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## AYI.N - Q4 2022 Acuity Brands Inc Earnings Call

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**OVERVIEW:**

Co. reported 4Q22 net sales of $1.1b and diluted EPS of $3.48. Expects FY23 total AYI net sales to be $4.1-4.3b and total AYI adjusted diluted EPS to be $13.00-14.50.

## CORPORATE PARTICIPANTS

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

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

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

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## PRESENTATION

**Operator**

Good morning, and welcome to the Acuity Brands Fiscal 2022 Fourth Quarter and Full Year Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to Charlotte McLaughlin, Vice President of Investor Relations. Charlotte, please go ahead.

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

Thank you, Liz. Good morning, and welcome to the Acuity Brands Fiscal 2022 Fourth Quarter and Full Year Earnings Call. As a reminder, some of our comments today may be forward-looking statements based on management's beliefs and assumptions and information currently available to our management at this time. These beliefs are known -- 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 statements.

Reconciliations of certain non-GAAP financial metrics with their corresponding GAAP measures are available in our 2022 fourth quarter and full year earnings release, which is available on our website at www.investors.acuitybrands.com.

With me this morning is Neil Ashe, our Chairman, President and CEO, who will provide an update on our strategy and highlights from the last quarter and full year; and Karen Holcom, our Senior Vice President and CFO, who will walk us through our fourth quarter and full year performance as well as provide an outlook for our full fiscal year 2023.

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.

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

Thank you, Charlotte. Good morning, and thank you to everyone joining us on the call. We continue to deliver strong results in the fourth quarter, concluding what has been a very good fiscal 2022. We had strong demand across our end markets, and we demonstrated the ability to capture price and drive volume through product vitality and service in both our lighting and spaces businesses throughout this fiscal year. We delivered solid operating profit and EPS growth, and we, again, created permanent shareholder value through share repurchases.

Both our lighting and spaces businesses have delivered strong results throughout 2022. Starting with ABL. Our team made good progress on product vitality and service initiatives. Our product vitality efforts are the combination of new product introductions and improvements to our existing portfolio to ensure that our products are more valuable to our customers and more profitable for us.

These product vitality efforts are being recognized. We won awards across our portfolio for design and innovation, including several Red Dot design awards for architectural lighting, EC&M Magazine recognized our contractor select stack pack as a category award winner for Product of the Year, and we received a BrightStar award for software and controls from LED Magazine.

Our service initiatives are also being recognized by the industry. We were named Supplier of the Year by each of the 2 largest buying groups in the industry, IMARK and AB. Throughout 2022, we've been focused on satisfying customer demand. To do that through the global supply chain conditions, we have continued to prioritize 3 key activities: first, investing in supplier relationships; second, empowering our teams to secure components in the open market; and third, reengineering products to available components. While these challenges have continued, our focus has remained the same.

In the fourth quarter, when our ABL business encountered sourcing interruptions with a few electronic components, we were able to leverage our strong supplier relationships to finish the quarter with a strong August.

I'd now like to highlight 2 other important aspects of our business. The first is Contractor Select. Contractor Select is a collection of the most important everyday lighting and lighting control products. We have done, and we continue to do significant work on product vitality in this portfolio. This work allows us to be competitive from a value perspective and the results have been impressive. Contractor Select is growing faster than our broader portfolio and provides a consistent foundational relationship with electrical distributors.

Second, as we pass the 1-year anniversary of our acquisition of the OSRAM DS business, I want to update you on our progress. We have successfully integrated the business with our go-to-market product and supply chain efforts. We have rebranded the product portfolio to OPTOTRONIC as part of our eldoLED product family. We have begun to integrate more OPTOTRONIC drivers in our luminaire portfolio, we have grown our OEM sales, and we have successfully integrated the production facility into our Mexico operations. The acquisition is delivering on our expectations [towards more] of the technology in our luminaires, expand our OEM channel, and take greater control of our electronic supply chain.

Now moving to our Intelligent Spaces Group. The Spaces team also had a very solid quarter, delivering net sales growth and expanding profit as we continue to make spaces smarter, safer and greener. Distech had strong sales in the fourth quarter, notably in the sales of our ECLYPSE controller, which uses open protocol technology to control and monitor systems and buildings, including heating, ventilation, lighting and other functions, essentially acting like the brain of the building. The data generated is then used to optimize energy consumption and occupancy comfort in a building or space.

