FINAL TRANSCRIPT

Thomson StreetEvents℠

SWK - Q4 2008 The Stanley Works Earnings Conference Call

Event Date/Time: Jan. 28. 2009 / 10:00AM ET

CORPORATE PARTICIPANTS

Kate White
The Stanley Works - Director of IR

John Lundgren
The Stanley Works - Chairman & CEO

Jim Loree
The Stanley Works - COO & EVP

Don Allen
The Stanley Works - VP & CFO

CONFERENCE CALL PARTICIPANTS

James Lucas
Janney Montgomery Scott - Analyst

Peter Lisnic
Robert W. Baird - Analyst

Eric Bosshard
Cleveland Research Company - Analyst

Sam Darkatsh
Raymond James - Analyst

Nigel Coe
Deutsche Bank - Analyst

Seth Weber
BAS-ML - Analyst

Michael Rehaut
JP Morgan - Analyst

Kenneth Zenner
- Analyst

PRESENTATION

Operator

Good morning. My name is Jennifer, and I will be your conference operator today. At this time I would like to welcome everyone to the Stanley Works fourth quarter 2008 results conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a Question and Answer Session. (Operator Instructions) . Thank you.

I would now like to turn the call over to Ms. White. You may begin

---

Kate White - *The Stanley Works - Director of IR*

Thank you very much, Jennifer. Good morning, everyone, my name is Kate White, Director of Investor Relations for the Stanley Works. Thank you all very much for joining us on the call this morning. On the call in addition to myself is John Lundgren, Stanley's Chairman and CEO, Jim Loree, Stanley's Executive Vice President and COO, and Don Allen, Stanley's Vice President and CFO. I would like to point out that our fourth 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 the Investor Relations portion of our web site, which is www.stanleyworks.com. This morning Jim, John, and Don will review Stanley's fourth quarter and full year 2008 results and various other topic 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 pm today. The reply number and access code are in our press release which again is on our web site. And as always, please feel free to contact me with any follow-up questions after today's call at 860-827-3833 or Corbin Wahlburger, at 860-827-3937. We will be making some forward-looking statements during this call. Such statements on based on assumptions of future events that is may not prove to be accurate, and as they involve risk and uncertainties. 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 8K which we have filed with today's press release. With that I will now turn it over to our CEO, John.

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

Thanks, Kate. Good morning, everybody. Thanks for listening -- phoning in. Let me start with just, I think, what we spend a lot of time talking about internally, I know you're interested in just an ever view of the state of Stanley as well as some fourth quarter and annual highlights. Our fourth quarter earnings results were in line with previously communicated estimates you will recall we had a pre-release on December 11, 2008. Those results were $0.66 in the fourth quarter '08 translating to $3.41 for the year, excluding the fourth quarter restructuring charge which we communicated in our December 11 release and that Don Allen will talk a little bit more about later this morning. It was a very good story in terms of cash flow. Free cash flow of $419 million, and that's despite an unplanned and unanticipated increase in capital spending of about $25 million due to the cancelation of several previously existing lease arrangements. Working capital turns, again, a good story and a great source of cash increased by 0.6 of a turn to 5.9 despite the unprecedented volume decline that we experienced during the fourth quarter. And Jim is going to talk about some of the sources both of cash as well as the program's driving the improved turns. It was particularly encouraging in the fourth quarter -- the improvement in turns. Price realization continues to be encouraging as we virtually offset the overwhelming majority of our inflation headwinds. For the last two years we've averaged about 85%, and I have a slide that will give you more granularity on that, but we're making a lot of progress via our pricing center of excellence. The high point certainly for us in the quarter was the performance -- and for the year, was the performance of our convergent security solutions business. Revenues grew 21% for the year, 32% for the quarter, and operating margin expanded significantly, and again Jim will get into some more detail when we talk about the segments and give you a little more granularity on what's taking place inside our security segment. And finally, the security segment currently makes up the largest portion or made up the largest portion of our fourth quarter sales at 38% as our portfolio transition proceeds and security thus far has been less adversely affected by the macroeconomic conditions.

Moving onto a closer look at revenues, revenues of a $1.086 billion, were down 5% from fourth quarter '07. As you know there is not a lot of seasonality in the Stanley business, and the primary factor contributing to the revenue decline was a 10% volume decline as you see in the bottom left, and importantly that followed a 7% unit volume decline in the third quarter. And the 10%, Don will talk to you a little bit more later on, that's not inconsistent with the outlook for the first half of the year where we're looking at or assuming 10% to 12% of volume decline for the foreseeable future. Price was a good story as we realized a 4% net price increase year-on-year resulting in a 6% decline in organic revenues. Currency was a negative as the dollar strengthened against the Euro, the British pound, as well as the Australian and Canadian dollars. Those four currencies making up the overwhelming majority of our foreign currency exposure, and acquisitions primarily in securities, secondarily in our engineered solutions business contributed about 6% to our top line, so the net result is a 5% decline in revenue with a 10% unit volume decline.

Looking briefly at the segments as I suggested, security performed well, and both the CDIY business was off 16% in total, 10% of which was organic, and industrial was off 10% -- 9% of which was organic.

Moving onto margin, we were pleased with our ability to hold gross margin rate for the year despite the decline in volume. You see gross margin holding steady at 37.8% as a result of a business mix towards a higher margin portfolio as well as the realization of many of the planned cost synergies from recent acquisitions. You see that operating margin did decline 140 basis points and the difference between flat gross margin performance and the 140 basis points decline in operating margin is primarily attributable to volume decline which of course was the catalyst for our announced fourth quarter initiatives.

