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Whirlpool Corp. (WHR)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Whirlpool Corporation's Fourth Quarter 2018 Earnings Release Call. Today's call is being recorded. For opening remarks and introductions, I would like to turn the call over to Senior Director of Investor Relations Max Tunnicliff.

Max Tunnicliff

Senior Director-Investor Relations, Whirlpool Corp.

Thank you, and welcome to our fourth quarter 2018 conference call. Joining me today are Marc Bitzer, our Chairman and Chief Executive Officer; and Jim Peters, our Chief Financial Officer. Our remarks today track with a presentation available on the investor section of our website at whirlpool.com.

Before we begin, I'll remind you that as we conduct this call, we will be making forward-looking statements to assist you in understanding Whirlpool Corporation's future expectations. Our actual results could differ materially from these statements due to many factors discussed in our latest 10-K and other periodic reports.

We want to remind you that today's presentation includes non-GAAP measures. We believe these measures are important indicators of our operations as they exclude items that may not be indicative of or are unrelated to results from our ongoing business operations. We also think the adjusted measures will provide you a better baseline for analyzing trends in our ongoing business operations. Listeners are directed to the supplemental information package posted on the Investor Relations section of our website for the reconciliation of non-GAAP items to the most directly comparability GAAP measures.

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At this time, all participants are in a listen-only mode. Following our prepared remarks, the call will be open for analyst questions. As a reminder, we ask that participants ask no more than two questions.

With that, I'll turn the call over to Marc.

Marc Robert Bitzer

Chairman & Chief Executive Officer, Whirlpool Corp.

Thanks, and good morning, everyone. On slide 3, we show our fourth quarter highlights. As you saw in our press release, we delivered strong results for the quarter including record ongoing EPS of $4.75. Excluding currency, we delivered revenue growth of 2.5%, driven by very strong price/mix actions throughout all regions as we continue to realize the benefits of the actions we initiated early in 2018.

Additionally, our North America region continued to deliver impressive results driving 5% revenue growth while again expanding EBIT margin 40 basis points despite a soft industry and significant cost inflation. In Europe, we drove sequential quarterly improvement in volume and EBIT margins, which were in line with our expectations, as we began to benefit from previously announced actions directed at returning the region to profitability.

Lastly, I want to remind you that our prior year results included the benefit of certain tax credits in our Latin America region, a 50 basis point positive impact to our fourth quarter 2017 consolidated EBIT margin.

Turning to slide 4, I'll discuss our full-year highlights. We delivered solid global results and expanded margins in North America despite a number of challenges such as softer than anticipated industry, significant cost inflation, trade tariffs, and currency volatility. In total, these challenges amount to an approximately 200 basis point impact. Additionally, our performance in Europe was worse than expected and drove a miss in revenues and margin for the corporation. Faced with these challenges, we quickly adapted our plans and took strong actions to address and offset them. These actions included strong execution of our previously announced cost-based price increases, delivering on our fixed cost reduction initiatives, refocusing and rightsizing our European business, and continuing in our disciplined approach to capital management.

Lastly, we delivered very strong free cash flow of $853 million for the year, driven by disciplined working capital management including significant improvement in inventory and the favorable timing of certain payments. The actions we took in 2018 coupled with favorable exit rates in Europe give us confidence that we deliver results in 2019 that put us back on track to our long-term goals.

Turning to slide 5, we show further details of our margin performance, which we highlighted on the previous slides. Full-year margin obviously benefited from successful execution of our global price/mix and innovative product launches throughout the year impacting margins by approximately 200 basis points. Additionally, our previously announced fixed cost reduction actions continue to progress in line with expectations, and the result of these strong price/mix and cost reduction actions will successfully offset with significant raw material, tariff and currency challenges we face throughout the year.

Now, I'll turn it over to Jim to view our regional results.

James Peters

Executive Vice President & Chief Financial Officer, Whirlpool Corp.

Thanks, Marc, and good morning, everyone. Turning to slide 7, I'll review the fourth quarter results for our North America region. We delivered very strong results in the quarter with both revenue growth and margin expansion

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despite continued challenges in the external environment. Net sales increased 5% despite negative industry demand. Overall, we expanded our ongoing EBIT margin approximately 40 basis points as we overcame more than 150 basis points of cost inflation. Our ability to once again deliver strong margin expansion regardless of external volatility and significant inflation demonstrates the fundamental strength of our North America business.

Turning to slide 8, we review the fourth quarter results for our Europe, Middle East and Africa region. Including the impact of currency, net sales were down 6%, but reflect sequential quarterly improvement. EBIT margins were positively impacted by continued year-over-year price/mix improvement, which was more than offset by approximately 225 basis points of cost inflation and currency. We delivered sequential EBIT improvement as we began to experience the benefits of our actions centered around stabilizing volume. I will provide an update on these and other actions later in the guidance portion of this presentation.