Atrius continues to roll out new and improved applications. In the fourth quarter, we launched product improvements to our Atrius locator, which enables customers to track high-value assets within their spaces, an Atrius' vision that can improve customer experiences by managing traffic in a space.

Now I want to spend a minute on capital allocation. Our capital allocation priorities remain the same. Our priorities are to invest for growth in our current businesses, invest in acquisitions, maintain our dividend and allocate capital for share repurchases when we perceive there is an opportunity to create permanent value for shareholders. Earlier this month, we announced Philippe Brzusczak as Senior Vice President of Corporate Development and Strategy. Philippe reports to me and will be responsible for evaluating mergers and acquisitions and building strategic relationships.

As I reflect on our fiscal 2022, we've had a good year. We have successfully repositioned the company at the intersection of sustainability and technology. Our businesses developed a technology that saves our customers' energy and reduces their carbon emissions. We are positioned for long-term growth by taking advantage of 2 of the most important megatrends, minimizing the impacts of climate change and maximizing the impacts of technology.

Acuity Brands Lighting is the largest lighting and lighting control company in North America. We have dramatically improved our product vitality, and we have demonstrated that we could serve business when others could not. Our Intelligent Spaces Group has differentiated technology in building controls and management systems with Distech; and with Atrius, we are beginning to effectively demonstrate the benefits of connecting the edge to the cloud.

We've changed how the company works with the introduction of our better, smarter, faster operating system. Better, smarter, faster is the combination of processes, tools and ways of working that spans from strategy to people, to operating rhythms, to problem solving. It is unique to our organization and allows us to drive strategic alignment, manage change and deliver results.

At the same time, we have purposely transitioned the company to be a values-driven organization. We have 7 shared values. Some of our values like integrity, owner's mindset and community are fairly common. Others like time and curiosity are more distinctive to Acuity. Collectively, they serve as a decision-making framework that empowers our associates. The combination of better, smarter, faster and our shared values allows us to operate more efficiently with greater distribution of responsibility and accountability throughout the company. It is how we will continue to improve our businesses, respond quickly and effectively in changing economic environments and successfully operate additional businesses in the future.

Our organization is clear on how we create value. We create value by growing net sales, turning those sales into cash and not growing the balance sheet as fast. We have overhauled our total rewards framework so that everyone in the organization is aligned with this. We've also demonstrated that we are effective capital allocators. We have made investments in our current businesses. We have successfully made and integrated acquisitions, and we have repurchased almost 20% of our company, creating permanent shareholder value.

Now looking to our fiscal 2023 and beyond, we're excited about how far we have come, and our prospects for the future. While we expect 2023 to continue to be a dynamic environment, we are confident in our ability to execute. We are well positioned in a variety of end markets. We are continuing to invest in product vitality and service, and we have developed a culture that supports change and is committed to improving.

Now I'll turn the call over to Karen, who will update you on our 2022 performance and provide a more specific outlook for 2023.

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

Thank you, Neil. 2022 was a strong year for Acuity. For the first time, we crossed over $4 billion in annual net sales. Our gross profit margin was 41.8%. Our operating profit increased by $82 million year over year, and we grew diluted EPS 32% to $11.08 for fiscal 2022. We continue to allocate capital effectively through the repurchase of approximately 3 million of our outstanding shares.

In the fourth quarter, we continued to have strong net sales growth. Net sales of $1.1 billion were 12% higher than the prior year, with both the ABL and ISG business segments contributing to the growth. As Neil mentioned, we've now had OPTOTRONICS for a full year, and the incremental sales impact of that acquisition was only 1% in the fourth quarter. We delivered gross profit margin of 41.7% despite the lower production levels at the beginning of the fourth quarter.

Operating profit in the fourth quarter was $150 million, and adjusted operating profit was $170 million. Finally, we continued to grow earnings per share. Our diluted earnings per share of $3.48 was an increase of $0.76 or 28% year over year, while our adjusted diluted earnings per share of $3.95 increased $0.68 or 21% over the prior year. Share repurchases made throughout fiscal 2022 favorably impacted adjusted diluted EPS by $0.30 during the fourth quarter.

I now want to expand on our segment performance. Net sales of ABL increased to just over $1 billion, an increase of 11% compared with the prior year, driven largely by strong performance within the independent sales network, which grew 11%, and the direct sales network, which grew 13%.

ABL's operating profit was $151 million, an increase of $2 million versus the prior year. This quarter, operating profit was impacted by 3 key factors: first, higher cost of inventory; second, increased cost for transportation to deliver our products to the customer; and finally, higher commission rates for certain project business.

