OVERVIEW:

Co. reported 2Q22 revenues of $4.4b and adjusted EPS of $1.77. Expects 2022 total revenue growth to be in low double-digits, GAAP EPS to be $0.80-2.05 and adjusted EPS to be $5.00-6.00.
CORPORATE PARTICIPANTS

Corbin B. Walburger  Stanley Black & Decker, Inc. - VP of Business Development & Interim CFO
Dennis M. Lange  Stanley Black & Decker, Inc. - VP of IR
Donald Allan  Stanley Black & Decker, Inc. - President, CEO & Director

CONFERENCE CALL PARTICIPANTS

Jeffrey Todd Sprague  Vertical Research Partners, LLC - Founder & Managing Partner
Julian C.H. Mitchell  Barclays Bank PLC, Research Division - Research Analyst
Michael Jason Rehaut  JPMorgan Chase & Co, Research Division - Senior Analyst
Nigel Edward Coe  Wolfe Research, LLC - MD & Senior Research Analyst
Timothy Ronald Wojs  Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

PRESENTATION

Operator

Welcome to the Second Quarter 2022 Stanley Black & Decker, Inc. Earnings Conference Call. My name is Shannon, 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 the Vice President of Investor Relations, Dennis Lange. Mr. Lange, you may begin.

Dennis M. Lange  Stanley Black & Decker, Inc. - VP of IR

Thank you, Shannon. Good morning, everyone, and thanks for joining us for Stanley Black & Decker’s 2022 second quarter webcast. On the webcast, in addition to myself, is Don Allan, President and CEO; and Corbin Walburger, Vice President and Interim CFO. Our earnings release, which was issued earlier this morning, and a supplemental presentation, which we will refer to, are available on the IR section of our website. A replay of this morning’s webcast will also be available beginning at 11 a.m. today.

This morning, Don and Corbin will review our 2022 second quarter results and various other matters followed by a Q&A session. Consistent with prior calls, we will be sticking with just one question per caller.

And as we normally do, we will be making some forward-looking statements during the call based on our current views. 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 materially differ from any forward-looking statements that we may 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'll now turn the call over to our President and CEO, Don Allan.

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

Thank you, Dennis, and good morning, everyone. As you saw from this morning’s results, we continue to navigate a dynamic macro environment, including inflation, rising interest rates; and now late in the quarter, we started to see these factors impact retail customer demand across our global tools and outdoor markets. The significantly slower demand trends in June, combined with a very late start to the outdoor season due to weather, resulted in significant volume pressure versus expectations, and revenue landed well below our plan.
In response to the sudden shift in demand, we have taken immediate corrective cost actions, which are already in progress. We are now expecting demand to normalize closer to 2019 levels for the remainder of 2022. The organization is focused on taking the necessary steps to reduce inventory, generate cash flow and resize our cost base through corporate simplification, organizational optimization and supply chain transformation.

We will provide more detail on these areas later in our presentation, but we expect these initiatives can deliver pretax savings of $1 billion as well as a significant reduction in inventory beginning in the second half of 2022 and through the end of 2023.

Over the last 9 months, we’ve executed a number of acquisitions and divestitures that have successfully focused our company around our market-leading Tools & Outdoor businesses as well as our strongly positioned Industrial products business. As you saw last week, our Security and Access Technology transaction successfully closed, and we are using the $3.5 billion in cash, gross cash proceeds net of tax to fund the $2.3 billion share repurchase from earlier this year as well as to strengthen the balance sheet and reduce debt levels in the third quarter. We also expect our Oil & Gas divestiture to close within the third quarter. These transactions enable us to intensify our focus on operational efficiency within our remaining now simplified business portfolio.

We also must continue to advance our strong innovation agenda, pursue a faster path of electrification in outdoor and engineered fastening, while we drive further global market penetration along the way. We are redirecting resources within our Tools & Outdoor businesses to ensure we are extremely well positioned for strong, long-term growth, profitability expansion, consistent annual cash flow and improved shareholder returns.

Incorporating the changes from this new demand environment as well as factoring in the impact of our cost reduction plan caused us to revise our 2022 adjusted diluted EPS range down to $5 up to $6 and to update our free cash flow estimate to be $1 billion to $1.5 billion in the second half of ’22. This free cash flow range excludes the tax payments associated with our Security divestitures.

To summarize our second quarter, revenues were $4.4 billion, up 16%, driven by our outdoor equipment acquisition. Organic revenue was down 6%, which was impacted by slower Tools & Outdoor demand trends across many of our global markets due to poor weather start to the outdoor season and reduced consumer spending. Price realization contributed 7%, which accelerated sequentially from the first quarter.

Our total company operating margin was 9.2%, benefiting from the contribution of our pricing actions but was down versus prior year due to lower volume, cost inflation and supply chain logistic cost increases. This resulted in second quarter adjusted EPS of $1.77. More from Corbin on Q2 and 2022 guidance a bit later.

As I previously mentioned, we saw a swift deterioration in consumer tools and outdoor demand. This was in contrast to professional tool demand and the professional outdoor independent channel, which remained healthy and continue to be active opportunities. During this time frame, the consumer faced price increases across many categories, including essentials like food and energy. Consequently, our consumer categories have started to become impacted. We have seen this phenomenon across many of our global markets as central banks tighten the money supply to control high inflation.

