THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SWK - Q2 2016 Stanley Black & Decker Inc Earnings Call

EVENT DATE/TIME: JULY 22, 2016 / 12:00PM GMT

OVERVIEW:

SWK reported 2Q16 diluted EPS of $1.84. Expects 2016 EPS to be $6.30-6.50.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Greg Waybright *Stanley Black & Decker, Inc. - VP of IR and Government Relations*

John Lundgren *Stanley Black & Decker, Inc. - Chairman & CEO*

Jim Loree *Stanley Black & Decker, Inc. - President & COO*

Don Allan *Stanley Black & Decker, Inc. - SVP & CFO*

CONFERENCE CALL PARTICIPANTS

Robert Barry *Susquehanna Financial Group / SIG - Analyst*

Joshua Pokrzywinski *Buckingham Research - Analyst*

Evelyn Chow *Goldman Sachs - Analyst*

Rich Kwas *Wells Fargo Securities, LLC - Analyst*

Michael Rehaut *JPMorgan - Analyst*

Tim Wojs *Robert W. Baird & Company, Inc. - Analyst*

Mike Dahl *Credit Suisse - Analyst*

Jeremie Capron *CLSA - Analyst*

David MacGregor *Longbow Research - Analyst*

Mike Wood *Macquarie Research - Analyst*

Dennis McGill *Zelman & Associates - Analyst*

Jeff Kessler *Imperial Capital - Analyst*

PRESENTATION

Operator

Welcome to the Q2 2016 Stanley Black & Decker Incorporated earnings conference call. My name is Nicole, and I'll be your 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 and Government Relations, Greg Waybright. Mr. Waybright, you may begin.

Greg Waybright - *Stanley Black & Decker, Inc. - VP of IR and Government Relations*

Thank you, Nicole. Good morning everyone, and thanks for joining us for Stanley Black & Decker's second-quarter 2016 conference call. On the call in addition to myself is John Lundgren, our Chairman and CEO; Jim Loree, our President and COO; and Don Allan, our Senior Vice President and CFO.

Our earnings release, which was issued earlier this morning, and a supplemental presentation, which we will refer to during the call, are available on the IR section of our website, as well as on our iPhone and iPad apps. A replay of this morning's call will also be available beginning at 2:00 PM today. The replay number and the access code are in our press release. This morning John, Jim and Don will review our second-quarter 2016 results and various other matters followed by a Q&A session.

(Caller Instructions)

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 is therefore possible that actual results may materially different from any forward-looking statement that we might make today. We direct you to the cautionary statements in the 8-K that we filed with our press release and in our most recent ['34 Act] filing. I will now turn the call over to our Chairman and CEO, John Lundgren. John?

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Thanks, Greg. Before we get started, it is with both a sense of accomplishment, and admittedly some sadness, that we are announcing my retirement today as the CEO of Stanley Black & Decker effective July 31, 2016. I say there is some sadness, simply because of how much I have enjoyed leading the Company and our world-class management team and employees since the first quarter of 2004. But I am pleased to announce that Jim Loree will be succeeding me as Stanley's Chief Executive Officer. And I am extremely confident in the prospects for this organization with Jim at the helm.

For those of you who followed our Company over the last several years, this transition will not come as a surprise. I, in conjunction with our Board of Directors, have always viewed the leadership succession plan to be a top priority to ensure consistency and stability throughout the organization, as well as to ensure that we continue to deliver the exceptional shareholder value that our investors have come to expect from this Company. And to that end, Jim is uniquely positioned to deliver on each of those things, given his tenure with the Company and his role in leading the transformation that we've executed over the last decade or so.

Furthermore, it's important to note that we have as deep and talented a management team today as we have had at any point during my 12 year tenure with the Company. There are strong, competent leaders in place across our various businesses. And we are not anticipating any major changes in strategy or to the team as a result of this announcement. I will be staying on as Chairman of the Board through the end of the year and will continue as a special advisor to the Company through the end of April next year in order to ensure an orderly transition, and of course to assist the Board, Jim and the rest of the management team in any way that I can.

I am proud of everything the Company has accomplished over the last 12-plus years, including compounded annual sales growth of 12% and a total shareholder return of over 300%. And while I've enjoyed my time here immensely, I am looking forward to the next phase of my career which will include among other things serving on a number of boards as well as continuing my efforts to impact policy in Washington and around the world to create an environment where manufacturing companies like ours can continue to succeed and to prosper.

I will turn 65 in September, and rather than thinking of this as going out at the top, I think of it more as a long-distance relay race where we've built a good lead and I'm passing the baton to a colleague and a management team who are well-positioned and fully capable of increasing that lead. And I'm confident that after you listen to this morning's call you will share in my belief that our best days still lie ahead of us.

So let's dive into the quarter and our outlook for the remainder of 2016. Here are some of the highlights during the second quarter. Organic growth was 4%, total growth was 2%. We had robust organic growth in our Tools and Storage business, 8%. That continues an incredible trend, with Europe leading the way at 14% growth during the quarter. Security was up 1%, as Europe organic growth -- the trend there continues. Europe was up 3% for the quarter. Industrial was off 6%, mainly due to single customer volume pressure in the electronic segment of our engineered fastening business and the well expected lower infrastructure volume, as oil and gas and hydraulics remain challenged by the weak energy and scrap steel markets, respectively.

Our operating margin rate of 15.8% was up 140 basis points versus the same quarter a year ago. That is a post-merger record, despite significant foreign currency pressure. That was led by Tools and Storage performance, which was up 240 basis points to 18.8%. And Security posted a strong sequential increase to 12.6%, while industrial declined marginally, but to a very respectable rate of 17%. Second-quarter diluted earnings per share of $1.84 was up 19% versus prior year on strong operational performance along with a lower share count.

