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PRESENTATION

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

All right. Good afternoon, everybody. We're going to kick back off here with Stanley Black & Decker. Joining me on stage, I have Don Allan, President and CEO. Let's -- we're going to do a few slides here first, I think, Don will walk through, and then we'll jump into the Q&A.

So Don, just right before you jump in, as a reminder to everyone. If you have any questions about the research disclosures, please check the related website or reach out to your salesperson. With that, Don, I appreciate you joining us. Take it away.

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Thank you, Josh. Good afternoon, everybody. And so as Josh mentioned, I want to walk through 3 slides, and then we'll open it up to Q&A. So it'll probably take me 5, 7 minutes to get through this. But the theme for Stanley Black & Decker in the last 90 days has really been about how we streamline our company and focus on the great franchises that we have. We went through a process last year of determining that it was time to get back to being a building products company, tools and outdoor, and we have a nice industrial business that's in addition to that. But 90% of our company is in the tools and outdoor space.

And therefore, we've focused on the things that make this company great, which are great brands, great people and a great innovation machine. We're a company that will be approaching $20 billion in revenue, about $18 billion, $19 billion this year. And as a result, we feel like we have something here that's really special and unique. And you see some of the core capabilities of Stanley Black & Decker. Fantastic portfolio of iconic brands, powerful innovation machine, as I mentioned, very broad set of categories and channel coverage across the globe and in all the major geographies. And then we continue to want to leverage our operating model that we commonly refer to as Standard Fulfillment System 2.0, which, as you can see, is powered by the great people of the company and guided by our purpose for those who make the world.

But where we are today, given the massive wave of inflation, the supply chain challenges that we've experienced in the last 12 to 18 months, there are some significant changes that we need to make to Stanley Black & Decker that are well underway. And so I'll start with the right side of the page and focus on reallocation of cost of SG&A.

We are streamlining our corporate headquarters to be much closer to our business and running the day-to-day operations of our business. We're optimizing the organizational structure, looking at the spans and layers. You probably heard me say, if you follow our company in the last 60 to 90 days, that on average, we have 12 spans in our organization structure, from C-suite to point of impact. Typical company our size has 7 to 8. World-class has 5. So the first step is to get down to 7 and 8, and then span of control will increase from roughly 3 to 6 on average. That will make us a more agile, lean, flexible company that can make decisions quicker and move faster in response to what's happening in the world.

We'll also reduce our indirect spend, about $200 million dollars. And you see the total of that is $500 million of annualized initiatives. The vast majority of this will be complete by early October and then with the final phase of -- the tail end of this being done in the fourth quarter of 2022. This frees up money for us to invest in certain core parts of our company that include user activation, digital marketing, advertising and also a little bit of innovation, especially focused on innovation around the electrification initiative of our outdoor products of recent acquisitions of MTD and Excel.

At the same time, we need to be very focused on transforming our supply chain. Many of you have heard from us in the past that we got to get closer to our customers. Our supply chain is too long coming from Asia and the North American markets and European markets. If you want to have that type of supply chain, you need to have high levels of inventory to make sure you meet the needs of your customers. We think a better model is a mix of certain products that come from Asia, but are high-turning products with powerful brands like DEWALT and some of Craftsman are made in the United States and North America and other parts of the world. For DEWALT are made in Eastern Europe to feed the European market. This transformation, as you see the 4 different buckets, can drive $1.5 billion of value. Product platforming, which really reducing the complexity of our product families and our SKUs across our company to improve our manufacturing footprint and our supply chain.

Second area is really leveraging our sourcing. So as we reduce the complexity, how do we also reduce the number of suppliers even further than what we've done over the last 10 years to make ourselves even more efficient with our spend. Looking at facility consolidation, about 30% reduction in facilities across our footprint over the next 3 years. And then the last piece is really getting back to what we've known for, for a long time, which is operational excellence. How do we drive continual lean productivity across our footprint on an annual basis where we lost some of that opportunity during the pandemic as we tried to meet the higher levels of demand.

What's great about this program is it does a couple of things: one, it gives us a supply chain that can meet a high-growth opportunity, which we think this business can grow 2 to 3x market growth over the midterm and the long term; it also allows us to get us our gross margin back up to 35% or better in our tools business in particular, our outdoor business will take a little bit longer to get hit that objective; and it gives us the flexibility and agility to meet the needs of our customers in the various regions.

