



A.O. Smith Corporation (AOS)

Updated November 6th, 2020 by Jonathan Weber

Key Metrics

Current Price:	\$54	5 Year CAGR Estimate:	2.8%	Market Cap:	\$8.7B
Fair Value Price:	\$41	5 Year Growth Estimate:	6.0%	Ex-Dividend Date:	01/29/21 ¹
% Fair Value:	130%	5 Year Valuation Multiple Estimate:	-5.2%	Dividend Payment Date:	02/15/21 ²
Dividend Yield:	1.9%	5 Year Price Target	\$55	Years Of Dividend Growth:	27
Dividend Risk Score:	B	Retirement Suitability Score:	C	Last Dividend Increase:	8.3%

Overview & Current Events

A.O. Smith is a leading manufacturer of residential and commercial water heaters, boilers and water treatment products. A.O. Smith generates two-thirds of its sales in North America, and most of the rest in China, whereas the rest of the world is just a small market for A.O. Smith. A.O. Smith has raised its dividend for 27 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 third quarter earnings results on October 29. The company generated revenues of \$760 million during the quarter, which represents an increase of 4.4% compared to the prior year's quarter. A.O. Smith's revenues were up 6% in North America, but at the same time, sales in the rest of the world, with most of those revenues coming from China, were flat year over year, which is why company-wide sales grew by only 4%.

A.O. Smith generated earnings-per-share of \$0.66 during the third quarter, which was up on a year over year basis, from \$0.53 during the previous year's quarter. This can mostly be explained by the solid revenue performance in the company's home market, which allowed for some operating leverage and a meaningful increase in profitability. A.O. Smith has issued new guidance numbers for 2020, the company is now forecasting earnings-per-share in a range of \$1.95 and \$1.98, down about 10% from fiscal 2019. The coronavirus impact will not be everlasting, though, and we see an eventual recovery. This is why we determine fair value using an earnings power estimate of \$2.30 for 2020.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$0.43	\$0.60	\$0.78	\$1.03	\$1.22	\$1.58	\$1.85	\$2.17	\$2.61	\$2.23	\$1.97	\$3.08
DPS	\$0.14	\$0.15	\$0.18	\$0.23	\$0.30	\$0.38	\$0.48	\$0.56	\$0.76	\$0.90	\$1.04	\$1.53
Shares³	183	184	185	182	179	176	173	172	171	164	160	145

A.O. Smith has grown its earnings-per-share by 20% annually since 2009, which is a very attractive growth rate. The company's profits grew relatively consistently during that time frame. The last financial crisis did not have an overly large impact on A.O. Smith's profits, as the company easily remained profitable. A.O. Smith raised its dividend during every year of the financial crisis, and the dividend growth rate over the last decade averaged more than 20%.

Thanks to a healthy housing market in the U.S., the company has enjoyed consistent growth in the domestic market throughout most of the last decade. A.O. Smith's sales performance was even more impressive in China, where sales have grown by ~20% per year on average during the last decade. China's huge population, its robust GDP growth, and the booming of its middle class 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. In the near term, the coronavirus is hurting A.O. Smith substantially in its two core markets US and China, which is why 2020's results will likely be substantially worse than those from 2019, although we believe that the company will recover in the early 2020s. The same growth factors as in China are in place in India as well, which is why A.O. Smith sees India as an important future growth market.

¹ Estimated date

² Estimated date

³ 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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	20.3	16.6	16.4	20.2	20.3	21.6	23.0	25.4	16.5	21.5	23.5	18.0
Avg. Yld.	1.6%	1.5%	1.4%	1.1%	1.2%	1.1%	1.1%	1.0%	1.9%	1.9%	1.9%	2.8%

A.O. Smith's valuation was very low in the midst of the financial crisis, but the stock's earnings multiple expanded 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 an 18 times earnings multiple would represent a fair valuation for the company's shares. This is less than the company's long-term median earnings multiple, but due to the fact that A.O. Smith's growth will not remain at 20%+ levels seen in the past, we deem this justified. Based on our earnings power estimate for 2020, shares are trading above fair value, which could pressure total returns going forward.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	32.6%	25.0%	23.1%	22.3%	24.6%	24.1%	25.9%	25.8%	29.1%	40.4%	45.2%	49.6%