Looking at pricing, I alluded to in the highlights you see at the top a history of our recovery of all of our inflation, 81% in 2005, a 45% in 2006, although it was against the lower base, but then 83% and 88% the last two years. We've talked about this on earlier calls, but several years ago we established a corporate pricing center of excellence which is really gaining traction. That has evolved in addition to the corporate center with a subset pricing center of excellence or expert attached to each major business unit and that's really starting to gain some traction, so we're pleased with our ability to -- thus far, at least the last two years, compensate for the overwhelming majority of materials inflation that we've received, and we anticipate that to continue going forward.

Looking quickly at inflation, because it's moving very quickly, and there's tremendous volatility. On the left-hand side it's clear commodity prices have declined significantly in recent months yet we've sill absorbed a tremendous amount of inflation. The materials inflation accounts for 60% to 75% of Stanley's cost of goods inflation, depending on the quarter. And then depending on spot prices 50% to 75% of Stanley's material inflation is normally steel. So, you see the quarterly lock of steel and -- of materials inflation, sorry, and all of our cost of goods inflation on the left-hand side where we're continuing to absorb in excess of $40 million a quarter.

Looking at the right, because steel is the most -- single most prominent element in our COGS inflation, you see first quarter '08 Stanley paid on average $660 for steel. In the fourth quarter that was up to $940 with the average for the year being $826. And that's the average that was included in the chart on the previous page.

Looking forward into the first quarter, we're anticipating an average cost in our P&L of about $790 million -- $790 a ton. That of course is above the current spot price, but I think -- and it creates $130 a ton head wind for us in the first quarter, and I think its important to note we did a good job throughout the year delaying some of these increases three to six months, and we do have steel in inventory, and that we've purchased in the fourth quarter and contractually even into the first quarter at higher prices, and we'll see some of the deflation that we've talked about in previous calls in the anticipated deflation starting to show up in our P&L midway through the second quarter. So, on a year-over-year basis inflation will be a reality in early '09, and of course the jury is still out, but Don's guidance talks a little bit about how we've accounted for that in our P&L. Let me now turn it over to Jim Loree, who is going to take us through the segments, and then we'll go onto Don Allen.

Jim Loree - *The Stanley Works - COO & EVP*

Thank you, John. We were very pleased with how the security segment performed during the quarter. We started building this business back in 2002 in in order to diversify our revenue base and provide a long-term source of growth, and in the quarter we certainly accomplished both of those objectives. As you can see revenues were up 14%. Its now at a run rate of about $1.6 billion annual revenue business. Segment profit was up 28% to $75 million, and the segment profit rate surged to 18.4%. A lot of this was driven by the convergence, the convergence security solutions business also known as our electronics securities business which is installation and monitoring electronic security systems. We had two major acquisitions during the year, Sonitrol and GDP and we also enjoyed the benefits of the reverse integration of our United States systems integration business into the HSM business model, really reaping the synergies that we expected when we did that acquisition. Great story. And kudos to Brett (Vontrauger) and his management team for excellent execution from this area. Mechanical access had a solid quarter under the circumstances. They had to deal with a continued loss of the Home Depot hardware business which has now finally anniversaried, and they did really well offsetting their volume declines with both price and productivity, so all in all a pretty good story in the securities segment.

I'd like to talk a little bit now about the portfolio shift that we've been undertaking since 2002, and as you can see from the next chart here, back in 2002 the revenues from our construction and DIY segment were approximately two-thirds of the company, and industrial and security were the remainder. As we look to 2008 on the right upper right part of the chart, you can see a much more balanced revenue -- diverse revenue base in the company with a construction and DIY business being 36% of the company, but the other two segments being very close in size, so a very balanced portfolio. Its even more interesting I think, when you look at the bottom part of the chart and look at how the operating margin mix has changed over the last six, seven years, where the construction and DIY business was contributing about 80% of the company's operating margin back in 2002. You can see today that's down to 31% although it has increased in dollar terms. The growth in the other two, the industrial and the securities segment have dwarfed on a percentage business the construction in DIY and now security represents, in terms of operating margin, 43% of the company's operating margin. So, really good story there and certainly one that served us well during this time frame.

And as we move onto the next chart, you can see we've also accomplished a reasonable amount of diversification as it relates to the end markets. The residential construction part of our business is now approximately 33% with about half of that in -- directly in the US. But we also have considerable positions in other areas as you can see 24% is in this industrial area, on the left upper part of that pie. We also have some commercial construction, about 12% of our revenue base, which has held up well even though the market has been down, in the US in particular, over the last year. We were slightly positive in terms of our revenue performance in commercial construction.

Then you see retail. We have some activity particularly in our security business in retail, and mostly in the access technologies automatic door business, and that business actually had positive revenue growth in -- last year. So, again even with the exposure to retail, they've been able to gain share, and they've been able to do a lot of refurb. type of activity in that particular market. Then we have exposure, about 12% of the end market in health care, education and government, automotive repair, which is not the manufacturing type of automotive volume but rather the auto mechanics supplying tools to auto mechanics, again, that market held up reasonably as well. Mac and (inaudible), you know, are the big elements of our activity there, and then I mentioned industrial and other. So, a good diverse revenue base in terms of end markets which has also served us reasonably well in this market. But that said we haven't been immune to the market declines in the industrial segment and the CDIY segment. I think this next chart sort of puts that in Crystal clear perspective PCI.