Now moving on to ISG. The Spaces segment also had a very strong year and improved both net sales and operating profit. Sales in the fourth quarter of 2022 were $61 million, an increase of $11 million or 22% versus the prior year. ISG's operating performance also improved while we continue to invest in the business. Operating profit in the fourth quarter of 2022 increased $8 million to $10 million.

Moving to cash flow. We generated $316 million of cash flow from operating activities for the full year of fiscal 2022. This was down $92 million from the prior year, primarily because we invested in working capital, particularly inventory to support our growth. I am pleased by our progress in the fourth quarter, during which we decreased inventory by $95 million.

We invested $57 million or 1.4% of net sales in capital expenditures during the full year fiscal 2022. Finally, we invested $107 million to repurchase approximately 600,000 shares during the fourth quarter, which means that for the full year of fiscal 2022, we have invested around $512 million in repurchasing approximately 3 million shares.

I would now like to spend a few minutes to talk through our 2023 outlook. After the call, you will find this outlook in the supplemental deck that will be available on our website. We are going to provide annual guidance anchored around net sales and adjusted diluted EPS. We will also provide other assumptions to help you with the construction of your models.

For full year fiscal 2023, our expectation is that net sales will be within the range of $4.1 billion and $4.3 billion for total AYI. This is based on the assumption that ABL will generate sales growth in the low to mid-single digits and ISG will generate sales growth in the low to mid-teens.

As Neil mentioned, we expect that fiscal 2023 will continue to be a dynamic environment. As we move from 2022 to 2023, our level of sales growth is returning to more normal levels. We are focused on any changes in the economic outlook, and we are prepared to react as necessary in the future.

Our expectation is that annual adjusted diluted earnings per share will be within the range of $13 and $14.50 for total AYI. You will recall that last year, we focused our framework on net sales and also on gross margin as we focused on product vitality and demonstrating our ability to manage the price/cost relationship. We are pleased with our performance on these metrics. And for fiscal 2023, our outlook will use the more traditional metrics of net sales and adjusted diluted EPS, as I've described.

The supplementary deck I mentioned will detail other key assumptions that should help you get to adjusted operating profit and adjusted EBITDA. We will not be providing quarterly guidance.

I also want to provide you with some qualitative context for these numbers. As you know, our quarters have historically been subject to seasonality, and we expect that we will be largely consistent during fiscal 2023. We are continuing to deal with the global supply chain challenges, particularly around component shortages, and we are continuing to work through some of the higher cost inventory. This could result in margins that are a little lower in the first part of the year as compared to later in the year.

Our capital allocation strategy in 2023 is unchanged. We will continue to generate cash and allocate capital effectively, prioritizing investments for growth in our current businesses, investing in acquisitions, maintaining our dividend and allocating capital for share repurchases.

Just before I turn the call to the operator for questions, I want to leave you with this. We are very pleased with our performance in fiscal 2022. We exceeded $4 billion in net sales. We made improvements to the business, and we increased our profitability. We continue to allocate capital effectively and deliver permanent value for our shareholders.

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

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from the line of Tim Wojs with Baird.

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

Maybe just -- I have one kind of question on the business and then another kind of bigger picture question. But I guess, if we get into an environment where Acuity -- I guess, an environment where maybe we have less inflation, does that change how Acuity goes to market at all? I guess, in other words, are you going to kind of change how you kind of react around product vitality service, those types of things in a different inflationary environment?

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

Tim, that's a good question, and thanks for asking it. The short answer is no. We feel like those product vitality and increase in the service levels are foundational to our long-term performance. And they've obviously served us well in an inflationary environment. And I think they're going to be equally as important in a more normalized environment. The ability to have products, which deliver value to customers and higher profits to us is essential. And so we've really pushed that on the product vitality front, and we're -- we've made a lot of progress there.

And on the service front, I still think we have a lot of room for improvement. As we come -- as we all continue to work our way through these component challenges and try to get to more normalized lead times and such, those are foundational to how I think we remain differentiated from the rest of the lighting industry.

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

Okay. Okay. Good. And is there any way to kind of put numbers around vitality? I don't know if it's percentage of sales or how you kind of frame that, maybe what the margins kind of generally look like on a new product versus what's it's replacing?

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

Yes. So I want to emphasize a couple of things on product vitality just that we mentioned in the prepared remarks, which is, when we say product vitality, we mean that as the combination of new product introductions and improvements to our existing portfolio. So we're doing both of those. And we are generally going to touch 20% to 30% of our product portfolio per year with those efforts, which -- the combination of which are what's driving the benefit. And that's up materially from where we would have been 3, 4, 5 years ago.

