



A.O. Smith Corporation (AOS)

Updated August 9th, 2021 by Jonathan Weber

Key Metrics

Current Price:	\$71	5 Year CAGR Estimate:	0.4%	Market Cap:	\$11B
Fair Value Price:	\$49	5 Year Growth Estimate:	6.0%	Ex-Dividend Date:	10/29/21 ¹
% Fair Value:	144%	5 Year Valuation Multiple Estimate:	-7.1%	Dividend Payment Date:	11/17/21
Dividend Yield:	1.5%	5 Year Price Target	\$66	Years Of Dividend Growth:	27
Dividend Risk Score:	A	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 second quarter earnings results on July 29. The company generated revenues of \$860 million during the quarter, which represents an increase of 30% compared to the prior year's quarter. A.O. Smith's revenues were up 26% in North America, while revenue growth was even higher in the rest of the world, which primarily means China, as this is the company's biggest foreign market that experienced a strong recovery from the pandemic.

A.O. Smith generated earnings-per-share of \$0.73 during the second quarter, which was up by a very large 74% on a year over year basis, from \$0.42 during the previous year's quarter. This can mostly be explained by the solid revenue performance, which allowed for operating leverage tailwinds and a meaningful increase in profitability. A.O. Smith has also updated its guidance for 2021, and the company is now forecasting earnings-per-share in a range of \$2.70 and \$2.76, which would reflect a meaningful earnings acceleration versus 2020. If A.O. Smith hits its guidance numbers, its earnings-per-share will also set a new record, as the previous high of \$2.61 in 2018 will be overtaken.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	\$0.60	\$0.78	\$1.03	\$1.22	\$1.58	\$1.85	\$2.17	\$2.61	\$2.23	\$2.12	\$2.73	\$3.65
DPS	\$0.15	\$0.18	\$0.23	\$0.30	\$0.38	\$0.48	\$0.56	\$0.76	\$0.90	\$0.98	\$1.04	\$1.53
Shares²	184	185	182	179	176	173	172	171	164	163	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. The coronavirus was hurting A.O. Smith in its two core markets US and China, which is why 2020's results were somewhat worse than those from 2019. It looks like the company will recover easily in 2021 and beyond, however. 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 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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	16.6	16.4	20.2	20.3	21.6	23.0	25.4	16.5	21.5	25.9	26.0	18.0
Avg. Yld.	1.5%	1.4%	1.1%	1.2%	1.1%	1.1%	1.0%	1.9%	1.9%	1.8%	1.5%	2.3%

A.O. Smith's valuation was very low during the financial crisis, but the stock's earnings multiple expanded quickly over 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 since A.O. Smith's growth will not remain at the 20%+ levels seen in the past, we think a reduction in the fair value multiple is justified. Based on the earnings estimate for 2021, shares are trading well above fair value, which could pressure total returns going forward.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	25.0%	23.1%	22.3%	24.6%	24.1%	25.9%	25.8%	29.1%	40.4%	46.2%	38.1%	41.8%

