



# Illinois Tool Works (ITW)

Updated July 23<sup>rd</sup>, 2018 by Nick McCullum

## Key Metrics

<b>Current Price:</b> \$147	<b>5 Year CAGR Estimate:</b> 6.6%	<b>Volatility Percentile:</b> 30.6%
<b>Fair Value Price:</b> \$129	<b>5 Year Growth Estimate:</b> 7.0%	<b>Momentum Percentile:</b> 35.7%
<b>% Fair Value:</b> 114%	<b>5 Year Valuation Multiple Estimate:</b> -2.5%	<b>Valuation Percentile:</b> 52.2%
<b>Dividend Yield:</b> 2.1%	<b>5 Year Price Target</b> \$181	<b>Total Return Percentile:</b> 51.7%

## Overview & Current Events

Illinois Tool Works is a diversified industrial manufacturer with a market capitalization of \$23 billion. The company has seven unique 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 July, Illinois Tool Works reported (7/23/18) financial results for the second quarter of 2018. In the quarter, total revenue of \$3.8 billion increased by 7% over the same period a year ago. Organic growth contributed 4% of this top-line expansion, with bolt-on acquisitions contributing the remaining 3%. Moving down the income statement, the company's operating margin of 24.3% expanded 10 basis points over the prior year's period. This margin expansion grows to 50 basis points if a one-time legal settlement charge is excluded from the company's quarterly financial results. The company's earnings-per-share were even more impressive. GAAP earnings-per-share of \$1.97 increased by 17% over the same period a year ago, or 19% excluding the aforementioned legal charge. Illinois Tool Works' strong performance was driven by broad-based growth across each of its seven operating segments, with the Welding segment's 13% growth being the most impressive. Remarkably, Illinois Tool Works reported an after-tax return on invested capital of 28.7% in the quarter, showing the company is doing an excellent job of allocating capital.

Illinois Tool Works also updated its financial guidance for fiscal 2018 with the release of its second quarter earnings release. The company now expects to generate full-year earnings-per-share between \$7.50 and \$7.70 for the twelve-month reporting period. The midpoint of this guidance bands reflects 15% growth over the prior year's comparable period. Moreover, the company's capital allocation guidance is very promising. Illinois Tool Works expects to repurchase \$1.5 billion of company stock in fiscal 2018.

## Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
<b>EPS</b>	\$3.05	\$1.93	\$3.03	\$3.74	\$4.09	\$3.63	\$4.67	\$5.13	\$5.70	\$6.64	<b>\$7.60</b>	<b>\$10.66</b>
<b>DPS</b>	\$1.18	\$1.24	\$1.30	\$1.40	\$1.48	\$1.60	\$1.75	\$2.07	\$2.40	\$2.73	<b>\$3.20</b>	<b>\$5.50</b>

We are updating our 2018 earnings estimate to reflect the midpoint (\$7.60) of Illinois Tool Works' recently-revised financial guidance. This is a modest improvement over our prior \$7.55 estimate. Moving forward, we can estimate the firm's future growth by considering historical base rates. 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 Aristocrat. 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 \$10.66.

*Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.*

## 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	19.3	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%

Due to the combination of a declining stock price and improved 2018 financial guidance, Illinois Tool Works' current valuation is incrementally better than at the time of our last quarterly research report. More specifically, the company is trading at a price-to-earnings ratio of 19.3, down from 20.6 previously. We continue to believe that a 17x earnings multiple is appropriate for Illinois Tool Works, which implies a 2.5% annualized headwind to annual returns if mean reversion were to occur over a 5-year holding period.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

