

FINAL TRANSCRIPT

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SWK - Q3 2008 The Stanley Works Earnings Conference Call

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Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Laura, and I will be your conference operator today. At this time, I would like to welcome everyone to The Stanley Works third quarter results conference call. (Operator Instructions). Thank you. I would like to introduce Mr. Greg Waybright, Interim Vice President of Investor Relations. Mr. Waybright, you may begin your conference.

Greg Waybright - *The Stanley Works - Interim VP - IR*

Thank you, Laura. Good morning, everyone, and thank you all for joining us on the call this morning. On the call in addition to myself is John Lundgren, Stanley's Chairman and CEO; and Jim Loree, Stanley's Executive Vice President and CFO.

I would like to point out that our third quarter earnings release which was issued this morning and a presentation supplementing today's call which we will refer to during the call are available on our investor relations website.

This morning, John and Jim will review Stanley's third quarter results and various other topical matters followed by a Q&A session. The entire call is expected to last approximately one hour, and a replay of the call will be available beginning at 2:00 p.m. today. The replay number is 1-800-642-1687, and the access code is 57411309. And as always, please feel free to contact me with any follow-up questions after today's call, at my number which is 860-827-3544.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Finally, two brief comments before we proceed, one is a reminder that we issue and/or update earnings guides on an annual basis in our press releases at the beginning of each quarter, and we cannot comment on such guidance thereafter. However, if our guidance changes materially, we will issue a press release and conduct a related conference call.

Secondly, we will be making some forward-looking statements during this call, such statements are based on assumptions of future events that may not prove to be accurate, and as such they involve risk and uncertainty. It is therefore, possible that actual results may differ materially from any forward-looking statements that we might make today. And we direct you to the cautionary statements in Form 8-K which we filed with today's press release and in our most recent 34F filing. With that, I will now turn the call over to Jim Loree. Jim?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Thank you, Greg. During the recent turbulence in financial markets, some of the characteristics of our financial strategy have become critical success factors in today's environment. These would be things like strong cash flow, conservative financial position, and proactive liquidity management.

Certainly, we have been able to accomplish all of those in recent years, and just some of the highlights as we sit here today. Our long-standing strategy to remain single A senior unsecured in A1 P1 commercial paper has served us very well. We were the first industrial in the United States to issue bonds since September 10th when the dislocation began. On the 24th of September, we were able to issue \$250 million of senior unsecured notes, five-year paper, and we issued that at 6.2% which was just a hair over 300 over treasuries, which in today's market looks like a pretty good coupon.

During this time, our access to the commercial paper market has been uninterrupted, and our commercial paper pricing today remains very attractive at about 25 to 70 basis points over federal funds. We also took early and decisive action this year to enhance our liquidity. In February, we upsized our revolving credit facility to \$800 million from \$550 million, and we extended the maturity out to February of 2013. In May, we also increased our commercial paper line from \$550 million to \$800 million increasing our capacity for short-term liquidity.

Our cash flow remains strong, our estimate remains at or slightly below \$500 million. And for 2009 as we look forward, we see no reason to believe that that is going to decrease materially. A lot of that has to do with The Stanley fulfillment system, John will talk about that later. This is an initiative that has been in place for many years, but has gained considerable steam in the last year or two. And as a result we're getting excellent working capital performance, and our working capital turns are improving. Improved last year, they'll improve again in 2008, in spite of a really gut-wrenching negative unit volume situation based on external conditions.

And our dividend record has been maintained. We currently are at about a 3.5% yield, and that dividend is very safe and reliable. So we are a very strong Company with a solid foundation.

Now, with that as a context, let's talk a little bit about the external environment. We all know that the economic conditions are very difficult right now with the instability in the credit markets, although in recent days that looks to be stabilizing somewhat. But around the world credit markets have created all sorts of dislocation in the economy.

We see currencies very volatile right now with the Euro, the British pound, the Canadian and Australia dollars, all of which are currencies that we have exposure to based on our world-wide activities. All down at least 15% since the beginning of the quarter, just a few weeks ago.

In the U.S., I don't need to tell you folks that it's tough. The industrial production is beginning to show big declines. Capacity utilization is decreasing. Housing starts are at really incredibly low levels, down 40% versus prior year. Unemployment has spiked

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

to 6%, 6.1%. And while the slowdown is nothing new in Europe, it is clearly intensifying as we went -- clearly intensified as went through the third quarter.

With industrial production down in the Euro area, Germany, Italy, France, Spain, and so on. Steep decline in construction permits especially in Spain, the Nordic countries and the UK. And basically GDP slowing in all of Europe with you can see the percentage declines in Germany, France, Italy. And we too saw a slowdown in our European business in the third quarter, especially after July.

Moving on now to the quarter, we recorded earnings per share of \$0.98 down 7% versus prior year, and yet we were still able to obtain a very healthy 14% operating margin in the quarter. Revenue growth was 1%. We'll talk more about that in a minute. But the story here was preservation of earnings per share and limiting the decline to a modest amount in the face of minus 4% organic growth, and as we go through the charts I'll give you more color on that.

The diversity of our end markets was helpful in the quarter. It certainly dampened the effect, but did not fully negate the sales volume contraction. It's important to note here that about a third of our business is in the residential construction, only about a third of our business in residential construction. And even within that only about half or so slightly over half is in the U.S. So about 17% total U.S. residential construction.