In the quarter for industrial, as we look at the left-hand side of the chart, revenues were down 10%, the operating segment profit rate fell to 10.3%, it was down almost 500 basis basis points in light of the steep volume declines. In industrial and automotive repair revenues, particularly hurt by the industrial markets in (inaudible) organic revenues declined 8%, that was a pretty significant drop for them. In our North American industrial and automotive repair business we did have the issue of economic contraction, particularly in our industrial business, and then in the automotive repair business most of our issues there were self inflicted as the driver count decreased in that particular business, and we are working diligently on fixing that issue as we speak. We also had growth in engineered solutions. We were up in double-digits there. That was driven primarily by acquisitions and a modest improvement in our storage business.

If we look over at the construction and DIY segment on the right-hand side, you can see even more dramatic revenue declines and even a more market profit rate decline, almost 700 basis points, the operating profit dropping to about 6%. We'd like to think that this is kind of troughed profit rate for this particular business with these types of revenue declines that we're experiencing, but we continue to have weakness in the US residential construction markets. I don't think that will surprise anybody. And in Europe we also had organic revenue declines which were different than in the beginning of the performance -- in the beginning of the year when we actually had increases in Europe. So, as time went on during the year, and we had talked about it on some previous calls, the organic weakness spread to Europe in the construction markets, and so now we pretty much have it across the board, and as well as in the emerging markets, so its a global phenomenon, not surprisingly. And the Bostitch margin rate was negatively impacted by inflation as steel inflation surged again, although we don't see that continuing in the future here in that particular business, and then their volume had some decline related to their continued market weakness. So, that's the story of the segments.

Now, as we move to working capital, I think this is a tremendously positive story. John mentioned the 0.6 of a turn improvement from 5.3 to 5.9 turns, that was $133 million reduction in absolute dollars of working capital and over $120 million of that was directly cash related -- there's a little bit of exchange impact as well, but as you look across the board, inventories came down

$41 million. If you think about the fact that we had a double-digit unit volume decline, the degree of difficulty in order to accomplish that was extremely high, and we were able to do it. And then on the receivables side we brought the accounts receivable down $128 million which included $40 million or so of reduction in over dues from a year ago. So, in this difficult economy with the credit issues and so forth, we were actually able to reduce the over dues in our portfolio by $41 million with a concerted effort, and then of course payables dropped slightly not surprisingly with the reduction in volume and inventories. What this says basically is that the Stanley fulfillment system that we put in place several years ago is gaining momentum as we speak and it couldn't be happening at a better time. I want to emphasize that the benefits from the Stanley fulfillment system are primarily process related, and they're not a one-time phenomenon. These are fundamental changes that we're making to the company's processes and the way we do business that are having a positive impact on our cash generation and in that regard as I said they are very timely. We even added a couple of years. As I mentioned, these are not -- this is not an over night sensation. This is three yards and a cloud of dust. There's four elements to the Stanley fulfillment system, it involves something we call transformational lean, which is Stanley's version of lean manufacturing and enterprise lean. Also, tremendous progress in something we called S&OP, which is the way you synchronize the front end of the business with the back end of the business, and we made enormous improvements across the company in S&OP and that's why we're able to endure a volume reduction of this magnitude and still bring inventories down. On top of that we have two other elements, one is complexity reduction, that is reducing the complexity of our products, the way we do business and our manufacturing footprint, and finally platform standardization. And so all of these things are progressing as we speak and contributing to this tremendous improvement in working capital, and obviously as I mentioned that's had an impact on cash flow, and now I'm going to turn it over to our CFO, Don Allen, he's going to talk about our cash flow performance.

Don Allen - *The Stanley Works - VP & CFO*

Thank you, Jim. On page 13 I just want to spend a few minutes and talk about that cash flow performance focused primarily on the year. As Jim mentioned the working capital contribution really bolstered our cash flow and our free cash-flow for performance for 2008 with about $127 million of a contribution in that regard. And our operating cash flow was $560 million which was an increase over the prior year of about $20 million, which is an impressive performance when you consider the fact that our net income from continuing operations before the restructuring charges in the fourth quarter was actually down 12%. And so, with with that decline and with the focus on working capital, we were still able to achieve a sizable -- a decent increase in operating cash flow. John mentioned earlier on, that our capital expenditures were slightly higher than we anticipated. It did increase about $50 million versus 2007. Approximately $30 million of that was really planned, strategic investments that we had in the pipeline since the beginning of the year. And then we had about $20 million of certain leasing structures that were terminated in the fourth quarter, that due to the difficult credit markets, we were not able to enter into new leasing structures at that point in time, so that's really driving that increase, but still a very healthy free cash-flow performance of almost $420 million in 2008. Regarding CapEx, as we look at 2009, we would expect that our CapEx would get down to more historical levels as a percentage of revenue which would be about 2% as we mentioned in our press release this morning.

