

## A. O. Smith (AOS)

**\$47.77** (As of 01/02/20)

Price Target (6-12 Months): **\$50.00**

Long Term: 6-12 Months

**Zacks Recommendation:**

**Neutral**

(Since: 01/01/20)

Prior Recommendation: Underperform

Short Term: 1-3 Months

**Zacks Rank:** (1-5)

**3-Hold**

Zacks Style Scores:

VGM:B

Value: B

Growth: B

Momentum: D

## Summary

A. O. Smith's long-term growth potential and strong position in the replacement market set it apart from its peers. Strength in the company's North America segment on account of robust demand for water heater and boiler products in the United States and improvement in effectiveness of its direct-to-consumer channel are likely to continue driving revenues of the segment. Also, the company's robust liquidity position adds to its strength. However, over the past six months, A.O. Smith has underperformed the industry. Going forward, the company projects weaker performance in the Rest of World segment, primarily due to lower growth forecasts in China. Also, if unchecked, higher costs and operating expenses might prove detrimental to its profitability. Analysts have become increasingly bearish on the company in the past 60 days.

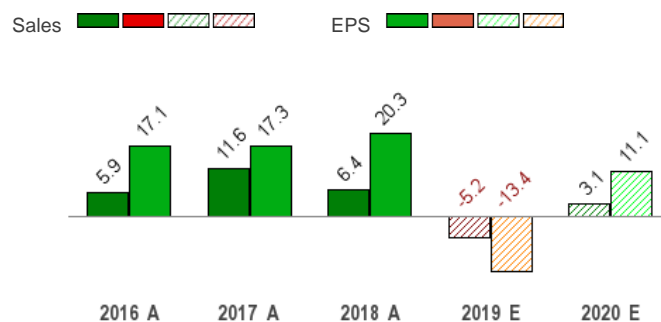
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	\$56.66 - \$40.38
20 Day Average Volume (sh)	1,171,258
Market Cap	\$7.8 B
YTD Price Change	0.3%
Beta	1.48
Dividend / Div Yld	\$0.96 / 2.0%
Industry	<a href="#">Manufacturing - Electronics</a>
Zacks Industry Rank	Bottom 31% (175 out of 253)

## Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-1.9%
Last Sales Surprise	-3.8%
EPS F1 Est- 4 week change	-1.0%
Expected Report Date	02/04/2020
Earnings ESP	-0.2%

P/E TTM	19.8
P/E F1	19.0
PEG F1	2.2
P/S TTM	2.6

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2020					3,118 E
2019	748 A	765 A	728 A	778 E	3,023 E
2018	788 A	833 A	754 A	813 A	3,188 A

## EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2020	\$0.55 E	\$0.62 E	\$0.60 E	\$0.70 E	\$2.51 E
2019	\$0.53 A	\$0.61 A	\$0.53 A	\$0.60 E	\$2.26 E
2018	\$0.60 A	\$0.66 A	\$0.61 A	\$0.74 A	\$2.61 A

\*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/02/2020. The reports text is as of 01/03/2020.

## Overview

Headquartered in Milwaukee, WI, A. O. Smith Corporation is one of the leading manufacturers of commercial and residential water heating equipment, and water treatment products of the world. The company specializes in offering innovative, and energy-efficient solutions and products, which are developed and sold on a global platform. Exiting 2018, the company's employee strength was approximately 16,300.

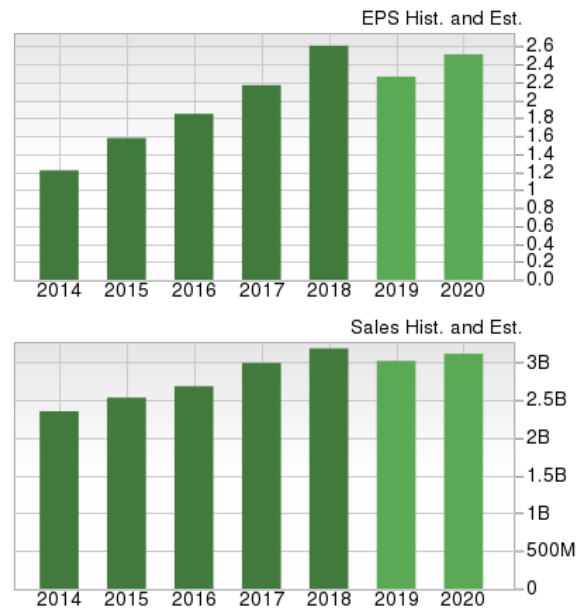
A. O. Smith reports operations under two geographic segments — North America and Rest of World. The segments are briefly discussed below:

- **North America** (70% of revenues generated in third-quarter 2019): This segment engages in manufacturing and marketing of water heaters, boilers, water treatment products, commercial solar water heating systems, expansion tanks, swimming pool and spa heaters, and others. These products are sold primarily to the company's commercial and residential customers in North America. The segment has 14 manufacturing plants (of which 12 are owned and two are leased).