And as you can see, we have a diverse array of other sub segments that we are exposed to; 12% of our revenues in commercial construction, 8% in retail primarily through our security business, and then health care, education, and government comprising about 12%. Automotive repair including the Mac business and Facom about 9%, and then the remaining 24% associated with industrial, which includes core industrial, manufacturing-type industrial, as well as utilities, distribution, power, rail, oil, and gas, etc. So we continue to have exposure to a diverse array of end markets around the world, but in some respects, that has been very helpful for us in terms of dampening the blow from the economic issues.

Moving on now to revenues. As I mentioned, we experienced significant unit volume declines, perhaps as significant -- more pronounced than in any quarter that I can recall since my time here in 1999, beginning in 1999. We look back certainly more pronounced than any quarter in the '90, '91 time frame when we had an economic recession, and going back to -- you had to go back all the way to 1981, to see a quarter where we had that kind of a unit volume decline. And we all remember 1981, or those of us that do remember 1981, remember that it was a very, a very tough economic environment. I think this one is equally as bad.

The breakdown for the revenue, if you look at it. The minus 7% volume decline was offset by about 3 points of price, which was consistent with our expectation and organic growth in total was down 4%. That was offset somewhat by currency, which was up 2 points, and acquisitions which added 3 points of revenue in the quarter. So we managed to eke out a modest 1% revenue growth in the quarter.

When you look at it by segment, construction DIY was down 2%, industrial was flat, security up 7%. And when you step back and peel off the onion layer there and see that the organic performance was down 5% in construction DIY, down 4% in industrial, and down 4% in security.

Now I have to say with security, excluding the hardware business, which is suffering the loss of its major customer, it's former major customer, and that will anniversary in the fourth quarter that was a \$55 million loss for that business. When you look at it excluding that loss, the security portfolio performed at a 1% organic growth rate. And so that, at least was positive.

And as we look at the fourth quarter, we can expect slightly better volume, we think, probably more in the neighborhood of minus 5% to minus 6% as the hardware loss anniversaries. And we have some load in from a relatively significant win at one of our larger customers, in the CDIY consumer tools and storage segment.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

In addition, price is likely to stay strong if not a little bit stronger. Acquisitions are likely to pick up in the fourth quarter vis-a-vis the third. And currency, I think will probably flip to a slight negative on a year-over-year basis. So all in we expect fourth quarter sales to be approximately flat with prior year.

So moving on to gross margin. With all of that negative pressure from unit volume declines, it is truly remarkable that we were able to achieve record gross margins; third quarter gross margins at this time. And further more, we did not really experience the classic, historical sequential dip in the third quarter that we do normally experience. You can see we had it in '06, we had it in '07, and we avoided it in '08.

And this margin rate accretion was attained with a 7% year-over-year reduction in inventory. So with a 7% unit volume decline and a 7% inventory reduction, that is approximately a 14% reduction in factory output. When you think about the difference between contribution margin and gross margin for Stanley, it's roughly equivalent to about 10 points. The absorption drag on margin rates was probably in the neighborhood of about 1.4 points or 14% times 10 points, the 14% decline times the 10-point difference. That is a headwind that we were able to absorb in the quarter and still provide gross margin rate accretion.

So for us to achieve that record margin rate, something very, very good is happening in operations and the way we're running the Company. And a number of factors contributed to that, clearly the portfolio shift that we have been undertaking over time has been a key factor. But in addition to that, the price realization efforts that we began in 2003 and have steadfastly pursued during this inflationary time have been successful, extremely successful.

The brand strength of Stanley Works clearly plays into that as well as our long-standing focus on creating very vital and viable value propositions for the customers. And then our whole approach with the center of excellence where we have pricing expertise centralized but also sprinkled throughout the businesses and a critical linkage between the inflation monitoring and the pricing tactical execution as well as strategy. All of that combined to generate a very favorable price. Performance we can talk about in a minute.

And then the Stanley fulfillment system which John Lundgren will talk about at length in just a few minutes contributed to both the working capital reductions as well as substantial productivity. And you can see, even with the pricing success that we had. And now I'm looking at that 3Q '08 VPY points box, the light blue one there, where it says "Inflation net of pricing cost us 2.2 points in the quarter on a year-over-year basis".

Even though we didn't recover all of our inflation, although our full-year estimate is still consistent with what we mentioned last time, I'll get into that in a minute. But we were able to achieve a 1.5 point increase in productivity despite the headwind from the absorption; lost absorption from the volume and decline in inventory decrease. So great story on margins.

I think what you see here is the fundamental shift in how we are managing the business which has evolved over the last five years or so, but as I recall back in the '02 time frame, '01, '02, the gross margins often averaged 33% or thereabouts, and today we're knocking on the doorstep of 39%, so a very significant seat change in the Company.

As we move on now to the pricing inflation update, we've encountered steady inflation increases in our estimates. I'm looking at the left-hand side of the chart right now. Throughout 2008, up to a point where we're forecasting as late as the second quarter earnings call, \$150 million up from \$100 million in the first quarter earnings call, and up from \$75 million based on the initial guidance that we released.

And over that time frame, our ability to recover that inflation with pricing power and pricing execution has been strong. In fact, it strengthened during the year as went from an 80% recovery in the beginning of the year to a 90% recovery even as the amount of inflation doubled in the estimates. And as you can see if you look at the history there, in the '05, '06 time frame, it's about \$50 million a year. So triple that this year. And the pricing has been there to protect our margins.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

When we look at the sources of inflation this year for, and that's on the right-hand side of the chart, you can see that of the roughly \$150 million of inflation, approximately half of that has been encountered in relation to steel, and then another \$20 million in regard to freight. So two items there that have the beginning, the seeds of stabilization and even slight dips, have been the source of most of our inflation exposure.

