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PRESENTATION

Operator
Welcome to the Third Quarter 2022 Stanley Black & Decker 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 third quarter webcast. On the webcast, in addition to myself, Don Allan, President and CEO; and Corbin Walburger, Vice President and Interim CFO.

On our earnings release, which was issued earlier this morning and 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 third quarter results and various other matters followed by a Q&A session. Consistent with prior webcast, we are going to be sticking with just one question per caller. And as we normally do, we will be making some forward-looking statements during the call 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 the actual results may materially differ from any forward-looking statements that we might make today. We direct you to the cautionary statements in the 8-K that we filed with our press release and in our most recent ‘34 Act filing.

I’ll now turn the call over to our President and CEO, Don Allan.
Thank you, Dennis, and good morning, everyone. As you saw from today's release, we made tangible progress during the third quarter towards our strategy around focusing our business and transforming our supply chain. We are building positive momentum as we deliver improved customer fill rates, deployed a new organizational structure, implemented cost controls and actively reduced our inventories.

In addition, we made significant progress reducing debt, utilizing $3.3 billion in proceeds from our strategic divestitures. All key priorities, we set out heading into the third quarter.

All of this is not yet apparent in the financials, but we are encouraged by a few items. One, our headcount reductions are largely complete. Two, inventory is coming down. Three, cash generation was positive in September, and we believe this can continue in the fourth quarter and next year. And four, gross margin will be the last to turn as we face the high cost of destocking, but we expect to be through that and pivot to better performance by the middle of next year.

While the macroeconomic environment remains challenging, notably softer North America consumer and European markets, combined with stubborn cost inflation, there were relative bright spots with continued strength in professional construction and industrial customer demand as well as incremental progress unlocking global supply chain constraints. Our actions to alleviate semiconductor constraints are progressing as expected and are contributing to results through our improved fill rates as well as slightly better organic revenue performance in Q3.

Third quarter revenue was $4.1 billion, up 9%, driven by our Outdoor Equipment acquisitions. Organic revenue declined 2%, which was an improvement over what we delivered in the first half, due to increased professional power tool supply and a solid performance by the Industrial business as organic growth was up 14%.

Price realization sequentially improved to 8% versus the prior year. U.S. retail point of sale was relatively consistent with the levels we saw exiting 2Q, supported by price and professional demand, even as softer DIY consumer demand persisted.

Europe continues to operate in a challenging environment as a result of the broader macro, the war in the Ukraine as well as the continued impacts from customer destocking due to elevated channel inventories.

Our improved supply position has set us up for strong merchandising support for the holidays across all major brands and categories, with much of the product already shipped to our customers in September and October. We have gained back some key aisle end caps and off-shelf promotion areas after 12 months of limited promotional activity.

During the third quarter, we successfully delivered $65 million in pretax savings from our global cost initiatives and reduced our inventory by approximately $300 million. In a few moments, I will dive deeper into our progress related to the company’s transformation plan announced in Q2.

Operating margin was 6.2% in the third quarter pressured by input cost inflation, which was partially offset by customer price increases. Additionally, our margins were impacted from our inventory destock as well as the process of significantly reducing manufacturing production levels in June and during the third quarter. This resulted in third quarter adjusted EPS of $0.76.

The divestitures of Electronic Security, Access Technologies and Oil & Gas businesses were successfully completed in the third quarter, which further focuses Stanley Black & Decker's portfolio on our leading Tools & Outdoor and Industrial businesses. Proceeds from the transaction supported $3.3 billion of sequential debt reduction. These deals also conclude the strategic portfolio moves we’ve been executing over the last 12 months and further intensifies the operational execution focus of our company as we move forward.

In terms of financial guidance, because of the ongoing changes to the demand environment, the impact related to foreign exchange and incremental costs due to our more aggressive pullback on production to accelerate inventory destocking in the first half of 2023, we are revising our 2022 adjusted diluted EPS range down to $4.15 up to $4.65 and updating our free cash flow estimate to approximate $0.3 billion up to $0.6 billion for the fourth quarter, which includes a substantial tax payment related to the gains on the business sales I previously mentioned.
Our near-term priority is cash generation, and September marked a turning point with planned production curtailments beginning to meaningfully contribute to inventory reductions, supporting positive cash generation in the month. The decision to escalate and continue production curtailments in Q4 will clearly carry a negative P&L implication as we incur the impact of our underabsorption of fixed plant costs, while concurrently liquidating higher cost inventory from the balance sheet.

Although the immediate P&L impacts are significant and will be incurred in Q4 and likely in the early stages of 2023, we believe proactively reducing inventory in a disciplined yet swift manner is the right strategy and will put our business in a position to optimize growth and margin expansion going forward.

Now I’d like to review how we are moving forward to accelerate organic growth. We have optimized the corporate structure, focused our operating model and are transforming our supply chain to drive efficiency and fuel reinvestment. As we deploy our new organization structure and operating model, we are elevating 3 key priorities to sharpen our focus: one, end user obsession and innovation; two, customer focus; and three, delivering operational and functional excellence.

