Fortune Brands Innovations, Inc.
Third Quarter 2023 Earnings Conference Call
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Presenters
Leigh Avsec, Vice President of Investor Relations and Corporate Affairs
Nicholas Fink, Chief Executive Officer
Dave Barry, Chief Financial Officer

Q&A Participants
Matthew Bouley - Barclays
John Lovallo - UBS
Stephen Kim - Evercore ISI
Michael Rehaut – J.P. Morgan
Adam Baumgarten – Zelman & Associates
Phil Ng - Jefferies

Operator
Good afternoon. 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 Third 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. You may begin the conference call.

Leigh Avsec
Good afternoon, everyone, and welcome to the Fortune Brands Innovations Third Quarter 2023 Earnings Call. Hopefully, everyone has had a chance to review our earnings release and supplemental financials. The earnings release and the audio replay of this call can be found in the Investors Section of our 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 references to operating profit or margin, earnings per share, or free cash flow in 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 today on the call 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 third quarter performance and offer some thoughts on the macro environment. I will also give an update on our ongoing evolution into a tightly aligned company, focused on brands, innovation, and channel. I will then turn the call over to Dave for a discussion of our financial results, our updates to our guidance for the remainder of 2023, as well as some thoughts on our emerging expectations for 2024.

Turning to our third quarter performance. Our teams executed well and delivered solid top and bottom line results in a macro environment that remains challenging. Our net sales growth outperformed the market for our products and our margin results sequentially improved over the second quarter of 2023.

We delivered above-market POS results across most of our businesses. Our recently acquired assets are performing better than we expected and our balance sheet remains very healthy as we continue to generate strong operating and free cash flow.

Our results this quarter demonstrate the potential and power of our aligned organizational structure and our Fortune Brands Advantage capabilities as well as our unwavering focus on outgrowing the market, preserving margins, and generating cash, all while continuing to prioritize key investments, including brand building, thoughtful capacity additions, and our digital transformation.

The actions we took over the past year to better leverage the strength of our organization and sharpen our focus on our leading brands, meaningful innovation, and our advantaged channel relationships, helped drive our results and give me confidence in our strong future.

Our Fortune Brands Advantage capabilities will continue to advance our growth and margin journey by reducing cost, informing our strategic pricing strategies, and enabling our high-growth focus areas like connected products.

Finally, I'm pleased to report that our integration of the Emtek, Schaub, and Yale and August assets is going extremely well, and we are even more optimistic about the growth potential that these businesses have, both regarding their stand-alone performance as well as the potential they have to accelerate our transformation into a digital disruptive company and a luxury goods powerhouse.

Net sales were $1.3 billion in the quarter versus $1.2 billion in the prior year, up 5%. Organic net sales were down 4% versus the prior year. Our operating margin was 17.4%, up 40 basis points versus the second quarter of 2023.

Our sales and margin performance, together with exceptional cash generation, resulted in earnings per share of $1.19, a 3% increase over the third quarter of 2022 and gives us confidence in delivering our revised EPS range of $3.80 to $3.90.

As we discussed on our last earnings call, we continue to expect some headwinds from lower point-of-sale performance as consumer softness continues and as we further digest the impact from the slowdown in the new construction market through the first half of 2023.

As has been widely reported, while single-family new construction permits and starts continue to improve off of cycle lows, based on where our products are installed in the production of a home, we do not expect to see the benefit until the end of 2023 and into 2024.

The repair and remodel market remains soft, although the Pro was relatively stronger than pure DIY categories and our strength with the Pros worked to our advantage.

We will remain proactive in our response to any short-term external headwinds, while continuing to focus on outgrowing the market, preserving margins, generating cash, and prioritizing strategic investments in the key growth priorities that we expect to pay outsized dividends when the market rebounds.

Now turning to some thoughts on the current U.S. housing market and the market for our products. The need for housing remains incredibly strong, although it is being constrained by current affordability challenges. In fact, we believe the recent slowdown has only added to the pent-up need for housing.

A recent third-party survey indicated that over 1/3 of respondents reported plans to purchase a residential property within the next 12 months. This remains well above the pre-pandemic average and the longer-term average dating back to 2014 of 29%, demonstrating significant supply and demand imbalance in the larger housing space.

While we cannot predict when the Fed will signal the end of the current cycle of rate increases and quantitative tightening, once it does so, we would expect interest rates to return to more normal levels and the corresponding significant return to growth in the housing market. We continue to believe this fundamental demand, together with our strong and optimally positioned brands, will result in medium- to long-term tailwinds for our business in both new construction and repair and remodel.

Starting with new construction, as has been widely reported, the single-family new construction market continued to improve versus what was initially anticipated at the beginning of 2023, despite higher-than-expected interest rates. Builders, particularly the large production homebuilders with whom Fortune Brands enjoys strong relationships, continue to respond to affordability challenges in a dynamic marketplace.

As we have previously stated, while the positive impact on our business will not be immediately apparent due to the timing of when our products are installed in a newly constructed home, this should be a growth tailwind in 2024.

Turning to R&R. R&R market remains dynamic, and there are many variables that are impacting the repair and remodel space, including consumer savings and confidence, employment levels, existing home

turnover, and home equity levels. We believe that we are well prepared for any external headwinds and remain confident that our products are increasingly well positioned to outperform in any market.

First, as mortgage rates rise to the highest levels in many years, homeowners are increasingly viewing their current homes as a longer-term investment and are interested in improving them to match their tastes and needs. We continue to believe our products are relatively more insulated than other R&R items because they're smaller ticket, are less disruptive to install, and because they offer immediate aesthetic improvement or meaningful innovation and functionality to a home.

A recent study indicated that for building products, performance, trusted brand names, and aesthetics were by far the most important factors consumers considered during their purchase journey, more so than price. Our brands perfectly align with those criteria.