Our DeWalt FLEXVOLT battery system was unveiled in June, delivering the power of corded and the freedom of cordless to professional and consumer end users worldwide. Some of you have seen the products perform, and you will have your own well-informed views. But I've participated in several of the major introductions, and the words game changing have been a common reaction from our customers. The product will hit the shelves in October this year. And Jim will provide you some more detail on our vision to create a cordless jobsite.

Given these results, we are raising our 2016 guidance to a range of $6.30 to $6.50. That's up 6% to 10% versus 2015 and from our prior guidance of $6.20 to $6.40. And concurrently we are reiterating our free cash flow conversion of approximately 100%.

Let's look quickly at the sources of growth. Both volume and price contributed to our growth, which was broad-based on a regional basis. During the second quarter volume was up 3%. We got a positive 1% from price, for 4% organic growth. Currency was a 2 percentage point offset for a revenue growth of 2%. All regions contributed positively to the total performance across the Company. If you see the US up 3%, Europe up 10%, emerging markets flat, rest of the world up 4% for again, total organic growth of 4% for the quarter and 4% for the first half of the year. Don will show you later that baked into our guidance is an increase in organic growth for the year from a range of 3% to 4% to an estimate of 4%.

There were lots of puts and calls within the emerging market group. Volatile markets, as you know, but our Latin America group was up 9%, with Mexico up 11% and Argentina up 46% albeit from a low base. The emerging markets were down in the low teens. Tools and Security growth was offset by industrial softness in the engineered fastening consumer electronics business. But all in all, really strong growth in the quarter.

Let me turn it over to Jim who's got an update on our game changing DeWalt FLEXVOLT program, as well as some of the details on the segments.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Thank you, John. Before that, I just want to thank John for being a trusted colleague and a mentor and a friend. And also for all of the John has done for this Company and our stakeholders over the years. He and I have enjoyed an outstanding business partnership for over 12 years, teaming up to lead the Company through a transformation from a small cap building products company to a large cap diversified industrial. It is no coincidence that John's arrival in 2004 marked the beginning of a growth renaissance period for Stanley. And I'm honored to be named as our next CEO, succeeding John with a mission to lead us through the next stage of our journey. The Company has never been stronger with all of its well-established global franchises, agile and deep leadership bench, and strong and evolving SFS 2.0 operating system.

Importantly, I want to highlight our world-class management team. This high-performing team to a person is totally dedicated to the success of this Company. They have supported me all the way through both their words and their actions, and thus enabled us to affect a smooth leadership transition. The impressive results you have seen quarter after quarter from this Company are a direct result of this team's experience, commitment and passion for winning.

What better way to highlight the immense opportunities present in this next stage of our evolution than to introduce you to the first output from breakthrough innovation, our SFS 2.0 initiative. The patent protected DeWalt FLEXVOLT system is the most exciting innovation in the power tool industry since Black & Decker unveiled the first cordless tool in the 1960s. It has the potential to revolutionize the job site. It allows users to switch from 20-volt to 60-volt to the never before seen 120 volts of cordless power, using the same battery pack regardless of the voltage rating. These battery packs are completely backwards compatible with our existing line of DeWalt 20 volt tools, and when used in these products, the FLEXVOLT battery combines with our market-leading brushless motors to provide significant runtime and performance advantages.

FLEXVOLT will ultimately enable professional users to completely eliminate the cord on the job site, achieving the freedom of cordless while maintaining all the power and flexibility of corded tools. And at the same time, none of our existing user base is left behind, as the FLEXVOLT battery packs used on their new 60-volt and 120-volt cordless tools will also enhance the performance of their existing 20-volt products.

FLEXVOLT is being commercialized as part of our SFS 2.0 commercial excellence initiative with the most global, most digitally enabled and most comprehensive marketing campaign in our history. We have already demonstrated the technology in person to over 700 customers around the globe, including major retailers, distributors and other channel partners. We have also introduced and demonstrated the products to the tool subject matter expert blogger community, and have created an enormous social media buzz in anticipation of the product's release to the market in October. We have coordinated our digital marketing campaign with our sports marketing assets, and we will be conducting a massive end-user demonstration effort as the summer proceeds.

This type of breakthrough innovation coupled with commercial excellence will provide significant organic growth runway, even as we comp up against several years of top quartile organic growth among peers. In the near term we will focus on delivering the end-users' long-held dream of the cordless job site. And over the intermediate to longer term we will be moving up the power curve, exploiting the rapidly advancing technology of electrification and opening up new markets and growth opportunities. This tremendous accomplishment within our Tools and Storage business is the first example of the output we expect to deliver from SFS 2.0, our enhanced operating system. We are currently taking the same approach to breakthrough innovation in several other businesses across the Company. So stay tuned.

I encourage all investors to take a deep dive in both FLEXVOLT and SFS 2.0, as they are essential to understanding what this Company will deliver in the form of continued organic growth and margin expansion. Our investor relations team is ready to assist those that are interested in that regard.

Moving onto 2Q, I will begin with the Tools and Storage business, which continued its forward momentum delivering another high single-digit organic growth performance, coming in at 8%, and equally as impressively improving profitability by 240 basis points for a segment profit rate of 18.8%. Total Tools revenue growth was 5% after absorbing a 3 point currency headwind. Organic growth across all regions and SBUs was once again positive. Europe led the way, up 14%, followed by North America, up 7%, and emerging markets, up 4%.

The gains in Europe are particularly impressive given the flat to very low single digit growth environment in those markets, and they highlight our ability to continue gaining share on the strength of our pervasive commercial excellence activities and new product development initiatives, such as our DC brushless motor products, which exemplify the importance of our very strong core, or normal course of business innovation. This all-important core innovation activity has been a key source of organic growth and a hallmark of our culture for quite some time. Core innovation provides a solid base for above market growth, thus enabling SFS 2.0 breakthrough innovations to turbocharge an already strong base.

