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SWK - Q3 2017 Stanley Black & Decker Inc Earnings Call

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OVERVIEW:

SWK reported 3Q17 adjusted diluted EPS of $1.95. Expects 2017 adjusted EPS to be $7.33-7.43.

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PRESENTATION

Operator

Welcome to the Third Quarter 2017 Stanley Black & Decker Earnings Conference Call. My name is Shannon, and I'll be the operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to the Vice President of Investor Relations, Dennis Lange. Mr. Lange, you may begin.

Dennis Lange - *Stanley Black & Decker, Inc. - VP of IR*

Thank you, Shannon. Good morning, everyone, and thanks for joining us for Stanley Black & Decker's Third Quarter 2017 Conference Call. On the call, in addition to myself, is: Jim Loree, President and CEO; Don Allan, Executive Vice President and CFO; and Jeff Ansell, Executive Vice President and President of Global Tools & Storage.

Our earnings release, which was issued earlier this morning, and a supplemental presentation, which we will refer to on the call, are available on the IR section of the website. A replay of this morning's call will also be available beginning at 2:00 p.m. today. The replay number and the access code are in our press release.

This morning, Jim, Don and Jeff will review our third quarter 2017 results and various other matters, followed by a Q&A session. (Operator Instructions) And as we normally do, we will be making some forward-looking statements during the 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's, therefore, possible that actual results may materially differ from any forward-looking statements that we may make today. We direct you to the cautionary statements in the 8-K that we filed with our press release and our most recent '34 Act filing.

I'll now turn the call over to our President and CEO, Jim Loree.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Thanks, Dennis. Good morning, everyone, and thank you for joining us. As you saw from this morning's release, we delivered a strong third quarter, continuing our track record of solid execution. In fact, this is the 16th consecutive quarter where we have met or exceeded expectations.

Tools & Storage and Industrial led the way, once again contributing to a robust organic growth performance, which was 7% for the quarter. Total company revenue growth came in at 14%, with acquisitions delivering 9 points of growth, which excludes the offset from the impact of the Mechanical Security divestiture.

Tools & Storage delivered 22% total growth, including 9% organic. All regions contributed to the continued growth in share gains of this franchise. And of note was the acceleration within emerging markets, which produced 16% organic growth in the quarter and mid-teens growth in all 3 regions: Latin America, Asia and the rest of the emerging world.

The tools folks are executing superbly by leveraging our SFS 2.0 operating system to deliver core and breakthrough innovation with operating margin expansion, at the same time integrating the Lenox, Irwin and Craftsman brands into our portfolio. This was an outstanding effort by Jeff Ansell and the entire Tools & Storage team. Jeff, as mentioned, is with us today on the call and will be providing some more color. And looking forward, we expect to benefit from a series of growth catalysts in tools, including DC brushless, FLEXVOLT, the Newell Tools acquisition and beginning in mid-2018, the Craftsman brand.

The Industrial segment delivered a significant outperformance for the quarter, continuing its 2017 trend of strong results. Organic growth at 8% was impressive. And in Engineered Fastening, we continue to see robust automotive system sales in addition to higher Industrial volumes, which supported 6% organic growth for the quarter. Our Infrastructure businesses delivered 15% organic growth, an outstanding performance, as commercial actions plus positive underlying markets benefited both project and inspection activity within Oil & Gas and expanded Hydraulic Tools volumes.

Our total company operating margin rate remained healthy at 15.3%, excluding M&A-related charges, a 10 basis point expansion versus the third quarter of 2016. We continue to focus on investing in future growth while generating meaningful operating leverage. In this vein, productivity execution and other cost actions enabled us to offset increasing commodity inflation while expanding our gross margin rate by 60 basis points. The strong innovation-fueled growth positioned us to continue to make a series of targeted investments to support future innovation, growth and margin expansion.

Diluted adjusted EPS for the quarter was $1.95, 16% above prior year, reflecting strong operational execution. So I want to thank our teams around the globe for their dedication and results-driven work that produced this great quarter and year-to-date performance. And based on the above-market organic growth and our confidence in the outlook for the balance of the year, we're once again raising the midpoint of our previous 2017 full year adjusted EPS guidance, this time by $0.10 with a new range of $7.33 to $7.43 or between 13% to 14% growth.

And now I'll turn to an update on the acquisitions of the Lenox and Irwin businesses as well as the Craftsman brand. In a nutshell, we remain at or ahead of our expectations both from a financial and integration execution perspective.

Specific to Newell Tools, we continue to execute on our plans to integrate employees, suppliers and customers into our existing operations. We remain focused on and confident in our ability to capture the $80 million to $90 million of cost synergies associated with this transaction. We're deploying core SFS principles into production facilities and are in the late stages of moving order fulfillment into our own distribution centers. We're happy to report that our actions to improve customer service levels across the Lenox and Irwin product lines have been successful, and we are now experiencing fill rates commensurate with the strong performance of our legacy brands across the portfolio. In addition, our commercial teams around the world are building detailed plans to support future revenue synergies. And we remain optimistic that a meaningful contribution in that area is achievable in 2018 and beyond.