As we continue to evolve our portfolio and focus on supercharged categories, which are categories that we have identified with high growth potential due to the exposure to secular tailwinds separate from the housing market, and as we continue to build upon our already strong brands and introduce meaningful innovations, we expect that our products will further distinguish themselves.

Consumers continue to have high confidence in their homes as an asset. This has resulted in an environment where the home space is still viewed positively and consumers are willing to invest in making their spaces reflect their lifestyles and needs. That said, we are watching macroeconomic trends closely, including consumer confidence levels, consumer spending habits, and employment levels, all of which impact repair and remodel trends.

While we are confident in the mid- to long-term trends for our products, we are anticipating an environment that continues to be challenging and uncertain. As we have in times before, we will respond quickly and decisively in any environment.

As Dave will detail more completely in his section, we are actively scenario-planning for a variety of outcomes in 2024.

Turning now to an update on our organizational transformation. As we approach the one-year anniversary of the Cabinet spin-off and reorganization of our business, I wanted to reflect on the many transformational activities we undertook over the past year. These activities are driving our future as an exceptional company, focused on growing our core, while also accelerating our emerging connected products business.

As we noted at the time, the separation represented a chance for Fortune Brands to evolve into an entirely new company, one marked by excellence in brands, innovation, and channel. And while we are proud of the amount of value creation the separation has generated for our shareholders, we're even more excited about the growth potential that we unlocked.

We've now had nearly a year operating as a more fully aligned company with an organization that is designed around accelerating growth. While it will take more time to realize the full impact of our new structure, we are already seeing tangible results. Our more efficient structure has allowed us to remove

unnecessary duplication, make strategic decisions faster and with more precision, and deploy our Fortune Brands Advantage capabilities across the portfolio.

By removing those activities that do not create value, we create space for those that do. This is a multiyear journey that has already begun to pay dividends. Our new structure has allowed us to invest additional capital and talent in those projects with the greatest opportunity to drive growth, including our digital transformation and connected products, which we believe have the potential to transform our entire space.

We now also have a dedicated transformation and integration office reporting directly to me, which is responsible for driving progress on the key growth initiatives across the company, and we are now able to deploy our best talent and our Fortune Brands Advantage capabilities across the entire enterprise in a much more rapid, efficient, and holistic fashion.

There has been an enormous amount of change across the organization, but our 12,000 associates across the globe have leaned into the change and embraced our transformation in a way that is nothing short of exceptional. I'm so proud of our team. Fortune Brands Innovations is stronger, more agile, and more aligned than it has ever been.

One of the key areas that we have identified as a growth catalyst is connected products. Today, I want to help put this business in its proper context. Our leading brands advantage route to market and technology backbone makes us uniquely positioned to capture growth in the connected products space. A recently aligned organization is helping us fully unlock our potential across the full company.

The addition of Yale and August enhances our capabilities and product set, giving us the scale and talent to lead in connected products. Now that our strength's combined, we are further on the path to becoming a digital innovative disruptor.

From 2020 to 2022, Fortune Brands connected product sales nearly tripled and this was during a chip-constrained environment that limited us from reaching our full sales potential. Including our recent acquisitions, our annualized run rate of connected product sales approaches $250 million. Today, we have 4.5 million activations of our connected products, and we expect those numbers to grow exponentially as we continue to transform and disrupt the market.

Our connected product portfolio offers real solutions to real needs for making life easier and more secure for the individual to addressing some of the world's most pressing sustainability and safety issues.

Businesses are using our Master Lock connected access solutions to help them work more efficiently. Individuals with Yale and August Smart Residential Locks have peace of mind and have been freed from using keys. Homeowners with products from the Moen Smart Water Network, including our AI-enabled flow, Smart Water Monitor and Shutoff, can better protect against damaging and costly leaks in their homes.

I cannot overstate the potential positive impact our Smart Water products can have on homeowners, insurance companies, and on the environment as we look to save billions of dollars in preventable water damage claims and trillions of gallons of water.

While our connected product journey is well on its way, we have much more runway ahead, including our ability to deliver first-of-its-kind connected products and ecosystems. We will continue to innovate to make our homes, communities, and the planet smarter, safer, and more sustainable. Expect much more from us as we continue to evolve this growth engine for our business.

Before I turn to the individual business's performance, I would like to put our results in their proper context. We were well prepared for the challenges that we are currently facing and took meaningful action in anticipation of the environment. As a result of these actions, we were able to deliver solid top and bottom line results.

As the external market remains soft due to affordability concerns and macro uncertainty, we will continue to protect our business while prioritizing investment in a tight set of key strategic priorities, such as those just discussed, in order to win for the long term.

In the third quarter, Water Innovation sales were $688 million, an increase of 8% compared to the prior year quarter. Our margins for the segment were 24.2%. On an organic basis and excluding FX, sales decreased 3% due to market-driven volume declines, partially offset by price.

Our Moen North Americas business was down low single digits versus last year's third quarter due to lower volumes as a result of market softness, particularly in retail. However, our POS data showed that we gained share in the market, driven by our strong outperformance in the key wholesale channel.

Retail promotional activity increased in the quarter. And we've been highly strategic about our promotional activity to ensure our promos are targeted and tailored to drive the best results.

Organic House of ROHL sales were down low single digits in the quarter. The U.S. luxury consumer continues to remain relatively resilient and our high-quality artisanal crafted products resonate.

Our recently acquired Emtek business performed above our expectations in the quarter. We are extremely pleased by the progress of the integration of Emtek. The more I learn about this business and their commitment to the consumer and the customer, the more impressed I am.

I look forward to a bright future as we bring all of the brands together under the House of ROHL platform, which is now a uniquely positioned global luxury powerhouse with exceptional growth potential.

