

Illinois Tool Works Inc. (ITW)

Updated October 23rd, 2020 by Eli Inkrot

Key Metrics

Current Price:	\$204	5 Year CAGR Estimate:	0.4%	Market Cap:	\$65 B
Fair Value Price:	\$131	5 Year Growth Estimate:	7.0%	Ex-Dividend Date¹:	12/30/20
% Fair Value:	156%	5 Year Valuation Multiple Estimate:	-8.5%	Dividend Payment Date¹:	01/15/20
Dividend Yield:	2.2%	5 Year Price Target	\$183	Years Of Dividend Growth:	46
Dividend Risk Score:	B	Retirement Suitability Score:	C	Last Dividend Increase:	6.5%

Overview & Current Events

Illinois Tool Works is a diversified multi-industrial manufacturer with seven unique operating segments: Automotive, Food Equipment, Test & Measurement, Welding, Polymers & Fluids, Construction Products and Specialty Products. Last year the company generated \$14 billion in revenue. The \$65 billion market cap company is geographically diversified, with more than half of its revenue generated outside of the United States. Illinois Tool Works has increased its dividend for 46 consecutive years, which qualifies the company to be a member of the Dividend Aristocrats Index.

On August 7th, 2020 Illinois Tool Works announced a \$1.14 quarterly dividend, representing a 6.5% increase.

On October 23rd, 2020 Illinois Tool Works reported Q3 2020 results for the period ending September 30th, 2020. For the quarter revenue came in at \$3.31 billion, which was down -4.9% compared to Q3 2019, and down -4.6% on an organic basis. Positive results in the Polymers & Fluids and Construction Products segments were weighed down by declines in the other five divisions of the business. Net income equaled \$582 million or \$1.83 per share compared to \$660 million or \$2.04 in the year ago quarter.

Prior to the pandemic Illinois Tool Works provided 2020 guidance expecting organic sales to grow +0% to +2%, with earnings-per-share between \$7.65 and \$8.05. However, this guidance has been suspended.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$3.03	\$3.74	\$4.09	\$3.63	\$4.67	\$5.13	\$5.70	\$6.78	\$7.60	\$7.74	\$6.25	\$9.82
DPS	\$1.30	\$1.40	\$1.48	\$1.60	\$1.75	\$2.07	\$2.40	\$2.73	\$3.56	\$4.14	\$4.56	\$5.42
Shares²	498	484	455	430	383	364	347	342	328	320	318	295

Since 2007 Illinois Tool Works has increased earnings-per-share by an average compound rate of 7.2% per annum. While there was cyclical volatility during the last recession, including a -40% drop in earnings from 2007 to 2009, generally the company has exhibited consistent progress. In the past Illinois Tool Works was able to grow via moderate top-line growth that was aided significantly by margin expansion (from 7% in 2009 to 18% in 2019) and share repurchases (reducing the share count by -35% since 2009). Moving forward these two items become a bit harder to formulate as the company is now coming off a much larger base.

Still, the balance sheet is in good shape allowing for some flexibility from a capital allocation standpoint. Moreover, attractive returns can be achieved without venturing outside Illinois Tool Works' existing core competencies. Illinois Tool Works can continue to invest cash into its sales networks, R&D, and production capacity and the company's cost-cutting efforts could continue to buoy margins.

That being said, the business is being tested in the short-term amid the COVID-19 pandemic. Previously Illinois Tool Works had a target of growing earnings-per-share by 7% to 10% annually through 2023. This may well come to fruition, but it is likely to be coming off a much lower base for 2020. We are using \$7.25 per share in underlying earnings power and a 7% growth rate for valuation and fair value estimate purposes.

¹ Estimate

² In millions.

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	15.4	13.7	13.9	19.4	18.5	18.0	19.0	21.0	19.3	19.8	28.1	18.0
Avg. Yld.	2.8%	2.7%	2.6%	1.7%	2.0%	2.2%	2.2%	1.9%	2.4%	2.7%	2.2%	3.0%

Over the past decade shares of Illinois Tool Works have traded hands with an average P/E ratio of between 17- and 18-times earnings. We believe that a P/E ratio of 18 is a fair starting point, considering the quality of the business and growth prospects, paired against near-term uncertainty. With shares currently trading at 28 times \$7.25 in underlying earnings power, this implies the potential for a meaningful valuation headwind.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	43%	37%	36%	44%	37%	40%	42%	40%	47%	53%	63%	53%

