THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SWK - Q3 2014 Stanley Black & Decker Inc Earnings Call

EVENT DATE/TIME: OCTOBER 22, 2014 / 12:00PM GMT

OVERVIEW:

Co. reported 3Q14 GAAP diluted EPS of $1.50. Expects 2014 EPS to be $5.52-5.58.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Greg Waybright *Stanley Black & Decker Inc - VP of Investor and Government Relations*

John Lundgren *Stanley Black & Decker Inc - Chairman and CEO*

Jim Loree *Stanley Black & Decker Inc - President and COO*

Don Allan *Stanley Black & Decker Inc - SVP and CFO*

CONFERENCE CALL PARTICIPANTS

Winnie Clark *UBS - Analyst*

Nigel Coe *Morgan Stanley - Analyst*

Rich Kwas *Wells Fargo Securities, LLC - Analyst*

Ken Zener *KeyBanc Capital Markets - Analyst*

Jeff Sprague *Vertical Research - Analyst*

Stephen Kim *Barclays Capital - Analyst*

Robert Barry *Susquehanna Financial Group - Analyst*

Tim Wojs *Robert W. Baird & Co. - Analyst*

Mike Wood *Macquarie Research - Analyst*

Will Wong *JPMorgan - Analyst*

Dennis McGill *Zelman & Associates - Analyst*

David MacGregor *Longbow Research - Analyst*

Liam Burke *Wunderlich Securities, Inc. - Analyst*

PRESENTATION

Operator

Welcome to the third-quarter 2014 Stanley Black & Decker Incorporated earnings conference call. My name is John and I will be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded. I will now turn the call over to Vice President of Investor and Government Relations, Greg Waybright.

Greg Waybright - *Stanley Black & Decker Inc - VP of Investor and Government Relations*

Thank you, John. Good morning everyone and thanks for joining us for Stanley Black & Decker's third-quarter 2014 conference call. On the call in addition to myself are John Lundgren, our Chairman and CEO; Jim Loree, President and COO; and Don Allan, Senior Vice President and CFO.

Our earnings release, which was issued earlier this morning and a supplemental presentation, which we refer to during the call are available on the IR section of our website as well as on our iPhone and iPad app. A replay of this morning's call will also be available beginning at 2 PM today. The replay number and access code are in our press release.

This morning, John, Jim, and Don will review our third-quarter 2014 results and various other matters followed by a Q&A session. Because of the size of the queue, we are going to be sticking with just one question per caller.

As we normally do, we will be making some forward-looking statements during the call. Such statements are based on assumptions of future events that may not prove to be accurate, and as such, they involve risk and uncertainty. It is therefore possible that actual results may differ materially from any forward-looking statements we might make today. We direct you to the cautionary statements in the 8-K that we filed with our press release and in our most recent 34 Act filing.

I will now turn the call over to our Chairman and CEO, John Lundgren.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Thanks, Greg. Good morning everybody, and thanks for joining us. I am really pleased with the performance of our team in the third quarter, given what's going on in the geopolitical front and many others. Let's get right into it.

Organic growth of 6% was led by CDIY and our Industrial business. The combination of the 6% growth and sharp cost focus on price realization delivered strong operating leverage. Our OM rate expanded to a post-merger record of 14.1%, that's ex-charges, of course, and 120 basis point increase versus 2013.

Diluted EPS up 12% versus 2013 to $1.55, $1.50 on a GAAP basis. Please note the convergence of GAAP and reported EPS as the large acquisitions accompanied by outsized restructuring charges are more fully integrated, and the overwhelming majority of that is now behind us.

CDIY revenue grew 10% organically. Another post merger record of 16.5% operating margin rate, as volume leverage, productivity, price, and cost actions offset the continued foreign exchange and emerging market headwinds that you will hear more about later in today's call. Industrial delivered 5% organic growth, 15.9% operating margin, and that's up 170 basis points.

The turnaround in Security Europe continues. At the same time, we are taking some further actions to strengthen the global Security business, as well as sharpen our focus on our vertical market solutions activities. Jim Loree is going to give you a lot more detail on Security in general and vertical markets in particular when he gets into the segment.

Free cash flow is $189 million in the third quarter and remains strong. Year to date it's up $464 million versus 2013, and as a consequence of the earnings performance in the third-quarter cash flow, we are raising our fiscal year free cash flow guidance and reiterating the earnings mid point while tightening the 2014 EPS range. We're looking at approximately $800 million of free cash flow for the year and EPS of $5.52 to $5.58.

Let's turn to the sources of growth during the quarter. The developed markets showed great strength and they led the way this quarter as both CDIY and Industrial performed well in the US as well as Europe. Remember, those two geographies account for 74% of our total revenue.

Pricing in the emerging markets, as well as surgical pricing actions elsewhere, primarily in our developed markets, led to a 1% overall increase. Pricing offset the negative foreign exchange impact of the strengthening US dollar against virtually every currency. More to come on that in the fourth quarter as we think this is going to continue, and Don will get into that in far greater detail in his piece of the presentation.

But within the regions, US demand remains healthy in both retail and industrial channels. Overall demand in Europe is flat, with the exception of the UK and several smaller countries. So the 4% growth that you see in Europe is clearly the result of share gains.

Emerging markets remained under pressure, most notably Venezuela, Russia, and Brazil. But we're really encouraged that the recent mid-price products that we launched earlier this year are gaining a tremendous amount of traction.

