Fortune Brands Innovations, Inc.
First Quarter 2023 Earnings Conference Call
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<u>Presenters</u>
Leigh Avsec, Vice President of Investor Relations and Corporate Affairs
Nick Fink, Chief Executive Officer
Dave Barry, Chief Financial Officer

<u>Q&A Participants</u>
John Lovallo – UBS
Matthew Bouley – Barclays
Stephen Kim – Evercore
Tim Wojs -- Baird Capital
Truman Patterson – Wolfe Research
Adam Baumgarten – Zelman & Associates
Susan Maklari – Goldman Sachs

Operator
Good morning. My name is Camilla, and I will be your conference operator today. At this time, I would like to welcome everyone to the Fortune Brands First Quarter 2023 Earnings Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

I would like to turn the call over to Leigh Avsec, Vice President of Investor Relations and Corporate Affairs. Leigh, you may now begin your conference call.

Leigh Avsec
Good afternoon, everyone, and welcome to the Fortune Brands Innovations First Quarter Earnings Call.

Hopefully, everyone has had a chance to review the earnings release. The earnings release and the audio replay of this call can be found on the Investors 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 the 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 reference 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 a reconciliation.

With me on the call today are Nick Fink, our Chief Executive Officer, and Dave Barry, our Chief Financial Officer. Following our prepared remarks, we have allowed time to address some questions.

I will now turn the call over to Nick. Nick.

Nick Fink
Thank you, Leigh, and thank you to everyone for joining us, today. On this call, I will walk through the highlights of our first quarter performance, give some color on the drivers of this performance, and offer some thoughts on the macro environment.

I'll then turn the call over to Dave for a discussion of our financial results and how we're thinking about the remainder of 2023, including the increase to our full year 2023 EPS guidance.

As a reminder, this is our first quarter as the new fully separated Fortune Brands Innovations. Our results in a tough market are a testament to our compelling new investment thesis.

We are a resilient and growth-focused company, powered by secular tailwinds, underpinned by leading brands, innovation and channel management and fueled by our Fortune Brands Advantage capabilities.

All of this is enabled by our new organizational structure, which was thoughtfully designed to accelerate growth. Our company is driven by a highly focused, aligned and motivated team who are keen to bolt even further in our long history of market outperformance.

Collectively, over the last year, our teams have led through a period of immense change to emerge as an even leaner and more ambitious growth engine, and I thank them for their dedication.

Turning to our first quarter performance, our teams delivered solid results amid a challenging external environment. As anticipated, reduced demand and a return to typical seasonality impacted our industry. Thanks to the proactive steps we took in preparation for the downturn and the inherent strength of our newly refined portfolio, our brands performed well.

As a result, sales margins outperformed our initial expectations for the quarter. Net sales of $1 billion were down 9% versus the prior year, and our operating margin was 13.1%.

Our sales and margin performance generated earnings per share of $0.69 in the first quarter. Our first quarter results look even stronger in the context of lapping the exceptional performance from the first quarter of 2022.

Putting our results in a broader context, our first quarter organic sales results were 24% higher than in the first quarter of 2019. These results highlight the long-term strength of our portfolio, which is now more focused on smaller ticket branded products.

Our results also reflect the team's focus on outgrowing the market, preserving margins, and generating cash while prioritizing key investments, including in brand building, meaningful innovations and our digital transformation.

Looking at the overall market and consistent with what we anticipated in our fourth quarter call, we encountered macro challenges driven by lower rates of new construction starts, reduced consumer spending and channel partner and order pattern inventory normalization in parts of the business.

We continue to expect headwinds through the remainder of 2023, and the teams are prepared to act proactively and with agility as part of our commitment to our stakeholders to outperform in all environments.

Specifically, as part of the reorganization work that we initiated last year, we also took concrete actions to right-size the cost structure of the business and improve our overall efficiency, including by reducing inventory, driving efficiency in our operations, and reducing duplication, throughout the company.

This new structure enables acceleration of our focus on branding and innovation, and we will continue to provide our customers with the high levels of service and partnership for which we are known.

Most importantly, our new structure is a catalyst for accelerated growth. It allows us to deploy the Fortune Brands Advantage capabilities across the whole organization of fueling growth by removing duplication and nonvalue-added activities.

The opportunities unlocked by our new structure will become even more evident, as the market returns to growth.

In the interim, we will closely monitor the trends and data across our business and we will respond to market conditions with additional actions, as necessary. I have full confidence in Fortune Brands Innovation's ability to deliver long-term growth and sustained value creation, through the cycle.

And we remain committed to achieving our long-term goal of a net sales growth CAGR of 6% to 9%, operating margins of 20% to 22%, and EBITDA margins of 23% to 25%.

Fueling this confidence is our strong belief in the medium- to long-term market opportunity, underpinned by attractive demographics and a significant shortage of U.S. housing, which has only been exacerbated by the current interest rate environment.

The recent acceleration of mortgage underwriting following rate drops demonstrates how much pent-up demand exists for housing. Our business is optimally positioned for acceleration, once the housing market returns to growth.

Turning now to some additional thoughts on the current housing market and the market for our products. As anticipated, the first quarter was marked by decreased demand driven by lower new construction starts, lower consumer spending and continued inventory reductions as more typical seasonal demand patterns return.

Compared to the prior year, new construction remains challenged. However, certain metrics are showing signs of improvement when viewed on a sequential basis. Single-family new construction permits, starts and completions were all up sequentially in March, although down significantly, year-over-year.

Over the last few months, mortgage applications increased significantly in response to a relatively small decrease in mortgage rates. This speaks to our previously communicated and well-accepted thesis: The market remains underbought and pent-up demand is only being exacerbated by the slowdown in construction.

