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SWK - Q3 2013 Stanley Black & Decker, Inc. Earnings Conference Call

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OVERVIEW:

Management discussed 3Q13 results, reporting GAAP diluted EPS of $1.07 on revenues up 10% vs. 3Q12. Guidance was for 2013 EPS of $4.90-5.00.

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PRESENTATION

Operator

Welcome to the Q3 2013 Stanley Black & Decker earnings conference call. My name is Dawn and I will be the Operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded.

I will now turn the call over to Greg Waybright, Vice President of Investor and Government Relations. Mr. Waybright, you may begin.

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

Thank you, Dawn. Good morning, everyone, and thank you for joining us for Stanley Black & Decker's third-quarter 2013 conference call. On the call, in addition to myself, is John Lundgren, our Chairman and CEO; Jim Loree, President and COO; and Don Allan, our Senior Vice President and CFO. Our earnings release, which was issued earlier this morning, and a supplemental presentation, which we will refer to during the call, are available on the IR portion of our website, as well as on our iPhone and iPad apps.

A replay of this morning's call will also be available beginning at 2.00 PM today. This replay number and the access code are in our press release. This morning John, Jim and Don will review Stanley's 2013 third-quarter results and various other matters, followed by a Q&A session. And due to

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the size of the queue, we are going to stick with just one question per caller. And please feel free to call me with any follow-up questions after today's call.

Finally, 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's therefore possible that actual results may differ materially from any forward-looking statements that we might make today. And 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. With that I'll now turn the call over to our Chairman and CEO, John Lundgren.

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

Thanks, Greg, and good morning, everybody. Just to touch on some of the highlights of the third quarter. Revenues did increase 10%, of which 4% was organic growth. The rest was the addition of Infastech and it was partially offset by currency. Diluted EPS of $1.39, up 14% versus 3Q 2012, diluted GAAP EPS including charges were $1.07. Our growth initiatives that we've talked about the last couple quarters really continue to deliver some strong results. They contribute about 200 basis points or 2 percentage points of the growth. Both CDIY and our industrial segments achieved some compelling top lines. Specifically CDIY achieved organic growth of 5% at a 15% OM rate. And within our industrial segment, oil and gas delivered another really strong quarter - organic growth of 32%.

In security growth, both the growth rate and the margin improved sequentially. Globally organic growth was 1% versus prior year driven primarily by our growth investments in the North American verticals and emerging markets. And the OM rate within security improved 170 basis points sequentially to 12.2%. So good progress.

And as a consequence, we see no changes to our expectations for the long-term financial prospects for security. And we believe the strategy and programs that are in place to deliver the long-term financial objectives will get where they need to be. But we are revising our full year 2013 guidance, EPS guidance to a range of $4.90 to $5 as a result -- primarily as a result of this lower margin recovery within security, weakening in emerging markets and the impact of the US Government shutdown on near-term organic growth. So full-year EPS $4.90 to $5 and resulting free cash flow at approximately $800 million and a lot more detail on those 2 projections and pieces of guidance from Don later on this morning.

Let's look briefly at our sources of growth because organic growth remains strong and the momentum is good. In the third quarter, volume was up 5% bringing it to 3% on a year-to-date basis, price was down 1%. So organic growth as previously stated at 4%, acquisitions added 7% currency detracted by 1%, so a total revenue growth of 10%. Looking at the organic growth year to date of 3%, just -- where third quarter was not too different from year to date, slow first quarter as you'll recall, very robust second quarter and a healthy third quarter which was right at about the midpoint or slightly above the midpoint of our year-to-date performance. So a little bit bumpy but good organic growth on a year-to-date basis with third quarter falling between first and second quarter. First quarter as you'll recall we had very little traction from our organic growth investments, but they're really starting to produce the kinds of results that we've expected.

Looking at the regions, and there is more detail in the appendix, but I think it's important to point out the US, our largest market, was up 3% and is up 3% year to date. It's still strong, but it's not accelerating. Europe was down 1% in total and was down 1% on a year-to-date basis. As I think all of you know, the macro environment is more stable than it has been but there's still certainly no tailwind and arguably a headwind. And within Europe within our businesses, security was down as per the detail in our press release as a combination of organizational changes and moves we're making in the macro environment. CDIY continues to gain share and John Wyatt and the CDIY European team are doing a terrific job driving new distribution and share gains with product and innovation and tremendous commercial efforts. Industrial within Europe was down slightly as well and pretty much in line with the market.

Emerging markets remain a bright spot, up 14% in the third quarter, up 8% on a year-to-date basis. Industrial and CDIY posting strong results and security was up nicely in emerging markets but it's from quite a small base, but we're making good progress there in our security business in emerging markets. And the rest of the world was flat. So again 4% organic growth on the third quarter, 3% on a year-to-date basis.

Just a quick snapshot, and I'll save some anecdotes, on the specific initiatives that we've talked about for the last couple calls. These initiatives are demonstrating results, and within the third quarter, the emerging market expansion continues. We've hired about 300 people including key country

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leaders and sales positions. Our distributor expansion's progressing nicely, both in the traditional and industrial channels or with that base as well as in the modern channels in Northeast Asia where those channels are more established. That all helps us prepare for the mid-price point product launches which will come later this year and the ability to launch those essential mid-price products in emerging markets has been accelerated by three to six months through the GQ acquisition that Jim spoke to you about on the last call.

