# A. O. Smith (AOS)

**$48.14** (As of 07/31/20)

Price Target (6-12 Months): **$51.00**

| | | |
|---|---|---|
| Long Term: 6-12 Months | **Zacks Recommendation:** (Since: 04/29/20) Prior Recommendation: Underperform | **Neutral** |
| Short Term: 1-3 Months | **Zacks Rank:** (1-5) | **2-Buy** |
| | Zacks Style Scores: | VGM:B |
| | Value: B \| Growth: B | Momentum: A |

## Summary

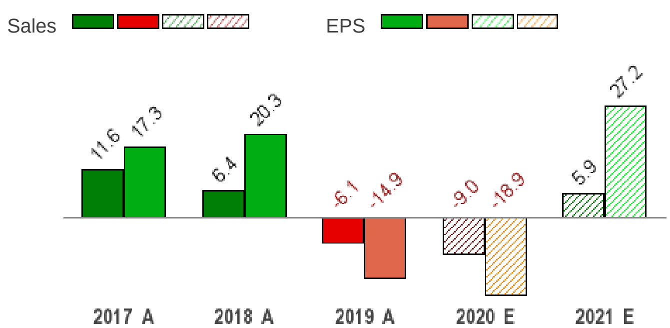
A.O. Smith's second-quarter 2020 earnings surpassed the Zacks Consensus Estimate by 2.3%, and revenues missed the same by 0.1%. The company is poised to benefit from its robust liquidity position and dedicated capital-deployment strategies. Also, its solid position in the replacement market, which accounts for 80-85% of the North American segment, is a long-term growth driver. A.O. Smith expects to achieve $35 million of savings from its cost reduction and restructuring activities in 2020. In the past six months, the company's shares have outperformed the industry. However, low demand for commercial water heater and boilers in North America, stemming from the coronavirus outbreak, is concerning. Foreign exchange headwinds might affect its performance. In addition, high capital expenditure might adversely impact its short-term liquidity.

## Price, Consensus & Surprise


## Data Overview

| | |
|---|---|
| 52 Week High-Low | **$53.72 - $33.81** |
| 20 Day Average Volume (sh) | **977,544** |
| Market Cap | **$7.8 B** |
| YTD Price Change | **1.1%** |
| Beta | **1.28** |
| Dividend / Div Yld | **$0.96 / 2.0%** |
| Industry | **Manufacturing - Electronics** |
| Zacks Industry Rank | **Top 20% (51 out of 253)** |
| Last EPS Surprise | **2.3%** |
| Last Sales Surprise | **-0.1%** |
| EPS F1 Est- 4 week change | **1.4%** |
| Expected Report Date | **NA** |
| Earnings ESP | **0.3%** |
| P/E TTM | **25.9** |
| P/E F1 | **26.9** |
| PEG F1 | **3.1** |
| P/S TTM | **2.8** |

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




## Sales Estimates (millions of $)

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | | | | | 2,884 E |
| 2020 | 637 A | 664 A | 695 E | 742 E | 2,723 E |
| 2019 | 748 A | 765 A | 728 A | 751 A | 2,993 A |

## EPS Estimates

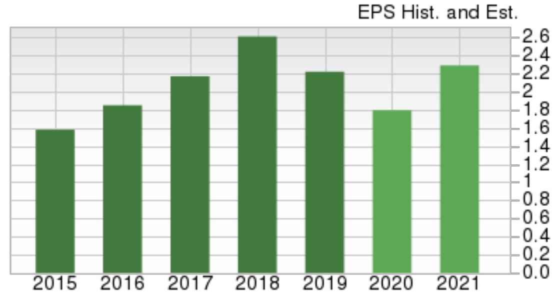
| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | $0.54 E | $0.58 E | $0.59 E | $0.65 E | $2.29 E |
| 2020 | $0.32 A | $0.45 A | $0.51 E | $0.57 E | $1.80 E |
| 2019 | $0.53 A | $0.61 A | $0.53 A | $0.56 A | $2.22 A |

*Quarterly figures may not add up to annual.

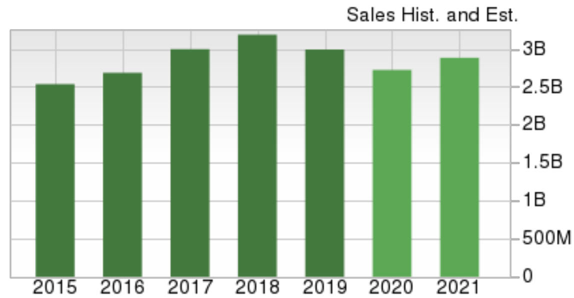
The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 07/31/2020. The reports text is as of 08/03/2020.