These are built upon the nonnegotiable priorities and values that make up our culture, such as people focus and talent management, health and safety, integrity, compliance, DE&I and ESG. In the next 3 years, we expect to redeploy $300 million to $500 million to advance innovation across our iconic brands, accelerate electrification in our Outdoor and Engineered Fastening businesses, rapidly accelerate our end-user market activation and create the supply chain of the future.

These investments will position the company for strong, sustainable, long-term growth, profitability, consistent free cash flow generation and shareholder return. We have a strong track record as the industry leader in breakthrough, world’s first innovations in our businesses. From FLEXVOLT to ATOMIC and XTREME to POWERSTACK, we will build upon this strength to deliver an even higher quality of core and breakthrough innovations with shorter development cycles and new technologies.

Electrification is a key growth driver across our Tools & Outdoor and Engineered Fastening businesses. We plan to make incremental investments to accelerate our efforts, capitalize on share gain opportunities and fortify our market leadership position as the technology continues to shift and adoption accelerates.

Market leadership includes more user activation at the front end of our businesses. As we introduce our new products and innovation, we will bring more digital tools and capabilities as well as additional commercial resources to engage directly with our customers, enhance interactions with our end users and drive market share gains.

Lastly, to fully leverage these investments, we need to have a world-class and more agile supply chain that brings us closer to our customers, increases our flexibility in response to demand and enhances our customer service levels, all to drive greater growth for us and for our customers.

Aligned with these growth investments and as we execute this strategy, we will be focused on a few key success criteria. One, our powerful innovation engine will position us to grow organic revenue 2 to 3x the market over the long term. Two, our supply chain transformation is a key enabler to improve our customer service levels and operational efficiency to return gross margins back to the 35% plus level with customer fill rates greater than 95%. Three, we have a long track record of generating strong free cash flow, and we’ll continue to target 100% free cash flow conversion to net income over the long term while ensuring consistent annual performance.

We are now a more focused company, executing a clear strategy with both immediate and near-term tactical actions to deliver strong value for our shareholders over the long term. Key to our success is and will continue to be market-leading innovation, and I will now highlight a few exciting new launches on the next slide.

As the world’s largest tool and outdoor company, we are continuing to push the bounds of our category offerings to serve the full spectrum of our makers and creators, from the DIY consumer to trade users and up to the most demanding pro. We are expanding DEWALT POWERSTACK with the launch of a new 5-amp hour battery. This is the most powerful, longest-lasting 20-volt MAX battery in its class and is compatible with our 300-tool strong DEWALT 20-volt system. POWERSTACK is the first pouch cell technology battery of its kind designed to deliver unparalleled power density...
to best serve our most demanding professional customers, and is expected to deliver over $100 million of revenue in its first 12 months since launch. Today, the 5-amp hour product is already in the European market and has received great reviews by our customers.

We’re also continuing to advance our high-power DEWALT FLEXVOLT line. By the end of this year, the portfolio will reach 60 products across power tools and outdoor power equipment, generating approximately $500 million of annual revenue and continuing to grow, approaching nearly 70 products by the end of 2023. The DEWALT FLEXVOLT 15 Amp-hour battery was introduced last year as a world’s first innovation. DEWALT FLEXVOLT converts users who are using corded, small-gas engine or pneumatic tools due to a high power need, and they convert them over to battery power. And it is one reason why 3/4 of the DEWALT power tool revenue is cordless today.

Our FLEXVOLT technology is also advancing innovation and sustainability across our industrial business, where customers desire to replace existing hydraulic tools with cordless solutions to increase portability and efficiency. To that end, the Stanley infrastructure team recently launched the first cordless automatic rail maintenance tool, the RD60 rail drill, which is powered by DEWALT FLEXVOLT.

These are just a few subset of examples where we are continuing to deliver industry-leading innovations to push the bounds of our categories and accelerate our success.

Another key enabler to our strategy is generating cost savings by taking the complexity out of our businesses while investing to accelerate our organic growth, recovering gross margins and generating consistent strong free cash flow. From an SG&A perspective, we are executing on our plan to rapidly optimize our organizational structure to become flatter and more agile. The new structure is largely complete, including a leaner corporate team. These actions will generate the $300 million of annualized cost savings as targeted.

Rigor around indirect spend is in place. Initial savings of $40 million were realized in Q3, and we are on pace to deliver approximately $200 million by the end of next year. As we shared with many of you, we moved quickly to deploy this new structure, so the organization can focus on its priorities and execution. We remain on track to deliver the cumulative savings of $500 million we set out to achieve last quarter, covering the simplification of the corporate structure, the reduction of indirect spend and the streamlining of spans and layers, all by the end of 2023.