Now we turn to slide 9 to review the fourth quarter results for our Latin America region. Excluding the impact of currency, net sales increased approximately 1%, driven by share gains and positive price/mix. Our underlying home appliance business drove EBIT margin expansion, which was more than offset by approximately 300 basis points of cost inflation and currency. Also, prior year results were favorably impacted by the sale and monetization of approximately $30 million in certain tax credits.

We now turn to the fourth quarter results for Asia region which are shown on slide 10. Excluding the impact of currency, net sales increased 11%. We benefited from unit growth and share gains in India. EBIT margins declined as strong price/mix was more than offset by raw material inflation and an increase in our bad debt provision.

Now, I'd like to turn it back over to Marc to review our guidance.

Marc Robert Bitzer

Chairman & Chief Executive Officer, Whirlpool Corp.

Thanks, Jim. On slide 12, we review our guidance assumptions for 2019. In line with our long-term goals, we expect to drive net sales growth of approximately 3%, adjusted for the divestiture of our Embraco compressor business and the carryover impact of currency. In addition to previously announced pricing actions, we are bringing innovative and compelling product launches across all regions in 2019, which will positively impact mix. We expect to deliver ongoing EBIT margins of 6.5% to 6.8%, a 40 basis point increase compared to 2018; and free cash flow of $800 million to $900 million, progressing strongly towards our long-term cash conversion goal.

Turning to slide 13, we highlight the drivers of our ongoing earnings per share expectations of $14 to $15. As you can see on this chart, there are certain elements, which make our 2018 ongoing earnings per share not fully comparable to our 2019 EPS guidance. Most notably is our tax rate assumption of 15% to 20% compared to 6.6% in 2018 as well as the absence of Embraco business for three quarters of the year. At the same time, the EPS measure has a carryover benefit from the share buybacks in 2018, while at this point, we have not included a specific number for share buybacks in 2019. The ongoing EBIT margin expansion is expected to drive approximately $1 earnings per share growth, which I will discuss in further detail on the next slide.

Turning to slide 14, we show the drivers of our EBIT margin improvement in 2019. We expect approximately 150 basis point improvement related to continued price/mix benefits and net cost improvement of 75 basis points as our fixed and ongoing cost reduction initiatives remain on track. With macroeconomic pressures remaining elevated, we continue to expect an increase of approximately $300 million in raw material inflation and tariffs, and we anticipate additional investment in our brands and products in support of upcoming product launches. We're confident that we have put the right actions in place to drive margin expansion in 2019.

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Now, Jim will cover our regional guidance and cash priorities.

James Peters

Executive Vice President & Chief Financial Officer, Whirlpool Corp.

Thanks, Marc. On slide 15, we show our regional industry and EBIT margin guidance for the coming year. Starting with industry demand, we anticipate continued economic and trade uncertainty to temper overall demand resulting in moderate, but positive industry growth of approximately 1% globally, with the exception of our Latin America region where we expect a strong improvement in consumer demand. As previously discussed, we expect to deliver margin expansion across every region driven by price/mix actions and strong cost takeout.

Turning to slide 16, I'd like to update you on the strategic actions we announced last quarter to refocus our EMEA business and return to profitability. First, we have taken specific actions to stabilize volume across the core EMEA business. We saw volume improvement in the second half compared to the first half of 2018, and we expect volumes to be positive in the first quarter of 2019. Discussions with our trade customers are focused on recovering floor spots lost during the peak of the integration. These negotiations began late in the fourth quarter of 2018 with the majority expected to be completed by the end of Q1. Our efforts to refocus marketplace investments towards our most profitable segments are on track to deliver benefits throughout 2019.

Second, looking at the bottom half of the slide, we are on track with the strategic actions we announced last quarter to refocus and right-size our EMEA business. The exit of Turkish domestic sales operations and Hotpoint-branded small appliance businesses is in process and is on track to conclude by the end of Q2, and we are actively marketing our South Africa operations for a potential sale. Finally, the previously announced $50 million fixed-cost reduction initiative for the region is on track. As a result of all these actions, we expect to drive approximately $100 million in annualized EBIT improvement in EMEA before exit costs.

For 2019, we expect to realize approximately $75 million for this first year of implementation and $100 million in total gross benefits thereafter. From a quarterly earnings perspective, we anticipate year-over-year EBIT improvement in the first quarter and expect to be around breakeven in the second quarter. We are firmly committed to improving our regional cost structure and restoring profitability in EMEA, placing us back on track toward our long-term margin targets for the region.

Turning to slide 17, I will discuss the drivers of our 2019 free cash flow. We expect cash earnings to positively impact free cash flow as margin expansion is partially offset by the sale of Embraco. Additionally, we remain committed to driving sustainably lower working capital, which is expected to result in $200 million of working capital improvement in 2019. We also anticipate lower cash outlays as major restructuring initiatives wind down. Lastly, free cash is impacted by several one-time items, which have a neutral impact to cash overall. These items are explained in more detail in the appendix of the slide presentation.

In total, we expect to drive $800 million to $900 million in free cash flow, excluding the anticipated proceeds from the sale of Embraco.