## 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 (71.7% of revenues generated in second-quarter 2020): 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 (28.3% of revenues generated in second-quarter 2020): 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 Buy:

> Strength in its replacement business, the acquired Water-Right business and strong liquidity position are likely to strengthen A. O. Smith's long-term competency.

- A. O. Smith's robust liquidity position adds to its strength. At the end of the second quarter of 2020, the company had cash and cash equivalents of $442.7 million, marking an increase of 6.4% on a sequential basis. For the first six months of 2020, its cash flow from operations totaled $179.3 million, up 24.8% from the year-ago comparable period. 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 the first half of 2020, it bought back 1.3 million shares for $56.7 million. Also, during the same period, the company paid out dividends worth $77.8 million to shareholders compared with $74 million in the year-ago period. In addition, the company hiked the quarterly dividend rate by 9% in October 2019. It noted that there is no change to its dividend plans, while share buyback activities have been temporarily halted due to the coronavirus crisis. Also, the company expects to achieve $35 million of savings from its cost-reduction and restructuring activities in 2020, of which $15 million is anticipated in the second half of the year.

- 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 80-85% of the North American water heater and boiler volumes, will act as a 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 along with improvement in the effectiveness of its direct-to-consumer channel are likely to continue driving revenues of the segment. For 2020, it anticipates sales growth of 20-22% from its water treatment business in North America. In addition, the company's continuous focus on investments in product developments, automation and production efficiency will likely be beneficial in the quarters ahead.

- 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. The acquisition has been strengthening the company's growth opportunities in the water treatment industry, especially in the wholesale and independent dealer array. It anticipates the Water-Right business to generate incremental sales in the second half of 2020. Further, at the end of second-quarter 2020, its total debt level decreased 17.9% to $281.1 million, sequentially. It is worth noting that its cash and cash equivalent were sufficient enough to meet its obligations. Also, the company seems to be less leveraged than the industry, with the respective long-term debt-to-capital ratios of 0.16 and 0.31. In the past six months, A. O. Smith's shares have gained 12.5% against the industry's decline of 6.3%. In the past seven days, the Zacks Consensus Estimate for its 2020 earnings has trended upward from $1.79 to $1.80 on the back of one upward estimate revision against none downward.

## Reasons To Sell:

The coronavirus-led market downturn, unfavorable movements in foreign currencies and high capital expenditure remain concerning for A. O. Smith.

- A. O. Smith's second-quarter 2020 revenues declined 13.3% year over year and missed the consensus estimate by 0.1%. The year-over-year decline was primarily attributable to a fall in sales in China (down 20% in local currency) due to a higher sales mix of mid-price products (lower water heater sales volume in China) and reductions in customer inventory levels. For 2020, it expects sales in China to see a year-over-year decline of 18-20% (in local currency). Also, the company is experiencing a low demand for commercial water heater and boilers in North America, driven by the coronavirus outbreak. For 2020, it expects sales volume from both of its commercial water heater and boiler businesses in North America to decline 10% on a year-over-year basis. In addition, weak end markets in India amid the pandemic remains concerning. The duration of the coronavirus pandemic and its impact on demand for the company's products and services along with the impacts of the governmental regulations imposed in response to the crisis will likely have a bearing on its overall results in the upcoming quarters. For 2020, it expects earnings of $1.72-1.86 per share, reflecting a year-over-year decline of 19.4% at the mid-point.

- A. O. Smith has a significant presence in countries in Asia like China and India. Both nations account for a significant part of 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 rate fluctuations and hyperinflation in some foreign countries. Furthermore, typically its 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 may affect the company's top line in the quarters ahead. In the second quarter, forex woes had an adverse impact on sales of the Rest of World segment by approximately $6 million.

- 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 $60-70 million in 2020. In addition, market prices for certain raw materials used by it, primarily steel, have been subject to volatility. On a P/E (TTM) basis, the stock looks a bit overvalued compared with the industry, with respective tallies of 25.88X and 19.33X. Consequently, the company's multiple is higher than the industry's six-month highest level of 19.33X.

## Last Earnings Report

### A. O. Smith Q2 Earnings Beat Estimates, Sales Miss

| Quarter Ending | 06/2020 |
|---|---|
| Report Date | Jul 30, 2020 |
| Sales Surprise | -0.14% |
| EPS Surprise | 2.27% |
| Quarterly EPS | 0.45 |
| Annual EPS (TTM) | 1.86 |

A. O. Smith has reported mixed second-quarter 2020 results, wherein earnings beat estimates, while revenues lagged the same.