Now turning to Craftsman. We are hard at work bringing our vision for this great brand to life. We continue to make progress on Craftsman product development, supply chain deployment and commercial strategy. We have now extracted all of our Craftsman supplier management activities from Sears and are fulfilling orders through a new distribution center in Charlotte. Importantly, in the last few weeks, we reached agreement with a major U.S. retailer on a program which features the 2018 rollout for the new Craftsman brand. Jeff will provide more color on this in a few minutes. We are excited about the opportunity ahead as we re-Americanize this iconic brand and are looking forward to it coming to life beginning in mid-2018.

So as you can tell, there is a growing momentum and continued enthusiasm for both of these transactions as catalysts. And we continue to find ways to deliver significant sustained value to our customers and in turn our shareholders. And I'll now turn it over to Don for a more detailed review of the third quarter results.

Donald Allan - *Stanley Black & Decker, Inc. - CFO and EVP*

Thank you, Jim, and good morning, everyone. I will now take a deeper dive into the results of our business segments, which enabled the company to deliver another outstanding performance in the third quarter.

Starting with Tools & Storage. Revenues were up 22% in the quarter as 9% organic growth, 13 points of acquisitive growth and 1 point of currency combined to more than offset 1 point impact from divestitures. Pricing was slightly positive for the quarter. The operating margin for this segment was robust at 17.8% as benefits of volume leverage and productivity more than offset growth investments and commodity inflation, yielding a 40 basis point rate expansion versus the prior year.

Importantly, the organic growth and related share gains were experienced across each Tools & Storage region and SBU. On a geographic basis, North America was up 9% organically with strong performances across all channels. U.S. commercial and retail channels posted high single-digit growth while our industrial and auto repair markets generated mid-single-digit growth.

Additionally, Canada contributed solid organic growth of 10%. North America's growth continued to be fueled by new product introductions across the portfolio and strong commercial execution. POS was up low double digits while inventory within our major customers was in line to slightly below prior year levels, giving us confidence that the strong sell-in was supported by strong underlying demand.

Europe delivered another solid performance with 5% organic growth. 9 out of the 10 markets grew organically with double-digit performances in Iberia and Central Europe and solid mid-single-digit performances in the U.K. and France. The team continues to leverage our portfolio of brands and expand our retail relationships to produce sustained above-market organic growth.

Finally, as Jim mentioned, the emerging markets delivered an outstanding 16% organic growth with mid-teens growth across all regions, diligent pricing actions as well as the ongoing MPP launch across the developing markets continued to support growth. We continue to see the e-commerce channel increase its share of the market and become a larger contributor to the business. Latin America was very strong, headlined by double-digit growth in Brazil, Argentina, Ecuador and Peru while Mexico and Chile delivered high single-digit results.

In emerging markets outside of Latin America, we experienced strong performances as well. For instance, our change to a direct selling model within Turkey and Russia are now paying dividends as both delivered exceptional growth within the quarter. Also India and China posted double-digit growth in Q3. This emerging market performance is quite impressive considering the team overcame challenges relating to natural disasters and geopolitical events yet still delivered broad-based share gains in the quarter.

Within the Tools & Storage SBUs, all lines demonstrated positive growth in the quarter. The power tool and equipment growth was up 10%, led by professional power tools as well as continued strength from the outdoor segment. This SBU also benefited from new product introductions, reflecting core innovation and FLEXVOLT and combined with strong commercial execution.

Regarding FLEXVOLT, this breakthrough innovation continues to deliver growth aligned with our expectations. Based on year-to-date sales and new product launches, we remain confident in our ability to deliver revenues approaching $300 million in 2017 as we discussed last quarter. We believe the impact of cannibalization on our corded products has been minimal and the program has carried positive benefits across the DEWALT brand. This is evidenced by above-market growth on our corded products as well as our base 20-volt system. This bodes well for the tool team's ability to deliver ongoing share gains.

Our hand tool, accessories and storage organization generated 7% growth on new product introductions while benefiting from strong performances within the construction and industrial end markets. This team continues to deliver a stream of core innovation while leading the integration activity for our Lenox, Irwin and Craftsman brands. So in summary, an outstanding quarter for the Tools & Storage organization, continuing its momentum by delivering solid above-market organic growth, along with operating margin expansion of 40 basis points, an outstanding quarter.

Turning to the Industrial segment, which had another impressive quarter of outperformance as well, as both the Engineered Fastening and Infrastructure businesses delivered strong organic growth well in excess of our expectations. This top line performance contributed to 120 basis point expansion in operating margin rate, which was driven from volume leverage, productivity and cost control.

