

A. O. Smith (AOS)

\$35.94 (As of 04/02/20)

Price Target (6-12 Months): **\$31.00**

Long Term: 6-12 Months

Zacks Recommendation: Underperform

(Since: 02/27/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:B

Value: C

Growth: B

Momentum: B

Summary

In the past six months, A. O. Smith's stock has underperformed the industry and looks comparatively overvalued. The company expects performance in China to be weak due to lower consumer demand in the first quarter of 2020. Its expansion initiatives, though good for long-term growth, usually require high capital expenditures. Further, given the company's extensive geographic presence, its financial performance is subject to risks like foreign currency exchange rate, interest rate fluctuations and hyperinflation in foreign countries. Also, analysts have become increasingly bearish about the company in the past 30 days, evident from a 6.3% decline in earnings estimates for 2020. However, its solid position in the replacement market, which accounts for nearly 85% of the North American segment, act as a long-term growth driver.

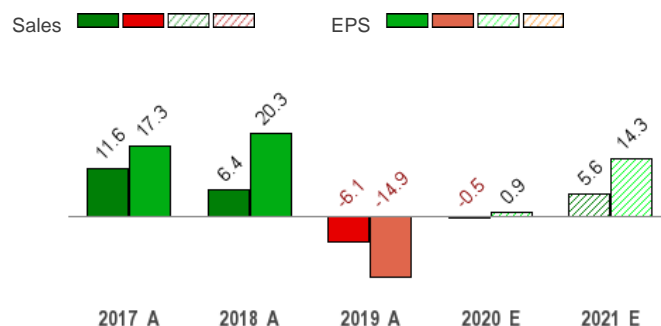
Price, Consensus & Surprise



Data Overview

| | |
|----------------------------|---|
| 52 Week High-Low | \$56.66 - \$33.81 |
| 20 Day Average Volume (sh) | 2,995,665 |
| Market Cap | \$5.8 B |
| YTD Price Change | -24.6% |
| Beta | 1.30 |
| Dividend / Div Yld | \$0.96 / 2.7% |
| Industry | Manufacturing - Electronics |
| Zacks Industry Rank | Bottom 35% (164 out of 254) |

Sales and EPS Growth Rates (Y/Y %)



| | |
|---------------------------|------------|
| Last EPS Surprise | -6.7% |
| Last Sales Surprise | -3.3% |
| EPS F1 Est- 4 week change | -6.2% |
| Expected Report Date | 05/05/2020 |
| Earnings ESP | -1.5% |

| | |
|---------|------|
| P/E TTM | 16.1 |
| P/E F1 | 16.0 |
| PEG F1 | 1.8 |
| P/S TTM | 2.0 |

Sales Estimates (millions of \$)

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|------|-------|-------|-------|-------|---------|
| 2021 | 817 E | 842 E | 811 E | 838 E | 3,146 E |
| 2020 | 690 E | 735 E | 738 E | 782 E | 2,979 E |
| 2019 | 748 A | 765 A | 728 A | 751 A | 2,993 A |

EPS Estimates

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|------|----------|----------|----------|----------|----------|
| 2021 | \$0.63 E | \$0.63 E | \$0.66 E | \$0.69 E | \$2.56 E |
| 2020 | \$0.40 E | \$0.54 E | \$0.58 E | \$0.65 E | \$2.24 E |
| 2019 | \$0.53 A | \$0.61 A | \$0.53 A | \$0.56 A | \$2.22 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 04/02/2020. The reports text is as of 04/03/2020.

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.

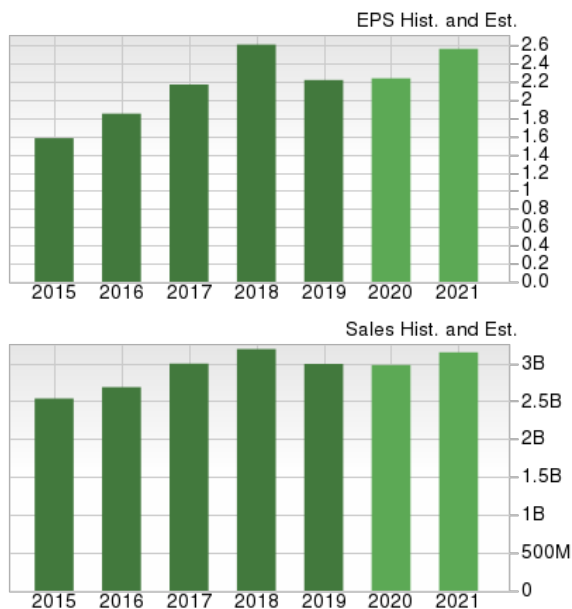
A. O. Smith reports operations under two geographic segments — North America and Rest of World. The segments are briefly discussed below:

- **North America** (69.1% of revenues generated in fourth-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.