The next page, if we take a look at our credit and liquidity status, its something that obviously everyone is concerned with in the current economic environment. We thought it would be good to just refresh everyone's memory on a few things related to that. The first thing we want to mention is obviously we've had a longstanding strategy to remain single A as far as our credit rating, and its served the company very well over the years. That is still a very important strategy for us going forward. In addition to that, we took several actions, two in particular in 2008 to ensure that we had ample liquidity. In particular in October when the markets were fairly turbulent, we did term out about $250 million of debt that will mature in 2013. In addition to that, we increased our credit line, which really gives us approximately $800 million of liquidity, and in this time and the economic circumstances is a wonderful thing to have available to us. And then the third thing to mention is we really have no major unfunded obligations until 2012 as the chart depicts here on the right. Due to the equity unit structure that we entered into a few years ago, we will have a cash in-flow as a result of the shares issuance in that transaction of $330 million in 2010 that will help us fund the bond obligation we have of $ $200 million that that year. So, we feel that we're in a very strong position regarding credit and liquidity at this stage.

As John mentioned earlier, we saw unprecedented unit volume declines in the fourth quarter here, 10% of volume decline in our press release in December, we indicated the importance of having to realign our cost base and our cost structures due to that, as well as due to the outlook we were seeing for 2009, so we took some significant actions as that press release indicated. Specifically our head count was reduced over 2,000 employees which is approximately 10% of our work force. We did certain reorganizations and elimination of management layers, and then we also had a closure of three plants in the United States as part of that restructuring. And last, but certainly not least, we did spend certain US employee benefits on a temporary basis to really assist in those cost reduction actions and to avoid to have to do additional head count reductions. The costs associated with these actions was -- for the year the entire restructuring was $92 million. The specific fourth quarter restructuring was $67 million which is about just less than $0.60 EPS. The total year restructuring charges were $0.80 per share. The cash outflow associated with these restructurings, we would expect about 85% of them are cash out-flows, and the remaining 15% are non-cash, in other words, asset impairments. And we would estimate about 60% to 70% of that cash would be paid in 2009 and the remainder would be paid in 2010 as it does -- the process in Europe is much longer for doing these types of actions. The savings associated with all of this is $140 million associated with the head counted reductions, and that includes what we did throughout the year, not just in the fourth quarter. And so we feel like we've taken the appropriate steps there. In addition to that, we really attacked our discretionary costs, $55 million of actions focuses on T&E and car and fleet costs, et cetera, and that's something that we'll continue to attack as we go through 2009. The EPS impact add is a positive $1.75 per share as a result of those actions with $0.24 of that carrying over to 2010.

Moving to the next page we made a decision as you saw in our press release not to provide 2009 guidance at this point until we see the economic conditions and the end markets begin to stabilize. However, we continue to constantly monitor the variables, and we'll pulse them as we go forward. But we did want to be able to provide, as we indicated in our December 11 press release, some assumptions to assist the financial community with some things that we're seeing in '09 as well as some assumptions to assist you with your modeling, and we have updated that in this press release this morning. If we start with unit volume, which is clearly the largest variable that we have at this point, as we head into the year, it appears that the 10% to 12% unit volume decline is what we're seeing in the early stages. If that was to continue throughout the entire year, the negative impact on our EPS would be $2.00 to $2.25. Now, some of that is volume associated just from the lost sales, but of course there's also an impact of under absorption in our plants thats factored into that EPS assumption. Currencies, as we mentioned in our December press release, will have a significant negative impact as well as the US dollar strengthened against some of the major currencies that is we have like the Euro, the Australian dollar, and the Canadian dollar in particular. And we're estimating that on current exchange rates that it would be about a $0.50 negative if those exchange rates remain constant throughout the year. If the exchange rates move 5% either way, it probably is about a 10% to 12% impact positive or negative, depending on which way they move. Now, the impact will likely be -- most of it will occur in the first half of 2009, about 90% of that is what we expect as exchange rates began to -- or the US dollar began to strengthen as '08 continued on throughout the year.

Looking at inflation and pricing, which is an area that everyone is very interested in, we do expect as John mentioned to see inflation especially in the first quarter and the early part of '09 as we have that carry over effect. If we look at commodity prices today, there is a possibility that we may have some deflation in the back half of the year, but that's difficult to predict at this point in time. Pricing, we will certainly have a carry over effect as mentioned in our press release that would likely contribute $30 to $50 million of a positive, so overall our view is that we will likely have some type of modest positive impact as a result of those two items, but clearly there is variable that could change that could alter that going forward. I mentioned the cost reduction program of $1.75 already. As far as restructuring charges, we mentioned in our press release this morning that we expect to probably have about approximately 50% of our '08 level charges which would be about $0.40 EPS in 2009. And then last, but certainly not least, accretion of further 2008 acquisitions that we've already done we'd be up $0.10 to $0.12 EPS. So, we feel this is helpful information for all of you as we begin to look at our company in 2009. Just keep in mind that we continue to be committed to take the actions to protect our earnings and our cash flow and our balance sheet going forward.

As we summarize the call this morning, just looking back -- a few things to point out, we feel we've taken, as I mentioned the aggressive and proactive restructuring actions to adjust our cost base and prepare ourselves for 2009 and be ready when the economic conditions begin to improve. We also demonstrated the ability to mitigate inflation with customer pricing actions where we had $140 million inflation in 2008 with offsetting $123 million in price recovery. Free cash flow is a great story, really driven by that strong working capital performance with a proven success of the Stanley fulfillment system. As we look forward, we are dedicated as I mentioned to continue to take steps needed to maintain our upper tear credit ratings, and I had also mention that have no unfunded debt obligations until 2012, and we feel very good about our liquidity position. As all companies who are multinationals like us, we will be subject to potential negative impacts, fluctuations, and currencies and (inaudible) to something that we monitor as we go throughout the year here. And certainly last but not least, is we will continue to be focused on successful integration of our acquisitions we've done, and maximize those synergies going forward as well as focus on SFS in 2009 and beyond.