Engineered Fastening posted 6% organic growth during the quarter, fueled by strong automotive and industrial results, up low double digits and mid-single digits, respectively. Within automotive, growth was led by higher-than-expected system shipments to support new model launches, primarily in Europe and Asia. Spare system orders were also stronger-than-expected, driving the overall automotive outperformance. Then auto fasteners sales delivered content gains and outpaced light vehicle production by approximately 500 basis points, which was better than our long-term assumption of approximately 300 to 400 basis points of growth ahead of this type of production. Finally, industrial fastener growth reflected positive market conditions and enhanced commercial actions with our Industrial-focused customers.

Moving to the Infrastructure businesses. They posted a solid quarter, up 15% organically. Hydraulic Tools grew 37% as it continues to see the benefits from the execution of successful commercial actions as well as an improved market environment. This performance reflects commercial excellence in action as all regions contributed to the business' fourth consecutive and highest quarter of organic growth. Meanwhile, Oil & Gas generated 8% organic growth in the quarter, driven by onshore pipeline project extensions in North America and increased global inspection activities. The inspection business continues to outperform as the team's commercial efforts have grown this business over 60% organically year-to-date. All of these activities more than offset a continued and expected decline in the offshore project activity.

Finally, the Security segment delivered flat organic growth for the third quarter as gains in Europe were offset by a decline in North America. Europe organic growth was up 1% as strength in the Nordics and the U.K. were offset by anticipated ongoing weakness in France. North America organic growth was down 1% as strong health care-related growth was more than offset by the impact of customer-directed project delays and hurricane disruptions within the commercial electronic security business. The impact of these external headwinds approximated 3 points of organic growth for the North American business. Our expectation is that these are timing issues which will resolve themselves over the coming quarters.

In terms of the profitability, the segment declined 240 basis points year-over-year. The sale of the mechanical locks business drove approximately 100 basis points of this contraction. The remaining 140 basis point decline was attributable to the previously mentioned customer-driven project delays and modest levels of investment to support long-term growth. The Security team remains focused on innovation, along with commercial and operational effectiveness, to position the business for future revenue growth and margin expansion.

Let's take a look at the quarter's free cash flow performance on the next page. For the third quarter, free cash flow was $266 million, which brings our year-to-date performance to $190 million. The lower year-to-date results compared to the prior year relate primarily to higher levels of working capital required to service the stronger organic growth we are experiencing, particularly within the Tools & Storage business. From a working capital turn perspective, we delivered 6.4 turns in the third quarter, a decrease of 0.7 turns versus the prior year. This decline reflects the impact of our recent portfolio activity, specifically the acquisition of the Lenox, Irwin and Craftsman brands. Excluding acquisitions and divestitures, turns were flat versus the prior year.

We remain confident in our ability to deliver strong cash flow in the fourth quarter, given our core SFS principles and focused execution on reducing working capital levels in line with Q4's seasonal activity. For those that have followed our business for the past several years, you know that the fourth quarter Tools & Storage seasonality dynamic is a regular occurrence, given the timing of the sales and the collections that occur within the quarter.

We expect by the end of 2017 that we will deliver a 2.5 working capital turn improvement, up from the 6.4 turns reported this quarter. This working capital result will generate $575 million of cash flow benefit in Q4, which will enable us to approximate and approach 100% free cash flow conversion. As a note, this conversion rate excludes the net gain from divestitures.

So now let's turn to our 2017 guidance on the next slide. As Jim mentioned earlier, we are raising the 2017 adjusted EPS midpoint by $0.10 and tightening the outlook range. Therefore, our revised guidance range is $7.33 to $7.43, which is an increase of 13% to 14% versus prior year. On a GAAP basis, this results in $8.20 to $8.30 earnings per share, which is inclusive of various onetime charges and the gains and losses on sales of businesses. The increase to our outlook range is primarily the result of higher organic growth, now approaching 6% for the full year, offset partially by increased other net expenses primarily related to foreign exchange losses on certain balance sheet positions caused by the recent volatility in currency markets.

Turning to the segment outlook on the right side of the page. Organic growth within Tools & Storage is now expected to be high single digits, given the solid year-to-date performance and outlook for the fourth quarter. We expect healthy construction markets in the U.S., combined with continued stable European and emerging market environments, to continue for the balance of the year. We believe that top line growth will translate into an improved margin rate year-over-year as well.

We are maintaining the organic growth view on Security, up low single digits in 2017. The margin rate for this segment will be down year-over-year due to the divestiture of the mechanical locks business, which occurred during the first quarter, along with the impacts of mix, both geographic and customer mix, as well as growth investments.

Finally, in the Industrial segment, we expect organic growth to be up mid-single digits, modestly higher than our previous expectation. While we did see outperformance in both Engineered Fastening and Infrastructure again in Q3, there are market-related pressures which will impact the fourth quarter. These pressures fall into 3 primary categories: the first, declining North America light vehicle production; second, less automotive system sales due to lower new model introductions; and three, expectations for lower North American Oil & Gas project activity in the fourth quarter. We continue to expect operating margins within the Industrial segment to improve for the entire year, which will reflect the solid year-to-date performance.