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

Okay. Good. And then maybe just bigger picture question on the agent channel. So over the last, I'd say, 6 months, we've seen just kind of higher agent consolidation in the industry and some [rapid] changes. I guess it's probably driven by some of the OEM consolidation that we've seen. But I guess as you look at the agent channel, do you see a trend towards more consolidation? And if that is a trend, is that positive for the industry and Acuity?

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

Yes. So we feel really good about our independent sales network and our collection of agents. We are in the process of kind of working through those agents and improving some of our representatives in different markets, which we feel really good about. What I say to our agents is that we're strategically dependent on each other. They need us and we need them. And as long as their business is good with us, we're good with them.

And -- but the world is changing, and we're going forward, and our first choice is to take them with us. And as a result, we have a natural gravitation of the best agent in each of these local markets wanting to be aligned with the largest and best player. And so I see that continuing. The -- as you mentioned, there is a fair amount of change that's going on kind of down market on some of the other independent sales agents. And that creates, frankly, an opportunity for us, we think, and our local agents in each market going forward.

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**Operator**

Our next question comes from John Walsh with Credit Suisse.

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**John Fred Walsh** - *Crédit Suisse AG, Research Division - Director*

A lot of very interesting things happening, but maybe we can just dive into some questions on the guidance. So just looking at the $4.1 billion to $4.3 billion, just wondering if you could talk about the visibility into that number. I'm thinking if there's price carryover, if there's any kind of stimulus carryover from infrastructure and Jobs Act or maybe even the IRA. And then obviously, you're not really a backlog business, but you have been carrying some backlog through fiscal 2022. So just anything around that touching on those things, the confidence on that revenue number.

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

Yes. Thanks, John. So as we indicated in the prepared remarks, we expect fiscal 2023 to be a dynamic environment. And so one of the things that I've told our team is that our plan shouldn't be predicated on our ability to predict the economic environment better than everyone else can. And so a lot of the work that we have done and are doing is to try and make our organization as dynamic as possible to respond to what we see going forward.

So specifically, as we look to the net sales guidance that we gave you, Karen gave you kind of the breakdown between ABL and ISG. So first, on the ABL side, as you indicated, we continue to carry higher than normal backlog. And we continue to see, as I said at the last quarter, things are more the same than they are different right now. So that's the -- that's kind of what's baked into those assumptions for ABL.

On ISG, the assumptions there are that we continue to grow in the low to mid-teens as we continue to take share in controls and we begin to accelerate the software at Atrius. So net-net, we don't have a perfect crystal ball, but we're confident in our ability to execute, and this is our best estimate of where we think we're going to be for the year.

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**John Fred Walsh** - *Crédit Suisse AG, Research Division - Director*

Great. And then maybe another one for you, Neil. You highlighted your business development higher. Obviously, your balance sheet is very strong. You've bought back shares during fiscal 2022. Obviously, the market is very choppy right now. But kind of as you look at the world, what are the expectations you would set for us around balance sheet deployment and usage over, I don't know, the next 6 to 12 months?

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

Yes. So let me expand the aperture a little bit, please, John, beyond 6 to 12 months and think kind of over the next couple of years. We've purposely been very, very consistent about our priorities. We're going to invest in our current businesses. We're going to invest in M&A. We're going to maintain our dividend, and we're going to use capital for share repurchase when the opportunity presents itself. That framework remains the same.

On the acquisition front, I believe that as we look forward over the next year or 2 years, we're better positioned to integrate -- execute, integrate and manage additional businesses based on all the work that we've done around better, smarter, faster and the rest of the company. And as you mentioned, the market is a little choppy, so the world is coming back to us a little bit from a valuation perspective. So we would expect over the next couple of years that M&A will become a more important component of our capital allocation.

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**John Fred Walsh** - *Crédit Suisse AG, Research Division - Director*

Good end to the year and good luck on '23.

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**Operator**

Our next question comes from Chris Snyder with UBS.

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

So I also wanted to ask about the guide and just kind of some back of the envelope math. If I take the midpoint, it seems like margins next year are down year on year at the midpoint of EPS in sales. So I guess, correct me if that thinking is wrong, but if it's right, can you just maybe talk about what are the margin headwinds next year? Is it on the price/cost side? Is it more on the SG&A investment in the Spaces group? Any color there would be helpful.