Main product brands under this segment are Lochinvar, Aquasana, Bradford White, Rheem, Rinnai, Navien and Aerco.

- **Rest of World** (30% of revenues generated in third-quarter 2019): This segment comprises operations in India, China, the Middle East and Europe markets. It primarily manufactures and markets vast products, comprising fully modulating, non-condensing gas tankless water heater. Apart from this, the segment manufactures air purifier and water treatment products, especially in Asia. The segment has six manufacturing plants (of which four are owned and two are leased).

In China, the company develops water purifier, combi boiler, gas tankless, residential & commercial heat pump, air purifier, and other products. Exiting 2018, more than 9,000 retail outlets sold its water heaters in China while as many as 3,500 sold its air purification products and 7,500 sold its water treatment products.



---

## Reasons To Buy:

- ▲ A.O. Smith's robust liquidity position adds to its strength. The company had cash balance of about \$514 million located offshore and net cash position of approximately \$195 million at the end of third-quarter 2019. Also, it dedicatedly follows a capital deployment strategy and continually rewards its shareholders via repurchases and dividend increases. In the first nine months of 2019, it bought back 4.9 million shares for \$230 million. It, at the end of third quarter, had roughly 4.1 million shares remaining under repurchase authority. In addition, the company hiked quarterly dividend rate by 9% in October 2019.
- ▲ A. O. Smith's long-term growth potential and strong position in the replacement market set it apart from its peers. The company believes its replacement market, which accounts for approximately 85% of the North American water heater and boiler volumes, will act as long-term growth driver. Strength in the company's North America segment on account of robust demand for water heater and boiler products in the United States and improvement in effectiveness of its direct-to-consumer channel are likely to continue driving revenues of the segment. Notably, the company expects the commercial industry water heater volumes to grow in the range of 4-5% for 2019, on the back of growth in the light-service electric models.
- ▲ A. O. Smith believes in adding complementary businesses to the portfolio via acquisitions. Notably, in April 2019, the company completed the buyout of Water-Right, valued at \$107 million. Notably, Water-Right business contributed \$14 million and \$16 million to sales in the second and third quarter, respectively. The acquisition has been strengthening the company's growth opportunities in the water treatment industry, especially in the wholesale and independent dealer array.

Strength in replacement business will likely strengthen A. O. Smith's long-term competency.

---

## Reasons To Sell:

- ▼ A. O. Smith's third-quarter 2019 revenues declined 3.4% year over year and missed the consensus estimate by 3.8%. The year-over-year decline was primarily attributable to fall of sales in China (down 20% in local currency) and unfavorable movement in foreign currency, which hurt its revenues by \$6 million. A. O. Smith expects weakness in China (on account of lower consumer demand) to persist for the rest of 2019. Sales in China are predicted to fall 19% (in local currency term) for 2019, higher than the 16-17% range predicted earlier. Also, the company has to continuously spend considerable resources for the development of innovative products, quality improvement of existing product and integrating advanced technological changes. This increases operating expenses and contracts margins. For the Rest of World segment, margins are expected to be about 4.25% compared with 12.7% in 2018. Also, weakness in the U.S. residential water heater industry is likely to adversely impact the company's sales. Notably, for 2019, it predicts that the water heater volumes in the U.S. residential industry will be down 100,000-150,000 units. Over the past six months, A. O. Smith's shares have returned 2.1%, compared with the industry's growth of 14.7%.

Ongoing business challenges in China, unfavorable movements in foreign currencies and volatile steel prices remain concerns for A. O. Smith.
  - ▼ A. O. Smith has a significant presence in Asian countries like China and India. Both the nations account for a significant part of the revenues from the Rest of the World segment. As a result, the company's financial performance is subject to various risks like foreign currency exchange rate, interest rates fluctuations and hyperinflation in some foreign countries. Furthermore, typically the company's products are priced in local currencies of foreign countries. As a result, an increase in the value of the U.S. dollar relative to the local currencies of foreign markets affects its profits. In the second and third quarter, the weaker Chinese currency adversely impacted sales by about \$16 million and \$6 million, respectively. For 2019, it expects unfavorable movement in Chinese currency to have an adverse impact of about 4% on revenues.
  - ▼ Although A. O. Smith's expansion initiatives hold good for long-term growth, the high capital expenditure incurred will negatively impact its short-term liquidity. Also, corporate expenses are likely to be approximately \$46 million for 2019. High corporate expenses, if not checked, might put pressure on the company's profitability in the near term. In addition, market prices for certain raw materials used by it, primarily steel, have been subject to volatility. In addition, analysts have become increasingly bearish on the company over the past 60 days. Consequently, the Zacks Consensus Estimate for 2019 and 2020 earnings has trended down from \$2.29 to \$2.26, and from \$2.56 to \$2.51, respectively.
-

