Fortune Brands Innovations, Inc.
First Quarter 2025 Earnings Conference Call
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<u>Presenters</u>
Leigh Avsec, EVP, External Affairs and Chief of Staff
Nick Fink, CEO
Jon Baksht, CFO
Dave Barry, President of Security and Connected Products

<u>Q&A Participants</u>
Phil Ng - Jefferies
John Lovallo - UBS
Trevor Allinson - Wolfe Research
Susan Maklari - Goldman Sachs
Mike Rehaut - JP Morgan

Operator
Good afternoon, everyone. My name is Morgan, and I will be your conference operator today. Welcome to the Fortune Brands' first quarter 2025 earnings conference call. All lines are muted to prevent background noise. Following the speakers' remarks, we will open the call for a Q&A session. At this time, I will turn the call over to Leigh Avsec, Executive Vice President, External Affairs and Chief of Staff. Leigh, please go ahead.

Leigh Avsec
Good afternoon, everyone, and welcome to the Fortune Brands Innovation's first quarter earnings call. Hopefully, everyone has had the chance to review the earnings release. The earnings release and the audio replay of this call can be found on the investor section of our fbin.com website. I want to remind everyone that the forward-looking statements we make on the call today, either in our prepared remarks or in our associated question-and-answer session, are based on current expectations and market outlook and are subject to certain risks and uncertainties that may cause actual results to differ materially from those currently anticipated. These risks are detailed in our various filings with the SEC. The company does not undertake any obligation to update or revise any forward-looking statements except as required by law. Any references to operating profit or margin, earnings per share, or free cash flow on today's call will focus on our results on a before-charges and gains basis unless otherwise specified. Please visit our website for reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures.

With me on the call today are Nick Fink, our Chief Executive Officer, and Dave Barry, our former Chief Financial Officer and current President of Security and Connected Products. We will also be joined by Jon

Baksht, our new Chief Financial Officer, and Curt Worthington, our new Vice President of Investor Relations and Finance during the Q&A session. Curt is a seasoned IR professional and joins us from Pactiv Evergreen where he worked alongside Jon. I will continue to be involved in investor relations as part of my role as Head of External Affairs and Chief of Staff, just in a different capacity. I am looking forward to working with Curt to ensure a seamless transition. Following our prepared remarks, we will have allowed time to address some questions. I will now turn the call to Nick. Nick?

Nick Fink
Thanks, Leigh, and thank you to those joining our call. On this call, I will discuss the impact of tariffs on our company, summarize our first quarter performance, give an update on a few of our key strategic priorities, and discuss the external macro environment. In addition to giving an overview of our expectations around the impact of tariffs, I will provide some color into the areas where we believe we have opportunities to outperform and grow share. Then Dave will review our financial results and assumptions and give more information on tariffs, our mitigation efforts, and our balance sheet. I would like to take a moment to thank Dave and extend my heartfelt gratitude for his partnership as our CFO. Now as he fully transitions to his new role of President, Security & Connected Products, I am excited for how he will accelerate our success with that portfolio.

I am also pleased to have Fortune Brands' new CFO, Jon Baksht, join us for Q&A today. Jon's level of experience as a successful public company CFO is outstanding, and he is quickly learning our business and already providing valuable insights. He and Dave are working closely together to ensure a smooth transition. Jon is one of several recent, highly talented key hires that we have made as we prepare to consolidate most of our U.S. office associates into one state-of-the-art campus in Deerfield, Illinois. We have been delighted by the quality of talent that we are attracting and now have a world-class leadership team fully in place. Additionally, we are pleased to have many of our existing out-of-state associates willing and able to continue their career journeys with us in Deerfield, with the numbers of associates who have chosen to relocate and remain with the company exceeding benchmarks.

Overall, I am extremely pleased with our progress as we consolidate our offices into one headquarters campus. By establishing an inspiring hub where our associates can effectively collaborate and ideate, we will elevate our execution and expedite our growth potential. We anticipate that our first wave of associates will come together at the new campus towards the end of the summer. These are very dynamic times. Fortune Brands Innovations has demonstrated the capabilities to respond promptly, adapt swiftly, and identify opportunities even in the face of challenging circumstances such as the initial tariff increases from 2017 to 2019, the COVID-19 pandemic, and the subsequent supply chain disruptions. Through each of these challenges, our team's execution exceeded our customers' expectations as well as our own, enabling us to capture additional share. This proven track record gives me great confidence that we will continue to thrive and deliver exceptional results for our stakeholders. Our associates are demonstrating the same urgency and strategic thinking with the current tariff situation from both a supply chain and commercial perspective. I am very grateful to our teams for rising to the challenge presented by the current uncertainty and focusing on the very real opportunities we have right now in delivering for our customers and consumers.

In response to the uncertainty of the external environment, we have established a focused set of priorities designed to ensure that we can continue to execute our strategy and deliver for customers and consumers. This includes mitigating the expected impact of tariffs by leveraging our strong U.S. footprint,

investing behind our successful brands and impactful innovation, expanding our digital business, and driving free cash flow to support our fortress balance sheet. By dedicating our resources to these crucial priorities and sustaining strategic investments, I have confidence that we will succeed.

We remain agile in a very rapidly changing environment and have already taken significant actions to mitigate our exposure to the anticipated impacts of tariffs and to optimize our competitive positions in light of our robust U.S. and North American supply chain and operations footprint and leading brand positions. Our initial guidance on February 6th included the impact of the then-announced tariffs, and our EPS range assumed that some additional tariffs could be imposed. However, because of the uncertainty around how consumer demand will trend throughout the year, we will not be providing detailed full-year financial guidance this quarter. Instead, we will be providing a framework that outlines how various volume scenarios may impact our full-year EPS.

I will provide a high-level view on how we're thinking about the impact of tariffs and the related mitigation actions in 2025. We expect to fully offset the anticipated $200 million of 2025 tariff impact through a combination of supply chain opportunities, cost-out activities, and strategic pricing actions across all of our channels and brands. Assuming current tariff levels, we expect the full annualized impact of tariffs in 2026 to be around 525 million, which we expect to fully mitigate through supply chain actions and other mitigation strategies.