Finally, the security verticals are gaining traction. We have order momentum building and we've had some recent success in our K-12 and healthcare programs on a global basis. Specifically new access card control systems in 73 schools across the country in the third quarter alone, and orders in excess of $1 million at three hospitals. Obviously we don't want to name them without their permission, but just as a demonstration of some meaningful points on the board with some of these initiatives. So as a consequence, we remain on track for our three-year commitments with the organic growth program.

And finally just a quick look inside emerging markets with some real highlights in our tools businesses, Russia up 32%, China 27%, Middle East and Africa 9%, Latin America 8%, Southeast Asia 7%. So total emerging market growth tools business growth of 13%. And previously as I said security has grown in emerging markets as well but from a very small base. Let me turn it over to Jim who's going to take a deeper dive into some of the segments.

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

Okay, thank you, John. Starting with CDIY, another respectable quarter for CDIY with 5% organic growth and near 15% operating margin. Revenues were $1.388 billion, up 5%. The operating profit was $207 million versus $204 million last year, or 2%. The profit rate was 14.9% versus 15.5% last year, a 60 basis point decrease which was largely attributable to the cost of the organic growth investments totaling 40 basis points of impact. Organic growth was solid across virtually every region and every business unit within CDIY. PPT, or professional power tools, was up 10% as NPI, emerging market growth, promotions and a recovering US construction market all contributed to the performance. In particular, the brushless XR and the cordless framing nailer new products registered significant gains.

CPG, or consumer products, was up 5% as outdoor continued its strength while the innovative MATRIX power tools gain share in the developed markets and new products in steam and hand vacs performed well in Europe. Emerging markets also contributed significantly to CPG's growth. Hand tools and storage was up 3% organically, led by continued growth in DeWalt hand tools in the US and positive growth in Europe. As far as the regions, Europe was up 3%, an especially encouraging performance and their best since the euro crisis began with share gains in a stabilizing economy and an especially strong performance in the UK. Emerging markets at plus 10% was strong but about 5 points of growth short of our expectation as slowing markets, credit issues, currency volatility and then channel congestion all took their toll.

North America was up 4% but could easily have been up an additional 2 points or so if inventory cautiousness at certain retailers and independence as a whole had not dampened shipments in September. All in all inventories at the larger retailers are in good shape with some dispersion across that universe. And POS in the aggregate at the large customers remains healthy. So it appears that the consumer demand in construction related activity have yet to be adversely affected by the US Government shutdown. So all in all, CDIY fared reasonably well in the quarter with somewhat less growth than expected due to the emerging market slowdown and late quarter caution in the US CDIY channels.

And now moving to industrial. Industrial too had a respectable quarter with 4% organic growth despite several headwinds and challenges. Operating margin at 14.5% was solid, down 90 basis points versus 3Q '12 driven primarily by organic growth investments and a slight mix down resulting from the addition of Infastech which remains on track. Revenues were $771 million, up 25%. And operating profit was $112 million up 18%. Infrastructure once again was the star of the quarter with 23% organic growth fueled by a 32% increase. As John mentioned in oil and gas, organic revenues in the high-margin onshore automatic welding activity drove the revenue growth in both the US and the rest of the world.

Industrial and auto repair delivered 2% growth in the face of several headwinds including a virtual no show for normal 3Q US Government spending as well as Europe being down in the mid-single digits as SAP was implemented there and their major industry trade show will occur in the fourth quarter this year versus the third quarter of last year. Without these two discontinuities, IAR Europe would have been modestly positive. Mac tools grew in the high single digits providing some offset. However, IAR's positive growth can be traced to the organic growth initiatives with emerging markets up 13% and smart tools and storage collectively contributing about 3 points of growth.

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Engineered fastening had what appeared to be an uncharacteristically weak organic growth performance being flat. However, underlying that story was a very difficult equipment sales comp from last year's third quarter, which resulted in equipment sales down 23%. And that was offset by fasteners up a more normal 6% organically about 2 X global light vehicle production. So the story for industrial this quarter was a solid performance in the face of several material, but mostly temporary, headwinds.

And now I will focus on security for a few minutes. Security is one of the drivers behind the recalibration of our outlook with a general theme of progress but not at the pace that was expected. However, there is a definite distinction between the North America/emerging markets piece and Security Europe. With the former showing good growth in OM rates nearing but not at normalized levels, and the latter taking more time to achieve desired growth, and thus profitability levels. I will delve into each one of these stories, but first a quick overview of the segment.

Revenues were $600 million, up 3%. Organic sales were up 1%. Operating profit was $73 million, down 22%. And the OM rate was 12.2% versus 16% a year ago. But importantly up sequentially from 10.5% in 2Q. And this represents 170 basis point improvement, which is moving in the right direction but just not at a fast enough pace. Now when we turn to the two pieces, starting with North America, you begin to see a reasonably positive story with the business returning to a healthier state. And there you can see 4% organic growth in North America/emerging markets and sequential rate improvement of 180 basis points from 13.3% to 15.1%. And without the investment in growth initiatives or adjusting for that, the operating margin rate would have been in the mid-16%s.

So the organic growth - pretty positive story there really resulting from several factors, some of which John touched on. The vertical market initiative definitely gaining traction particularly in healthcare education, also in financial services. The automatic doors business was robust with mid single-digit growth. We had strong product introductions across the businesses and a really outstanding ASIS show, which is the industry show in Chicago in September, where we showcase new products across the businesses, were very well received by our customers as well as our vertical solutions.