In China, sales were down low teens year-over-year or mid-single digits, excluding FX. While we saw higher-than-expected project completions as the government is increasingly incentivizing developers to deliver finished projects, the overall market remains soft and the Chinese consumer remains cautious.

However, on non-developer channels that focus on the emerging R&R market, which include showroom, home decorator, and e-commerce, all saw growth, and our business is well positioned to capture the market evolution away from new construction.

Turning to our Outdoor segment. Sales declined 9% in the quarter, reflecting market softness, particularly in the doors business. Our margins were 14.8%. In decking, third quarter sales were up mid-single digits

versus prior year as we gained share in the key wholesale channel. Looking forward, we are focused on driving meaningful innovation in this space and have the resources and talent to innovate for the future in this growth category.

In Doors, sales declined low double digits as the slowdown from the 2022 single-family new construction market continues to impact Therma-Tru and general market softness remains in the space.

Looking forward, as the impact of the recent improvement in the single-family new construction market begins to float through in late 2023 and early 2024, we expect to see improving results from Outdoor brands.

Lastly, in Security, third quarter sales increased 32% year-over-year and grew 6% organically. Operating margins for the segment were 16.8%. Our organic results were driven by price and continued growth in commercial and international markets. Importantly, improvement in our operating margin is a true testament to the power of the new organizational structure and our Fortune Brands Advantage capabilities. We expect we will continue to see even more impressive margin results in Security as we continue to deploy these capabilities.

As we integrate Yale and August, we continue to be extremely impressed by their innovative focus and start-up mentality. There's clearly deep talent and passion, and I look forward to seeing their knowledge and insights contribute to the entire Fortune Brands connected product portfolio.

Importantly, Yale and August exceeded our expectations as they recover from the impact of chip shortages and are working to develop new customers and channels. As with Emtek, the more I learn about these incredible brands and the teams who support them, the more enthusiastic I am.

Before I turn the call to Dave, let me share a few final thoughts. Our reorganization into a more efficient, centralized company, focusing on brands, innovation, and channel has progressed faster than we anticipated thanks to the strong engagement and trust from our teams. We continue to invest in our key strategic priorities, including our iconic brands, digital transformation, and meaningful innovation. We are growing our connected products portfolio. And finally, we made meaningful progress in the integration of our transformative acquisition.

We are transforming Fortune Brands into an even more growth-focused, highly innovative company in spite of continued external and macro headwinds. I'm encouraged by all that we have accomplished and excited about what we will achieve next.

We're constantly monitoring and are well prepared to respond to uncertain end markets in the short term, while we position ourselves for accelerating long-term outperformance in the market supported by fundamental growth characteristics. As we head into the last part of 2023 and as we set our sights on 2024, we are focused on execution and delivering on our commitments to above-market sales growth and margin performance.

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

Dave 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 third quarter results.

As Nick highlighted, our teams executed well and delivered solid sales, margin, and free cash flow performance. Sales were $1.3 billion, up 5%, and consolidated operating income was $220 million, up 2%. Total company operating margin improved sequentially to 17.4% and earnings per share were $1.19, up 3%. Free cash flow in the quarter was $269 million, which brings our year-to-date free cash flow generation to $660 million.

Turning to sales. On an organic basis, net sales were down 4%, driven by volume declines. Overall, volume was down mid-single digits driven by high single-digit POS volume declines, partially offset by low single-digit favorable channel inventory comparables. Price contributed a low single-digit benefit in the quarter.

Through the quarter, our POS volume softened sequentially in line with normal seasonal trends and DIY channels continue to remain softer than Pro channels. Our operating margin of 17.4% reflects our team's continued ability to drive continuous improvement savings and fund key strategic priorities, while remaining agile in the face of challenging end markets.

Our teams remain focused on driving above-market growth, preserving and enhancing margins, and generating cash. As I will detail later, our balance sheet remains strong and we have the flexibility to manage through various economic outcomes, while deploying additional capital to drive shareholder value.

Now let me provide more color on our segment results. Beginning with Water Innovations, sales were $688 million, up 8%. Organic sales were down 4% or down 3% excluding the impact of FX. The organic net sales results reflect the impact of lower volumes, partially offset by price. Water Innovations operating income was $166 million and operating margin remained strong at 24.2%, reflecting lower volumes, partially offset by continuous improvement initiatives.

U.S. Moen point of sale was down mid-single digits while U.S. House of ROHL point of sale was down low single digits. The luxury consumer continues to outperform the broader market.

China sales declined low teens or down mid-single digits when adjusting for the impact of FX. The Chinese market remains soft and though the completion of delayed projects accelerated as a result of government programs, new home sales and starts are moderating as the Chinese consumer remains cautious.

That said, we continue to see growth in the emerging R&R channels, including at brick-and-mortar locations and online. As we have stated, our performance in the face of challenging external conditions has been nothing short of remarkable, and we are confident we will lead as that market continues to evolve.

Turning to outdoors. Sales were $366 million, down 9%. POS for the segment was down low double digits, which was partially offset by mid-single-digit favorable channel inventory benefit from the prior year

comparable. Segment operating income was $54.3 million, down 18%. Operating margins for the third quarter were 14.8%, driven by reduced volumes.

Door sales were down low double digits. As expected, sales were impacted by lower volumes from single-family new construction and market softness. However, these brands should be positively impacted by the recently improved new construction environment as we look toward 2024.

In Decking, we saw sales increased mid-single digits in the quarter driven by mid-single-digit POS growth in the wholesale channel.

Finally, in Security, sales increased 32% to $207 million or 6% on an organic basis, reflecting the impact of the acquisition, increased distribution, price, and continued strength in Master Lock's commercial and international channels.

