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PRESENTATION

Operator

Good morning, and welcome to the Acuity Brands Fiscal 2023 Second Quarter Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. I'd now like to hand the conference over to Charlotte McLaughlin, Vice President of Investor Relations. Charlotte, please go ahead.

Charlotte McLaughlin - *Acuity Brands, Inc. - VP of IR*

Thank you, Liz. Good morning, and welcome to the Acuity Brands Fiscal 2023 Second Quarter Earnings Call. As a reminder, some of our comments today may be forward-looking statements based on our management's beliefs and assumptions and information currently available to our management at this time. These beliefs are subject to known and unknown risks and uncertainties, many of which may be beyond our control, including those detailed in our periodic SEC filings. Please note that our company's actual results may differ materially from those anticipated, and we undertake no obligation to update these results.

Reconciliations of certain non-GAAP financial metrics with their corresponding GAAP measures are available in our 2023 second quarter earnings release, which is available on our Investor Relations website at www.investors.acuitybrands.com.

With me this morning is Neil Ashe, our Chairman, President and Chief Executive Officer, who will provide an update on our strategy and our fiscal second quarter highlights and Karen Holcom, our Senior Vice President and Chief Financial Officer, who will walk us through our fiscal second quarter financial performance. There will be an opportunity for Q&A at the end of this call. (Operator Instructions) We are webcasting today's conference call live.

Thank you for your interest in Acuity Brands. I will now turn the call over to Neil Ashe.

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Thank you, Charlotte. Good morning, and welcome to all of you joining us on this call. We delivered solid performance again in the second quarter of fiscal '23. We grew sales in both our lighting and spaces businesses, expanded adjusted operating profit and grew adjusted diluted earnings per share. We generated strong cash flow from operations and created permanent value for shareholders through share repurchases.

Both our lighting and spaces businesses delivered solid revenue while improving adjusted operating profit. In the Acuity Brands, lighting and Lighting Controls business, our strategy of increasing product vitality and service levels continue to differentiate us in the market.

A few weeks ago, we hosted our annual sales conference in Atlanta, NEXT 23. It was a great event, where we brought together our network of independent sales agents and shared our strategic vision for ABL and introduced new products. I'd like to take a minute to describe our independent sales network.

Stated simply, we have the best agency network in the industry. To give you an idea of their scope, we have about 80 agents in North America, and they have about 50 employees per agency. In other words, we have over 4,000 local sales and sales support people working for us every day throughout North America.

While our agents are independent, they are exclusive to us for key controls and do not represent the other majors. They are generally the largest in their market, and we are their most important partner.

Our partnership works very well. With our product vitality and service efforts, we make products that deserve to be chosen and our independent sales agents ensure that they are chosen.

Product vitality is driving success across our portfolio, and during NEXT 23, we introduced several new products. I want to highlight a couple here. The first was the new nLight AIR System Input Device. This is an indoor controller that can be used in multiple spaces, including office, commercial and retail. The device converts analog outputs to wireless broadcast to control intelligent luminaires. This reduces the need for complex wiring solutions during installation and reduces the associated cost for the customer.

The second was the nLight AIR rPOD Micro. This is a battery-powered wall switch that can be used as a traditional wall switch or as a remote, providing control from anywhere within a build space. This is a really exciting extension of the technology and an elegant response to our customers' need for flexibility.

These and other products continue to gain market attention. This quarter, several of our architectural lighting brands, A-Light, Eureka and Luminis, won a total of eight Good Design Awards from the Chicago Athenaeum, which recognizes products and industry leaders in design and manufacturing that have chartered new directions for innovation.

Now moving to our Intelligent Spaces Group. The spaces team continued to perform well, delivering another quarter of solid sales and operating profit growth, driven by the continued success of Distech. Distech is winning because we have the best digital control solutions in the market. It's technology is open protocol, which means you can connect our controller to most new or existing systems in a build space, giving our customers significant flexibility.

We are also winning because Distech goes to market through independent system integrators. We are continually curating the highest quality network of SIs in each market in which we compete.

Our focus is on expanding the addressable market for Distech, which we have started to do in two ways. The first is geographic, as we mentioned last quarter. Today, we sell our controls primarily in the U.S., Canada and France, and we are expanding our presence in the U.K. and in the future in Asia. As we enter new markets, we are identifying and recruiting the highest-quality SIs as our partners.