Moving to global SBU results, power tools delivered another double-digit quarter, up 10% with consistent strength across professional and consumer tools. Hand Tools and Storage posted 2% growth as construction hand tools were up in high single digits, driven by our new line of DeWalt and FatMax measuring lasers offsetting pressure in Protoindustrial hand tools.

Taking a regional look at the segment, in North America momentum was good across all major retailers with high single-digit performance from the group. POS data remained very strong and in the mid-teens for the quarter. Ending retailer inventories were in line with or below historical norms.

Turning to Europe, which posted extraordinary 14% organic growth on the heels of two years of 7% compounded growth, the outperformance was widespread. Every major underlying market grew organically with most up double digits, including a noteworthy performance by the UK team which delivered the highest growth in the region. France also showed unusually strong growth driven by share gains in professional power tools.

And finally, emerging markets were up 4% organically with Latin America and Asia leading the way, both up in high single digits more than offsetting continued issues in Middle East and North America, which was down. Latin America continued to overcome a generally distressed market environment. Within Latin America, Argentina and Mexico turned in strong country performances with growth in our tradesmen segment and continued penetration of our recently introduced Stanley MPP cordless power tools. E-commerce and pricing excellence initiatives also contributed to drive growth in the region.

Asia also delivered a notable performance with good organic growth in China, South Korea and Indonesia. And as I noted earlier, we continue to see pressure within the Middle East, North Africa. However, efforts are underway to revitalize the businesses in those markets, which continue to be challenged by severely depressed macroeconomic conditions amidst geopolitical turmoil.

In summary, Tools and Storage continued its strong momentum this quarter, leveraging SFS 2.0 to drive outsized share gains while preparing for the largest product launch in the Company's history. Despite the challenging macro in several regions of the world, we remain highly constructive on the growth and margin prospects for Tools and Storage as we look forward.

Shifting over to Security. Security delivered its second consecutive quarter of organic growth and its third consecutive quarter of year-over-year margin improvement, highlighting the solid progress this business has made. Total revenues increased 1% on 1% organic growth, while the operating margin rate improved 220 basis points year over year to finish at a healthy 12.6% for the quarter, its highest second-quarter rate since 2013.

Europe Security grew 3% organically for the third quarter in a row, marking its seventh consecutive quarter of organic growth. And strong performance in the Nordics and central Europe drove the top-line performance and offset mild pressure in the UK and France. Order intake was in line with expectations. The unit continues to successfully manage attrition and stabilize the RMR portfolio. Europe Security profitability continues to improve as volume leverage, productivity and cost actions all contributed to margin growth and rate improvement in the quarter.

North American Security also made progress. Solid organic growth in healthcare and automatic doors was offset by lower volumes in electronic security, or CSS. However, CSS is driving growth in its RMR portfolio, with orders and backlog in a healthy position heading into the second half of the year and attrition is in line with targets. North America also realized margin growth and rate improvement as field efficiency initiatives took hold.

In total, Security improved on almost every front, with order rates, backlog and attrition at targeted rates across Europe and North America. And the team is well-positioned and motivated to continue driving forward progress.

Moving onto Industrial. Industrial revenue was under some pressure in the quarter as weakness in engineered fastening combined with anticipated pressure in infrastructure resulted in a 6% organic decline. Expense deleveraging on lower volume combined with negative FX drove a corresponding profit decline, although segment margin continue to be at impressive, well above Company line average levels. And within engineered fastening, the negative growth was overwhelmingly driven by significantly lower than expected volume with one major electronics customer. The general Industrial business was down modestly, in line with expectations. And the automotive segment remains solid, with fastener growth continuing to outpace light vehicle production around the globe.

Infrastructure was down 11% organically as a slowdown in offshore oil and gas activity combined with continued weakness in hydraulics end markets resulted in year-over-year declines. Encouragingly we see sufficient project activity in our onshore business to enable positive growth for oil and gas in the second half of the year.

So while Industrial posted an eye-opening negative organic growth number for the quarter, it was caused largely by a decline in sales to one specific electronic fastening customer, partially driven by changing end-user demand and partially driven by our strategic decision to remain disciplined on price. Nonetheless segment profitability remains strong, although the revenue impact of this situation will be felt for a few quarters until it anniversaries.

So in summary, like all multinational businesses in today's environment of slowing global growth and unprecedented geopolitical volatility and an ever more rapidly increasing pace of technological change, we face ongoing challenges across our businesses in many of the markets we serve. We view these challenges as opportunities.

Our continuing goal is to achieve outsized organic growth supplemented with inorganic growth, expand margins, and do it all with a capital efficient approach. SFS 2.0 with its sharp focus on breakthrough innovation, digital excellence and commercial excellence will continue to enable us to outperform on the organic growth front. We will soon be back on the acquisition trail and our pipeline is full with solid opportunities to deploy capital to inorganic growth.

Today's announcement of 4% organic growth, 19% earnings per share growth, a record operating margin rate of 15.8%, and $418 million of free cash flow underscores the health and earnings power of the Company while highlighting the strength and agility of our management team. I look forward to leading the Company in the coming months and years as we tackle the challenges and opportunities ahead and continue to drive positive momentum. And with that, I will now turn it over to Don Allan who will provide a financial update.

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Thank you, Jim. Let's start with free cash flow for the second quarter, which came in at $418 million for a year-over-year improvement of $171 million. As you can see, the primary drivers of the outperformance were stronger earnings of $44 million and continued improvements in working capital which generated a positive $58 million of cash in the quarter for a meaningful $108 million of year-over-year improvement. Our working capital turns were 8.2 times at the end of Q2, which was a 1.2 times improvement versus the prior year's second quarter. On a year-to-date basis this leaves our free cash flow $256 million ahead of prior year, again with earnings growth and working capital efficiency explaining essentially all of the improvement.

