we're seeing some stabilization.

I would – you mentioned paint. With regards to paint, it's really a dichotomy there. DIY paint has been hit more significantly. As we all know, we had a significant pull forward of R&R activity and particularly, for us, the DIY paint business coming out of COVID. And what we've experienced over the last 18 months or so is really a hangover from that pull forward. And that's really hit our business. That said, what we are seeing is growth in the propane business; and that's really performed well. We've had significant growth over the last three years and we continue to have growth this year. Year to date, it's up low-single digits. And our guidance for the year is that we expect our propane business to be up low-single digits for the year. So that's encouraging.

And what I would say is probably overarching all of this is the fundamentals of the business. As we look out here today. Yes, we're going through a bit of a transition year. We expect things to be roughly flattish for the second half of this year but, ultimately, we will return to growth. And the foundation, the core level of growth that we see in the R&R space is about 3% to 5%. And that's underpinned by a few things. One is the increase in home equity value that we've seen over the last number of years and people's willingness to invest in their homes. Second is the age of the housing stock. Every year the housing stock gets a year older and we've seen a significant shift of

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homes into what is often termed the prime remodeling age of 20 to 40 years. And we understand that there's about 1.7 million homes that will be entering the prime remodeling period over the next three years. And that really bodes well to the strong fundamental growth. And so, it's really – as we look here, I know your question is more short term, Phil, but as we look here longer term, we're really excited about the prospects of the industry and how we're positioned to grow going forward.

Philip Ng
Analyst, Jefferies LLC

Q

That's a perfect segue. Rates have come down and hopefully we get some rate cuts in the not so distant future. Help us kind of think through what needs to happen for R&R to return back to growth and for Masco to kind of return back to that low to mid-single digit range. What type of lag should we expect?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. It's a good question. What I would say is, is obviously we've all been watching the interest rate environment very closely. We think that interest rates will obviously come down here gradually over the course of this year and into next year, and that will be a helpful tailwind to the business.

As I alluded to before, the "hangover" from the pull forward of the COVID spending is working its way through kind of the sector. And now we've really entered a period what we believe is deferral of spend, and that is partially driven based off of the higher interest rate environment. And as the interest rates start to decline and people get more comfortable with regards to stabilization, interest rates and positive trends and affordability, they will reenter the market, the R&R space, and deploy some of that equity that they've built up over the last number of years. And so, we believe that it's not going to be a hockey stick type of recovery, but we believe a gradual recovery which trends towards the 3% to 5% long-term growth rate, which I think will be healthy for all players, but particularly ourselves in terms of how we're positioned.

Philip Ng
Analyst, Jefferies LLC

Q

Some of the companies that have been at our conference this week, that have R&R exposure, have talked about, with that framework, maybe we get a recovery in the back half of next year, 2025, on R&R. Your business is a little different, right? It's smaller ticket, it's more consumer facing. And then even within paint, it's more nuance with DIY versus Pro.

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Right.

Philip Ng
Analyst, Jefferies LLC

Q

Give us a little perspective on how you think the shape of recovery could look like for your business?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. So, it's difficult to have a crystal ball in terms of how things will recover. As I mentioned before, we do believe that the recovery is that our business will be roughly flat in the second half of the year. So, again, more of

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that stabilization in terms of performance. As interest rates continue to come down and people that may be on the sidelines reenter the market from an R&R perspective and invest in their house, we'll see a gradual uptick in that business overall from an industry perspective and, again, for Masco.

The way oftentimes to describe it, it's not a matter of if but when. And knowing exactly when, that is difficult to pinpoint. But we do believe that this year, 2024, is really a transition year. And as we move into 2025, we'll see return to growth whether that's Q1, Q2, Q3, tough to say exactly when that will pivot to growth. But, again, the long-term fundamentals of the business are strong gravitational force towards that 3% to 5% growth. And we're very bullish longer term in terms of the business.

What I would say in terms of particular segments of the business, the North America Plumbing business, as I mentioned before, actually saw some signs of growth here in this past quarter, Q2. And so, we're cautiously optimistic that that may bode a bit more strong as we get into the recovery period. Our international business may be a bit more lagged. They entered the downturn in terms of the R&R space later than the North America market. And we do expect that that will take a bit longer to return to recovery. And in paint, as I've talked about already, the DIY paint, we need to get first to stabilization and then into growth. But we're – with our industry leading, with our very strong brand and strong market position, we're really well-positioned for when the market does turn. And Pro paint, it is a growth story and continues to be a growth story for Masco. And that is something that we're very bullish on with our partner, the Home Depot, with regards to continuing to grow that business.