So in summary, we believe we have a solid path to deliver the full year revised guidance, which contemplates continued above-market organic growth and margin expansion while our businesses remain focused on working capital turns improvement in Q4 and acquisition integration. We also believe we are taking the appropriate actions to position the company for earnings growth, margin expansion and strong cash flow in 2018, consistent with our long-term financial objectives.

With that, I would like to turn the call over to Jeff for a brief update on Tools & Storage and some exciting news related to Craftsman.

Jeffery D. Ansell - *Stanley Black & Decker, Inc. - EVP of Global Tools & Storage and President of Global Tools & Storage*

Thank you, Don. 2017 is shaping up to be a strong year for Global Tools & Storage. We've delivered organic growth in every region, every strategic business unit and with all of our top customers. In fact, we've received vendor awards from more than 10 of our largest customers this year. Our brands continue to perform well on a global basis with brands like Black & Decker, Stanley, Porter Cable and Mac Tools all up single digits while brands like Proto, Vidmar and DEWALT all grew double digits.

Innovation is a clear differentiator. Using DEWALT as an example, we posted 3% growth this year in the declining corded power tool market simply based upon our Made in the U.S.A. strategy. Add to this, over 20% year-to-date growth in our world's largest and best 20-volt cordless range, which continues to expand with our core innovation focus, finally add over 100% growth in our technologically superior FLEXVOLT range. All in all, it's a formidable share gain machine from top to bottom as demonstrated by at least a 2x market POS growth. All of this has occurred concurrent with the integration of the second and fourth largest acquisitions in our company's history, namely Irwin, Lenox and Craftsman brands.

With this as a backdrop, I am pleased to provide an update on an initiative that will be a catalyst for further organic growth relating to the Craftsman brand. Over the past 6 months, we built a completely dedicated team to bring our vision of a new re-Americanized Craftsman to life. This team is responsible for the development of a best-ever Craftsman product pipeline to reinvigorate the iconic Craftsman brand. As Jim mentioned earlier, we continue to make great progress on Craftsman product development, supply chain deployment and commercial strategy, which includes the full support of Ace Hardware through their 2,800 stores supporting Craftsman.

Today, we are also pleased to announce that we will roll out the Craftsman brand in the second half of 2018 with Lowe's in the home center channel. We have been more than impressed with the level of commitment and support afforded by Lowe's for the Craftsman brand. We continue working with other channel partners to continue to provide them with successful programs to facilitate their growth as well.

With this said, I'd like to turn the call back over to Jim to wrap up today's presentation.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Thank you, Jeff. Another extraordinarily strong quarter for Tools & Storage and an exciting development in connection with the Craftsman brand. To recap, for the total company, we delivered strong third quarter results, maintaining our trend of above-market organic growth and robust operating margin performance.

Facilitated by our continued strong operating results, we increased EPS guidance for the year, excluding charges and a gain on the sale of Mechanical Security. We upped guidance to $7.38 at the midpoint, a 13% increase over the prior year. And we continue to be excited about the opportunities to deliver value from our recent acquisitions. And as I mentioned earlier, both the Newell Tools and Craftsman brand integrations remain on track and the experienced integration teams are energized to deliver our financial and customer commitments.

Our deep and agile leadership team, along with our entire employee base, are focused on closing out 2017 with a good setup to 2018, leveraging our SFS 2.0 operating system to deliver strong free cash flow, organic growth with earnings leverage and continuing to successfully integrate the Lenox, Irwin and Craftsman brands into our portfolio. We're encouraged by our results thus far in 2017 as we continue to position the company for a strong 2018.

A little over 1 year into the role as CEO, I could not be more pleased with the energy and enthusiasm from the team as we remain focused on delivering top quartile performance, becoming known as one of the world's great innovators and demonstrating our commitment to social responsibility. These are all enablers to achieve our 22/22 Vision and to be a great human-centered diversified industrial company.

And on a final note, I would like to thank Greg Waybright for his many years of dedicated service as our VP of IR. He is retiring at the end of this month to be succeeded by the very capable Dennis Lange. All the best, Greg, in your retirement. And we're now ready for Q&A.

Dennis Lange - *Stanley Black & Decker, Inc. - VP of IR*

Shannon, we can now open the call for Q&A, please. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jeff Sprague with Vertical Research.

Jeffrey Todd Sprague - *Vertical Research Partners, LLC - Founder and Managing Partner*

Just looking for a little bit more detail on Craftsman, if you could share it, if you have any preliminary thoughts on what channel fill or year 1 revenue could look like. And also I think you were planning on marrying this with the Craftsman-specific e-commerce strategy. And I wonder if you have fleshed that out any more yet.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

So the advantage of being able to talk about Craftsman at the level we did is that it enables our partner, Lowe's, to be able to report what could be a material item to their -- in connection with their releases and so forth. It really -- we would have preferred actually not to have to disclose as much as we actually did right now, just from the standpoint of competitive intelligence protection of our competitive strategy and so forth. So it makes it very difficult to go into too much more detail. But with that, I will turn it over to Jeff. And he will give you whatever else he can.