Once the market is confident that the Federal Reserve has stopped raising rates, we expect consumers and builders will react positively. Ultimately, the only solution for the supply and demand imbalance in housing is to build more homes. And with our balanced exposure to new construction, we are well positioned to capture the opportunities that will result when the market returns to growth.

All that said, we are cognizant and prepared for future volatility, as long as challenging macroeconomic conditions persist.

Turning to R&R. We saw the R&R market decelerate over the first quarter and into April in response to inflation and general economic uncertainty. Although the overall R&R market is expected to be down for 2023, there are some important nuances.

For example, recent credit card data indicated that while spending decreased across the home product space, the declines were most pronounced in big ticket and more commoditized products.

Further, while down on a year-on-year basis, both spend and keyword search data are significantly higher than pre-COVID levels.
We believe our products are relatively more insulated because of their smaller ticket price, are less disruptive to install and, therefore, less tied to housing turnover and offer a higher return on investment potential for the cost.

Supporting this was a recent study conducted by Therma-Tru, showing that replacing an outdated door with a Therma-Tru door offers one of the best returns on investments in the home and can even raise a homebuyer's perceived value of a home, by up to 7%.

We expect the softness in R&R to continue throughout 2023, as macroeconomic uncertainty persists. However, the fundamentals of the market point to a favorable mid- to long-term future for the R&R market.

The combination of high home equity levels, the low supply of homes and aging housing stock, and the fact that many homeowners are living in homes they purchased with no mortgage or with record low interest rates, is causing many people to rethink their existing space and undertake R&R projects to turn what they have into what they need.

Finally, in China, the market remains soft, but we believe it is starting to find a bottom. As has been widely reported, the Chinese economy is showing signs of a steady recovery, including strong new home sales growth in March.

However, as a reminder, many Chinese homes are sold before they are completed, and our products are used later in the building cycle. As a result, we would expect to see positive impact 12 to 18 months from the point that home sales inflect positive.

We have confidence in our team's ability to successfully navigate short-term disruptions and remain focused on creating long-term value in China, including in the emerging and high-potential R&R space.

In short, while these are certainly challenging times for our industry, and for the overall global economy, Fortune Brands Innovations is well positioned. Our branding power, meaningful and value-add innovation and channel strength are powerful moats in uncertain times.

Our consumers continue to reward us with growing market share, and our customers continue to view us as value partners with unique insight and category management expertise. Our products and brands are uniquely positioned to outperform the market in all environments, as our results demonstrated this past quarter.

Starting this quarter, we began reporting on three segments: Water Innovations; Outdoors; and Security. All of our segments are unified by their strategic focus on brand, innovation and channel and there are opportunities for supercharged growth.

Our Water Innovations segment includes our leading Moen and House of Rohl brands.

As the world increasingly focuses on the power and importance of water, we've positioned ourselves to capture the powerful growth associated with this category, including water management, sustainability and connected products tailwinds.

Our core suite of faucets and showers employs sophisticated technology to maximize water savings, while still delivering an enjoyable water experience. And our pioneering connected water products have phenomenal potential to change the way residential water is managed.

Our Outdoors segment includes our leading door brands, Therma-Tru, Larson and Solar Innovations, as well as our Fiberon decking brand and our Fypon decorative millwork brand.

This segment is exposed to key growth drivers, including outdoor living, sustainability and material conversion trends. We're excited about the opportunity ahead to continue converting consumers and pros away from commoditized lumber products, as they increasingly understand the performance characteristics and Advantage value proposition of our brands.

Finally, our Security segment is comprised of our iconic Master Lock and SentrySafe brands and is also driven by high-growth secular tailwinds, including connected products and commercial safety.

Companies across the globe are increasingly focused on the importance of worker safety as something that is both the right thing to do and good for business. We believe we have a unique opportunity to grow in this space as we look to leverage our subject matter expertise, focus on innovation and unparalleled brand recognition.

Turning now to our individual business results. In the first quarter, Water Innovations sales declined 8%, compared to the prior year, driven by volume declines across the segment, partially offset by price.

These results were stronger than we initially projected and reflect higher-than-expected sales across the Moen North America business, particularly in wholesale. Our margins for the segment were 21.6%, reflecting lower operating leverage from lower volumes and our inventory reduction efforts.

In the quarter, Moen North American POS outperformed the market and was, particularly, strong in the wholesale and e-commerce channels. However, POS on both a unit and dollar basis trended down towards the back half of the quarter and through the first part of April, in line with the overall market softness and a significant lap from prior year.

The pricing actions we took at the beginning of the year have remained in place as the value proposition of our products is increasingly well understood.

As we highlighted during Investor Day, over the past few years, we have simultaneously increased price, elevated the perception of Moen as a high-end brand, while also significantly increasing the perception of delivering high value for price.

This is an example of our brand-building capabilities, which are now being deployed across the entire organization. We feel confident that our attractive, trusted and innovative products will remain the choice of consumers and pros in any environment.

Our House of Rohl brands also delivered market-beating performance, with total sales up 20% for the quarter, including Aqualisa, and U.S. POS was up low single digits. The higher-end consumer remained strong, and we continue to outperform in this attractive market as our story of craftsmanship and unique designs continues to resonate.

In China, as expected, we saw sales decline near 30%, excluding FX. Our China business is exceptionally well run and is taking into account prevailing market trends and assessing new growth opportunities, including pivoting toward the emerging R&R market and pioneering new markets and service models. In addition, our China business continues to serve as an incubator for innovation introduced, across the Water portfolio.

In Outdoors, we saw sales declines of 16%, reflecting expected new construction market softness and the lapping of prior year as the market returns to more typical seasonality. The lower volumes were partially offset by price.

Operating margin was 5.2%, reflecting standard production costs from lower volumes and our inventory reduction efforts.

In decking, we saw an expected sales decline as inventory levels rebalanced and seasonal buying patterns returned. While the first quarter had a lower-than-expected inventory build, as distributors maintained leaner levels of inventory, POS was still strong in the quarter.

