Seeking Alpha

Transcripts | **Industrial**

A. O. Smith Corp (AOS) CEO Kevin Wheeler on Q3 2019 Results - Earnings Call Transcript

Oct. 29, 2019 1:30 PM ET2 comments | 2 Likes
by: SA Transcripts

Q3: 10-29-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $0.53 misses by $-0.00 | Revenue of $728.2M (-3.43% Y/Y) misses by $-24.41M

Earning Call Audio

Subscribers Only

00:00 -44:58

A. O. Smith Corp (NYSE:AOS) Q3 2019 Earnings Conference Call October 29, 2019 10:00 AM ET

Company Participants

Patricia Ackerman - SVP, IR, Corporate Responsibility & Sustainability and Treasurer

Kevin Wheeler - CEO, President & Director

Charles Lauber - EVP & CFO

Conference Call Participants

Jeffrey Hammond - KeyBanc Capital Markets

Saree Boroditsky - Jefferies

Michael Halloran - Robert W. Baird & Co.

David MacGregor - Longbow Research

Robert McCarthy - Stephens Inc.

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the A.O. Smith Third Quarter 2019 Results. [Operator Instructions]. I would now like to hand the conference to your speaker today, Patricia Ackerman. Ma'am, please go ahead.

Patricia Ackerman

Thank you, Victor. Good morning, ladies and gentlemen, and thank you for joining us on our third quarter 2019 results conference call. With me participating in the call are Kevin Wheeler, Chief Executive Officer; and Chuck Lauber, Chief Financial Officer.

Before we begin, I would like to remind you that some of the comments that will be made during this conference call, including answers to your questions, will constitute forward-looking statements. These forward-looking statements are subject to risks that could cause actual results to be materially different. Those risks include, among others, matters that we have described in this morning's press release. [Operator Instructions].

I will now turn the call over to Kevin, who will begin our prepared remarks on Slide 3.

Kevin Wheeler

Thank you, Pat, and good morning, ladies and gentlemen. I'm pleased to review several items regarding our third quarter performance. Sales in our North America segment increased 6%, and operating margin performance in North America improved approximately 200 basis points over last year. Our North America water heater and boiler operations continue to perform well. I'm particularly pleased with our commercial water heater performance, where we continue to outperform the market. Productivity within North America water treatment, manufacturing and the effectiveness of our direct-to-consumer channel continued to improve, and Water-Right's performance is right on track with our expectations.

We announced a 9% increase to our quarterly dividend rate in early October to $0.24 per share, which represents a 5-year CAGR of 24%. In China, while the third quarter came in where we expected, we are disappointed to see further weakness in demand and expect that to continue in Q4.

Moving to Slide 4 please. As weakness in our end markets in China persist, we have implemented further cost reduction actions. Over the course of the last 10 months into Q1 2020, we are targeting a 20% reduction in headcount from December 2018 levels. We continue to review and rationalize brand building and advertising spend, selling expenses, travel costs and other SG&A spend. By the end of the year, on a net basis, we will close over 700 in non-productive stores. We are continuing our aggressive cost reduction programs in both manufacturing processes and product costs, and we'll continue to work with our distribution customers on programs to reduce their inventory.

Total annualized savings as a result of these actions is estimated to be $38 million to $40 million, of which approximately $28 million will be realized in 2019.

I will now turn over the call to Chuck, who will review our third quarter results in more detail. Chuck?

Charles Lauber

Thank you, Kevin. Sales for the third quarter of $728 million were 3% lower than the same quarter in 2018. Earnings in the third quarter of $87 million declined 17% from the third quarter in 2018, and third quarter earnings per share declined 13% to $0.53. Sales in our North America segment of $515 million increased 6% compared with the third quarter of 2018. Higher water heating, heating, heater and boiler volumes in the U.S. were supplemented by $16 million in sales in our recently acquired Water-Right business.

Rest of the world segment sales of $220 million declined 20% compared with the same quarter in 2018. China sales declined 20% in local currency, primarily related to weak consumer demand and previously disclosed channel inventory levels. The weaker Chinese currency unfavorably impacted translated sales by approximately $6 million. India sales grew at 9% in local currency compared with the same period in 2018.

On Slide 6, North America segment earnings of $122 million were 15% higher than segment earnings in the same quarter in 2018, driven by the favorable impact to profits from higher U.S. water heater and boiler volumes as well as lower steel costs, improvement in the profitability of Water-Right sales without Water-Right and incremental profit from Water-Right. As a result, third quarter 2019 segment margin of 23.6% improved from 21.7% achieved in the same period last year.