The company's adjusted earnings were 45 cents per share, beating the Zacks Consensus Estimate of 44 cents. However, the bottom line declined from the year-ago figure of 61 cents.

**Top-Line Details**

The company's second-quarter net sales decreased 13.3% year over year to $663.9 million. The decline was primarily attributable to lower sales in North America as well as China and weakness in other global end markets amid the coronavirus pandemic. Notably, the figure narrowly missed the Zacks Consensus Estimate of $665 million.

A.O. Smith's sales in **North America** (comprising the U.S. and Canada water heaters and boilers) moved down 8.3% year over year to $480.5 million. The segment's results were affected by lower sales volume of commercial water heater and boiler products, partially offset by higher sales volume of water treatment products.

Segmental operating earnings were down about 14% to $105.4 million on a year-over-year basis. The decline was on account of lower sales volume of commercial water heaters and boilers.

Quarterly sales in **Rest of World** (including China, India and Europe) fell about 24% year over year to $189.7 million. The decline was primarily attributable to a higher sales mix of mid-price products and reductions in customer inventory levels.

Operating loss at the segment was $5.8 million against operating earnings of $22.4 million recorded in the year-ago quarter. Lower sales in China were detrimental to the segment's income.

**Liquidity & Cash Flow**

On Jun 30, 2020, A.O. Smith's cash and cash equivalents totaled $442.7 million compared with $374 million as of Dec 31, 2019.

At the end of the reported quarter, long-term debt was $274.3 million compared with $277.2 million as of Dec 31, 2019.

In the first six months of 2020, cash provided by the operating activities totaled $179.3 million compared with $143.7 million in the year-ago comparable period.

**Share Repurchases**

In mid-March, the company suspended its share repurchase activity, owing to the uncertain business environment created by the coronavirus pandemic. Therefore it refrained from buying back any shares in the second quarter of 2020.

**Guidance**

The company issued earnings guidance for 2020. It expects adjusted earnings of $1.72-1.86 per share. The mid-point reflects a year-over-year decline of 19.4%.

## Recent News

**Dividend**

On **July 13, 2020**, A. O. Smith's board of directors approved the payout of a quarterly cash dividend of 24 cents per share to shareholders of record as of July 31, 2020. The payment will be made on Aug 17, 2020.

## Valuation

A. O. Smith shares increased 1% and 10.2% 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 6.1% and 7.3% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry increased 17%, while the sector increased 7.5%.

The S&P 500 Index has moved up 1.7% year to date and increased 15.5% in the past year.

The stock is currently trading at 23x forward 12-month earnings per share, which compares to 22.9x for the Zacks sub-industry, 21.43x for the Zacks sector and 22.64x 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 21.69x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our $51 price target reflects 24.37x 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 | 23 | 22.9 | 21.43 | 22.64 |
| | 5-Year High | 29.19 | 23.22 | 21.53 | 22.64 |
| | 5-Year Low | 14.41 | 13.13 | 12.55 | 15.25 |
| | 5-Year Median | 21.69 | 17.36 | 17.15 | 17.55 |
| P/Sales F12M | Current | 2.75 | 2.8 | 2.8 | 3.59 |
| | 5-Year High | 3.57 | 2.8 | 2.8 | 3.59 |
| | 5-Year Low | 1.91 | 1.46 | 1.52 | 2.53 |
| | 5-Year Median | 2.73 | 2.03 | 2.03 | 3.04 |

As of 07/31/2020

## Industry Analysis **Zacks Industry Rank:** Top 20% (51 out of 253)


## Top Peers

| Company (Ticker) | Rec | Rank |
|---|---|---|
| IIVI Incorporated **(IIVI)** | Outperform | 1 |
| Rexnord Corporation **(RXN)** | Outperform | 1 |
| AZZ Inc. **(AZZ)** | Neutral | 3 |
| Enersys **(ENS)** | Neutral | 4 |
| SPX FLOW, Inc. **(FLOW)** | Neutral | 3 |
| Pentair plc **(PNR)** | Neutral | 2 |
| Regal Beloit Corporation **(RBC)** | Neutral | 2 |
| Franklin Electric Co., Inc. **(FELE)** | Underperform | 3 |