Turning to slide 18, we show our capital allocation priorities for the year. We remain committed to fully fund the business for growth, while maintaining strong cost disciplines across all regions. Additionally, we continue to expect to close the sale of our Embraco compressor business in early 2019 and use the anticipated proceeds to pay down debt. Consistent with our balanced approach to capital allocation, we intend to continue share buybacks, albeit at a moderate pace, while continuing to strengthen our balance sheet. We are committed to

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maintaining a strong investment-grade rating and optimal capital structure as we target a gross debt to EBITDA ratio of approximately 2 times.

Now, we will end our formal remarks and open it up for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Mike Dahl from RBC Capital Markets. Please go ahead.

Michael Dahl
Analyst, RBC Capital Markets LLC

Q

Good morning. Thanks for taking the questions. Just wanted to start off on the North America guidance and what you guys are thinking from a price and a volume perspective just given some of the moving pieces in the industry, tariffs rolling off, new capacity coming online, some of the other items.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

First of all, good morning, Michael. It's Marc. Let me maybe just talk a little bit about 2019 North America guidance. First of all, as you have seen, we guide towards a very strong EBIT margin of 12%-plus and we expect the industry to grow approximately 0% to 1%. Let me just elaborate on both items. The 12% is pretty close to where we were already running in 2018. As you've seen also in Q4, we had 11.8%. On a GAAP basis, we were even above 12%. So even in somewhat softer than expected market environment which we experienced in Q4, we are pretty close where we are already running at 12%. So we are highly confident with 12%-plus and that is also a result of the carryover of pricing which we had in 2018 and the effect of previously announced price increases in the kitchen segment which came into effect late December.

So there's a significant portion of carryover benefit from the pricing coupled with what we still expect to be a somewhat inflationary cost environment, but at the same time, we're having confidence that we're getting more and more traction on the cost takeout actions. So a combination of that leads to a further expansion of margins.

Now in the industry, as you see, we're guiding 0% to 1%, and that is on the back of what I would say a stable replacement market and the housing market which as you have seen in Q3 and Q4 went somewhat sideways, but as we also said on the previous earning calls, we are not surprised about the sideway moves of the housing market, we're still fundamentally bullish on the long-term demand driver of the U.S. housing market and that probably explains the broader context.

Now particularly with regards to tariffs and I presume you're talking about the washer tariffs, the Section 201 tariffs, first of all, as we already indicated, one competitor was already fully kind of live and up and running kind of Q3 and Q4, so we wouldn't see any further change or impact in the marketplace, and the other one has been partially online. So I don't expect dramatic changes coming out of this one because we've seen already most of that.

With regards to the other tariffs and that may be also a point of clarification for the broader guidance, we at this point have included the tariffs as they have been announced or as they have been communicated by the government, which also includes the Section 301 List 3 part which is supposed to go to 25%, I think, early March.

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So we have full effect of that in, but also recognize of course there's a lot of uncertainty on moving parts on the tariff side.

Michael Dahl
Analyst, RBC Capital Markets LLC

Q

Got it. A lot of helpful information. And then just a quick follow-up. When thinking about the overall guidance and the different moving pieces in there from a segment region, I think if you look at it from a segment standpoint, there's upside to the numbers. So, on a consolidated basis, is there someone that you guys are bringing in conservatism or is there another moving piece that would help explain how to square away all of those numbers to the consolidated range?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Yeah, and Michael, this is Jim. I think if you step back from it to begin with as we give the different range on the regions, obviously there's some rounding that comes in there and all that. So if you take it perfectly, you may get a little bit higher and lower than our overall range. Second is we believe overall the guidance is set at the appropriate level, and again as you look at the different regions, I think that's pretty close to where we expect to be. Outside of that, I think it's just rounding and nothing else in there.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Michael, it's Marc. Maybe to just elaborate a little bit further, first of all stepping back on the guidance and I think that's an important thing to note and recognize, as we said in our prepared remarks, the 2019 guidance of EPS is not fully comparable to 2018 because there is a big element which just comes from what I call a more normalized tax rate of 15% to 20% and the absence of Embraco. So you take these two elements out, it's basically $2.25. So, that particularly when you look at the broader guidance is a big element. Underneath that, we are still planning margin expansion, margin expansion on the back of pricing but also recognizing some cost elements.

So to Jim's point, I will call our guidance realistic, but I think as we've evidenced in Q4 and hopefully what you hear, we're very confident, we're very confident that we're in control of all the actions. We delivered good margin and good performance also on cash flow side in Q4 despite a soft industry, so we're highly confident. But I also recognize there is uncertainty as we experienced in 2018 and we're probably going to be volatility in 2019. Right now, I think volatility points more towards, call it, upside risk, i.e. the raw material going in the right direction, but we all recognize on the currency side on the raw materials, there is still a lot of uncertainty out there and that's what we have appropriately reflected in our guidance. But again I want to reiterate we are highly confident on our actions.

Michael Dahl
Analyst, RBC Capital Markets LLC

Q

Understood. Thanks for taking the questions.