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

- **Rest of World** (30.9% of revenues generated in fourth-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.

In China, the company develops water purifier, combi boiler, gas tankless, residential & commercial heat pump, air purifier, and other products.



Reasons To Sell:

- ▼ A. O. Smith's fourth-quarter 2019 revenues declined 7.6% year over year and missed the consensus estimate by 3.4%. The year-over-year decline was primarily attributable to fall of sales in China (down 23% in local currency) and unfavorable movement in foreign currency. Also, in 2019, sales in China recorded a decline of 19% (in local currency) year over year due to continued soft end market demand. A. O. Smith expects weakness in China (on account of lower consumer demand) to persist in the first quarter of 2020.
- ▼ 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 third and fourth quarters of 2019, weaker Chinese currency adversely impacted sales by about \$6 million and \$4 million, respectively. Also, in 2019, unfavorable movement in foreign currency hurt its revenues by \$39 million. As a matter of fact, unfavorable movement in Chinese currency may affect the company's top line in the quarters ahead.
- ▼ Although A. O. Smith's expansion initiatives hold good for long-term growth, high capital expenditure incurred will negatively impact its short-term liquidity. For instance, the company expects to incur a capital expenditure of \$80 million in 2020, higher than \$64.4 million in 2019. Also, corporate expenses are likely to be approximately \$50 million for 2020, higher than \$46 million in 2019. High corporate expenses 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 the past six months, A. O. Smith's shares have lost 21.1% compared with the industry's decline of 17.6%. On a P/E (TTM) basis, the stock looks a bit overvalued compared with the industry, with respective tallies of 16.12x and 13.7x. Further, analysts have become increasingly bearish about the company in the past 30 days. Consequently, the Zacks Consensus Estimate for its 2020 earnings has trended downward from \$2.39 to \$2.24 on five downward estimate revisions. This makes us a bit cautious about the stock.

Ongoing business challenges in China, unfavorable movements in foreign currencies and high capital expenditure remain concerns for A. O. Smith.

Risks

- A. O. Smith's robust liquidity position adds to its strength. At the end of 2019, the company had cash and marketable securities of \$551.4 million (primarily outside the United States), an increase of 7.2% on a sequential basis. In 2019, the company's cash flow from operations totaled \$456.2 million, up 1.6% from 2018. Notably, the company expects to generate cash flow from operations in the range of \$475-\$500 million, reflecting year-over-year growth of 6.9% at the mid-point. We believe that improvement in cash flows will effectively support the company's capital allocation strategies. Also, it dedicatedly follows a capital deployment strategy and continually rewards its shareholders via repurchases and dividend increases. In 2019, it bought back 6.1 million shares for \$288 million. It, at the end of 2019, had roughly 3 million shares remaining under repurchase authority. Also, in 2019, the company paid out dividends worth \$149.2 million to shareholders compared with \$130.1 million in 2018. 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 treatment products in the United States and improvement in effectiveness of its direct-to-consumer channel, are likely to continue driving revenues of the segment. For 2020, the company expects water treatment business in North America to grow in low-teens year over year. For 2020, the company believes that the residential water heater volumes will shoot up by approximately 225,000-275,000 units, on the back of new construction and expansion of replacement demand. Also, the commercial water heater industry volumes are likely to grow in the range of 2-3% for 2020, on the back of growth in electric models. Further, the company expects the North America boiler business to grow roughly 8% for 2020. It expects to register overall revenue growth in the band of 4.5-5.5% year over year for 2020.
 - A. O. Smith believes in adding complementary businesses to the portfolio via acquisitions. In April 2019, the company completed the buyout of Water-Right, valued at \$107 million. Water-Right business contributed \$16 million and \$14 million to sales in the third and fourth quarter of 2019, respectively. The acquisition has been strengthening the company's growth opportunities in the water treatment industry, especially in the wholesale and independent dealer array.
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Last Earnings Report

A. O. Smith Q4 Earnings and Revenues Miss, Down Y/Y

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

The company's adjusted earnings were 56 cents per share, missing the Zacks Consensus Estimate of 60 cents. Also, the bottom line declined from the year-ago figure of 74 cents.

The company reported 2019 adjusted earnings of \$2.22, a decrease of about 14% from the prior year.