Rest of the world earnings of $4 million declined significantly compared with to third quarter 2018. The unfavorable impact to profits from lower China sales and a higher mix of mid-price products, which have lower margins, more than offset the benefit to profits from lower SG&A expenses in that region. As a result of these factors, segment margins declined to 1.9% compared with 14.3% in the same quarter of 2018.

Our corporate expenses of $10 million were lower in the current quarter compared to the third quarter last year, primarily due to incentive-based compensation. Interest costs were higher in the third quarter than a year ago due to higher debt levels associated with the acquisition of Water-Right in April. For the year, we expect interest expense to be approximately $11 million.

Cash provided by operations of $280 million during the first 9 months of 2019 was lower than $289 million in the same period of 2018 as a result of lower earnings, which were partially offset by a lower investment in working capital compared to a year ago.

Our liquidity and balance sheet remain strong. Our debt-to-capital ratio was 16% at the end of the third quarter. We have cash balances totaling $514 million located offshore, and our net cash position is $195 million at the end of September.

During the first 9 months of 2019, we repurchased approximately 4.9 million shares of common stock for a total of $230 million. Approximately 4.1 million shares remained on our existing repurchase authority at the end of September. On Slide 9, we expect our cash flow from operations in 2019 to be approximately $400 million compared with $450 million in 2018, primarily due to lower earnings. Our 2019 capital spending plans are approximately $80 million, and depreciation and amortization expense is expected to be approximately $75 million in 2019. Our corporate and other expenses are expected to be approximately $46 million in 2019, essentially the same as last year. Our effective tax rate is expected to be approximately 22% in 2019. We expect to purchase our shares in the amount of approximately $300 million in 2019, and we expect average diluted outstanding shares in 2019 to be approximately 167 million.

On Slide 10, we continue to see headwinds in our markets in China. The fourth quarter is typically the strongest consumer demand quarter of the year. However, with continued weak year-over-year consumer demand and persistently high channel inventory levels, we are forecasting the fourth quarter in China to be similar on the top line and operating profit line to the third quarter of 2019. As a result, we revised our 2019 EPS guidance to a range of between $2.25 and $2.28 per share, a 13% decline at the midpoint compared with last year.

I will now turn the call to Kevin, who will summarize our guidance and business assumptions for 2019, beginning on Slide 11.

Kevin Wheeler

Okay. Thank you, Chuck. Our outlook for 2019 includes the following assumptions. First, let me start with China. We saw year-over-year consumer demand in the third quarter decline compared with first half of the year and project full year sales to be down approximately 19% in local currency terms. Combined with our expected 4 points of unfavorable currency translation, our 2019 China sales projection is a decline of approximately 23%. Our forecast for the Chinese currency in Q4 substantially levels with where it is today.

The sales decline of 19% in local currency is roughly equally attributable to weaker consumer demand and the change in China inventory year-over-year based on our projections of year-end channel inventories. Total channel inventory remained relatively unchanged from the second quarter at approximately four months. Historically, channel inventory increases in Q3 as it did in 2018 as the market prepares for the higher fourth quarter sales. This year, the channel did not experience a third quarter inventory increase. While we expect that consumer demand will be higher than other quarters of the year as the fourth quarter is typically a period of high promotion and buying in China, our assumption is the fourth quarter demand will run at a year-over-year decline similar to what we saw in the third quarter. We project that the channel inventory will be reduced nearly 1 month. We expect that we would exit the year with channel inventory levels remaining above normal. Normal is in the 2- to 3-month range.

In the U.S., we project residential water heater industry volumes will be down 100,000 to 150,000 units in 2019. Commercial industry water heater volumes are expected to be up 4% to 5%, primarily driven by growth in the light-service electric models.

Based on boiler sales growth of 5% year-to-date, we expect our North America boiler sales to grow approximately 5% for the full year. We project India water heater EBIT will be positive in 2019, and we expect India will achieve breakeven in 2020.

Please advance to Slide 12. We project revenue will decline by approximately 5% for the year in U.S. dollars and 3.5% in local currency. We see sales growth in North America with our water heater, boiler and water treatment products collectively expected to grow approximately 4% in 2019, including $40 million to $45 million in Water-Right sales. EPS is projected to be $2.25 and $2.28. We expect North America segment margin to be between 23.5% to 23.75% and Rest of World segment margins to be approximately 4.25%.