In addition to our three main mitigation strategies, we have been actively engaged with senior-level officials in the Trump administration, key agencies, and members of both the House and the Senate to educate them on our story and to find ways to further bolster U.S. manufacturing. While we are not planning on any tariff exclusions or exemptions, we believe ourselves to be well-positioned if there are government actions to support U.S. manufacturers. Notwithstanding some of the shorter-term cost challenges, we believe the tariffs and current geopolitical situation are creating some very relevant short- and long-term growth opportunities, and we are working to maximize these opportunities, including leveraging our significant U.S. and North American manufacturing presence.

We are predominantly a North American-based manufacturer, with around 60% of our COGS from the U.S. and 70% from North America. We have 15 North American manufacturing and distribution sites, including 12 U.S. sites employing thousands of Americans. Since 2017, we have reduced our spend from China by over 60%, and by the end of the year we expect our China COGS to be around 10%. We have already made significant progress on other large supply chain moves, which will further reduce our exposure to China. Many of our competitors, particularly in our outdoors and security segments, source almost exclusively from China, putting us at a clear and immediate advantage. In other parts of our supply chain, we are noting potential trans-shipping of Chinese products, and we are confident these actions will be exposed and stopped, leading to further opportunity. In the coming months, we expect our advantage supply chain will offer us opportunities to take share in many of our categories.

Beyond our supply chain, we have several other competitive advantages. We are price leaders, and the majority of our sales are through complex channels, which allow us to more effectively pass along price increases where and as needed. We have sophisticated data capabilities, allowing us to take strategic and more surgical pricing actions. We have leading brands in spaces where brands, innovation, and quality matter, giving us a competitive advantage during periods where consumers are looking for more value. Our products are generally smaller ticket items that can enhance a space at a relatively low cost. Finally,

we make digital products that help solve some of the most pressing challenges facing the world today and can help consumers and commercial customers reduce costs and therefore have idiosyncratic demand curves with non-traditional drivers.

Importantly, we have a fortress balance sheet with strong annual cash flow. This robust foundation allows us additional flexibility to navigate challenging external conditions without compromising our long-term strategy of opportunistically deploying capital and paying a reasonable dividend. We believe that we are well prepared for any future economic downturns with the ability to generate cash and maintain a strong balance sheet while continuing to invest for the future. We have demonstrated that we can deliver attractive decremental margins in the face of material market declines and take various cost-out actions if necessary. Importantly, while our recently announced headquarters consolidation was driven by highly strategic reasons, it also has the expected impact of reducing our SG&A. Additionally, we are now hiring for those roles made available by associates who chose not to relocate and have full control over the pace of hiring with the ability to scale back discretionary rehiring if external conditions warrant. We are many months ahead of other companies that may potentially look to make tough decisions about their workforce in the coming months.

Turning now to some thoughts on the current housing market and the market for our products, we continue to see the effects of uncertainty around the economy weighing on the consumer and ultimately on our demand. The spring selling season has been slower due to cautious consumer behavior. In the repair and remodel sector, consumers are similarly hesitant delaying major purchases because of the uncertain environment. Larger, more discretionary projects are expected to be more impacted than smaller R&R tasks. Despite this, the housing market is still under bolt with significant pent-up demand, and historically the housing sector tends to recover first during economic downturns. We believe the medium and long-term fundamentals in this space remain strong.

Turning to our first quarter performance, our first quarter results reflected a softer market including inventory reductions across our channels, primarily in water. Consumers and customers are showing caution due to the external uncertainty. Amidst this uncertain backdrop, we delivered margins and EPS in line with our expectations. Sales were $1 billion, down 7% versus the first quarter of 2024. We're down 5% organically excluding the impact of China and FX. Our results reflected the impact of a soft demand environment with point of sale excluding China down low single digits and reductions in wholesale inventories. Our teams remain focused on our key priorities amidst a volatile environment and delivered margin results in line with our expectations while continuing to invest in a narrow set of long-term strategic initiatives. Our operating income was 136 million, and our operating margin was 13.1%. Our earnings per share were $0.66.

This past quarter, we saw the implementation of several key initiatives. We believe the progress that we made on these strategic initiatives will result in long-term value. Our new Master Lock and SentrySafe brand campaigns launched, and we have seen an immediate positive uptick of sales and website traffic. Our Larson Perfect aisle rollout accelerated this past quarter with extremely favorable responses and will bring new energy to this category. Our Moen brand is stronger than ever, and we were recently recognized as the most trusted brand of faucets for the 10th consecutive year. Moen introduced updated fashionable product suites that are in line with current trends receiving very positive market feedback. These products are expected to perform well throughout the year and beyond. And as I will detail in a bit, our flow leak

detection device continues to have incredible momentum. We've sold more flow devices year to date than in all of 2024.

We are pleased with the performance of our digital products with over 200,000 device activations in the first quarter. Our digital business remains strong, and we believe that we are on track to deliver around $300 million in sales in 2025 in this portion of our business. Our flow business was especially strong with impressive momentum. We added three new major insurance partnerships in the first quarter, including our recently announced partnership with Liberty Mutual Insurance, one of the largest national insurance companies. Flow sales increased by 180% over the first quarter of 2024.

We also unveiled our first bundled subscription model with very positive feedback on our pricing structure. Even before we started marketing this new pricing model, we saw consumer uptake. We're confident that our flow business will continue to accelerate even in the current uncertain environment, driven by its clear win-win value proposition for both homeowners and insurers. These new insurance partnerships, growing consumer awareness of the criticality of this product and its ability to protect homes and lower insurance premiums, is fueling its continued strong momentum. Our Yale lock business is accelerating with many recent developments and new partnerships. This past quarter, Yale expanded into some of the largest retailers with very encouraging initial sales, and we introduced new multifamily smart lock solutions. In partnership with Google, our new enhanced Yale smart lock with Matter will roll out later this quarter, replacing the prior Nest Yale lock. We recently announced that ADT and Yale have partnered together to introduce the first ever biometric Z-Wave credential command Class lock, an industry first innovation, which allows ADT users to unlock and disarm their security system from their door using just their fingerprint.