Philip Ng
Analyst, Jefferies LLC

Q

That's great. From a margin standpoint, you guys have managed a lot over the last – since COVID, whether it's inflation, tariffs and this air pocket and housing margins have been pretty awesome. Your longer term target, you're calling for another call it 100 basis points, 150 basis points from here. What are some of the levers you need to see to kind of drive that? And do you need to see growth kind of get back to that low to mid-single digit range to kind of get there?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. And I think I'd start with a little bit of history as well in terms of our margin performance. So, I think they'll set the stage for Masco's ability to deliver that margin expansion going forward. So, historically, pre-pandemic, Masco's operating profit margins were in the 15% to 16.5% range. And as recently as 2022, Masco had an operating profit margins of about 15.5%, 15.6%. And currently, we generated 16.8% margins in 2023, and we're guiding to 17% to 17.5% margins here in 2024. And so, really, a 150-basis-point increase over the last couple of years and that's in the face of a very challenged environment. And that's really a testament to our team's ability to execute. And that's really manifested itself in terms of managing the inflationary headwinds that we encountered, as well as really leveraging our Masco operating system to drive efficiencies, productivity, cost reductions, et cetera, to drive that margin expansion.

The reason I mentioned that is because as we look forward, and as you mentioned, Phil, we have guided targets or communicated targets out there of 18.5% in 2026 for the Masco business, and that's another 100-basis-point, 150-basis-point expansion. And that will be underpinned by continuing to execute across the businesses, as we have done here over the last couple of years, but it will also be based off of growth, the return to growth that we've talked about over the next couple of years. And to put it in perspective, our incremental margins or we often call it our dropdown margins of the business is 25% to 30%, so very accretive to our currently 17% to 17.5% margins. And so, leveraging the business and leveraging that growth is a key ingredient, but I'd say it's a combination of the two.

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Philip Ng
Analyst, Jefferies LLC

Q

Okay. That's great. Can you give us a little color what you're seeing on the inflation front? We've seen some movement on metal, ocean freight, shipping container prices and all that. So just gives a little perspective in your ability to kind of manage through that as we look out to 2025.

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. Import costs have been volatile. Obviously, we saw significant inflation over the last couple of years, and we've been able to mitigate that through pricing and through cost efficiencies and productivity as I mentioned before. What we saw is real stabilization in 2023, actually a deflationary environment for some of our import costs, and that's primarily copper, zinc, TiO2 and resin from our paint business. And we saw deflation in the second half of last year and really flattish for 2023. Unfortunately, we saw a return to an inflationary environment as we enter 2024. Particularly in Q2, copper hit record highs in Q2. Fortunately, we've seen a pullback in those input costs. It's also worth noting that logistics costs, notably ocean freight, has been elevated as well.

Important to note, though, that given the timing for procurement and our inventory turn, it's about a six-month lag between when we see those types of inflationary costs in the market and when it hits our P&L. So the benefit of that is it gives us time to react and calibrate the business. So we will – as we articulate in our Q2 earnings, we do expect to see a bit of a headwind later this year because of input cost. But importantly, we factor that into our guidance. And despite those inflationary costs, we do expect to increase margins in the second half of the year, primarily in the fourth quarter as well as for the calendar year overall. So, that's what I would say. But in terms of going forward, we're seeing some stabilization and we'll manage the business accordingly.

Philip Ng
Analyst, Jefferies LLC

Q

What are the big levers? Is it going to be continuous improvement or will pricing be a lever as well?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

Yeah. It'll be a combination. So pricing is a lever. Obviously, we do that very judiciously with regards to a very disciplined price strategy, particularly in the Plumbing business. And so, as we communicated in our second quarter earnings, we do expect our price-cost relationship in the year to be low-single digits positive. So, we've been able to price for that inflationary cost. Paint is a bit of a different dynamic because of our relationship with the Home Depot where we are price-cost neutral, and so we manage our price with our partner accordingly. So, price is certainly a lever and that's something that we continually look at. Cost is, obviously, a really important lever. And as I've mentioned a couple of times, the team is really focused on productivity, efficiency, automation, the real levers to drive cost, not only just offset input cost, but also to drive the margin expansion, as I mentioned earlier.

Philip Ng
Analyst, Jefferies LLC

Q

Super. Rick, you were talking about a bolt on you've done recently, reverse osmosis filtration.

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

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Well, it wasn't a bolt on. It's an inorganic.

Philip Ng
Analyst, Jefferies LLC

Q

Inorganic. One of your competitors have been growing that water filtration, that [indiscernible] (00:30:46) home water business. Is that an area that you guys are thinking about on the digital water side of things?

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

A

We're exploring different opportunities. I think one of our key focus is water quality and purification. And so, we are focused really on the local water filtration, reverse osmosis solution that we're focused on and we introduced that. I think, you saw that in Vegas during the show in February. And so we're really excited about that. And that's I think really going to be start off a beachhead for us.

Philip Ng
Analyst, Jefferies LLC

Okay. Super. Well, Rick, thank you for all your great insights. Really appreciate it.

Richard Westenberg
Vice President, Chief Financial Officer and Treasurer, Masco Corp.

Great. Thanks again.

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