Pivoting to supply chain, we also activated this transformation with a sense of urgency. Detailed planning and, in some cases, project execution is underway across all 4 pillars of the strategy.

I will now cover some noteworthy progress in the quarter. Regarding the SKU rationalization, we have approved and initiated action on approximately 50,000 SKUs, which represents roughly half of the targeted reduction. We expect the remaining SKU reductions to occur from now through the end of 2023.

Second, within the strategic sourcing initiatives, we are activating quick wins that are already generating savings. In tandem, we are defining the wave 1 implementation plan for 2023, which covers about 1/3 of the addressable spend.

Lastly, we are being thoughtful as we progress the facility consolidation and distribution optimization to ensure we plan effectively for successful execution with our teams and for our customers, even as we work with speed. We have completed the feasibility analysis and are now finalizing detailed planning, with implementation targeted to begin in 2023. Additionally, we expect to take initial actions to begin the optimization of our distribution network in the fourth quarter.

We have gained some significant early traction and are on pace to deliver the savings targeted for 2022, and we’ll continue to build momentum as we enter 2023.

I will now pass it to Corbin, who will take you through more detailed commentary on the third quarter performance, including gross margin and inventory levels as well as the latest guidance on how we expect to close out 2022.
Thank you, Don, and good morning, everyone. Let me walk through the details of our third quarter business segment performance.

Beginning with Tools & Outdoor, revenue grew 10% to $3.5 billion as the MTD and Excel outdoor acquisitions contributed nearly $600 million of revenue or approximately 18% growth, and price realization contributed 7%. These factors were partially offset by a 12% decline in volume and a negative 3% impact from currency.

On an organic basis, we were down low single digits in emerging markets in North America and down 12% in Europe. U.S. retail point-of-sale was supported by professional demand and remained consistent with levels exiting the second quarter of 2022. Aggregate weeks of inventory in these channels remain below 2019 levels. The European results were impacted by retail market pressure due to high levels of customer inventory and inflation as recessionary concerns and the war in Ukraine continue to weigh on consumer spending, particularly in the Northern region.

Adjusted operating margin for the segment was 6.8%. Excluding charges and acquisitions, margin was 140 basis points better at 8.2%, however, still below the 15.5% level from the same period last year as the benefit from price realization was more than offset by commodity inflation, higher supply chain costs, production curtailment costs and lower volume. Consistent with normal seasonality, the MTD and Excel outdoor businesses deliver only about 40% of full year volume in the back half at operating margin, substantially below the annual average as margins in the first half of the year are typically bolstered by peak outdoor seasonal volume leverage.

Across the North American channels, organic sales in retail and e-commerce were down versus 2021 levels with moderate strength in Commercial and Industrial. However, as compared to a pre-pandemic 2019 baseline, organic sales performance was up double digits across these channels.

Turning to the strategic business units within our Tools & Outdoor segment. Power Tools declined organically by 2%. This modest decline reflects an improvement versus the front half performance as we’re seeing better semiconductor supply, which helped to raise customer fill rates and contributed to positive organic growth in North America. Looking ahead, we expect further progress in the fourth quarter and are serving a normalized merchandising and promotional schedule for our professional products with our customers.

Hand tools declined organically by 7%, driven by retail consumer demand softness in European customer destock. These factors were partially offset by strength among professional-oriented customers in the U.S. commercial and industrial channels as well as successful new product launches in our CRAFTSMAN plastic storage. The Outdoor business declined 12% on a pro forma organic basis. Total revenue was impacted by moderated consumer demand like many other discretionary retail categories and lower orders as our retailers are also working down inventory.

The outdoor team is progressing on our platform integration initiatives, and we have a host of new outdoor innovations across our brands and categories in the pipeline to be launched for the 2023 season.

Now shifting to Industrial, which had a great quarter, leveraging the cyclical recovery with 14% organic growth and margin expansion back to the double digits. Segment revenue increased 5% versus last year as 9 points of price realization, coupled with 5 points of volume, were partially offset by 6 points from currency headwinds and 3 points from the Oil & Gas divestiture, which closed in August. The team leveraged this growth and our price increases to overcome commodity inflation and deliver adjusted operating margin of 11.1%, up sequentially 180 basis points and up 340 basis points versus last year.

Looking within the segment, Engineered Fastening organic revenues were up 15%, led by aerospace growth of 28%, auto growth of 22% and 4% growth in general industrial fasteners. The auto fasteners business continues to navigate a dynamic supply environment for our customers and is also leveraging tailwinds related to the recovery in auto manufacturing. Our industrial fastener business is continuing to outperform the industrial production index and is maintaining a healthy backlog, which is up 7% versus last year.

Aerospace fasteners delivered its fifth consecutive quarter of sequential revenue improvement. This business continues to focus on capturing the emerging recoveries in both narrow-body and wide-body OEM production.
Infrastructure organic revenues were up 12%, driven by 19% growth in attachment tools, which was partially offset by the Oil & Gas divestiture in the latter half of the quarter. Orders from our dealer channel partners are beginning to slow, yet our backlog remains robust and year-to-date OEM orders are up versus last year.