Quarter Ending **12/2019**

| | |
|------------------|---------------------|
| Report Date | Jan 28, 2020 |
| Sales Surprise | -3.30% |
| EPS Surprise | -6.67% |
| Quarterly EPS | 0.56 |
| Annual EPS (TTM) | 2.23 |

Inside the Headlines

The company's fourth-quarter net sales decreased 7.6% year over year to \$750.9 million. The decline was primarily attributable to lower sales in China. Also, the figure missed the Zacks Consensus Estimate of \$777 million.

In 2019, the company reported net sales of \$2,992.7 million, down 6.1% from the year-ago number.

A.O. Smith's sales in North America (comprising U.S. and Canadian water heaters and boilers) inched up 0.2% year over year to \$523.1 million. The segment's results benefited from higher sales volumes of water treatment products and contribution from its Water-Right acquisition, partially offset by lower sales volume of boiler products.

Segmental operating earnings were relatively flat year over year at \$128.4 million. Benefits of lower steel costs were offset by lower boiler volumes.

Quarterly sales in Rest of World (including China, India and Europe) fell 21.3% year over year to \$234.3 million. The decline was primarily attributable to soft consumer demand and above normal channel inventory levels, as well as a higher mix of mid-price products.

Operating earnings at the segment significantly declined to \$1.5 million from \$39.5 million in the year-ago quarter. Lower sales in China proved detrimental to the segment's income.

Margins Details

In the quarter, A.O. Smith's cost of goods sold declined 4.1% year over year to \$455.9 million. It represented 60.7% of net sales. Selling, general and administrative expenses were \$179.9 million, representing 24% of net sales.

Gross profit decreased 12.5% year over year to \$295 million, with margin decreasing 220 basis points to 39.3%.

Share Repurchases

In 2019, A.O. Smith repurchased around 6.1 million shares for \$287.7 million. At the end of the quarter, the company had approximately 3 million shares remaining under the existing discretionary repurchase authority.

Liquidity

At the end of 2019, A.O. Smith's cash and cash equivalents totaled \$374 million compared with \$259.7 million as of Dec 31, 2018. In 2019, the company generated net cash of \$456.2 million from operating activities, reflecting increase of 1.6% year over year.

At the end of the reported quarter, long-term debt was \$277.2 million compared with \$221.4 million as of Dec 31, 2018.

Guidance

Concurrent with fourth-quarter results, the company issued guidance for 2020. It expects adjusted earnings to lie in the range of \$2.40-2.50 per share. The mid-point reflects impressive year-over-year growth of 10%. In addition, the company expects to register revenue growth in the band of 4.5-5.5% for 2020.

Recent News

Dividend

On **Feb 18, 2020**, A. O. Smith paid a quarterly cash dividend of 24 cents per share to shareholders of record as on Jan 31, 2019.

Valuation

A. O. Smith shares are down 24.6% and 34.4% in the year-to-date period and over the trailing 12-month period, respectively. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector are down 31.6% and 30.9% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 24% and 28.4%, respectively.

The S&P 500 index is down 23.1% and 14.3% in the year-to-date period and over the past year, respectively.

The stock is currently trading at 15.19x forward 12-month earnings per share, which compares to 14.64x for the Zacks sub-industry, 14.06x for the Zacks sector and 15.37x 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 22.01x. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$31 price target reflects 13.08x 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 | 15.19 | 14.64 | 14.06 | 15.37 |
| | 5-Year High | 29.19 | 20.28 | 19.93 | 19.34 |
| | 5-Year Low | 14.41 | 13.14 | 12.55 | 15.18 |
| | 5-Year Median | 22.01 | 17.05 | 16.56 | 17.44 |
| EV/EBITDA F12M | Current | 10.29 | 11.52 | 11.97 | 9.81 |
| | 5-Year High | 17.05 | 25.03 | 18.17 | 14.17 |
| | 5-Year Low | 9.42 | 9.9 | 10.58 | 9.07 |
| | 5-Year Median | 13.59 | 13.69 | 14.07 | 10.84 |
| EV/Sales F12M | Current | 1.9 | 2.07 | 2.31 | 2.58 |
| | 5-Year High | 3.43 | 2.86 | 3.12 | 3.52 |
| | 5-Year Low | 1.75 | 1.52 | 1.76 | 2.3 |
| | 5-Year Median | 2.66 | 2.09 | 2.29 | 2.8 |

As of 04/02/2020

Industry Analysis Zacks Industry Rank: Bottom 35% (164 out of 254)