Now that will take a few months to work it's a way through into the P&L statement, but we are cautiously optimistic that, in fact, it's probably the one silver lining in the backdrop of all of the other issues in the economy, that we probably will experience some lowering of that inflation rate as we go into '09.

Then we have a look at our SG&A. SG&A was up \$23 million in the quarter, and when you kind of look into that with a little more detail, you see that \$11 million of the \$23 million was related to acquisitions; \$7 million wage inflation, salary inflation; \$5 million of foreign exchange-related increases; \$9 million of emerging markets and other strategic investment, which relates primarily to increasing the size of the sales and service force in the electronic security business -- was \$9 million. And then the cost reduction some of which we implemented in the post-2Q earnings release accounted for a \$9 million benefit.

So we're continuing to monitor and place emphasis on SG&A control. Clearly this will be a significant focus for us in the fourth quarter and as we go through 2009.

And then, as it relates to free cash flow, simply put, it was great story, our third quarter free cash flow was up \$19 million at \$138 million in the quarter. A very impressive performance led by a \$66 million favorable swing in working capital, which we can attribute almost exclusively to the success of Stanley Fulfillment System which John will comment on in a few minutes.

And then, our year-to-date performance, we're right at about the same level we were slightly above; \$4 million above the same place we were last year. A year in which we generated a record \$457 million of free cash flow. And we see no reason why at this point that we can't have another great year for cash flow.

So with one quarter to go, we're able to reiterate our total year estimate of free cash flow equal to just under \$500 million and that's a very good sign for the health of the balance sheet and our ability to pursue capital deployment, both in the fourth quarter and as we go forward.

Looking at working capital in a little more detail there, as you can see from this chart, the inventory was down 7% to \$571 million, that was a five-day improvement. The receivables were flat with prior year, a one-day improvement. And I would also note that on the receivables that are delinquencies in this area have actually improved as the year has progressed. Again, directly attributable to The Stanley Fulfillment System.

And our accounts payable despite the inventory decline were up 9%. And that's largely attributable to the fact that as we were absorbing price increases that resulted in the inflation, we were requiring the vendors that were giving us increases to extend their terms with us. So those payments are in accordance with terms. Those payables are in accordance with terms and up 9% or a 5-day improvement.

With all of that put together, we achieved a 4.8 working capital term performance a 0.4 point (sic -- see Press Release) improvement over the prior year, and John will talk in a few moments about what drove that.

As we look at the balance sheet, balance sheet is in good shape. It's very, very consistent with the same time last year. Our debt is in the same zone, our equity is up, and our cash position is about the same. And this was achieved after spending about \$380 million on acquisitions year to date, on strategic acquisitions.

So with that said, John Lundgren will now walk you through some more color on The Stanley Fulfillment System, and touch upon some other elements of our performance, and I'll turn it over to you, John.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

John Lundgren - *The Stanley Works - Chairman & CEO*

Thanks, Jim. For those on the call, I understand there may have been a minute or two of technical difficulty, particularly during Jim's comments on market conditions and our end markets. So rather than go back and trace over that, I will be sure to touch on the high points that may have been missed, although they were on the visuals.

As Jim suggested, we feel that the third quarter has been a strong performance, in a relatively difficult environment. And an important question, of course, is what is driving the performance in general, and the continuously improving cash flow in particular? And the answer is our Stanley Fulfillment System.

It is a transformation of processes, systems, as well as structure with three very important objectives. First and foremost, we're striving for a scalable platform that's capable of supporting an ongoing acquisition growth strategy, in other words, a business that's much larger than the current business we have today. We've had good success with our integration history. Our business is twice the size as it was five years ago, but we're working very hard to be sure that the platform that we're putting in place is capable of handling a business much bigger than our business today as we look down the road.

Second, we're focused on a material improvement in working capital terms. Jim has already showed those results. That's freeing up substantial cash for productive uses. Historically, as we suggested in our press release, two thirds of the cash has been used for acquisitions, one third has been returned to shareholders, pretty much in equal proportions on the dividends and stock repurchases. And we're suggesting, or we're looking at slight modification to that going forward, as we respond to the short-term environment in which we're working.

But any improvement in working capital turns at the expense of service would clearly be a losing proposition, so the third key objective of the SFS process is to have best in class service levels which will ultimately drive organic share gain which we're experiencing despite the down markets. We focus on lead time, fill rates, and all forms of customer-related execution.

Fill rates have significantly improved from year-ago levels, or the levels of the last twelve to eighteen months, and they're currently at or approaching record levels across virtually all our businesses.

So SFS is a top-down initiative. That being said, it involves all Stanley employee from the executive office to the factory floor. What are the elements? What is creating the value or importantly what are the drivers behind SFS? Specifically, there are three. First and foremost, lean. We're implementing lean throughout the plants, throughout our supply chain, throughout our entire organization with a focus on cycle time, inventory reduction, and service excellence. Each metric is systematically recorded and reported and reviewed at all levels of the organization.

Second, we're re-engineering core processes, and we're standardizing them Company-wide. We're striving to achieve excellence in customer-facing processes, as well as extract the maximum efficiency from back room activities. Another way to look at that very simply is if it touches a customer or an end user, it's done locally in the marketplace, and if it doesn't, then it's done one way in one place or a limited number of places across Stanley.