I’ll now spend a few moments covering our gross margin and inventory performance and expectations. Third quarter gross margins continued to be pressured by several points as we navigated the impacts from inflation and temporary impacts from under-absorption of fixed costs related to our planned production curtailments. This is a strategic choice as we prioritize cash flow generation through inventory reductions. We’re making progress with our inventory reductions, which totaled nearly $300 million in the third quarter. We expect to make further progress in the fourth quarter, which will translate into positive cash flow. While these curtailments put temporary pressure on our margins, they are necessary as we get our days of inventory back closer to historical levels.

With this goal in mind, we made the strategic choice to extend our planned production curtailments versus our original plan to ensure we make continued progress through the middle of next year. Back in July, we assumed our production levels will begin to normalize at year-end. However, we’re now planning to maintain low production levels through the first quarter of 2023. This puts additional pressure on our gross margins and depresses payables for the near term, with the trade-off and capturing a cash generation opportunity as inventory continues to decline. These items also impact our total cash generation forecast for 2022 as we incorporate assumptions for lower working capital reductions, including the previously mentioned impact of payables and a lower earnings base.

However, the cash flow generation for the company is gaining momentum. We generated positive free cash flow in the month of September, and we believe this will continue for the fourth quarter. Our capital deployment priority is debt reduction as we look to get to our targeted 2x debt-to-EBITDA level. In the third quarter, we reduced debt by approximately $3.3 billion, utilizing the cash from our divestitures. We expect to achieve further reductions to our debt levels as we generate cash flow in the fourth quarter and in 2023.

Turning to gross margins. We believe that this quarter and the first quarter of 2023 should represent the trough as production curtailments and higher cost inventory liquidations are most impactful over the next 6 months, pressuring margins to the low 20s. The destock impact is expected to alleviate beginning in the second quarter of 2023, with gross margins recovering into the high 20s before any of the benefits from our supply chain transformation.

As you heard from Don, we expect that the supply chain transformation savings will start to accrue as we move through the year and build to approximately $500 million by the end of 2023, which will provide further support for the improved gross margins into the 30s on the journey towards 35% plus gross margins in 2025. We believe our focus on inventory reduction, cash generation and balance sheet health are prudent as we work in parallel on structural supply chain savings to improve our gross margins in 2023 and beyond.

I’ll now walk through what this means for our 2022 guidance. For full year 2022, we expect low double-digit total revenue growth for the company. We’re updating our adjusted earnings per share full year guidance to a range of $4.15 to $4.65. On a GAAP basis, we expect the earnings per share range to be $0.10 to $0.80, inclusive of onetime charges. The current estimate for pretax charges in 2022 is approximately $755 million to $795 million.

On the right side of the slide, we’ve outlined the key assumption changes to our adjusted EPS versus our prior estimate. Lower fourth quarter revenue, primarily driven by European retail market pressure due to high levels of customer inventory and inflation, reduces EPS by $0.30. Foreign currency translation pressure further reduces EPS by $0.23. Our strategic choice to prioritize inventory reduction and free cash flow generation is accompanied by higher production curtailment costs and inventory de-stocking costs, which are estimated to be $0.82 of a reduction. Then the 2022 tax impact from lower earnings is expected to increase EPS by $0.25, bringing the revised midpoint to $4.40.

We’re continuing to expect $150 million to $200 million of gross savings to be achieved in 2022 from our transformation programs, of which $65 million was realized in the third quarter. We have also disclosed other below-the-line planning items for modeling purposes on the slide.
Turning to the segments. Tools & Outdoor is expected to realize a mid- to high single-digit organic revenue decline. Margins continue to be down versus prior year as a result of inflation, acquisition mix and volume deleverage. We are continuing to focus on the outdoor acquisition synergy realization as a lever to improve margins within this business unit over the coming years.

The Industrial segment organic revenue growth expectation remains unchanged at high single to low double digits. The industrial margin rate is expected to continue to improve sequentially. However, it will be pressured year-over-year largely due to inflation and mix.

Turning to cash flow. The fourth quarter free cash flow is expected to approximate $300 million to $600 million, which will support our strong commitment and track record for returning value to our shareholders via cash dividends as well as further debt reduction. As we look into 2023, we’ve positioned the company with $1 billion of annualized cost savings, which Don covered earlier. We’re also aggressively working to capture the opportunities of recent spot market pullbacks on many of our commodities, such as metals and resins, transportation as well as others. These input savings could benefit us next year after our planned destocking. We believe we are taking the appropriate actions, which are in our control, to position the company to navigate a variety of demand environments and contribute to gross margin accretion. Once our visibility improves, we will also invest for share gain by advancing our innovation, electrification and end-user activation.

With that, I will now turn the call back over to Don to conclude with a summary of our prepared remarks.