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

Yes, Chris, good morning. Karen and Charlotte will follow up with you and help you build the model after the call. Resident in these, obviously, EPS is growing year on year. The -- and we talked about -- we talked through the net sales guidance. So as you cascade that down, no, it doesn't imply margin degradation.

As Karen indicated, we expect to work through the first part of next year with continued inconsistency and some component availability, which impacts our ability to level load the factories, one; and two, some higher cost inventory related to -- that's in inventory right now related to higher container costs historically. But we feel pretty solid about where we're going for next year.

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

Appreciate that. Then I guess also does the guide -- obviously, the company has done a lot of buybacks the past couple quarters. Does the guide assume incremental buybacks next year or anything on the M&A side that we should be thinking about as we kind of build into that framework?

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

Yes. Chris, when you see the deck that we'll post to our website after the call, you'll see we're giving an estimate of share repurchases for next year in the range of $125 million to $150 million. So that's assumed in our assumptions for 2023, but we've not built anything in for M&A.

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**Operator**

Our next question comes from the line of Christopher Glynn with Oppenheimer.

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**Christopher D. Glynn** - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

So it's kind of interesting. You spent a little more emphasis on Atrius this quarter. IGS has been largely defined by Distech, but I think with Atrius, you mentioned a couple functionality improvements. And I think it's been a story of active piloting the last few years. So wondering what sort of transition and inflections you're anticipating for the ability to scale the software piece there?

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

Yes. Thanks for the question. On Atrius, you're exactly accurate. We've really been focused on improving the product and adding additional functionality to it, largely with an emphasis on the impact on buildings. So you'll see us -- that's why we've been talking about building insights and you'll see some of the work that -- the new product introduction that we talked about, an improvement that we talked about, with locator and vision are really all about those spaces. We don't feel like we're yet at an inflection point with Atrius, and we don't assume that. But we're confident in the work that we've been doing.

And it's worth taking a second to talk about the edge to cloud opportunities. So when we talk about the edge, that's obviously -- with Distech, we have powerful edge computing inside spaces that control those spaces and generate the data that can be used, as we mentioned, to control everything that happens in that space. And then the data creates options to increase additional functionality in those spaces, some of which currently exists and some of which we're building forward towards the future. So, no, I don't think we've turned to an inflection point yet on Atrius, but we are excited about the possibility of edge to cloud, and we're excited about our ability to compete effectively in the developing market around edge to cloud.

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**Christopher D. Glynn** - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Great. And the other one was on the ABL margins in the quarter down a bit sequentially, a little more year-over-year pressure than in the earlier quarters. You did mention the discrete kind of call out on some supplier relationship for -- relationships in the quarter and some make good in August. But are those 2 connected?

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

Yes.

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

Yes. Chris, there's a couple of things going on in the ABL margins that we've highlighted. So first, as Neil mentioned, we are working through some of that higher cost inventory related to the increased container costs from earlier in the year. That was one factor that impacted it. Definitely, the component shortages that we've experienced had some impact on our ability to level load our facilities, particularly earlier in the first couple of months of the quarter.

And then we did see costs for freight to our customers. So the outbound freight to the customers also increased in addition to the higher commissions that I mentioned. So that really kind of impacted the margins at ABL this quarter.

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**Christopher D. Glynn** - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Okay. The commission rate is stable, right? Or did the rate adjust?

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

The commission rate went up slightly because of the project work and some of the higher rates on that project business.

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**Operator**

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

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

Just wanted to expand on the ABL question for the quarter. If you could, can you size what the revenue and margin impact was from some sourcing interruptions? And then when you talk about higher cost of inventory, can you give any sense of how much of that still needs to kind of flush out through the P&L? What kind of a margin headwind we're looking at there?

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

Yes. Joe, so looking at the sizing impact of ABL, we're not going to kind of break out the different pieces of how much that impact was. We talked about the OPTOTRONICS had a 1% impact. So you can look at the rest of that. And know that in the quarter, because of the sudden price increases that we've had, we were a little bit more price this quarter than what we've historically seen earlier in the year, just to give you some idea of the ABL size impact.

And then on the question for the margins, we talked about working through some of the higher cost inventory at the beginning of the year as well as some of the component shortages. So for the balance of the year, you'd probably see a little bit lighter in the first part than you would in the second part of the year.