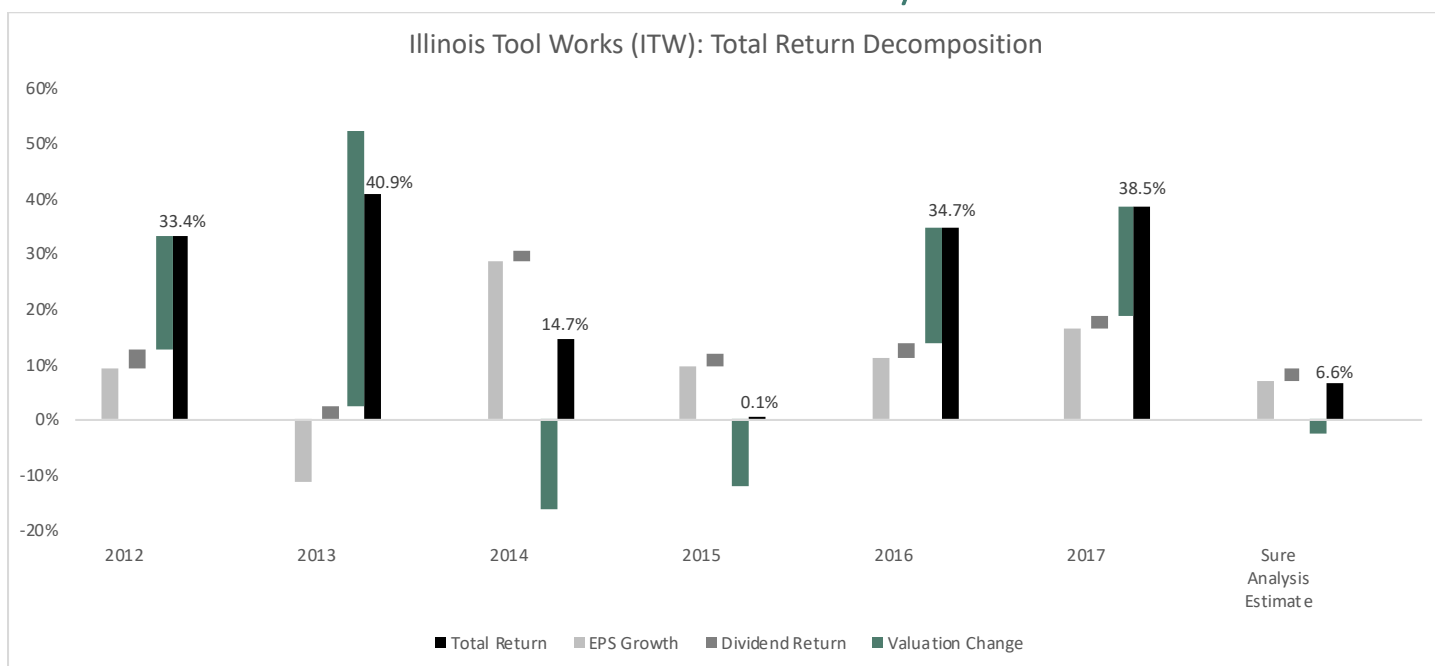
Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	38.9%	29.4%	33.3%	30.2%	29.3%	28.0%	33.3%	35.1%	37.5%	35.8%	33.0%	33.0%
Debt/A	49.6%	45.2%	42.3%	44.3%	45.3%	51.4%	61.0%	66.8%	72.0%	72.7%	70.0%	55.0%
Int. Cov.	16.2	8.4	15.0	15.8	19.5	13.7	15.9	16.9	15.8	16.4	15.0	15.0
Payout	38.7%	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%

Illinois Tool Works' debt has increased over time, but its interest coverage remains robust. We continue to expect the company to deleverage as interest rates rise. Elsewhere, the company's gross profits as a percent of total assets is quite good. We note that the company has a sub-50% payout ratio, leaving room for healthy dividend growth moving forward.

## Final Thoughts & Recommendation

Illinois Tool Works' improved 2018 financial guidance combined with its decline in stock price over the last three months has created a marginally better buying opportunity for prospective investors. Still, the company's expected total returns sit at 6.6% today (up from 5.2% at the time of our last research report). Our recommendation remains unchanged from last quarter's report. Illinois Tool Works' implied returns do not appropriately compensate investors for the equity risk they are exposing themselves to. We are recommending that investors look elsewhere for more attractively priced opportunities within the industrial sector.

## Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.