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

Thank you, Corbin. So in summary, a lot of progress was made in our first 90 days, and these benefits will become even more apparent within the financials in the coming quarters.

Our headcount reductions are largely complete. Inventory is now coming down. Cash generation was positive in September, and we believe this will continue in the fourth quarter and next year. Gross margin will be the last to turn as we face the high cost of destocking, but we expect to be through that and pivot to better performance by the middle of next year. And we will continue to focus on debt reduction, further strengthening the balance sheet, all as we continue our commitment to return value to our shareholders through cash dividends.

As we move forward, we have a clear strategy, vision and execution plan. And we are laser-focused on optimizing what is within our control. The macroeconomic environment will definitely continue to be choppy, and 2023 will clearly bring new challenges. However, we believe our actions to reshape, focus and streamline our organization as well as reinvest in our core businesses will enable us to deliver strong shareholder value over the long term via robust organic growth and enhanced profitability.

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

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

Okay. Thanks. Shannon, we can now open the call to Q&A, please.
Julian C.H. Mitchell - Barclays Bank PLC, Research Division - Research Analyst

For my question, I'd just like to circle back to Slide 9, which was very helpful, and completely agree with the effort to get cash flow up even if it means near-term earnings are down. But I guess 2 related questions on that. One is the free cash flow was still negative $500 million in Q3. You've got the plus $400 million to $500 million in Q4. So really just trying to test the conviction in that tailwind on free cash given it was, I think, worse than expected in the third quarter.

And then secondly, when you look at that gross margin chart sort of bottoming in Q1 next year, just wondered what you're assuming for the macro on that point, because I guess the risk would be that as you keep trying to lower inventories, the macro rolls and they stay kind of stubbornly high. So extra on the production is needed. So just trying to test sort of what are you assuming on the macro on the pro channel for early next year when looking at that gross margin recovery slope.

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

Thank you, Julian, for the question, and so we'll give you a little more color in response to that. But as I think through the -- you're right with your opening comment. This is really a heavy focus on cash flow right now, and I was very pleased to see that we generated some solid cash flow in the month of September. Our conviction related to the fourth quarter is very strong. I feel like that we've done all the right things to ensure that our inventory continues to go down.

We took additional steps in the third quarter to lower production even further, which is obviously having a bigger impact on Q4 versus Q3. We made that decision as we started to get a little more insight into what we needed to produce in the first half of next year, what the inventory levels were going to be. And we looked at a variety of different scenarios: growth scenarios, flat scenarios and declining scenarios. And we utilized all those scenarios to help what we feel is the best decision we can make related to production at this stage. The chart is a depiction at a high level of what we believe the gross margin rates will be when you blend all those different scenarios together and you look at all the possible outcomes.

Could there be a scenario where we have a deeper decline in revenue when we have to pull back production even further? Yes, that could play out over 2023, but we'll see how that -- we'll see how things evolve as we get deeper into the end of this year into early next year.

The focus for us, though, continues to be, as I mentioned at the start of this commentary, our top priority is cash flow. We believe there's $1.5 billion of inventory that still needs to be liquidated. You could look at history and even say that number might be as high as $2 billion. So it's somewhere in that range of $1.5 billion to $2 billion. We are going to aggressively pursue that. There will be some pain to our margins in the short term as we go through this transition, and the pain might be even a little more challenging if we see further top line deterioration in 2023. That being said, it is the absolute right thing to do, and I think we all agree with that.

The second thing is we need to really aggressively pursue, and we have been pursuing what's happening with commodity deflation and freight deflation. We see that as a big opportunity to potentially offset maybe some of these pressures we might see in a declining revenue environment in that particular situation. But either way, we need to pursue those as opportunities because they are becoming significant. You have declines since April in commodity prices at 30%, 40%, even 50% in some cases. And there's an opportunity that we have been actively pursuing for the last several months that we will continue to pursue. And yes, it will not hit our P&L until the later stages of 2023 post the liquidation of a large chunk of this inventory, but we have to make that come to life. That's another -- that's a lever that can help us maybe offset some of the pressure we might see at the top line if that does play out.

And the third thing I'd say is we have a robust supply chain transformation plan that will create $1.5 billion of value, as we both mentioned in our opening commentary over the next 3 years. That is significant. We see opportunities within product platforming, strategic sourcing, facility consolidation and then operational excellence that are significant that add up to that opportunity. And we will begin to achieve some of those benefits in 2023 and then further enhance those benefits in 2024. All those levers are there and available for us to pursue to ensure that we have healthy cash flow in 2023, and we continue to make progress in the back half of the year in improving our gross margin rate.
Operator

Our next question comes from the line of Tim Wojs with Baird.

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

Maybe if you could just talk a little bit, Don, about some of the improvements in some of the market-facing metrics that you kind of talked about on the call in terms of where are fill rates today versus where they might have been kind of early part of this year and what the progress on that looks like. And then just as you're talking with your customers, how are they kind of thinking about promotional activity and pricing as you move into '23?