The chart on the left illustrates our Tools U.S. POS trends against a 2019 base. Late in the quarter, it became clear that the point-of-sale trends were settling into a much lower growth position. And with information we have now, we believe it’s prudent to build this into our plan for the back half. Price in a strong professional market delivered total dollar growth off the 2019 baseline. However, volumes turned negative versus 2019 in the later part of the quarter or specifically in the month of June. We have analyzed the trends and the pricing in the market and do not see retail price gaps versus competition. This, coupled with our information at the category and retailer level leads us to conclude that our markets are softening.

Outdoor power equipment also experienced slowing demand during the month of June. Customer inventory levels are elevated, largely driven by a very slow start to the season due to poor weather, which clearly is impacting replenishment demand across the retail outdoor power equipment industry. The poor consumer outdoor season is a well-known fact in the industry initially due to poor weather start and then declining consumer spending due to inflationary pressures previously discussed.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. ‘Refinitiv’ and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.
However, there are a couple of significant positive factors to consider in this difficult demand environment. One, we will be past the constraints on semiconductor supply in the third quarter, and other inputs have greatly improved as well. Therefore, we are expecting better fill rates in the back half to capitalize on the continued strength we’re seeing for professional end-user-driven demand in tools and outdoor.

And two, the tools inventories at many of our major customers in North America are below 2019 levels, which should limit our destocking risk to customers in certain other geographies, such as Europe and as well as the U.S. outdoor retail category I mentioned. Across our industrial businesses, backlogs remain strong and demand for aerospace fasteners is steadily climbing as the recovery in narrow-body production has begun. The auto recovery continues to be choppy, but we do see some improvement and continue to outperform light vehicle production levels as demand of electric vehicles remains well above supply and OEMs continue to pursue strategic long-term transformation to EV-centric portfolios.

In summary, we see a demand environment that is modestly higher than 2019 levels, and therefore, we are implementing an aggressive cost and inventory response to this new environment while also pivoting the company to a new strategy for long-term success. We continue to have conviction in the long-term outlook of the markets we serve around construction, repair and remodel, outdoor and across the industrial sector. With the housing inventory at historical lows and relative strength in the industrial markets we serve, our businesses are squarely positioned to satisfy our customer demands after we navigate the current environment.

The portfolio transformation that we have orchestrated over the past 9 years is coming to conclusion, and we are setting up our core businesses to emerge even stronger on the other side of demand disruption. As we look ahead, Stanley Black & Decker is at an important point of inflection in our vision and strategy. We must ensure our customers and end users and their needs are where our energy and resources are fully focused. Our plan is to rapidly optimize our organizational structure to support our simplified company. We will take the complexity out of our businesses and the decision-making processes. Then we will invest to accelerate growth to enable us to grow organically 2 to 3x the market.

The operating environment clearly has dramatically changed in the last month, especially as we really evolved into the last stages of the quarter or June. Since accepting my current role, the leadership team and I have accelerated and intensified the organization and operational streamlining efforts. We are rallying the teams around a more focused portfolio and providing the businesses with the resources closer to the point of impact.

Our Tools, Outdoor, Industrial businesses are high-quality assets today, and we have the opportunity to improve them further through faster organic growth and significant operational enhancements to improve our margins. As we think about our leading franchises, the key areas of focus will be innovation, electrification, market leadership and supply chain transformation, with always keeping the customer and end user needs in our sights.

First, we are reimagining Tools & Outdoor innovation to create shorter innovation cycles and new technologies, so we can provide differentiated competitive offerings with speed to market. This includes introducing a high quality of new margin-accrative core innovations to the portfolio in addition to more big swing innovations that carry the same disruptive power of our successful franchise extensions such as FLEXVOLT, ATOMIC, XTREME and POWERSTACK.

Secondly, we are taking meaningful action to deliver innovation and electrification with power tools and outdoor power equipment as well as capitalizing on our partnerships with auto OEMs to leverage our highly engineered auto fastening solutions, the electric vehicle market as it rapidly expands. These are big opportunities for growth and margin expansion across the portfolio. We are accelerating our efforts in these areas as these trends are moving quickly, and we must maintain our market leadership position during this technology shift.

Next, we will step up our commercial support, bringing more digital tools to our commercial model and increasing sales leadership to directly engage with our customers and end users. These resources drive share gain and key information from our end users related to our products and potential new innovations. In addition, we will enhance our efforts in digital marketing around new innovation launches, promotions and other key end user interactions.

Finally, to enable this growth, we need to accelerate our supply chain transformation. One of many lessons from the pandemic is that complex and long supply chains are prone to disruption and in our specific case, are not matched well with the short-cycle nature of our businesses. So you have
a choice: maintain very high levels of inventory due to the long supply chain or have your supply chain closer to your customers, elevate your agility and resiliency to better serve those customers. We believe being closer to the customer is the right answer.

Organizationaly, we are working to ensure that I have the right people in the right roles to execute this vision. We have an accomplished leadership team supported by a diverse, extremely capable organization, which is comprised of Stanley Black & Decker veterans and supplemented by new talent with fresh perspectives and industry expertise. We continue to bring in new members of our leadership team to partner with our existing seasoned leaders. A few examples of this are: Robert Raff and John Wyatt are leading our Tool & Outdoor businesses; and Tamer Abuaita, sorry, Tamer, who joined us as our Chief Supply Chain Officer in January.