Retail POS was up high single digits and wholesale POS was down low single digits.

We are responding to the current environment by maximizing our operational efficiency and optimizing our Fiberon brand for future growth by making strategic and disciplined capacity investments and leveraging our newly aligned organizational structure to accelerate our branding and innovation strategy.

While these investments impact margins in the short term, especially as we compare them against prior periods marked by an unusual lack of seasonality, mid- to longer term, these thoughtful and stage investments will help us capitalize on a long-term growing market.

We remain laser-focused on taking profitable share by converting a commoditized lumber market into a brand and innovation-led market and we remain disciplined in our pricing actions.
In Doors, we saw sales decline in the mid-teens as the overall market softened.

The wholesale channel saw some regional destocking in the quarter, which we now believe is complete. We're confident in the strength of our product offerings and our long-standing advantage relationships with our key customers and channel partners, and we will remain disciplined and thoughtful, as we look to maintain and grow market share in the most attractive parts of the market.

We continue to leverage our recent acquisitions to drive innovation across the portfolio. We recently unveiled the exciting new Veris collection, a contemporary entryway product line that incorporates the technology we acquired as part of the Solar Innovations acquisition.

With Larson and Therma-Tru, we are continuing to expand our offerings under our impression store systems, which are the first of their kind, a fully integrated storm and entry door system.

Lastly, in Security, sales increased 2%. These results were driven by price, together with new business wins, inventory replenishment at customers and strong demand in the commercial safety and security space.

Operating margin Operating margin increased 70 basis points to 14%, reflecting the implementation of the strategic improvement initiatives that have been in place for the past few years.

Our Security business is powered by our iconic Master Lock and SentrySafe brands, and we believe it has significant growth opportunities, as we begin to leverage these world-class brands in new ways, including in the connected and rapidly growing commercial safety space.

We expect our Security business will see outsized benefits from our new organizational structure, as we focus on driving the brand, augmenting our connected product capability and offerings and increasing operational efficiencies in the business.

Lastly, we are very excited about the potential of commercial safety and security, which has seen impressive growth over the past several years and now accounts for around one third of our overall sales for the segment.

Finally, we remain optimistic and very excited about the potential acquisition of two world-class businesses from ASSA ABLOY, the Emtek premium and luxury door and hardware business and the U.S. and Canadian Yale and August residential smart locks business.

These businesses will be strong accelerants to our connected product and luxury portfolio strategies. We continue to expect this highly disciplined and strategic acquisition will successfully close midyear, and we will update you as we know more on that front, including on the potential synergies associated with the transaction.

Before I turn the call to Dave, let me share a few final thoughts. As we highlighted last quarter, we expected and planned for a challenging 2023.

Beginning in mid-2022, we took steps to prepare by streamlining our cost structure, reducing our inventory and prioritizing cash generation, while continuing to invest in the key strategic priorities that will fuel our future outsized opportunities when the market returns to growth.

These proactive steps generated around $50 million in annualized fixed cost and SG&A savings and reduced inventory ahead of plan, including over $150 million of inventory reduction since the third quarter of 2022.

Importantly, we saw no negative impact on our best-in-class service levels, and our lead times have returned to normal levels.

In our 2023 outlook, which Dave will discuss in a moment, we have developed a plan to deliver market-leading sales performance, preserve margins and generate cash, regardless of the headwinds we may face. We are prepared to confront challenging end markets in the short term, while we position ourselves for accelerating long-term outperformance in a market supported by fundamental growth characteristics.

With that, I'll turn it over to Dave.

David Barry
Thanks, Nick. As a reminder, my comments will focus on income before charges and gains to best reflect ongoing business performance. Additionally, comparisons will be made against the same period last year, unless otherwise noted.

Let me start with our first quarter results. As Nick highlighted, our teams executed well against a challenging and dynamic environment.

Sales and operating margin came in higher than what we initially anticipated during our call last quarter. Sales were $1 billion, down 9%, and consolidated operating income was $137 million, down 22%.

Total company operating margin was 13.1% and earnings per share were $0.69. Our first quarter performance was driven by higher-than-expected sales in our Water and Security segments and resulting margin flow-through.

However, we are still anticipating a volatile remainder of the year and will remain agile and proactive in response to any changing market conditions.

For the quarter, the 9% sales decline included a 3% unfavorable impact from our China business on our consolidated results. Excluding China, sales were down 6%, with POS down low single digits and a mid-single-digit unfavorable impact from current year channel inventory reductions and prior year service recovery, predominantly in our Outdoor segment.

As we discussed last quarter, we expected first quarter operating margin to be most acutely impacted by production inefficiencies and stranded fixed costs related to our inventory reduction efforts. As Nick mentioned, we have made very good progress against our near-term inventory reduction target of $175 million.

We remain focused on driving outperformance, including above-market growth, preserving and enhancing margins and generating cash. Our teams continue to focus on appropriately managing our P&L and balance sheet, while maintaining key strategic growth investments.

Now, let me provide more color on our segment results, beginning with Water innovations. Sales were $594 million, down $49 million, or 8% ,and also down 8%, excluding the impact of the Aqualisa acquisition and FX.

Net sales results reflect the impact of lower volumes, partially offset by price. Importantly, our Moen U.S. POS was down low single digits in the quarter, reflecting a better-than-expected start to the year.

China sales declined around 35%, or 30% excluding FX, driven by the prior year's decline in housing activity. While new home sales are improving, the Chinese consumer remains cautious in the housing space.

And as Nick indicated, based on the timing of when our products are installed during the construction cycle, we don't expect to see the benefit of these improving indicators for another 12 to 18 months.

Water Innovations operating income of $128.6 million was down 14%. Operating margin was 21.6%, reflecting the impact of production inefficiencies and lower volumes.