Operator: Your next question comes from the line of Susan Maklari from Credit Suisse. Please go ahead.

Susan Maklari
Analyst, Credit Suisse Securities (USA) LLC

Q

Good morning.

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James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Good morning.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Good morning.

Susan Maklari
Analyst, Credit Suisse Securities (USA) LLC

Q

In 2018, we saw you get really significant price action in North America especially sort of relative to the way the volumes came through. Can you just give us some color on how you're thinking about pricing in 2019? I know that there will be some sort of continued benefit that comes through from what we saw last year, but just how should we think about the breakdown in terms of pricing as we move through this year?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Susan, it's Marc. So first of all, I want to also reemphasize it's not just North America. We had globally very strong price/mix actually across all four regions in Q4. So, that's a pretty remarkable progress. North America was particularly positive on the pricing side, and to your point about 2019, there's a significant part which is carryover, carryover from the price increases which we announced early in the year and of course there is kind of a new announced price increase from kitchen which came in effect late December.

As you also know, we're not making any forward statements about what we might or might not do on pricing. The only thing which I want to reiterate is I do believe based on our strong product pipeline and the product launches, we have significant mix opportunities ahead of us beyond list price increases. So beyond the list price, our mix opportunities are big, our product pipeline is strong, and we are confident behind that.

Susan Maklari
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And then I just wanted to dig in a little bit more into the $300 million of raw material and tariff inflation in there. Can you just talk to what you have been seeing in steel? Maybe any color around how much or to what extent you were able to lock in prices? And how we should be thinking about maybe some tailwinds that could perhaps flow through over the next few quarters?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Susan, it's Marc again. And this all comes back to what we said on the previous earnings call. The $300 million, as you rightly point out, is both a combination of raw material inflation and the effect of tariffs. So these are the two big components in there. On the raw materials when we first kind of indicated $300 million, we took a forward assumption on raw materials into account. So we factored in a certain, call it, normalization of steel prices and we also factored in a kind of improvement on particular plastic prices because, as you know, these are the two big components in our raw material purchase.

So I think sitting here today, of course we saw the steel price coming down and plastics coming down, which is in line with pretty much what we expected, And given the kind of long nature of our steel contract, we locked in, I

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would say, reasonably good conditions, but they still mean a year-over-year increase because we're comparing not against spot, but against kind of full-year average. So we still have some increases, but I would agree right now this steel and plastic are pointing in right direction, but as you also know, there's other raw materials which have a lot of volatility.

The other big part which has not changed, because at this point we just don't have new information, is the tariff landscape, the combination of Section 232 and the three different lists on Section 301, and as I mentioned earlier in my answer to Michael, particularly on the Section 301, we have fully factored in a potential increase – or a likely increase of 25% as of end of March or mid-March. So, that is sitting in these assumptions, but frankly we can't speculate about whether this happens or not. We right now took into account what is known and what has been communicated by the U.S. government.

Operator: Next question comes from the line of Michael Rehaut from JPMorgan. Please go ahead.

Michael Jason Rehaut
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks. Good morning, everyone.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Good morning, Michael.

Michael Jason Rehaut
Analyst, JPMorgan Securities LLC

Q

The first question, I just wanted to circle back a little bit and just make sure I'm thinking about the components of the margin guidance correctly. I think earlier it was kind of pointed out that if you kind of sum up the regional components, you'll get something maybe slightly above the 6.5% to 6.8%. By contrast, actually, if you sum up the components of price/mix, cost, raw material inflation on slide 14, you actually get right at the lower end of the range. So, obviously, there's a little bit of rounding, Jim, as you said. Are we just to take it that each of the components on slide 14 you might want to slightly – that you're being a touch overly conservative? I'm just trying to understand how, perhaps, if you look at the components on slide 14, if there are any areas where, let's say, price/mix, maybe it's not a 1.5 point, you're really thinking 1 point than 160 basis points, 170 basis points of their – movement within those components that gets you a little bit to the closer of the midpoint of the range.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Yeah. And Michael, this is Jim. I think as you start out, and you pointed out here that as you start to go through the different components there, and I think Marc highlighted this earlier in some of his answers, is that all of these are a point-in-time estimate and there's some variability within them. Right now, as we look at RMI, we would say yes, based on what we've said, we see the conditions similar to maybe slightly favorable. Tariffs are in the same situation as we had expected before. But there still could be some movement throughout the year in there. Net cost with inflation in there, again, this is an approximation and we do expect to see, obviously, some variation in there, as you continue to work down the list there, as I said.

I think if you add up all the pieces, could it be a 0.25 point either direction, in aggregate? Yes, and that's why we put a range around this right now. These are our best estimates at this point in time. If you look at across the different regions, I think also as we've said there that there's probably some rounding, as you add it all up and try

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and get. But we feel very comfortable. As Marc said, we feel very confident about the range we've given on EBIT margin. We feel very comfortable where it's coming in that it reflects the best information we have today.