I am excited to see Robert rejoin the Tools business to lead the team with fresh energy and insight. He’s a veteran Tool executive who also led our Security business transformation. He knows the business, the team and our customers and will bring that perspective as he gets the Tool organization focused on our shared vision.

Tamer brings nearly 30 years of experience leading global transformations, expansions and post-acquisition integrations of supply chains for multibillion-dollar consumer goods organizations. He is ideally suited to lead the transformation of our supply chain.

All of these growth and supply chain investments are necessary to support higher growth and share gains with our target objective being 2 to 3x the market growth.

Now let’s get tactical. Let me describe our global cost reduction program, which has a savings potential of $150 million to $200 million in 2022, growing to $1 billion by the end of next year and totaling $2 billion within 3 years. These actions are necessary as we successfully navigate the current market environment but importantly, when the time is right, will give us the ability to further accelerate investment in the commercial programs I just outlined. Over the past 2 months, we have applied rigorous prioritization to eliminate and reduce overlapping capabilities and functions.

As a more straightforward company, we don’t need the same structure that was set up for a diversified industrial model. The corporate simplification is nearing completion, and it will generate $200 million of annualized savings. The resizing effort allows us to ensure our resources serve our core businesses and are closer to the point of impact with the customer and in our supply chain. As a result of these initiatives, we expect the 2023 corporate spending level will be below the 2019 spend.

To help us navigate today’s economic crosscurrents and in the spirit of simplification, we are also attacking indirect spend. We are prioritizing across all categories and cost centers to requalify what we will continue in the near term. We expect this exercise to generate an additional $200 million of annualized savings.

Next, we have an opportunity to improve the speed and agility of our operating and decision-making processes. We are doing this by reducing the complexity of how we are operating as an organization, including evaluating the number of layers in our structure from the C suite to the point of impact. To put this in perspective, we believe we can move from our current organizational structure, which has 12 layers, down closer to 7 to 8 layers. I believe that we function much better as a company when our leaders can come together quickly for prioritization and decision-making and results in us moving forward in a more agile manner.

Additionally, as we have gone deeper into our outdoor integration, we see opportunities for savings where there are synergies with our tools business. We are implementing the spans and layers and cost synergy exercises during Q3 and expect this effort to deliver an additional $100 million in annual savings.

Lastly, we are accelerating our supply chain transformation. We believe there is approximately $1.5 billion of P&L efficiencies that can be gained by this acceleration over the next 3 years with $500 million by the end of 2023. I will go into more detail on this value stream in just a moment. So to summarize, we believe this program can deliver cost savings of $150 million to $200 million in 2022, $1 billion by the end of 2023 and $2 billion within 3 years.
I will now delve a little bit deeper into the supply chain transformation, which is the largest driver of this global cost plan, particularly in the medium term. As mentioned, we are embarking on a 3-year journey that will completely reshape our supply chain. We will be focused on accelerating our Make Where We Sell strategy to be closer to our customers and more responsive to demand.

Our supply chain needs to be agile and adaptive with new product innovation. And therefore, as we ramp up our investments in innovation and expand the quantity of our new products we bring to market annually, we also need a supply chain that significantly reduces our innovation cycle time to launch new products much faster than today. This transformation is a key pillar of our strategy and a catalyst for returning our gross margins to 35% plus level. Our success with this transformation will build a more sustainable, agile and efficient supply chain that is resilient in an ever-changing and dynamic operating environment and further enable our advanced manufacturing technologies.

We’ll be focused around 4 value streams. First, product platforming shifts our optimization focus from cost to supply by leveraging product families designed around common building blocks. This shift enables us to standardize our components through platform solutions that create economies of scale with our key suppliers, which ultimately reduces the complexity in our product design and supply base. It also reduces time to market on innovation by leveraging common design. We also believe we can reduce the number of SKUs in our system by 40% plus. These programs collectively can deliver cost savings of approximately $300 million.

The next significant opportunity is strategic sourcing, which has a savings potential of $500 million. As we look to set up our supply base through our Make Where We Sell strategy, we have an opportunity to deepen our relationships with suppliers and help them optimize supply and efficiency. In addition, we have significant opportunities to leverage contract manufacturing in parts of our supply chain that can improve cost and speed to market. Finally, our simplification efforts within our first value stream, product platforming, also carries benefits here as we have less unique parts in sourcing complexity, which results in higher scale purchases.

Our current supply chain is a result of organic growth and additions through acquisitions. And while it has been optimized over the years, there is significant opportunity to reduce complexity, eliminate logistical inefficiencies, increase scale for our manufacturing and serve our customers better.

Currently, we have approximately 120 manufacturing facilities in our network. As we think about our supply chain in the future, we want to be closer to our customer and we want to do it at a lower cost. This means we need to simplify and consolidate our regional footprints around high-performing industry [core auto] technology-enabled sites. Our target is to reduce our operating footprint by at least 30% and optimize our distribution network, which can generate approximately $300 million in savings.