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

Yes. Thanks, Tim, for that question. Yes, I'm really pleased with the team's progress in fill rates over the last 90 days. It's not 95% or above, so we still have more opportunity in front of us. But depending on the product category, we've made anywhere from 300 basis point improvement to 600 basis point improvement in the last 90 days. And so that's a great accomplishment by the team in a very short period of time.

Now a large part of it is triggered by the supply constraint that we were dealing with in semiconductors that now is pretty much behind us at this stage. And therefore, we feel like we can really focus on making sure that we're meeting the demand that our customers have.

Another metric that we've looked at is what is the on-shelf percentage of all our products within our major customers. And those numbers are actually very good, 95-plus percent when you look at our products on the shelves. Those products are on the shelves. We have very little out-of-stock situations at this point in time.

The third thing that I looked at is we actually did a really sizable promotion set of shipments to many customers in September and here in the month of October. A substantial amount of promotional activity is something that we haven't seen in well over a year, and so we're very pleased to be able to get back kind of at the end cap, get into some of the off-shelf areas within our major customers and begin to really drive some of that promotional activity and share gain in those particular circumstances.

So all 3 of those things are what we're looking at to really say, hey, we're making progress and we're getting back to a nice mix of core business and promotional activity, which is really what makes the Tools and the Outdoor business successful over the mid-term and the long term.

As far as 2023, at this point, our customers are very excited about the upcoming year and the opportunities they see. They still believe that professional will continue to be strong. As I mentioned earlier, we are preparing a variety of different scenarios that could be a healthy environment or could be a significant decline that we have to manage through. And so therefore, we think given the amount of inventory we have, we have the ability to meet the needs of the customers, both core and promotional activities. And hence, why we continue to cut back production to ensure that we do actually lower our levels of inventory over the next 12 months.

Operator

Our next question comes from the line of Nigel Coe with Wolfe Research.

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

So Don, a question on inventory, you might be shocked by that. So obviously, no surprise, but I'm just wondering if maybe you could quantify the actual -- you've called out the $0.82 of incremental production penalty to the guide, but where does that stand for the full year? I mean how much are you absorbing maybe on an annualized basis so we can try and gauge the opportunity when inventory does eventually normalize?
And then secondly, just kind of second part of that question is, you talked about promotional activity, which obviously is top part of the business, but do you have to promote and discount to shift that inventory over the next couple of quarters?

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

Yes. Thanks, Nigel. Yes, I would say that we've seen obviously a pretty significant impact on our margin this year due to basically heavy pullback in production. And we've done it probably almost -- we had to make 3 to 4 different adjustments as the year has gone on. As we got into late May and June, we had to make an adjustment based on what we're seeing with the slower consumer demand. We did it again in the early July time frame to prepare for our back half. And then we did -- we're doing it again here in the late stages of third quarter into the fourth quarter for the early part of next year.

So the impact to the P&L is probably around $400 million. It's a pretty substantial number for us in 2022. So that would equate to well over $2 of EPS, probably higher than that given our tax rate is very low. So it's substantial. And so that, in my view, obviously, is a temporary situation that we have to navigate through and really figure out what that impact would be as things start to come back in a positive way. What was the second question, Nigel?

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

Discounting.

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

Discounting, yes, on the inventory. So right now, I think we're being very balanced in our approach on how we liquidate inventory. We're looking at promotional activities. We're looking at alternative channels. The interesting part of the situation is that this is not old inventory. This is inventory that's been created in the last 15 to 18 months. That is very healthy inventory that we should be able to sell at reasonable price points.

The question is time, how long do we want to take for the liquidation to occur? So I think we're going to strike the right balance between pursuing promotional discount activities and really just pursuing it more through normal core activity at normal price points.

Operator

Our next question comes from the line of Nicole DeBlase with Deutsche Bank.

Nicole Sheree DeBlase - Deutsche Bank AG, Research Division - Director & Lead Analyst

Just maybe we could talk a little bit about pricing. I think that's also an important variable as we all kind of think through the puts and takes for 2023. So with demand now moving into negative territory and now that we're seeing some refreshing declines in commodity prices, what's the conviction that you guys can stick the price increases that you've taken so far? And maybe what is your view of what's going on from a competitive perspective as well?

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

Yes. I think when I look -- when I think about this situation, it obviously is something that's very unusual. We can't go back in time and look at anything in Stanley Black & Decker and say we had a period of time where we had 10% to 12% price increases. That just hasn't been part of any history here within the company, at least recent history. And so therefore, you have to look at it a little bit differently.
That being said, we all have to remember there's been a period of time leading up to this where we had no price increase of any substance, and we were incurring substantial impact in our P&L from the inflation back in 2021. And so we can't forget that. We have to recognize that that's the dynamic that we went through.