But it's not just about a cost reduction program. This is about reducing complexity by removing costs through a very systemic set of actions that allow us to be a company that optimizes our corporate structure, focuses on our operating model and getting closer to our customers and suppliers and being much more effective with them. And then transforming our supply chain, as I just mentioned.

We'll take a chunk of those savings, as I said, and we're going to invest in our core growth. We need to invest more in innovation on the electrification side, as you see as the second bullet. We also have some core innovation investments we want to make above and beyond our current investment level. Market leadership and more responsive supply chain. What market leadership means is more user activation at the front end of our business. More resources, more dollars, more digital marketing, et cetera.

And then, of course, we need to invest in our supply chain to really drive this transformation. This ultimately will enhance the shareholder value that's created by Stanley Black & Decker. We believe we can have a company that grows organically 2 to 3x the market. The market tends to be defined as GDP for an industry like ours. 35-plus percent gross margin, as I mentioned, by 2025. Getting back to being a strong free cash flow generator with 100% free cash flow conversion to net income, continuing to drive powerful innovation across this industry and Stanley Black & Decker.

And then, of course, making sure that we're continuing to improve our fill rates with our customers to drive an enhanced level of service and continue to drive more growth for them as well. We are now a more focused company, which is purpose-driven, that's delivering value to our shareholders, and we see a significant opportunity in front of us for the next 5 to 10 years. So with that, I'm going to pass it over to you, Josh, for the Q&A.

QUESTIONS AND ANSWERS

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

So maybe just to start off with the cost savings program and the supply chain version of -- because some of these pieces seem like there are things that have been kind of in your orbit for a while, they've been discussing. So I guess, first, like is there a part of this that was always the intent and is now at the forefront or is this more of a reaction to kind of the near-term softness in demand? I guess, so how much of this is sort of new versus trying to manage typical decremental margins?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I would say that when I look at the $1.5 billion, probably about half of it is things that we would have done anyway prior to the pandemic. The other half is new things addressing the complexity of our supply chain. We have a significant amount of SKUs. There's a large -- 20% of our SKUs generate 80% of our revenue. So the 80% of the other SKUs, we need to go through a very thorough process and decide whether all those SKUs are necessary to meet the needs of our end users and our customers. And we know there's a large portion that is not the case.

The second thing is we need to do a little more platforming across certain areas of power tools and outdoor where we use common components, semiconductors, et cetera, that are more common across the families versus the innovation machine over the last decade or so has created a lot of different nuances within a family of products. Those are the things that maybe were necessarily on our radar before the pandemic that, as we went through the last 2 years and saw the stress and the strain on the supply chain, I really became -- recognized that this needs to be addressed. And we're not trying to do something that's going to reduce our revenue. We're trying to really optimize the opportunity and optimize the service levels with our customers.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

So seeing sourcing is sort of a big number right now, at the same time, when a lot of folks are struggling with supply chain, it seemed sort of out of sync. Like how do you go about reducing your sourcing costs when literally getting anything is sort of tough these days? Like how challenging is that?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Well, I think if you think about what I'm referring to around SKU reduction and platforming, what that does allow you to do when you reduce that complexity in the product family and the SKUs, it allows you to better leverage your spend across a smaller group of suppliers. So we've done a good job for a long time of leveraging our spend, but there's another wave of opportunity here because of this complexity that we're trying to address. And that's the larger component of that sourcing benefit.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

And help me understand how near shoring and some of the other things you talked around about IoT feed into this. I think you guys talked about near-shoring before, certainly, before it was as topical as it was today and probably before it was cool. But it's also 3 or 4 years in process and still a big opportunity. Like does that sort of speak to how much time it takes to kind of duplicate these cost structures locally? Or within that, was there more of a change because of what the pandemic did?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

I would say that the Industry 4.0 opportunity continues to be quite significant, especially on the power tool and outdoor, handheld outdoor products in particular. I think also eventually, it will migrate into manufacturing for larger platform outdoor products, such as mowers as we start -- as we continue to electrify that particular space. The technology continues to evolve here where you've gone from a situation where if you did a power tool assembly in China or Mexico, you might have 50 to 75 people on the line.