Lastly, we see an opportunity to capture $400 million through operational excellence. This is focused on driving incremental efficiencies across our facilities, leveraging the SBD operating model, having the right levels of inventory and streamlining the spans and layers within our operations organization to align around our core businesses.

These value streams total approximately $1.5 billion of our -- over 3 years with an opportunity for $500 million during the first 18 months of the program. Clearly, this represents a significant value creation opportunity. However, it also creates an opportunity to elevate the focus on our customers and end user needs.

Corbin will now take you through more detailed commentary on the second quarter results as well as what we believe this near-term demand environment means for the remainder of the year. Corbin?
As a result, U.S. retail point-of-sale demand softened during May and June. That said, our professional customer channels and products remain solid and outperformed our consumer-oriented offerings. On an organic basis, regional performances were flat in the emerging markets, down 10% in Europe and down 11% in North America.

Operating margin for the segment was 10.8%. Excluding acquisitions, margin was 1 point better at 11.8%, however, still below the 19.9% level from the same period last year as the benefit from our price actions was more than offset by inflation, higher supply chain costs and lower volume. Across channels, sales were down versus 2021 levels. However, against the pre-pandemic 2019 baseline, retail was up mid-single digits, and commercial and industrial was up low double digits.

Turning to the Tools & Outdoor SBUs. Power tools and hand tools declined organically by 6% and 8%, respectively, driven by the softening of retail demand and against a very strong period in the prior year. Operationally, the teams have been successful in alleviating our semiconductor supply constraints and are beginning to see semiconductor-driven fill rate improvements for the previously constrained products. The fill rates are on a path to return to targeted levels in the third quarter.

As we look forward, our investments in innovation, electrification and commercial resources will support the launch of new product introductions expected in the back half and into 2023. We're launching a series of new DEWALT cordless solutions continuing to electrify the professional job site. As we convert current product categories still relying largely on corded and gas-powered products to next-generation battery-powered tools, we will also pair these new products with the DEWALT POWERSTACK, our industry-leading battery technology that launched only 7 months ago.

Coming later this year is the world's first innovation, the new DEWALT Impact Connect, which consists of new accessories that attach to an Impact driver and will allow end users to effortlessly cut copper and PVC pipe up to 4x faster than standard hand tools. We'll also launch new category solutions for the trade users with our Craftsman and Stanley brands, expanding these 20-volt systems to more than 100 products by early 2023.

As we have throughout our history, we remain committed to serving the ongoing performance needs of the most demanding pro and trade users of the DEWALT, Stanley and Craftsman solutions. The Outdoor business declined 8% on a pro forma organic basis. This decline was driven by a very slow start to the season due to poor weather as well as softening consumer demand similar to many other discretionary retail categories. Due to the softer demand, our retailers are working down inventory and have eased replenishment at this point. Despite this season being slower than 2021, pro forma sales are still favorable as compared to 2019 levels, primarily driven by the secular gains we have experienced from electrification, which remains our focus going forward.

The Outdoor team continues to advance our platform integration efforts, and we're excited about the innovation, growth and synergy opportunities ahead. Stay tuned for the exciting launch of a host of new outdoor offerings, including innovations in handheld, walk-behind and ride-on equipment for the 2023 season.

Now shifting to Industrial. Segment revenue increased 8% versus last year as 8 points of price realization, coupled with 4 points of volume were partially offset by about a 4-point negative impact from currency. Operating margin was 9.3%, which compares to 10.5% in the second quarter of last year as the benefit of price realization was more than offset by commodity inflation.

Looking within the segment, Engineered Fastening organic revenues were up 7% as 7% general industrial fastener growth was accompanied by 4% growth in the auto fastener business, along with an acceleration for aerospace fasteners, which was up 36%. The auto fastener business continues to successfully operate in a dynamic environment and outpaced light vehicle production by 5 points.

Our industrial fastener business has a healthy backlog, which is up 18% versus last year. Aerospace fasteners delivered its fourth consecutive quarter of sequential revenue improvement. This business is focused on capturing the recovery in OEM production, which is underway.

Infrastructure organic revenues were up 26%, driven by 17% growth in attachment tools. Infrastructure backlog remained strong, up 44% versus last year, and the team continues to partner with suppliers to successfully fill booked orders.
Moving on to our aggressive plan to reduce inventory to generate strong cash flow in the second half. Our second quarter ending inventory balance was $6.6 billion, up approximately $400 million versus the first quarter and up versus historical levels of stock.

The main factors contributing to the increase versus prior years were an elevated level of in-process inventory as a result of the congested global supply chain, along with higher inflation, finished goods above current demand requirements and approximately $1 billion of additional inventory from the outdoor acquisitions.

We are implementing actions to significantly reduce working capital by $1 billion to $1.5 billion in the second half of 2022, primarily from inventory reductions. There are 5 parallel work streams already underway to enact a sequential inventory decline with a sense of urgency: First, production curtailments to slow finished goods manufacturing have already started; second, commercial teams are working on expediting sell-through of on-hand finished goods; third, safety stock levels are being reviewed and optimized; fourth, goods in transit are being actively addressed as we work to reduce lead times and slow production; and lastly, levels of raw material and WIP are being evaluated to meet current production requirements. This inventory reduction plan has P&L cost implications for the next few quarters but is necessary to realign our inventory to the current demand environment and meet our cash generation requirements.