Last, but certainly not least, we're implementing SAP as a Company-wide systems platform. We're not implementing a big bang with insurmountable business risk. It's a sequential execution where we're focusing on the businesses with the greatest needs or the businesses where we'll achieve the greatest benefits in a very logical, time-sequence way in terms of both expense and internal resource allocation. And the process is proceeding nicely. All of these activities are well underway or in a full implementation mode.

So let's move briefly to some of the individual segment results. We'll wrap it up and we'll open it up for questions.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Our security segment was clearly a bright spot in the third quarter. Strong revenue and profit performance in general, and outstanding if we exclude the hardware business, that we talked about the loss of a major customer about a year ago. Specifically, revenue is up 7%, 13% without hardware. Profitability up 8% in absolute terms, that was 27% excluding the hardware loss. And the profit rate improved 30 basis points, 220 basis points without the loss of hardware. We reference that in our press release, Jim touched on it.

We lost a \$50 million of annual business with about a 40% gross margin, just about a year ago. That will anniversary midway through the fourth quarter, and we'll move on from there, but I think it's important to remind everybody that that was a tremendous headwind that our mechanical security business faced, roughly \$12.5 million worth of business a quarter since February that will anniversary in the middle of the fourth quarter.

Our Convergent business performed extraordinarily well with 21% sales increase driven primarily by the Sonitrol acquisition, but we continued our margin expansion with the U.S. systems integration business primarily as a result of the successful reverse integration of the legacy Stanley systems integration business into HSM and the thus far successful integration of Sonitrol.

The mechanical access business grew 5% in total 2% organically, excluding the impact of hardware. And as already suggested the segment profit rate was aided both by execution in all of the businesses within security, as well as productivity and pricing action.

A brief look at our most recent acquisition, a French Company, General de Protection. It's a leading independent provider of electronic security solutions in France and Belgium. And we're enthusiastic about this acquisition because it creates, we'll say, an HSM-like continental platform for Europe for security expansion.

You'll recall that most of our European business right now is UK-centric and this is a major geographical expansion into continental Europe. GDP has a direct sales model to small and mid-sized commercial customers, again the focus being on commercial or B to B. Very highly recurring monthly revenue, recurring monthly revenue content, approximately 60%, with a 75% customer renewal rate. Very high numbers for the industry.

It's roughly \$87 million at current exchange rates and annual revenues with operating margins at or above 20%. Basically, it will be earnings neutral in '08, and a modest impact in '09. We paid roughly \$166 million or EUR118 million. And just for those who follow acquisitions in the securities space, that's roughly 33 times RMR or recurring monthly revenue, or 1.8 times revenue. We think a very fair and reasonable purchase price for a good piece of business.

I would like also to remind everybody, we at Stanley have a very strong track record in our industrial tools group and in our Company with good French businesses, with good market positions and capable management teams. We view GDP as more of the same, and it creates a platform for our Convergent Security business in continental Europe.

Looking briefly at industrial and CDIIY, the market performed negatively and certainly were impacted by the end markets in which they compete. Revenues in our industrial tools groups were flat, and profitability was down. The profit rate was down 40 basis points. Organic growth in total was down about 4%.

Industrial and automotive repair tool revenues were handicapped a little bit. Facom did maintain its revenues in very difficult market conditions, while North American revenues declined slightly. Our engineered solutions business continued to experience some nice results with growth in both industrial storage and hydraulic tools businesses domestically and abroad. And the segment profit rate as I've already suggested declined due to both higher inflation as well as some volume pressure. On the CDIIY side, the business facing probably the most headwinds of any of our businesses. Revenues in total were down 2%, profit rate declined 380 basis points from a comfortable 16.5% level down to 12.7% for the quarter with a 5% decline in organic growth.

Obviously there was softness in the North American or U.S. residential and construction markets. European organic revenues did decline as a result of slowing demand in the UK and other European markets that Jim cited in his overview, as well as the

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

decline in our lower-margin storage businesses across the Company. Our plastic storage business sold through the home centers.

Bostitch continued to shift towards more profitable business, but the segment margin rate was negatively impacted by inflation in the third quarter, as well as the continuation of weakness the U.S. markets. So no surprises there, but all in all, a 13% operating margin on a 2% decline in revenues.

So in summary, global markets do continue to be negatively impacted by unfavorable economic conditions. No surprise there. What you might have missed in the technical blackout, Jim talked about our diverse portfolio. The advantages it's having, which does insulate us but certainly doesn't make us immune to those conditions.

U.S. residential construction and retail markets are soft, 33% of our business in total is focused in construction and DIY, about half of that or 17% is in North America. The North American industrial market is contracted, particularly the U.S. automotive market. And the European growth is continuing to slow as the economy contracts.

And as Jim indicated, the slowdown in Europe happened rather abruptly. In our case, or certainly in the markets we serve, where normally we see a very nice strong pickup in September after a return from the August vacation period. That pickup really never took place, and we don't see the situation as any more robust or healthy in the fourth quarter.

Commodity inflation is at a record high, that's the bad news. The good news is, it's beginning to taper off. And our full-year 2000 estimate remains unchanged since July at about \$150 million. That trend arguably could get a little better.

And Jim did review our estimates for recovery, despite that level of inflation our current estimates suggest we'll have 90% of it recovering, which is strong pricing performance across most businesses due largely to the brand strength. And secondarily just due to a good internal process to get out ahead of it, identify where the inflation is coming from, and try to be proactive in recovering as much of it through price and productivity as possible.