Michael Jason Rehaut
Analyst, JPMorgan Securities LLC

Q

Appreciate it. I guess secondly, I just also wanted to go back to price/mix more broadly. You talked about some of your expectations around the carryover of 2018 price actions, price/mix actions as well as new price increases effective the first quarter, essentially. On the mix side, you also said you think you have some positive or upward potential there. I was hoping if you could just talk a little bit about the industry backdrop in North America right now from a mix standpoint, how it's trending. One of the things that we've observed across different building product companies is somewhat of a negative mix shift or strength in lower price points across different building product sectors in 2018. I'm curious if you've seen any of that in the appliance world this past year from a mix standpoint and how your own business has performed against that. And what you expect for the upcoming year?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Hi, Michael, it's Marc, and let me try to answer that. To your point about the building products and kind of more of the lower end growing, I would say, in the pure new housing side, I would say, yes, there's some trends or some signs that, in particular, the first-time buyers are coming more into the market, which overall, I would see as a good news and its demand, which comes with a slightly lower mix. But keep in mind, that is only a fraction of the total markets, the new housing. On the broader base, we don't see that massive shift down. Actually, I would say, the broader mix is pretty stable.

But then I would also, again, point back to what we're doing on product launches and innovation. I mentioned in one of my earlier calls, we have this year for Whirlpool brand an entire new global brand language for the kitchen products. We've just launched a new front-load washer – an entire new front-load washer platform in North America, and we will, in Q2, launch an entire new top-loader line. So, I think we're bringing out a lot of new products with a lot of innovation, which ultimately, I think – and that's our job to kind of bring the consumer to buy it and to mix up. And I think we feel very good about what we have in our pipeline.

Michael Jason Rehaut
Analyst, JPMorgan Securities LLC

Q

Great. If I could just sneak one more in, Embraco, what was the contribution from a revenue and profit standpoint in 2018? And I think you're only baking in one quarter of that in 2019.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Yeah, I mean, right now, Michael, we've assumed that that's about – as we said in our margin walk, our EPS walk, it's about $0.50 is the difference, as we pull that out. We have factored in approximately one quarter of that, and then from a top line perspective, approximately $1 billion.

Operator: Your next question comes from the line of David MacGregor from Longbow Research. Please go ahead.

David S. MacGregor
Analyst, Longbow Research LLC

Q

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Yes. Good morning.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Good morning, David.

David S. MacGregor
Analyst, Longbow Research LLC

Q

Just kind of a high-level question, first of all, and then I've got a follow-up. But I guess having covered you guys for a long time now, this is a pretty strong pricing environment, probably the strongest pricing environment I ever remember seeing with you in over 20 years. And I'm just wondering if something's changed here with regard to the tariffs. You've got foreign manufacturers adjusting to U.S. cost structures. You truly have an acceleration in new product introductions and innovation going on as well. But the big risk to the 2019 guide seems to be your ability to hold on to pricing in North American market. And I'm just wondering if something's changed structurally in the marketplace competitively that would suggest that maybe the industry, as a whole, has a little more pricing power. In other words, maybe the space is becoming a little more rational. What are your thoughts there?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

David, it's Marc. So, yes, you're correct, in 2018, we had a very significantly positive price/mix for the entire company. I also want to remind everybody we had also very significant cost inflation out there, so both the cost base needs and I think that explains a big part. The other part which I can't speak for the industry, I can speak for ourselves, we shifted, I would say, several years ago where we said we will participate in promotions, then we believe it creates value for us as company. That policy hasn't changed even under pressure.

I think there is a strong commitment on our side to expand margins. We saw cost increases reflected appropriately in the product pricing. And on top of that, and again I can't stress that enough, we launch a lot of new products. We invest every year $600 million in capital and almost the same amount in engineering, and that ultimately pays off. I mean we feel very good about our product pipeline. There is not a single platform in North America which I right now would see is behind. We feel very good and that helps us also having these prices fixed.

David S. MacGregor
Analyst, Longbow Research LLC

Q

Great. Follow-up question just regard to the balance sheet, you talked about trying to get your leverage down to 2.0 times or approaching 2.0 times by the end of the year. Can you just talk about how that plays out in terms of your share repurchase plans versus deleveraging plans and what we should expect there?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Yeah, so, David, this is Jim. And the first thing on the deleveraging that's obvious is when we close the Embraco transaction, that brings $1 billion worth of debt off our balance sheet within a very short period of time. The second thing as we've highlighted we do expect our cash flows to be very similar to strong this year, so we'll have adequate free cash flow to handle all the various things we've talked about in our capital allocation. And we've talked about that we want to get our debt levels closer to 2 times and very close to 2 times by the end of the year. If you look at share buybacks right now, as we've said, while we don't give a solid number, we do say we'll

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continue to do it opportunistically throughout the year. I think if you look at the back half of 2018, that's probably a good example of how we intend to buy back shares at least in the near to mid-term on an ongoing basis.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

And, David, it's Marc. Let me maybe just add to Jim's point. First of all, I also want to underline we have today a very strong balance sheet and our debt rating is a very solid one and this is consistent with what we have communicated for quite some time on capital allocation. We want to have directionally a balance sheet or debt leverage of 2 times. We will not be exactly at 2 times, but we will get pretty close to 2 times by the year-end. So the combination of strong cash flow, kind of a reversal of Embraco-related loan, and kind of a moderate share buyback that exactly leads it to that level, and I think then we have a very strong balance sheet, which leaves buying power and prepares us for whatever might happen.