Let’s transition to the next slide, where I’ll speak further about gross margin. Total company adjusted gross margin for the second quarter was approximately 28%, down 2 points from the prior 2 quarters and against the 36% we had in the prior year. The confluence of the elongated supply chain, inflation and easing consumer demand impacted gross margins, partially offset by the implementation of price increases.

Over the last 12 months, we’ve been responding to inflation with multiple rounds of price increases, which is reflected in our price performance over the last few quarters. At this stage, given the slowing demand environment and moderating spot commodity rates, we’re targeting surgical opportunities for price as opposed to additional broad-based global price increases.

The cumulative impacts of rising inflation and global supply chain costs and inefficiencies are now capitalized in inventory. While we believe we can optimize moving forward, these capitalized costs will be with us until our inventory returns to normalized levels.

In addition, there will be costs associated with plants running at curtailed levels while we destock. We expect the cost dynamic of this inventory normalization process to take 3 to 4 quarters with gross margins sequentially improving as we move into and through the first half of 2023. These are short-term but necessary impacts as we prioritize cash flow in this environment. To quantify this opportunity, we see 300 basis points of improvement potential once the destocking is complete.

We’re clearly not satisfied with 30% gross margins and have begun implementing the following actions to accelerate the pace and increase the magnitude of this improvement. First, we’re immediately attacking the fixed and semi-fixed costs across our manufacturing base, capturing the quick wins from the first phase of our supply chain transformation. Second, spot commodity prices have moderated from the peak levels in April. While this will take until 2023 to work its way into the P&L, we plan to aggressively go after savings to capture this opportunity.

In total, these 2 actions can accelerate the pace of margin improvement and enable us to achieve low 30s gross margins in the back half of next year. Our 3-year target is to get our gross margins back to 35% plus, and the $1.5 billion supply chain transformation that Don discussed is how we do it. So to summarize, prioritizing cash generation is the right decision for the company by curtailing our production plans and lowering our inventories to set ourselves up for a stronger 2023 and beyond.

Now let me pull all this together into what it means for 2022 guidance. We’re expecting total revenue growth to be in the low double digits. We’re updating our adjusted earnings per share to a range of $5 to $6. On a GAAP basis, we expect the earnings per share range to be $0.80 to $2.05, inclusive of onetime charges related to restructuring expenses, a voluntary retirement program, the Russian business closure and integration-related costs.

The current estimate for pretax charges in 2022 is approximately $760 million to $810 million. The change in pretax charges from April guidance primarily relate to a roughly $170 million noncash asset impairment charge related to the Oil & Gas divestiture and an estimate of $150 million to $200 million in restructuring to support our cost reduction plans.
On the right side of the slide, we've outlined the components of our adjusted EPS assumptions versus our prior estimate. The slowing consumer demand in Tools & Outdoor, along with moderated price expectations, contributes to lower revenues and reduces EPS by $4.25. Currency translation, below-the-line items and second quarter performance impact EPS by another $0.55. We expect the plant production curtailments to range from $0.50 to $0.70 of a reduction as we minimize fixed and semi-fixed cost during this period but do not completely avoid them. Then the 2022 benefit from the cost savings initiatives that we previously described adds $0.80 to $1.

I want to spend a moment to recap the drivers of our cost savings plan. Simplifying the corporate structure, reducing indirect spend, optimizing organizational spans and layers and streamlining the operational footprint are expected to total $100 million to $200 million in savings over the remainder of 2022 with cumulative savings of $1 billion by the end of 2023. We've also disclosed other below-the-line planning items for modeling purposes on the slide.

Turning to the segments. Tools & Outdoor organic revenue is expected to decline mid- to high single digits with margins down on a year-over-year basis. Pricing is expected to contribute high single-digit growth for the back half and full year. We believe there is a meaningful mid-term opportunity to improve margins within the Outdoor acquisitions over the coming years, and this continues to be a significant priority for us. We expect high single-digit margins this year, and we see the potential for low double-digit margins over the coming years.

We're targeting the Industrial segment to achieve high single-digit to low double-digit organic growth, driven by innovation, pricing and cyclical recoveries across much of the portfolio. The industrial margin rate is expected to be pressured year-over-year largely due to inflation and mix. We're closely following the recoveries in auto and aerospace and still believe there to be a solid growth outlook in those markets.

Shifting more specifically to the third quarter. We expect adjusted EPS will approximate 13% of the full year. This is comprised of relatively flat sequential tool sales, a slight sequential improvement for Industrial and a seasonally lighter Outdoor quarter as compared to the first half of the year.

Now turning to cash flow. Second half free cash flow, excluding the tax payments from the Security sale, is expected to approximate $1 billion to $1.5 billion, supported by our inventory and cost optimization actions. The divestiture-related tax payment is expected to approximate $500 million to $600 million; and therefore, total free cash flow is expected to be $400 million to $1 billion in the second half.