And as we mentioned earlier, the emerging markets are also contributing. So the sequential OM rate improvement on top of the growth is promising. Several key drivers for that, the vertical market mix as these systems are at above line average profitability, some improvements in field efficiency, not as much as we were looking for but definite improvements in efficiency in North America. And then the commercial lock transition in the mechanical access business now nine months into the transition entering a phase where the OM rates are now improving. So North America and emerging markets, about 60% of this segment is returning to a healthier state and will continue to make progress in 4Q and beyond.

And then when we focus on Europe, turning the page, the other 40% of the segment, we see a situation where organic growth is still elusive and negative, which in turn is slowing the sequential rate improvement and slowing our ability to get the operating margin rates back up into that zone that we're looking for. And the reality here is that the shortfalls in organic growth have gone beyond the two-year shortfalls that we were expecting when we closed Niscayah and they're now cutting into the margin rates. And we haven't had much help from the macro environment, although frankly we didn't expect much and it is stabilizing. But we are dealing with several structural issues. The first being historical over dependence on referrals from the mother Company, Securitas, that really referred a lot of business to Niscayah back in the days when they were affiliated. So we had to rebuild the sales force almost from scratch over the last two years.

And then we had in various countries weak legacy management that we had to undertake a significant Management replacements and changes. And then finally we had a legacy systems integration model mindset and business model at Niscayah versus a recurring revenue model which is what we're familiar with in North America. And then there is just the pace of change in Europe in general, which is a challenge. And so these are all significant challenges, some of which we expected some of which were deeper than expected. But we have a strong and capable Management team in place in our Brussels headquarters for Security Europe, and although the progress is slower than desired, real progress has been made.

As I mentioned the sales force rebuild is well underway. And the France and UK and even Southern Europe elements of this business are now performing quite well. And Nordics and Germany, Nordics being the largest region which fortunately for us are both in decent economic environments over there, are really more self-inflicted works in progress. And we just made a significant Management change, leadership change in the Nordics. And so most of the Management upgrades are complete at this point in time. And we're gradually moving the model now towards a recurring revenue base model. So we should continue to see progress here in Europe, but we are not going to over commit of the pace of change at this point.

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I will now turn it over to Don Allan who will cover the financial aspects of the quarter.

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

Thank you, Jim. So I'd like to start with a walk through of working capital and then move into cash flow. So our working capital performance was flat versus the prior year at 5.9 working capital turns, which was slightly off expectation. We expected to improve our working capital turns by about 4/10 of a turn in the third quarter of this year. Let me walk through a couple of the specific reasons for that variation. The first of which is that when you look at our receivables, or DSO, the expectation was is that we'd be closer to a flat performance versus the prior year. But given the timing of how the revenue occurred within the third quarter, it actually drove an increase in our DSO of about 5%. We view that as a temporary situation and don't see that as a major hurdle for our objectives related to working capital and cash flow for 2013.

Second area is inventory DSI, which was flat. We did expect our DSI actually to improve in the third quarter, but due to the lower organic revenue performance in certain businesses in the third quarter versus our expectation, it caused some inventory pressure in our supply chain. And then the fourth area is the payables, or DPO, which improved by 9% and this is an area that we continue to demonstrate improvement over the last several years. This is really where the impact of the Stanley Fulfillment System and the hard work of our supply chain teams continues to demonstrate the benefits that the Stanley Fulfillment System can have on working capital as we continue to accelerate our progress there. The end result was 5.9 working capital turns as I mentioned, which was about 4/10 below our expectation. The vast majority of that was a combination of inventory and receivables. Our expectation for the end of the year is that we will be closer to a flat performance versus 2012 at 7.5 working capital turns versus our original expectation, which was a modest improvement over 2012 and I'll walk through that in a little more detail on the next page. But our expectation is that we still believe with all the things that we're doing through the Stanley fulfillment system that we can continue to work our way towards our goal of 10 working capital turns.

So moving to free cash flow. You can see the significant impact of working capital in the third quarter which was a cash outflow of $244 million and year-to-date cash outflow of $372 million. The good news is the expectation is given the way that our fourth quarter works and the seasonality of several of our businesses, specifically the CDIY business, where a large portion of the revenue occurs in October and November, we believe given that that we can reverse the vast majority of this negative by the end of the year. However, instead of it being a slight modest positive versus our original expectation, we expect it to be flat or even a slight small negative at the end of the year. The reasons I walked through on the previous page.

The other area, other category made some modest improvement. If you remember back in July I talked about some negatives that occurred in other that were more timing issues. We saw some of that reverse itself in the third quarter and that trend will continue in the fourth quarter as that becomes more in line with our expectations by the end of the year.

So the question some of you might be asking is, what's the road map from where we are to $800 million in free cash flow? Well, if we start with our original expectation of $1 billion, back in July, there's really two drivers that reduce it to $800 million. The first is our working capital expectation has dropped by about $100 million. And you'll hear on the guidance section and right after this that our earnings expectation is $100 million lower as well. So those are the two main drivers versus prior guidance.