Total Security segment operating income was $35 million, up 46%, and operating margin was 16.8%, an increase of 170 basis points. Utilizing the playbook first deployed in our Water Innovations business, our team continues to work to transform our security business into a higher-growth, higher-margin business focused on attractive categories where our brands and innovations can drive consumer and customer share gains over time. This strategy will be accelerated by the continued integration of Yale and August.

Turning to the balance sheet and our cash flow performance. Our balance sheet remains strong with cash of $453 million, net debt of $2.4 billion, and net debt-to-EBITDA leverage at 2.6x. Our working capital reduction efforts continue to shrink our balance sheet and generate cash. We continue to make excellent progress against our near-term inventory reduction targets and our organic third quarter inventory finished at $829 million, down roughly $260 million from our peak in 2022.

Our impressive free cash flow of $269 million in the quarter allowed us to make significant progress in deleveraging following our recent acquisition. In addition, our cash generation enabled us to opportunistically repurchase $30 million of shares in the quarter. And as of today, our total 2023 share repurchases are $150 million.

To summarize the quarter, we delivered solid sales and margin results in a soft environment, while further reducing inventory levels and generating significant cash flow.

With that in mind, I'll now provide an update to our 2023 guidance. As today's press release indicates, we are updating our full year 2023 guidance to reflect our current expectations and market conditions. Due to our continued strong execution and agility in this dynamic environment, we are increasing the midpoint of our EPS guidance by $0.02 and narrowing the overall range to $3.80 to $3.90. In total, our updated EPS guidance reflects a $0.15 increase over the midpoint of our initial guidance earlier this year.

As a reminder, our fourth quarter EPS will be unfavorably impacted by $0.05 as a result of a nonrecurring extra fiscal week in the fourth quarter of last year.

We are also updating our sales and margin guidance to reflect current market conditions, including a softer-than-anticipated second half R&R market, which is predominantly impacting sales in our Outdoor segment.

The full details of our updated guidance can be found in our press release.

As we head into 2024, we are actively planning for a variety of scenarios. While it would not be prudent for us to provide a full set of guidance assumptions for 2024 at this point, we are able to share some initial thoughts.

Our base planning assumptions currently include a low single-digit market decline, with U.S. R&R also down low single digits. Our U.S. single-family new construction market is up low single digits based on the impact of second half 2023 starts growth and a 2024 starts and completion forecast of up 3% to 5% and roughly flat, respectively.

We expect China and Canada markets to be more challenged than the U.S., both down high single digits. We would expect our organic sales to beat this market estimate and given the work we continue to do to replatform the business and drive efficiencies, we see a path to operating margin improvement and earnings growth if the market is down low single digits or better.

Our teams have done a fantastic job navigating the uncertainty of the past few years. And as we approach the end of 2023, we remain confident about the future of the business and our team's ability to create value regardless of the macro environment.

I will now pass the call back to Leigh for question and answer. 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?

Operator
Thank you. If you would like to ask a question, please press star one on your telephone keypad at this time. A confirmation tone will indicate that your line is in the question queue. You may press star two if you'd 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 star keys. One moment, please while we pull for questions.

Thank you. Our first question comes from the line of Matthew Bouley with Barclays. Please proceed with your question.

Matthew Bouley
Hey, good evening, everyone. Thanks for taking the questions. Maybe to start off on the guide and kind of how you're looking at the fourth quarter here. Clearly, a lot of crosscurrents in the market. I think you just mentioned some deceleration on the DIY side, sort of looking at the guide, it looks like you're implying some sequential deceleration in the top line. So just -- I know we can kind of back into what you gave,

given with the full year guide, but just sort of any puts and takes, upside, downside to how you're thinking about the fourth quarter. Thank you.

Nicholas Fink
Yeah, Matt, why don't I give you some kind of high-level thoughts on that, and then Dave can take you through some of the puts and takes. But a couple of things. I mean certainly, just from -- as we said in the prepared remarks, the market has been more or less as we've expected. I think with some of the point-of-sale DIY, maybe some of the retail stuffing a bit softer, single-family new construction being a bit stronger. And as we see how it plays through the year, the top line performance of every quarter has been improving.

And so as we look to the fourth quarter, on an organic basis, none of that 53rd week, we'd expect that to be flat, which is a sequential improvement. And so good to see the business kind of coming back to flat in particular with the market outperformance.

And then as I look at some of the actual dollar point of sale that we get, which is more retail-based, that's actually held remarkably steady for the last, call it, 10 to 12 weeks on a dollar basis. So obviously, comparables move around in terms of percentages versus last year. But just what are consumers doing when they go into stores, what are the dollars they're spending. That's been very steady. So while we'd like it to be higher, the predictability of seeing a kind of steady line sort of feeds into our degree of confidence around the fourth quarter. Dave, do you want to add a bit more color?

Dave Barry
I'm happy to provide a bit more color. I think starting with sales, if you look at our organic performance throughout the year each quarter, and as Nick mentioned, we've gotten better versus prior year. So it started down 10 in the first quarter, then down 8, now down 5, and we'd expect the fourth quarter to be flat, excluding that extra fiscal week comp or likely down 3% to 4% reported organically when you factor in that comp. So nice sequential improvement versus the prior year on the sales line.

And then on margin, you know, we still see the second half operating margin around 16.5% or better, which would imply a fourth quarter of 15.5% or better, which is expected in the fourth quarter to see a bit of a sequential pullback from the third quarter just given volumes are down, but still well ahead of where we were in the first quarter, which is our other low volume quarter. So we feel good about how the business is managing, I think, both the top line and the margin opportunity.

And then if you think about just EPS, I'd remind people that our prior year had two favorable impacts that won't repeat, one being the flow-through from that extra fiscal week and the other being some favorable tax outcomes as we spun cabinets that were onetime in nature.