As John noted earlier, we are reiterating our free cash flow guidance at 100% conversion rate. This takes into account the incremental inventory build that we expect to undertake in the second half of the year related to the DeWalt FLEXVOLT system launch. Even with this modest headwind to working capital in the second half of 2016, we still plan to end the year at approximately 9.5 times for working capital turns.

Moving to the next slide, I want to take a moment to address the potential impact of the UK's EU referendum vote, or Brexit, on our anticipated business results in 2016 and potentially beyond. As you can see on this page, we are expecting to generate somewhere north of $500 million in pounds sterling denominated revenues in the UK. And more than $1.7 billion in euro denominated revenues across the euro region in 2016. To date we have not seen any meaningful reduction in demand within the UK and more broadly in Europe. It is likely too early to speculate on the demand side impact of Brexit in both the UK and the rest of Europe.

What I can tell you at this point is that our plans for the second half of the year continue to contemplate roughly low to mid single digit growth organically in the European region, as we expect our recent share gain momentum to be further augmented by the FLEXVOLT battery system rollout that Jim discussed in detail earlier. As you might expect we are monitoring this situation very closely and will continue to assess the potential impact as events evolve. We will update all of you accordingly as a more definitive picture materializes.

From a currency perspective, however, we have seen some impact to our operating margin based on the FX movements following the referendum result. At current spot rates for the euro and pound sterling, we see approximately an $8 million additional currency pressure relative to the $140 million of FX headwinds we disclosed in our April guidance.

The uncertainty created by the UK's decision, both with regards to the mechanics of their exit as well as the future of the European Union as a whole, could result in continued currency related pressure to our operating margin. I'd like to give you an example of that potential impact. If the euro were to go to parity with the US dollar and the pound were to fall to $1.20, the combination of these moves would generate an incremental $12 million of operating margin pressure to earnings in 2016. This is above and beyond the current $8 million of incremental pressure measured at spot rates that I just mentioned. Of course, the longer FX rates hold at current levels the more muted the impact of any future deterioration will have on 2016 results. I believe this provides an adequate range of the potential worst-case impact for 2016.

On that note, let's move onto page 14 where we provide an updated view on the net FX impact to the Company's operating margin across all currencies. As you can see, net FX headwinds have increased by approximately $10 million to $150 million since our April guidance was issued. This movement is primarily driven by the incremental pound and euro pressures I just mentioned, as well as further devaluation of the Argentinian peso and Canadian dollar. These negatives are slightly offset by the appreciation in Brazilian real, which is up about 7% against the dollar since our April guidance was communicated.

Finally I'd like to remind everyone of a statement I made during the April call where I pointed out that should FX rates again deteriorate in 2016, we have actions and countermeasures at our disposal to maintain our EPS guidance. We continue to have similar plans in place, but as you would expect the size of the actions we can effectively execute on begins to shrink as the year wears on. As a result, we now have approximately $20 million in contingency plans that can be put into place should they be necessary.

One last point on currency. Our hedging actions are now primarily focused on exposures in 2017 and beyond. And we will continue our practice of locking in portions of our largest exposures, such as the Canadian dollar and the euro, to dampen volatility throughout the year. Based on current spot rates and the existing derivative hedges in place for 2017 volumes, we estimate the carryover impact of currency to be approximately $20 million for 2017.

Let's turn our attention to the next page and our updated 2016 outlook. As John noted at the beginning of the call, we're raising our EPS outlook to a range of $6.30 to $6.50 from the April guidance range of $6.20 to $6.40. The revised range represents a 6% to 10% year-over-year increase in EPS. At the same time we are reiterating our free cash flow conversion at approximately 100% of net income.

As you can see on the left side of the page, this 10% increase across the range is being driven by an increased organic growth estimate for the full year, moving to 4% from approximately 3% to 4% which generates $0.07 of additional EPS. In addition we believe $0.10 of our incremental productivity and cost actions will stick for the full year. Embedded in this amount is modest incremental growth costs related to SFS 2.0 initiatives. Specifically, these costs will fund key incremental commercial excellence and breakthrough innovation activities to help drive above market growth beyond 2016. These two positive improvements to guidance are partially offset by $0.07 of increased FX headwinds and one-time new CEO costs. Finally, note that we are providing some color on EPS for 3Q, with approximately 25% of the full-year EPS expected to be delivered in the third quarter.

Moving to the right-hand side of the page you get a better sense of the drivers behind the organic growth increase, as Tools and Storage is now projected to grow high single digits for the year on the great momentum we have seen in the first half combined with the impact of the pending FLEXVOLT launch. However some of these gains are being partially offset by our industrial segment, as we continue to see pressure in the general industrial and electronics businesses, which is now projected to produce low single digit declines in 2016. The organic growth guidance for the Securities segment remains unchanged, with low single digit growth expected for the full year.

Finally, we expect the Tools and Storage and Security segments to deliver positive year-over-year improvements to their respective operating margin rates. The Industrial segment's operating margin rate will be lower in 2016 versus 2015 as the impact from lower volumes and FX pressure more than offsets the productivity gains and cost actions being taken by the engineered fastening and infrastructure business teams.

In summary, the second quarter was another solid performance for the Company as a whole. Despite some additional pressures in our Industrial segment, Tools and Storage delivered an outstanding quarter. And the Security businesses continued to make solid progress and take additional positive steps forward. Organic growth in the quarter finished up 4% and earnings per share were up 19% versus prior year, coming in at $1.84. Excellent operating leverage.