But where we are today at $150 million roughly of free cash flow, what is the path that gets us to $800 million? Well our fourth quarter would have approximately net income and D&A of about $310 million based on current outlook. The working capital reversal of roughly $372 million as you see up above. And then other continuing to improve by about $50 million. And then CapEx was about $80 million to $90 million would get you to roughly $800 million of free cash flow for the year, and that would be the road map to that expectation.

So with that, I'd like to turn to our revised outlook for 2013. Our current view of organic growth for the year is that we expect it to approximate 3%. We're at year to date through nine months at right around 3%, which means the fourth quarter is expected to be a similar number versus our prior expectation of 4% to 5%, and I'll walk through some of the details of that in a few minutes. What that means to our EPS is that combined with the security slower recovery we believe that EPS will $4.90 to $5 this year versus our previous expectation.

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So let's walk through some of the details of that. About half of the EPS reduction relates to a slower than expected pace of security margin improvement versus our expectation in July. Jim did a great job walking through the detail of that a few minutes ago, so I'm sure you can understand the aspects of that in more detail. The second portion of it is related to a reduced view of organic growth that I previously mentioned a few minutes ago of now 3% for the year. And there's really a couple drivers to that.

We believe that with the pressure that we're seeing in emerging markets, which is a slight temporary deceleration, we believe, associated with some of the macroeconomic environment pressures we're seeing in those geographies around the world, will contribute to this. And then, too, we really believe the US Government sequestration and shutdown has had a modest impact in Q3 on us and will have a slightly more significant impact on us in Q4. The good news is we believe these issues are temporary, that they're not issues that will carry over into 2014. But we cannot guarantee that at this point. So our view is to be prudent about where we are today and focus on what we can achieve through our growth initiatives and other organic initiatives across the Company.

The last thing I'd say is that partially offsetting this pressure is an improved tax rate. As you saw in the third quarter, we did have some accelerated tax credits as well as a shift in the distribution of our earnings across the world that allowed a lower tax rate. We expect that to carry through for the year and our tax rate will be 20% versus the 23% expectation in July.

The last thing I'd say associated with guidance is that when you think through where we were in July, we were at a situation where we felt we were beginning to accelerate in organic growth. As we closed Q2 we saw accelerating organic growth in many areas, emerging markets, the US and even Europe continuing to slightly improve. Our second quarter organic growth was 5%. Our second-half view was organic growth slightly above 6%. Now we see some deceleration with the second half being closer to 3% to 4% organic growth versus that 6% number.

The second area, which is a change, is really our slower recovery in Security. We believe we're doing all the right things in Security to get this business back to historical levels. But in the case of Europe, it's going to take a little longer than our original expectation, but we're hitting all the right areas to make sure we achieve that in 2014 and beyond.

There's a little bit of segment detail associated with our guidance to the right. I'll touch on a few things very briefly and then you can have a follow-up questions as you see appropriate. CDIY will still be a mid single-digit organic revenue performance for 2013 although slightly at the lower than original expectation due to the emerging market growth expectation being slightly muted. The modest OM rate increase is still expected to occur for the segment versus 2012.

Security's organic revenue is expected to be a modest decline versus 2012 and we'll continue to see modest growth in North America, which will be offset by the continued mid single-digit declines that we've been seeing in Europe. The operating margin rate will decrease year over year based on the information that Jim provided a few minutes ago. And then Industrial will continue to be a low to mid single-digit organic revenue growth expectation for 2013, slightly lower than our expectation in July due to the emerging market situation as well as the uncertain government situation here in the United States. And then the OM rate is expected to decrease slightly mainly due to the initial Infastech margins being slightly below line average as well as the impact of some of the growth investments.

The last thing I'd say on this page is that our view for 2014 is still being developed. But we still believe that many of the things that we're seeing here are temporary around the pressures in organic growth and that our long-term objective of 4% to 6% organic growth is achievable in 2014. Along with that, we believe that we can grow our EPS year over year 7% to 9% associated with that. Obviously those numbers are excluding charges.

So to summarize the presentation portion of the call this morning, we believe 2013 is continuing to demonstrate traction in organic growth even though we are seeing some pressures in certain areas that I just touched on. We continue to focus on the organic growth initiatives. They drove half of our 4% organic growth in the third quarter and we're definitely seeing the benefit of them. CDIY and industrial had a solid performance in the third quarter, we continue to see positive momentum in those businesses. We've recalibrated our Security margin performance. The expectation is below, or is below expectations but it's progressing. And we really believe that we will regain position in this business as being a revenue and earnings grower and a driver for our performance in 2014 and beyond.

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The emerging market macro environment is difficult and the US Government situation is creating some uncertainty for us, but we're still demonstrating solid organic growth even with that. Our 2013 outlook has been revised for the items that I mentioned and we remain focused on driving organic growth in our Company, the efficiencies across the Company, trying to maximize synergies and then allocating our capital in a way that provides excellent returns for our shareholders. So that concludes the presentation portion of the call and we'll move to Q&A.

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

Great, thanks, Don. Dawn, we can now open the call to Q&A, please.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session.

(Operator Instructions)

Jason Feldman, UBS.

Jason Feldman - *UBS - Analyst*

Last couple of years I know have certainly been challenging from a macro perspective and currency and a lot of acquisitions and divestitures, but when I look at your revised guidance for this year it's actually very similar to the initial guidance you gave for 2011 two years ago. When you look back over the last three years, what do you think over that period drove the shortfall versus your expectations? Do you see any kind of structural issue with the three segments that you have, was it execution, was it M&A or was it really just end markets and macro?