Top Peers

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

| Industry Comparison Industry: Manufacturing - Electronics | | | | Industry Peers | | |
|---|------------------|------------|-----------|----------------|--------------|----------------|
| | AOS Underperform | X Industry | S&P 500 | EMR Neutral | FELE Neutral | PHG Outperform |
| VGM Score | B | - | - | D | A | A |
| Market Cap | 5.82 B | 1.91 B | 17.16 B | 29.20 B | 2.07 B | 34.93 B |
| # of Analysts | 10 | 4 | 13 | 10 | 4 | 2 |
| Dividend Yield | 2.67% | 0.22% | 2.5% | 4.19% | 1.39% | 2.08% |
| Value Score | C | - | - | C | C | B |
| Cash/Price | 0.09 | 0.12 | 0.06 | 0.06 | 0.03 | 0.05 |
| EV/EBITDA | 9.95 | 8.29 | 10.80 | 8.19 | 13.04 | 10.64 |
| PEG Ratio | 1.86 | 1.92 | 1.74 | 2.51 | NA | 1.49 |
| Price/Book (P/B) | 3.50 | 1.38 | 2.33 | 3.44 | 2.59 | 2.47 |
| Price/Cash Flow (P/CF) | 13.02 | 9.42 | 9.11 | 9.42 | 15.45 | 9.34 |
| P/E (F1) | 16.25 | 15.62 | 14.73 | 15.18 | 19.68 | 16.79 |
| Price/Sales (P/S) | 1.95 | 1.31 | 1.81 | 1.59 | 1.57 | 1.60 |
| Earnings Yield | 6.23% | 5.62% | 6.71% | 6.58% | 5.09% | 5.97% |
| Debt/Equity | 0.19 | 0.32 | 0.70 | 0.47 | 0.14 | 0.39 |
| Cash Flow (\$/share) | 2.76 | 2.05 | 7.01 | 5.07 | 2.89 | 4.20 |
| Growth Score | B | - | - | D | A | A |
| Hist. EPS Growth (3-5 yrs) | 14.94% | 5.54% | 10.92% | 0.92% | 9.43% | 31.59% |
| Proj. EPS Growth (F1/F0) | 0.81% | 3.30% | 1.02% | -14.77% | 9.42% | 3.32% |
| Curr. Cash Flow Growth | -13.97% | 4.43% | 5.93% | 7.06% | -7.80% | 15.89% |
| Hist. Cash Flow Growth (3-5 yrs) | 9.81% | 1.94% | 8.55% | -0.68% | 1.94% | 15.00% |
| Current Ratio | 1.96 | 2.16 | 1.24 | 1.13 | 3.05 | 1.36 |
| Debt/Capital | 15.93% | 23.63% | 42.33% | 32.20% | 12.17% | 28.12% |
| Net Margin | 12.36% | 6.86% | 11.67% | 11.79% | 7.26% | 6.00% |
| Return on Equity | 21.77% | 9.67% | 16.70% | 25.55% | 12.62% | 14.90% |
| Sales/Assets | 0.96 | 0.79 | 0.54 | 0.88 | 1.07 | 0.73 |
| Proj. Sales Growth (F1/F0) | -0.47% | 0.00% | 1.54% | -3.59% | 3.72% | 3.11% |
| Momentum Score | B | - | - | D | A | A |
| Daily Price Chg | 0.93% | 1.13% | 1.45% | 4.44% | 5.52% | 1.50% |
| 1 Week Price Chg | 6.04% | 9.18% | 12.29% | 3.38% | 0.78% | 18.59% |
| 4 Week Price Chg | -13.67% | -25.11% | -21.33% | -26.26% | -14.17% | -8.37% |
| 12 Week Price Chg | -23.61% | -33.76% | -28.56% | -38.65% | -23.73% | -20.92% |
| 52 Week Price Chg | -34.44% | -24.22% | -22.55% | -32.89% | -13.86% | -1.56% |
| 20 Day Average Volume | 2,995,665 | 321,353 | 4,257,668 | 7,967,853 | 288,344 | 1,928,179 |
| (F1) EPS Est 1 week change | -0.67% | 0.00% | -0.04% | -0.89% | 0.00% | 0.65% |
| (F1) EPS Est 4 week change | -6.20% | -6.20% | -4.30% | -15.69% | 0.55% | 1.30% |
| (F1) EPS Est 12 week change | -10.80% | -9.99% | -5.47% | -14.46% | -5.23% | -1.68% |
| (Q1) EPS Est Mthly Chg | -11.26% | -12.57% | -5.91% | -13.88% | 0.00% | NA |

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 | C |
| Growth Score | B |
| Momentum Score | B |
| VGM Score | 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

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