On the back of this outperformance we're raising EPS guidance to the range of $6.30 to $6.50, as we expect the improved organic growth outlook and incremental productivity to more than offset certain pressures.

In June we introduced the world to DeWalt FLEXVOLT system, which we expect to revolutionize the construction job site, delivering the power of corded with the freedom of cordless to millions of professional around the world.

And finally we announced the retirement of John as CEO. His tenure has been an era that is characterized by transformational growth and exceptional shareholder returns. Among John's many accomplishments as CEO is the impact he had on building our high integrity, agile winning business culture across our entire executive leadership team. And as a result, we are well-positioned to deliver outsized growth and margin expansion going forward. And we have a highly energized organization, motivated toward achieving these goals. On a personal note, I have appreciated John's mentorship and thank him for the support over the past decade.

That concludes the presentation portion of the call. Let's move to Q&A.

Greg Waybright - *Stanley Black & Decker, Inc. - VP of IR and Government Relations*

Great. Thanks, Don. Nicole, we can now open the call to Q&A, please. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Robert Barry, Susquehanna.

Robert Barry - *Susquehanna Financial Group / SIG - Analyst*

Hey, guys. Good morning. John, best of luck to you going forward. And to Jim, congratulations.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Thank you.

Robert Barry - *Susquehanna Financial Group / SIG - Analyst*

I was wondering if you could provide some detail on what your assumptions are for growth in the various verticals within fastening and for industrial infrastructure in the back half or for the year?

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Sure. Happy to do that. So, the Industrial segment, we were down 6% here in the second quarter. We don't expect the decline to be as severe in the back half of the year, probably low single digits, with it being a little larger in the third quarter and smaller in the fourth quarter as the comps get easier, in particular related to the electronics business.

When you look at the different pieces, we do feel pretty good about our automotive fastener businesses in the back half of the year. It's seen a strong performance in the first half, up mid-single digits as far as organic growth. And then in the back half we expect that trend to continue as we get over a more difficult comp related to some of the equipment sales that we had in the first half related to the automotive systems business.

The electronics business will continue to be a pressure point in the back half, although the comps will slowly get easier as time goes on. We would expect that to be rather large negative V in the back half as it has been in the first half. And the general industrial business will kind of be a low to mid single digit decline as well in the back half.

Operator

Joshua Pokrzywinski, Buckingham Research.

Joshua Pokrzywinski - *Buckingham Research - Analyst*

Hi. Good morning, guys. And I guess congratulations to John and Jim both.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Thanks.

Joshua Pokrzywinski - *Buckingham Research - Analyst*

On the tools margin, clearly strong execution in this quarter, I think a host of things, productivity and likely price/cost included. Can you maybe give us a bit of a trend line? I know you have FLEXVOLT's launch costs here in the second half and FX. But maybe excluding those out, how should we think about incremental margins or how should we think about the margin from here, and maybe the line of sight beyond some of the 2016 launch costs, just given the outperformance that we saw on this quarter?

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Obviously the second quarter was an outstanding margin performance and organic growth performance, as Jim mentioned, for Tools and Storage. As we look at the back half, we still see very strong margins. We're certainly not going to see 18.8% at this stage because some of the reasons that you mentioned. We're also beginning to anniversary the commodity deflation that we've experienced over the last year. That's been a strong benefit for the business and will not be a continued incremental benefit on a go-forward basis.

And then FLEXVOLT, as you mentioned, is an area that is an initial pressure point to gross margins as we roll that out. Over time they will be accretive to gross margin as we get deeper into the launch next year. And then we also have launch costs that are specific to this program that will continue out through the remainder of 2016, which means that the gross margin in the back half of the year will be roughly somewhere between the 15.5% to 16.5% range, most likely because of those dynamics.

The ongoing margins, however, from an incremental margin perspective will continue to be healthy and consistent with what we've said in the past, that as we see organic growth incrementally, we would expect 30% to 35% drop through in margins, sometimes affected by specific quarter activities where it might be slightly lower if we're making investments or if there's certain types of mix that occurs.

But our trend line over the long term for Tools and Storage is still positive. They will likely end the year close to 17% operating margin, if not slightly over. We'll see how the year progresses. And we would expect that they would continue to improve from that on a go-forward basis.

Operator

Joe Ritchie, Goldman Sachs.

Evelyn Chow - *Goldman Sachs - Analyst*

Good morning. John, Jim, congratulations. This is actually Evelyn Chow pinch-hitting for Joe.

Maybe focusing on the gross margins for the Company as a whole. They were incredibly strong this quarter. In your release you said a few different factors, and you mentioned commodity deflation has helped. Can you provide some more color on the relative contributions of the drivers you cited and the sustainability of this kind of expansion?

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Yes sure I'll take that. You want to take it, Jim?

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Yes, I'll take it because this is something that we work really hard on at this Company. You think about the gross margin performance this quarter in light of the FX pressures that we have, which almost totalled $40 million. It is really remarkable that we have been able to achieve this kind of accretion in the gross margin rate.

And what it really derives from working on everything that we possibly can to impact the margin rate in a positive way. And that starts with productivity and working hard on four-wall cost productivity, working hard on vendor productivity, G&A productivity, our functional transformation initiative starting to pay some dividends, the commercial excellence initiative from SFS 2.0.

We're driving price realization, price optimization, all of these things kind of combined, we are very, very focused on managing mix, focused on managing the lifecycle of new products or products in general and introducing new products at higher margins as the more mature products kind of margin has a degrading tendency over time.

It's a combination of all those things. And we continue to target gross margin improvements over the medium term as well. And I think you will see that over the coming years as a result of everything I just mentioned.