And finally, we made important strides with our Master Lock Connected Lockout Tagout this past quarter. This commercial safety solution has been adopted at several large-scale customers, including Ozinga Manufacturing and Cushman Wakefield. Connected Lockout Tagout is a significant and attractive opportunity for manufacturing companies because it leverages technological advancements to provide superior protection, efficiency, and safety for employees during maintenance and servicing of machinery while reducing workers' compensation claims. We continue to expect big things out of this digital business.

Turning now to our individual business results. Starting with water innovations, this segment saw sales decrease by 10% or 7% organically, excluding China and FX. Our results reflect the softer demand environment with point of sale excluding China down low single digits as well as inventory destocking and wholesale as our partners prepared for a softening environment. Our results also reflect a transition to enhanced pricing discipline in our e-commerce channels, resulting in lower point-of-sale and shipments in the quarter. Within this segment, we saw market outperformance in our House of Rohl business as the luxury consumer remains resilient.
Looking forward to the remainder of 2025, this segment will be impacted by tariffs, and we cannot accurately predict the demand landscape. We are focused on addressing our tariff exposure through sourcing moves, cost-out activities, and selective pricing actions.

We believe that our domestic Moen operations will provide us with a competitive advantage, particularly against finished goods which come directly from China or other tariffed countries. In addition, the current geopolitical environment is providing us with opportunities to distinguish our safe and reliable Moen products versus inferior and dangerous imposter brands. We will focus on achieving above-market sales

by targeting areas of the market with significant growth potential. Our strategy includes making careful and selective investments in our key priorities such as branding, marketing, and digital initiatives. I am confident in the ability of our new leadership in our water business to launch another era of market outperformance for this storied business.

Turning to outdoors. Sales decreased 3% on softer retail point-of-sale and wholesale inventory reductions in doors, partially offset by double-digit sales growth in decking. We remain laser focused on leveraging our expertise and investing behind our core categories and in those products which we expect will offer the most attractive growth opportunities. Our outdoors business has a significant North American manufacturing base with strong domestic manufacturing presence. We expect this advantaged operational footprint will give us a strong competitive advantage particularly in the case of Therma-Tru where many of our competitors are sourced directly from China. The high tariffs should result in narrowed price differentials, and our North American supply chains should provide more stability of products. In addition, we are in the first phase of our anti-dumping lawsuit where we are seeking to address unfair trade practices of a number of China sourced fiberglass store products. The combination of tariffs and the anti-dumping lawsuit is an opportunity to even further accelerate our expected market outperformance.

Finally, our security segment sales decreased 4% in the quarter primarily due to soft point-of-sale as consumer confidence decreased and channel partners took out inventory. However, we see opportunity in this business to take share because many of our competitors' products come from China, and we are accelerating our branding efforts around helping consumers understand the true value of our products which has already been proven very successfully in our safes business. We expect to see some benefits in the second half of the year related to some new product rollouts in both traditional security and our digital locks business. Our Yale lock business is showing positive momentum as we look to the back half of the year and comp against disruptions in 2024.

To recap, as we look across the balance of the year, we are acutely aware of the pressures of the external environment and will be executing on a narrow set of clear priorities. These priorities include mitigating the expected impact of tariffs, controlling costs, continuing to drive our strong brains in digital portfolio, and maintaining our fortress balance sheet. We have full confidence in our team's ability to mitigate the expected impact of tariffs through strategic sourcing moves, cost-out activities, and pricing actions. While we have less clarity around volume and demand trends, the current situation creates several opportunities to drive market outperformance across our portfolio.

Our digital business remains strong with opportunities for growth even in the current environment. Our brands are trusted and known for their dependability, safety, and design. We have advantage supply chains across our portfolio with reduced reliance on China which we can leverage to our advantage. And finally, we have a world-class leadership team in place and engaged high-performing associates who are energized by external challenges. As we have done in the past, we will seek and execute upon opportunities to excel in the current environment. I will now turn the call over to Dave.

David Barry

Thank you. Before I begin, I would like to express my heartfelt gratitude to Nick for his exceptional friendship, leadership, and mentorship during my tenure as CFO. As I continue in my new role, the enterprise perspective I have gained as a result of my tenure as CFO will be invaluable, and I know all of our stakeholders are in great hands with Jon. As a reminder, my comments will focus on results before

charges and gains to best reflect ongoing business performance. Additionally, comparisons will be made against the same period last year unless otherwise noted. As Nick mentioned, in light of the uncertainty around price elasticity and the demand environment, we will not be providing our usual detailed guidance for the year, and we have suspended our prior financial and market assumptions. However, I will provide a framework and range for two different EPS scenarios based on different volume assumptions resulting from potential consumer behavior. But first, let me start with our first quarter results.

As Nick highlighted, our teams executed our priorities amidst a very dynamic macro environment in which we saw demand slow from mid-February through the end of the quarter and continuing into the second quarter. In the first quarter, sales were 1 billion, down 7% and down 5% organically excluding China and FX. Consolidated operating income was 135.8 million, down 19%. Total company operating margin was 13.1%, and earnings per share were $0.66. Our first quarter sales performance was driven by low single-digit POS declines and low single-digit impact from inventory reductions in wholesale and retail channels as consumers and customers reacted to an uncertain economic environment.

Beginning with water innovations, sales were 565 million, down 10% and down 7% organically, excluding the impact of FX and China, which was, as expected, down significantly versus 2024. Our results reflect POS, which was down low single digits, excluding China, and channel inventory reductions at wholesale and retail, as well as the impact of lower POS and shipments into the e-commerce channel as we transitioned to enhanced pricing discipline. Within our water segment, House of Rohl continues to outperform the market. Water Innovations operating income was 113.2 million, a decrease of 20%. Operating margin was 20%, as expected, reflecting the impact of lower volumes and higher cost inventory moving on to the P&L.