David S. MacGregor
Analyst, Longbow Research LLC
Q

Great. Thank you.

Operator: Your next question comes from the line of Sam Darkatsh from Raymond James. Please go ahead.

Sam J. Darkatsh
Analyst, Raymond James & Associates, Inc.
Q

Good morning, Marc. Good morning, Jim. Happy New Year.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.
A

Good morning, Sam. Happy New Year.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Happy New Year to you as well.

Sam J. Darkatsh
Analyst, Raymond James & Associates, Inc.
Q

I was kicked off earlier, so I apologize profusely if you have already covered this, but I've got two questions and both of them have to do with slide 5. So first with net cost for the year, it was a favorable 25 basis points to margin, but I think last quarter in October, you were pegging that at 75 basis points for the year, which is a pretty significant swing. It's like a $100 million negative variance. And I'm trying to piece together why that would have occurred in such a truncated period of time in the quarter. I'm guessing there's some freight and warehousing in there, but could you talk about what happened with net cost in the quarter versus plan?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.
A

Yeah, Sam, this is Jim. Let me start off and then Marc can add some color commentary here. The first thing is we had some of it that was just a shift from marketing and technology to net cost. So again, as I said, these are always approximate buckets and we had some movement within the different cost lines, but being close to where we expected to be.

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The other thing you've got to remember if you look at our strong cash flow that we generated, a lot of that came through inventory reduction, and that continued to put pressure on our net cost takeout throughout the fourth quarter. And so it was slightly below where we'd expect it to be from a conversion perspective, but we had a significant benefit within working capital and inventory that we really felt was appropriate.

And the other thing that you highlighted is that we saw continued trends in inflation outside of raw materials, especially in logistics costs that continue to put pressure on those areas. So those are three of the big items that really caused that to move from where we thought it would be at the end of Q3 to where it was at the end of the year.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Yeah, and Sam, the only thing which I want to add is, one is on the tariff in particular if you compare the first half with the second half, the tariffs largely sit in the second half. So, that is what we saw in Q4, but that's pretty much reflective of what we expect to see in Q1. Good news is we delivered North American margins with all the tariffs already being in effect. Now, the other point and again let's echoing what Jim was saying on the inventory, we drove year-over-year a very significant inventory reduction in a pretty much flat demand environment.

So depending on if you count Embraco in or not, we have more than $400 million, actually close to $500 million inventory reduction. You also know there is a certain fixed cost leverage, which is fairly significant. So, kind of a negative impact of not having that production volume is fully sitting in these net cost elements. The good news is we're starting the year with, I would say, very balanced inventory levels and we don't have to reduce that as we go into 2019.

Sam J. Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

And my second question, the marketing and technology investments were ultimately trimmed, although again there may be some definitional things as you suggested, Jim, in the fourth quarter, but for 2019 guiding to a 25 basis point headwind, that seems like you're taking your discretionary expenses lower, especially in an area where one could argue it's designed for long-term growth and brand support. Is that you getting more efficient with marketing and technology investments or is that a decision you're making based on perspective end market activity and elasticity? Why take those investment spending numbers down?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

And Sam, I'd say you kind of hit the nail on the head on part of it there. We are becoming a lot more efficient in what I will say is our R&D or engineering spending. And we've talked about that over the last few years, the reorganization that we've done of that group and how we've aligned to get more projects done with less spending and make ourselves much more efficient in that area. We continue to invest significantly in our products. Additionally, in that space, there are some technology investments that we have had that can ebb and flow throughout periods of time, especially with some of the integrations that we have done. And so we're seeing a slight reduction – a reduction in some of those as we wrap up some of the integration within EMEA. So those are the big drivers that we have there, but we do continue to invest in our products significantly.

Sam J. Darkatsh
Analyst, Raymond James & Associates, Inc.

Q

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And if I could sneak one more in really quickly. The Embraco sale proceeds, are they guaranteed no matter what the regulatory timing or ruling is ultimately on the sale?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Yeah, Sam, it's Marc. As you know and I think we mentioned in one of our previous calls, the buyer is required by contract to do whatever is needed to get the regulatory approval by the end of April. So, that is technical. Legally it's called a hell or high water clause. So they have to take all actions necessary to get the regulatory approval. They got already a lot of regulatory approval. The ones which are still missing is Europe and Turkey, but we're confident that the buyer will get it by the end of April. And then kind of that triggers that happening, that would mean the reversal of the short-term loan which we took on the share buybacks last year.