So as we look at EPS in the quarter, we see something normalized that's down low single digits or better versus the prior year. So I know our teams are still working hard to capitalize on opportunities in the quarter, but still feel like we're managing the business well given the environment.

Matthew Bouley
Got it. Okay. Thank you for that. Thanks for buttoning that up for us. Second one, a little higher level. Now that you've had the assets on your team for another quarter and been able to dig in and get the

integration underway, you know, I'm curious, you had some comments at the top alluding to this, but sort of what have you learned incrementally as you've been able to dig into the assets? And specifically, the comments you made around the help with how Yale and August could benefit your connected products portfolio.

Curious number one, is do your synergy targets include benefits to the Connected Products portfolio? And then just number two, more broadly, as you looked into this further, what areas of upside could you see in those synergy targets? Thank you.

Nicholas Fink
Yeah. I'd be happy to take that question. We were -- as you heard in the prepared remarks, we're just delighted with the acquisition. Even putting aside the fantastic value that came across that, just the quality of the assets themselves are really phenomenal. The quality of the teams that support those assets look fantastic. And the performance since we've owned them has even exceeded our expectations on the top line, and on the bottom, you'll see that we've actually been able to accelerate some of our investments in the integration just because the integration is going really well. And so that's kind of the big-picture message.

Now you asked a great question, what have we learned? I take each of it separately. But certainly, it's sort of the Emtek business. I mean they're just really remarkable, continue to gain share, really, really outperformed the market. We were just recently on a market visit and speaking to one of our customers pointed to displays in a relatively small footprint of the store and said this is 50% of the sales in the category just from this little area. And I think it just speaks to how powerful the brand is.

What we've really learned is what is the formula that supports that and the business model and how does that work as profitably as it does. And so a lot of learnings coming from that that are starting to be integrated into the whole House of ROHL strategy. And so just last week, we were going over annual operating plans and as those teams are coming together, not just thinking about how do we offer these as an entire suite of product, which was part of our initial thesis, but really thinking how do we elevate the best of the best in the business models to be an even better solution for customers and designers. And so we think there's a lot of potential and a lot we can learn there.

And then on the Yale and August side, look, we're very proud of the connected products progress that we've made and the digital initiatives that we've made up to this point, but getting to know those teams, I mean, they really are in mid-cycle area, like a mid-cycle start-up. And a lot of that team is the original August team, which spends some time in speaking to people in that part of the world. They are some of the most highly respected connected engineers around. And so we're really looking to them to help lead us as we think about how to bring these teams together and how do we take what we've already created, which we're really proud of, the investment that we're already making, which is not as significant, and then combine it with what we just acquired. And we really think that could be a huge growth unlock.

And so you asked about synergies. I think we went in with a pretty good synergy case of some -- won't call them easy because they take a lot of work, with some lower-hanging fruit like distribution overlaps and those sorts of things. What we're coming away is with some transformational ideas around both the House of ROHL and the connected business that the teams are leading into. It's not me saying, you got to

deliver more. I mean they sort of took the case and they said, we think we can do far more than this because we really think that this unlocks pretty significant growth for both portfolios.

And so those are being refined now, but we're really, really excited. And as you heard in the comments, I mean, the connected business now approximating and approaching $250 million on an annualized basis, but over 4 million activations and compounding at a really, really fast growth rate now feels like a scale connected business and connected platform and having one technological backbone to which we can continue to refine the products we have, but also add more to the ecosystem over time, is really, really exciting.

So I could go on for a while. I'll stop cause I'm sure we have other questions, but you can tell we're pretty excited about it.

Matthew Bouley
Great. Well, thanks, Nick. Thanks, Dave. Good luck, guys.

Nicholas Fink
Thanks, Matt.

Operator
Thank you. Our next question comes from the line of John Lovallo with UBS. Please proceed with your questions.

John Lovallo
Good evening, guys. And thanks for taking my questions. Nick, I actually did want to follow up on what Matt just asked to some extent on the connected product portfolio. Very interesting opportunity goes beyond Smart Locks, obviously, with Smart Water. You guys -- I think you mentioned you've tripled the sales over the past few years. So the question is, I mean, where do you go from here? What's sort of the expected growth trajectory? And what are the potential product expansion opportunities?

Nicholas Fink
Yeah. Well, John, thanks for that question. I mean we've really taken a big step forward, I think, through the strat plan cycle and really ask ourselves that question you just laid out, so just thinking about it incrementally. We're really like what is the addressable market here? And what do we expect that we could gain in terms of ownership of that market?

And you touched on Smart Water. I mean when you look at the Smart Water opportunity from a number of different lenses, it is pretty staggering, right? Just to start with just the pure -- how much preventable water damage is there today. We think that's $15 billion of claims a year. It's greater than Fire and Burglary combined, right, so $15 billion of preventable water damage.

I actually believe we're going to grow that addressable market because we're going to come up with more products that can address more types of preventable water damage. We can take that pretty much to zero. I mean we did a study with LexisNexis. In 10,000 homes, we reduced 96% of the claims to zero, and the other 4% of claims, I believe, we reduced by over 70%. So pretty much going to zero.

There's an ESG lens to it, right? In addition to saving, we think potentially trillions of gallons of water, there's a huge energy component to processing and cleaning water. And so you take Mission Moen, which is really based on what we have in the market today, our commitment to save 1 trillion gallons by 2030. That according to the math available on the EPA website is the equivalent of us taking a million cars off the road for a year, right? And so you can start to see now for municipalities, right, it has a huge dollar value impact.