## Last Earnings Report

### A. O. Smith Q3 Earnings Miss Estimates, Decline Y/Y

A. O. Smith reported disappointing third-quarter 2019 results wherein both earnings and revenues lagged estimates.

The company's adjusted earnings were 53 cents per share, missing the Zacks Consensus Estimate of 54 cents. Also, the bottom line declined from the year-ago figure of 61 cents.

#### Inside the Headlines

The company's sales decreased 3.4% year over year to \$728.2 million. The decline was primarily attributable to fall of sales in China. Also, the figure missed the Zacks Consensus Estimate of \$757 million.

A.O. Smith's sales in **North America** (comprising U.S. and Canadian water heaters and boilers) increased 5.7% year over year to \$514.6 million. Higher sales volumes of water heater and boiler products in the United States proved beneficial for the segment.

Segmental operating earnings jumped 15% year over year to \$121.6 million. The improvement was primarily driven by higher sales volumes of water heater and boiler, lower steel costs and incremental profits from acquired Water-Right business.

Quarterly sales in **Rest of the World** (including China, India and Europe) were down 20% year over year to \$220.3 million. The decline was primarily attributable to soft consumer demand and above normal channel inventory levels, particularly in China.

Operating earnings at the segment significantly declined to \$4.1 million from \$39.1 million in the year-ago quarter. Lower sales in China proved detrimental to the segment's income.

#### Share Repurchases

In first nine months of 2019, A.O. Smith repurchased around 4.9 million shares for \$230 million. At the end of the quarter, the company had approximately 4.1 million shares remaining under the existing discretionary repurchase authority.

#### Liquidity & Cash Flow

On Sep 30, 2019, A.O. Smith's cash and cash equivalents totaled \$219.4 million compared with \$259.7 million as of Dec 31, 2018.

At the end of the reported quarter, long-term debt was \$312.4 million compared with \$221.4 million as of Dec 31, 2018.

#### Guidance

For 2019, A.O. Smith expects adjusted earnings to lie in the range of \$2.25-\$2.28 per share compared with the previous estimation of \$2.35-\$2.41.

Quarter Ending **09/2019**

Report Date	<b>Oct 29, 2019</b>
Sales Surprise	<b>-3.84%</b>
EPS Surprise	<b>-1.85%</b>
Quarterly EPS	<b>0.53</b>
Annual EPS (TTM)	<b>2.41</b>

## Recent News

### Dividend

On **Nov 15, 2019**, A. O. Smith paid a quarterly cash dividend of 24 cents per share to shareholders of record as on Oct 31, 2019. The company's board of directors approved a hike of 9% in its quarterly cash dividend on Oct 10, 2019.

### Valuation

A.O. Smith shares are up 8.3% over the trailing 12-month period. Over the past year, the Zacks sub-industry increased 25.9%, and the Zacks Industrial Products sector gained 22.1%.

The S&P 500 index has moved up 26.3% in the past year.

The stock is currently trading at 21.08x forward 12-month earnings per share, which compares to 20.39x for the Zacks sub-industry, 18.5x for the Zacks sector and 19.06x for the S&P 500 index.

Over the past five years, the stock has traded as high as 29.19x and as low as 14.41x, with a 5-year median of 22.2x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$50 price target reflects 22.06x forward 12-month earnings per share.

The table below shows summary valuation data for AOS.

Valuation Multiples - AOS					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	21.08	20.39	18.5	19.06
	5-Year High	29.19	20.39	19.88	19.34
	5-Year Low	14.41	13.14	12.58	15.17
	5-Year Median	22.2	16.97	16.48	17.44
EV/EBITDA F12M	Current	15	17.39	17.8	12.66
	5-Year High	17.05	25.03	18.18	12.66
	5-Year Low	9.67	9.9	10.66	9.08
	5-Year Median	13.61	13.34	13.97	10.78
EV/Sales F12M	Current	2.97	2.86	3.14	3.26
	5-Year High	3.43	2.86	3.14	3.37
	5-Year Low	1.78	1.52	1.76	2.3
	5-Year Median	2.66	2.06	2.27	2.78