The automated solution that we've created in North Carolina, current version has about 10 to 12 people on that line because of the high level of automation, and the 2.0 version looks like it's going to get down to 2 to 3 people on the line. The cost of that is almost equivalent to the cost of doing the old line in Mexico. And so -- and that's because you can leverage to a lot more product in that automated line, you can run it for 24/7 versus these other manual lines, you tend to have to do changeovers. And frankly, you're not always running them 24/7. And that's really where you get the leverage effect.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. And then, I guess, a similar question on the SG&A bucket. Portfolio composition looks a little bit different today than it did a few years ago. Some of this looks like just kind of managing down some of the stranded costs, which I don't want to say it's easy. But like it's sort of an opportunity like kind of in front of you versus needing to get hyper creative with it. Is that a decent part of the story there, just sort of the blocking and tackling of the new portfolio size?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I mean the SG&A, I mean, at corporate, we took out $200 million on an annualized basis because we focus on really simplifying what we're going to put our effort into. We were investing in certain things that were interesting but not necessarily driving core value in our business today. And so we've eliminated that. We've also looked at some of the midterm, long-term initiatives that were in place under the corporate umbrella and decided to either defer them or reduce them in some way, shape or form. And so that, to me, was although it's difficult because you're affecting people's jobs, but the actual decision-making process wasn't that complicated and was done in about 45 days.

The spans and layers exercise is a little more complicated because what you're doing is you're looking at your business organization structure and trying to reduce the layers and increase your span. So it's not overly complicated necessarily, but it takes you time to get through that exercise. So people understand the new ways of working. But the biggest thing you're trying to do is remove the bureaucratic steps that exists because you have a complicated organization structure, which slows you down, and therefore, by making these changes, it allows you to operate at a higher level of speed and intensity. So I don't think they're really, really difficult. It just takes some time to go through them.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. If I had to roll all this together, and we'll get into kind of how the market is influencing this in a second, but does that sort of mark margins as kind of a low watermark here and as these come through, they lift up? Or are there a lot of other kind of background considerations apart from the cost savings program that could kind of influence those more readily? I'm thinking like inflation being the big one.

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes, I would say that our gross margins right now in the back half of the year are being impacted by some pullback in production to kind of regulate our inventory levels for the next 6 to 12 months. That's about 300 to 400 basis points. So if you kind of add that back, our gross margins are sitting in the low 30s on a run rate basis.

Then you look at the transformational activities that gets you to 35%. There's a path to get to 35% by 2024. You might get there sooner if you get more deflation at a faster pace. But at this point, we haven't really factored that into our estimates. And then operating margin rate, I mean, I think we were always kind of focused on mid-teens. Our new model is going to be focused on making sure that we have gross margin rates around 35% or better. And we're going to be investing in our business in these areas that you see in the middle of the page, and we're going to continue to invest as we grow. And so our operating margin rate may end up being 13% or 12% versus 15% because of that. But if you're getting higher levels of growth organically, it's a model that makes a lot of sense, and it works and it creates a lot of shareholder value.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. Shifting over to the demand side. And I think during parts of 2Q, you were kind of back below pre-pandemic level in the tools business. Sort of update us, if you would, on where we're sitting today and I guess, like what we should be watching for, if we've kind of washed out a lot of the COVID bump already in terms of what are areas that could still be sensitive or maybe on the other side, trying to improve.

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I would say that if I think about the next 12 months, I mean, the consumer piece for us is a bubble, whatever you want to refer to it, has kind of washed out of our guidance for the remainder of the year into next year. And if you look at that business compared to '19 levels, it's probably actually slightly down from '19 levels on the consumer side.

On the pro side, the pro side continues to be strong, continues to grow. It's still up -- it's obviously up over '19, and it's been growing over the last 2 or 3 years. The strength is there. When you look at pro backlog for a construction worker, a general contractor or a builder, it's pretty healthy. And also when you look at companies that provide material to construction, whether that's lumber or windows or doors, whatever it might be, their backlogs are pretty big, and they tend to average 6 to 9 months. And so that feels like there's enough momentum to keep the pro going for a period of time here.

The question is when you get into '23, is there a bit of a pullback in the housing industry. Does it slow the construction market a little bit? I think most of us think there's going to be some type of modest pullback at this stage. I mean the housing industry and the construction market is healthy over the long term. It's healthy over the midterm. I mean we don't have an overbuilt situation like we had back in 2007, 2008, where the industry was overbuilt, and we had to have a massive correction.