And then when the tail end of this happens and we're recovering the commodity deflation that we're now experiencing, which actually won't hit our P&L until the later stages of 2023, we have to be vigilant with the price increases and recognize that, just because the commodity indices have changed, it does not mean we can lower our prices, because we have the high-cost inventory in our system that has to flow through and be sold to our customers and eventually the end users over some period of time, which is probably at least 9 to 12 months at a minimum.

And therefore, I think the tail, we will continue to be disciplined about this. We always are looking at what's happening with our competitors in the market. At this stage, we feel like our price points are very consistent with their price points across virtually every category. So we don't see anything unusual happening there. And we do know there are some competitors that are still putting some price increases into the market even today. So there's going to be a tail here that we're going to have to navigate through. I believe the impact of deflation and what happens with price over the next 2 years will still be a substantial positive for Stanley Black & Decker's P&L.

Operator

Our next question comes from the line of Chris Snyder with UBS.

Christopher M. Snyder - UBS Investment Bank, Research Division - Analyst

So I just wanted to ask more about the decision to have higher production curtailments versus what the company expected 3 months ago, because back half demand is trending as expected versus the July update. So does this reflect a softer outlook on demand into 2023 or just more urgency around bringing working capital down and generating cash, maybe after that working capital winds down that the company expected in the September quarter?

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

Thank you. Maybe, Corbin, you can provide that because I gave some color to that question.

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

Yes. No, I don't think that our --- our view in North America is pretty consistent as we -- we're seeing levels of demand that were consistent with how we exited the second quarter. Obviously, we're seeing weaker demand in Europe. But the production curtailments are really, to your point, about generating cash, and that's really what's been driving it. So that, as Don said, we've been through 3 or 4 of these. And as we look at the desire to get the inventory out, there are a few ways to do it. But the quickest way for us was to reduce our production, which we've done throughout the last 3 or 4 months.

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

Yes. I think I'll just add to that, that when I made some comments in response to the first question, we have looked at a variety of different scenarios. And one of the scenarios is a continued retraction of demand as the housing market continues to slow, and potentially construction slows down for a period of time. And therefore, we're factoring that into our decision as well. So it's a combination of what Corbin said, but it's also looking at what we think are potential scenarios for next year and being thoughtful about what our production should be today.

We have to remember that our supply chain is fairly lengthy. So things that we're producing today, we're selling -- something we produce this month, we're probably selling in the month of March and April of next year. And so that's really the decision we're making. And we're trying to
strike the right balance and reducing the inventory, as Corbin was describing, and being as proactive and aggressive about that to continue to drive a healthy cash flow performance going forward. And then two, making sure we meet the needs of our customers and not have a retraction in our fill rates. And I think based on the decision we've made around production, we are striking the proper balance in that particular area.

Operator

Our next question comes from the line of Michael Rehaut with JPMorgan.

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

So just wanted to try and get a sense -- obviously, a lot of near-term disruption. And just trying to -- I guess, in 2 ways, number one, kind of zero in on the next couple of quarters, I guess, 4Q, for example, is going to be low single-digit margins in Tools & Storage. How much of that margin level is what you’d consider to be relatively temporary, primarily, I think, driven by the inventory reductions? And how much is kind of a reset versus expectations 90 days ago?

And I guess, ultimately, where I'm going with this is, I think in your most -- in Slide 9, you're talking about a high 20s gross margin by the end of the year. Potentially, it could -- the opportunity for low 30s, but it does look like that's a little bit of a reset versus also 90 days ago. And what type of headwinds are you seeing today compared to getting to -- I believe, you kind of threw out like that $7 per share run rate by the end of 2023. It looks like there's a few more moving pieces or headwinds that might take that number down by $1 or $2 even.

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

Well, so I'll -- there was a lot in that, Michael. So I'll start with the first question you had around fourth quarter margins and how much they may be being impacted by these pullback in production decisions. The impact in the fourth quarter is about 5 points or 500 basis points. So that's substantial, clearly.

So we're also dealing with the last stages or the middle stages of the high-cost inventory from the big inflation wage that we've had that are in our inventory now, and that we're starting to sell that through. So that's another factor that that's pushing down margins that will take time to work through. Because even when you get 90% or 100% price recovery when you go to these actions, you still have an impact in your margin rate that's substantial. And in this case, the differential in our margin rate is about 300 basis points just from the difference of inflation, dollar and price dollar, because it's not a one-for-one offset. The only way you're going to offset it completely in your margin rate is going to be if you get like 120%, 130% recovery on inflation through price.

And so you got a bit of a double impact that's impacting the margins right now in Q4. And so I think that's something that we just have to be thoughtful about as we analyze the view of Q4.