Turning to outdoors, sales were 305 million, down 3%, driven by low single digit POS declines. Looking forward, we expect doors to be a relative beneficiary of the anticipated impact of tariffs, particularly in Therma-Tru, and we expect to see the benefit of the Larson aisle reset, which is accelerating through the second quarter. Outdoor segment operating income was 31.7 million, down 16% from the prior year quarter. Segment operating margin was in line with our expectation at 10.4%. In security, our first quarter sales were 163 million and declined 4%, reflecting low single digit POS declines and continued Yale destocking of older product lines ahead of new product line introductions later this year. Our safes products delivered positive POS as the impact of our innovative marketing campaign continues to resonate. Segment operating income was 23.2 million, down 13%, and segment operating margin was 14.2%, reflecting the impact of lower volumes and continued investment into innovation and brand building. As noted, many competitors in this space are sourced from China, and we would expect to have an opportunity for us in the near term given the current tariff environment.

Turning to the balance sheet, our balance sheet remains solid with cash of 340 million, net debt of 2.6 billion, and our net debt to EBITDA leverages 2.8 times, reflecting a seasonal peak. Given the EPS scenarios that I will outline shortly, we expect net debt to EBITDA to be between 2.0 times and 2.5 times at year end. We have $970 million available on our revolver. In the first quarter, we returned over $200 million to shareholders via a combination of share repurchases and dividends, including $175 million of share repurchases in the first quarter. We have repurchased $225 million of shares year to date. Our first quarter of free cash flow was negative 113 million, reflecting the typical seasonality of our business and in line with our expectations. Given the current environment, we are actively managing our expenses and cash flow, and after paying our dividend, we will remain returns-focused and opportunistic in deploying

capital through additional share repurchases and M&A. Additionally, we have a head start on expense and cash flow management given the timing of the headquarter consolidation project currently underway.

Before turning to our outlook, let me provide additional detail on our tariff exposure. As a reminder, we are a predominantly U.S.-based manufacturer with 60% of our cost of goods in-country and 70% of our cost of goods in North America. Our footprint leaves us very well positioned to both service our customers at a high level and take share in this current environment. As Nick mentioned, under the current tariffs as of May 5, 2025, we expect unmitigated impact of approximately 200 million in 2025 and 525 million annualized. Of the 525 million annualized impact, 425 million is related to China, and the balance is rest of world. We expect to fully mitigate the in-year and annualized impacts.

Turning now to our outlook. Given the uncertain external market environment, we are not providing our usual detailed financial guidance for 2025. However, I will provide a framework to set a range for our expectations. This framework assumes all tariffs remain in effect at the current levels. We expect to fully offset the impacts of anticipated tariffs in 2025 through supply chain moves, cost-out activity, and strategic pricing actions, with the most meaningful in-year impacts coming from price and cost controls.

While we have good line of sight to our ability to mitigate tariffs, we cannot predict how the consumer will react, and consequently, the impact on our volume remains uncertain. To help frame potential outcomes, we are providing new guidance for a full-year 2025 EPS range of $3.70 to $4.20 underpinned by two different volume scenarios. Both scenarios assume that we fully offset the in-year impact of tariffs through supply chain moves, cost-out activities, and pricing actions at an average mid-single-digit percentage rate across the entire business. Each scenario also assumes an additional $0.06 to $0.08 negative impact to EPS due to required withholding tax from China cash repatriation that will take place in the second quarter, partially offset by the full-year impact of incremental share repurchases.

Given the uncertainty surrounding the consumer in recent data points suggesting a slowdown, our EPS outlook incorporates two potential outcomes, low single digit or high single digit volume declines. In the event we see low single-digit volume declines, coupled with the mid-single-digit price increase from tariffs, we expect to see low single digit revenue growth and operating margins around 17%. This would equate to EPS of around $4.20. In the event we see high single digit volume declines, coupled with the same mid-single digit price increases, we expect to see low single digit revenue declines and operating margin around 16%. This would equate to EPS of around $3.70. Regardless of what scenario plays out, the teams are working with agility and urgency on executing our supply chain moves, cost-out activities, and pricing strategies. We will continue to find win-win solutions with our customers where our products are more favorably positioned versus our competition.

In conclusion, while the current external environment remains uncertain and challenging, we have full confidence in our team's ability to navigate these complexities. We expect to fully offset the impact of anticipated tariffs in both 2025 and 2026 through supply chain actions, cost-out, and pricing. By focusing on our key priorities, including mitigating the impact of tariffs, concentrating on our successful brands and impactful innovation, expanding our digital business, and managing our balance sheet, we believe we are well positioned to succeed. We believe our competitive advantages, such as our North American-focused supply chain, strong balance sheet, and leading brands, will enable us to thrive despite the current external conditions. We will proactively manage these dynamic periods while actively positioning Fortune Brands innovations for the future. We will now pass the call back to Leigh to open the call for questions.

Leigh Avsec
Thanks, Dave. That concludes our prepared remarks. We will now begin taking a limited number of questions. Since there may be a number of you who would like to ask a question, I will ask that you limit your initial questions to two and then re-enter the queue to ask additional questions. I will now turn the call back over to the operator to begin the Q&A session. Operator, can you open the line for questions? Thank you.

Operator
If you'd like to ask a question, please press star followed by the number one on your telephone keypad. A confirmation tone will indicate that your question has been added to the queue. To withdraw your question, press the number one. If you are using a speaker phone, please pick up the handset before pressing the star keys. Once again, press star followed by the number one to ask a question. Your first question comes from Phil Ng with Jefferies. Your line is open.

Phil Ng
Hey, guys. Dave, congrats on the new role, and Jon and Curt, looking forward to working with you guys again. I appreciate all the great color. I guess, first off, Nick, a question for you, obviously, a very dynamic environment. You guys announced this transformation effort, kind of moved the headquarter and kind of thinned out the layer of management. How does that kind of progress, and how does that allow you to kind of navigate in this dynamic backdrop?

Nick Fink
Well, hey, Phil. Happy to give some perspective around that. Why don't I start just by putting it in context, at least the way I think about it? I think of this as we're in the third of three phases around our transformation. If you think about that kind of first phase, we transformed the portfolio. We spun the cabinets business out, right? Yale, M-Tech acquisition. We also did the acquisition around Springwell, so a lot of portfolio transformation, kind of phase one.