Kate White - *The Stanley Works - Director of IR*

Jennifer, now we are ready to take question and answers.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from James Lucas.

Kate White - *The Stanley Works - Director of IR*

Hi, Jim.

James Lucas - *Janney Montgomery Scott - Analyst*

Two questions. First, granted these are, you know, to use a word that's overstated these days, unprecedented times, and you did a good job of laying out what actions have been taken, what other opportunities are ahead. You know, factoring in the volume decline of down 10% to 12%, and you look at your contingency planning in 2009, at what point do you think about having to take additional actions or do you think that you've got the cost structure in line if things were to remain stable today? And secondly, cash flow has been a fantastic story, and otherwise where there hasn't been a lot of good news, when you look at the jobs you've done on working capital, what opportunities remain there?

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

Look -- Jim, this is John. Good morning. I'll take the first half, and I'll let Jim take the second part of that question because he took it in the presentation and some of the initiatives that he is leading are really, really the drivers in cash flow. Your question on contingency planning if you will or is there yet another way that is right on, its a topic that as recently as the middle of December and again already this year, we've discussed with senior management. If volume continues to decline at the rate its declined the last two quarters, and -- we may well need another round of downsizing businesses later on in the year, without being terribly specific, it would be in the second half of the year, everything we've talked about and everything we've done. Its going to take us six months to get it implemented, so sometime between April and June we'll have a look forward, hopefully the situation will be a little more clear. If its no worse than it is now, what Don has put forward in terms of guidance suggests we've done everything we can do with a reasonable payback. If the situation is worse sometime in the third quarter, we have contingency plans, I would say 50% developed and we've got three to four months to finalize those for yet another round which of course we're hoping isn't necessary, but I think we'd be less than responsible as an executive management team if we didn't have those contingency plans in place. I'm going to let Jim talk about the continued operations -- on -- continued opportunities in cash flow primarily via SFS because as Don suggested, its -- working capital in general is a huge source of cash for us. We are not going to let up, and I am going to turn that one over to Jim.

Jim Loree - *The Stanley Works - COO & EVP*

Okay. Thank you, John. Well, I think first of all we could have done better than 5.9 turns had it not been for the precipitous volume decline, and so I think there is a calibration that can occur where we clearly believe that in '09, that we can do better than 5.9 turns, so starting with that I think that is relatively clear to us. As we get into north of -- 6 turns and north, it gets a little more murkier. We do know that we have great momentum. We do know that we have a business process transformation and not just a one-act play, and there is a lot of activity that is going on that is addressing the root cause of waste in the system, waste meaning trapped cash in this particular case that can be freed up. So, we internally believe that we can continue to improve working capital turns. In our peer group, somewhere between 6 and 7 is the best anybody has done. We expect and hope to do better, but we're not going out there and saying we can do it until we put the numbers on the table. That's how we've addressed this Stanley fulfillment system from day one. You'll note that we've never really gone out and said we're going to do this or we're going to do that, we just do it and then let the numbers speak for themselves.

James Lucas - *Janney Montgomery Scott - Analyst*

Okay. Thank you.

Kate White - *The Stanley Works - Director of IR*

Next question, Jennifer.

Operator

The next question comes from Peter Lisnic.

Peter Lisnic - *Robert W. Baird - Analyst*

Good morning, everyone.

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

Hey, Pete.

Peter Lisnic - *Robert W. Baird - Analyst*

Can you -- do you mind running through the security profitability? It was a very nice surprise relative to our expectations, and I'm just wondering can you maybe break it down a bit between acquisitions, convergent, and mechanical and kind of how the numbers flowed through for the individual businesses in the quarter?

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

Yes and no, Pete. There is a level of granularity that historically we've proven that providing it gives more information to more people than quite frankly we want to have out in the public domain. We'll say two things. Acquisitions contributed for two reasons. One they were positive and Brett's team did a really good job bringing them on board quickly and having them up and running as part of our business in absolute terms. Secondarily, we acquired, albeit at relatively high prices, we acquired some very high margin businesses with the equivalent to become even higher margined, when we started to realize the synergies, number one. Number two, their markets were not as adversely impacted as I suggested by some of the macroeconomic factors, so there was some reasonable organic growth. Third and last, offset by, as Jim touched on, on the mechanical side, the continued head wind from the loss of about $50 million annually or $12.5 million a quarter, of high margin hardware business. So, to summarize, great performance in convergent, both in terms of growth and margin enhancement and synergy achievement, solid performance in our mechanical side, somewhat offset by the volume in margin drag of hardware which, as Jim pointed out, has anniversaried, so we see some potential for some reasonable momentum in the mechanical segment going forward.

Peter Lisnic - *Robert W. Baird - Analyst*

Okay. I just -- I appreciate that answer, and I just wanted to fine tune my question a bit because what I am wondering is has the structural profitability of the convergent business improved, when you do take out the acquisitions that sort of mix up the margin?

Jim Loree - *The Stanley Works - COO & EVP*

Absolutely. I think what you basically have, when I talked earlier about the benefits of the reverse integration, that is what -- said another way, what's happened is we've taken the legacy systems integration business that we had before we bought HSM, and we've converted it to the HSM business model. Now, what that means is that recurring revenue has become an extremely important part of what -- first of all you can't distinguish between the two organizations any more. They become one. And secondly, the folks that use to do sell systems integration, which was basically installation are now selling -- monitoring in addition to their installation which in and of itself, drives higher gross margins and higher operating margins. And that's what's happening in the segment is basically the legacy operating margins have gone from mid-single digits up to double-digits and at the same time HSM brought in very high operating margin and Sonitrol, with the synergies, in addition to GDP, all mix up the operating and the gross margins.