As of 01/02/2020

## Industry Analysis Zacks Industry Rank: Bottom 31% (175 out of 253)



## Top Peers

AZZ Inc. (AZZ)	Neutral
Eaton Corporation, PLC (ETN)	Neutral
Franklin Electric Co., Inc. (FELE)	Neutral
Panasonic Corp. (PCRFY)	Neutral
Koninklijke Philips N.V. (PHG)	Neutral
Pentair plc (PNR)	Neutral
Regal Beloit Corporation (RBC)	Neutral
Emerson Electric Co. (EMR)	Underperform

Industry Comparison Industry: Manufacturing - Electronics				Industry Peers		
	AOS Neutral	X Industry	S&P 500	EMR Underperform	FELE Neutral	PHG Neutral
<b>VGM Score</b>	<b>B</b>	-	-	<b>A</b>	<b>B</b>	<b>A</b>
Market Cap	7.79 B	2.27 B	23.76 B	47.20 B	2.71 B	44.63 B
# of Analysts	9	4	13	10	3	2
Dividend Yield	2.01%	0.00%	1.78%	2.58%	0.99%	1.65%
<b>Value Score</b>	<b>B</b>	-	-	<b>C</b>	<b>B</b>	<b>B</b>
Cash/Price	0.07	0.09	0.04	0.03	0.02	0.04
EV/EBITDA	11.96	11.85	13.97	12.97	16.40	14.30
PEG Ratio	2.14	1.88	2.02	2.69	NA	1.47
Price/Book (P/B)	5.50	2.26	3.38	5.76	3.48	3.33
Price/Cash Flow (P/CF)	15.58	13.40	13.70	15.30	18.82	14.20
P/E (F1)	18.67	19.00	18.83	21.37	24.44	20.83
Price/Sales (P/S)	2.55	1.84	2.68	2.57	2.07	2.07
Earnings Yield	5.25%	4.88%	5.30%	4.69%	4.09%	4.81%
Debt/Equity	0.21	0.27	0.72	0.52	0.14	0.40
Cash Flow (\$/share)	3.07	1.83	6.94	5.07	3.10	3.48
<b>Growth Score</b>	<b>B</b>	-	-	<b>A</b>	<b>A</b>	<b>A</b>
Hist. EPS Growth (3-5 yrs)	17.24%	5.47%	10.56%	-1.19%	8.60%	27.28%
Proj. EPS Growth (F1/F0)	11.04%	7.94%	7.41%	-1.76%	10.65%	13.91%
Curr. Cash Flow Growth	16.21%	12.53%	14.83%	7.06%	12.55%	53.21%
Hist. Cash Flow Growth (3-5 yrs)	15.74%	3.18%	9.00%	-0.68%	4.89%	-1.48%
Current Ratio	2.06	2.16	1.23	1.19	2.40	1.27
Debt/Capital	17.53%	24.28%	42.92%	34.08%	12.34%	28.64%
Net Margin	13.26%	6.86%	11.08%	12.55%	7.62%	6.76%
Return on Equity	23.66%	9.99%	17.10%	26.32%	13.46%	14.60%
Sales/Assets	0.98	0.86	0.55	0.88	1.07	0.71
Proj. Sales Growth (F1/F0)	3.15%	0.62%	4.20%	0.59%	3.66%	4.66%
<b>Momentum Score</b>	<b>D</b>	-	-	<b>A</b>	<b>F</b>	<b>B</b>
Daily Price Chg	0.27%	1.62%	0.33%	1.60%	1.90%	1.35%
1 Week Price Chg	0.82%	0.07%	0.13%	0.31%	-0.21%	1.05%
4 Week Price Chg	1.86%	5.04%	3.31%	4.73%	5.91%	6.41%
12 Week Price Chg	3.09%	21.05%	9.70%	19.11%	27.37%	18.01%
52 Week Price Chg	12.61%	28.96%	30.28%	32.53%	38.91%	49.70%
20 Day Average Volume	1,171,258	185,872	1,603,615	2,557,958	130,259	400,848
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-0.97%	0.00%	0.00%	0.06%	-0.14%	0.00%
(F1) EPS Est 12 week change	-6.30%	-4.06%	-0.57%	-5.72%	-2.15%	-2.66%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	-0.20%	-12.50%	NA

---

## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

### Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

### Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

---

### Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	<b>B</b>
Growth Score	<b>B</b>
Momentum Score	<b>D</b>
VGM Score	<b>B</b>

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

---

### Disclosures

**This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock. The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page.** Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment. This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. ZIR is not a broker-dealer. ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients. Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.

No part of this report can be reprinted, republished or transmitted electronically without the prior written authorization of ZIR.