



A.O. Smith Corporation (AOS)

Updated August 26th, 2019 by Jonathan Weber

Key Metrics

Current Price:	\$45	5 Year CAGR Estimate:	12.1%	Volatility Percentile:	63.8%
Fair Value Price:	\$48	5 Year Growth Estimate:	9.0%	Momentum Percentile:	18.7%
% Fair Value:	94%	5 Year Valuation Multiple Estimate:	1.1%	Growth Percentile:	88.2%
Dividend Yield:	2.0%	5 Year Price Target	\$73	Valuation Percentile:	59.1%
Dividend Risk Score:	A	Retirement Suitability Score:	C	Total Return Percentile:	67.1%

Overview & Current Events

A.O. Smith is a leading manufacturer of residential and commercial water heaters, boilers and water treatment products. The company has a market capitalization of \$7.4 billion. A.O. Smith generates 64% of its sales in North America, 34% in China and the remaining 2% in the rest of the world. The company has gained market share in water heaters for 15 consecutive years. A.O. Smith has raised its dividend for 25 years in a row, making the company a Dividend Aristocrat. A.O. Smith was founded in 1874 and is headquartered in Milwaukee, WI.

A.O. Smith reported its second quarter earnings results on July 30. The company generated revenues of \$765 million during the second quarter, which represents a decline of 8.1% compared to the prior year's quarter, missing the consensus estimate by \$47 million. A.O. Smith's revenues were down marginally in North America during Q2, but at the same time, sales in the rest of the world, including China, declined by a substantial 19% compared to the previous year's quarter. A.O. Smith produced earnings-per-share of \$0.61 during the second quarter, which represents an improvement on a quarter-to-quarter basis, but which was still less than the profits that A.O. Smith has generated during the previous year's quarter. This came as no surprise due to the weak revenue performance.

A.O. Smith guides for earnings-per-share of \$2.35 to \$2.41 for the current fiscal year, which is significantly less than the guidance range that A.O. Smith had announced earlier. The new guidance also represents a negative growth rate versus the earnings-per-share that the company generated during the previous fiscal year.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$0.57	\$0.43	\$0.60	\$0.78	\$1.03	\$1.22	\$1.58	\$1.85	\$2.17	\$2.61	\$2.38	\$3.66
DPS	\$0.13	\$0.14	\$0.15	\$0.18	\$0.23	\$0.30	\$0.38	\$0.48	\$0.56	\$0.76	\$0.88	\$1.56
Shares¹	194	183	184	185	182	179	176	173	172	171	169	162

A.O. Smith has grown its earnings-per-share by 18% annually over the last decade, which is a very attractive growth rate. The company's profits grew relatively consistently during that time frame. Earnings-per-share declined from 2009 to 2010, but rose during all other years. The last financial crisis did not have an overly large impact on A.O. Smith's profits as the company remained highly profitable. Importantly, A.O. Smith raised its dividend during every year of the financial crisis. The dividend growth rate over the last decade has also been very high, exceeding 20% on average.

Thanks to the booming housing market in the U.S. and stronger consumer spending, the company has enjoyed consistent growth in the domestic market throughout most of the last decade. Performance is even more impressive in China, where sales have grown 21% per year on average during the last decade. China's huge population, its robust GDP growth, the booming of its middle class, and the strong preference of Chinese people for foreign brands are major tailwinds in this important market. In addition, thanks to the severe pollution of the country, the demand for air purifiers should remain strong as well. The same growth factors are in place in India as well, which is why the company plans to replicate its large growth success in China in India. Trade worries and a cooling of the global economy provide headwinds in the short term, though, which is why the outlook for 2019 is not strong.

¹ In Millions

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.



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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	10.1	20.3	16.6	16.4	20.2	20.3	21.6	23.0	25.4	16.5	18.9	20.0
Avg. Yld.	2.2%	1.6%	1.5%	1.4%	1.1%	1.2%	1.1%	1.1%	1.0%	1.9%	2.0%	2.1%

A.O. Smith's valuation was very low during the last financial crisis, but the stock's earnings multiple expanded relatively quickly during the following years. A.O. Smith was valued at more than 20 times earnings throughout the majority of the last decade. We believe that a 20 times earnings multiple would represent a fair valuation for the company's shares. This is less than the company's median earnings multiple, but due to the fact that A.O. Smith's growth has slowed down, we believe that this reduction is justified. Based on updated guidance for 2019, shares are slightly undervalued, trading for close to 19 times this year's expected net profits.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	22.8%	32.6%	25.0%	23.1%	22.3%	24.6%	24.1%	25.9%	25.8%	29.1%	37.0%	42.6%