Kate White - *The Stanley Works - Director of IR*

Next caller, Jennifer.

Operator

Your next question comes from Eric Bosshard.

Eric Bosshard - *Cleveland Research Company - Analyst*

Good morning. Two questions for you. First of all, the lack of providing 2009 guidance you attributed to the volatility. Can you just talk about where you see the greatest volatility or uncertainty in 2009 that's sort of pushing you to that decision?

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

I think, yes, Don provided the guidance obviously with unanimous agreement from Jim and me and others and a big piece of it of course is volume because we've had a 7% and 10% consecutive volume decline, so economically, numerically, that's the biggest piece, but, Don, why don't you address the first half of Eric's question.

Don Allen - *The Stanley Works - VP & CFO*

Yes, Eric, I think the volatility clearly is in the unit volume, and the difficulty of seeing out beyond a few months is very hard for many companies including us to see. And, you know, the performance we saw in the fourth quarter with our different segments where we had our CDIY and industrial segment having significant volume losses and those would be the ones that we would be most focused on, you know, what it would mean for them going forward into 2009. Obviously the security segment we want to monitor closely as well to ensure that there is no volume loss and impact there, but its the first two segments that we're really focused on going forward.

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

And Eric, so you don't get cut off and you get to ask your second question, let me just add, you know our business extraordinarily well. With the exception of some of our security business and our engineered storage solution business and hydraulics, these are very short cycle businesses, particularly CDIY and Bostitch and many of our smaller industrial tools business. I know you know and most of the people on the call, you know, understand that a major customer orders on Monday and we ship it on Wednesday, and that's, you know, we have our supply chains linked as well as we can, but simply said, the short cycle nature of those businesses and the recent history that's just so out of proportion with anything else we've ever seen is what causes, you know, let me say our lack of clarity into even short-term future. But you had a follow-up, I know.

Eric Bosshard - *Cleveland Research Company - Analyst*

Yes, the follow-up is in security, the flat organic performance in the fourth quarter is impressive. As you look at -- historically you've talked a little bit about the order book in that business, and can you just give us a little bit of sense of what that looks like and how we should even be thinking about that business in total for 2009 based on, sort of, indications and orders and quoting activity you're seeing now?

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

No. All we want to say, you know, although I'd argue we have probably better visibility into security than others, but we really don't want to be talking about order books on this call. Two things happened. Two things I will -- I think are appropriate and hopefully helpful. One is, a relatively small percentage of our security business, mechanical and convergent is based on new construction, smaller percentage than one might think. Second, regardless, I could give you a number for the order book, and it would not help you unless I were to give you more granularity than it is readily apparent because it could be a contract that Brett's business has won for a new hospital that's going to be constructed in December or it could be an installation at a retailer next week. So, the number itself, depending on when those projects are scheduled to be performed, you know, really wouldn't help you, but candidly its a fair question, but it's just not one we want to be talking about on an earnings call.

Kate White - *The Stanley Works - Director of IR*

Ready for the next question, Jennifer.

Operator

The next question comes from Sam Darkatsh.

Sam Darkatsh - *Raymond James - Analyst*

Good morning, John, Jim, Don, how are you?

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

(Inaudible), Sam.

Sam Darkatsh - *Raymond James - Analyst*

Three real quick questions. First off, your pricing in Q4 was up four, if I recall correctly it was up 3% in the third quarter. Does that imply that you had a -- perhaps a small round of price increases in the fourth quarter or was that a timing issue as to when the pricing went through in the third quarter? Was that mix? That was the first question. Second question would be, what are your trends you're seeing sell through versus sell-in? And the last question would be, I don't recall whether you said what convergent organic growth was? You mentioned what it overall was, but not organically. Those are my three questions .

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

Okay, well, let's address them in reverse order, how about that, although I think the limit is two questions isn't it. That's all right. We'll do all three. As far as the convergent organic growth, its very difficult to give an accurate number for the subsegment of convergent because the HSM acquisition and the -- all the -- all the acquisitions are mixed together, but as far as we can tell, we were up modestly -- up a point or two, something like that, nothing dramatic, but I wouldn't take that number to the bank and bet on it, but I think directionally its accurate.. The sell through, sell in, retailers in the United States were very judicious with their inventory management. If anything, they're average to slightly below average levels with their inventory at this point in time, so I think that bodes -- you know, our inventories are in good shape. Their inventories are in good shape. If we ever get stable stabilization in-housing prices, it could be very interesting in terms of volume, but we don't see that at this point in time -- or housing sales. Housing prices, we're beginning to see stabilization, and then the third question was --

Jim Loree - *The Stanley Works - COO & EVP*

Price.

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

Oh, yes, do you want to take it Jim.

Jim Loree - *The Stanley Works - COO & EVP*

Well, just simply said, Sam, very few pricing actions implemented in the fourth quarter. What you saw in the third quarter -- fourth quarter were actions taken in the second half of the year and reflected in Don's outlook is the fact that despite what's going on in materials markets, it took us awhile to get those prices. We do see some carry forward that is going to help us in the early parts of the year and of course it us in the early parts of the year and of course it should be clear as closely as you follow Stanley, what focus we place on price -- price realization through our COE and maintaining those prices as long as we can because it took us three to six months to get them despite 88% recovery. So, its important that we don't -- that they don't decline up faster than it took us to realize them. And that's the positive lift, but its much more carry over than it is new actions.