Second, we believe that any control that is currently mechanical or analog will become digital over time. So we are increasing what we can control and build spaces. This will provide us a second vector for continued growth.

Finally, I also joined our spaces team at the AHR Expo in Atlanta, where HVACR professionals gathered to share ideas and to showcase technology. It was great to hear firsthand from the SIs there, how differentiated our Distech and Atrius products are.

Now looking to the rest of fiscal 2023. We've been intentional around our product vitality and service efforts and how we operate the business. We have demonstrated our ability to manage price and cost, both in our go-to-market efforts and in our operations. Today, we are in greater control of the things we can control than we have ever been.

As you know, there are meaningful changes in the economic climate. During the quarter, we began to see a slowing in the order rate for our project business, while we continue to work through our extended backlog. We believe that the slower order rate is driven by the lead time compression that we discussed last quarter and now the changing C&I lending environment.

At the same time, our Contractor Select business continued to be strong. We will continue our focus on end markets and identifying new ways to grow.

As we deal with these changing market conditions, our focus is on generating profits and turning those profits into cash. We are continuing to manage the price/cost relationship and we'll continue to generate strong cash flow.

In closing, we entered the second half of fiscal '23 with our strategy unchanged. We are in control of what we can control, and we are confident in our ability to adapt to the changing market conditions and requirements of our customers.

Now I'll turn the call over to Karen, who will update you on our second quarter performance.

Karen J. Holcom - *Acuity Brands, Inc. - Senior VP & CFO*

Thank you, Neil. We delivered a solid performance in the second quarter of 2023. Sales in both businesses grew, delivering improved adjusted operating profit and margins and adjusted diluted EPS. We generated strong cash flow from operations and continued to allocate capital effectively.

In the second quarter, we generated net sales of $944 million, which is 4% higher than the prior year. This was largely due to price with both the ABL and ISG businesses contributing to the growth during the quarter. Operating profit in the second quarter was $112 million and adjusted operating profit increased $10 million to $132 million from the prior year. Adjusted operating profit margin improved 50 basis points over the prior year to 14%. The improvement in adjusted operating profit and adjusted operating profit margin was a result of the increase in gross profit performance as we successfully managed price and cost.

Finally, we continued to grow adjusted diluted earnings per share. Our diluted earnings per share of $2.57 was an increase of $0.44 or 21% year-over-year while our adjusted diluted earnings per share of $3.06 increased $0.49 or 19% over the prior year. The growth in adjusted diluted earnings per share was primarily due to higher operating profit and lower shares outstanding due to the share repurchases.

Moving to our segment performance review. ABL, net sales grew to $891 million, an increase of 3% compared with the prior year. This increase was primarily driven by higher year-over-year sales in our independent sales network, the direct sales network and the retail channel.

As Neil mentioned, the order rate related to our project business slowed during the quarter, However, our Contractor Select business targeted at distributors and retail continued to grow.

ABL's operating profit was $124 million, an increase of 6% versus the prior year with ABL adjusted operating profit at $133 million, an increase of 5% versus the prior year. The adjusted operating profit margin was 15%, which was 30 basis points better than last year. The improvement was a result of our ability to manage price and cost.

Now moving to ISG. The spaces segment continued to perform well with another good quarter of net sales growth and improved adjusted operating profit. Sales in the second quarter of 2023 were $58 million, an increase of $8 million or 16% versus the prior year, primarily as a result of the growth in Distech. During the quarter, both Distech and Atrius delivered growth across new and existing customers.

Operating profit in the second quarter of 2023 increased to approximately $6 million this quarter, with ISG adjusted operating profit at $11 million.

Now I want to expand on our cash flow performance. We generated $306 million of cash flow from operating activities for the first 6 months of fiscal 2023, an increase of $179 million over the prior year's first half, driven largely by improvements in working capital. Last year, we invested in inventory in order to support our growth as well as insulate our production facilities from inconsistent supply availability with the intention of working down that inventory over several quarters, which we have done. We are now down 16 inventory days from the peak in February of 2022, and we have brought inventory levels down by over $50 million sequentially from the first quarter of fiscal 2023. We also invested $36 million in capital expenditures and $124 million to repurchase approximately 700,000 shares during the first half of fiscal 2023.

As we said before, our capital allocation priorities remain the same. We have invested for growth in our current businesses through R&D and CapEx. We've expanded our platform through acquisitions as evidenced by the purchase of OPTOTRONIC in our lighting business. We've maintained our dividend and we've created a permanent shareholder value through over $1.1 billion of share repurchases since the fourth quarter of fiscal 2020, which was funded by our organic cash flow generation.