Phase two was really the transformation into an operating company so we could fully leverage our scale, particularly for the digital transformation but also around marketing, supply chain. I think things that you're really starting to see yield dividends, particularly in this dynamic environment. I'm sure we're going to talk about tariffs a bit, but you can see the speed at which we're going to be able to move, and I think a lot of that is thanks to the fact that we are much more of a consolidated and aligned operating company.

And the third phase is really, co-location to drive innovation and performance acceleration. And so, we're in the midst of that third phase, which I think will get us to the finish line of this transformation effort. To date, it's a heavy lift. I won't minimize it. It's a heavy lift. But it's going really well. We now know who is coming along to continue their careers with us amongst the impacted population and who isn't, and we turned up actually pretty materially better than industry benchmarks would suggest. And so, we were very happy about the talent choosing to relocate to the area and continue their careers with the company. For those not continuing, they've remained very engaged, and our hiring process is well underway. And I've got to say, maybe part of this was the timing ended up even better than we thought because we are in a dynamic economic environment. But both the quantity and quality of talent that we are seeing interested in joining our company is pretty spectacular, and so, I think we're going to see a very, very dynamic group join the company, and I think you're already seeing that as we filled out the leadership team.

And then the third part that you alluded to here just sort of like in this very dynamic environment that actually unintended but perhaps happily gives us a lot of flexibility is, we're now in the rehiring process, and we can control the pace of that rehiring in what is going to be a dynamic and changing economic backdrop. I know that a lot of companies out there are thinking about restructuring, are thinking about how to control costs and manage this environment. We're actually, if you think about it, almost six months ahead of that process. Because of the move, people have opted out. We're in the rehiring phase, and we can really control the pace of rehiring.

Right now, we're all systems go full steam ahead on critical roles, but as we see the economy unfold here, we're going to be able to control the pace of that. And I think that's just going to give us a lot more flexibility than had we been just at the front end of it now. So, in sum, it is a heavy lift, but I think we're going to land in a really good place. Headquarters open towards the end of this summer, so everyone gets to come together in a highly energized place, and I invite you to come visit us. The first thing that's going to hit people in the face as they walk through the door is this is a company that innovates and makes things, and that's going to be a big part of this. This is about bringing people together so they can ideate, innovate, move faster with more agility, and perform even better. It's going to be an exciting chapter for our company.

Phil Ng
Super. Super. Appreciate all the color. Dave, on the tariff side of things, great colors. If I heard you correctly, you're fully expecting to offset the 220 impact this year, and then, I guess, on an annualized basis, it's 525. So, number one, how should we think about that 525 being divvied up by segments where you have exposure? And then how much of these mitigate actions you have, whether it's a price increase, cost offsets? And to kind of help us contextualize when this hits your P&L. There's a lag dynamic. It's pretty impressed if you're expecting your downside scenario is 370. That's pretty manageable. Just any color would be helpful.

Dave Barry
Yeah. Thanks, Phil, and thanks for the kind words. I'm happy to give some more color on tariffs. Let me first clean up just the exposure. So, its in-year impact was 200. Annualized was 525. And as we've talked about on prior calls, the teams have anticipated that this environment would likely be coming at us, although it's more extreme. I think we all could have imagined a few quarters ago. So, there's been work underway to move the supply chain. The supply chain moves are the most impactful lever we will deploy. But, as you know, they take time, time to implement, but also then longer time to actually impact the P&L. So, those are underway. We expect supply chain to be more of a mitigating factor as we move late into '25 and into early '26. So, in the meantime, all of our brands across channels are taking price. And I think it's also good to remember that about 65% of our business is through wholesale and/or direct to consumer, where we have a better ability to pass through price with ease. And so, successful negotiations with customers on price already, more negotiations ongoing.

Price and cost out are going to be the two biggest levers for us this year and feel good about line of sight to delivering that mitigation. As I think about impact -- I can break it down a little bit. So, 525 annualized impact, I'd say about 425 million of that or 80% is China-related. Balance is rest of world. And then looking at segments, water is about 60% of the impact, security 25%, outdoors 15%. We'll start to see P&L impact

from the tariffs in this quarter, late in this quarter, but then really ramping third quarter into fourth quarter and see more than 50% of the in-year impact in the fourth quarter.

So, pricing coming in now will offset here in the next couple quarters [inaudible] start to ramp as we go through the year, and then supply chain actions impacting the P&L late this year into next year. So, that's how we're thinking about it. Now, I think in our two scenarios -- a bit of context around the downside scenario. High single digit volume decline implies an acceleration in volume declines from where we are year-to-date. So, year-to-date, we've seen volume down low single digits in the first quarter. It's down mid-single digits to start the second. So, it would be an acceleration to get to that 370. I mean, I think we, as we think about it, the consumer reaction to what's happening in the external environment remains the biggest unknown for the business, and we can control supply chain. We can control the pricing, our cost out. It's just what's going to happen to the consumer, and that's why we decided to frame our guidance a little bit differently this time and give these two end posts.

Phil Ng
Okay. Appreciate all the great color, guys. Thank you so much.

Dave Barry
Thanks, Phil.

Operator
Your next question comes from John Lovallo with UBS. Your line is open.

John Lovallo
Good evening, guys, and thanks for taking my questions. The first one is on the digital initiative. I mean, there's certainly a lot of focus and excitement internally on that, and there's been some good progress with the 200,000 activations in the quarter, the major insurance wins, I think Liberty this quarter. I guess the question is, how confident are you in still achieving that 300 million in sales? And along the same lines internally, how do you sort of balance these efforts with continuing to drive the performance in the core business where the market is, for better or worse, focused?