Internally within Stanley, I think it's clear the balance sheet and cash generation do provide stability and ample liquidity. I think Jim provided just what you need short-term in a snapshot to reaffirm that. Our earnings guidance of \$3.75 for the year all in is down 3%. It's relatively stable despite the unprecedented volume decline that Jim talked about.

Cash flow estimate is unchanged at near \$500 million. SFS does continue to aid in terms of the positive cash flow benefits. I have talked about timely pricing actions, or together we have, that is doing a lot to mitigate inflation. And as we sit looking at the remainder of the year into 2009, we think we have done what we can, and we are well-positioned to weather a difficult economic environment as long as it lasts in 2009.

We have good price momentum with inflation abating as we enter 2009. We have about \$60 million of carry over from gross cost actions, about \$25 million of which will be incremental in 2009. And the portfolio refinements, specifically the addition of Sonitrol, GDP, and Xmark, continue to give us a more stable earnings base, less susceptible to significant economic downturns looking forward.

As I've discussed, and we've mentioned in our press release, our short- to intermediate-term capital allocation will shift as we think about repurchase within our current rating constraints. And with that, we'll open it up for questions and answers.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Mr. Waybright? Excuse me, Mr. Waybright?

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Greg Waybright - *The Stanley Works - Interim VP - IR*

Yes, Laura.

Operator

Hi. Your first question comes from the line of Eric Bosshard from Cleveland Research. Mr. Bosshard, your line is open.

Greg Waybright - *The Stanley Works - Interim VP - IR*

Eric?

Eric Bosshard - *Cleveland Research Co. - Analyst*

Yes.

Jim Loree - *The Stanley Works - CFO & Executive VP*

He can hear.

Eric Bosshard - *Cleveland Research Co. - Analyst*

Can you hear me now?

John Lundgren - *The Stanley Works - Chairman & CEO*

Yeah, go ahead.

Eric Bosshard - *Cleveland Research Co. - Analyst*

Thanks. Jim, you commented on the outlook for revenue growth in 4Q that basically implied that volumes in the fourth quarter would be, I guess, similar to what we saw in the third quarter. First of all, can you confirm that that's right? And then secondly, the thinking within that when considering the trends that you are seeing underlying in Europe, why the numbers wouldn't be worse in 4Q, and then as we go into 2009.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Yeah, well, I can confirm that I said that, whether it's right or not, only time will tell. Unit volume was down 7% in the third quarter, price was 3%, organic was down 4%. We think that unit volume will be slightly better, partially because the third quarter in Europe. A lot of the softness was already reflected in the third quarter number.

So from a sequential perspective there's not a lot of negativity to happen. But also because of the two things that we have going on; one in security, which is the mid-quarter anniversary in the fourth quarter of the hardware loss, which is worth about \$10 million to \$20 million. I mean, it's a \$55 million a year loss. So on a quarterly basis it's about \$12 million, and about half of that is \$6 million, so you can see that is working in our favor.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

And then, in addition to that we did have a win. I don't know if when the telephone cut out, whether or not you heard it or not, but we had a relatively significant win with a major construction DIY customer impacting consumer tools and storage. And that load in has begun and it is rather significant win.

So for all of those reasons we think that the volume, assuming that the market conditions were similar in the fourth quarter to the third quarter, in the late third quarter in Europe that we would probably be a point or so, maybe favorable on a volume perspective; on a unit volume perspective.

Eric Bosshard - *Cleveland Research Co. - Analyst*

And then, secondly, within Europe can you frame a little bit how the Europe numbers, the year-over-year Europe numbers have moved as we have gone from 2Q into 3Q? And kind of where that's going, just sort of what the overall Europe revenue unit numbers look like.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Europe is running about a point negative in terms of organic growth, and probably about 4 points negative in terms of physical volume, unit volume.

John Lundgren - *The Stanley Works - Chairman & CEO*

And an important thing to think about, Eric, in 3Q and 4Q, this is John, FX is having a tremendous impact. Of course, Jim touched on the volatility and relative strength of the dollar or weakness of the European currencies, as it relates to the third and fourth quarter. You can do the math.

But remember that 45% of our business is outside the US. So roughly, it's \$500 million a quarter and with a 10% currency change is fairly significant in terms of reported revenue growth. Despite the fact we don't put FX in organic. So you have got a big swing there that began in the middle of the third quarter that will carry through the fourth quarter.

Eric Bosshard - *Cleveland Research Co. - Analyst*

And the down four units, do you know what that number was in the second quarter?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Down -- are you talking about Europe?

Eric Bosshard - *Cleveland Research Co. - Analyst*

Yes.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Oh, well, I think we showed it last quarter. I don't have it in front of me, but I'm guessing it was probably down a point, maybe.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Eric Bosshard - *Cleveland Research Co. - Analyst*

Do you think down 4 units is as bad as it gets or does it get worse than that and then stay worse than that for a while similar to what we've seen in the U.S.?

Jim Loree - *The Stanley Works - CFO & Executive VP*

I don't know, I think that since the first month of the quarter was strong, I would guess that it could get a little worse than that in the fourth quarter, but if it's anything like the U.S., it could be in the 7% - 8%, minus 7% or 8%, but I think that's factored into our fourth quarter view.