Jeffery D. Ansell - *Stanley Black & Decker, Inc. - EVP of Global Tools & Storage and President of Global Tools & Storage*

Thanks, Jim. I guess the view would be Craftsman is a broad-based brand across North America, plays across so many categories and channels. And given that we serve every geography, well over 50,000 discrete customers, we're very proud to announce this partnership with Lowe's in the home center channel. We are concurrently working through the commercial process across other channels, which includes e-commerce. And we do well know that Craftsman is the #1 searched term in the e-commerce space. It also is a great brand across the MRO spaces, et cetera. So a lot of good work to be done, as Jim reported. We announced everything we could at this point, but Craftsman continues to be a good opportunity across many different customers and channels.

Operator

Our next question comes from Nigel Coe with Morgan Stanley.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Greg, congratulations. Hey, I just want to say Greg has been -- was one of the best IRs and big loss. But Dennis is awesome, so I think you're good. So just want to clarify your FLEXVOLT cannibalization. I think you previously said $300 million of growth, $200 million net. Are we now closer to $300 million net for the year? So if you can just clarify that. My question is really on just to follow up on Jeff's point on Craftsman. I think your original kind of plan was for 2020 sales of $300 million to $400 million for Craftsman. Given the conversations you've had with your e-commerce and big-box partner, where do we stand there now? I'm assuming it's higher than that, but any sense there would be helpful.

Donald Allan - *Stanley Black & Decker, Inc. - CFO and EVP*

Well, I'll start with FLEXVOLT, and then kick over the Craftsman question to Jeff. But FLEXVOLT, as I indicated, we're approaching $300 million for the full year of 2017. We do not believe we're seeing very much cannibalization. I said minimal, probably minimal close to 0. And therefore, from that perspective, the net number would be $300 million. Jeff?

Jeffery D. Ansell - *Stanley Black & Decker, Inc. - EVP of Global Tools & Storage and President of Global Tools & Storage*

In regards to Craftsman, second question was -- I guess, at this point, there's so much work yet to be done. We've built a dedicated team of well over 100 folks to do the really good work of building out, as we call it, a re-Americanized best-ever Craftsman platform. And what that means is we're starting with a parcel of land overlooking the ocean with no structure on it, okay, as an example. So, so much work to be done. But the great news is you take a 90-year emotionally charged brand like Craftsman and you can build it from the ground-up, very rarely do you have that opportunity. So there is so much to be done with thousands of products in development that I think that 2018 looks like really a labor of love to us at this point with much great work to be done. But we remain on track probably for the second half of next year. And we feel really confident about the guidance we've previously presented around Craftsman growth.

Operator

Our next question comes from Ken Zener with KeyBanc.

Kenneth Robinson Zener - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

We'd recently done a piece on the tool industry noting the consolidation of brands over the last 30-plus years. And obviously, we think you're well positioned within that environment. Given the success that the Black & Decker merger ultimately provided, your high margins to hand tools indicates that's still an upward trajectory, it appears. And now Craftsman, when I walk into my Ace Hardware, it's pretty much just you all. And with Lenox and Irwin, I mean, you're now into that accessories business, which is very -- well, it's been very opaque and now it's consolidated. What do you think your appetite is for bringing in perhaps another power brand into your portfolio as you look to move into gas. I think you touched on at the Investor Day. Do you have the brands to get into gas today?

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Yes. So let me just sort of circle back and talk about what our strategy is from an M&A perspective, and then I think that will help put things in context. So the first element of our strategy is protect the core. And I think you've seen as assets have become available, quality assets in the tool business, which is part of a significant, really most significant part of our core, we have been agile and made some moves that have been designed to not only protect but also enhance the core. And I think one of the things that's hard for people to understand, and I think maybe you got a little bit of it from listening to Jeff, is the absolute amount of effort that goes into integrating something like -- even like a Lenox or an Irwin. But when you talk about Craftsman, starting from literally nothing more than a brand, a history and 3 people, which is what we got with that, that is an enormous undertaking. And we're so pleased with the progress that we're making along the way here to do the design work and the supply chain work and the commercialization and so forth. But it is very consuming for the organization. And I have never seen, including at the time that we integrated Black & Decker and Stanley, I have never seen the organization work so hard, so diligently and produce so much. And so right now, it's almost impossible to imagine until we get further on down the pike, probably another year, 1.5 years, something like that, when the organization has more bandwidth to think about doing something else in tools, whether it be Lawn & Garden, which has now become essentially part of the core as a result of the Craftsman acquisition, or whether it be some of the other assets that might be out there and available in the future. And then so the second part of our strategy is really to make sure that we continue our progress to invest in some other areas outside of tools that are also parts of our core, important parts of our core, so things, areas such as Industrial and in Security. And we fully intend to be feeding those segments or those businesses, franchises with capital and allocate the acquisition capital into those segments where it makes sense. And so one of the nice advantages of being a diversified industrial company is that it enables us to direct capital in different parts of the portfolio based on availability of assets but also bandwidth of the organization and financial capacity of the company to absorb. So I hope that's helpful. But I think it basically says that it will be a while before we endeavor into something like Lawn & Garden or some other tool areas.