And so the opportunity is huge. We're really not thinking of it as a multibillion dollar opportunity. We're building teams around really addressing not just the core product, making it better and better all the time, we're building an ecosystem around it. So when it connects to your Moen Irrigation, Smart Irrigation System, or your Moen Smart Faucet or your Moen Smart Pump Monitor, and I could go on and on, it really gets better and better and smarter and smarter because it's able to speak to all these nodes in the home, understand what's going on, and really do things like protect you from freezes because it can -- pulls water out of your kitchen faucet, or health protect you if you're on vacation from bacterial build up and things like that.

And so we're really now leaning into this, I think, in a much more serious way. And as I just said in response to Matt's question, if you then add on the scale of having the Yale, August team come on board and think about what it is to be able to think about cloud as a single team or WiFi as a single team or AI, right, the Smart Water Network is AI-powered. So our AI team becomes sort of a single team with dedicated people to different projects and products, but still functioning as a scale team. We think the opportunity is really, really significant, and we look forward to speaking about it more in the future.

John Lovallo
That's helpful color. Thank you. And then the next question is on water specifically. The sales outlook was raised from, I think, flat to down 2% to now flat to down 1%. U.S. new construction a little better, China, a little worse. So I guess how are you thinking about House of ROHL and Moen in this equation, which I think were both down organically in the quarter? Then also, what's driving the decrease in margin outlook from, I think, 23.5 to 23 on an improved sales outlook? Thank you.

Dave Barry
John, this is Dave. I'll handle the margin one first. I think it's more around some of the accelerated investments that we're making, as Nick mentioned, some with the Emtek acquisition and then some in the base. And so as we've talked about in the past, our margin quarter-to-quarter stays in that low to mid-20s, and you may see some fluctuations. It was 24.2 in the third quarter, and we'll step back a little bit in the fourth, but more around investment timing than anything else.

And then on the sales line, the team really continues to perform well and drive outperformance. And so House of ROHL, as we've mentioned, down low single digit organically in the third quarter, probably at similar levels in the fourth quarter. And then for Moen America, it's a similar performance we see that down low single digits in the fourth quarter, which really implies that our POS run rate stays at mid-single digits or better, and we have some favorable inventory tailwinds from last year that we've discussed. And so I think it's more as we have line of sight to the end of the year, just tightening that range around the performance that we're seeing out of the business.

John Lovallo
Thank you, guys.

Operator
Thank you. Our next question comes from the line of Stephen Kim with Evercore ISI. Please proceed with your question.

Stephen Kim
Yeah, thanks, guys. Appreciate all the color. I wanted to ask a little bit on the U.S. residential side. You, I think, increased the U.S. -- the single-family new construction component of your guide. But multifamily has been looking weaker and what with the increase in rates and so forth. I think the concerns exist about how things might look over the next few months.

So I know that you have a fairly constructive view of that given the undersupplied state of the industry. Obviously, I share that view as well. But I was curious if you could talk specifically about the multifamily side to the degree to which that may be weighing and on the overall outlook because I didn't hear you call that out.

And then similar to this, in your Outdoors division, your Doors business has a lot of starts exposure, I guess. Your sales, you said it was kind of as expected, the starts effect, but the sales guide came down a bunch. And so just curious if you could sort of maybe tie that in there as well.

Nicholas Fink
Sure. Why don't I -- I'll start and just give you some perspectives and Dave will add some more color around it. I'll just start more on your question about the starts and multifamily. And multifamily is actually a pretty small part of our business. And so I don't disagree with you. I do think it's challenged. I mean, it's going to be challenged. But it's a pretty small part of our business. And then within that, the part of multifamily that we serve tends to be the higher end of multifamily.

And so I think where a lot of (audio gap) is coming in places where we don't have a ton of exposure because we're more, if you think about in multifamily for sale, large concept buildings, those are the type of things that we tend to be calling on versus, I think, we're seeing a lot of pressure in the rental market, which tends to gear more towards the price competitive stuff.

So why not pause there. Dave may have some color and then we can talk about that Doors piece.

Dave Barry
Yeah. Steve, so multifamily in total is about 6%, 7% of the portfolio, so pretty small. And recall, our products go in towards the end. So our multifamily estimate for this year is actually up high single digits. And so we're not feeling much headwind in the macro this year based on when our products are consumed on multifamily.

I'd say what's a little bit softer is probably the overall U.S. R&R, right? If we're still down 4 to 6, I think, we are at the midpoint of that, maybe a bit below the midpoint, and that's offsetting the single-family new construction benefit in the overall macro.

Nicholas Fink
On your Door's question, you're right, more single-family new construction exposure there. What's been interesting is we kind of haven't yet seen the benefit of the starts acceleration pull-through our products. So we think that's probably just got to do with when our products are installed. And that varies. I mean not the point of inflation doesn't vary, but the lag between starts and completes tends to vary. And so it's kind of an inexact science.

And so we've not seen it pull-through very strongly in doors or valves, which for us is a great indicator given our exposure to large production builders. We get a great sense given the valve install is fairly early on when that's pulling through. And so we think that's probably most likely to be a end of '23 and into '24 tailwind.

Dave Barry
Yeah. And Steve, just some color on that. So our Moen valve POS in the third quarter, so the component of the product that goes behind the wall into construction, was still down mid-single digits. And then our doors wholesale POS, which predominantly serves new construction was down low double digits. So we're not seeing that new construction pull-through yet, to Nick’s point, probably late fourth quarter, early 2024.

I say the other piece on the outdoors guide is driving it down a little bit. Channel inventories are still lean across that segment. And we expected really a bit more inventory to come in in the quarter than we saw, as we exited the quarter, still pretty lean, both on the decking and door side.

Stephen Kim
Okay. That's helpful. Yeah, I appreciate that. That info in the valve is interesting because we have seen that pull-through happen in some other segments, so another product. So that's interesting that it should come soon.