Nick Fink
John, I'll start a couple thoughts, and then coincidentally, we're very lucky that we got the president of the connected business on the call here today, so I'll let him really dig in and opine. We're obviously super excited about the connected and the digital business, and the performance has been phenomenal. I mean, we talk a lot about flow, the growth rate in the quarter alone, and it's no longer a small business, so I probably get this clip. Dave touched a lot on, in his remarks, on the security business, which had some bumpy laps last year as we really transitioned that from more of kind of mid-cycle startup to a more consistent sort of roll out of new products. But we're really seeing some great performance there and some big new partnerships announced that are really meaningful.

The confidence really comes from the fact that these drive a lot of value outside of kind of the normal sort of consumer repair and remodel need, whether it be something like flow that actually takes cost out of the system, right? People are going to have to take cost out of the system no matter the economy. In fact, the tougher the economy, the more likely they're going to be driven to do that, and flow just does that. And our new subscription model that we've just started trialing really allows consumers to do that at a very low

entry level. And then you look at on the security side, whether it be the [inaudible] business, which is really actually going to help save lives at the end of the day, and it's hard to put a price on that, or the consumer business, where you could do things like disarm your alarm system with your finger as you enter your door and the fingerprint, I mean, again, huge value driver to a consumer that just sort of detaches us from the normal cycle. So, a lot of confidence there.

The second part of your question, which I just want to answer before I end it today, there's a very important one, which is how do you balance these things? And obviously, we put a lot of focus and a lot of investment on the rest of the business. I do think coming together in our new headquarters, single campus, again, driving industrial design, innovation, commercial discussions, supply chain discussions, performance, all in the same place is actually really going to help accentuate that performance. We've got a really big and very important core business that we need to continue to drive. If you look at this year -- and you'll see it roll out over the course of the year. You're going to see a lot of innovation around the core business. Moen has a lot that's coming to market that we rolled out at our sales events and the K business here. You're seeing the Larson Perfect aisle, which will be a total refresh of that aisle. Our 1700 store is really, really impactful. And then in security, brand new campaigns behind Master Lock, SentrySafe, new industrial design rolling up, much cleaner product segmentation and making it much easier for the consumer and the pro to navigate our products and our shelves. So, I think you're going to see a lot of focus and excitement around the core. And I really think it's going to show up in our share numbers.

Dave Barry
Yeah, a couple things I'd add. So, one -- I'm sorry, just one -- couple things. So, good start to the year, and [inaudible] pays to deliver the full year goals. So, that's a performance update. I'd keep it that simple. I'd say the team is actually doing a great job of staying focused on opportunities given the challenges in the current environment elsewhere. And Nick talked through in his prepared -- in his prepared remarks, we have signed new insurance partners, we've launched subscription-based pricing test. Additionally, we've qualified another national installation partner for flow and signed up more than 40 regional carriers, which was a new initiative this quarter to -- if we focus on national carriers the past year now moving into the regional carriers and really been adding focus on driving sales activation through the agent base, which is going to the next level of activation that we're doing to drive sales on flow. And then for Yale, we touched on some of the neat partnerships that are coming to launch with ADT. Google is selling. We've also won more than $10 million of placements in retail and e-commerce, which was a focus and a point of synergy from this acquisition to take this brand back through our traditional channels. And we're starting to see that play out and come to fruition. So, we're excited about the momentum and on track to deliver our full year estimates.

John Lovallo
Great. That's really helpful. And then, so far, the feedback that we've received today from investors has been on the water segment and the seeming underperformance versus your large competitor. And POS was down low single digits. I know there's some inventory destock, but I guess the question would be, one, just any more color on that e-commerce pricing strategy that you mentioned, and then any kind of relative share shifts that may be worth noting in the quarter, please.

Nick Fink
Yeah, I'm happy to give a bit of color on it, and Dave can round it out. But as you look at that, you're right. Low single digit declines in POS. We did see a fair amount of inventory come up, particularly from our

wholesale channel, I think, in preparation for some softness, and we've probably seen that come through a bit with the builders. And then as we sort of de-segment the low single digit POS declines and look across, the feedback from the retailers on our business has actually been very good, particularly of late, where they've been telling us that we're doing better than category. So, I'm going to take that at face value. In e-commerce, we did transition, and we are transitioning through to a firmer pricing strategy so that we can keep our all channels healthy and competitive. But that is a transition as you do it.

I mean, you sort of got to force it in one place, and then it takes a while before you see the uptick in the other channels. We also have to make sure that we have all offerings available, no matter where the consumer is. So, we felt it was a necessary and important thing to do. We noticed with some new analytics, we've gotten a bit out of whack, and now we're transitioning through it. But I acknowledge -- I think it did cost us some share in e-commerce as we're doing it. But our focus is being a long-term share gainer, and we will do the right things for the health of the brand, even if it means a trade-off in a quarter or two.

Dave Barry
And I would add, John, if you think about the water sales down ten, organic ex-China, FX down seven. Now, Nick talked about that low single-digit POS decline, which is really consistent with what we saw across the rest of the portfolio. I think where we were surprised as the quarter went along was the inventory drawdown, especially in wholesale. It was a mid-single digit impact on the segment. As we look at weeks of supply with some of our bigger wholesale customers, they're now below any point they've been in the past 18 to 24 months. And so, I think it's a sign potentially of softening single-family new construction volume and multi-family new construction volume they're seeing. But that was probably the biggest surprise in the quarter on the water side.

John Lovallo
Okay. Thank you, guys.

Operator
Your next question comes from Trevor Allinson with Wolfe Research. Your line is open.

Trevor Allinson
Hi. Good evening. Thank you for taking my questions. First one, you talked about reducing your China exposure. I think you said that 10% of COGS by the end of the year. On the 525 million impact in 2026, is that assuming current China exposure or your exposure after you've moved that to 10% of COGS? And then what additional assumptions are there around cost to move products elsewhere? And what other countries are you primarily moving that exposure to?

