Illinois Tool Works (ITW)

Updated April 12th, 2018 by Nick McCullum

Key Metrics

Current Price:	$156	**5 Year CAGR Estimate:**	5.2%	**Quality Percentile:**	N/A
Fair Value Price:	$128	**5 Year Growth Estimate:**	7.0%	**Momentum Percentile:**	N/A
% Fair Value:	122%	**5 Year Valuation Multiple Estimate:**	-3.8%	**Total Return Percentile:**	N/A
Dividend Yield:	2.0%	**5 Year Price Target**	$180	**Valuation Percentile:**	N/A

Overview & Current Events

Illinois Tool Works is a diversified industrial manufacturer with a market capitalization of $23 billion. The company has a remarkable *28 operating segments* and generates more than half of its revenue from outside of the United States. Illinois Tool Works has increased its dividend for 54 consecutive years, which qualifies it to be a member of the Dividend Aristocrats Index.

In late January, Illinois Tool Works reported (1/24/18) financial results for the fourth quarter of fiscal 2018. In the quarter, revenue increased by 7%, or 4% organically (excluding acquisitions and foreign exchange fluctuations). Operating margin expanded by 160 basis points, and adjusted earnings-per-share increased by 17%. Full-year results were similarly strong. Total revenue increased by 5%, or 3% organically, and adjusted earnings-per-share increased by 16%. Illinois Tool Works' strong performance in the quarter was driven by robust revenue growth across most operating segments combined with disciplined expense management and corresponding levels of margin expansion.

Illinois Tool Works also updated its financial guidance for fiscal 2018. The company is now expecting to generate earnings-per-share between $7.45 and $7.65, which is up $0.40 from previous guidance of $7.05 to $7.25. This updated guidance reflects tailwinds from the U.S. Tax Cuts and Jobs Acts as well as predicted fluctuations in foreign exchange rates. In the same announcement, Illinois Tool Works reported that, subject to Board approval, it intends to bolster its dividend policy by distributing 50% of free cash flow (up from 43% currently). This should boost the company's rate of dividend growth in the near-term.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$3.05	$1.93	$3.03	$3.74	$4.09	$3.63	$4.67	$5.13	$5.70	$6.64	***$7.55***	***$10.60***
DPS	$1.18	$1.24	$1.30	$1.40	$1.48	$1.60	$1.75	$2.07	$2.40	$2.73	***$3.20***	***$5.50***

Illinois Tool Works has compounded its earnings-per-share at a rate of 9.0% per year since 2008. Looking ahead, we expect a more modest rate of growth for this blue-chip Dividend Aristocrats. Illinois Tool Works is likely to deliver 7.0% earnings-per-share growth over full economic cycles, driven by margin improvements, expansion into new manufacturing segments, bolt-on acquisitions, and international growth opportunities. Applying a 7% growth rate to 2018's financial guidance allows us to calculate a 2023 earnings-per-share estimate of $10.60.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	14.9	20.1	15.4	13.7	13.9	19.4	18.5	17.0	19.0	21.5	***20.6***	***17.0***
Avg. Yld.	2.6%	3.2%	2.8%	2.7%	2.6%	1.7%	2.0%	2.2%	2.2%	1.9%	***2.0%***	***2.4%***

Using the midpoint of 2018's financial guidance, Illinois Tool Works is trading at a price-to-earnings ratio of 20.6. The company has traded at an average price-to-earnings ratio of 17.3 over the last decade. We believe an earnings multiple of around 17 represents a semblance of fair value for Illinois Tool Works. Accordingly, our expectation is that valuation contraction will have a negative impact on the company's returns during the near-term. If Illinois Tool Works' price-to-earnings ratios reverts to 17 over a period of 5 years, this will introduce a headwind of 3.8% to the company's annualized returns during this time period.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	38.9%	29.4%	33.3%	30.2%	29.3%	28.0%	33.3%	35.1%	37.5%	35.8%	***33.0%***	***33.0%***
Debt/A	49.6%	45.2%	42.3%	44.3%	45.3%	51.4%	61.0%	66.8%	72.0%	72.7%	***70.0%***	***55.0%***
Int. Cov.	16.2	8.4	15.0	15.8	19.5	13.7	15.9	16.9	15.8	16.4	***15.0***	***15.0***
Payout	38.7%	64.2%	42.9%	37.4%	36.2%	44.1%	37.5%	40.4%	42.1%	41.1%	***42.4%***	***51.9%***
Std. Dev.	43.4%	37.4%	26.0%	32.3%	19.9%	16.1%	14.6%	18.7%	16.6%	13.7%	***18.0%***	***18.0%***

Although Illinois Tool Works' debt load as a percent of its total assets has increased meaningfully over time, its interest coverage remains robust. This suggests that the company's increased debt load may have occurred as it took advantage of better borrowing opportunities in the form of lower interest rates. We expect Illinois Tool Works to deleverage as interest rates rise. Elsewhere, the company's gross profits as a percent of total assets is quite good. We also note that Illinois Tool Works' distributes less than half of its earnings as dividends to shareholders. This means there remains a buffer for continued dividend growth in the event that the company's performance stalls for a short period of time.

From a qualitative perspective, Illinois Tool Works' most compelling competitive advantage is its technical expertise in the industrial manufacturing sector. The company holds more than 17,000 granted and pending patents. Separately, the company's differentiated portfolio management strategy also separates it from its peers. Illinois Tool Works employs a management process called "80/20" where the company focuses only on its best opportunities and divests non-core operating units. This creates a decentralized and entrepreneurial culture that empowers its employees to make better decisions over time.

Final Thoughts & Recommendation

Illinois Tool Works has increased its dividend for more than *five consecutive decades*, and next year's financial performance should be one for the books. If an investor were to look exclusively at the underlying business (and not the stock price), then there's a lot to like about this blue-chip dividend stock.

Unfortunately, Illinois Tool Works is historically overvalued right now. Because of this, we believe that valuation contractions will reduce the company's total returns to the ~5% level, which does not appropriately compensate investors for the equity risk they are exposing themselves to. We are recommending investors look elsewhere for more attractively priced opportunities within the industrial sector.

Total Return Breakdown by Year