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

Okay. And then I guess we'll see when the slides come out, but I wanted to ask on kind of how to think about segment margins. So it looks to me like based on kind of midpoints, you'd be implying similar types of margins in '23 versus '22. Not sure about kind of mix between gross margin and SD&A, what that contributes. But trying to kind of think through the segment pieces of it after we've seen really strong margins in ISG over the last couple of quarters, and whether or not that's moving up or whether kind of what we've seen in 2022 at the segment level is sort of a pretty good indication of what we should be seeing in '23 at the respective segments?

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

Yes, Joe, I'll take that and answer it at a strategic and qualitative level. So big picture with ABL, we -- as I mentioned earlier, we feel like our product vitality efforts and our service level efforts have positioned us in a better place in the industry. So that would allow us to maintain these margins and hopefully increase them over time. As we look at ISG, obviously, they had a really good quarter in performance. That demonstrates what's possible there.

Our expectation is that we'll continue to invest as necessary for that growth and for that growth to continue for a longer period of time. So this isn't a margin point, but for example, we're investing in capacity for Distech so that we can increase their manufacturing capacity for additional controllers. So the short-term answer is, yes, we're expecting similar margins for next year, and we're positioning ourselves for the opportunity to expand those margins over time.

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

That's helpful. If I could sneak one more in. I'm curious about the pricing power that goes with product vitality and then how that flows through in a hyperinflationary environment. So are you getting what you think is sort of properly compensated for that vitality in this environment? Or it sounds like if we see deflation, there's continued pricing opportunity because of the value you're delivering?

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

Yes. That's a really good question. And obviously, we spent a lot of time kind of debating that. On the -- from an entire industry perspective, and I'll use us as representative, we've made 7 price increases in our last fiscal year. That's more than -- obviously, I haven't been in the industry that long, but that's more than anyone in our company can remember. So it's dramatically kind of changed the dynamic of the pricing environment. And so I would observe, it's not as linear as the question would imply that we introduced a new product, therefore, we can charge more for it. It really is a little bit more dynamic than that.

What has been consistent, though, is that between the combination of our product vitality, our ability to serve and our channel positions in the marketplace, we've been able to realize more of that volume and more of that price. Obviously, the input costs in this year moved more than we had anticipated. And so we got -- we found ourselves chasing that a little bit, but I think that's true of pretty much everybody. So then as we look forward to a more normalized environment, that's where I think our product vitality and service will actually be that much more important.

So while it allowed us to take volume in this -- kind of in this choppy market of 2022, as we look forward, I think what we're doing is building a more consistent position in the marketplace where contractors, distributors, lighting specifiers know that we have the highest quality and highest value products for them, and we can service them on a consistent basis, which I believe will bode well for us from a share and margin perspective going forward.

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**Operator**

Our next question comes from Jeffrey Sprague with Vertical Research Partners.

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

You really broke up. It was unclear who you were calling. Neil, the answer to that question plays a little bit into kind of what was on my mind. Obviously, with kind of FIFO inventory, we would expect some higher cost stuff coming through with a lag. But given all the price that you've got, I would have thought kind of your price cost equation was getting better. And at least, in this quarter, I guess, it got worse, right? And so I just wonder if you could kind of address that. And maybe just tie it to kind of the second question I had.

Sounds like you're quite pleased with how Contractor Select is performing. But I wonder if you are seeing a clear mix down in the business in light of kind of the inflationary pressure. So it sounds like you're pleased you can offer that offering, but do you see actually some kind of pain in the market where price is forcing people to mix down into other products?

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

Yes, Jeff, there's a couple of good questions in there. So first, on the lag, it's just math. So container costs were, what, $16,000, $18,000 a few months ago, and they're more in the $6,000 to $8,000 range now just for context and those spikes. So those are going to work themselves through.

I would say big picture, what we're pleased about is that we could deliver the blended margin based on all of the factors on volume, on price and on mix. So strategically, with our Contractor Select portfolio, we feel very, very good about where we are and where we're going. And we think it's really important because it does provide that foundational relationship with the distribution industry, the electrical distributors that I mentioned earlier, and it does become a solid and core piece of where we're going forward. And we've obviously demonstrated with these margin levels that we can both be competitive from a value perspective in the marketplace and deliver margin at the same time.

As it relates to kind of trade downs in the inflationary environment, that is something that obviously is always happening. But I would tell you as anecdotally that the performance of our architectural portfolio, so the things which are -- I think we would all generally consider more at the top of our product portfolio, has been stronger this year than in -- certainly in any time since I've been at the company.