Nicholas Fink
Given that we're pretty much locked into -- I mean not for (inaudible) locked into that portion of the builders is very high. It's a pretty (inaudible) for us.

Stephen Kim
Yeah, clearly. Okay. Second question relates to just kind of generally, if you could talk about the dynamic between price cost, if there was anything sort of to call out there that we should be thinking about across your -- the various segments?

Dave Barry
Yes, there's nothing material to update really from where we've been in the past few quarters. So still see price as a low single-digit contributor to sales. Started to see some deflation -- metals deflation in the P&L in the third quarter as we expected. But I'd say overall deflation still less than 1% of COGS given offsets to labor. Some of the freight lanes have increased and then around indirect spending. And so tracking to where we thought we'd be at the beginning of the year and no material update or change.

Nicholas Fink
And I'd just add for some color. You talked about this previously, but one of our key Fortune Brands Advantage capabilities is category management. And so what are the -- these are the things that we decided to invest in to get really, really good at things like our next-generation sourcing capabilities, global supply chain, category management, complexity reduction, and digital.

And we're finding that having that capability, which is really data analytics driven and understanding of the shelf, the consumer, and shopper behaviors, the elasticities, having that tool now has been very powerful because it's allowed us to have very constructive conversations with our trade partners and allows us to be very precise and targeted in how we manage price and therefore, continues to be a contributor while keeping us competitive in the marketplace.

Stephen Kim
Okay, great. Thanks very much, guys.

Operator
Thank you. Our next question comes from the line of Michael Rehaut with J.P. Morgan. Please proceed with your question.

Michael Rehaut
Great. Thanks very much. Good afternoon, everyone. Just wanted to for my first question, make sure I'm getting some of the nuances of the change in guidance here. And I guess just on a basic level, it seems like the slight reduction in operating margin is predominantly driven by the slight change in sales. So I just want to make sure I'm thinking about that right. It just appears like it's more just a function of the sales leverage.

And when you think about from a top-down perspective, you have a couple of the segments, a slight tick-down in the sales guidance. What's really driving that from an end market perspective? And it also appears, if I'm looking at it right, that you were a little better than your outlook on 3Q and a little worse than what we were thinking about for 4Q. So if there's any type of shift between timing here or if things are a little better, things are a little worse in the last three. months of the year. Just wanted to appreciate any of those differences as well.

Dave Barry
Hey, Mike, it's Dave. I'd say your first question, that's accurate. It's really, you know, sales -- slight reduction in our sales guidance flowing through to operating margin just based on the volume leverage. So that's really coming in Outdoors. I mean if you look at the segment changes, water segment guidance overall up slightly, so from minus 2% to flat to minus 1% to flat, and then security same, up slightly 13 to 15 up to 14 to 15. So it's really Outdoors as we mentioned earlier on the call. Slightly lower R&R, POS, and then some channel inventories that are leaner. So I think that's the simple way to think about the change in guidance.

Third quarter, fourth quarter, there are always some timing benefits across the quarter or challenges across the quarter. As I mentioned earlier, teams are working hard to get the best results out of the fourth quarter that we can, given the market environment.

Michael Rehaut
Right. And I appreciate that. I guess I was focusing a touch more on the organic change. I mean it brings me really to the second question, which is that you'd mentioned both acquisitions are doing better than you expected. And so I was hoping to get a sense, number one of, I know it's just one quarter, perhaps, that's under your belt here. But any kind of updated thoughts about how to think about an annualized revenue run rate for these two businesses? I think a quarter ago, you're talking about, I believe, $240 million for Emtek, Schaub, and $170 million for Yale, August. If there's any changes to how we should think about those numbers on an annualized run rate?

And from -- again, from an end market perspective, if you think about those two different businesses, where is that upside coming from? If it’s, again, a certain channel or end market or if there's even any initial benefits from some of the sales synergies, which I do expect would be more in '24. But -- just any thoughts in terms of the drivers there?

Nicholas Fink
I'll start with the drivers and then I'll give it to Dave who can talk you through the rest of it. But I'd say the drivers are, A, on the -- and again, two different -- Emtek and Schaub. I think they -- we, I guess, now have just built a fantastic business model and mousetrap that really, really works for the high-end designer consumer, and that continues to take share. And so it is outperforming some market in a very healthy way. But I think the real opportunity will be to take what's really working in that model and leverage it across the rest of the luxury portfolio.

And then on the Yale and August side, just a really fantastic product set that have been growing really nicely, but have been chip-constrained for a while. And as that is starting to flow now, and I think also, we're giving the team there sort of the privilege of focus on really working on a number of things that they had on their plates that they wanted to do, but they were also working on other priorities for their predecessor organization, which they told us -- give us a privilege of focus for a while and let us get some things done next quarter or two, and we're seeing some of that come to fruition.

I think it's early days to say, does that change our view on the run rate? I mean we’ve sort owned it since like June, but what it's allowing us to do is lean into the synergies with a lot of confidence and also invest ahead of plan on bringing some of those synergies to life.

Dave Barry
Yes. And I think Nick said it well, Mike. I mean we'll provide a more detailed view of 2024 on our next call for those businesses, but it is going well. It is early days, and the team is capitalizing on a lot of opportunities.

Michael Rehaut
Great. Thank you.

Operator
Thank you. Our next question comes from the line of Adam Baumgarten with Zelman. Please proceed with your question.

Adam Baumgarten
Hey, guys. Good evening. Just curious on some of the benefits you've been seeing from the leadership reorganization and kind of how that's playing out. And I know there's been some savings you've called out in the past year, in the first year or so, but just kind of how to think about it going forward, and then I'll stop there.