Kate White - *The Stanley Works - Director of IR*

The next question, Jennifer.

Operator

The next question comes from Nigel Coe.

Nigel Coe - *Deutsche Bank - Analyst*

Yes, thanks. Good morning. Inventories was obviously a fantastic story during the quarter, particularly when you think about the price inflation within those inventories. What impact did that have on the margins year-on-year?

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

The impact of the price inflation arbitrage, is that what -- ?

Nigel Coe - *Deutsche Bank - Analyst*

No, no, its Inventory reduction.

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

Oh, inventory reduction. Well, (inaudible) to see exact impact on margin year-over-year is difficult to assess, but certainly as you lower your volumes, you lower your inventory, you definitely get a negative impact to your margin rate, and it can -- you know its certainly part of the, kind of assumptions we gave you for '09 related to the volume impact. As far as inventories, I would say that it was not a huge impact in 2008, but it did have a slight negative impact to us.

Nigel Coe - *Deutsche Bank - Analyst*

Okay. And then just follow on as well, I think S&P announced last week their putting you on -- you know, reviewing the rating. Can you just confirm there'd be no impact from losing a notch or two of your rating?

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

Well, last I heard is it was Moody's and not S&P, and what they did was they put us under review for possible down grade, from wherever -- you know, single A, wherever we are at this point in time. That is about a several-month process where we have the opportunity to go talk to them and explain our situation in more detail, and then have a discussion with them about what we might do prospectively if they have continuing concerns after that and we'll see how that plays out, so there is nothing that is cast in concrete at this point in time. It clearly is a possibility. We don't see why it makes sense. However, we want to talk to them and get their prospective on it.

Operator

Your next question comes from Seth Weber.

Seth Weber - *BAS-ML - Analyst*

Hello, good morning. Can we go -- just go back to the security margin and acquisition question again for a second? Do these acquisitions that you made, do they change the season that the -- you know, the historical seasonality that we've seen in the margin in that business, you know, where fourth quarter is typically lower?

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

A little bit. You'll recall there were two things, and what it will do is somewhat -- is partially mitigate it. The two things historically driving the large swings in margins, 200 to 400 basis points in a quarter, where second and third quarters were historically higher than fourth and first quarters, were primarily in our mechanical securities segment. Those seasonality elements still exist which is one reason we're not providing margin by subsegment within subsegment because its more information than anybody can realistically or practically use, but we do a tremendous amount of mechanical locking business on University campuses. We normally do that when University students are not there. Those tend to be the months of June and July which tend to be -- well, which are in the second and third quarter, and that's very good, incremental high margin business which inflates second and third quarter at the expense if you will, of first and fourth quarter. The second issue is on installs which relates primarily to our excess technologies business, secondarily to some of our monitoring and other businesses where we encounter site readiness issues in the first and fourth quarter where we show up to put in a door and the concrete hasn't been pored because of a snowstorm or because of rains in the southwest or something of that nature. Again, so we get some unanticipated and difficult to plan volume reductions, weather related in the first and fourth quarter which are rarely an issue in the second and third calendar quarters. Because HSM, Sonitrol, GTP have added meaningful revenue and they've added it in convergent and they are less susceptible to site readiness issues and slightly less involved in particularly University campus installations, although they do do some of that, that seasonality will be partially mitigated, but it will not disappear.

Seth Weber - *BAS-ML - Analyst*

Okay. Great. That's helpful. Thank you. And if we could go just flip over to the other two business segments, I think last -- on the call last quarter you talked about a new fairly large contract or some sort of award that you won on the CDIY business. Did that weigh on the margin at all in the quarter? And then my follow-up question would be, I think -- Jim you had mentioned that you kind of hope the CDIY margins have bottomed here. You didn't make that same comment on industrial. Do you think industrial margins could yet still go down further?

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

Yes, we -- as a policy we don't name customers names on this call, but the contract we won is encouraging. There was little impact in the fourth quarter although what impact was there was positive, and it will offset some of the head winds going forward in the first quarter on the CDIY business. Jim, do you want to take the second half?

Jim Loree - *The Stanley Works - COO & EVP*

Yes. I mean, I think there is a number of things that are going to occur within industrial -- that might occur within industrial that could move the margins down a little bit, probably not precipitously from here. On the other hand, they could go up, so its a little bit of the same kind of issue that we have relative to guidance, the big $64,000 question is what's unit volume going to do and what's the economy going to do? And clearly there's a healthy dose of fixed costs in the industrial business, perhaps -- not perhaps, definitely as much as anywhere from a manufacturing perspective in the plant system, and so there is a significant absorption issue in this segment when volume goes down by the same token you know, get benefits when it goes up. So, didn't really -- I can't give you a specific answer per se, although I will say that the unit volume declines that the company has experienced over the last two quarters are unprecedented. We have not -- looking back all the way to the 70s, we have not ever had two quarters where the unit volume declines were greater than 7% for two consecutive quarters, so now we have had that for the first time and so we're now in uncharted territories. We expect as we indicated in our documentation we expect that we'll have similar unit volume performance in the first quarter that we had in the fourth. That would be three consecutive quarters -- that's difficult for me to imagine that this could go on at this level for an extended period of time. However, we have to prepare for the possibility that it could, and we are preparing for that possibility although we don't expect it to occur. If we had a dramatic further drop in volume in industrial, yes, they could go down further. And yes, we would take action.