Operator

Rich Kwas, Wells Fargo Securities.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Good morning. Congratulations, best wishes John. And congratulations Jim.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Thanks Rich.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Just a couple -- I'm going to squeeze in a couple here on the inflection and margin in Security. Just thoughts around if this is a true inflection. Any puts and takes as we think about the back half, sustained momentum, comments along those.

And then on electronics with the one customer being such a headwind, what is the focus on progress in terms of trying to diversify the customer base? Thank you.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Go ahead, Don. Let me just say, Rich, you're talking two different businesses, Security and then you moved to fastening. We will get them both. But the sequential consistent improvement in Security, it's real and it's here to stay.

In Europe the team has really embraced the need to grow organically, and they've done it consistently in a very tough market. US, the focus has been on -- more on operational excellence, field efficiency. And both teams are focusing on what we've asked them to focus on. They are doing a great job on both fronts. But I will let Don answer your question specifically.

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Yes. So John is absolutely correct that the Security business continues to generate a positive momentum around various initiatives. Specific to profitability we've talked about several of them over the last year so on different occasions is driving more efficient field productivity, really trying to streamline their SG&A to achieve certain objectives over the long term as a percentage of revenue. And they continue to make progress in that regard.

And combining that with the fact that they are being much more disciplined around pricing and the new business that they enter into so they ensure the right levels of profitability on new business have allowed us to continue to increase the profitability.

And you see in the first half, we had roughly 12%, just under 12% profitability in Q1 and then 12.6% in Q2. And we think that is a good indicator of the trend we will see in the back half. And for obviously the full year, with hopefully being close to 100 basis points improvement year over year in operating margin rate in that business.

And the good news is that we are seeing in all three regions. Obviously emerging markets is relatively small. But in the case of North America and Europe we're seeing traction in both regions in a significant way. And we see more opportunity for additional upside as we continue this disciplined approach on a go-forward basis.

As it relates to specifics to electronics business within engineered fastening and industrial, yes, I think that's a business that we continue to be very disciplined with and around pricing. And we are interested in certainly some aspects of that business, but as a result of some of these decisions as well as some of the customer decisions that have been made over the last year, the business has [shrunk] dramatically and now represents close to $70 million on an annualized basis.

And we think for the long term that's probably a reasonable number, somewhere between $50 million to $70 million. But we will see where we go from here. But that is kind of how we are viewing the business at this stage.

Operator

Michael Rehaut, JPMorgan.

Michael Rehaut - *JPMorgan - Analyst*

Thanks. Good morning everyone, and also like to add my congrats to Jim and John. My question is focused around raw materials. If you could remind us what the changes in raw materials has impacting 2016?

If that has changed at all with the move in steel prices? And I know it's obviously very early on right now, but maybe how to start thinking about, with the recent move in steel, how that may or may not impact 2017. And if there are certain hedges or pricing offsets that you think are in your wheelhouse to offset any pressures into next year.

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Sure, Mike. This is Don. I will take that. We think this year we are probably getting about $40 million to $50 million of benefit from commodity deflation. A lot of that primarily is in the first half as we really starting to anniversary some of those benefits that we started experiencing last summer.

And so in the back half of the year we don't expect incremental improvement, and we may even see a little bit of pressure in certain commodities, as you just touched on a couple of them. We don't expect that to be material in the second half of the year.

We have mentioned previously that we had locked into a lot of commodity-based contracts with certain key vendors earlier this year for the remainder of 2016. So that will clearly probably create a little bit of pressure in 2017. At this stage we think it's a manageable number, below $25 million for the full year. But obviously we will continue to monitor commodity prices, as we always do, throughout the remainder of 2016. But that's kind of where we are at the stage.

Operator

Tim Wojs, Baird.

Tim Wojs - *Robert W. Baird & Company, Inc. - Analyst*

Good morning, everybody. And I will add my congratulations to Jim and John as well. I guess just quick a two-part question on Security. First, in North America that business has organically been declining for the past few quarters. And I noticed that the tone was a little bit more positive on orders and backlog. So maybe if you could talk a little bit about when we can see an inflection on growth in the North American part of Security.

And then second, just given your improvement in Europe, could you talk about what the margin differential is now between North America and Europe?

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Sure Jim is going to take that. We've had the good fortune of spending a lot of time with both of those businesses. Jim, just very recently. We are really up to speed. And Jim, why don't you to take it?

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Sure. The simple one is the second question, which is about 400 basis points of difference at this point in time. And as far as the volume in North America, they've been working really hard on getting their field execution up to a level where the orders and the backlog can be installed efficiently and in a timely fashion.

And I would say one that gives us the ability to be at what we think is an inflection point is the fact that the field has made a lot of progress in North America. So we actually haven't had that much of an issue generating the orders. And we have the ability to go out and generate even more orders.

However, we've been throttling that a little bit as the field was sort of a bottleneck. And so that's really the answer, is the reason we are more optimistic about our ability to generate modest growth in electronic security in North America is because the field execution is improving and the field capacity is therefore improving.

Now just as a side note, there are several components of North America which are doing just fine in terms of growth, including the automatic door business and mechanical security. So this is the third leg of the stool, if you will. And once we get that moving in a positive direction I think we will be in a similar situation that we are in Europe where we are generating organic growth on a more consistent basis.

Operator

Mike Dahl, Credit Suisse.

Mike Dahl - *Credit Suisse - Analyst*

Hi. Thanks, and congratulations John and Jim. Wanted to also ask about Security. And it looked like there were some small bolt-on recurring revenue acquisitions in the quarter. So just wondering if you could give a little more color on that. And if we should interpret this as kind of a sign that you feel comfortable enough that this business is on solid footing that you will embark on, or you will re-embark on some inorganic growth initiatives within Security?