We are pleased with how our North America segment is performing, particularly on the water heater side on lower industry volumes. We see long-term growth drivers in water treatment solutions and boilers across North America.

In the near term, the China economy remains weak, and we have taken further action to rightsize the business while continuing to invest in innovation. We have a strong brand, broad product offering in our key product categories, broad distribution and a reputation for quality and innovation. Over time, we are well positioned to maximize favorable demographics in both China and India to enhance shareholder value.

Our replacement markets remain stable, which we believe represents approximately 85% of North America water heater and boiler volumes. We have strong cash flow and balance sheet, providing an opportunity to continue to invest in ourselves, acquisitions and return cash to shareholders.

That concludes our prepared remarks. We are now available for your questions.

Question-and-Answer Session

Operator

[Operator Instructions]. Our next question will come from the line of Jeff Hammond from KeyBanc.

Jeffrey Hammond

Just on China, I guess, just a lower expectation, your margin top line. Are you seeing that as more aggressive destock or weaker consumer demand? And then just on inventory, should we expect kind of first half '20 to still be under margin pressure as you guys continue to destock? And when do you think that kind of wraps up and gets back to normal?

Charles Lauber

Yes. This is Chuck. So when we look at kind of the change from our last guidance, what we really have seen is the consumer demand, our sellout, down a bit, which declined since -- it was kind of running flat year-over-year. That was our assumption. So we've seen a weaker decline in consumer demand of about 5% to 8%. So what that did is it pushed back a little bit our inventory reduction that we were expecting at the end of Q3. The good news is inventory did not go up. Typically at the end of Q3, inventories would go up in that 12% to 15% range. This year, it remained flat. So even last year, the inventories went up at that low end of that range. So as we go up the back half of the year, we're looking at a bit of a weaker Q4 based upon that weaker consumer demand and the needs that inventories are still going to be needing -- we still expect inventories to come down by about a month, which is going to cost a headwind. So to your question going out at the end of the year, we're looking at going out at the end of the year somewhere around three months. And as Kevin mentioned, typically, it's in that two to three month range that we would have this channel inventory. So we do have a bit of a headwind heading into next year.

Jeffrey Hammond

Okay. And I think that you said commercial -- North America commercial sounds better and was good in the quarter. Can you just give us the water treatment core growth and just talk about, I guess, qualitatively at least, what you saw in residential water heaters?

Kevin Wheeler

Well, I'll take the residential water heater side of it. First, in Q3, we expected residential to bounce back a little bit stronger than it did. And although it was positive, not nearly where we expected it to be at the end based on -- through August, the industry was down 194,000. We look at our September. We don't see much more of an improvement once we get that data coming out of -- from our industry.

So overall, we took the industry down a 50,000 compared to what we did in Q -- on our 2Q -- Q2 call. And simply, we just don't think in Q4, we can make up that delta. And so -- but when you look at it, again, you'll remember there's 120 million households out there, and we estimate somewhere in those households is about 132 million water heaters. And so 100,000, 150,000 units, there can be some variability there from year to year. We're coming off of 2 straight years of over 4% growth. This one looks like it's going to be down in the 1.5% range. So overall, we feel pretty good about our water heater business. We don't see -- we see going forward our replacement market remaining strong. So overall, the residential business, slight down year, but there is some variations from year to year.

Charles Lauber

And on water treatments, on the water treatment side, the North America water treatment, that is, last year, we had a bit of a tough comp because we had some ramp-up going on with one of our major customers. But if you look at the base business, we grew at about 9% for the quarter. So the base business is growing nicely like the back half of the trajectory on growth as well as continuing to look at improvements in operations.

Operator

And our next question will come from the line of Saree Boroditsky from Jefferies.

Saree Boroditsky

I appreciate the commentary on North America but wanted to see if you could dig into the results a little bit more. You talked about a 4% price increase back in August. How has this been received by the market? And are you seeing some more price increases from competitors? Or just in general, any changes in the competitive dynamic?

Kevin Wheeler

We're going to be very consistent here since we're the only public company. What I will say is we announced and implemented a 4% increase as stated in August, and that's been implemented.