Kate White - *The Stanley Works - Director of IR*

Next question, Jennifer, please.

Operator

The next question comes from Michael Rehaut.

Michael Rehaut - *JP Morgan - Analyst*

Hello. Thanks, everyone. First question, just on volume, when you did the pre-release about a month ago, you indicated expectation for volume down 12% to 14% and it came in a bit better than that. But, you also at the same time in the '09 sort of guidelines kind of, you know, took the range a little bit lower I guess being a little bit more cautious or conservative there in terms of first negative 10, you kind of went to negative 10 to 12. Just wanted to know if there was anything that occurred, I guess, in the December month that caused the 4Q volume decline to be a bit better than initial guidance, and if, you know, that had anything to do with a little more conservative take, you know, in the '09 guidelines?

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

Yes. I mean, simply said, December ended a little better than we had anticipated given where our order books stood on December 11 when we did a pre-release. The teams did a nice job shipping what we had on order at the same time as Jim demonstrated quite -- quite well, we're not -- we did nothing to pull any business forward. We worked hard on balancing production with demand and as a consequence the last two weeks of December were a little better than we anticipated that they might be, and as a consequence we said it wasn't our intent but to the extent any of that came out of the first quarter -- the first quarter could be a little softer. As I know you're acutely aware the home centers and all large retailers given that they're fiscal years end January 31, the month of January is a very, very difficult month to project business, and its not even always a good indicator of the quarter. Specifically, its the -- the way the business models work, orders tend to be light as do shipments in the month of January, and quite often the lighter they are in January the better they are in February and March thus making first quarter a relatively normal quarter in terms of volume. Given the tremendous uncertainty out there right now, it makes it even more difficult to project December actuals in January orders into a first quarter number so, simply said we've changed nothing, Mike, from the long-term perspective. December was a little better. We said if that unintentionally came out of the first quarter of the year, it might be a little worse.

Michael Rehaut - *JP Morgan - Analyst*

Okay. I appreciate that. And you know, I guess the second question -- well, first just a follow-onto that. Where was it a little bit better in December than you anticipated and I just don't want to get cut off in terms of my actual second question, but any type of comments you can give in terms of pension expense expected in '09, versus '08, given the declines in the equity markets and you know, to the extent that you can help us in terms of your thinking for budgeting there?

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

Yes, thats fine, because I think its a relevant question and because its a non-issue for Stanley, I'm glad you asked it and its one that Don will address. In terms of the volume, you know, quite frankly, it was better literally across -- across the board. Both security business finished strong, our CDIY segment did not finish as weakly as we'd anticipated and there were, as you know, our industrial segment is a very large diverse portfolio of businesses, some a little up, some a little down. But, simply said, it was across the board with convergence and mechanical security finishing strong. Neither Bostitch or Consumer Tools and Storage finished strong, but they weren't quite as weak as we'd anticipated and mixed results across our industrial portfolio. Don, you want to talk a little bit about pension expense?

Don Allen - *The Stanley Works - VP & CFO*

Sure, yes, you know as you are probably aware, you know, pension expense is not a big number for Stanley works. We don't have many defined contribution plans which would drive a lot of pension expense, I am sorry, we don't have defined benefit plans. We have a lot of defined contribution plans. And as a result, we don't expect our pension expense to go up much at all in 2009, could be a modest increase. But, the overall number is relatively immaterial to the company and the the increase would follow that same lag.

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

And as a consequence that's probably nothing you need to adjust existing models for.

Kate White - *The Stanley Works - Director of IR*

Last question, Jennifer.

Operator

Your last question is from Kenneth Zenner.

Kenneth Zenner - - *Analyst*

Good morning.

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

Good morning, Ken.

Kenneth Zenner - - *Analyst*

Just looking at security and the convergence side of that business, I think about 30% of that business currently is recurring revenue. Given the backward integration that you're having in HSM and the likelihood that installs will fall at a greater rate than recurring revenue I assume, can you talk about where that might go in terms of some level of sensitivity if your install slides down, could that convergence get to 40% plus of recurring revenue?

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

Well, first of all, convergent recurring mix in convergent is about 40%, not 30%, and at the moment we're not expecting a significant contraction in the installs nor are we experiencing one. If it were to occur, basically the profit margin on install is considerably less than it is on the recurring revenue. I mean you're talking about gross margins that are double on a rate basis on the recurring side, so its not going to -- it is not going to have a dramatic impact because it will, you know the -- it will have some negative impact if we had a big dive in installations but not a dramatic impact because the mix -- the rate mix would go up. It would have a longer term impact for sure because that stream of recurring revenue over time would be affected by lower installs, so that's really the dynamic there.

Kenneth Zenner - - *Analyst*

Great. And that 40% (inaudible) that includes the recent French acquisition I assume?

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

Includes everything, yes.

Jim Loree - *The Stanley Works - COO & EVP*

Includes everything, all in Brett's convergence business as we reported.

Kate White - *The Stanley Works - Director of IR*

Thank you very much, everybody for your participation today. Again, if you have any questions please call Corbin Wahlburger or myself our contact information is both in the press release and on the web site. And have a wonderful day. Thank you.

Operator

This does conclude today's conference call. You may now disconnect.