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

We actually do feel that the business is on solid enough footing in both North America and Europe to digest a few small bolt-on acquisitions. And in fact are thinking along the lines that these types of the bolt-on RMR acquisitions, basically is what they are, will supplement the installation business in terms of generating RMR.

And that one of the keys to success in electronic security is to get the RMR portfolio, that's recurring monthly revenue for those that are unfamiliar with that term. But to get that portfolio sequentially increasing every quarter in both of those geographies. And the combination of installation growth and attrition management and small bolt-on acquisitions, we almost think of them as if they were CapEx for growth in the Security business. So you will continue to see small ones.

As far as major acquisitions in Security, no, there is nothing on the horizon in the medium term, short to medium term for that. We are actually enjoying working on operational excellence and execution of the business to -- at the customer level in particular to ensure that while all of this consolidation is going on in the industry, we are providing the customers with the absolute best value proposition possible. And we think that we can continue to gain share -- or we're gaining share already in Europe, and I think we can continue to gain share in Europe. And in the North American business I think we can begin to gain some share along the way with that as a strategy.

Operator

Jeremie Capron, CLSA.

Jeremie Capron - *CLSA - Analyst*

Hi. Good morning. John, Jim congratulations, and all the best in your new roles.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Thank you, Jeremy.

Jeremie Capron - *CLSA - Analyst*

Have a question on the tools business. I think you made some pretty positive comments regarding the inventory situation in some of the large distributors and also point-of-sales data. So if you could come back to those comments and maybe provide a little more color here.

Also I would like to hear how we should think about quantifying the impact of the FLEXVOLT launch going into the end of the year and the next year? What kind of numbers and benchmarks are you looking at to measure the success of FLEXVOLT? Thanks.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Jeremie, it is John. I'll start and turn it over to Don. In terms of inventories, inventories are in great shape both from our perspective and our customers'. I think it's important to note that our large customers have done a really, really good job mining data, working with us in a -- with all their suppliers, but certainly us among their largest in a collaborative manner to get retail down to the 8 to 9 range when historically 10 to 12 was as well as they could do without being out of stock.

So the silver lining in the cloud for us is retail inventory -- for us and our customers, retail inventories are at about their lowest levels that they have been in years. But despite that sell-off or decline in inventory, we've been able to grow nicely. And from the customer's perspective, in-stock is as good as it's been. Our fill rates are as good as they've ever been.

It's really the power of sharing the data on a collaborative basis. And sell-through remains good. So we see no issues in terms of inventory adjustment going forward.

What I'll say on FLEXVOLT so far, and Don will quantify it to the extent he feels comfortable. So far, so good. The customers have responded really, really well. We are capacitized to fill a tremendous amount of demand to the extent it exceeds our expectations. But I'm going to let Don quantify that to the extent that he is comfortable doing so.

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Thanks, John.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

You get the hard one.

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Yes, I appreciate that. As we've mentioned related to breakthrough innovation, just as a reminder everybody, when we have major programs like this, our expectation is it will generate at least $100 million of revenue over a three-year period. And clearly we think FLEXVOLT is going to exceed that, probably exceed it in a very significant way.

As we look at 2016, we've had initially very high demand for the product. We expect, as Jim said, for it to hit the stores in late September, early October. And as a result, I indicated previously, that I think we will probably experience here in 2016 as a percentage for the total Company about 0.5 point of growth when you look at the entire year. And so that would be roughly $50 million to $60 million.

That number could creep up as we go throughout the fourth quarter and could become closer to 0.75%. So we will see how that progresses. But that's kind of the range you should look at initially.

As we think about 2017, we would expect this to be probably a multi-hundred million dollar program next year, likely around $200 million. But we'll see as the year progresses and the success of the launch.

We think the launch will be very, very successful. What we will be looking at is the sell-through and how strong the sell-through is in the initial 90 days and how quickly the inventory turns. And we've clearly positioned ourselves through all the things that Jim mentioned around commercial excellence and digital excellence to try to maximize that opportunity.

Operator

David MacGregor, Longbow Research.

David MacGregor - *Longbow Research - Analyst*

Yes. Good morning everyone, and congratulations gentlemen to you both. My question was to the European Tools and Storage growth. You talked about new products, you talked about expanded retail distribution.

I'm wondering if you could talk a little bit about the sustainability of that growth, and maybe how much runway is left with the retail distribution side of that? Or just deconstruct the drivers and talk about the sustainability.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Anybody that had 14% organic growth in Europe and said it was sustainable would not be credible. So that's a very special performance. And on the heels of the two years of 7% comps makes it even more challenging.

But having said that, the European Tools team is literally on a rampage, a growth rampage. And the environment is the big unknown over there. And the success of FLEXVOLT is also a big unknown. It's difficult to say, peg a number. But I think the one thing that we can say for certain is that whatever the market is, we will continue to outperform it over there and continue to gain share for the foreseeable future.

Operator

Mike Wood of Macquarie.

Mike Wood - *Macquarie Research - Analyst*

Hi, John. I hope you enjoy your retirement. And Jim, congratulations. My question is on the innovation in tools.

Is the 1% or so price gain that you've been reporting sustainable and part of your internal goals going forward? And is there any potential for bigger innovation in hand tools to move the needle on the 2% growth there that is well below the growth you are seeing in power tools? Thank you.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Starting with the innovation in hand tools, the innovation in hand tools is quite robust actually. And it is really remarkable how much innovation there is in products that are relatively simple, seemingly relatively simple.

The reason the organic growth in hand tools is a bit lower right now is not because of any lack of innovative growth, because there is a fair amount of that, most notably with lasers in this past quarter. The pressure in the hand tools business derives largely from the weakness in the industrial channels, in particular our Proto branded products are relatively -- have negative offsetting the positive growth in the other areas.

And then the first part of the question -- repeat the first part of the question?