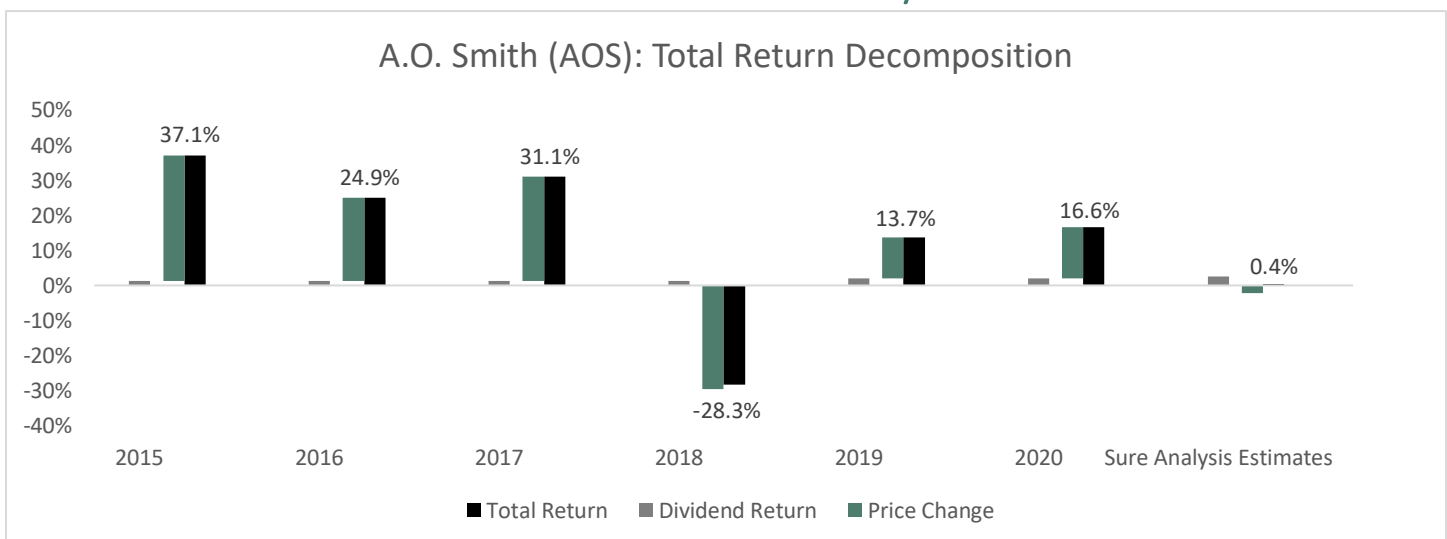
A.O. Smith has raised its dividend at a highly attractive pace during the last decade. Over the last five years the company's average dividend growth rate is at a high level of more than 20%. This was partially possible due to payout ratio increases. A.O. Smith will likely continue to raise the dividend 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 not only sells 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.

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, which is why we forecast solid earnings-per-share growth in coming years. Shares will not provide attractive returns from the current level, due to a high valuation, which is why we rate the stock a sell for now.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	1,711	1,939	2,154	2,356	2,537	2,686	2,997	3,188	2,993	2,895
Gross Profit	513	652	774	859	1,010	1,114	1,232	1,306	1,181	1,108
Gross Margin	30.0%	33.6%	35.9%	36.5%	39.8%	41.5%	41.1%	41.0%	39.5%	38.3%
SG&A Exp.	373	451	525	572	611	663	723	754	716	660
D&A Exp.	47	55	60	60	63	65	70	72	78	80
Operating Profit	140	202	249	287	399	452	510	552	465	448
Operating Margin	8.2%	10.4%	11.6%	12.2%	15.7%	16.8%	17.0%	17.3%	15.5%	15.5%
Net Profit	306	159	170	208	283	327	297	444	370	345
Net Margin	17.9%	8.2%	7.9%	8.8%	11.2%	12.2%	9.9%	13.9%	12.4%	11.9%
Free Cash Flow	5	74	182	178	279	366	232	364	392	505
Income Tax	50	71	67	79	120	136	224	114	102	99

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	2,349	2,279	2,392	2,515	2,629	2,891	3,197	3,072	3,058	3,161
Cash & Equivalents	463	267	381	319	324	330	347	260	374	573
Accounts Receivable	368	425	459	475	501	519	593	647	590	585
Inventories	168	163	193	208	223	251	297	305	303	300
Goodwill & Int. Ass.	787	774	758	737	712	800	825	806	884	871
Total Liabilities	1,263	1,085	1,063	1,134	1,187	1,376	1,553	1,355	1,391	1,312
Accounts Payable	303	329	387	394	425	529	535	544	510	595
Long-Term Debt	462	244	192	224	249	324	410	221	284	113
Shareholder's Equity	1,086	1,194	1,329	1,381	1,442	1,515	1,645	1,717	1,667	1,848
D/E Ratio	0.43	0.20	0.14	0.16	0.17	0.21	0.25	0.13	0.17	0.06

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	13.7%	6.9%	7.3%	8.5%	11.0%	11.8%	9.7%	14.2%	12.1%	11.1%
Return on Equity	31.1%	13.9%	13.5%	15.3%	20.0%	22.1%	18.8%	26.4%	21.9%	19.6%
ROIC	22.7%	10.6%	11.5%	13.3%	17.2%	18.5%	15.2%	22.2%	19.0%	17.6%
Shares Out.	184	185	182	179	176	173	172	171	164	163
Revenue/Share	9.18	10.41	11.61	12.95	14.17	15.19	17.16	18.51	17.95	17.81
FCF/Share	0.03	0.40	0.98	0.98	1.56	2.07	1.33	2.11	2.35	3.11

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

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