More on our recent product launches as well as the current initiatives in those markets, as Jim dives into the segment. In the interest of time, let me turn it over to him.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

Okay. Thanks, John. Let's start with CDIY. It was a blockbuster quarter for organic growth in the developed markets with double-digit performances in both North America and Europe, overwhelming a second consecutive slow growth quarter, in this case 2% in the emerging markets, for total performance of 10% globally. CDIY operating margin grew 19%, achieving another post-merger record rate of 16.5%, and margin gains resulting from volume leverage, modestly positive price, operations productivity, and tight SG&A cost management overcame currency pressures.

Last quarter in my remarks I said, and I quote, so as we step back from the CDIY picture, we see a very healthy franchise with world-leading brands, broad and deep global distribution delivering record margins. As we look forward, we have tremendous NPI momentum in both developed and developing markets, and a cost structure that is poised for operating leverage, end of quote.

That is, in fact, exactly what our CDIY team delivered, and bigger proportions in North America and Europe than even we expected. Across the global product lines strength was broad-based, with growth in professional power tools, consumer products, hand tools, and storage, and fastening and accessories, each in a range from 8% to 11%.

As the cover page indicated, CDIY new product development momentum is driving both revenue and profit growth. DeWalt DC brushless, an important and growing segment of cordless, is off to a very strong start. A host of other examples around the globe ranging from highly-innovative products such as the first-in-world cordless electric pneumatic nailer and the AutoSense drill, as well as practical products such as the new designed-in-the-market-for-the-market emerging market power and hand tools lines all contributed.

Putting the Company's leading array of brands to work across categories also continues to produce strong results, with examples such as DeWalt storage, adhesives, and hand tools, Stanley FatMax power tools, and Porter Cable hand tools, all registering gains. Although difficult to quantify exact incremental revenue from these types of activities, we are confident that contributions from our NPD effort yielded 3 to 5 points of global growth benefit in the quarter.

In the US, our Built in the USA program, which promotes tools assembled in our US-based production facilities including our recent plant addition in the Carolinas, has been highly successful. The US business also enjoyed a kicker from an unexpected 3Q appearance of the outdoor season initially thought to be lost to weather back in the second quarter.

On top of these benefits, underlying US tool demand remains solid as DIY fundamentals are strong, even as new construction markets are choppy but positive. So to sum up North America, exceptional growth execution and a good underlying market led to great 12% organic growth.

Now moving to Europe where the market fundamentals are weak but the performance is equally as impressive. As I said last quarter, we couldn't be happier with the progress that the CDIY European team is making.

With organic growth up 11%, representing a 6 quarter streak with growth averaging 7% in one of the more consistently stagnant economic regions within the developed markets. This sustained performance is indicative of clear market share gains stemming from intensive NPD, new listings at retailers and distributors, and a high-performance commercial team, which refuses to succumb to a victim mentality in a weak market.

The other growth challenge in the quarter, emerging markets, up 2% organically was one of continuing high volatility in the face of generally slower markets. It was a quarter in which Latin America, about half of our emerging markets tools business, once again grew only 2%, but Brazil flattish.

While issues in Venezuela and the western money-dependent countries essentially offset stronger performances in Argentina, Mexico, Columbia, and Central America. The other half of the emerging markets portfolio was also up only marginally as modest rebounds in Russia, Turkey, and India were offset by weakness in China and Southeast Asia to a lesser extent.

Our major NPI foray into mid-price point power tools and hand tools across these markets is hitting the sweet spot for end users at a time when they tend to be more cost conscious with their purchases. The program is thus tracking to plan, but generally cutting into distributors' share of wallet as tougher markets create constraints on distributor willingness and ability to finance incremental inventory levels.

As we look ahead for CDIY in total, we see the continued benefit of forward momentum with a winning combination of global scale, robust NPD, great brands, a growth culture, and a tight reign on margins and cost, more than compensating for lackluster markets in Europe and some of the emerging regions, as well as the strengthening dollar environment. In that vein we expect what is already an excellent CDIY growth story to continue.

Turning to Industrial.

Industrial this quarter once again performed well and delivered respectable 3X operating leverage off of 5 points organic growth with 17% growth in operating margin. The rate came in at 15.9%, up 170 basis points versus a year ago as price, productivity, SG&A control, and volume all contributed to the performance. Both Industrial and Automotive Repair and Engineered Fastening delivered strong OM growth, up 29% and 19% respectively.

For IAR, organic growth of 7% benefited from strong demand in developed countries, North America was solid at 9%. Europe was up 11 points and still up an impressive 7% when adjusting for prior-year SAP conversion, which resulted in a 4 point easier comp.

IAR Europe enjoyed strength in virtually all regions, driven by strong NPD and commercialization activities. Emerging markets were only modestly positive, the latter impacted by the same type of market issues as CDIY.

Engineered Fastening was also up 5 % organically, with automotive up 16%, significantly outpacing global light vehicle production which was up 5%. The industrial portion of Engineered Fastening was flattish, with sales to electronics OEMs weighing down a positive performance in industrial distribution.

Infrastructure was down 1% organically, with Oil and Gas down 4% and Hydraulics up 7%. In total, it was another overall strong quarter for Industrial with a similar story shaping up for fourth quarter.

Moving to Security. Revenues were down 3% with organic growth down 2 points, and operating margins at 11.0%, down 12% and 120 basis points year over year. North America emerging markets was up 1% organically with Europe down 7%.

North America Emerging Markets organic growth was modestly positive in both convergent and access technologies, partially offset by a decline in mechanical access. Operating margin was essentially flat with last year. The OM rate was also consistent with a year ago, solidly in the mid teens, and just slightly shy of historical norms.