Saree Boroditsky

Okay. And then based on the 20% total headcount reduction in China, can you just confirm if that would be another 5% reduction in the fourth quarter? And maybe provide some color on where those headcount reductions are occurring, if you feel like the business will be rightsized for the 2020 market conditions at this point.

Charles Lauber

Yes. Saree, this is Chuck. So we've increased that percentage from 15% to 20% from the last quarter. We did that based on the continued weakness in consumer demand. We'll look at whether that would be increased as we go forward. There will be some of that, that goes into Q1. It's going to be over the course of probably the next 2 quarters that we'll see that come out. The areas impacted, it's been largely across the board. We have not -- what we've been very careful to do is maintain our R&D and engineering capabilities and maintain that investment so that we can continue to lead with innovative products. So we have not leaned on those types of headcount reductions, but it's been pretty much across the board.

Kevin Wheeler

Yes. And a little color to that. What's important for us is we're going forward in making the adjustments for the current environment that we're in, that the business overall, whether it be in operations, manufacturing, engineering, we're still in position when the economy turns that we can ramp up quickly. So it's a very strategic way that we're doing it. And we know the economy is going to come back. We just -- we don't know exactly when, and we want to position our cost structure to the environment but also the ability for us to ramp up when the economy comes back and be able to service our customers at the appropriate level. So it's a balance here, and we're looking at it from all sides.

Operator

And our next question will come from the line of Mike Halloran from Baird.

Michael Halloran

So just some thoughts on China here from a competitive dynamic, market share perspective. Last couple of quarters, you've given some good detail about how you think you're tracking versus the market, both at the high end as well as kind of overall. Maybe you can just give us an update there and then specifically talk about how you think you're performing versus the market as well as competitive situation.

Kevin Wheeler

Yes. This is Kevin. Let's just talk Q3, because we look at this quarter by quarter, and it does vary. In Q3, our gas tankless shares, we held our share. And on wall hung electric and water treatment, we were down slightly, about 200 basis points. On the water heater electric side of it, we know exactly where those share declined. We've seen a couple regions. We'll take some action there. And you got to remember, in Q2, we also talked about that we had improved market share in Q2. So we gave a little bit back. But again, there is variation from quarter-to-quarter. We don't see any issues there. We expect to recover our share over time. And we have the products, the distributions to handle that.

With regards to competition, certainly, every -- China has been a competitive market for the past 20 years. We have people that are -- have entered into our space on the premium side, and we have to compete, and we're competing on a regular basis. Now again, we're in a market that's a little bit down. And so it's -- we have some mid-price point products that have done fairly well, and we have some premium products that continue to provide value to consumers. But there's a balance there. So overall, when you step back, our share is continuing to be in line with our expectations. And you'll tend to see a little bit of up and down quarter-to-quarter.

Charles Lauber

And I think, Mike, on your comments or your question about high end of the market, the water treatment side, when we look at this year-to-date compared to 2018, we've seen it pretty stable. We haven't seen any decline, consistent with what I think we've talked about in the other quarters within the water heating side, both gas and electric. We saw the high end come down a couple of hundred basis points as far as the total market, percentage of market.

Michael Halloran

Okay. That makes sense there. And then the margins in the fourth quarter, I think, Chuck, you said about consistent with the third quarter. I think the math I ran was closer to breakeven. Just to confirm that one way or another. And then more importantly, just maybe talk about some of the puts and takes going into the fourth quarter to get to that margin profile. How much of this is just really volume deleverage versus maybe including severance or some of these other one-off kind of cost items? Any kind of color on the puts and takes and factors there would be helpful as well.

Charles Lauber

Yes. So the Q4 volume, it's largely volume and -- hold on a second here. Yes. It's largely volume, Mike. The puts and takes compared to last year, think of it in terms of 50% channel inventory carve out that's going to hurt our volume, and the other 50% of it being part of just lower consumer demand. The puts and takes on the headcount reduction and those other costs, I mean, we still have some costs going into headcount reduction and severance in Q4, although those benefits are higher than the cost that we've incurred. We've got a little bit of -- the plant's inefficiencies that occurred in the third -- or inefficiencies that occurred at the low end of that rate also. So those two kind of offset each other. But the risks on kind of the Q4 number probably relate more along consumer demand than what happens to channel inventory because we're forecasting channel inventory to come down by about a month. And back to your question on Q4. Yes, we think of it as being pretty much a breakeven quarter for the fourth of the quarter in China -- the fourth quarter in China to be pretty much breakeven.