Turning to Outdoors. Sales were $290 million, down $54 million, or 16%, driven by lower volumes and channel inventory destocking, partially offset by price. Door sales were down mid-teens.

As expected, sales were impacted by lower volumes and channel inventory reductions at Therma-Tru, as production builders worked through their completion backlog and new starts softened.

Decking sales declined mid-teens, driven by channel inventory rebalancing and expected lower volume.

Outdoor segment operating income was $15.2 million, down 57%. Segment operating margin was 5.2%. Segment operating income declines were driven by unfavorable volume leverage in our businesses due to production inefficiencies and stranded fixed costs in support of our inventory reduction efforts.

We expect Outdoor's margin will improve to mid-teens or higher in the second quarter, as expected seasonal volume increases drive scale through the P&L. Importantly, Outdoors remains on track to deliver their 13.5% to 14.5% operating margin guidance for the year.

In Security, momentum in the segment continued with low single-digit sales growth driven by price and new business wins in locks and commercial safety and security. Segment operating income was $21.8 million, up 7%. Segment operating margin was 14.0%, an increase of 70 basis points versus the prior year and was driven by price and continuous improvement initiatives.

Turning to our balance sheet. Our balance sheet remains strong with cash of $539 million, net debt of $2.1 billion and net debt-to-EBITDA leverage at 2.3x. We finished the quarter with full availability under our $1.25 billion revolver.

As mentioned, this past quarter, we continued our efforts to drive improved cash flow, including reducing our inventory levels. In line with our disciplined capital allocation strategy, this enhanced cash generation enabled us to, opportunistically, repurchase $100 million of shares in the quarter.

Further capital deployment will depend on the timing around the closure of the potential ASSA ABLOY transaction, our leverage ratio in the context of the external macro environment and business performance and the attractiveness of other value-creating opportunities.

We continue to be committed to maintaining a strong financial profile, enabling pursuit of above-market growth, while prioritizing the best returning opportunities for value creation.

To summarize the quarter, we delivered sales and margin results above our initial expectations in a very challenging environment. While our Q1 results were certainly encouraging and speak to the strength of our business, we are anticipating and preparing for continued headwinds and volatility.

As a reminder, our initial financial guidance included prudent market and demand forecast, the ability to maintain price while achieving reasonable continuous improvement actions and the impact of production inefficiencies and stranded costs from our inventory reduction actions.

With that in mind, I'll provide an update to our 2023 guidance.

As today's press release indicated, we are increasing the midpoint of our EPS guidance by $0.05 to the range of $3.65 to $3.85, reflecting our higher-than-anticipated operational performance in the first quarter, as well as the impact of first quarter share repurchases.

We are mindful of the ongoing uncertainties inherent in the external macro environment, and we continue to expect full year net sales to be down in the range of 5% to 7%, operating margins to be between 16% and 17%, and EBITDA margins to be between 19% and 20%.

We continue to expect--to generate free cash flow of approximately $475 million during the year, with a cash conversion rate of around 100% of net income.

During the quarter, we generated positive free cash flow, driven by our working capital and inventory reduction efforts. Our teams are off to a great start against our full year targets and will remain agile in the execution of our key priorities.

I will now pass the call back to Leigh to open the call for questions. Leigh.

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 reenter the queue to ask additional questions.

I will now turn the call back to the operator to begin the question-and-answer session. Operator, can you open the line for questions?

Operator
Thank you. If you would like to ask a question, please press "*", "1" on your telephone keypad, at this time. A confirmation tone will indicate that your line is in the question queue. You may press "*", "2" if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset, before pressing the start keys.

One moment, please, while we pull for questions.

And our first question is from John Lovallo with UBS. Please proceed with your question.

John Lovallo
Thank you for taking my questions. Maybe just starting from a high level strategic one, first. Nick, I mean, in your opening comments, you talked about construction starts and consumer spending, how they've moderated. But there's been some positive green shoots in different housing metrics, whether it's mortgage apps or new home sales, and even in some renovation initiatives.

Curious how Fortune sees demand for both R&R and new construction evolving over the coming quarters, given its presence in both markets, R&R and new construction, and how you view Fortune as being positioned to capitalize on this?

Nick Fink
Hi, John, happy to talk about that, and I'll give you some perspectives. Dave may want to add a few other perspectives here. But look, without a doubt, 2023 is a challenging environment, and we've prepared the business to navigate a challenging environment. And I think it's going to remain so as long as you have economic uncertainty, as well as this return to seasonality on shoulder quarters that we're experiencing.

You got lower consumer spending; you've got lower starts. But if you step back for a second, I think, and put it into context of the macro demand levels, I mean, as we see it from a number of Advantage points, the fundamental demand that we all talk about is still there.

For starters, as I think Dave said in his remarks, organically, this quarter is still 24% up on same quarter in 2019, pre-COVID, right. And so, notwithstanding all the noise and all the economic uncertainty and everything we hear in the marketplace is still 24% increase, and it tells you that it takes a consumer to be there, it takes pros to be there in order to drive that.

And then where you seeing any sort of positive--a little bit of positive inflection certainly around traffic, orders and even new home sales, you see the consumers have shown up, even with a little bit of easing.

And so we take that--and I mean we just remain pretty sanguine about the whole marketplace, stepping back and looking at the fundamentals, the demographics, expect the markets to be underbought. The fact that a lot of existing home product is very old out there and that you have an environment that I think is primed for consumers to spend against.

And I think there's enough evidence, even in a quarter like Q1, which we don't like because we're down, of that happening.

Now how we play the portfolio against that? I'll just start by saying we really, really aim to gear the portfolio where the consumer hits, right? And I think you've seen us move up and down the price and premium spectrum. As we built up the portfolio, we saw a large amount of millennial homebuyers coming through.