Operator: Your next question comes from the line of Ken Zener from KeyBanc. Please go ahead.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Good morning, gentlemen.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Good morning, Ken.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.
A

Good morning.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Very solid North America margin. Could you talk a little bit, Jim, maybe just to start, is there a first quarter or first half weighting ratio that we should be focused on? If I missed it, I'm sorry.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.
A

Yeah, and Ken, we really haven't said anything about weighting. I think you should expect it to be similar to our normal pattern of seasonality within the year and especially as you look at Q1, just I would say it's going to be very similar to prior years. There's no distinct items. Obviously, Marc did mention earlier the tariffs do weigh a little bit heavier in the first half of the year on us because they accelerated throughout the year, and we do have some additional interest costs within the first quarter due to the term loan we took out in the second quarter of last year and we'll have that until we get the Embraco proceeds in. But outside of that, it's going to be relatively similar from an operational perspective.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Okay. Appreciate that. Marc, you mentioned – I just want to be clear to the effect to another company that I cover, you said the 25%, I assume, tariff increase was fully priced in. Could you go over that again in terms of – clarify

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that as well as quantify that in case the 25% does not go through? I mean, how much is that worth if it doesn't go? I assume you're talking about the tariff.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Yeah. So, Ken, as you know and given that you cover it quite extensively, there's a lot of tariff components, there's Section 232, there's Section 301 which has three different lists and what we have factored in everything which has been communicated or announced at this point, which means basically everything on the Section 301, all three lists, including the increase to 25% of the famous List 3 of part of 301 Section. That is all factored in. We typically don't split kind of the different components between List 1, List 2 and List 3. But needless to say, if List 3 stays at 10%, yes, that will be positive impact. But in total, it still will be a headwind, but it will be a positive impact.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Right. I'm just trying to get a little – because there was another company that had 10% and said the 25% would be an x-percent headwind. So if it doesn't go through, I'm just trying to extract from you a perhaps benefit that might accrue to your guidance, but...

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Yeah, Ken, maybe to just help you a little bit frame it a little bit more, in total and again without going through all the details and components, in total, you should assume the net of all tariffs right now weigh about $10 million or $10 million to $12 million every month on us, and that's just the reality.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Every month?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Every month. So, the 301 is a part of that and the 301 List 3 is a part of that. So, yes, if it would stay 10%, it will be a few million every month and that will be good news. But in total, it's right now still a headwind.

Kenneth R. Zener
Analyst, KeyBanc Capital Markets, Inc.
Q

Okay. And I think I'm going to cheat here, so with AM flat kind of your guidance for this year, you have a positive outlook on housing buying. Can you split it up a little more in terms of the suites that you're selling, so stuff that's a little more R&R versus replacement demand? And just pontificate on that a little. Thank you very much.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.
A

Ken, now you successfully sneaked in four questions. Having said that, right now, again, we guide North America to a very modest growth of 0% to 1%, and that is against a housing market which is right now still moving sideways. However, we expect the fundamental demand drivers to be intact and still a reasonably good – actually, if you look at the numbers, actually a very good consumer confidence.

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With that in mind, on a pure – in the traditions between replacement and discretionary, right now we see slightly more than half of the market around replacement and discretionary being less than half. As a comparison, the discretionary volume is still way below what we saw, for example, in 2005 or 2006 at the peak of appliance demand. So if you want to say so, replacement is a pretty predictable number because that just typically comes with a – for life of appliances. So the discretionary, yeah, in the long term, you could argue, still has some upside potential, but we did not factor that in, in our 2019 guidance.

Operator: Your next question comes from the line of Curtis Nagle from Bank of America Merrill Lynch. Please go ahead.

Curtis Nagle
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks so much for taking the questions. So I guess just kind of the first one going back to North America volumes. I guess, could you give any color in terms of how things look from a cadence perspective given that the comparisons are just a little bit choppy kind of quarter to quarter?

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

Yeah, Curtis, this is Marc. And let me, first of all, talk about Q4. As you've seen in Q4, frankly, we expected the industry to be a little bit stronger in Q4, largely driven by we expected Q4 industry to have probably a little bit more inventory load by retailers, which did not happen to full magnitude. On the sell-through base, internally, we probably would have expected 1% to 3% sell-through growth and probably now in Q4 the sell-through from consumer perspective was probably around 0% to 1%. So, a small change versus what we originally had in mind. So, I would expect also, on a quarter-by-quarter basis, you will see the plus or minus 1% up and down quarter-by-quarter.

But having said that, the fundamental driver of consumer confidence in housing, we consider, to be intact. That doesn't mean that we will have a strong growth, but we just don't see right now the scenario that you would have a significant quarterly contraction of the market. Again, we see consumer confidence and the fundamental drivers of demand being fairly intact.

Curtis Nagle
Analyst, Bank of America Merrill Lynch

Q

Okay. Fair enough. And just quickly going back to the $300 million, I understand I guess the basis of why it's still at $300 million. But let's just say, hypothetically, steel and, perhaps, resins continue to be weak and maybe get a little bit of relief there, would you have to pull back any of your cost-based price increases, say, later in the year, if that would happen?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Yeah. Curt, this is Jim. I'd say, right now, as we said, we based the $300 million on what we've seen to-date and what we expect, obviously, throughout the year, different dynamics can drive that. The price increases that we have announced are based on the cost increases we've seen. And so, at this point in time, that's also our best estimate of that.