Dave Barry
Yeah. Hey, Trevor. This is Dave. I'll start with someone, and then Nick can give some context. On the -- the 525 number is unmitigated, so before any mitigation action. And so, we'd expect to be able to – that number will come down, obviously, as we mitigate, and then we'll update in subsequent quarters how that's progressing. As we looked at supply chain shifts, right, as we talked about, we have a global footprint. We have significant presence in the U.S. and in other North American sites. And so, it's leveraging – really finding the best cost position for our customers given our footprint. And those things take time. And there are investments, to your point. Most of the investments, though, are capital – and I'd say a reasonable amount of capital to stand up some assembly lines and production lines in our nearshore

facilities. So, that's how I think about the incremental cost. I think our capital forecast around that 3% to 4% of sales kind of encompasses that. I wouldn't expect it to be a material number outside of our typical capital range. And then on the cost side, I mean, we're, again, trying to get to a lowest cost position given our network to be able to continue to be competitive and take share in our market.

Nick Fink
I'll just add for a bit of context, Trevor. From the strategic perspective -- and a call out to our supply chain team that have just simply been phenomenal. I've really led -- I kind of have said two-part strategy. One is a bet on our U.S. and North American manufacturing footprint. And so, as I said in my remarks, 12 U.S. sites, 15 North American sites. That was a decision that was made. I mean, we've been thinking about debating this and preparing this, obviously, for several years now. The other leg to the strategy has been a hyperflexible supply chain. And so, as we've debated what to do over the last several years, rather than betting on any particular country, we've bet on making our supply chain hyperflexible so that we could move it about as needed. And you're seeing that come through now in the speed of some of the mitigation that Dave's discussed. And as we've done in other kinds of great dislocation, we really expect that this is going to generate a competitive advantage for us, and we're going to press that advantage to service our customers very well.

Trevor Allinson
Yeah. Makes a lot of sense. And then my second question is somewhat related in just your general approach to China here. I mean, there's been speculation that tariff rates could come down here in the not-too-distant future. You've been moving your supply chain out of China for a while. You're accelerating here. Do you change your approach to moving your supply chain if tariff rates on China specifically were to come down significantly? And then a second question would be on your business actually in China, just given everything that's going on between the two countries. Do you have any differing views on that business now that the dynamics have changed between the two countries? Thanks.

Nick Fink
I'll just take this quickly. Firstly, on the moving about, I think the lanes of travel are pretty well set. The amount of tariff may vary greatly, but I think the lines of travel are pretty well set on where this administration expects the supply chain to go from a regionalization standpoint. And as I just said, we're going to maintain a hyper-flexible supply chain and be able to move it around. And at some other point, I'm happy to detail how we do some of that. But there are specific initiatives that we undertake to make it very flexible. But I think the lanes of travel are pretty well set, and we expect it to be shored up and to take advantage of our U.S. footprint.

The second part is, our business in China is really, at this point, as we said before, China for China. It's manufactured in China. It's for China and sold in China and managed very, very well by a team there. It's organic. It's been homegrown, and they've done a phenomenal job managing it through a lot of disruption over the last few years. I'm not going to predict where that economy goes, but I will say what we were expecting to see was certainly kind of the end of the big disruptions and at least a bottoming out of that business. We'll see if this makes it any worse. But I think strategically, it kind of stays where it is, which is a closed-loop system that still serves that consumer over there and also gives us exposure to a lot of innovation that we see from suppliers in that market.

Dave Barry
Yeah. I'd just add, as a reminder, this is the last quarter of a challenging comp where we were comping accelerated completions. And so, our sales were down in the 30% range in China as expected but now expect to see a much more stable, not necessarily return to growth, but at least not these 30%, 40% decline quarters in that market. And also, the size of the business makes it much less impactful on the overall fortune results going forward. So, we feel like from what we see today, the worst of that is behind us.

Trevor Allinson
Thank you for all the color, and good luck moving forward.

Nick Fink
Thank you.

Operator
Your next question comes from Susan Maklari with Goldman Sachs. Your line is open.

Susan Maklari
Thank you. Good afternoon, everyone. Thanks for taking the questions. I want to start with your comments around the ability to leverage this environment and the assets that you do have in the U.S. to gain share. Can you talk a bit about how some of those conversations may be starting or areas that you're especially focused on and how we should think about that coming through over time and what it could mean for the upside, perhaps, to some of those already really meaningful growth targets that you've set across the various segments?

Nick Fink
Yeah. Well, we're very focused on it. I would say, we never let a disruption go to waste, and we do believe there's a lot of opportunity. I'll start with outdoors. I mean, you look at outdoors business, very vertically integrated through a U.S. manufacturer and is the leader -- particularly the leader in exterior fiberglass stores with manufacturing here in the U.S., capacity that we invested in. And we've seen a lot of competition over the last few years, and frankly, some unfair competition as we've outlined in our anti-dumping suit from China that I believe between those two things is going to go away. No matter where tariffs settle, I think that that kind of behavior has been called out. And people are going to need the volume in the marketplace, and we're one of the few that can provide that volume.

So, that's an example of a place where we think there's a lot of opportunity. There's still a lot of inventory that was dumped into this market that will have to be chewed through, but that's going to happen at some point, and I think people are going to be actually looking for those that can provide consistent, reliable volume. So, a big opportunity for that business. I’m going to counter Dave's business for a second in the security business. A lot of competition from Chinese brands entirely sourced product from China in the securities and safes business. We think there's a big opportunity there with our North American manufacturing footprint.

And then finally, in water, we've maintained a high level of manufacturing here in the U.S., and that's a very complex supply chain with a lot of moving parts. But we see a lot of opportunity, as we outlined in our mitigation, to really continue to leverage and grow the U.S. North American footprint that we have to serve

customers. And ultimately, when you look at all this mitigation we're talking about, we're talking about doing it with just mid-single price adjustments on average across the portfolio, which is really very modest for the amount of dollars we're mitigating. And so, we think that in and of itself will give us a competitive advantage in addition to being able to supply consistently through any disruptions, have that footprint. The fact that we can do it at what is going to be a fairly modest relative to other price increases is going to give us an opportunity across the portfolio.

Susan Maklari
Yeah. Okay. That's great color. And then turning to security, the margin there really outperformed nicely relative to what we had in our model and appreciating some of the current operating pressures that are coming through. But any thoughts on some of the cost benefits that you're seeing there and anything on how we should think about the path forward over time as some of those benefits continue to come in?