So it's really a healthy -- we're really healthy across the portfolio. We're significantly more healthy across the portfolio -- our portfolio at the high, the middle and the more value components, which is how we've delivered kind of the volume, the margin and the mix as you see it. And that's what we feel good about going forward.

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

Great. And maybe just a follow-up on the capital deployment strategy. It does seem like you're sort of on schedule. Like if I go back to the July 2021 meeting, right, it was kind of like we're focused on bolt-ons. And 18 months from now we'll be thinking about bigger things, and you make this higher. And sounds like you're struggling to cultivate a pipeline.

I just wonder if you could provide a little bit of color on kind of the nature of the sort of things you would consider adding to the portfolio. I would think we're talking adjacencies, but are you talking more than that? Or could we actually see outright diversification in the portfolio as you pursue this strategy?

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

Yes, Jeff, good questions. And I don't want to get too far out in front of ourselves. Obviously, we will always consider bolt-ons. So -- and one person's definition of adjacency may be different than a different person's definition of adjacency. So we'll obviously be -- we continue to look at things which are kind of in the sweet spot of the things that we are currently doing or very close there to. We are -- obviously, we had the OSRAM OPTOTRONIC acquisition, which has performed really well for us and was good for our organization to go through a meaningful integration process like that.

We see very interesting adjacencies currently in the pipeline around our Spaces Group, which are both on the Distech side and on the Atrius side. And then we need to earn our -- I wouldn't call it outright diversification, but we've said consistently that we're positioned in front of megatrends, specifically minimizing the impact of climate change and maximizing the impact of technology. Obviously, those things -- those 2 megatrends affect everything. So that can be a relatively liberal definition. But we think there are going to be long-term growth opportunities inside that realm that we're focused on.

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**Operator**

Our next question comes from Ryan Merkel with William Blair.

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

My first question was just a clarifying question on the gross margin cadence. So it sounds like -- and tell me if I'm wrong, but it sounds like the second half gross margins will improve due to better access to components, which will help factory productivity and then also lower costs. And

I'm wondering, do you have line of sight to better access to components? And then which one of those is more important, or are they equally important?

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

Yes. I'll take it, Karen. The -- first of all, on line of sight. One of the things that we emphasized is that we've invested significantly in our supplier relationships. We are establishing long-term multiyear relationships with some of the key component suppliers on the electronic side. So the -- we expect that to over time be -- to provide more consistency.

Specifically, what we were working through in the first half of the -- fourth quarter and the first half of the year is knowing when exactly those components will come so that we can schedule everything else around them. So, obviously, you can't build a luminaire without a driver, you can't build a driver without certain chips. And so if we end up with short uncertain pacemaker items, then we need to adjust.

So we're working to be better planners on the demand side and on the supply side so that we can smooth that, and that should -- we should expect some benefits for that towards the middle or later part of next year. That's the majority of it.

Secondarily, as we -- we won't kind of beat this one to death, but the container prices that we're working through will work through -- that inventory will work through in the first half of this year.

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

Yes. Okay. That's helpful. And then I just had a follow-up on the deflation question because it's a question I get from investors. We've obviously seen freight rates coming down quite a bit, raw material prices have come down. So the question is, will the lighting industry have to reduce prices? Or are you going to keep the extra profits? What is your view there? It sounds like you expect to keep the extra profits.

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

Well, I would note that even though those prices have come down off their high, they're larger -- they're higher than they were before. So on a relative basis, there still is -- there still are -- kind of the general market is an inflationary market. We believe, as I've said before, that the combination of our product vitality and our service levels allows us to earn a different place at the table maybe than we have had before with our collection of channels. And so the key to longer-term success will be our ability to continue to drive the product vitality so that we can deliver value to customers and make more margin for ourselves in the process.

And then to be able to service business more consistently, and therefore, be lower cost to do business with than any of our customers. So another element of delivering value. And we feel like the more value we can deliver, the more of that we can share.

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

Got it. Great. Okay. Last one for me is just back to the assumptions for the sales guidance. And I appreciate you don't have a crystal ball, but could you help with maybe what are you assuming for lighting industry growth or maybe even non-res? And then for volume and price, I don't know if you want to give a number, but is one contributing more than the other?

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

Yes. So I don't want to imply a level of precision that we didn't -- that we don't want to imply. So big picture, on the ABL side, we have taken share. We continue to -- we expect to continue taking share. So #1. #2 is, as Karen has indicated, we do have a fair amount of price that we are working through. And volume right now, unit volume is largely dependent on our ability to manufacture it. So those 2 things are highly consistent. But I would -- but our ABL sales expectations are that we will outperform the market, and that's resident in these assumptions.