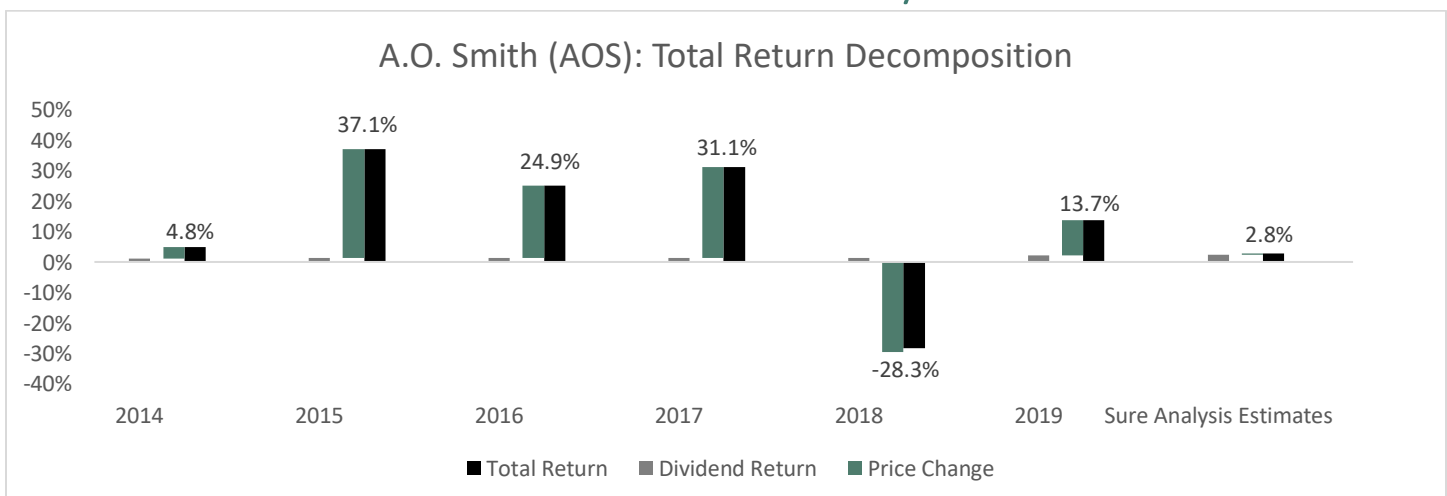
A.O. Smith has raised its dividend at a highly attractive pace during the last decade. Over the last five years the company's average dividend growth rate is at a high level of more than 20%. This was partially possible due to payout ratio increases. A.O. Smith will likely continue to raise the dividend at a compelling pace, which will result in further growth in the company's payout ratio. Despite the payout ratio increases, the dividend looks relatively safe, we believe.

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, as replacement demand means that A.O. Smith also finds willing buyers during recessions. Its earnings-per-share declined by 25% between 2008 and 2009. During the current crisis, we also forecast a profit decline, but believe that A.O. Smith will remain profitable.

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 in the long run in both the US and foreign markets, but in the near term, profits will be hurt by the current coronavirus crisis. Shares will not provide especially attractive returns from the current level, we believe, which is why we rate the stock a sell for now.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	1,489	1,711	1,939	2,154	2,356	2,537	2,686	2,997	3,188	2,993
Gross Profit	446	513	652	774	859	1,010	1,114	1,232	1,306	1,181
Gross Margin	29.9%	30.0%	33.6%	35.9%	36.5%	39.8%	41.5%	41.1%	41.0%	39.5%
SG&A Exp.	329	373	451	525	572	611	663	723	754	716
D&A Exp.	41	47	55	60	60	63	65	70	72	78
Operating Profit	117	140	202	249	287	399	452	510	552	465
Operating Margin	7.9%	8.2%	10.4%	11.6%	12.2%	15.7%	16.8%	17.0%	17.3%	15.5%
Net Profit	112	306	159	170	208	283	327	297	444	370
Net Margin	7.5%	17.9%	8.2%	7.9%	8.8%	11.2%	12.2%	9.9%	13.9%	12.4%
Free Cash Flow	71	5	74	182	178	279	366	232	364	392
Income Tax	17	50	71	67	79	120	136	224	114	102

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	2,112	2,349	2,279	2,392	2,515	2,629	2,891	3,197	3,072	3,058
Cash & Equivalents	119	463	267	381	319	324	330	347	260	374
Accounts Receivable		368	425	459	475	501	519	593	647	590
Inventories	147	168	163	193	208	223	251	297	305	303
Goodwill & Int. Ass.	430	787	774	758	737	712	800	825	806	884
Total Liabilities	1,231	1,263	1,085	1,063	1,134	1,187	1,376	1,553	1,355	1,391
Accounts Payable	263	303	329	387	394	425	529	535	544	510
Long-Term Debt	261	462	244	192	224	249	324	410	221	284
Shareholder's Equity	881	1,086	1,194	1,329	1,381	1,442	1,515	1,645	1,717	1,667
D/E Ratio	0.30	0.43	0.20	0.14	0.16	0.17	0.21	0.25	0.13	0.17

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	5.5%	13.7%	6.9%	7.3%	8.5%	11.0%	11.8%	9.7%	14.2%	12.1%
Return on Equity	13.5%	31.1%	13.9%	13.5%	15.3%	20.0%	22.1%	18.8%	26.4%	21.9%
ROIC	10.2%	22.7%	10.6%	11.5%	13.3%	17.2%	18.5%	15.2%	22.2%	19.0%
Shares Out.	183	184	185	182	179	176	173	172	171	164
Revenue/Share	8.07	9.18	10.41	11.61	12.95	14.17	15.19	17.16	18.51	17.95
FCF/Share	0.39	0.03	0.40	0.98	0.98	1.56	2.07	1.33	2.11	2.35

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

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