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

Jason, it's Don. When I look back at the last three years, there's things that have happened in that timeframe. And obviously we've had shifts in the portfolio, we sold businesses such as HHI, we've had acquisitions that have shaped shift the structure of the Company in that timeframe. In 2011, the performance my view is pretty solid and achieved our objectives for that year. In 2012, we had some dynamics in Europe that were difficult that hit every company, not just ours, in the second quarter and the third quarter of that year. And we think we responded accordingly with appropriate actions.

And then the acquisition of Niscayah has certainly had an impact on us here in 2013. And Jim walked through that in a lot of detail and we're responding accordingly to it. We feel like we've taken the actions to get the business back on track here in 2013 so it can get itself closer to historical levels as we enter 2014 and move further into 2014. But my view is there's not something structurally wrong with the portfolio of the Company or structurally wrong with other aspects of the Company. I think it's more due to the continued portfolio transformation of our Company and driving performance and trying to maximize shareholder value along the way.

Operator

Nigel Coe, Morgan Stanley.

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Nigel Coe - *Morgan Stanley - Analyst*

You're guiding for 2 or 3 points of sequential margin improvements at security in 3Q and you got within that range. And it sounds like you're implied guidance suggests there's no further improvement in 4Q. So can you confirm that? And give us some color in terms of what's changed in the last three months?

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

Yes, Nigel, it's John. I'll confirm there is no implied guidance despite your calculations for the fourth quarter. That being said, nothing has changed other than I think Jim did as detailed a job as could possibly be done on this call that we're pleased with the direction of Security. We are not pleased with the pace. I think the other very important point is the situations in the US and Europe are dramatically different. Europe, we are in the midst of meaningful organizational changes and those take time -- that does take time --to I'll say, put points on the board and have you realize the results. And as I think Jim pointed out pretty clearly, we've got a lot of things going on in the US on the mechanical side.

We've talked about our business model change which to distribution versus direct, which is going to help with volume. Short term have an impact on margins, I think that's quite clear. And on the convergence -- access is making great progress. And on the convergence side, we've also talked about the need to focus or refocus on more recurring revenue and less systems integration and installation which was I don't want to say a trap but which was a path we found ourselves going down that's not consistent with our long-term strategy. So a lot of things going on but there was no implied guidance in the fourth quarter as it relates to margins. My expectation is we'll continue to improve globally. The question is, at what pace?

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

Yes, the only thing I would do to clarify what Nigel said is that we certainly gave an indication of the sequential improvement back in July with the expectation in Q3 being a much higher number than what you said, Nigel, which was we expected it to improve about 300 to 350 basis points. And it improved 170, so about halfway there. And then by the fourth quarter get to historic -- closer to historical levels. So if there was a quote-unquote, implied guidance, that was really what it was.

Operator

Rich Kwas, Wells Fargo.

Rich Kwas - *Wells Fargo Securities - Analyst*

I know 2014's influx a bit, but when you look at that 7% to 9% EPS growth and you're saying 4% to 6% organic revenue growth, seems like you should be able to get much better leverage on that organic revenue growth than what you're implying in that EPS growth for 2014. What are the drivers of the deleveraging or the reduced leverage on the volume growth that could potentially occur next year? I'm just trying to square that.

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

I would say that, this is Jim, I would say that the single biggest aspect of that is a hedge because the Government is shut down, business confidence is shaky right now in the US. We don't know what the consumer's going to do, so we're putting 4% to 6% out there because the assumption is if the economy stays at the current level, then we should be able to generate 4% to 6%. If that 4% to 6% does not materialize, we still think that we're in a situation where we'll be able to generate some meaningful earnings growth in the range that Don mentioned. However, it will require some more cost cutting and perhaps some deferral of investments and that type of thing and we're just at an early stage here and we can't really determine what the external environments going to bring with it. So hold on for a couple months and come January we'll be talking about that in more detail.

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Hopefully the US Government will be back in business and business confidence and consumer confidence will be moving in the right direction again.

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

Yes. And I would add that we're really looking to give folks an indication that we saw the potential for growth next year, both top line and EPS growth. It wasn't necessarily to say that this is a locked in number and the view of exactly what it's going to be. But I think the way that Jim articulated it is an excellent summary.

Operator

Sam Darkatsh, Raymond James.

Sam Darkatsh - *Raymond James & Associates - Analyst*

I've covered Stanley for a long time and historically at least, there's been a clear pattern of any time there's been weakening business conditions and/or executional issues. You've also announced further restructuring actions in order to right size the organizational cost structure and offset the earnings shortfall in short order. And notably I'm not seeing that new restructuring announcement today which seems really curious given the scale of the current shortfall. So how should we read that as it really seems like it's a significant departure from historical Management actions at Stanley not to announce a restructuring at the same time where there's a material miss?

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

Sam, it's Don. The way I would respond to that is I certainly understand that perspective and I think we are very, as you know we're very active in managing our Company and responding quickly to situations. The current situation though, our view is that it is temporary to some extent we believe on organic growth. Now, we do have some situations related to Security that are taking a little longer for us to recover. But frankly we're taking all the restructuring actions we can take in our Security business to make sure that that gets back on track. And it would be difficult to do a lot more beyond what we've already done, especially given that we're talking about a European business where it takes time to do these types of restructurings and they can't be done overnight.