Eric Bosshard - *Cleveland Research Co. - Analyst*

And then third, in terms of security growth and pulling hardware out, but as you look at the underlying organic growth where it sounds like mechanical was up a little bit. And Convergent, I'm not certain but it looks like Convergent maybe was flat organically. Can you just talk about what you're seeing in terms of end-market demand in that business as we see slowing commercial construction, and I understand you've got a diverse customer base. But just talk about what perhaps the order book or the outlook is for how the growth is going in that business.

Greg Waybright - *The Stanley Works - Interim VP - IR*

Yeah, I think the security growth continues to be stable. The principle reason, there's two reasons why the Convergent was slightly, I think it might have been down a point in electronic. One of them is that there's still a little bit of a hangover from the reverse integration of HSM which should be behind us by the first quarter, and a lot of that has to do with business we're simply walking away from because it does haven't monitoring revenue attached to it on an on-going basis.

And then the other part of it is, there is a small business in relation to the overall Company, but maybe large in relation to Convergent; a business that we inherited with one of our acquisitions. I believe it's about \$20 million a year in revenue, which we're literally just walking away from because it's a non-value-add business for us. It's inconsistent with our strategy.

It's something called The Com Group that we're potentially even going to sell it in the fourth quarter. And if so it will become a discontinued operation but that has been a bit of a drag all year on the organic growth and in Convergent as well. If you took the two things that I mentioned out, I think we would be in a much better place probably closer to 5% organic growth in Convergent, and hopefully both of those issues will take care of themselves here in the next quarter or so. (multiple speakers)

John Lundgren - *The Stanley Works - Chairman & CEO*

I was going to say, Eric, I just think the other point that Jim and I are asked a lot. A relatively small percentage of our security business, particularly that one, 15% to 20% is our internal estimate, is purely driven by commercial construction or new commercial construction.

The advantage of our install base, and I think the reason there has been relative stability in the top line despite the rather pessimistic both news and views is when there aren't new store openings amongst large retailers, where you know we have an extraordinarily large install base and position as well as other commercial construction, the bad news is new starts are falling dramatically. The good news is when that happens, existing facilities step up their retrofit activities and their maintenance activities. And given our strong install base, that's an important partial mitigator.

Our view right now, Brett's and Justin's view, would be that's why the business is holding up as well as it is, in total, despite as you've indicated, a meaningful decline in new commercial construction.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Eric Bosshard - *Cleveland Research Co. - Analyst*

And so I guess the last point, as you look at the order book in as much as exists in either of these businesses. Does the order book suggest the overall business should be able to sustain the rate it's at before we consider some of the one-offs that Jim mentioned as you look over the next 90 or 180 days? Or do you see some easing along with the overall easing of commercial spending?

John Lundgren - *The Stanley Works - Chairman & CEO*

The answer is yes.

Eric Bosshard - *Cleveland Research Co. - Analyst*

Okay. Great. Thank you.

John Lundgren - *The Stanley Works - Chairman & CEO*

Thank you.

Greg Waybright - *The Stanley Works - Interim VP - IR*

Laura?

Operator

Mr. Greg Waybright, your next question comes from the line of Sam Darkatsh, Mr. Darkatsh, your line is open.

Sam Darkatsh - *Raymond James & Associates - Analyst*

Good morning, John. Good morning, Jim, How are you?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Hi, Sam.

Sam Darkatsh - *Raymond James & Associates - Analyst*

You mentioned the \$150 million in inflation would remain static in terms of your expectations for '08. If oil and steel and all of the other various base metals remain flat from here on out at current levels, what is the '09 inflationary situation versus '08?

Jim Loree - *The Stanley Works - CFO & Executive VP*

We don't really have a number that we're sharing at the moment because it's such a dynamic environment, and we don't really, I can't say I have done the static analysis as of the last day or two. But I will say the reason we put the chart in there that shows what we buy so you can come to your own conclusions about what you think the commodities will do. If they stay flat, or, where

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

they are today, the steel has come down, depending on the type of steel, dramatically in the last few, in the last month or so. And, obviously, oil prices have come down, and that may iterate into the freight rates at some point. And so when you look at, on the chart, if you could actually put that chart up there, please. The pricing inflation update, number 8. Hang on one second while we get the chart. Eight, please.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Keep going.

John Lundgren - *The Stanley Works - Chairman & CEO*

There you go.

Jim Loree - *The Stanley Works - CFO & Executive VP*

There it is. You can see the steel is about half of the \$150, the inflation is about \$20 million, That's a pretty substantial part of the \$150 million, so if that were to reverse in some fashion, you can kind of come up with your own estimate as to how significant it could be, recognizing that \$1.1 million is \$0.01 a share for the company.

Sam Darkatsh - *Raymond James & Associates - Analyst*

Okay, I guess what I was getting at is whether there were any hedging or time lags with respect to when you see the commodities impact your bottom line versus when we would see on the stock market?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Yeah, there's always, a certain number of days of raw and in-process inventory in the plants and so on. And it helps obviously to have the inventories as lean as we have them right now. Clearly that will reduce the time frame.

There is sometimes, we don't really hedge deals but sometimes we buy ahead a month or two to make sure that we get, when the prices were going up, that we get the best pricing. But I think that typically you probably see about a three month lag before you really see the P&L effect from something like this.

Sam Darkatsh - *Raymond James & Associates - Analyst*

Okay. I guess my next question would be piggybacking on what Eric was asking. When you look at a lot of your businesses, John, that are economically sensitive to a certain extent, CDIY, Bostitch, some of the industrial businesses; certainly the mechanical access with the 15% to 20% of your security business. What gives you the confidence that things don't get worse or that you are being conservative enough in your expectations? Because it sounds like you are assuming a similar type run rate in Q4 at least, despite the fact that things got progressively worse as Q3 progressed. So what gives you confidence that things will stabilize in some of those more economically sensitive businesses?