Dave Barry
Hey, Suze. Dave. As we've talked about with security, now that Yale is in that segment, the margins can be a bit lumpier quarter-to-quarter just based on investment patterns within that business and new customer launches. The core Master Lock margins remain very strong, right, in that high teens level. And then as we as we invest behind Yale, the margin could fluctuate, and it might move a few hundred basis points over the quarters based on our expectations. So, nothing that we're seeing that's unusual. We are continuing to invest there. And they highlighted the brand campaigns that we've launched for SentrySafe and Master Lock. It's Master Lock's first campaign in decades. And we immediately -- you can watch our website traffic, and our brand metrics start to spike in the market. So, it's resonating with consumers. And we'll continue to lean in that. We're driving some new innovations for all three brands with Master Lock, SentrySafe, and Yale having launched new products or having new products coming later this year. So, you're seeing this margin a bit of the investment cycle timing, predominantly for Yale with a very healthy core Master Lock business underneath.

Nick Fink
And I'll just add, just to put in some context, I mean, this is -- that was part of a multi-year plan. We looked at that business, and we said the brains in that business were far too solid, beautiful, great brains that we had for us not to be investing behind them, but we were not going to be investing behind them at the margins that the business used to have, as you recall. You've tracked us for a long time. And so, we undertook even going back to our investor today to do a lot of work to re-platform that whole business to really healthy margins so we could start to invest in innovation and branding. And that is just coming to the marketplace now, right? So, it takes a while, but we're really excited that not only did we deliver that margin journey, but we did it in a way that's actually allowed us to reinvest in a significant way behind the business.

Susan Maklari
Yeah. Okay. Thank you all for the comments and good luck.

Nick Fink
Thank you.

Operator
Your next question comes from Michael Rehaut with Fortune Brands. Your line is open.

Mike Rehaut
Thanks. Mike Rehaut with JP Morgan, not joining the company.

Nick Fink
Welcome to the team.

Mike Rehaut
You didn't realize how much the new headquarters would change personnel, I guess. I'd love to try and delve in a little bit more in terms of at least the guidance framework. And in particular, a couple of aspects. One, looks like you're baking in, in this 370 to 420 framework, a high mid-single digit price increase to offset tariffs. It looks like, if you just do the back of the envelope math, on your sales base, that's about 230 million, which would exceed the 200 million that you expect to hit you this year in tariffs. So, I know you had also talked about cost reductions. And I'm just curious if those numbers are right, because it would seem like the pricing is more than offsetting the tariff headwind. And also, just a second element to the pricing question -- or to the guidance question, it looks like you're -- also even without the negative impacts of the potentiality around volume being impacted by tariffs, that that volume is coming in a little bit softer than expected just given that the high end of the impact maybe -- the high end of the framework is still below your prior guidance. So, just trying to understand some of the moving pieces there.

Dave Barry
Yeah, Mike. It's Dave, I'll try to put it into context. On the pricing side, I think if you're kind of lower in the range of mid-single digit, you probably get to a more realistic number of where we'll be. Still in that mid-single digit range. And then, that as that comes across the year, there'll be different realization levels and timing. And so, it'll flow through a bit differently as it comes across. So, there will be then cost out and supply chain activities that help that. On the two scenarios, I'd say a couple things on volume. Recall from our prior guidance that the second half has easier comps. We exited some low margin product, right? China flattens out. We had the issue with the security distributions that are going offline in the fourth quarter. So, they're -- they get better on like the comp perspective in the second half from a volume -- year-over-year volume comparison. And then I'd say as we think about the volume scenarios with the downside scenario at 370 and high-single digit volume declines, we'd be looking to target decrementals on the volume in the mid-twenties or better. And that's where the cost leverage that Nick outlined come into play. And so, if we see volume trending that way, we can pull back on hiring and reduce some SG&A. And that would be our target from a volume standpoint.

Mike Rehaut
Okay. No, no, that's helpful. And I guess secondly, just maybe zeroing a little bit into the upcoming quarter, the second quarter, you had said that sales were on track to be down I believe mid-single digits if I heard that right. Any other type of framework around how to think about 2Q either by segment and also from a margin standpoint?

Nick Fink
Yeah. Happy to give it at the Fortune level. I think we see sales down in that low to mid-single digit range, Mike, as you mentioned. That's roughly in line with quarter trends where we see POS down in that four-ish percent range. It does imply sequential growth. We're not right now seeing inventory moves one way or another, really. There isn't a lot of pre-pricing buys, and we don't see any inventory reductions. The other

unusual item I'd call out in the quarter is around the tax rate. And because we are repatriating about $100 million of cash from China as a one-time dividend, our tax rate is going to approach 30% in the quarter, and that's going to be unusual given where we've been historically. So, I just want to make sure I call that out for the group.

Mike Rehaut
Okay. Very good. Thank you very much.

Operator
I'll now turn the call back over to Nick Fink for closing remarks.

Nick Fink
All right. Well, thanks, everyone, for joining us today, and thank you for your thoughtful questions as we navigate a choppy environment but do our very best to put this company on some really good footing. And we see some solid advantages we can take advantage of. And thank you also for welcoming Jon and Curt to their first call.

Jon Baksht
Thanks, Nick. I'm really thrilled to be here. I'm joining at a really exciting time with the transformation underway and the move to the new headquarters. I see an enormous opportunity at Fortune Brands Innovations, and I look forward to speaking with many of you on the call today in the future.

Nick Fink
Well, we're delighted you joined. And I'll just say we had a lot of interest for Jon's role. We set a very, very high bar, and Jon cleared it easily. So, we're very excited to have Jon and Curt on board. And I'll just say as we continue to progress on this ongoing transformation, Jon, Dave, Curt, and Leigh are all emblematic of the phenomenal talent that we can both attract and retain in this business. And so, I have full confidence that with the very strong team we have, we're going to navigate choppy waters ahead and deliver ahead of competitors for our customers while seizing the opportunities that disruption inevitably creates. So, with that, thank you.

Operator
Thank you for joining today's conference call. You may now disconnect.