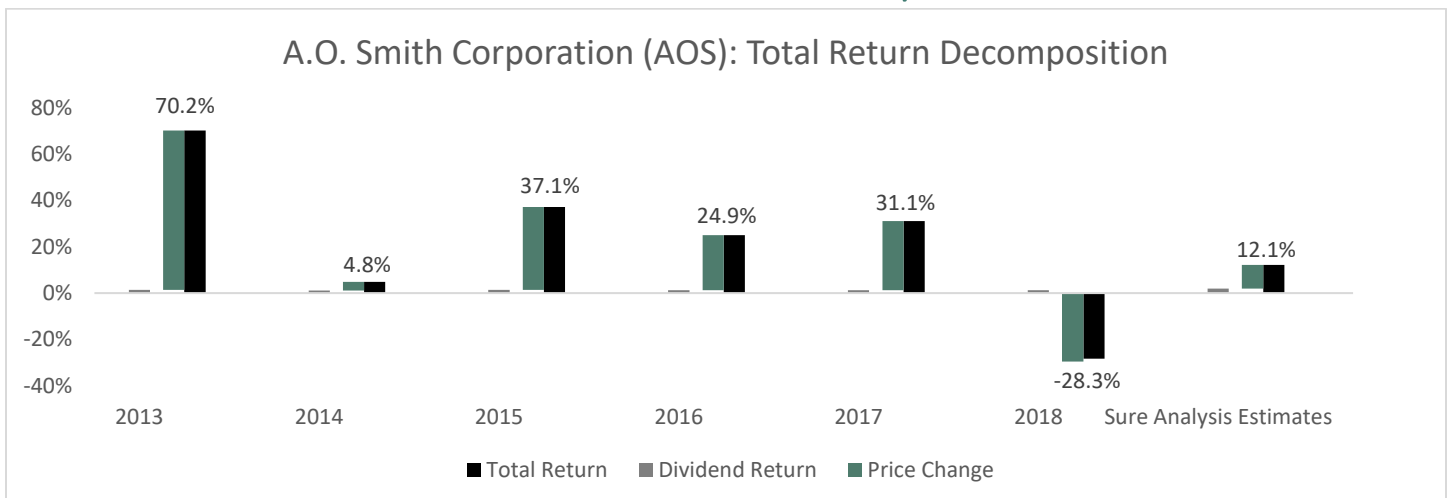
A.O. Smith has raised its dividend at a highly attractive pace during the last decade. Over the last five years the company's average dividend growth rate is an outstanding 30%. This was partially possible due to payout ratio increases. A.O. Smith will likely continue to raise the dividend at a compelling pace, which will result in further growth in the company's payout ratio. The dividend looks relatively safe as well.

A.O. Smith has exposure to the housing industry, which means that the company's underlying operations are impacted by troubles in the housing market. A.O. Smith does not only sell to homebuilders, though, and replacement demand means that A.O. Smith also finds willing buyers during recessions. A.O. Smith's earnings-per-share declined by 25% between 2008 and 2009, which shows that the company's recession vulnerability is not too large.

Final Thoughts & Recommendation

A.O. Smith has been a high-quality growth stock that provided excellent dividend growth and substantial share price gains in the past. Demand for A.O. Smith's products should remain strong going in the long run, although the company will not be able to grow as quickly as it did in the past. The company should still offer double-digit total returns from the current level, which is why we rate A.O. Smith a buy at current prices.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	1375	1489	1711	1939	2154	2356	2537	2686	2997	3188
Gross Profit	395	446	513	652	774	859	1010	1114	1232	1306
Gross Margin	28.7%	29.9%	30.0%	33.6%	35.9%	36.5%	39.8%	41.5%	41.1%	41.0%
SG&A Exp.	292	329	373	451	525	572	611	663	723	754
D&A Exp.	38	41	47	55	60	60	63	65	70	72
Operating Profit	103	117	140	202	249	287	399	452	510	552
Operating Margin	7.5%	7.9%	8.2%	10.4%	11.6%	12.2%	15.7%	16.8%	17.0%	17.3%
Net Profit	81	112	306	159	170	208	283	327	297	444
Net Margin	5.9%	7.5%	17.9%	8.2%	7.9%	8.8%	11.2%	12.2%	9.9%	13.9%
Free Cash Flow	220	71	5	74	182	178	279	366	232	364
Income Tax	31	17	50	71	67	79	120	136	224	114

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	1975	2112	2349	2279	2392	2515	2629	2891	3197	3072
Cash & Equivalents	76	119	463	267	381	319	324	330	347	260
Accounts Receivable	N/A	N/A	368	425	459	475	501	519	593	647
Inventories	111	147	168	163	193	208	223	251	297	305
Goodwill & Int. Ass.	436	430	787	774	758	737	712	800	825	806
Total Liabilities	1185	1231	1263	1085	1063	1134	1187	1376	1553	1355
Accounts Payable	237	263	303	329	387	394	425	529	535	544
Long-Term Debt	253	261	462	244	192	224	249	324	410	221
Shareholder's Equity	771	881	1086	1194	1329	1381	1442	1515	1645	1717
D/E Ratio	0.33	0.30	0.43	0.20	0.14	0.16	0.17	0.21	0.25	0.13

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	4.2%	5.5%	13.7%	6.9%	7.3%	8.5%	11.0%	11.8%	9.7%	14.2%
Return on Equity	11.5%	13.5%	31.1%	13.9%	13.5%	15.3%	20.0%	22.1%	18.8%	26.4%
ROIC	8.1%	10.2%	22.7%	10.6%	11.5%	13.3%	17.2%	18.5%	15.2%	22.2%
Shares Out.	194	183	184	185	182	179	176	173	172	171
Revenue/Share	9.97	8.07	9.18	10.41	11.61	12.95	14.17	15.19	17.16	18.51
FCF/Share	1.60	0.39	0.03	0.40	0.98	0.98	1.56	2.07	1.33	2.11

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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