Operator

Our next question comes from Rich Kwas with Wells Fargo Securities.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Best wishes, Greg, and Dennis, look forward to continue to work with you. Just on Craftsman, as we think about the next couple years with limited detail around revenue contribution, et cetera, no detail around revenue contribution, but as we think big picture on incrementals for Tools & Storage, should we think about a dampening effect at least in the initial year or so of the launch because of cost and integration, et cetera, and

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getting us up to speed from a marketing standpoint? And just broad, Don or Jim, around how we should view incrementals over the next 12 to 18 months within the segment?

Donald Allan - *Stanley Black & Decker, Inc. - CFO and EVP*

Sure, I'll take that, Rich. It's a very good question and a good point. As Jeff and Jim both articulated very well, we're incredibly excited about this relationship. And it's one of the many steps as we continue to build out the plan for Craftsman. But as we enter into the execution of Craftsman, it will clearly be margins that will be below line average initially for various different reasons. We will not be manufacturing a lot of the product initially. We'll be using a sourcing model in the first year or 2, then we'll begin to ramp up manufacturing in that same time frame. That will help margins and continue to improve them. We'll also have launch costs like we do with all major initiatives that will pressure margins as well. So we don't think it will be a major dampening impact on the tools margin. But it certainly will have a modest negative impact in 2018 and likely at least the first half of 2019, if not the full year of 2019. Difficult to quantify the impact at this stage as we're still working through, as Jeff mentioned, exactly how the launch and the timing and what products will go in with Lowe's and other customers still to be determined. But over time, we'll provide more clarity as we get deeper into providing guidance for 2018 and then further into 2018 throughout the year.

Operator

Our next question comes from Josh Pokrzywinski with Wolfe Research.

Joshua Charles Pokrzywinski - *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

Just on the Lowe's launch, I'm trying to dig in here on maybe some of the opportunity set in ring-fencing that $300 million to $400 million target you have a couple of years out. Given that I think DIY U.S. for you guys and individual big-box retailer would be something north of $1 billion, one would think that just given some of the limited overlap, particularly on Lawn & Garden, that you could have a pretty big number initially just with channel sale. I mean, is that an unfair way to think about it? Or is the price point come much lower in Lawn & Garden versus power tools that if shifts occur -- I guess I'm surprised that, that number might not be biased to the upside, just given the magnitude of even one big DIY launch.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

I mean, I think Jeff said it all, is that it's early days here and the amount of specifics, even as it relates to the Lowe's conversations, are TBD in terms of a lot of work still to be done. So it's hard to really come out and answer that question with anything specific, other than to say that when we put the $1 billion over 10 years out there on the -- when we announced the acquisition and when we -- when our board approved the acquisition on that basis, we really didn't really fully know how the customer conversations would evolve. So I think it's fair to say that we felt we were being conservative when we put those numbers on the table. But as it relates to the time frame, the profitability, the ramp, all these types of things, it's just too early. But we'll keep you posted as we get more clarity as time goes on.

Operator

Our next question comes from Saliq Khan with Imperial Capital.

Saliq Jamil Khan - *Imperial Capital, LLC, Research Division - VP*

Jim, kind of getting away from Craftsman and looking at the Security business, can you provide us detail on what the free cash flow profile looks like? And what are some of the efforts and programs that you have in place that help you drive business in new markets and new customer segments, so you can better leverage the channel partnerships, particularly as you look into the next year?

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Yes, well, it's always a -- Security is always a great cash flow business for us because we're in the commercial security business. And in commercial security, the customer pays for the installation as opposed to residential security, where historically the vendor, if you will, has paid for the CapEx upfront. So cash flow is a great stream and the recurring revenue is a dependable stream as well. So the existing business, we'll call it the core commercial security business, is -- it's a good business. But what's happening in the digital world, I think as everybody knows, is the advent of Internet of Things, artificial intelligence, robotics, I could go on. We all are familiar with a laundry list of new technologies that are facilitating great value creation for customers, be they commercial or otherwise. But in this case, I think the fact that they would be commercial is relevant. And I think we have a really, really great asset that we can leverage to become an integrator for those types of technologies in specific applications, specific areas, and not only that but to also develop recurring revenue streams that are differentiated and the value propositions are differentiated and the recurring revenue streams will continue. So I think we will end up with a core commercial security business that we have today that will be enhanced through innovation and sustainable for a long period of time. And on top of that, I think we will start to see the emergence of a growth-oriented, higher technological content business that is scalable and will develop an ecosystem. That will take some time. But we are doing everything in our power to accelerate that and to make sure that as the market unfolds that we have a position to play in that market.