## Industry Comparison Industry: Manufacturing - Electronics

| | AOS | X Industry | S&P 500 | ENS | RBC | RXN |
|---|---|---|---|---|---|---|
| | | | | **Industry Peers** | | |
| **Zacks Recommendation (Long Term)** | Neutral | - | - | Neutral | Neutral | Outperform |
| **Zacks Rank (Short Term)** | 2 | - | - | 4 | 2 | 1 |
| **VGM Score** | B | - | - | A | B | D |
| Market Cap | 7.76 B | 2.50 B | 22.59 B | 2.86 B | 3.73 B | 3.48 B |
| # of Analysts | 10 | 2.5 | 14 | 2 | 4 | 5 |
| Dividend Yield | 1.99% | 0.37% | 1.83% | 1.04% | 1.30% | 1.10% |
| **Value Score** | B | - | - | B | C | D |
| Cash/Price | 0.07 | 0.09 | 0.07 | 0.12 | 0.16 | 0.16 |
| EV/EBITDA | 13.39 | 10.98 | 12.94 | 11.44 | 9.24 | 10.57 |
| PEG Ratio | 3.08 | 2.91 | 3.04 | 1.70 | 2.29 | 2.61 |
| Price/Book (P/B) | 4.68 | 2.60 | 3.17 | 2.18 | 1.62 | 2.57 |
| Price/Cash Flow (P/CF) | 17.44 | 14.16 | 12.51 | 8.68 | 10.28 | 10.42 |
| P/E (F1) | 26.89 | 24.65 | 21.87 | 17.03 | 22.89 | 19.01 |
| Price/Sales (P/S) | 2.79 | 1.98 | 2.44 | 0.92 | 1.20 | 1.73 |
| Earnings Yield | 3.72% | 3.60% | 4.31% | 5.87% | 4.37% | 5.25% |
| Debt/Equity | 0.19 | 0.20 | 0.75 | 0.85 | 0.62 | 0.85 |
| Cash Flow ($/share) | 2.76 | 2.20 | 6.94 | 7.74 | 8.94 | 2.78 |
| **Growth Score** | B | - | - | A | B | D |
| Hist. EPS Growth (3-5 yrs) | 11.96% | 6.15% | 10.85% | 4.78% | 4.97% | 7.80% |
| Proj. EPS Growth (F1/F0) | -19.14% | -16.55% | -7.75% | -15.60% | -26.82% | -24.18% |
| Curr. Cash Flow Growth | -13.97% | 2.39% | 5.39% | 18.95% | -9.82% | 5.35% |
| Hist. Cash Flow Growth (3-5 yrs) | 9.81% | 3.59% | 8.55% | 2.95% | 1.95% | 4.56% |
| Current Ratio | 1.96 | 2.21 | 1.31 | 2.60 | 3.16 | 2.52 |
| Debt/Capital | 15.83% | 16.52% | 44.32% | 45.87% | 38.10% | 45.89% |
| Net Margin | 10.72% | 6.11% | 10.44% | 4.44% | 6.38% | 8.42% |
| Return on Equity | 18.38% | 9.05% | 14.73% | 15.17% | 9.49% | 17.52% |
| Sales/Assets | 0.92 | 0.70 | 0.52 | 0.94 | 0.69 | 0.59 |
| Proj. Sales Growth (F1/F0) | -9.00% | -6.55% | -1.95% | -4.72% | -14.57% | -8.48% |
| **Momentum Score** | A | - | - | A | B | C |
| Daily Price Chg | -9.08% | -0.74% | -0.92% | -2.12% | -1.54% | -2.08% |
| 1 Week Price Chg | 1.54% | 0.00% | 0.37% | -1.22% | -0.10% | 1.18% |
| 4 Week Price Chg | 1.73% | 4.80% | 3.81% | 6.44% | 6.76% | 0.17% |
| 12 Week Price Chg | 11.15% | 23.04% | 11.93% | 19.72% | 26.37% | 8.42% |
| 52 Week Price Chg | 10.19% | 4.88% | -1.92% | 1.01% | 18.46% | 1.08% |
| 20 Day Average Volume | 977,544 | 184,190 | 1,887,986 | 164,223 | 180,050 | 693,862 |
| (F1) EPS Est 1 week change | 0.67% | 0.00% | 0.00% | 0.00% | 0.00% | 2.57% |
| (F1) EPS Est 4 week change | 1.35% | 0.76% | 0.38% | 0.00% | 2.75% | 6.92% |
| (F1) EPS Est 12 week change | -7.91% | 0.00% | -0.07% | 2.73% | 0.29% | -1.24% |
| (Q1) EPS Est Mthly Chg | 1.42% | 1.62% | 0.16% | 0.00% | 1.62% | 11.70% |

## 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 |
| Growth Score | B |
| Momentum Score | A |
| 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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