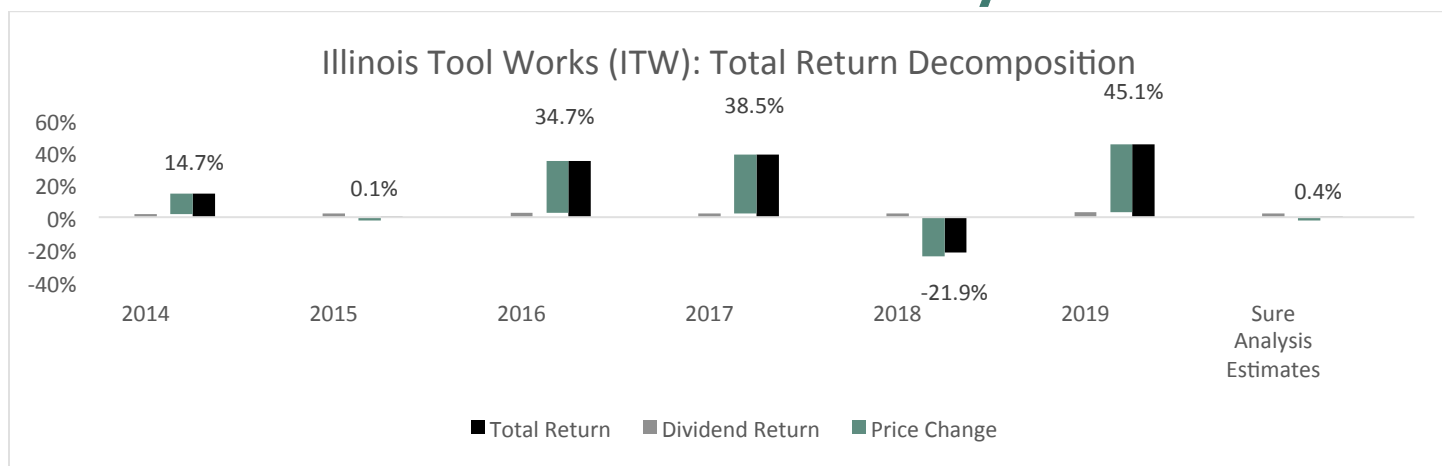
Illinois Tool Works has an excellent dividend growth history. Its payout ratio was relatively high during the last financial crisis, but the company was not forced to cut the payout. Today the dividend payout ratio sits above 50% - the company's long-term target - meaning that future dividend growth may trail earnings growth.

Illinois Tool Works' industry is not glamorous or one with outstanding growth rates, but the company has established itself as a major player that continues to grow profitably. Its experienced management and strong fundamentals, such as an above-average return on capital, function as competitive advantages. The company's profits were reduced during the last financial crisis, posting earnings-per-share of \$3.36, \$3.05, \$1.93 and \$3.03 during the 2007 through 2010 stretch. This is something to consider for the next downturn, as the business will be tested in the short-term.

Final Thoughts & Recommendation

After being up 17% in our last report, shares are up another 10% in the last three months. Illinois Tool Works has a number of positives, including solid earnings growth, a nice dividend yield, a long and successful dividend growth history and a compelling long-term track record. However, total return potential comes in at just 0.4% per annum, stemming from 7% growth and a 2.2% dividend yield offset by the possibility of a meaningful valuation headwind. We are enthused about the business, but we are less keen on the valuation. We are reiterating our sell rating.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	15416	14515	14791	14135	14484	13405	13599	14314	14768	14109
Gross Profit	5419	5426	5657	5581	5811	5517	5703	6005	6164	5922
Gross Margin	35.2%	37.4%	38.2%	39.5%	40.1%	41.2%	41.9%	42.0%	41.7%	42.0%
SG&A Exp.	2957	2846	2928	2815	2678	2417	2415	2400	2391	2361
D&A Exp.	549	594	613	613	507	477	470	462	---	---
Operating Profit	2255	2361	2477	2516	2888	2867	3064	3399	3584	3402
Op. Margin	14.6%	16.3%	16.7%	17.8%	19.9%	21.4%	22.5%	23.7%	24.3%	24.1%
Net Profit	1503	2071	2870	1679	2946	1899	2035	1687	2563	2521
Net Margin	9.7%	14.3%	19.4%	11.9%	20.3%	14.2%	15.0%	11.8%	17.4%	17.9%
Free Cash Flow	1200	1603	1690	2160	1255	2015	2029	2105	---	---
Income Tax	637	448	973	717	809	820	873	1583	831	767

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	16250	17984	19309	19966	17465	15729	15201	16780	14870	15068
Cash & Equivalents	1190	1178	2779	3618	3990	3090	2472	3094	1504	1981
Acc. Receivable	N/A	2819	2742	2365	2293	2203	2357	2628	2622	2461
Inventories	1547	1716	1585	1247	1180	1086	1076	1220	1318	1164
Goodwill & Int.	6574	7431	7788	6885	6466	5999	6021	6024	5717	5343
Total Liabilities	6869	7950	8739	10257	10641	10501	10942	12191	11612	12038
Accounts Payable	754	697	676	634	512	449	511	590	524	472
Long-Term Debt	2830	3990	5048	6344	7419	7422	7829	8328	7380	7758
Total Equity	9370	10017	10561	9703	6819	5224	4254	4585	3254	3026
D/E Ratio	0.30	0.40	0.48	0.65	1.09	1.42	1.84	1.82	2.27	2.56

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	9.3%	12.1%	15.4%	8.6%	15.7%	11.4%	13.2%	10.6%	16.2%	16.8%
Return on Equity	16.5%	21.4%	27.9%	16.6%	35.7%	31.5%	42.9%	38.2%	65.4%	80.3%
ROIC	12.4%	15.8%	19.4%	10.6%	19.4%	14.1%	16.5%	13.5%	21.8%	23.5%
Shares Out.	498	484	455	430	383	364	347	342	328	320
Revenue/Share	30.63	29.35	31.26	31.46	35.80	36.22	38.08	41.27	43.81	43.33
FCF/Share	2.38	3.24	3.57	4.81	3.10	5.44	5.68	6.07	---	---

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

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