Operator

Our next question comes from Chris Belfiore with UBS.

Christopher Belfiore - *UBS Investment Bank, Research Division - Equity Research Associate Analyst of Industrials*

Greg, thanks for all your help, it's been a pleasure. And I look forward to working with Dennis again. So just kind of wanted to kind of go talk a little bit on pricing, especially in tools and business -- in Tools & Storage business, just sort of a lot of the other headwinds you're seeing out there from some of the distributors that we cover. But it's been relatively flat year-to-date. You had commodity headwinds continue. So just kind of a little color on the pricing environment, and then maybe kind of how we can expect that to the price cost equation to kind of be as we kind of move into the next year.

Donald Allan - *Stanley Black & Decker, Inc. - CFO and EVP*

Sure. I will start, and then we'll pass it over to Jeff to provide a little more color. But yes, we had a third quarter that was slightly positive for price in Tools & Storage. Within that, if you kind of break it apart, you have a North American business that had kind of the normal promotional activity that occur in the quarter. So there was some negative price of about close to 1 point in North America. And then outside of North America, we had positive pricing actions that offset that due to various different things, such as commodity inflation, currency movements, et cetera. And so the net result was a slight positive. So that's just to give you a little more detail. As we go into next year, we actually see a fair amount of commodity inflation coming into the mix. As I've mentioned before, we had about $100 million, it looks like, next year. Now the number looks to be closer to $150 million of commodity inflation. And we're in the process now of looking at what additional pricing actions we can take in response to that. If you look at our history, we probably get anywhere from 60% to 70% of price recovery in year 1. But we're looking at how we can be more aggressive and make that number much closer to 100%. But as you all know, it's a process that takes quite a bit of time working with our customers. Jeff, any additional color?

Jeffery D. Ansell - *Stanley Black & Decker, Inc. - EVP of Global Tools & Storage and President of Global Tools & Storage*

Maybe the other thing to add would be a bit on the process. So when it comes to an inflationary environment from a commodity perspective, as Don just described, our first action is to do everything possible inside of our network to drive productivity to attack those costs. And the things that we can't cover, we certainly pass along in the way of price. So we work with our customers in that regard. We also get smarter as time goes on. So clearly, the second and fourth quarter are the biggest promotional periods for any tool company. But probably, 25% of all the programming that we do annually is eliminated in 1 year and changed for the next. So we learned what worked, what didn't work, where we'll spend money, whether we had a good payback on that. And at least 1/4 of what we do every year changes as we get smarter, get more experienced, et cetera. And we'll continue to work those things so that we get the best possible payback for the investment price that you mentioned.

Operator

Our next question comes from Rob Wertheimer with Melius Research.

Robert Cameron Wertheimer - *Melius Research LLC - Research Analyst*

A lot of things happening that seemed to be going quite well at once. Jim, could you maybe give an overview of how you think about the process and progress in the breakthrough innovation centers? Would you consider, like, staging whatever the next innovations might be, just given all the opportunities you have at Craftsman, maybe there's something at Craftsman I don't know? Just maybe give us an update on that, where I know there's a lot percolating behind the scenes.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Yes, well, I'm actually quite thrilled with the innovation that's come out of our breakthrough innovation teams. Obviously, FLEXVOLT was our pilot. And it really was a major home run. Some of the other innovations, a good portion of the other innovations are a little bit more on the periphery of our core. So an example would be the connected job site that we have put together. We have the world's best connected job site, which brings WiFi to construction projects and then brings Internet of Things to the projects and then construction sites, and then brings in intelligent analytics and interfaces with architectural design systems, and even integrates things like augmented reality and so forth, very exciting innovation. They've worked really hard on it. It's been piloted 3 times successfully on different major construction sites. And so now it's time to scale it. And that's where I'd say our biggest challenge comes in. And what we're needing to do with this to make sure that we scale it appropriately is to create a more exponential-oriented organization. So in the traditional organization, in this case, this came out of the power tool business. So you have the power tool commercial people who have a history of great success commercializing power tools. And now we're trying to sell connected job sites. Well, it's a different skill set. The customers are the same, but it's a different skill set. And so we need partners, we need different skill sets in our own organization. And we also need to liberate them, so they can go spend more money to scale it faster to the extent that we can afford that in our very measured kind of investment management way that enables us to both achieve operating leverage on one end, at the same time, make investments. I know there were some people on the phone this morning before the call, some of the analysts were saying, "Well, why didn't you get more operating leverage in tools?" Well, we spent more money on investments for the future in tools. That's one of the big reasons. And so that's kind of the challenge, it's really gating from a financial standpoint. But getting them enough capital and expense to liberate them, to go off and scale appropriately when they've created a great thing like the connected job site, and then just providing a little different organizational model, which we'll talk more and more about in the coming quarters. But we're doing some work with -- breaking out some exponential organizations from the traditional organization. And I think that's going to be one of the key elements of the success in commercializing the breakthrough innovations that are not, let's say, necessarily right in the middle of the fairway. Like the FLEXVOLT is a battery system, the power tool commercialization people know how to commercialize battery systems. And the digital marketing folks from the Digital Accelerator down in Atlanta, who were very helpful in enabling that digital marketing approach for that project. And it was just a fabulous combination of leveraging our existing resources. And some of the other innovations, and not all of them, probably 2 or 3, 4 of them are really in the queue, and you'll see them coming out over time in the traditional organization. But I think some other ones, you probably see a little different approach, more of a Silicon Valley-like approach to commercializing.