We made sure we kind of had that heart of the market set, very innovative product that served us really, really well as they've started to mature into some second homes or even third homes, here we've kind of positioned the portfolio like House of Rohl or sort of the premium parts of our other portfolio to be able to capture them. And you see in the House of Rohl results, how resilient those consumers have been.

So, from a product perspective and a brand perspective, we really, really aim to leverage the innovation and insights machine to meet the consumer where they are. From a market-backed perspective, we are approximately two thirds R&R. And fundamentally, that's going to be a market that grows nicely, over the long run.

And then we like the torque that we get from new construction because, as I said in the prepared remarks, the only way to rectify the imbalance in supply and demand is to build more homes.

And so, we want to give investors the benefit of that exposure to new construction. And we view it as the responsibility of this management team to manage any downdrafts and to manage the cost structure, appropriately. And I think that you're seeing us do that, and you'll see us do that through the rest of the year.

And so, we really aim to have a portfolio of both on a product, brand and then channel perspective, really exposed at where the market is and where we think the long-term growth will be.

And then a final comment that I'll make is we're putting more and more emphasis on finding these secular growth pockets, these supercharge kind of subcategories in our categories, where you're going to have growth no matter what because you just have underlying trends pushing them along, and I think that was

evident in some of the security results where you've got a really nice tailwind in the commercial safety space.

You've got a really nice tailwind in the connected space. and that's now pushing on a third of that business. And you see it kind of powered through a tough macro environment, notwithstanding. We aim to turn that dial more and more in the whole portfolio.

David Barry
John, this is Dave. Let me add a bit about our market view for the rest of the year. And if you recall, our market guidance that we gave last quarter was for the global and U.S. markets to be down between 6.5% and 8.5%.

With U.S. R&R down 4% to 6%, and U.S. single-family new construction down 18% to 22%, as we look at the first quarter and some trends into the rest of the year, I think there's probably a bit more momentum in single-family new construction that maybe leans us more towards the better end of that range.

And while R&R was better in the quarter, especially in the first half of the quarter, I think it's too early to call any full year improvement on our R&R market right now, even though the first quarter was a bit better than expected.

And I'd remind you, as we talked about last quarter, I mean, there's a pretty significant lap in our POS that we see in our data from March through June. And so, we want to get through that period of time and understand how the business is performing because we're comping 2021 stimulus effects that were then lapped in full by 2022 price and demand. So, I think too soon to kind of give any new color around R&R, but single-family seems to be a little bit better.

John Lovallo
Okay. Thank you for that guys. And then the second question is, the first quarter decremental margins were around 40%. And I think you articulated last quarter that the first half would be under more pressure, particularly in the first quarter, given production curtailments and stranded costs.

With that said, though, it looks like inventory only came in by about 9%, sequentially. And just curious if you guys reduced the production as much as you anticipated, and how we should sort of think about the progression of decremental margins, as we move through the year.

David Barry
Yeah, John, this is Dave. So as we said on the last call, when we gave a bit more color around the first quarter than usual, we expected margins--operating margins to be between 12.5% and 13%. We came in at 13.1%, so a bit higher than the range, really driven by better sales.

On the inventory side, we're actually a bit ahead of our plan in what we were able to take out in the quarter. Now some of that was because of our internal efforts and some of that was because of the sales being a bit better.

So, we're kind of ahead of inventory coming down. And as we look forward, I think we set up the year on the last quarter, first half, second half, talking about first half sales declined between 7% and 9% with operating margins between 15% and 15.5%. And we still see that as the right expectation for the first half.

And then similar with the second half, with sales down 3% to 5% in operating margin, 17% to 18%, still feel like that's the right expectation for the second half. In terms of your question on decrementals, we're targeting 25% to 30% OI decremental margin for the year and still see that as the right range for the business.

And I think we look to achieve that, even if the market were a bit softer than what we're projecting. So, that's how the company and the portfolio is geared towards that 25% to 30% decremental.

John Lovallo
Thanks, Dave.

Operator
Thank you. Our next question is from Matthew Bouley with Barclays. Please proceed with your question.

Matthew Bouley
Hey, good evening, everyone. Thanks for taking the questions. Maybe a question on Outdoors. You had the 5% margin result there in the quarter. And I think I heard you say at the top that you still expect that to improve to mid-teens, by Q2.

And correct me if I misheard you, but any sort of detail on what kind of underlies that confidence in the sequential margin improvement in that business? And then how you think about the margin progression in Outdoors, through the balance of the year. Thank you.

Nick Fink
Yeah, Matt, this is Nick. I'll just kick it off a little perspective on Outdoors and then hand it to David to walk you through the margin story. I would say Outdoors POS was down around mid-single digits. And that business is probably, of all the businesses, sort of mostly impacted by kind of a return to seasonality.

And the fact that with respect to the Doors business and to a degree, the decking business, you're lapping a period where things are not just going full bore, but we're on allocation and people are taking everything that they could.

And so, that's a little bit of the effect we saw last year, also in the business kind of now rolling through here because it's the last thing to come off of allocation. But as it does, it's good to see sort of POS kind of hanging in there.

But I would just add to that, as a reminder, this is a materials conversion business, right. Whether it's on the door side, on the decking side or even on the millwork side, like it's all about that material science, investing in the material science and having the capacity. And so, as we work through this, we've continued to, I think, be very strategic about how we feather in capacity increases.

But with the long-term view that this is a growing category, we need to be able to capture the growth. And so, in a period where you're going to have inventory coming off for some lower volume, you're going to see the impact through the bottom line. But over the long run, we're very confident in the margin progression that we expect this business to make.

So Dave, you want to give a bit more detail?

David Barry
I think that's it, Matt. It's really a quarter with some volume deleverage. If we look at the sales results for Outdoors, down 16%. As Nick said, POS was down mid-single digits. Volume was actually down mid-teens, from a POS perspective. And then there was a low double-digit impact from channel inventory.