Nicholas Fink
Yeah. That work, and it was a lot of work, and it's still a lot of work because we're really in the first cycle of the new operating structure, right? So we just saw the first integrated annual plans a week ago. Next month, we'll see the first integrated brand plans, product plans, innovation plans.

But in short, it is actually going ahead of schedule and better than we expected, and I say that with a lot of credit to our teams because I think it's really their sort of trust and enthusiasm of leaning into it that's delivering. But it was designed to unlock growth and productivity.

And Dave can talk a bit to the numbers, but the economic -- the immediate cost-out benefit is a really nice byproduct of not wasting energy on things that weren't creating value and allowing the organization to spend their time on things that will. And so we're seeing a lot more of that. We're seeing us be able to move through initiatives a lot quicker.

And a simple example, Dave and I talked about sort of Fortune Brands advantage. You have these capabilities, and we were getting much better at deploying them across the organization. But now it's not a question of is it a good idea, not a good idea, you know, those leaders -- Cheri Phyfer leading our commercial organization, you know, Ron Wilson leading our supply chain organization, if they want to go execute on something across the entire portfolio, they get their teams and they go execute. And so we're seeing a much faster execution of our key initiatives. And I think that will be the real unlock over time, and where I expect it to show up more than anywhere else is growth.

Now you asked, where are we in that? I think we've taken out kind of like the bite out of the third. Now again, I caution myself using the word easy because I think our team would say, nothing was easy about it, but it's the obvious lower-hanging fruit opportunities. The next 2/3 will really come from things like simplifying our systems, being able to work more easily across the business, taking out more duplication as we have more efficient systems in place, and we see that as a multiyear growth and productivity journey for the company.

Dave Barry
And Adam, just to put the financials behind it. So as we've mentioned, that first third or so was $55 million of gross SG&A out, and we have invested some back into the business to drive some key priorities. And the teams have been busy working this year on the next phase of that organization in the future. And as we move to design it, it's going to come with process improvement, system simplification to really get more lean operating environment relative to where we've been.

Adam Baumgarten
Okay. Great. Yeah. And I guess the other switching gears question I would have is just on the decking business, it seems like that's a pretty meaningful positive standout, you guys, your peers and competitors in terms of, you know, versus the broader backdrop. I guess maybe if you have any color on what's driving

that? How sustainable it is? Anything you're seeing there just because of the broader, I'd say, home improvement market is kind of soft at this point.

Nicholas Fink
Yeah. I would start out a couple of things. I mean, firstly, again, as you know really well, just the underlying value prop of composite and PVC materials continues to really be healthy and particularly when you add in all the other costs of installing a deck. And so that will take share against wood and will continue to do so for a very, very long time.

And in our own capacity modeling, we will play with that conversion ratio. We think it's somewhere between 1% and 2% of wood. So in a really hot year, it might be a 2, and a slower year, like this year, we think it might be closer to 1, but it's still happening. And so I think that does continue to drive the top line.

The next piece, I think, is really important that you mentioned was sustainability, right? And we've tried to be very thoughtful and very judicious about how we go to market to do it in a sustainable way for us and all of our route-to-market partners. And so be thoughtful about pricing, be thoughtful about our product offerings and therefore, be thoughtful about the where we go press the portfolio.

And I think what you see in these latest results is we've been willing to give up a little bit of lower-margin business where we think it's not going to be healthy or sustainable to go focus on areas that are and more up the price spectrum, and then that's where we ended up taking share. And I think that's what read through in these results. We'll continue to pursue that strategy because we think that's the most sustainable way to build this business out for the long term.

Adam Baumgarten
All right. Thanks. Best of luck.

Operator
Thank you. Our next question comes from the line of Phil Ng with Jefferies. Please proceed with your question.

Philip Ng
Hey, guys, thanks for squeezing me on the call. And Dave, really appreciate you giving us a early look on 2024 in terms of the market. You're calling for a low single-digit decline in 2024, but you're expecting margin expansion and earnings growth. So can you help us unpack what are the key drivers in terms of growing earnings and any color on ranges because The Street is certainly modeling a pretty robust earnings growth next year, so maybe well off the lows set a little bit. But I really appreciate you giving us an early look on 2024.

Dave Barry
Yes, happy to. I think our confidence in margin expansion and earnings growth really stems from the work that we talked about on this call. So replatforming the business, getting after some synergy opportunities. We've mentioned some changes in the security business that we've made. And so there's a lot of, I'd say, internal activities that we see coming through the P&L next year. We have -- we will be comping that inventory reduction headwind in the first quarter. Given where production is likely going to be planned, I

wouldn't expect to get all of that back because we'll still be producing at a level lower than we were in '21 and '22.

And then we still see price cost as a benefit. And our teams are still working through their strategic recommendations to our customers around pricing, but looking to have price contribute again positively to net sales growth next year as we really think about taking price using our category management capabilities and based on the strength of our brands and innovations in a way that both maximizes our share, but also profit for us and our customers.

And we've demonstrated our ability to do that over the past couple of years. So I think it's really those three levers. The internal actions we've taken some favorable comps on our cost bar and then some price cost favorability.

Philip Ng
Is there any way to size up those buckets for us so we have a better handle? And should we assume flattish market, if you're outpacing the market and you're taking price against? So maybe flat sales or you could actually -- you could add some top line growth?

Dave Barry
Yeah, Phil, I think, certainly, our teams are still working through all the details. We've seen enough to be able to give this confidence now, we'll provide more in January. And then yes, I think depending on where the market settles, you would expect us to beat the market. And typically organically, we're targeting 150 to 200 basis points above the market. And so that would imply organic growth in that flat to down low single digits depending on how the market settles out.

Philip Ng
Okay. Appreciate the color.

Operator
Thank you. We have reached the end of our question and answer session. And with that, thank you for joining today's conference call. You may now disconnect.