Installation of a large vertical market retail win in North America, which has substantial future recurring revenue content, coupled with lower sales in the higher-margin mechanical access business, produced a less than desirable operating margin result in the quarter. Vertical market order progress continued to be a bright spot.

In the spirit of allocating management resources where they are positioned to optimize their contribution to business success, several recent Management adjustments have been made in North America and Emerging Markets Security. Jim Cannon, a proven Stanley Black & Decker Management veteran who previously led both Oil and Gas and IAR, including responsibility for the Mac turnaround, has been named President of the unit.

Brett Bontrager, who was succeeded by Jim, has been named to lead global vertical markets where he will continue to leverage his strength in developing these markets and winning customer accounts in North America, while coordinating the transfer of vertical solutions to Europe, as well. And then finally, Joe McCormack, another seasoned Stanley Black & Decker leader with extensive experience leading distribution commercial teams, has assumed leadership of Mechanical Access. We expect these changes to enable the continued forward progress of the Security North America and Emerging Markets team in both revving up organic growth and tightening operational execution.

Moving to Security Europe this quarter, performance was stable and consistent with commitments, extending its recent track record of predictability. OM is now in the mid-single digits, once again improving sequentially, this time by approximately a point.

3Q attrition came in within the target range of 10% to 12%, and order rates were up in the high-single digits. This is an important calculus in that we will be looking for an easing of negative organic growth in the first half of 2015, and then a flattish second half of 2015 in order to continue to drive forward OM rate growth in the business turnaround.

Finally, as mentioned last quarter, of the 14 country P&Ls in Europe, 12 are now considered stable or improving, and only 2, Spain and Italy, representing 10% of the European portfolio, are still facing both significant structural and operational headwinds. We are committed to completing our strategic review of these countries in Q4, and you can expect a decisive solution dealing with the issue in the near future. While Security still has a ways to go, especially in Europe, we are confident that we are on the right track and our recent actions will continue to improve the probability of success.

With that, I will turn it over to Don Allan for some commentary on the financials including the total-year outlook and some preliminary thoughts on 2015. Don?

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

Thank you, Jim. We are very pleased with our third-quarter 2014 cash flow performance, which resulted in $189 million of free cash flow. On a year-to-date basis our free cash flow performance was $355 million as we continue to benefit from increased operational earnings, lower restructuring payments, and reduced capital expenditures. These three factors are responsible for the vast majority of our year-over-year improvement through the first nine months.

Additionally, we are also pleased with our third-quarter working capital turns performance at 6.4 times, which is up a half a turn versus the prior year. We believe this bodes well for us achieving our year-end goal of 8.5 to 9 working capital turns, as we are looking for a half turn or better improvement versus the 2013 year end.

Many of you are aware that every year we experience a significant positive working capital benefit in the fourth quarter due to certain seasonality aspects of our CDIY business. As a result, we tend to generate close to 60% of our annual free cash flow in the fourth quarter.

If you extrapolate our year-to-date performance through the third quarter, which is $355 million, and consider this fact, then it indicates our free cash flow for the full year of 2014 will approximate $800 million. Considering all these factors I just mentioned, we are increasing our annual guidance for free cash flow to approximately $800 million from the previously communicated at least $675 million. This improved performance will ensure we will achieve our debt deleveraging goals for 2014, and then allow us to begin the previously communicated share repurchase program at some point in the fourth quarter.

Now let's review our 2014 EPS outlook on page 10. As indicated by John earlier, we are reiterating the mid point of $5.55, while tightening our range, which is now expected to be $5.52 to $5.58. There are factors changing within our annual guidance which have an overall neutral impact on full-year earnings.

As a result of the strengthening US dollar versus other key currencies, we now expect $75 million of currency pressure versus the previously communicated $60 million for the full year of 2014. However, offsetting virtually all of this new $15 million of Q4 currency pressure will be continued strong operational performance of several key businesses within CDIY and Industrial. This operational performance is being driven by solid organic growth in developed markets, strong cost controls over indirect cost, and focused customer pricing initiatives, all the things that you heard from Jim a few minutes ago.

An additional factor potentially impacting our annual guidance would be a modest benefit to earnings from the potential or possible reclassification of our Security southern European business to discontinued operations. We'll finalize this strategic decision in the later stages of Q4 and communicate it in the appropriate timeframe.

Let's turn to segments. We continue to expect mid-single digit organic revenue growth and solid operating margin rate expansion year over year in both the CDIY and Industrial segments, primarily due to volume leverage, solid price actions, and cost controls, which are more than offsetting currency. Our Security segment will have a modest organic revenue decline for the full year, and the margin rate will decline modestly as well versus the prior year. The organic growth in North America and emerging markets will be more than offset by the declines we are experiencing in Europe, as Jim has discussed based on Q3 performance.

Although headwinds have been somewhat unrelenting in 2014 due to currency pressures, combined with economic or political issues in emerging markets which have caused volume challenges, we believe we are taking all the correct actions to combat these headwinds through cost control actions and customer pricing initiatives. This approach will allow us to achieve strong operating leverage on solid organic growth; specifically, earnings will expand 13% on organic growth of 3% to 4% in 2014.

We'd like to give you some thoughts on 2015. We see these currency and emerging markets volume headwinds continuing and currently estimate it to be $50 million to $75 million against our 2015 operating profit growth expectation. Most of you know we have a track record of responding to these types of headwinds with focused cost reduction actions or other profit-enhancing initiatives.