Before I turn the call to the operator for questions, I want to summarize our performance. We continued to deliver solid performance in the second quarter of 2023. We grew sales in both our lighting and spaces businesses, we improved adjusted operating profit and margins, and grew adjusted diluted earnings per share. We generated strong cash flow from operations and created a permanent value for shareholders through share repurchases. Our guidance provided for fiscal 2023 remains unchanged, and we are continuing to focus on what we can control and position ourselves to quickly adapt to changing market conditions.

Thank you for joining us today. I will now pass you over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. Our first question comes from Tim Wojs at Baird.

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

Nice job on the quarter. Maybe just kind of starting off on the sales side. Just wondering if you can maybe add a little bit of color on kind of what you're seeing on the order rate front that you alluded to and just how those orders maybe trended through the quarter, both on a project basis and in distribution? And then how do you think we should maybe think about the back half of the year from a revenue perspective, just given some of the slowing you talked about?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. So Karen, why don't I start and you add anything at the end. So the big picture, let's break down kind of the lighting business into several component parts. We'll focus on the projects through C&I. And that's where we started to see some of the softening in the order rate.

We think that is related to two things, Tim. The first is the compression of the lead times as we started to introduce last quarter. The -- for context, those lead times now are down about -- are running currently down about 30% from where they were at the peak, which was in the fourth quarter of fiscal 2022. So that -- as you see those compressing, obviously, there's projects that would have been ordered later that have already been ordered.

Second, on the distributor side, there's two ways to think about the distributors. The first is where they're managing that project business. So obviously, that's correlated to that project business. That's where we referred to the stock and flow last quarter. The second is around inventory that they purchased for resale, which is largely our Contractor Select portfolio. That portfolio grew in excess of where the rest of the business.

So as we look forward, we think the market is presenting us with mixed signals. Obviously, there's some economic turmoil. The C&I lending rate, federal loan survey would indicate that there's fairly significant tightening on the C&I side, which we -- which gives us pause. At the same time, we're -- the parts of our business, like Contractor Select that are around everyday products are performing really well.

So net-net, we are -- as we said, we're positioned to respond to whatever it delivers us -- the market delivers us. And as Karen indicated, we feel good with kind of where we are from a current projections perspective.

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

Okay. Okay. And then just, I guess, on the margins within the quarter. Just wondered if there's a way to kind of break down some of the sequential improvement because normally, you'd see kind of a seasonal kind of step-down in margins from Q1 to Q2. And so I'm just kind of wondering kind of what drove the step up and as you think about seasonality in the back half of the year. I mean, do you see that kind of normal kind of Q3, Q4 kind of margin step-up that you've seen historically as well?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

So the margin performance at the gross margin level was delivered by managing price and some increasing favorability on the input cost front. So obviously, we've got a -- we've taken a much more strategic approach to pricing, we believe, and that is -- our Contractor Select portfolio is aggressively positioned right product, right place, right price, and we're purposeful about that.

On the project side, we have the ability to choose the projects that we want to take so we can strategically manage price there. And we're starting to see favorability on the input cost side. So that's -- we're obviously very aggressively managing that, and that should be the trend going forward for the rest of the year.

Operator

Our next question comes from Ryan Merkel with William Blair.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst & Partner*

First off, can you speak to the risk of channel destocking later this year? Any view on if the channel has too much inventory out there?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. So not surprisingly, we get this question a lot. So let me kind of break it, as I did in the first question, break it down into its component parts. So -- and specifically, now we're talking about the electrical distributors. So there's two parts to their business. There are -- there is the project business, which they're staging and storing for delivery to job sites that's basically kind of a fee-for-service business. And then there's -- so they own inventory for that, but that's attributed to existing projects. As we said last quarter, we think there was more inventory in their system because of that, and that will work its way out as the projects are executed.

The second is the inventory that they buy for resell, which is our Contractor Select portfolio. We continue to see, as I indicated earlier in the comments, we continue to see strong volume there. So that short lead time, high turns kind of inventory and that's performing pretty well.

Digging in deeper to the channel, which is -- which would -- which is a different perspective is our OEM business, where obviously, we -- you can see in the disaggregated revenue that, that business was down year-over-year. We do think that, that is a combination of a few things that our customers burning off inventory that they bought earlier, which is destocking and then a couple of other things.