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**Operator**

Our next question comes from Jeff Osborne with Cowen.

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**Jeffrey David Osborne** - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Just 2 quick ones on my side. Neil, I was wondering if you could walk us through the nature of the supply chain challenges. Is it something on the analog chip side or power supplies? Can you just elaborate on what the challenges were in the early part of the quarter?

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

Yes. It's -- as I said, it was related to specific pacemaker items in our drivers that then we use to manufacture the luminaires. So the -- as I indicated in the earlier answer, we do have line of sight to those components over time. It's just they didn't come when they were supposed to in June and July. So that was the hold up.

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**Jeffrey David Osborne** - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Maybe just a quick follow-up on that then. What the -- post OSRAM, what percentage of your luminaires that you're manufacturing, broadly speaking, would have an internal acuity eldoLED and OSRAM driver in it? I'm just trying to get a perspective.

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

Yes. No, it's not yet quite half. So we are still both a large consumer of external drivers and obviously, a large OEM provider of external drivers now.

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**Jeffrey David Osborne** - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Got it. And then the last one I had just quickly is on the project business. You mentioned the heightened commissions. I was just curious what the pipeline is on the project business? Projects are still kind of hanging out in there, if those are moving forward and being released, what's your expectation for 2023?

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

So as I said, we -- I guess the -- unfortunately, the simplest answer is things currently are more the same than they are different. So our -- our agents have -- are still successful bidding businesses. There is still a lot of project work that is in the work that they are doing. And we maintain -- currently maintain higher-than-normal backlog. So we don't -- as I said earlier in the call, we don't have a crystal ball for 6 -- 3, 6, 9, 12 months, 16, 18, whatever months out. But as of right now, things are more the same than they are different.

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**Operator**

Our next question comes from Brian Lee with Goldman Sachs.

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**Brian K. Lee** - *Goldman Sachs Group, Inc., Research Division - VP & Senior Clean Energy Analyst*

I have 2 questions. I'll try to get in here quickly. It definitely sounds like there's price tailwinds into 2023. Would you characterize those as kind of similar to what you saw in '22? Or maybe kind of level set us on the year on year? It seems like the pricing strategy is a lot more fluid than maybe what you've done in the past just based on your comments. So just wondering if there's any way to think about what price impact is being embedded in your views for '23?

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

Yes, Brian, you're right. With 7 price increases over the course of the year, it is a bit more dynamic than it has been historically. So as Neil mentioned, we do expect to see a little bit heavier mix of price, but also as we regain kind of footing with the component supply, we expect volume to be there as well. But pricing will have an impact year over year.

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**Brian K. Lee** - *Goldman Sachs Group, Inc., Research Division - VP & Senior Clean Energy Analyst*

Okay. Fair enough. And then on the margin guidance, I know there's been a number of questions around this, but the margin is lower in the first half and then picking up in the second half. You kind of walked us through the different pieces around supply chain and utilization. Any way you can kind of quantify this first half, second half dynamic? I assume this is still in the context of your 42% gross margin target range you've outlined in the past, but sort of how big is that delta expected to be as we move through the cadence of the next several quarters?

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

Yes. So big picture, Brian, what we're trying to do is provide an annual outlook about kind of where we think we're going to go strategically and what that will mean from a -- both a topline perspective and then ultimate productivity perspective. As I said, our organization is focused on how we create value, which is to grow net sales, turn it into cash and to outgrow the balance sheet as fast. And so that's what you'd see here -- everyone here focused on if you were kind of walking the halls.

So we wanted to provide the additional color within the year to -- just to highlight kind of what we're working through as we go through that. But we think, long term, as I said, that our goal is to maintain and increase margins. And so we -- that's why we wanted to provide the transparency.

I'm sure Karen and Charlotte can help you on the model construct. And there will also be additional information in the presentation, which will help with that as well.

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**Operator**

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

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

Thank you, Liz, and thank you all for joining us this morning. We are pleased with our strong results in the fourth quarter and throughout 2022. And we're excited about how far we've come and our prospects for the future. While we expect 2023, as we've said, through the questions and the construct of our expectations to be a dynamic environment, we're really confident about our ability to execute. We're well positioned in a variety of end markets. We're continuing to invest in product vitality and in service. And we developed, most importantly, a culture that supports change and is committed to improving. So thank you for your interest in our company, and we look forward to talking to you again real soon.

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**Operator**

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







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