I think 2014 is a great example of this. We are currently considering several cost reduction initiatives, which would largely, if not completely, offset these headwinds that we see for 2015 at this point in time.

We are evaluating three areas for potential cost reductions. The first is combination of a few existing Stanley Black & Decker businesses to maximize the commercial go-to-market opportunities, and of course, leverage the back-office functions. In my mind, this would be a continued evolution of the Stanley and Black & Decker merger.

Number two, further cost rationalization of the Security businesses to improve profitability while enhancing our SG&A investments to stimulate growth within the verticals. And then three, other surgical actions and certain functions as well as corporate overhead.

If we proceed with these actions, which I believe are highly likely, it will require additional restructuring charges of $10 million to $25 million in excess of our current 2014 estimate of $25 million. However, do not misinterpret our 2015 comments. We do expect solid growth and profit during 2015 and we are simply discussing one headwind we need to offset.

Moving to the next slide, I'd like to spend a few minutes discussing 2015 foreign currency impacts. As we are all aware, the US dollar strengthened during late September against the four major currencies which impact us, the Canadian dollar, the European euro, Brazilian real, and Argentinian peso.

As a reminder, these transactional exposures primarily exist in our CDIY and Industrial businesses with 80% of it within CDIY. This is due to the extensive global supply chains that are in place, as well as the importing of finished goods and components into Latin America and Canada in US dollar-based transactions.

We have finalized most of our initial key currency hedging activities for 2015 at this stage. Based on yesterday's spot rates, we estimate the 2015 negative currency impact to approximate $45 million to $50 million versus 2014, which includes the impact of these recently executed currency hedges.

To give you an example of the sensitivity of these four major currencies shown on the chart, a 1% movement of the Canadian dollar versus the US dollar will result in approximately a $2.5 million to $3.5 million annual currency impact. And you can see examples of the other three currencies on the page.

As I mentioned previously, we are focused on managing these types of headwinds with mitigating actions and are currently in the process of evaluating what these potential offsets could be. I believe this slide provides good transparency to the impact of currency in 2015 on our Company.

So I'd like to summarize the presentation portion of our call today. We are very pleased with the strong Q3 2014 EPS and cash flow performance; the strong organic growth of 6% mentioned by John has been supported by solid innovation and the 2013 growth investments continuing to blossom. The tight cost control and surgical price actions across the entire Company enabled excellent operating leverage, and our operating margin expanded to a post-merger record. Security Europe continues to perform better and made another positive step forward in Q3.

Our focus in 2014 continues to be on improving the near-term returns and relative performance of Stanley Black & Decker through organic growth initiatives, Security margin improvement, cost actions, pricing, ongoing working capital focus, and of course, the rebalance of our capital allocation through the end of 2015.

Finally, we are preparing for new currency and emerging market volume headwinds with offsetting mitigating actions in 2015. So we continue to drive operating leverage as we grow revenue organically. We believe this approach in 2014, 2015, and beyond positions our Company to deliver on the long-term financial objectives we have established.

That concludes the presentation portion of the call. Now let's move to Q&A.

Greg Waybright - *Stanley Black & Decker Inc - VP of Investor and Government Relations*

Thank you, Don. John, if you would, we can now open up the call to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Winnie Clark from UBS.

Winnie Clark - *UBS - Analyst*

Could you talk a bit about -- a little bit more about the emerging market expectation? Continuing to be sluggish, and now somewhat weaker in 2015. You quantified the dollar change in your expectation. But what does that translate to from an organic growth expectation? Does that impact your ability to drive 3% organic growth via your initiatives next year?

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Very fair question. Let me start at a higher level. Emerging markets, depending on exchange rates, accounts for 17% to 19% of our total revenue. So first and foremost put that in perspective.

Within the emerging markets, we didn't touch on specific geographies, but historically, as a group, these were growing in double digits, low teens, and now they are growing at 2% and 3%. Specifically, certain markets in our case, Venezuela where we've had essentially no business for the last 12 months, that will anniversary, which is nice, in terms of our ability to grow. Argentina is difficult, but continuing, we've seen some bright spots in the last quarter. Brazil, it's much about currency and the economy.

And of course, China, a very, very -- switching to Asia, China, a big piece, we saw 7.3% GDP growth in the third quarter. That's encouraging. It's below where they have been, but better than of late. And of course the geopolitical situations in Russia, Turkey, the Ukraine is impacting all of that.

So at the end of the day, it is 17% of our volume. If the markets are growing at 10% and we are maintaining share, that's 170 basis points of organic growth. If they're flat, it's zero.

Simply said, we have the products to go into those markets. We are certainly tempering our expectations for those markets in total. But that's what's baked into the kind of guidance that we've been able to provide thus far.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

If you just think about it from a macro point of view, there clearly is a rotation of economic growth away from -- in the short-term -- away from the emerging markets and more into North America, in particular. And Europe expected to stay the same, maybe get slightly better.

So we would expect to see the organic growth profile of the Company mirror that economic growth rotation. So I would expect to see developed markets and emerging markets converge for a period of time in sort of similar growth rates. Then over the long term, emerging markets to ramp up again.

We have taken considerable action in terms of product innovation, product development, brand development, channel, made significant investments in the emerging market. So we do think that we will be able to outperform the market -- or the economic performance of the various countries. However, the volatility does remain high in the short term and it probably will for the medium to long term, as well.