So, as we've signaled a quarter ago, we expected Outdoor margins in the first quarter to be high single digits. They were mid-single digits. I think a bit more channel inventory came out than expected, and we're anticipating some of that in Doors and that occurred.

So, looking forward, this would be the lowest volume quarter of the year. And as volume returns to that business, we'll gain operating leverage pretty quickly and get that margin back up into the mid-teens.

Matthew Bouley
Got you. Okay, that's helpful. Thanks for that, guys. And then I guess, on that topic of channel inventories, I mean, it sounded like you still saw destocking, certainly as you just mentioned, and in the Outdoors business and I think in Water, as well.

So, where are we in that cycle of channel inventory rebalancing? Where does it feel like there still need to be a little bit more to come versus where are we closer to the end of that destocking? Thank you.

David Barry
I think--Matt, this is David. I think we're pretty close to the end. So Outdoors, if we look at the quarter, Outdoors, as I mentioned, had the biggest impact in the low double digits. Within Water, it was really only a low single-digit impact from channel inventory. And then Security was pretty well balanced.

And so, as the teams continue to look at our data and do channel checks, we feel like here in entering the second quarter. So, we're relatively balanced to this rate of demand in this macro environment, and we really have finished comping the prior year service level recoveries that are also creating some noise in the year-over-year reported results.

So the team feel like we're in a pretty good place and that sell-in and sell-out will be more approximate to each other, going forward.

Matthew Bouley
Got it. Alright, thanks Dave, thanks Nick. Good luck, guys.

Operator
Thank you. Our next question is from Stephen Kim with Evercore ISI. Please proceed with your question.

Stephen Kim
Yeah, thanks very much, guys. Just touching on the downtime. I think you had said last quarter, I think you had talked about maybe $50 million to $55 million or something for the year, with about 80% of that in the front half of the year. I just want to make sure that that is still what your expectation is.

And I believe the reason why you would describe the downtime effects sort of lasting throughout the entire year was because that was just basically going to be how it flows out of inventory. But are the actions that have sort of generated that headwind, are those actions at this point pretty much complete?

David Barry
Yeah, Stephen, this is Dave. In fact, on your numbers question, that's right. We said full year P&L impact, $50 million to $55 million. First quarter, roughly $30 million. As I said earlier, we're actually a bit ahead of our inventory takedown expectations. And so, there was a low single-digit million incremental impact to the P&L in the first quarter, still probably within that $50 million to $55 million range for the full year.

And so the actions to drive the results mostly taken, at this point. I mean, if you consider in Water and Security, where we have long lead time supply chains and we started pulling levers in the third quarter of last year to kind of get those supply chains normalized.

And then where we're more vertically integrated in Outdoors, those levers are a bit more real time, and we're pulling those kind of in the first quarter, beginning in the second quarter.

And you're correct, the spread of that cost through the year is just the impact of those stranded costs flowing from the balance sheet into the P&L.

Stephen Kim
Great. Yeah, okay thanks for that. And the second question relates to mix. And I was curious if you could just sort of, across your businesses, talk about where, if anywhere, we might be--or you might be experiencing or anticipating a change in the mix profile that would be worth calling out?

And then just a quick housekeeping item. I think there was a $6 million number or something in other. I was just wondering what that was related to.

Nick Fink
Okay. I'll kick off with some thoughts on mix. And then, David, can--$6 million plus, any other thoughts he has on the mix. And then just I'd say as a reminder, my comments earlier about we really try to gear the portfolio to be at the heart of the market then capture consumers, up and down the spectrum.

We've done so through a lot of our initiatives in a way in which we've also kind of maintained, I would say, very similar percent margin profiles, no matter where the mix lies. Really leveraging volume at the lower price points and kind of more bespoke stuff at the higher price points.

Yeah, it was interesting in this past quarter to see some of the higher-end products kind of hang in there, as they did. I think House of Rohl is a good example of that, that we saw POS that was actually up just on

an organic basis in the U.S. market. And I think that speaks to the resiliency of that consumer for a price point.

And then from a channel perspective, I would say as a general rule, you saw retail mix be pretty strong, as Dave pointed out, kind of up until about March and then when you hit the lap, that really goes kind of March, April and a bit into May. We saw the consumer come off, so that was as we expected. And the wholesale mix was a little bit more favorable than we expected. And I think that is going to probably continue a little bit here with some of the results that we've seen.

David Barry
And Steve, on the other items, so a portion of that is interest income, which is something we haven't had in a while. But it's nice to be able to generate some interest income with our cash. And the other portion is pension income. And as the team is going to finalize pension for the year, post cabinet separation.

Okay, great. Thanks very much, guys.

David Barry
Yeah, sure.

Operator
Thank you. Our next question is from Tim Wojs with Baird. Please proceed with your question

Tim Wojs
Hey, guys. Good afternoon.

Nick Fink
Hey, Tim.

David Barry
Hi, Tim.

Tim Wojs
Maybe just on the wholesale side. I mean, Nick, maybe just if you can step back and maybe kind of give us some color on where the channel inventories are now within wholesale. And have you started to see like a meaningful restock in that channel, or is it just that the destocking is kind of subsiding?

Nick Fink
Yeah, I would say, as Dave pointed out, the inventories are much healthier than they were. And just as a reminder, a lot of the inventory that we saw accumulate and then come out in 2022 was not where we would normally look for inventory. It was kind of at our customers' customers, particularly in the Water business where we serve a lot of production builders who are, in turn, served by large plumbers. And so, that's where a lot of that inventory was built.

And our sense is in taking these sort of numbers again, most of that's out. We saw a bit of regional inventory in the Doors business, a bit in the Water business. As I've said, Security pretty balanced at this point. And so, we think it's in a pretty healthy spot. That said, we've not seen much restocking.