Stanley Black & Decker remains focused on disciplined capital allocation, and our current priority for excess capital deployment will be debt repayment to support our strong investment-grade credit ratings and our commitment to the continued return of value to our shareholders as reflected by the recently announced 55th consecutive annual dividend increase. After we strengthen the balance sheet and the macro improves, our plan for excess capital is to prioritize our share repurchase program. And I'm sure many of you are thinking about what the normalized earnings power is for the company. It will take until the first half of next year to work through our inventory destocking plans and fully implement and realize the benefits from our cost reduction actions. We believe the initiatives we've outlined today are sufficient to return to our 2019 earnings power on an annualized basis once we hit the second half of next year. This does not assume any improvements to revenue.

Here's how you get there. We believe destocking is a 3- to 4-quarter process that will improve our gross margins by approximately 3 points as we move into and through the front half of next year. Then the annualized benefit of our prioritization, complexity reduction efforts and impact from our indirect spend reductions are worth approximately $500 million by the end of 2023.

Finally, the supply chain transformation can add another 2 to 3 points to gross margins as those savings are realized. These are all items within our control, and if we were to achieve them at a faster pace or realize improvements from revenue or input pricing, we will be prepared to accelerate investment in our core businesses and capitalize on the growth opportunities that Don outlined.

With that, I will now turn the call back over to Don to conclude with a summary of our prepared remarks. Don?
Donald Allan - Stanley Black & Decker, Inc. - President, CEO & Director

Thank you, Corbin. There’s no doubt we are operating in one of the most challenging environments in recent history, which underscores the need to accelerate our strategic transformation that will carry the benefits of increasing agility and improving our responsiveness to customer demand. Our portfolio transformation comes at an ideal time as it enables us to unlock significant value by rapidly pivoting the organizational structure and operating plan towards a more focused company centered around great franchises within our Tools & Outdoor and Industrial businesses.

We have an aggressive cost program that we expect will yield $1 billion of savings by the end of next year and approaching a cumulative savings of $2 billion within 3 years. This will allow us to accelerate investments in our core businesses as the demand environment clears. As we look forward, we have a clear vision, and we believe these actions will reshape our organization and elevate our focus on our customer and end user needs, enabling us to deliver strong shareholder value through long-term growth and enhanced profitability.

With that, we are now ready for Q&A, Dennis.

Dennis M. Lange - Stanley Black & Decker, Inc. - VP of IR

Thanks, Don. Shannon, we can now open the call to Q&A, please. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jeff Sprague with Vertical Research Partners.

Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder & Managing Partner

I guess my one question would be picking up with where kind of Corbin closed back to the kind of earnings power question over time. I just want to clarify, really, how you’re defining earnings power relative to 2019. Obviously, we’ve got Outdoor in. We’ve got Security out. We’ve got a different share base. Are you suggesting that kind of earnings power is shown by EPS or some other metric is in line with 2019? So maybe just give us a little more color on that and how you see that trajectory play out through the quarters of 2023.

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

Yes. I’ll start and then pass it over to Corbin with a little more detail. But we -- obviously, we’ve utilized 2019 as a base to compare things to because it was pre-pandemic. And so before all the unusual activities of ‘20 and ‘21 of a recession in early ‘20 and then a boom for 3 or 4 quarters, and now things are starting to shift with potentially a significant recession on the horizon, the -- we believe that we are kind of normalizing back to 2019 levels as a result of what we’re seeing right now.

The earnings are not at that point yet, as you can see from the back half guidance we’re providing. But if you start to think through the cost actions we’re taking, some of the temporary pressures that we’re going to experience in the back half, as Corbin described, around inventory liquidation, you start to build a path that gets you closer and closer to what the 2019 EPS was, which was about $7.25 roughly.

Yes, very different comparable as far as Outdoor versus Security, but it does give you kind of a guideline of what we’re thinking about internally for kind of our initial objectives of where we want to take earnings. And then obviously, with a $2 billion plan over a 3-year period, if we have a stable environment from a revenue perspective over that 3-year period or a growth environment over that 3-year period, which I would expect would occur, you can see a path where earnings really start to improve in a more dramatic way as we get through ’23 and then into ’24. Corbin, any more color, details you like to give on that?
Corbin B. Walburger - Stanley Black & Decker, Inc. - VP of Business Development & Interim CFO

Yes, the only thing I would add is if you think about the second half of ’22 and then you annualize that, that gets you a little over $3. And then if you take the $1 billion of incremental cost in 2023, that gets you a little over $4. And so you get -- it’s another way to get back to what we did in 2019, the $3 plus $4, a little over $7 a share.

Operator

Our next question comes from Tim Wojs with Baird.

Timothy Ronald Wojs - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

I kind of have a two-parter, but I guess what gives you the confidence that this is really, I guess, a market phenomenon versus something that's more kind of Stanley specific? And as you're thinking about these cost reductions, can you just talk through how you're kind of protecting brand and R&D investments just to make sure there's no long-lasting impact on some of the brand values?

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

Thanks, Tim, for the question. The -- when I think about what's happening right now, I mean, there's a lot of information that we have, data we have around POS that's impacting, clearly, our business and our products. We also have conversations with many of our customers that we serve. We also have seen some recent earnings releases from other companies that are in spaces where we are as well as -- or close to that type of category in the building product space.