What we have really going on in housing is the real estate values are probably overinflated because of what happened in the last 12 months. But the need for construction and need for new homes, new buildings, infrastructure of roads and bridges, I still see that need there. So I think it's going to be healthy and that doesn't mean there won't be a dip next year, but I don't think that's going to be a long-lived dip. And so companies like us that are tied to this industry in a major way are going to benefit from growth and improving margins because of that.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. And it sounds like you've kind of been in a more stable environment here, maybe the last 60, 90 days versus like the bigger surprises in 2Q, like not hearing them well, there's another leg down or anything like that?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

No, the POS continues to be kind of tracking to expectations this quarter at this stage. And September is always a big, big month because you're feeding in all the product to our customers for the upcoming holiday season, so is October. So there's a lot of shipping and activity that needs to happen in September. But so far, it's tracking with expectations.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

And how does Europe play into that? You guys have had some good success in Europe over the last -- really going on like a decade now in terms of outgrowth. But obviously, macro-wise it's a little more sensitive there. How does the push and pull of that work?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I would say Europe is -- we obviously had a step down in Europe in the second quarter. The inventory levels in some of our customers are a little higher than they would like. But so far here in the third quarter, things are kind of tracking to expectations. We're watching that region very closely, like probably most people are because of the shift of what's happening in the war in the Ukraine and Russia. And will Russia do some things that really jack up energy prices in the European region, which it feels like that will play out. And does that have an impact on our markets. It's certainly possible. But at this stage, we're not seeing anything that would indicate that's happening.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. And then you touched on a little bit of it in terms of the kind of the backlog positions and some shortage that we have in certain parts of the housing market or contractor bases. Is the contractor market shortage good for Stanley in that like there's not enough of them, but the number is going to go up, like people won't leave the industry and it's more people that need to buy tools over time. Like is that a place you'd rather be or is it really more about are we building more houses or not?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Well, I think the workforce related to that industry or our industry really took a big hit in the Great Recession, and it never recovered. And so people that had left the industry found other jobs, other things to do. It's slowly growing and the labor reports is slowly improving. I do think companies like us and other players in our space continue to invest in the trades to get more and more people into that labor force.

But the benefit of having the current labor force is if you have a recession, you're probably not going to lose a lot of those folks. They'll probably stick with it and ride through it, and it will probably be a relatively quick recovery. But I think we all believe anyone tied to housing would love to find more labor to get into the workforce because ultimately, you're going to want to convert them to your tools, your products, your innovation and your brand. And it's a way to continue to build out the organic growth machine.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Right. Just on market share. I mean you guys have a competitor that's pretty chirpy about what they think they're doing in the market. And I think from your perspective, it's more than like head continues to grow and there's kind of like a long tail of folks who are not there. But how do you see that really evolving? And like is it important to you to be in a leadership position in terms of growth in the industry or just be kind of better than average in terms of the growth rate? Like I guess it's sort of a question of is growth to KPI or ultimately like profit growth, which isn't necessarily the reflection of sales?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I think we want to go after as much organic growth as we can get, but at the right profit levels. And if our gross margins are 35% or better, then we're at the right profit level. And so that's what we're striving towards. 2 to 3x the market, which, depending on GDP, can be 7% to 9% or it could be better depending -- in a robust environment. I think that's a road map that makes a lot of sense for us.

We believe we have a very strong innovation machine, that we're a significant leader in many products in these different categories around innovation. We do think we need to invest more in the front end of the business, as I said, to stimulate more market share and more organic growth opportunities, and we will do that. You got 2 companies in this space that are kind of slugging it out as heavyweights. That's what it is right now. That's the way it's going to be. And we're going to keep -- both of us are probably going to keep aggressively going after share gains. And where it all ends up 5 years from now, I don't know.