So net-net, the -- if we're talking about the distributors, they are -- our Contractor Select portfolio continues to turn over, which would imply that their inventories are fine.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst & Partner*

Got it. That's helpful. And then my second question, in some of the channel work that we've done, we heard about shortages of switchgear and then also a positive outlook for infrastructure work. Can you just comment on those two items, please?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes, I'll start on switchgear and then Karen can talk about the infrastructure. So on the switchgear, that's largely what's holding up the stage in store orders. So the switchgear lead times continue to be far in excess of what the lighting lead times are, for example. So that's why these projects are kind of inconsistently executing. And I believe that the consensus is that, that won't improve until kind of later in the calendar year.

Karen J. Holcom - *Acuity Brands, Inc. - Senior VP & CFO*

And then on infrastructure, Ryan, as we've said before, we do think this is a place of opportunity for us, and we are starting to see some green shoots in the infrastructure projects. But it's still pretty early. We're going to continue to position ourselves for -- to be on project specifications, which will eventually turn into bids and then orders down the road.

Operator

Our next question comes from Joe O'Dea with Wells Fargo.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

I wanted to start on revenue mix and trying to kind of understand your views on the percent of revenue that's most exposed to credit availability and interest rates. So I think about the exposure as being roughly 50% kind of new construction, 50% renovation. I think you're roughly 20% kind of Contractor Select. And so trying to think as you're talking about some of the projects and what you're seeing in terms of maybe evidence of some slowdown in ordering. Just what part of the portfolio, what part of the revenue you think is maybe most exposed to some of these slowing trends?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. Thanks, Joe. The -- as we've said pretty consistently, obviously, we get to these projects through multiple different channels, which you see in our disaggregated revenue around C&I and our direct, which is -- which would be the two most.

In terms of end markets, they obviously vary in different ways. So the infrastructure government dollar projects are not going to be impacted by this. The educational market impacts are not going to be impacted by this. But some of the others obviously are.

We don't have a perfect quantification of that for you. And we're not sure that we have a perfect crystal ball on how this is going to play out. So the process -- the C&I project business would be the big bucket that would be most impacted by this. And of that business, it's probably half of that business that's -- that would be most impacted by this. Those are just round numbers.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Got it. Okay. And then can you expand a little bit on cost coming down and the degree to which -- that you're seeing that in component costs. How much of that is, as supply chain eases, there's just smoother operations and that enables some costs coming down? How much of that is you sort of be more proactive at the negotiating table? And then given the recent move up in steel, how you're thinking about the durability of some of those costs coming down?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. So we have been very intentional about our managing of input costs going forward. So first of all, on the component side, those -- the electronic components, those prices are not changing much. In fact, their prices and terms are largely staying the same. Beyond that, we've been intentional about what we're sourcing, who we're sourcing it from on all of the other inputs. We feel really good now about our ability to manage those going forward.

You highlighted steel. We've improved our steel sourcing fairly significantly. Another one we've called out is transport costs, which have come down. And we're now working towards designing our products so that our products are designed so that it's easier to source at the appropriate levels. So the combination of all of those things, we think, positions us with some durability going forward on the input cost side.

Operator

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

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

So prior communication suggested that gross margin would step up in the back half relative to the first half. Is that still the case, just given the higher first half starting point and then some of the cycle concerns called out in the back half?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Basically, it started to perform the way we expected to perform earlier than we expected it to perform that way. So we're not surprised by these gross margin levels.

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

Okay. Appreciate that. And then, Neil, I think earlier, you kind of called out taking a more strategic approach to pricing. Can you just maybe provide a little bit more color on that? And does this mean essentially a trade-off of higher gross margin maybe at the expense of volumes? Is that the right takeaway?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. Thanks, Chris. I mean, look, this is a very, very important topic. So we want to be strategic about our pricing, so we can manage the relationship between volume and margin. We believe that as the largest player in the industry, we're demonstrating pricing -- a very important strategic pricing. We compete every day on everyday products with our Contractor Select portfolio. We think that's working. Obviously, it's growing.

It's growing in the face of a couple of things. One is Asian imports. Census data suggests that Asian imports are down over 30%. Obviously, we're growing. And our portfolio is a portion of those numbers. So it's obviously differentiating. So that relationship is working. We're delivering higher value at the same -- kind of at competitive price for both the customers and margin for us.

And then on the project side, it's this relationship between price and volume. So we're going to be strategic about where we take volume and we're going to continue to deliver these margin levels.