Operator

Our next question comes from Robert Barry with Susquehanna.

Robert D. Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Actually, just, first, had a quick follow-up on that prior question on price. I know last quarter, you had talked about these pricing experiments, pushing price a little harder, and then assessing the volume impact. I was curious if that continued this quarter. And then my question though was really on the core growth outlook. I mean, last quarter, you raised it 50 bps that added $0.10 to EPS. I must say it was a little anticlimactic to see a 150 basis point rise this quarter, largely offset by this other net. Can you quantify and provide more color on what's going on there? And then how does that line in the model track next year? Would that be expected to step down materially in 2018?

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Okay, I'll answer the part related to your question about the experiments, the pricing experiments, and then I'll turn it over to Don. So I have promised myself, and actually I promised my team as well, never to say the word experiment in connection with pricing again after the brouhaha that it created after the last call. So pricing is an iterative process. And I think Jeff kind of addressed it already. Jeff, is there anything else you want to say about that before we turn it over to Don for the second part of the question?

Jeffery D. Ansell - *Stanley Black & Decker, Inc. - EVP of Global Tools & Storage and President of Global Tools & Storage*

No, sir.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Okay, then Don?

Donald Allan - *Stanley Black & Decker, Inc. - CFO and EVP*

Okay, so I'll walk through in a little bit detail. We had very good operating leverage in the quarter. So if there's any confusion on that, we'd be happy to walk through it after the call in a little more detail. But if you look at the revenue outperformance versus our operating margin outperformance, pretty much in line with what we previously communicated, if we have a point of revenue better than expected, what would drop through, through OM. So that conversion rate was pretty much in line with what we've communicated, which is anywhere between 25% and 35%. What happened in other net, which is below operating margin, is as I mentioned in my presentation was that we had some currency positions related to balance sheet items that sometimes as they get settled throughout the quarter based on currency movements, you experience as gain or losses. In this case, we had about $7 million to $10 million of losses in the third quarter from that activity. That put a lot of pressure on the additional EPS flow-through. But still, $0.10 outperformance versus expectation versus maybe $0.12 to $0.14 expectation, I still think that's a heck of an operating leverage performance. As far as what it means for next year, I continue to believe that we will grow in line with our long-term financial commitments and objectives. We have 4% to 6% organic growth, 10% to 12% EPS growth and 100% free cash flow conversion. Those have been our long-term financial objectives. And I think next year at this stage, even with $150 million of commodity inflation coming into the mix next year with offsetting pricing actions of some magnitude, I believe that we can hit those objectives.

Operator

Our next question comes from David MacGregor with Longbow Research. Our next question comes from Scott Rednor with Zelman & Associates.

Scott L. Rednor - *Zelman & Associates LLC - VP of Research*

Wanted to go back to LatAm or emerging market growth in Tools & Storage. I was hoping you guys could give a little bit more color kind of what in terms of the distribution change was kind of a onetime lump versus what's a go-forward rate, just realizing that, that business saw such strength this quarter.

James M. Loree - *Stanley Black & Decker, Inc. - CEO, President and Director*

Yes, it's more of an ongoing growth initiative than a onetime bump because the reason we made these changes is absolutely for the purpose of driving share gain and organic growth in Turkey and in Russia. So if you think about the approach that we used to have, we had a couple of major distributors and that was it. And I think it was one in Turkey and a couple in Russia. And instead of blanketing the market with sales reps, end user demand-stimulating activities and distribution, physical distribution centers, so we've gone from a kind of half-baked approach to a full-frontal attack on those markets. And so it is a very sustainable approach. And we should expect some pretty good growth out of those in the regions, notwithstanding any geopolitical turmoil that may occur in those very volatile regions in the years to come.

Operator

This concludes the question-and-answer session. I would now like to turn the conference back over to Dennis Lange for closing remarks.

Dennis Lange - *Stanley Black & Decker, Inc. - VP of IR*

Shannon, thanks. We'd like to thank everyone again for calling in this morning and for your participation on the call. Obviously, please contact me if you have any further questions. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation, and have a wonderful day.