If anything, I think we maybe expected to see a bit more in the quarter. If you take something like decking and dealers are continuing, I think, to keep things pretty lean, understandably, with the economic uncertainty out of there. So, we'll just watch that as that goes.

David Barry
Yeah, I think, Tim, just some color I'd add. So as Nick mentioned, the wholesalers really started to rebalance inventory last year, as single-family new construction slowed down. So, they kind of saw that coming and got out ahead of it in the quarter. Low single-digit impacts in the Water business from inventory is predominantly in retail and a bit in e-commerce, which were expected heading into the year.

Tim Wojs
Okay, good. And then just maybe bigger picture on China. Could you just give us a little bit of help or just a little bit of background on just where the business is in terms of transitioning that towards more of a R&R-type business? I don't know if it's a percentage of the sales at R&R today versus where it might end up. But just a little bit of color on what the progress of that might look like, over time.

Nick Fink
Yeah, so I'll just start with kind of the big macro, right, which is, as you obviously know, like China has been a big new construction powered market for a very, very long time. And while we had a lot of exposure to that, we worked very hard to stay away from the very speculative building, like the Tier 3 or 4 cities with like empty buildings that you read about. And we really kind of focused on Tier 1 and Tier 2 cities.

So, while we peg even our share, say, like around a 10%-ish mark, our Shanghai shares are probably closer to 25%. And so that's just how we constructed the business. But still even a market like Shanghai over the years, a lot of new construction.

Those buildings are aging now and space is more scarce. And so what you're starting to see is a pivot now. A while ago, people were just buying empty concrete boxes and then go and decorate them, that's evolving to what's called a--either a finished unit or a decorated channel where you work with the designer to go in and finish the new construction unit. And now, as you would imagine, that's becoming a bigger and bigger part of R&R.

And so it's not a huge market yet, but it's a growing market, and we think it's one that's going to become very important in the future, as these consumers need to start refreshing these units. And so, focusing on those bigger markets that are more established where we have stronger share, and focusing on that channel is a big part of that strategy.

Now we want to see some of the bottoming out of new construction, because it's just been certainly part of the business. We think we're seeing that now, and we're being cautious about how long it may take for that positive inflection it starts to then translate into decorated units down the road.

But the team is managing the business incredibly well, kept it quite profitable and focused on building out these new growth channels, as well as being an innovation engine for the entire company. So they continue to serve our products that we're launching into other markets.

And increasingly, with our new Fortune Brands Innovations structural organization and all the work that we've done to sort of simplify the business breakdown silos, it can have an even bigger role working across all of our businesses to help drive business both in China, as well as innovation into markets like North America.

Tim Wojs
Okay, great. Thanks for the color, guys. And welcome here.

Nick Fink
Sure, thanks.

Operator
Thank you. Our next question is from Truman Patterson with Wolfe Research. Please proceed with your question.

Truman Patterson
Hey, good afternoon, everyone. Thanks for taking my questions. Last quarter, you all suggested that freight and material deflation would be about 1%, but that would be offset by other inflation in the business. Could you just talk about what you're expecting kind of by segment, give an update there, as well as maybe the cadence through the year is kind of 1Q peak inflation, and then it levels off kind of, sequentially? Or how are you all thinking about it?

David Barry
Yeah, Truman, this is Dave. I'll tackle that one. So yeah, you're correct. We kind of said, hey, 1% freight material deflation offset by labor, some other items. I'd say that's pretty consistent with what we're seeing today with a few puts and takes.

I mean, labor remains pretty sticky. There's actually some upward pressure on brass in the quarter, driven by copper, although that was offset by some incremental freight deflation, primarily ocean freight for the year. And so I think pretty sticky. Across the segment is really pretty consistent across the segments in terms of input cost and inflation, deflation.

So if we kind of look at the margin goals for the year, I don't think there's a big deflationary tailwind in any of the margin goals in any of our segments. And that's really true long term as well, Truman. Looking at our Investor Day target that Nick mentioned, we see most of that path there through help--self-help, 75% to 80% of that path is self-help. And so not banking on big deflation, and our view of the world today is pretty consistent to what it was about a quarter ago.

Truman Patterson
Okay, perfect. And then you all mentioned the consumer being a little softer moving throughout the quarter, but I think that was primarily in plumbing. There are a lot of offsets with destocking, etc.

I'm really just hoping you can help us understand, just overall, for the company R&R demand trends, just the cadence kind of through the quarter and if there's any way you can help us understand exit rate March, kind of POS or early April indications?

Nick Fink
Yeah, I'll be happy to try to put some context around it. And so, if you think about the shape of the year and, interestingly, you look at '21 and '22, and they had very similar shapes, which is you start out the year and then you built a big head of steam starting in March and into the early summer, the first head of steam in '21, I think, very stimulus-driven.

And if you recall, we said we were quite surprised that the consumer really tracked almost dollar for dollar. A little bit less in 2022 as they move through that same period. We plan for an expected--that this year the consumer would be beneath that. What we saw for the first part of the quarter, before you got to that big lap was actually the consumer sort of held in there, pretty flattish for most of the quarter.

And then as that big lap started, that's where we saw a relative slowness in the consumer compared to that 2021, 2022 hill that I would say kind of comes off, as you get more towards the middle of the summer in line with our expectations.

And so if I go back to sort of our business most impacted, Outdoors is kind of down mid-single digits. But Plumbing down low single digits, really low single digits, and Security up low single digits.

So still kind of hovering in--better than we might have anticipated at the beginning of the year.
Dave, I don't know if could add anything.

David Barry
That's that, here.

Truman Patterson
Perfect. Thank you all for the time.

Nick Fink
Sure.

David Barry
Thank you.

Operator
Thank you. Our next question is from Adam Baumgarten with Zelman & Associates. Please proceed with your questions.