But one has to be in these markets because these markets are the future. Two thirds of the world's economic output within 20 years will be from the emerging markets and we will be there. So this is not a period where one should get shy or cautious about being in these markets or second guess their strategy. This is a time to hunker down and gain as much share as possible.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Yes. Thanks, Jim. Just a follow-up, because you only get the one question. I think two things. Jim's referring specifically to our feet-on-the-street advertising promotion efforts in those markets. But of greater importance, made-in-the-market-for-the-market to hit the right price points, to get the product particularly to the distributors who are short on cash and thinking very hard about their purchase.

So at the end of the day, think about the math. And in the appendix, if you're not familiar with it, we don't go through it in each presentation, but it will just help you with the math that we will give you every region of the country and the percent of Stanley Black & Decker revenue that that region accounts for. So if you are modeling, it will just help you with a weighted average and you can apply your own assumptions to the market, and to Jim's point, we will mirror that.

Operator

Nigel Coe from Morgan Stanley.

Nigel Coe - *Morgan Stanley - Analyst*

Great top-line performance there. Don, I wanted to dig into your comment about currency with the hedges about $45 million, $50 million headwinds in 2015. You are mentioning the possibility of further actions this year to offset that. So, what I'm trying to figure out is, do the incremental actions you are considering offset the $45 million to $50 million? Or do we think about that as the total actions you are taking this year offsetting that headwind, potentially?

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

The actions that we are evaluating would offset the currency impact, as well as the emerging market volume impact. We described a $50 million to $75 million headwind for 2015. Within that, there's a $45 million to $50 million currency pressure. And then the other component is the volume concerns that we were just talking about related to emerging markets. We're looking to take actions that would offset all of that.

Operator

Rich Kwas from Wells Fargo.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Just quickly on two questions. Don, I think you said buyback in Q1 because of higher cash flow. Just wondering why you wouldn't be aggressive here in Q4, given this is seasonally the strongest cash flow quarter?

And then second question, CDIY margin, 16.5%, very strong number. How should we think about this from a sustainable standpoint? I know there's some seasonality within the business. Just trying to understand, as we think about 2015, given the strong margin here this quarter. Thanks.

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

The first question is, I said the fourth quarter. Maybe there was a Freudian slip and the word first came out. I did say fourth quarter. We expect to start to repurchase in the fourth quarter.

So our objective has always been since the beginning of the year, would be that we would focus on deleveraging. We had about $300 million of deleveraging we wanted to do. We believe with this outperformance of cash flow, we will be able to adequately achieve that, and then we'll be able to move forward with our repurchase program at some point in the fourth quarter.

As far as the cash flow and the seasonality comment, yes. When we look at the history of our CDIY business, it was a little muddy last year I think because of some other dynamics. But every other year post merger, about 60% to 70% in some cases of the free cash flow or working capital benefit occurs in the fourth quarter. That's because of the timing of the different promotions and other activities related to the holiday season and the vast majority of those shipments occur in October, early November.

The good news is we are able to collect a lot of those receivables, and then we ramp down our production in our plants. So our inventory levels are actually able to decline because we do -- our major customers tend to have a weak first quarter because it is the winter months.

Operator

Ken Zener from KeyBanc.

Ken Zener - *KeyBanc Capital Markets - Analyst*

On the Security, it seemed to be very specific in the US on mechanical, if I interpreted your comments correctly. So would you expand on that, if it was related to going to the distribution model? If it was aggressive behavior by a competitor? Or was it simply more mis-execution? Thank you.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

The mechanical issue is kind of the issue for North America / Emerging Market Security in the quarter, without a doubt. The other issue, which is the CSS efficiency and operating margin rate, is simply a one quarter blip where we have a big installation of a huge vertical market customer project. You do have that correct.

I'd say, what we believe about the mechanical business today, is that we have selected the correct strategy and we have attempted to implement it effectively for about two years now. At some point, once patience dwindles with execution, and we've made some mistakes along the way and we expect that new leadership will tackle the project and get it right. So that's the impetus behind the Management change, and we are looking forward to Joe's experience coming into this job and getting this right very quickly.

We've studied the strategic elements and aspects of this in depth and we see that as the right strategy. We've got the specifiers in place. We haven't seen any untoward competitive activity. The market is going to be good at some point in time. It's not bad right now, we're just not performing at that level. We get to those situations and it's time to make a change.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Just to add to what Jim said, the one thing he did mention is coming out of ASIS, which as you know the largest -- annual Security tradeshow, it's not a product issue, as well. Product, very, very well received. We are encouraged by that. Just to reinforce everything Jim said, plus not only do we feel the strategy is right, we feel we're in better shape than we've been in the past in terms of product offering. It's up to us to execute.

Operator

Jeff Sprague from Vertical Research.

Jeff Sprague - *Vertical Research - Analyst*

Just a question around Europe Security. I was wondering if you could provide us a little bit of granularity. Maybe it's collectively, not by country.

But what's going on in the 12 P&Ls you view as at least satisfactory versus the other two? What would actually be the gating decision to drop Spain and Italy into disc ops? Obviously, if you decide to exit that might be one thing. But if you are looking at a sale, I wonder if you would consider dropping it into disc ops before you have an agreement on the exit.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

I'll take it and Don can correct me on the accounting. Let me take the second part of your question, first. We've said all we can say about whether or not -- what we said is we are evaluating it, we will have a decision in the fourth quarter and we will communicate it. That is all we are going to say. It's all we are in a position to say for all the reasons that I know you understand.

I respect the question. Please respect the fact that we are not able to provide any more insight on it, other than we want you to be aware we are not letting that issue fester.