But going back to the organic growth point of view is we believe that we're seeing a bit of a deceleration as I mentioned here and it's not the right time to react by dramatic cost takeout. But to what Jim was saying earlier, if we get into 2014 and we start to see this trend continue because there's more issues related to the US Government or there's some other type of economic impact either associated with that or independent of that, then we will have to take those types of actions and I am convinced that we'll do that because this leadership team knows how to respond to those types of difficult situations.

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

And if you look at where we are in the cycle, reiterate Don's point about this, we think this is temporary. If you look at where we are in the cycle you have a construction market and resi, which is pretty hot here in the US. You have a non-resi market that looks like it's going to be pretty hot in 2014. You have Europe which is stabilizing, not out of the woods but certainly not a big negative like it has been from an economic point of view. And you have the emerging markets which are slower but still two to three X times the growth of the developed markets.

So when you look at the macro backdrop, you say well this is not a permanent problem, it's a bit of a deceleration right now. And particularly our emerging market activities performing in the low teens is pretty impressive. I think performance under these circumstances, our issue is that to sustain a mid-to-high teens performance in markets that are decelerating would only put us in a position where we'd be getting into a trap where the channels would get too full. So we're throttling back temporarily and next year we have a significant MPP (mid-price point) growth program

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that John referenced, that's going to help us in the emerging markets. So we look around and we say, the environment is not terribly negative right now. In fact there's more positives than negatives, therefore, we're cautiously optimistic that 2014 will be a good growth year.

There's no point in going and taking a business that has great organic growth momentum in general and going to take a hatchet out and take a big chunk of cost out because we're trying to make up for a couple of -- $0.50 of EPS this year. So that is the backdrop and as I said we'll have another look in early 2014 and we'll share with you our view. And we haven't lost our ability or our inclination to cut costs when the revenue isn't going to be there. But we think based on everything we see at this point, that the environment could be relatively favorable in 2014.

Operator

Mike Wood, Macquarie.

Mike Wood - *Macquarie Research Equities - Analyst*

It looks like in terms of the Security margins, without knowing how much you're spending in terms of the growth investments and the restructuring that you're doing with Niscayah, it's hard for us to model that out. But in a similar fashion in terms of getting to your growth investments targets, of the 35% gross margins and somewhat robust operating profits by 2015, can you provide us some more clarity in terms of what gets the gross margins up from where they are currently and what leads to that margin ramp over the next two years?

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

Yes, Mike. I would say -- well first of all the gross margins are not a major drag related to these initiatives here in 2013 and they won't be in 2014. The drag tends to be more at the operating margin rate level, which is where we're making the SG&A investments and the feet on the street in the emerging markets. Some of the enhanced resources and investments we made around vertical solutions and Security business here in North America, those are all SG&A related costs, so the drag is more at the operating margin rate level. Now as we get into 2014, we'll be embarking on our mid-price point product launch in the emerging markets, which our expectation is that'll be reasonably close to line average gross margins and should not be a drag in that area in 2014. So our view is that we continue to make these SG&A investments. It's more about a volume leverage, getting the volume up to the right level so the SG&A is giving -- investment we're making is giving us a return that's in excess of 15% OM.

Operator

David MacGregor, Longbow Research.

David MacGregor - *Longbow Research - Analyst*

Jim you talked about throttling back a little bit on the emerging markets business, you are at low teens now. Can you talk about the profitability as it stands today on the emerging markets business? You've talked in the past of it being 20% or better margins, I'm wondering how it shook out in the quarter and your thoughts for the next couple of quarters.

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

Well, there hasn't been any significant change in the profitability levels of emerging markets with the exception of the fact that the SG&A investments are a bit higher. So that's probably costing us 200 basis points of operating margin or something on that order. So instead of 20% we're probably closer to 17%, 18% but it's still above line average profitability.

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Operator

Stephen Kim, Barclays.

Stephen Kim - *Barclays Capital - Analyst*

I wanted to ask you a question about the Security business and in particular any lessons you think that are applicable as you look into future opportunities? You cited the fact that there were some sales relationships and maybe a sales force there that wasn't exactly up to your expectations in relationship to the parent Company that we're losing some of the reported results beyond your expectation. As you look in the rear view mirror and you try to assess the lessons you learned from this, and you apply that forward, what would you think you might do differently as you assess future M&A opportunities? Thank you.

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

Steve, great question. And maybe there's a spot for you on our Board of Directors because we've had the same conversation with them and I mean that very, very seriously. I'll give you the short answer and then I'll add some color, because I think it's a really, really important thing to understand. The answer is nothing. And the difference -- I would argue that Stanley Black & Decker has a core competency rapidly developing, if not already recognized, for acquiring, integrating, improving the performance of the business, and even in the past when it's been suggested we've acquired at a very high price, relative to our trading multiples within a year or two, it looked brilliant.

In the case of Niscayah there was one really, really important distinction. It was a contested publicly-traded company where the former parent tried to buy it. We had the opportunity to intervene as a white knight, for lack of better terminology. It was a business we knew strategically was a very important fit. We had tried to buy that business when it was part of Securitas. That being said, Jim, myself, the Security team did a lot of due diligence to the extent we could, three or four years prior. We had the opportunity. We did not have the opportunity to do the kind of due diligence that we do, so we hit the ground running day one where we know what the organization looks like, we know what the projections are, we're really comfortable with the synergies. We used our best estimates.