Adam Baumgarten
Hey, good afternoon, everyone. Just talking about the higher end kind of holding up better, at least relative to the other parts of the business. I guess, did that part of the portfolio also decelerate throughout the quarter and into April, alongside some of the broader business, but just still is relatively better from a growth perspective?

Nick Fink

Yeah, that's more of a--so that deceleration I was referring to was what we were really seeing through retail. And this being a much more wholesale designer showroom focused business, we didn't see any particular deceleration there.

Adam Baumgarten
Okay, got it. And then just thinking about pricing, are you seeing any channels or products where pricing is perhaps softening or promotional activities picking up? Or are you largely holding on to the price that's been put through the system, over the last year, plus?

Nick Fink
Well, as a reminder, I mean, big, big focus for the portfolio, right, is brand and innovation, and then bringing the insights to the channel that allows both us and our channel partners to do very well from a price and margin perspective. And with that in mind, I mean, we've certainly seen other categories that were commoditizing some pricing pressure. We're probably seeing a bit more real estate for private label.

By the way, that seems to sway between 10% and 15% market share at any given time, over a long period of time. But there are lines that consumers and pros will draw around brand recognition, but also service and backing, that sort of people feel they need to have in the products.

And so, I wouldn't say, at this point, we're seeing undue pressure in any of the lines is certainly keeping an eye open. But we will continue to focus, I would say almost maniacally, on driving the brand and driving innovation and getting paid for it.

And I sort of referred to my prepared remarks, like in the case of Moen, we've taken a lot of products over the last few years and raised the brand perception, both in terms of premiumness, but also probably price ratio. The consumer feels they're getting a better deal notwithstanding the price that we've taken than they were a few years ago.

And that is really the engine that we want over all of the brands. And so, if I go back to all the design changes that we made towards the end of last year is really to unleash all of those Fortune Brands Advantage capabilities: brand building; category management; innovation across the entire portfolio, because with, especially with our restructured portfolio now, if we're going to be in the business, we're going to be in the business with brands that drive value where we can come on good price to get paid for it.

David Barry
And then, Adam, just as a reminder, last quarter, we said that our guidance--sales guidance incorporated low single-digit positive impact from price with 50% of that carryover and 50% new. That's still the appropriate the guidance for the year. We don't see any change to that.

And we will, as we always do, monitor competitiveness on the shelf and POS rates and elasticities and promote and reposition as needed, both up and down, depending on what we see with our elasticities. But no real broad change to our expectations around price realization.

Adam Baumgarten
Okay, great to hear. Good luck.

Nick Fink
Thank you.

David Barry
Thank you.

Operator
Thank you. And our final question is from Susan Maklari with Goldman Sachs. Please proceed with your question.

Susan Maklari
Thank you. Good afternoon, everyone. My first question is, can you talk a bit about how you're thinking of capital allocation? Obviously, with the ASSA deal out there, that will have some implications for it. But in general, how are you thinking about the ability to generate cash this year as things normalize? And then some of the opportunities for it.

Nick Fink
Okay. I'll just start broadly, and Dave can take you through some of the details. But I would say at the highest level, our capital allocation strategy remains unchanged. We continue to invest in ourselves. Those are our surest and highest return investments. And the teams continue to bring some great ideas forward for great returns.

And so, we'll put capital first and foremost. Second to corporate development, there where we can generate value. And we're very--as you know, from our long history, we're very disciplined about that part. And then we will return to shareholders, what doesn't go into the first two buckets. And that certainly has not changed.

Now we do have the ASSA deal pending. We're very excited about that. We think we're a great home for those brands and can really build them in a very exciting way. And so, we're being mindful of that, as we move forward.

But while maintaining a conservative leverage, particularly in this environment, you saw like in this quarter, an opportunity, as the teams did a really nice job generating cash to be opportunistic about share repurchase at wonderful values. So we stepped in and we did that.

And I think that's very consistent with how we've approached it in the past and we'll continue to approach it in the future.

David Barry
Yeah, and Sue, just to put some points around cash flow has been a focus for us, as we mentioned on our call prior. But we were cash, free cash flow positive in the first quarter, which is unusual for us. It's usually a cash bleed quarter as we're ramping up inventories for the building season.

So, it really demonstrates that our initiatives to right-size working capital and inventory are working. And in fact, our free cash flow was $270 million better, quarter-over-quarter this year versus last year. So, as long as we can continue to generate cash in this environment and as we've talked about in the past, this business in a downturn does generate a lot of cash as we shrink the balance sheet. We'll have opportunities to deploy that capital, effectively.

Susan Maklari
Okay. That's very helpful. And then turning to Water innovations, when you think about the trajectory for the margins in that segment, how should we think about the relative cadence, as we go through this year?

You talked about China being weak but, obviously, seeing new construction there pretty strong, and maybe R&R sort of in between those two. How do you think about the dynamics and especially maybe as well ,as you think about the strength in House of Rohl relative to Moen?

David Barry
Yeah, Sue, this is Dave, I'll handle that. So just a reminder, our full year target for Water is 23% to 24%. As we look at their margin cadence through the year, improving sequentially, I'd say, first quarter to second quarter. And then second quarter to third quarter before probably a seasonal step back a bit in the fourth quarter, that's back to kind of a seasonal pattern for this business, quarter-to-quarter.

And then within the portfolio, as we've talked about on the call, our China business is profitable, it remains profitable. And in fact, it was going to add the Fortune Brands Innovation average for the first quarter on much lower volumes. So the team there is doing a great job.

And then House of Rohl as it grows, becomes an accretive piece to the portfolio overall,1l as well. So, we feel like the business is performing as we would expect it to, and we'll see some of the sequential seasonal margin builds that we've had in years past.

Susan Maklari
Okay, that’s very helpful. Thank you and good luck.

Nick Fink
Thank you.

David Barry
Thank you.

Operator
That concludes our question-and-answer session. Thank you for joining today's conference call. You may now disconnect.