What I think is important to understand -- time doesn't allow us to go through 14 P&Ls. We do report them. The big ones that matter, UK, France, and Sweden, all performing pretty well. Very near line average and historical margins.

The math is really important and it's interesting. We talked about Spain and Italy, which together from a revenue perspective represent 10% of European Security if you just cascade that with the math which represents 4% of Stanley Security, and 1% of Stanley Black & Decker revenue. Yet that region is accounting for 70 to 100 basis points of headwind or negativity to our Security margins. Quite frankly, that's just math.

It's two things going on. Those are very competitive markets, they're difficult markets, as you can imagine. But secondly, particularly Spain, which is 80% of that 10%, or 70% of that 10%, the financial services industry, as you know, is in turmoil. Our retail bank branches closing left and right, I shouldn't speculate, at least 30% to 40% down. That was our strength in Spain.

So when you've got a very competitive market that's 30% to 40% smaller than it was a year, year and a half ago, that's just tough sledding. So we are evaluating all the options in the best interest of our shareholders and of our employees and the Company, recognizing the pros and cons of the two or three different alternatives that you outlined. When we are ready to -- when we're in a position to take a firm stance, you'll be among the first to know.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

Let me also just mention that another way to look at this situation, Security Europe, and at the P&L, is that once you excise the Southern Italy part that we're talking about, the gross margin rate is north of 40%. The operating margin would be a couple -- kind of in the mid to slightly above mid-single digit range.

So what that says, is that the SG&A is quite high. It's in the 35% plus range, which is just too high for a Security business, no matter where it's located in the world. So it's very important that part of what Don mentioned, in terms of this cost exercise that we'll be going through in the fourth quarter to yield profitability improvements in 2015, there will be a significant, as he mentioned, a significant portion of it targeted at the Security Europe cost structure, and particularly as it relates to the SG&A.

We will find a way to make some significant improvements in that structure, that cost structure, so that we get the operating margin lift that comes with that. So I think it's very encouraging, from my perspective, that the gross margin is north of 40% once you get that Southern Europe portfolio excised.

Operator

Stephen Kim from Barclays.

Stephen Kim - *Barclays Capital - Analyst*

I wanted to follow-up a little bit on the CDIY. I think you talked about the outdoor previously as, I think, hindering you by about 2 points of growth. I think you mentioned that either in 2Q or 1Q. I'm triangulating on that to be about $30 million impact. Was curious if you could give a sense of is that in the ballpark of what you benefited from this quarter, did you get it all back? Or just some color around that?

And what you think the incrementals on that looked like. Is there reason to think the incrementals there are higher or lower than the segment average typically? Thanks.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

Just for clarity, we only got about a third of that back. So it didn't even contribute -- it might round to 1 point of growth for CDIY. But it wasn't as significant an issue as -- a benefit as it was a hurt in the second quarter. And incrementals are going to be pretty much consistent with the rest of the portfolio.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Steve, just to quantify what Jim said, outdoor was up 2% VPY in the quarter, which was nice. But it's still down 3% year to date, -- it helps quantify what Jim just said. So despite the pleasant surprise in the third quarter, it didn't begin to fill the hole in the second quarter, it just added a bit in the third.

Operator

Robert Barry from Susquehanna.

Robert Barry - *Susquehanna Financial Group - Analyst*

I wanted to just ask about the vertical market solutions revenue in Security and how much revenue you are expecting that to contribute in North America in 2014. I wanted to also clarify the margins there. I know there was some mention of project mix headwinds in the quarter and some mention of perhaps that was related to a big vertical market install? I wanted to clarify that, because I thought the margins on the VMS was higher. And then just finally, the latest thinking on bringing the vertical market solutions to Europe? Thank you.

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

I will take that one. I think that was four questions in one. I'll have to break that down.

When we look at 2014 for the vertical market solutions, we've said throughout the year that our expectation is that we probably would get pretty close to $100 million of revenue from these solutions during the year. We are tracking relatively well to that at this stage of the year. We feel pleased about how that's progressing.

As far as the gross margins, we've also said that they most likely will be accretive to the overall business. But you have to look at this across the entire contract. What I mean by that is when you have large jobs like this, you have an installation component, and in the case of the third quarter, as Jim was describing, the impact of a large job, we were doing the install. We will be close to finishing that here in October. That does have a negative mix impact, but the profitability is lower on the installation.

Then the recurring revenue stream starts later this year and continues into next year. And then when you look at the overall profitability of the entire job, it achieved the type of profitability we were describing before. That's the way you have to evaluate it.

It's important to remember that as we continue to focus on the vertical selling solutions, that we are occasionally going to have a quarter where we have a little bit of a mix challenge we have to work through and we have a large installation. But over the long term, these will be profit enhancing activities.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Simply said, you need to do the installations to keep the pump primed to generate the future recurring revenue. It's always a challenge to balance the mix and balance the timing. But it's the nature of the business, and the larger the install, the more of a short-term challenge it is with -- yet, at the same time, the greater the long-term reward.

Operator

Tim Wojs from Baird.

Tim Wojs - *Robert W. Baird & Co. - Analyst*

Just on European CDIY, really strong growth, there again. What type of growth should we expect going forward there? I know you said new products and retail expansion has been a driver. But can you give us some color on what might be in the pipeline there? Especially if comps get more difficult into 2015, what we should expect for growth?