But what I do know about Stanley Black & Decker is that we're going to go aggressively after this. We're going to focus on running our business, and we're growing it as fast as we can because we have amazing innovation, a great team, and we have great brands, and that allows us to do that. The other competitors outside the 2 of us, I don't know what's going to happen to them. We'll see how that plays out. But I'm not sure they have the same advantages that Stanley Black & Decker has.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

On the innovation front, is -- do you or does the market need sort of like another breakthrough like FLEXVOLT to really sort of get people's attention again? I know there's been kind of a steady stream since then, but that seemed like kind of more of a killer app maybe relative to kind of the few years on either side of it. Does that really drive activity or do the smaller line extensions or kind of other categories move the needle, too?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

You got to do both. I mean you got to be going after breakthrough solutions like FLEXVOLT, like DEWALT Atomic, DEWALT Extreme, DEWALT Power Stack. All those are great breakthrough technologies that you have to keep pushing more of that into the market. You also have to go hard and aggressive at your core incremental innovation, which is really looking at how you keep fundamentally improving your existing products with adding additional functionality.

And it may not -- the user may not appear to be a massive improvement as far as a breakthrough, but it makes their job more efficient as far as productivity or it reduces the wear and tear in the body with less vibration. Whatever it might be, you got to do both. And both those engines of innovation ultimately are the things that are going to drive strong share gain when you marry it with that user activation, digital marketing and advertising that I was referring to.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Shifting over to price/cost. I think since 2019, you've had like $2 billion of cost inflation and maybe it's even higher than that with some other like cost to serve type numbers. You're starting to see some commodities come down. I know not everything across the board and certainly things like labor or not. But how should I think about just where we are today? What sort of that pool of deflation could look like for you guys? And is that a net pool? Or is there still kind of other things that would offset that like a labor or other components?

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. I think what we've seen so far is that you've had 3 ways of inflation that hit us. The last one was when the war broke out in the Ukraine. And that was a substantial number. For a lot of the commodities since then, we've seen them pull back to levels before the war. So -- which means we still have high levels of commodity inflation, you just don't have that kind of third phase in the numbers right now, except for certain things like lithium as an example, which is still very high because the demand is very high.

So there is right now a net benefit that -- or net deflation that we're seeing. But at the same time, we've also backed off on the price increase that we originally were going to do in the beginning of the third quarter because of that shift in commodities that played out. Our last price increase was in May, May 1, and we were planning on doing one in July 1. With that last wave, we decided to pull back on that.

Our competitors are doing price increases in the market right now. Some of them are going in effect in October. When that's all said and done, we'll look at where everything shakes out, where their price points are versus our price points. And then we'll decide how we respond accordingly to that. But right now, there feels like there's good momentum on the deflationary side, but it's certainly still not -- there's still a lot of dollars to go at this point in time.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

But that is going to drop to the bottom line, like it doesn't get eaten up by...

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Later -- the next year, yes.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. Got it. We do have some time left and if there are any questions in the room.

Unidentified Analyst

So you talked a lot about share -- getting share and give us some sort of qualitative views on how you're going to go after that. When you think about the major home center footprint, I was just in one this past weekend. And it's very obvious. There's a lot of your competitor and not as many of your tools. And I would assume that going forward, that's going to be a renewed focus of yours. So I'm curious how you think about that, one; and number two, give us an answer in the context of the announcements you've made in terms of reducing SKUs, reducing labor and how do we foot that up with what seems to me based on just really observing this past weekend, it's going to take a pretty aggressive approach on your part to really get those aisles with an S, plural, back.

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Yes. So I would say there's -- each customer is different. So certainly, with one customer, we have a competitor that has a big presence in that -- those particular stores. We also have a nice presence in there, but we want to do more with them, and we're going to do more with them.

Other customers, you go in there, the vast majority of the product in there the Stanley Black & Decker product. So each customer is different depending on the dynamic. But I spent over the last 60 days, almost 90 days now, I've visited each one of our major customers at least once. We've talked about where we go from here. I want to be very aggressive with all of them to figure out what the opportunity is for DEWALT and the opportunity is for Craftsman. Those 2 brands have great deal of power to them. DEWALT is a global brand, Craftsman is more of a North American brand. There's more that we can do with our major customers. The interesting part of the conversations is they're ready to go. They want to do more. So now we just need to figure out how to do that. So yes, it will be a big part of what we do.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

I see we're at time. Don, Dennis, thank you for joining us here. Good to see you, as always, especially in person. Thanks for everybody for joining us on in the room and on the webcast.

Donald Allan - *Stanley Black & Decker, Inc. - President, CEO & Director*

Thank you, everyone. Have a good day.