

A. O. Smith (AOS)

\$49.85 (As of 06/03/20)

Price Target (6-12 Months): **\$52.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 04/29/20)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:F

Value: D

Growth: D

Momentum: F

Summary

A.O. Smith is poised to benefit from its robust liquidity position backed by dedicated capital-deployment strategies. The company's solid position in the replacement market, which accounts for nearly 85% of the North American segment, is a long-term growth driver. A.O. Smith proactively handled the coronavirus-induced pandemic situation by eliminating redundant investments and reprioritizing capital expenditures with efficient supply-chain initiatives. However, the company withdrew its guidance for 2020 on end-market uncertainties, stemming from the coronavirus outbreak. Although A. O. Smith's shares have gained 6.3%, the industry has recorded a decline of 11.4% in the past six months. Foreign exchange headwinds might affect its performance. In addition, earnings estimates for 2020 have gone down in the past 30 days.

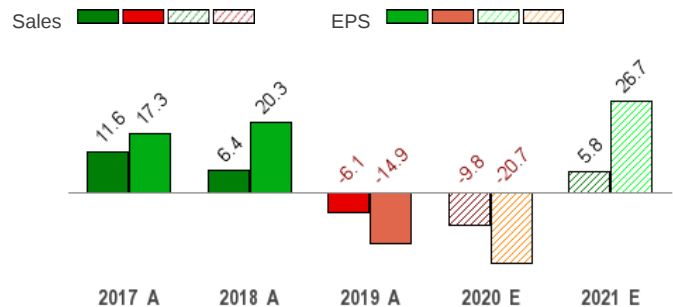
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$52.61 - \$33.81
20 Day Average Volume (sh)	1,581,750
Market Cap	\$8.0 B
YTD Price Change	4.6%
Beta	1.28
Dividend / Div Yld	\$0.96 / 1.9%
Industry	Manufacturing - Electronics
Zacks Industry Rank	Bottom 40% (153 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-5.9%
Last Sales Surprise	-2.7%
EPS F1 Est- 4 week change	-9.9%
Expected Report Date	08/04/2020
Earnings ESP	-3.2%

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					2,857 E
2020	637 A	651 E	686 E	737 E	2,700 E
2019	748 A	765 A	728 A	751 A	2,993 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.58 E	\$0.56 E	\$0.60 E	\$0.66 E	\$2.23 E
2020	\$0.32 A	\$0.42 E	\$0.49 E	\$0.57 E	\$1.76 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.

P/E TTM	24.7
P/E F1	28.3
PEG F1	3.2
P/S TTM	2.8

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/03/2020. The reports text is as of 06/04/2020.

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.

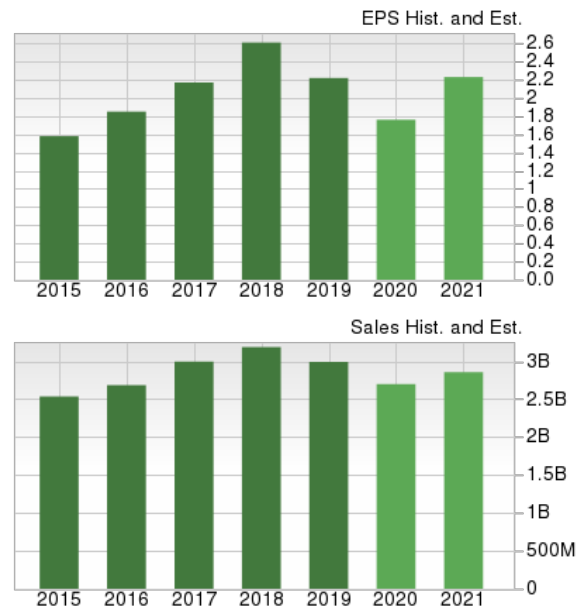
A. O. Smith reports operations under two geographic segments — North America and Rest of World. The segments are briefly discussed below:

- **North America** (82.9% of revenues generated in first-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** (17.1% of revenues generated in first-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:

- ▲ A. O. Smith's robust liquidity position adds to its strength. At the end of the first quarter of 2020, the company had cash and cash equivalents of \$416.1 million, marking an increase of 11.3% on a sequential basis. For the first three months of 2020, the company's cash flow from operations totaled \$54.1 million, up 150% 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 first-quarter 2020, it bought back 1.3 million shares for \$56.7 million. Also, in the first quarter, the company paid out dividends worth \$39 million to shareholders compared with \$37.1 million in the year-ago quarter. 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, in response to the pandemic, some of the actions being taken by the company include supply-chain initiatives, reduction of discretionary expenses, eliminating unnecessary investments and reprioritization of capital expenditure. The measures will likely help it maintain a healthy margin performance amid the crisis.
- ▲ 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 a long-term growth driver. Strength in the company's North America segment, on account of robust demand for water heating and water treatment products in the United States along with improvement in effectiveness of its direct-to-consumer channel, are likely to continue driving revenues of the segment. 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 Water-Right business contributed \$14 million and \$16 million to sales in the fourth quarter of 2019 and the first quarter of 2020, respectively. The acquisition has been strengthening the company's growth opportunities in the water treatment industry, especially in the wholesale and independent dealer array. Although, at the end of first-quarter 2020, its total debt level increased 20.6% to \$342.4 million, sequentially, its cash and cash equivalent were sufficient enough to meet its obligations. Also, it seems to be less leveraged than the industry, with the respective long-term debt-to-capital ratios of 0.19 and 0.50. Moreover, the company's ability to meet its debt obligations based on its current income is higher than that of its industry. Notably, its times interest earned ratio is 39.2, much higher than the industry's 12.