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

I'll take that one. Yes. Obviously, we talked about how pleased we are with the performance in CDIY Europe. Jim went through that in a great deal of detail. There's been a lot of activities around new product introductions, new customer listings, some new brands put on products that didn't exist before in the European marketplace, such as the Stanley FatMax brand on power tools. So there's some great examples of that.

I do think there's momentum to continue that into 2015 in the sense of having new product introductions, expansion of some of the things that we did in certain countries into other countries within Europe that we haven't penetrated yet. I wouldn't expect to see high-single digit revenue performance, but I do expect them to our perform the market as a result and continue to have share gain.

Operator

Mike Wood from Macquarie.

Mike Wood - *Macquarie Research - Analyst*

I wanted to focus in on the CDIY business. The CDIY sales in North America for Stanley took a while to reflect the housing recovery, given there was a considerable lag. Now we're starting to see building product companies reflect more tepid growth than end markets that are slower compared to last year. What are you able to do, or what are you planning to do proactively in the North American CDIY business to get out in front of the curve from a cost or share gain perspective? Thanks.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

I think what we're doing is exactly what we did in the quarter, which is we're basically driving new product innovation as hard as we ever have. As I said in my remarks that new product innovation resulted in 3 to 5 points at a minimum of contribution to revenue growth.

Mike Wood - *Macquarie Research - Analyst*

So a third to half the growth.

Jim Loree - *Stanley Black & Decker Inc - President and COO*

Yes, which also drives profit growth because you mix into higher-margin new products. And so it's an innovation machine right now, which is clearly -- I can guarantee you that there is significant share gains going on in the US and in Europe and frankly, globally. This business has grown its market share significantly over the last four years, and it will continue to do so.

Now, we don't see any near-term abatement in the CDIY business US market. It is largely DIY driven, much more so than new construction driven. New construction, when it hits and the lag occurs and so forth, that will be an added bonus. But we did not ride that curve up in the last couple of quarters like some of the building products companies did, and we certainly aren't going to ride it down, having not ridden it up. So I wouldn't correlate us quite as closely to the building products companies as your remarks seem to imply, as well.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Just to help you, Mike, I think you are aware of this. Perhaps not. For the 10, 11 years I've been here and I think for the 100 years before that, we have been three to nine months, so take the midpoint, six months behind any significant change in North American residential construction. That's just the nature of our business. The wallboard folks and the timber folks and those who are involved in foundations, et cetera, are obviously at the beginning of that program and we're closer to the end.

So the lag, to use your words, and Jim I think described it well, he just didn't put a number on it. That's been going on for 100 years and we don't anticipate that it's going to change.

Operator

Michael Rehaut with JPMorgan.

Will Wong - *JPMorgan - Analyst*

It's actually Will Wong on for Mike. Don, thanks for providing the additional color regarding the cost cuts. The Company's initiated cost-cutting actions over the last two or three years to offset weakness in end markets as well as FX. We're just wondering how long this can continue without cutting into the core capabilities for growth and operations, particularly since these appear to be unplanned reactive rather than proactive.

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

Well, I think, as I mentioned, for those of you that have followed us over the years, we are very proactive about looking at certain headwinds we see and how we are going to react to them. You can describe that as reactive or you can describe it as proactive. I look at it as proactive.

At the same time, I look at our Company and I see every year significant productivity programs that occur in the supply chain, productivity programs that occur in our SG&A cost that we never talk about. We just do those every year and those are the more proactive things that you are describing that need to happen to enhance our profitability, to allow us to deal with occasional periods of time when we have commodity price pressures, et cetera.

We don't like to sit back and just let things come at us and then not do anything about it. Our response is to do something about it. What we are basically saying is that we are going to take a proactive approach to a headwind that has become a reality in the last 30 days.

And we are going to do it in a way that is surgical in nature, it's going to be a combination of continued evolution of the Stanley and Black & Decker merger, it's going to be the continued improvement of the Security profitability, Europe specifically, as Jim and I have both talked about it, and then it's also going to be the continued enhancement of the efficiency and effectiveness of our functions and our corporate overhead. These are all things that we need to do every year and sometimes we accelerate some of these things to deal with headwinds that come at us quickly.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Just again to quantify, we've said this before in a lot of calls. What Don's talking about, proactive or ongoing nature of our business, particularly in CDIY and IAR, for that matter, the tools business. It's as simple as -- real prices have declined 1% to 2% a year, let's say 1% for the last 15 years -- real prices. We get price by mixing into higher margin items and a good price discipline.

But with gross margin's raw numbers at 35%, real prices declining 1% a year, if you don't get net 3% productivity every year, your margins would decline. Look at the math. Our CDIY margins are not declining. If you exclude all of the new headwinds to which Don's referring, particularly foreign currency, emerging market growth, just to stay in the game you need 3% productivity every year to offset 1% real price decline. We've been doing that for a long time.

I think Don can account for 15 years of it, and that's just part of our DNA, that's part of SFS that we don't talk about too much. But I just want to steer you away from anything we're doing, as we see something going wrong and the knee-jerk reaction is to fix it. That's a necessity too. We wouldn't be where we were this year if we haven't done a whole lot of those programs. As Don described, the level of unanticipated and uncontrollable macroeconomic headwinds we faced, yet we are plodding along with a pretty successful year relative to expectations.

Operator

Dennis McGill from Zelman & Associates.

Dennis McGill - *Zelman & Associates - Analyst*

Don, can you just talk a little bit about some of the cash flow items that are dropping below the free cash flow line? I think one seems to be on the hedge settlements, and there's a lot grouped in the other line of $200 million so far this year. And I think last year it was about $30 million. Can you just maybe explain what those are? And then let us know if there's anything you would expect along those lines in fourth quarter or next year?