John Lundgren - *The Stanley Works - Chairman & CEO*

Yeah, I have tried to answer that twice, Sam. I'll try to answer it one more time. We're not economists any more than anybody on the phone. We read the same macroeconomic reports that you do. I think our biggest, if you will, internal or operational hedge in CDIY as well as mechanical security, or security in general, excluding our industrial tools group, is the fact that when

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

new commercial constructions don't start or even new residential constructions don't start, there is more retrofit in commercial construction. And more, quite frankly, remodeling in residential construction.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Laura, hang on one second. (multiple speakers)

John Lundgren - *The Stanley Works - Chairman & CEO*

I think Sam might have gotten cut off. Anyway, Sam, in both those businesses, we see the partial mitigator in that more service and maintenance gets done when the new construction isn't starting. Even in the automotive business while it is going to take a while. Very little as you know of our business is OEM to the car manufacturers in Detroit or around the world. That being said, when people aren't buying new cars they are driving their existing cars longer. They may skip maintenance for six months, but eventually that's going to have a positive impact on businesses like Mac and Facom.

So, I'm not confident any more or less than anyone else could be on the macroeconomic drivers. All I feel is I have faith in our portfolio being more diverse, automotive repair, rebuilds, maintenance, etc. that's going to insulate us from some of that decline.

Operator

Thank you. Your next question comes from the line of Pete Lisnic.

Pete Lisnic - *Robert W. Baird & Co., Inc. - Analyst*

Good morning, gentlemen.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Hey, Pete.

Greg Waybright - *The Stanley Works - Interim VP - IR*

Hey, Pete.

Pete Lisnic - *Robert W. Baird & Co., Inc. - Analyst*

The first question is sort of a housekeeping item. In terms of the working capital reductions that you are showing, do those comparisons, are they impacted at all by currency to any great extent or are those pretty clean the way you are looking at them?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Very small impact from currency the way we're looking at them.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Pete Lisnic - *Robert W. Baird & Co., Inc. - Analyst*

Okay. Looking forward in terms of the cash generation profile and the benefits that you are getting from SFS, it just seems to me like the cash generation has actually improved or accelerated because of some of these initiatives. And how do we think about that in terms of '09? Should we expect to see some more improvement on the working capital front, and thus, another relatively robust year from a free cash flow perspective?

John Lundgren - *The Stanley Works - Chairman & CEO*

I think the words in the pitch and in our press release, and we haven't given '09 guidance yet. And I have to apologize because when Jim talked about it. It may have been when we were in our technical difficulty problem.

We see another robust cash flow in 2009. Why do we say that without putting a number out there? Why do we think we can duplicate this year's performance? A huge source of cash flow is working capital improvements, and SFS 2010 is just beginning to really, really gain traction. We have been at it for a while.

So our view is to the extent that cash flow could be adversely impacted by more volume decline than we have anticipated, we think continued improvement on working capital, on inventory reduction in general, and working capital turn improvement in particular, is going to help continue, is going to help duplicate this year's cash flow performance.

Remember, as Jim pointed out. There was a 7% volume decline, yet we still took inventory down. We took receivables down despite a precipitous decline in our actual unit production. That gives us confidence that this thing is gaining traction, the organization is focused on it, and we're cautiously optimistic that that trend will continue.

Operator

Your next question comes from the line of Michael Rehaut..

Ray Horn - *JPMorgan Chase & Co. - Analyst*

Hi, good morning. This is actually Ray Horn on for Mike. Couple of questions. First question, given the current weak market environment, I was wondering if you had any type of update in terms of what you expect for your cash contributions towards your pension this year and over the next couple of years? I think, in the 10-K you guys talk about \$15 million of cash contribution, but I think that was based off of a 8% expected return, but given with the S&P down 20% to 30% this year, what did that do in terms of your cash outflow for the pension?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Okay. First of all, let's understand pension a little bit here at Stanley. We froze our defined benefit plans about eight or nine years ago in the U.S. and subsequently froze them in Australia and the UK, and so on. And basically all we have today is the stub that remains from that as well as a little bit of defined benefit plan exposure that we picked up along the way from various acquisitions.

So, we don't have a massive pension overhang to begin with. It just so happens that the funding status of our pensions this year requires almost no incremental cash contribution. Largely because they are just not very significant plans, and as we have analyzed their funding, we found that we need to make no contributions this year.

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Operator

Mr. Waybright, your next question comes from the line of Mike Sheridan. Mr. Sheridan, your line is open.

Mike Sheridan - Cobalt Capital - Analyst

Good morning, how are you? Quick question. You said that fill rates were good in virtually all of the businesses. Could you talk about where they were not good, and why?

Greg Waybright - The Stanley Works - Interim VP - IR

Yeah, probably the -- when I say virtually all the businesses, we were struggling for quite a period of time in our UK home center business, in our North American Proto business, as well as hardware. As we consolidated for the exit of the business from a large customer and dramatically increased SKU count.

They are virtually at targeted levels. They are at targeted levels in the UK home center business and in our Proto business. We are still sorting through the consolidation of the National and the Stanley brand's significant reduction in SKUs and the consolidation of the business in Rock Falls. So the business that still could stand some improvement, which represents about 6% of Stanley revenues is in our builder's hardware business.