So I feel like when you triangulate all that information, it definitively says there's a slowing demand environment happening that is occurring. And so we also are looking at it. We've looked at all our pricing, as I mentioned, versus our competitors. And our price points are pretty much at par with all our competitor products in all the major key categories. So we don't see any big gaps where we have premiums that are significant versus our competition.

So it does not -- based on all that factor, it doesn't feel like there's anything unique that's happening related to Stanley Black & Decker that this is truly more of a market phenomenon that's playing out, which makes sense because a lot of the products that we're providing, there is some discretion associated with those products and certain buying decisions versus some of the other building products that are necessary to build a home. Whether that's lumber or whether that's insulation, windows, doors, there's still a fair amount of backlog that exists in the pro market.

And although we're starting to see signs that maybe that backlog is dwindling a little bit and the orders going in there are not as strong as they have been in the last year, however, there is a fair amount of backlog to continue probably a strong pro performance for another 6 to 9 months. But when you get to the discretionary decisions on tools, and some of the other categories that I mentioned, you can start to see where we begin -- begun the tip of a spear of a downturn, and that's really what I believe we're seeing right now.

On the cost side -- thank you for asking that question -- we've been very thoughtful about how we're going to do this. So the $2 billion, $1.5 billion will be very focused on supply chain transformation. I went through all the details of that. That's not touching brand. That's not touching engineers. That's not touching the sales organization. So that leaves you with the $500 million of SG&A. $200 million of that is the corporate simplification, where we're really just taking out a lot of the complexity of our corporate organization. We're no longer a diversified industrial company. We are primarily a tools and outdoor company with an excellent industrial business alongside of it as well.

Makes us a very simpler company, and we can be more streamlined, more efficient and effective. And then we have a significant indirect spend component, which is not people related. And then there is the, what I would call, the optimization of spans and layers, which is about $100 million.
And that really looking at that structure of how our business is organized and how many layers do we need, what’s the span of control and really trying to optimize that.

And that really, for the most part, will avoid the R&D organization, the sales organization, our digital marketing organization and really be more focused on the leadership team and the management of the businesses and also simplifying the processes that they utilize to make decisions throughout the day and the week as they drive the business. I feel pretty confident that we’re very much focused on making sure we do not impact the organizations that you mentioned.

**Operator**

Our next question comes from Nigel Coe with Wolfe Research.

**Nigel Edward Coe - Wolfe Research, LLC - MD & Senior Research Analyst**

I want to go back to '23. Obviously, '23 seems like a long way. But just going back to the comments, Corbin, you made about sort of getting back to a normalized earnings kind of number. And I think you said $6 to $7 when you layer in the cost savings initiatives and things like that. Number one, is that the right way to read that?

And then just around that sort of mathematics, are we seeing any benefit whatsoever from raw material deflation coming through? Obviously, your kind of input costs you laid out in April are well off those levels back in April. But is that part of your supply chain savings? And I’m assuming that the ‘23 buyback is off the table at this point. Just if you can hit that as well.

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

Yes. I would say that when we go through that -- those questions there, when you think -- why don’t we start with the buyback? We will get to the buyback as soon as we can. But as Corbin said, we are focused on inventory reduction, getting our cash flow performance to higher levels, fairly significant performance in the back half of this year as we both described. Another strong performance next year will be expected for cash flow, and we’ll be focused on that. We’ll also be focused on getting our debt levels down to where we want them to be, where we’ve had them historically related to debt-to-EBITDA ratios.

When we feel like we’re in a good position to do that, we will do the buyback. That could be in ’23 or it could be a little bit later. Time will tell. We’ll see how things play out. The -- Corbin, maybe you can take the question on the $6 to $7 in ‘23 and provide a little more granularity and clarification of that.

**Corbin B. Walburger - Stanley Black & Decker, Inc. - VP of Business Development & Interim CFO**

Yes, you bet, Nigel. The way that I was thinking about it was if you take the run rate for the second half of 2022, which is about $1.50, and you analyze that, that becomes about $3 on an annual basis of an EPS base. And then if you add the $4, which is the $800 million of additional cost savings we plan to get in 2023, that’s $4. So the $3 plus $4 gets you to $7, which is close to what the ’19 base is. Just another way to think about the 2019 being a baseline for earnings going forward.

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

Yes. And so the other part of Nigel’s question was about commodity trends. So yes, we had a high in the March, April time frame. We have seen commodities pull back significantly, except for lithium. Lithium is still holding in pretty strong because there’s still a high demand for batteries across many industries. But a lot of those spot prices have dropped back to levels that are closer to where they were at the beginning of the year.
And so we are aggressively pursuing that opportunity. It’s unlikely to have an impact on 2022 just because of where we are with inventory at this stage and trying to really liquidate a large portion of our inventory. But as we go into ‘23, we have not factored that into our transformation savings.

So that’s an opportunity that we want to pursue. If these spot levels are maintained where they are, that clearly could be a significant opportunity that would improve the performance that we’re talking about that could potentially play out for 2023. But as the year goes on and we get more progress in that area and we begin to see the impact of that in the later stages of ‘22 as we start to plan for ‘23, we’ll provide more color. But that is an opportunity that’s out there that we will be pursuing as it has really reached a level of significance from a spot rate differential versus where it was in April.

Operator

Our next question comes from Michael Rehaut with JPMorgan.