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.

Reasons To Sell:

- ▼ A. O. Smith's first-quarter 2020 revenues declined 14.9% year over year and missed the consensus estimate by 2.8%. The year-over-year decline was primarily attributable to a fall in sales in China (down 56% in local currency) due to continued soft end market demand on account of the coronavirus outbreak. Also, the company is experiencing low order rates for residential water heaters in North America. In April, its orders declined in low-single digits on an average basis compared to the average order rate in the first quarter. Moreover, in April, the commercial water heater order rates in North America were down 30-35%. 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. Notably, on uncertainties, regarding the impacts of the outbreak on financial and operating results, it has withdrawn its previously issued guidance for 2020.
- ▼ A. O. Smith has a significant presence in Asian countries 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 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 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 \$60-70 million in 2020. 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 gained 6.3% against the industry's decline of 11.4%. On a P/E (TTM) basis, the stock looks a bit overvalued compared with the industry, with respective tallies of 24.68x and 17.52x. Nevertheless, the company's multiple is at par with the industry's six-month highest level of 24.68x. Further, in the past 30 days, the Zacks Consensus Estimate for its 2020 earnings has trended downward from \$1.91 to \$1.78. This makes us a bit cautious about the stock.

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

Last Earnings Report

A. O. Smith Earnings and Sales Miss Estimates in Q1

A. O. Smith has reported disappointing first-quarter 2020 results, wherein both earnings and sales missed estimates.

The company's adjusted earnings were 32 cents per share, missing the Zacks Consensus Estimate of 34 cents. Also, the bottom line declined from the year-ago figure of 53 cents.

Quarter Ending **03/2020**

Report Date	May 05, 2020
Sales Surprise	-2.71%
EPS Surprise	-5.88%
Quarterly EPS	0.32
Annual EPS (TTM)	2.02

Top-Line Details

The company's first-quarter net sales decreased 14.9% year over year to \$636.9 million. The decline was primarily attributable to lower sales in China and weakness in other global end markets amid the coronavirus pandemic. Also, the figure missed the Zacks Consensus Estimate of \$655 million.

A.O. Smith's sales in **North America** (comprising the U.S. and Canadian water heaters and boilers) moved up 2% year over year to \$532.9 million. The segment's results benefited from higher sales volume of water treatment and water heater products, and contribution from its Water-Right acquisition.

Segmental operating earnings were up about 10% to \$127.1 million on a year over year basis. The improvement was driven by benefits of higher sales volume of water treatment products and lower steel costs.

Quarterly sales in **Rest of World** (including China, India and Europe) fell about 53% year over year to \$110.2 million. The decline was primarily attributable to a significant decline in consumer demand, owing to the coronavirus-led market downturn.

Operating loss at the segment came in at \$42.2 million against operating earnings of \$12.3 million recorded in the year-ago quarter. Lower sales in China proved detrimental to the segment's income.

Liquidity & Cash Flow

On Mar 31, 2020, A.O. Smith's cash and cash equivalents totaled \$416.1 million compared with \$374 million as of Dec 31, 2019.

At the end of the reported quarter, long-term debt was \$335.6 million compared with \$277.2 million as of Dec 31, 2019.

In the first three months of 2020, cash provided by the operating activities totaled \$54.1 million compared with \$21.6 million in the year-ago comparable period.

Share Repurchases

In the first quarter of 2020, A.O. Smith repurchased 1.3 million shares for \$57 million.

Guidance

On uncertainties, regarding the impacts of the coronavirus outbreak on financial and operating results, the company has suspended its guidance for 2020.

Recent News

Dividend

On **May 15, 2020**, A. O. Smith paid a quarterly cash dividend of 24 cents per share to shareholders of record as on April 30, 2020.

Valuation

A. O. Smith shares are up 4.6% and 14.9% 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 14.8% and 13.2% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are up 2.3% and down 5.2%, respectively.

The S&P 500 index has moved down 4.4% year to date and increased 9.1% in the past year.