That being said, what did we get right and what did we miss? And I think you asked that. We knew that senior management was not there for the long haul because it was a newly traded, newly created public company. They had no desire to carry on and weren't a good fit with our organization and they left. We underestimated the degree to which the field sales organization and the field tech organization in both countries needed to be upgraded. That took some time. I think it's well in process. But as we've suggested earlier, we depleted some of our existing Security business's bench. And we've put some very capable resources, including Massimo Grassi, one of our most tested and proven European leaders, added him to our Security business team in an effort to drive the changes that needed to be made.

And I think the other thing Jim mentioned that we missed and I don't think without proper full due diligence in hindsight, with the value of 20/20 hindsight it's easy, but we underestimated the degree to which the Niscayah business depended on referrals from Securitas to maintain their install base, and as a consequence turn that into recurring revenue. So all those things that Jim touched on are real, we've sat back and asked ourselves the hard question, would we, could we have anticipated that ahead of time? And the honest answer is we think no.

To answer the last part of your question, were it to be a publicly-traded company and we were having the -- we had the opportunity to intervene because we've never made a hostile acquisition in our careers, it's not our style and it tends to not work out very well. We might try to ask more questions, do more research. But understand we had two weeks to mobilize to do this deal or not. I think two years from now, because we're asking ourselves the question now, would we have made the acquisition if we had it to do over again? The answer is absolutely yes. Are we enduring some short-term pain for long-term gain? The answer is yes. And it's a long answer to a simple question, but it's appropriate that we've had this question internally. And we've had the discussion with our Board and I think that that's exactly where we come out.

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

Yes, and I'll just add to it, that when we did this deal, we knew there were a lot of unknowns. And we knew the environment in Europe was uncertain although we were not in the midst of a euro crisis. And so we put pretty significant hedges in the plan. There was a $100 million revenue hedge as an example. We assumed we would lose $100 million of revenue. That would have been sufficient to cover the Securitas issues and some of the other things John was talking about but it wasn't sufficient to cover the euro crisis and that at the same time. So not a big enough hedge, a very large hedge. We outperformed the cost synergies and we continue to outperform the cost synergies on this deal as well and we knew that was a conservative estimate of the cost synergies that we undertook when we announced the deal. And the hedges just weren't big enough based on a combined euro crisis and some of the internal structural issues at the same time.

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

And last point, Steve, it relates to Sam Darkatsh's question on restructuring which I think Don answered quite well. We haven't forgotten how to do it. We do it when we need to. We've made over 50 acquisitions in the last 10 years. We haven't gotten them all perfect on day one. There are very few that after we've owned them for a reasonable period of time we haven't fixed them or figured out what's wrong with them and dramatically restructured them or changed them. And I personally am confident that we'll get there.

We'll get there with Niscayah. It's going to take longer for all the reasons you've identified. They're all completely accurate. They're all with the benefit of 20/20 hindsight and that's where we stand on it. And then I'm hoping within a year or so from now, we'll be able to say we told you so, you asked the right questions and we had the right programs in place. But spot on for now.

Operator

Peter Lisnic, Robert Baird.

Josh Chan - *Robert W. Baird & Co. - Analyst*

This is Josh Chan filling in for Pete. On the idea of possible deceleration I know Jim, you talked a little bit about some slowing in September in CDIY. I was wondering if September was a slow month in general across your different kind of businesses? I was wondering if you have any color on that?

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

Well, September was a slow month in industrial and automotive repair for sure with the Government basically shut down and there's usually a surge in September related to the Government spending and so forth that just didn't occur, so that was clear. We think that there was some inventory corrections as I mentioned at retail which was definitely a factor in CDIY. And then we also had the systems implementation in IAR as well as the Equip Auto Show the trade show which occur in the fourth quarter and not in the September as in the previous year. So these factors all contributed to a slow September. It was a very slow September in relation to what we expected and what we've been experiencing on a run rate basis. And that's why a fair amount of the deceleration is attributable to both the emerging market slowdown and the US Government issues that we have right now with respect to the budget funding levels.

Operator

Michael Rehaut, JPMorgan.

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Mike Rehaut - *JPMorgan Chase & Co. - Analyst*

Wanted to focus on North America also for a bit. If you could go into more detail with regards to I guess what you would call some of the areas that you're happy with and that you still expect some additional improvement in particularly in Security? You had mentioned on the -- where you still have room to go is on the field efficiency side for example. And also in the CDIY where you had mentioned the inventory reductions, if it's possible to give an additional clarity there? If you think that'll continue into the fourth quarter for example? Thanks.

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

I can't give too much clarity on the inventory reductions other than to say that I said there was some disparity across the population or the universe of these customers and we would never call out any one specifically. But what I will say is that there is a pattern where the retailers that are performing well are not necessarily adjusting inventories, their inventories are in pretty good shape. And the retailers that are struggling a bit are in a different place, so their inventories are getting a little bit out of line. On the average the inventories are in good shape so. But you do have a little bit of a dispersion across the universe.

And on Security, the third-quarter performance in terms of margin probably fell about 200 basis points or so short of where we had hoped it would be. And a good half of that is related to the field efficiency. So we did make improvements, but there definitely are some areas in the area of efficiency that are improving even as we speak on a month-to-month basis but just not improving at a fast enough rate and we have good visibility into that. And we should see some improvements continue into the fourth quarter on that front. And then in general what I'm very happy about in North America is the organic growth. We really haven't -- we made a lot, talked a lot about it but I defy anybody to go back and find out when the last time CSS organic growth was at that level in North America.