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

I appreciate that. If I could maybe just squeeze one last one in. There's some communication earlier around potential inventory destock. Because when I look at the quarters, it seems like volumes were roughly flat year-on-year, whereas nonres activity has continued to grow quite nicely. Any way to just quantify maybe the level of destock that impacted the quarter? And then kind of maybe where are we in that destock cycle?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. I mean, I think there's -- I think we've tried to answer this question kind of consistently so -- every time we've been asked it. The one thing I would just want to make sure that people appreciate is that the -- we believe that the lead time compression is part of what the destocking story is. So we don't think that there's a significant other -- there's not a significant amount of a hold-for-sale inventory in the distributors or retailers or our Contractor Select portfolio wouldn't be performing as well as it is right now. So these are projects that are in the market or in the distributors.

Where this is impacting us, we think, the most is on this lead time compression. So that has an impact on the order rate, and that's continuing. So we expect that to continue through the -- at least through the third quarter.

Operator

(Operator Instructions) Our next question comes from Jeffrey Sprague with Vertical Research Partners.

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

It's Jeff Sprague. That broke up when she was introducing me. Hopefully, that was me. Just -- yes, we got you. Okay. I just want to come back to just kind of the lending environment, Neil, not to parse words here, but in your opening remarks, it actually sounded like you felt the negative impact of lending changing already in the quarter, but really, it sounds more like you're just flagging it as obviously an issue to be concerned about and the order softening was more of this compression of lead times. Can you just kind of clarify that? Are you actually seeing like tangible evidence of, for lack of a better term, a credit crunch in your end markets?

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

So thanks for the question, Jeff, and the opportunity to provide as much clarity as possible on this. The Fed C&I loan survey started to turn negative kind of last fall, basically. So that is clearly rolling through. And we're highlighting that as a new factor because the -- our data would suggest that, that will -- that is now flowing through and will continue to flow through.

Does it stay the same? Obviously, we don't have a crystal ball. We all can just look at that. But the data source we're looking at as the Fed C&I loan survey. And that will impact obviously the nongovernmental pieces of it. So it won't impact education season, but it will have some effect on things going forward with the tightening.

And then the second half of that is, and we've said this consistently, is that if there's higher discount rates, there'll be less projects. So -- and I think we're seeing the combination. We are collectively, as an industry, seeing the combination of these going forward. And that's -- it will be determined. We'll have to see what the Fed does to see how that plays out.

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

Yes. Then I guess just kind of coming off that and just thinking about your guidance, right? What would have to happen to get us to the bottom end of the range, right? I mean if we look at kind of historical first half, second half patterns, right, unless there's an abrupt change in the economic environment, it seems like you're in the upper 1/3 of that range by historical standards. What -- I don't know if you agree with that, but what do you think would have to happen here to get you to the bottom of that range? It's a wide range with half a year to go.

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Yes. I mean as we said, Jeff, what we're -- our intention is not to update the range throughout the year. The -- based on our performance for the first half of the year, it would imply for the rest of the year that sales will be harder to achieve, but we're demonstrating that profits are achievable. That's the bullet point summary of kind of how the rest -- we think the rest of the year plays out.

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

Great. And maybe just one quick last one. Just on inventories. Your own inventory performance has been notable, right? You brought it down pretty dramatically. It looks like you're kind of near historical averages on days inventory. Anyhow, is there -- I mean, is there a lot of additional opportunity in your view at this point to unlock cash through further inventory liquidations? Or have we reached some kind of normalized level here?

Karen J. Holcom - *Acuity Brands, Inc. - Senior VP & CFO*

I think, Jeff, for the most part, we are at a more normalized level. We're still a little bit heavy on component inventory for electronics, but it's modest compared to the decreases that we've made so far.

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

And then I'd add to that, we have multiple efforts ongoing to continue to reduce that. So I think we are at historically normal levels. And I also believe that we can improve those over time.

Operator

Thank you. And I'm showing no further questions in the queue at this time. I'd like to turn the call back to Neil Ashe for any closing remarks.

Neil M. Ashe - *Acuity Brands, Inc. - Chairman, President & CEO*

Thank you. We really appreciate you joining us this morning. We're pleased with our performance so far this year. We are in control of what we can control, and we're confident about our ability to deliver no matter the market conditions on our customer requirements. So thank you for spending some time with us this quarter, and we look forward to talking to you again next quarter.

Operator

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