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

Yes. The other line in operating cash flow is where you see the impact of all the reduced restructuring payments.

Dennis McGill - *Zelman & Associates - Analyst*

Down in the finance and investing side.

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

That would simply just be the activity around commercial paper and financing and -- as we go through the year, we see fluctuations in there and we tend to increase our commercial lines, our paper lines as the year begins, because we have cash outflows in the operating levels. As the year goes on and we have a strong fourth quarter as I described, that slowly and gradually goes away. You will see that this year.

You do have some other type of currency and hedging activities that do happen below there, but we can certainly walk you through that in a little more detail off-line.

Operator

David MacGregor from Longbow Research.

David MacGregor - *Longbow Research - Analyst*

Nice quarter. Congratulations on the progress. The questions I have are really on the mid price point. You mentioned that the launches are pacing to expectations. I guess the question is, are your distribution buildouts where they need to be? Jim, I think you've made some passing reference to some pressures that are being felt by some of those distributors. Can you just talk about what you might be doing to support those distributors such that the fourth quarter and beyond isn't at risk in terms of growth?

Jim Loree - *Stanley Black & Decker Inc - President and COO*

Well, we are doing everything we can. Obviously, we're not going to overextend ourselves from a credit point of view with distributors and markets that are relatively volatile and weak, so there's only so much you can do in terms of financial support. And we're certainly not giving significant extended terms or anything like that. You'd certainly see that in the working capital if we were doing that.

So what it really boils down to is distributor training and end user support, through advertising, through having feet on the street, working with the end users to try to stimulate demand in construction projects, those types of things, creating awareness for the products in the market.

But this is just going to take its course. We are not going to jam these products into channels. We are going to allow them to gradually take root and let the products speak for themselves. I'd say we've done a pretty good job about a year and a half ago, sort of sprinkling resources into the various markets.

And what we are also doing right now, we've done a study of our sales force effectiveness and managing this distribution channel across all the different countries. And we're looking at the emerging markets right now as sort of a portfolio of countries and we are saying, okay, we added about 300 feet on the street, 200 salespeople, 100 marketing people during that timeframe.

Now we are kind of looking at that resource allocation and saying, okay, number one, where are the folks effective and are there certain folks who are more effective than others? Of course there are. Some rank ordering, some performance evaluation, some changing out some of the folks who are non-performers.

And then the other piece of the activity is to look at some reallocation of resources based on economic outlook for various countries. For instance, you wouldn't want to have an army of people in Venezuela trying to sell products when there's no market. So those type of resources could be reallocated to countries such as Columbia, which is very, very robust right now. So that kind of process, looking at the whole picture of doing the resource reallocation.

No incremental cost of any significance. However, more effectiveness: that's really what we're looking for.

But this is not going to be -- given the market status that we are in right now, this is not going to be a huge sensation. Don't look for 20% growth because of the new products or 10% growth, this is going to be keep us in the game, drive market share quietly, market share increases steadily, methodically, and then when the markets come back, there will be a lot more share for us and a lot more growth.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

Importantly, David, the key is, as Jim said in his presentation, made-in-the-market-for-the-market. In our history, if you go way back -- and you followed us a long time -- we would make western specification products, then we try to take 10% of the cost out and sell it for 20% less, and it was a strain on margin. It's not quite that simple, but it was a strain on margin. Nor were the products at a price point that appealed to the distributors in some of these emerging markets where wage rates are so much lower and things of that nature.

So the acquisition of GQ, which we've talked about, leveraging that capability across the broader portfolio. Our design to value program where we are truly starting with a blank piece of paper, building these tools from scratch with no extra costs or no extra features that the end user isn't willing or able to pay for, that's what's driving this. As I say, it's early days, but we are encouraged thus far.

Operator

Liam Burke from Wunderlich Securities.

Liam Burke - *Wunderlich Securities, Inc. - Analyst*

IAR was very strong, particularly in Europe and the US. Was there any particular vertical that showed inordinate strength? Or did you see strength across the board?

Jim Loree - *Stanley Black & Decker Inc - President and COO*

I wouldn't say across the board. Mining is still weak. But generally speaking, pretty strong, general manufacturing very strong. But a lot of strength in various verticals.

Operator

Jeremie Capron from CLSA.

John Lundgren - *Stanley Black & Decker Inc - Chairman and CEO*

He's on mute, we will figure that out.

In Rich Kwas's multifaceted question, but it was an important one. As Don was processing, he didn't get to it, on the sustainability of CDIY margins. It's probably worth the word from Don before we close.

Don Allan - *Stanley Black & Decker Inc - SVP and CFO*

So Rich was asking about the 16.5% margins we saw in Q3, what's the sustainability, what does it mean going into 2015? What I would tell you is that for this year, as I mentioned in the guidance, we'll probably see 60, 70 basis point improvement in the CDIY margins year over year. It's due to a lot of the great things that Jim walked through and that we discussed through the first nine months of this year.

We expect continued improvement in the margins going into 2015. As we all know, quarters change and fluctuate, but on a full-year basis, we would expect that we would continue to see improvement. I think the next step and hurdle is we want to try to move them toward 16%. We will see a little bit of pressure against them next year because of the FX that we talked about, and maybe all the cost actions don't get allocated directly to CDIY. But even given that, I do expect to see some year-over-year improvement.

Operator

Thank you ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.