Michael Jason Rehaut - JPMorgan Chase & Co, Research Division - Senior Analyst

I guess I wanted to focus -- you had kind of alluded to your competitive positioning earlier, Don. And I know you’ve put a lot of thought and analysis into that. As you look into the back half, I think there was a part where you said you’re still considering surgical price increases. And I’m just kind of curious, as you look at how the retail sales backdrop is softening and given the level of competition that’s out there, what’s the ability to hold on to price in the current environment?

And as you look into ’23, you had mentioned that a lot of the cost savings don’t necessarily come at the expense of the front forwarding, the front-facing part of the business, so to speak. But to the extent that we are in this reverted or more normalized demand backdrop, which is much less than these past 18 months. How do you assess the need to perhaps invest more in the business and plow some of those cost savings back into the company, either through some targeted price reductions or areas of investment in terms of marketing or R&D.

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

Yes. I think, Michael, the -- it’s a good question. As you think about the dynamics, we’re navigating here. And I guess I’ll start with as -- we’ve done 3 rounds of price. I mentioned in my presentation that our price points are very consistent with our competitor price points in virtually every category. So we feel like the current price environment is a level playing field from that perspective.

The -- we did mention surgical price increases as an opportunity in the back half. But that is very modest. That’s not a large number we’re pursuing. Corbin also mentioned we’re not doing a round 4 price because of the dynamics we just described around commodity prices and slowing demand that’s playing out as well.

We also have to remember there was a big part of a front-end inflationary period last year where we didn’t have price recovery for the first 6 to 9 months in some cases of that cycle. And so as this -- as the tale of the cycle plays out, where we start to experience deflation, we tend to hold on to the price through the cycle as that tail plays out.

And then once we’re starting to capture significant benefits in our P&L from commodity deflation, we begin to look at where are our margins, where do we want our margins to go, where is the pricing versus the market, do we need to make some surgical changes based on that. And we have a very robust team and process that we’ve created over the last 2 years that is 100% dedicated to this work in this type of analysis that allows us to be very fluid and agile, but I always remind people of there’s a significant gap we had at the beginning of the cycle, where we had very little recovery of inflation versus price. And at the tail, there will be a period of time where we have the benefit of higher prices as commodity inflation is receding or we’re having deflation in this particular case.
That's the way it's historically paid out. It's most likely the way this is going to play out. That doesn't mean there won't be occasional surgical promotional things that happen versus those list prices to drive higher levels of volume or performance in certain categories. Those things will happen. But in a general playing field, that's likely how the price versus commodity deflation will play out over the next 12 to 18 months.

Operator

Our next question comes from Julian Mitchell with Barclays.

Julian C.H. Mitchell - Barclays Bank PLC, Research Division - Research Analyst

I suppose I just wanted to sort of circle back on to the margin outlook just to try and understand what sort of operating margin trajectory you're dialing in for the back half. Any major ramp-up in Q4 there? And also as we think about sort of early '23, which you've alluded to a few times, do we expect a sort of similar margin rate first half of next year to second half of this year? Just trying to get a bit more color around that and sort of the confidence that once those savings and cost actions are realized you can really retain those in your margins and not have to pass them on.

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

Yes. I'll start and then pass it over to Corbin for a little more detail. There's nothing unusual in the margins between the 2 quarters in the back half of this year. So there's no dramatically low number in Q3 and dramatically high number in Q4. They're relatively consistent overall for the company.

Corbin talked about what we expect to do with gross margins as a company as we go into next year and getting into the low 30s with a road map for the longer term of 35-plus percent. We believe that's a model that works very effectively for this portfolio of businesses and products. And that's something that if you look at history, you have a history that would demonstrate that. But really, the model that I described when I laid out kind of the strategy of where we need to go and the focus on investing in innovation, investing in commercial leadership, investing in our supply chain, et cetera, et cetera, all those different areas, that consistent investment model will allow for not only strong growth 2 to 3x the market growth but also allows for higher levels of profitability.

One of the benefits of having the pro market and the pro brand like DEWALT in particular, but some of our other niche brands such as Facom and Proto, our programs as well, obviously, on the Outdoor side, we've got some great brands with Hustler from the Excel acquisition, Cub Cadet, DEWALT as well in that category, those channels have and always have had high levels of profitability. And so that gives us confidence as well because we're looking to continue to shift, especially on the Outdoor side, more and more into the pro category where the higher levels of profitability are. But Corbin, maybe you give a little bit of color on...

Corbin B. Walburger - Stanley Black & Decker, Inc. - VP of Business Development & Interim CFO

Julian, the only thing else I would add is that if you think about going into 2023, the benefits that we'll start to see from a gross margin standpoint from the supply chain transformation and then from an SG&A standpoint, from the other cost reduction that we laid out, those will be pretty even throughout the course of 2023. So you'll start to see both gross margin and operating income margin slowly start to improve throughout the year.

Operator

Thank you. This concludes the question-and-answer session. I would now like to hand the conference back over to Dennis Lange for closing remarks.
Dennis M. Lange - Stanley Black & Decker, Inc. - VP of IR

Shannon, thanks. We'd like to thank everyone again for calling in this morning and for your participation on the call. Obviously, please contact me if you have any further questions. Thank you.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.