The stock is currently trading at 25.26x forward 12-month earnings per share, which compares to 22.75x for the Zacks sub-industry, 21.8x for the Zacks sector and 22.29x 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 21.66x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$52 price target reflects 26.40x 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	25.26	22.75	21.8	22.29
	5-Year High	29.19	22.75	21.8	22.29
	5-Year Low	14.41	13.13	12.55	15.23
	5-Year Median	21.66	17.22	16.58	17.49
EV/EBITDA F12M	Current	11.33	17.05	16.44	12.31
	5-Year High	17.04	25.26	18.09	12.65
	5-Year Low	9.58	9.98	10.59	9.05
	5-Year Median	13.33	13.75	14.13	10.81
EV/Sales F12M	Current	3.12	2.9	3.1	3.21
	5-Year High	3.43	2.9	3.13	3.52
	5-Year Low	1.75	1.52	1.76	2.28
	5-Year Median	2.68	2.12	2.31	2.82

As of 06/03/2020

Industry Analysis Zacks Industry Rank: Bottom 40% (153 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
IIVI Incorporated (IIVI)	Outperform	1
AZZ Inc. (AZZ)	Neutral	3
ESCO Technologies Inc. (ESE)	Neutral	4
Franklin Electric Co., Inc. (FELE)	Neutral	4
SPX FLOW, Inc. (FLOW)	Neutral	3
Regal Beloit Corporation (RBC)	Neutral	4
Rexnord Corporation (RXN)	Neutral	3
Energys (ENS)	Underperform	4

Industry Comparison Industry: Manufacturing - Electronics				Industry Peers		
	AOS	X Industry	S&P 500	ENS	RBC	RXN
Zacks Recommendation (Long Term)	Neutral	-	-	Underperform	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	4	4	3
VGM Score	F	-	-	A	B	A
Market Cap	8.03 B	2.35 B	22.50 B	2.86 B	3.40 B	3.78 B
# of Analysts	11	4	14	2	5	6
Dividend Yield	1.93%	0.37%	1.88%	1.04%	1.43%	1.01%
Value Score	D	-	-	A	B	B
Cash/Price	0.07	0.10	0.06	0.10	0.19	0.16
EV/EBITDA	13.99	10.84	12.98	13.35	8.58	11.99
PEG Ratio	3.26	3.27	3.05	1.75	2.27	3.54
Price/Book (P/B)	5.88	2.40	3.11	2.18	1.48	2.93
Price/Cash Flow (P/CF)	18.06	12.73	12.18	8.70	9.39	11.35
P/E (F1)	28.42	24.56	22.19	17.51	22.75	21.13
Price/Sales (P/S)	2.79	1.77	2.40	0.93	1.09	1.83
Earnings Yield	3.53%	3.53%	4.31%	5.72%	4.39%	4.72%
Debt/Equity	0.23	0.19	0.76	0.85	0.62	1.06
Cash Flow (\$/share)	2.76	2.20	7.01	7.74	8.94	2.78
Growth Score	D	-	-	B	A	A
Hist. EPS Growth (3-5 yrs)	11.96%	6.22%	10.87%	5.11%	4.97%	7.80%
Proj. EPS Growth (F1/F0)	-20.68%	-22.24%	-10.74%	-17.84%	-32.71%	-25.71%
Curr. Cash Flow Growth	-13.97%	2.39%	5.48%	18.95%	-9.82%	5.35%
Hist. Cash Flow Growth (3-5 yrs)	9.81%	2.26%	8.55%	1.43%	1.95%	4.56%
Current Ratio	2.06	2.12	1.29	2.60	3.16	2.78
Debt/Capital	18.75%	16.14%	44.75%	45.87%	38.10%	51.54%
Net Margin	11.54%	5.53%	10.59%	4.44%	6.38%	8.71%
Return on Equity	19.95%	9.49%	16.29%	15.17%	9.49%	18.93%
Sales/Assets	0.94	0.70	0.55	0.94	0.69	0.61
Proj. Sales Growth (F1/F0)	-9.78%	-3.02%	-2.65%	-6.34%	-15.82%	-17.51%
Momentum Score	F	-	-	B	D	D
Daily Price Chg	4.11%	2.95%	2.42%	5.01%	2.84%	2.20%
1 Week Price Chg	12.51%	4.67%	4.60%	3.03%	3.78%	6.32%
4 Week Price Chg	14.20%	14.67%	13.40%	23.67%	17.94%	20.65%
12 Week Price Chg	24.72%	13.77%	12.78%	33.64%	15.94%	17.94%
52 Week Price Chg	14.94%	7.62%	0.89%	10.67%	9.84%	12.20%
20 Day Average Volume	1,581,750	209,366	2,528,787	244,979	212,920	841,406
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-9.91%	0.00%	-0.14%	0.00%	-7.79%	-7.63%
(F1) EPS Est 12 week change	-24.62%	-25.00%	-16.00%	-33.82%	-36.49%	-28.83%
(Q1) EPS Est Mthly Chg	-1.56%	0.00%	-0.02%	0.00%	-26.38%	-7.59%

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	D
Growth Score	D
Momentum Score	F
VGM Score	F

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.

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