Operator

Just a moment.

THOMSON REUTERS

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

It was just hand tools 2%. Could we ramp up organic growth on hand tools, which is 2%. (Multiple speakers) And I think we got it.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Okay.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

I hope so. If not, Mike, obviously you can follow up with Greg. Because I know after your question you didn't have access to speak again.

Operator

Dennis McGill, Zelman and Associates.

Dennis McGill - *Zelman & Associates - Analyst*

Hi. Just a quick two-parter, I guess on the transition. Jim, is your COO role going to be backfilled, either immediately or over time?

And then just looking for an update with respect to how you guys would phrase the Securities strategy now. I think we are about a year past the initial review. It sounds like status quo, but just wanted to hear how you're thinking about it.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

I'll answer the first part of the question and then I'll turn it over to Don who'll give his regular answer to that question. The answer is, no backfill for the COO role right away. There may at some point in time as the succession plan for me is developed and so on. It may be filled, it may not be. That all remains to be seen at this point. And then, Don, on the Security portfolio strategy?

Don Allan - *Stanley Black & Decker, Inc. - SVP & CFO*

Yes, absolutely. So you are right, Dennis. We have -- we made an announcement a little more a year ago about our evaluation of this portfolio. We frankly really began that evaluation in the early parts of this year, with last year more focused on continued improvement of the operational performance across the board. And we're starting to see some of the fruit from that labor.

And we had a good discussion at this Board meeting and we will likely have another one in October. Hopefully that will solidify our discussion and we will be able to announce something post-October.

We've looked at obviously the three options we've discussed previously, which is keeping the entire business, potentially selling or spinning the entire business, or divesting a portion of it, and we specifically had mentioned our mechanical lock business as a potential candidate for that. So we continue to evaluate those. I would say that it is getting very close to the finish line. And I would imagine the next 90 to 120 days we will have something very clear to say on that.

Operator

Jeff Kessler, Imperial Capital.

Jeff Kessler - *Imperial Capital - Analyst*

Thank you. It's interesting -- firstly, congratulations to both John, and congratulations to Jim. Keeping Security questions going, which is kind of unusual for all of these -- after all these years.

Looking at the various components of what makes up the electronic security side of your business, and looking at some of the smaller parts of it that have been added and you've been showing off at trade shows such as healthcare and Sonitrol and tracking, things like that. You are talking still about fairly slow growth, but consistent growth on the electronic side.

Is there going to be a point at which some of these higher growing areas begin to start affecting the overall growth of electronic security in -- particularly in North America, or indeed in Europe if they begin to add to that as you begin to try to start adding more value and offering more value to your customers out there?

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

The answer is yes. But I will let Jim give you a little more detail.

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

Yes. This industry that we're talking about, electronic security, is in very rapid flux right now, as I think most people know. And the IoT in particular, the cloud, advanced analytics, these type of things are all impacting our industry. And in fact our industry is extremely well-positioned to exploit some of those technological advances.

We are working very diligently and aggressively on several verticals, including healthcare and retail in particular in the United States, and in Europe we're taking a bit of a different approach where we are working more on specific applications and then trying to market those, generally kind of in the $1 million to $5 million annual revenue range whereas the healthcare and retail solutions are a little bit higher ticket.

The growth from those activities in the higher-end verticals, the real key is to create this recurring revenue business model that will provide superior profitability and therefore enable us to get paid for the value. That is definitely something that we've been able to accomplish in healthcare. And now in healthcare we are really investing in significant growth, because the next challenge that one faces in these types of verticals is scaling and being able to make those significant investments that enable 10%, 20%, 30% growth.

That is challenging in a business that's in kind of a turnaround profitability mode. But we are going ahead and making some of those investments. In fact, healthcare is one area where we're doing. Retail is another one here in the States.

Now, the fundamental growth model in traditional electronic security, is always very challenging to grow it quickly because of the high recurring revenue content of the total revenue base. That -- which means that, and also the attrition in the recurring revenue portfolio, which goes back to one of the reasons I think these bolt-on RMR acquisitions are a good idea because it takes some of the pressure off of the installation growth and the attachment of RMR to that installation revenue. And it enables more investment in the high growth areas.

So you will see over time an improvement in a more consistent -- in the growth rate and in a more consistent growth rate coming out of electronic security, which is one of the reasons that we like the business, because it does have that stable revenue stream once you get it moving in the right direction. And that is what we're really attempting to do right now.

Jeff Kessler - *Imperial Capital - Analyst*

Is what you are doing in healthcare and in retail, is it portable to other verticals?

Jim Loree - *Stanley Black & Decker, Inc. - President & COO*

I would say it's probably 60% to 70% portable. Lots of times there is platforms and certain technologies, like IoT, cloud, analytics that you have those capabilities within the organization.

But then there is application-specific activities that have to be tailored to specific applications, whether it's in a hospital or whether we are working on electronic article surveillance in a retail establishment. So that part of it, call it the other 40%, is not portable.

John Lundgren - *Stanley Black & Decker, Inc. - Chairman & CEO*

Jeff, said differently, and you know this as well as anyone. In any vertical about 50% of what we do is standardized across every vertical. But about 50% of what we do in a vertical is unique to that vertical, which is why we go to market that way. To Jim's point, a whole lot of what we're doing is portable. And we're looking forward to leveraging those opportunities.

Operator

I'm showing no further questions at this time. I'd like to hand the call back over to Greg Waybright for any closing remarks.

Greg Waybright - *Stanley Black & Decker, Inc. - VP of IR and Government Relations*

Great, Nicole. Thank you very much. We would like to thank everyone again for calling in this morning, for your participation on your call, and your questions and your comments. And clearly please contact me if you have any further questions. And thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Have a great day, everyone.