So we've been talking for a long, long time about Security ultimately becoming a growth engine, organic growth engine for the Company. The vertical market solutions is the way to do that. It's a terrific, terrific business because it has a defensible value proposition, it has above line average margins and you can grow it. It's not like the basic monitoring business which is the more you install, the lower your margins go until you get the recurring revenue built up. It doesn't have that dynamic, so it helps us deal with that. Very excited about the growth in North America Security.

Operator

Liam Burke, Janney Capital Markets.

Liam Burke - *Janney Capital Markets - Analyst*

You had engineered fastening, you had a tough comp in terms of the systems orders year over year. It did affect your operating margins for the quarter. Looking at current order rates, how do you see that business trending for the balance of the year and into 2014 both on the systems side and on the margins?

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

Well this is Don. The portion of the business that we're referring to was the legacy engineered fastening business which is tied more to light vehicle production globally. And as Jim mentioned, the fastener piece of the business essentially outperformed light vehicle production growth in the third quarter and then that over two to one has done that for quite some time. But we did in the third quarter last year have a significant set of equipment sales that occurred in our European business that was a difficult comp for them in the third quarter.

But our view going forward is that we believe that that performance versus light vehicle production will continue to be strong and healthy. And they've been very focused on gaining market share over -- well that's certainly part of their differentiation model over the long term, but in the last two years they've really been able to demonstrate that in the financials. And we believe they will be able to continue to do that at a significant

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pace. And when you look at the Infastech business, which is more significantly tied to the electronics industry, we believe that we're doing similar things there around differentiation that allows this business to continue to demonstrate mid single-digit growth going forward over the long term.

Operator

Dennis McGill, Zelman & Associates.

Dennis McGill - *Zelman & Associates - Analyst*

Jim, on the 2014 numbers on the puts and takes, I can appreciate risk from the Government side and the uncertainty, but I would think that would flow through the revenue outlook as well. But for a given 4% to 6% increase and realizing it will be anniversarying some of the brand investment or the strategic growth investments you'll have lapped a lot of the problems in Security it would seem like the incremental growth should be a lot stronger for that given level of 4% to 6%. So is there something else within the margin structure that would be offsets to that?

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

There's nothing structural at all. I think Don as you said earlier put that number -- those numbers out there because he wanted people to understand that we expect positive growth in 2014 no matter what in the environment looks like based on the Government shutdown, et cetera. So for you to conclude that if anything beyond that would be wrong, and the 4% to 6% growth is a number that as I said earlier I think we can make, if the economy is more of the same that we've had this year for the most part, and the organic growth initiatives will buttress that number up against a normalized economy that we're having this -- we had in the first half of this year and hopefully we'll have in 2014. So it's just as I said earlier, there's a pretty substantial hedge in that number. And if the volume doesn't come through, we still expect to be able to deliver growth of that magnitude at the earnings line.

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

Dennis, it's John. Let me add a little perspective that I think will help you, but Jim and Don described it perfectly accurately. It's available in the public domain, it's in our proxy. And a lot of it reflects on how we compensate in an effort to motivate our organization. And the overwhelming majority of the organization is compensated based on three metrics - organic growth, earnings and cash flow and/or working capital turns if you're in a business. And we want the organic growth number to be more of a stretch than the earnings number for all the reasons Jim and Don talked about.

But all three of those metrics are important. That's how we measure our people. That's how we measure ourselves. That's how we pay our people. But I think it's important to note that earnings per share or operating margin depend on where you sit in the Company. Cash flow and working capital turns are weighted slightly higher than the organic growth.

We've had a lot of conversations about that internally with our comp committee, with our folks and we think it's the right weighting. So don't jump to any conclusions based on that. But hopefully what I just walked you through will help you understand it.

Operator

Andy Noorigian, Vertical Research.

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Andy Noorigian - *Verical Research - Analyst*

Really quick, I think on the CDIY you mentioned emerging market channel congestion. I was wondering if you could elaborate on what exactly that was? And as you look to 2014 will the median price point rollout, are the channels all in place for that as you look out or is there more investment to be made there?

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

The channel congestion that I referred to simply relates to the fact that almost all business in the emerging markets is done through distribution, independent distribution. We have done a lot of developing distribution this year. And in doing so, we have sold a lot of tools to these distributors who are now in the process of marketing these tools to end users and we are in the process of creating end user pull and end user demand and it's a natural process that you go through when you develop distributors.

When you look at the markets, just to be clear, these markets are not growing at the pace that we're growing in the emerging markets. So our growth is coming from the development of distribution as well as share gains that are with the existing distributors. And so part of the deceleration is driving a slower growth outlook because we certainly are not going to fill the channels to the point where it becomes an issue for the end distributors from a liquidity perspective or just doesn't make business sense. So we're being prudent in not pushing too hard until the pull is sufficient at the end user level, so the channels are operating smoothly.

Operator

Thank you, that was our last question. I will now turn the call back to Greg Waybright for closing comments.

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

Dawn, thanks and we'd like to thank everyone again for calling in this morning. Please contact me if you have any further questions, and again, thanks for your participation.

Operator

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

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