Obviously, throughout the year as we see different trends within the marketplace around cost and all that, we'll update our guidance in those areas, but there's a lot of different lines of volatility in addition to RMI that we're

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seeing today. As we mentioned tariffs, there's still some unknown on currency, obviously some up and downs on, and inflation in other areas of our P&L, especially around logistics and other areas, that can fluctuate also. So at this time, in aggregate, we really feel that in terms of what we're seeing in cost, in terms of cost increases, are appropriate for the year right now.

Operator: Your next question comes from the line of Alvaro Lacayo from Gabelli & Company. Please go ahead.

Alvaro Lacayo
Analyst, Gabelli & Company

Q

Good morning, gentlemen.

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

Good morning, Alvaro.

Alvaro Lacayo
Analyst, Gabelli & Company

Q

Just two quick questions. On North American, the expectations you see for that 0% to 1% growth, if you can maybe just talk to us about your assumptions on what you think repair and remodel spend growth will be and what your expectations are on new construction. And then secondly, with regards to the tariffs, particularly the piece that would step up to 25% in March, if that were to change or if that doesn't materialize – if the step-up doesn't materialize, would that impact pricing realization in any way based on the conversations you have with your retailers on what price increases may be, especially the ones in kitchen that were just announced?

James Peters
Executive Vice President & Chief Financial Officer, Whirlpool Corp.

A

I think, Alvaro, let me start with your second question. As I just mentioned previously, there's a lot of different moving parts within our cost structure today in terms of raw material increases, tariffs, logistic cost increases. And so, the 301 tariffs in that last piece is only a small part of all those increases that you see. So, I think there's a lot of other moving pieces and cost pressures that we're seeing right now on top of that. I think as Marc mentioned that while it could be a benefit to us, it's not going to be a significant benefit against that total bucket of cost increase that we're seeing right now.

The second thing, and I'll kind of let Marc talk a little bit about the demand, as we have looked over time in terms of how much of the demand is replacement versus discretionary, it typically treads around the 50% range, plus or minus 5% from there. And as we look forward to 2019, we don't see a significant deviation in that in terms of what we expect to be – versus the last three or four years what we expect to be discretionary versus replacement.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

A

And Alvaro, it's Marc. Let me maybe just add a few additional comments on particularly the housing. Obviously, we all follow the present analysts' reports on housing and it almost feels like there was first a period of overconfidence and now over-pessimism. I think both extremes are wrong. I think fundamental housing, yes, we saw some moderation, but the fundamentals are solid. To give a little bit more color and I think I made some comments on this one on previous earnings call, the U.S. housing market, ever since recession, has been supply constraint. That supply constraint led to probably an acceleration of home prices ahead of where you would

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expect them in the demand cycle. And kind of that started to cipher down demand a little bit. Come on top of that the mortgage increase which were particular in, I think, August or September of last year, that together led to a small moderation.

Now having said that, if you look at the fundamentals of household formation, entry buyers, age of the housing stock, rental occupancy, et cetera, et cetera, the fundamentals actually leave a lot of upside opportunity. So with that in mind, whenever people talk about the housing market, it's not even remotely comparable to what we saw like a decade ago. We're still on the new housing, way below a 25-year average of new housing, and even existing home sales are far away from high numbers. To be more specifically, yes, on existing home sales, we would expect a number clearly north of 5, probably somewhere around 5.3 to 5.6 in that ballpark, and in the new housing, we would expect the number getting close to 1.3 million, which again is way below kind of what you have seen in previous cycles and way below long-term average. At the same time, we don't expect kind of a double-digit or high-single-digit growth of that market. It will be a solid, probably low-single-digit growth in the housing markets.

Alvaro Lacayo
Analyst, Gabelli & Company

Q

Thank you.

Marc Robert Bitzer
Chairman & Chief Executive Officer, Whirlpool Corp.

I think we're coming to the end of the Q&A session. So let me maybe just quickly summarize a little bit some of our key messages from this call, from Q&A on slide 20. As we exit 2018, we are encouraged by the results of our actions to overcome significant external pressures and volatility. Looking back at 2018, we took decisive actions to overcome these headwinds including the successful execution of our previously announced cost-based price increases, delivering our cost takeout commitments, refocusing and rightsizing our European business, and driving sustainable improvement in working capital. We are confident that the strategy and actions currently in place will generate margin expansion and strong free cash flow in 2019.

Regarding capital allocation, we will continue to buy back shares at a moderate pace while we are on track to further strengthen our balance sheet. And finally, we will be providing you with a strategic update on our long-term plans at our Investor Day in New York City on May 23.

With that, I just want to thank you for joining us today, wish you all a good week and looking forward to talking with all of you at our earnings call in late April.

Operator: This concludes today's conference call. You may now disconnect.

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