Mike Sheridan - Cobalt Capital - Analyst

Thank you.

Greg Waybright - The Stanley Works - Interim VP - IR

Tough business.

Mike Sheridan - Cobalt Capital - Analyst

Thank you.

Operator

Your next question comes from the line of Chitra Sundaram. Your line is open.

Chitra Sundaram - Cardinal Capital Management - Analyst

Thank you. The first is could you discuss the foreign exchange impact on international operations? And I mean by that, revenues obviously in local currency. How do costs typically get incurred in the two-product segments; in the construction DIY and in (inaudible)?

John Lundgren - The Stanley Works - Chairman & CEO

They tend to move, Chitra, in the same direction. As you are probably aware, we buy commodities centrally and globally. They are global commodities. That being said, they tend to move in the same direction and as the European or Asian currency weakens so does the commodity price in that area. There's a time lag like anything else. But simply said, if you see a decrease in revenue,

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

assume a comparable, obviously with the margin impact decrease in cost or conversely an increase, albeit with a two to three month time lag.

Jim Loree - *The Stanley Works - CFO & Executive VP*

Although -- I'm not sure if the circuits were on when I was talking about currency. But, we've experienced just like the whole world has experienced a rather significant strengthening of the dollar vis-a-vis the Euro, the British pound, the Canadian dollar, and the Australian dollar. All of which are very important currencies to us, especially the Euro and the British pound. And since the beginning of the quarter, this quarter, we have seen a 15% decrease in the value of most of those currencies and a 28% decrease in the value of the Australian dollar.

And so, whereas in past quarters, we have had some modest benefit from currency translation. As an example in the first three quarters of this year, we averaged about \$0.05 a quarter. In the fourth quarter, we will experience a 5% negative impact from the weakening of those currencies assuming that the currency rates stay where they are today.

Chitra Sundaram - *Cardinal Capital Management - Analyst*

Yeah, and I guess that's just where I was going with that. Obviously, we see that as impacting the revenue line. I just wanted to get clear that the cost centers and production centers and all of that stuff, we were producing stuff for local area in general, so that the costs would be aligned?

Jim Loree - *The Stanley Works - CFO & Executive VP*

Yeah, it's mostly alignment. We have some cross-border currency flows, most of those are hedged a year out, so really the issue for us is more about translation, obviously the gross margin rates or gross margin dollars come down, the SG&A dollars come down, and the difference between those is really what the effect is for us for the most part.

Operator

The next question comes from the line of Nicole Diblaze. Your line is open.

Nicole Diblaze - *Analyst*

How are you?

Greg Waybright - *The Stanley Works - Interim VP - IR*

Hi, Nicole.

Nicole Diblaze - *Analyst*

Couple of questions for you. On restructuring, you guys had said that you were planning on doing \$15 million in 2008. I see that you only did \$5 million in the third quarter. Can we assume that the rest of that gets pushed into the fourth quarter?

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Jim Loree - *The Stanley Works - CFO & Executive VP*

Some of that was actually done at the tail end of the second quarter. We had \$17 million of restructuring in the second quarter. So you can assume that the fourth quarter will be similar to the third quarter in terms of restructuring volume. But I think it's important to note as we go into 2009, we expect to have approximately \$30 million of restructuring embedded in the comp.

So that as we look at the sales outlook for '09 as we get closer to the actual first quarter, we will have the flexibility to determine whether we want to deploy that \$30 million that's embedded in the comp. Kind of pay as you go, if you will, in terms of additional restructuring to deal with any volume declines that we may have. Or if the volume picture is better than what we might be implied that would require a significant restructure, we would have the ability not to spend the money in which case the comp would kind of not be required to repeat.

Nicole Diblaze - *Analyst*

Okay. That makes sense. And then you guys are under FIFO accounting in the U.S. and LIFO internationally. So, I mean, is it fair to say that margin pressure could be building going in to 4Q, especially in the industrial segment?

Jim Loree - *The Stanley Works - CFO & Executive VP*

We're actually under LIFO in the U.S. and FIFO internationally.

Nicole Diblaze - *Analyst*

Sorry, I mixed it up.

Jim Loree - *The Stanley Works - CFO & Executive VP*

But with that as sort of the factual background, do you want to re-ask your question, or is it a moot point?

Nicole Diblaze - *Analyst*

No. I mean, I'm still curious about what they could do as far as margins go?

Jim Loree - *The Stanley Works - CFO & Executive VP*

I don't think it's going to have a dramatic impact. I mean there's a lot of, when you think about all of the variances that arise from basically the FIFO accounting from the inflation, and then are capitalized in the FIFO accounting, we have had that going on for quite a while. As you get currency impacts in there, and as the inflation starts to abate, I think you are going to get -- it will be fairly insignificant in terms of the overall impact to the Company.

Operator

There are no further questions at this time. Mr. Waybright, do you have any closing remarks?

Oct. 21. 2008 / 10:00AM, SWK - Q3 2008 The Stanley Works Earnings Conference Call

Greg Waybright - *The Stanley Works - Interim VP - IR*

No, I think we'll just thank everyone for their participation. Apologize for the brief technical difficulty, which is obviously beyond our control. But I think you have gotten the gist of the message. Third quarter is behind us with I think pretty good earnings in light of a volume decline. The conditions remain difficult but cash flow continues to be very, very strong. It will remain an area of focus. And we think we are well-positioned to weather the storm and the conditions ahead regardless of what the market serves us. Thanks a lot for your attention.

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