We're not going to give a ton of color on 2023. What we're trying to do is help people understand that there's a path to get our gross margins back to the high 20s and eventually to 35-plus percent. The path is really about eliminating some of these temporary things, because these things are temporary in the sense of pulling back on production will eventually get back to a more normal level of production because we're going through a period of time that's whatever this recession is going to be and how long it's going to last. But if you just kind of put that in the rearview mirror and focus post the recession, we are going to be back to normal levels of production. We're going to have transformed our supply chain. We will have pursued all the commodity deflation that's out there. And yes, could there be a partial price offset to that? Yes, there could be. But at the end of the day, all these different things are going to have -- these are levers that drive our margin back to those levels.

As far as what we guided back in July, what we're doing now has nothing to do with guidance in July. We have a new view on 2023, and so we're adjusting our manufacturing on that. I talked about the different scenarios we looked at as a result of that. We're getting closer to 2023, so it gives us the opportunity to adjust our manufacturing at this point. And then we also want to be more aggressive and focus on generating more cash flow and reduce our inventory in the short and mid-term. And that's really what's driving the temporary impact to our gross margins.
I understand nobody likes the gross margins where they are. I don't like them where they are either. But I feel like we're pulling all the right levers that are in our control that are going to get our gross margins back to where they need to be. But it's going to be a multiyear period of time for that to happen.

**Operator**

Our next question comes from the line of Adam Baumgarten with Zelman & Associates.

**Adam Michael Baumgarten** - Zelman & Associates LLC - MD

I'm just wondering if you could run through some of the point-of-sale trends that you saw in U.S. retail throughout the quarter and maybe into October, if you saw any deceleration. It sounded like it was relatively stable, but any nuance would be helpful as we enter the fourth quarter.

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

Sure. Do you want to take that, Corbin?

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

Yes. As we said earlier, we really did not see a big difference in the third quarter from what we exited in the second quarter. So in some ways, particularly around power tools, they've held up pretty well. Hand tools obviously was down a little bit. But in general, I think the POS sales in the U.S. have held up somewhat surprisingly well through the third quarter. Hard to tell what's going to happen in the fourth quarter and next year, as Don mentioned. But in the third quarter, we were relatively -- on a relative basis, pleased with what we saw.

**Operator**

Our last question comes from David MacGregor with Longbow Research.

**David Sutherland MacGregor** - Longbow Research LLC - President & Senior Analyst

Can you hear me okay?

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

Yes. Good morning, yes.

**David Sutherland MacGregor** - Longbow Research LLC - President & Senior Analyst

Yes. I think we got a pretty good handle on inventory and gross margins at this point. Let me just ask about the outdoor acquisitions. And you talked about slower consumer demand and the seasonal patterns, which I guess we understand it probably comes as a surprise to anyone. The seasonal pattern, was it consistent? Or was there something changing there?

And just talk about margin contribution expectations and the progress on integration. How do you avoid not being distracted by everything you're focusing on with inventory, gross margins and keep an appropriate level of focus on the integration and the achievement of value for the steel?
Donald Allan - Stanley Black & Decker, Inc. - President, CEO & Director

That's a great question. We've actually integrated or folded in the integration process of MTD and Excel into the transformation plan in all the rhythms and rigors that we have around that. I mean we spend a lot of time every day, every week, focusing on these different things that we're talking about over the last hour. And so we have created a set of processes and rhythms that allow us to really pulse these different things, make decisions related to a variety of different items. And folding in the integration of MTD and Excel into that has actually been a bit of an efficiency for us to make sure that we don't lose sight of the importance of those acquisitions and effectively integrating them into the Stanley Black & Decker operating system.

I think -- when I think about the outdoor business, yes, it was a rough outdoor season this year for sure due to weather primarily. And then there was a bit of a consumer impact at the tail end of it as well as consumers started shifting their dollars to other areas. That being said, as you talk to our customers, they're -- as usual, they're very bullish about the upcoming outdoor season and early next year. I think it will be a good season if the weather cooperates. Again, I think we've planned for a variety of different scenarios that could play out. Whether it's a flat scenario or an up scenario or a down scenario, it will be determined. But our production levels have been focused on those different scenarios because we are producing products in the fourth quarter for the upcoming season.

So it's difficult to know where that season is going to go. But if you listen to our customers, they're very excited about it. We're taking a balanced point of view on it to make sure that we effectively meet the needs of our customers and ensure that we don't get stuck with a lot of extra inventory if something unusual plays out.

Maybe Corbin, you might want to talk a little bit about where we are with margin profile, how the integration is going and provide a little more color on that.

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

Yes. The integration, I think, has gone very well. And the colleagues that joined from MTD and Excel have been fantastic, and it's great to have them as target team. And they are very innovative right now. Given the seasonal weakness that we saw in the spring and summer, obviously, margin rates were hit probably more than we expected because of the weaker season. However, as we go forward, we don't -- our view hasn't changed in where we think the business can get to over time. And we're generally very strong on hitting our synergy targets and getting the margins of our acquisitions to where we want, and we feel the same for both MTD and Excel on this one.

Operator

Thank you. 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. Thank you.

Operator

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