Operator

And our next question comes from the line of David MacGregor from Longbow.

David MacGregor

I wanted to start off by, while we're on China, parsing out, if we can, sort of the difference between what you might been seeing in your mid-price point product versus your premium price point product. And if we're able to talk about that four months of surplus inventory, are you able to parse out how many months are you in terms of just if we isolate the premium? Because it seems like the mid-price point is probably turning relatively well given where the markets migrated and maybe the concentration that might be in premium. So if it's four months on the aggregate inventory, what would it be on the premium?

Charles Lauber

Yes. I mean I'll say that right now, in Q3 and Q4, what we're seeing as sell into the channel is more heavily weighted towards the mid-price, lower-margin product. The channel does have more of the higher price product that's taking longer to move in this sort of an environment. To parse it out and split it, we don't have that kind of clarity exactly right now. It looks like we see it changing over time because we know that we're selling mostly, and that's why our margins are lower in these two quarters, we're selling a larger percentage of mid-price product with lower margins. As far as the months, so we've got about four months of inventory, and I want to help define that a little bit. So four months, think of it in terms of the guidance we gave, so down 23% from last year. And we're thinking of four months as you take that number and divide it by 12, and that's roughly the number of dollars we kind of have in the inventory. So I wanted to frame it a bit because we're not looking at it as the next three months sellout. We're kind of looking at it as the 12-month average and working to get that down. So as the total year volume goes down, that's where we got a little bit more aggressive. But it's about four months looking to go to about three months by the end of the year.

David MacGregor

Okay. And then, I guess, as a follow-up, just maybe talk about the boiler business. And I guess you've reduced guidance twice so far this year. Can you just talk about performance in the third quarter with maybe a little bit more granularity? And also, I guess, any color you can provide in terms of just the backlog dynamics? Are you seeing backlogs up or down the boiler business? And just what does quoting activity look like in the boiler business?

Kevin Wheeler

Yes. The boiler business, it's kind of a mixed message I'm going to send here. The activity, bidding and quoting has been very active, and it's been that way throughout the year. It actually spilled in from last year, and we're getting a lot of activity there much more than -- it actually is turning into orders right now where we're seeing more and more jobs being delayed or postponed, and we can make some speculation around labor shortage and things of that nature. But when you look at it, the 5% that we're forecasting, we're gaining share in most of our categories that we compete in. But -- and we have this backlog of quoting that just has been released as we expected it. The good news is we do expect it to be released over time, but there is just a kind of a delay between -- much further delay between quoting and actually turning into orders than we've seen in the past. But overall, the commercial business seems to be good, and we're getting our fair share of the jobs that are being turned into orders. And we look for that to carry over into next year.

Operator

And our next question will come from the line of Robert McCarthy from Stephens.

Robert McCarthy

Can you hear me?

Kevin Wheeler

We can, Robert.

Charles Lauber

Yes. We can.

Robert McCarthy

I guess one thing, thinking about China, I mean, one thing we can say -- and I'm not trying to be impolitic, but clearly, there is a bit of a visibility issue here, understandably, with respect to the channel and what's occurring just given the fact that you've taken down your assumptions consistently and then obviously, certainly 2Q versus 3Q. But I think next year is the year of the rat as opposed to the pig, and New Year starts on the 25th. But are you going to be in a position to really guide with any granularity or visibility or conviction when you report fourth quarter for China given just the dynamic nature of what we're seeing right now?

Kevin Wheeler

Well, let me take that. I believe I'm asked more than once, are we at the bottom? And we kind of said, hey, we hope so. And -- but we really don't know. The data is a little bit unclear. And what we're going to look at is we're coming off a difficult Q3. Consumer demand was down as we talked about. We're going to look at Q4, and that's going to give us kind of the vision into 2020. But it's one of these markets that we have to take month by month, quarter by quarter. And hopefully, we get to Q4, maybe there is a Phase 1 of the China agreement that may help going into 2020. But we don't know. What we do know is that we're trying to give you our best view based on the data we have today, and Q4 is going to be a critical quarter as we set up going into 2020. And we're in the middle of our planning process right now, but we just need to see how Q4 plays out.

Robert McCarthy

All right. And then moving on to kind of back to North America. And obviously, I think there is some limits to what you want to talk about given competitive dynamics or whatnot. But just in terms of the granularity, I mean, is there anything you could say about kind of the relative growth rates in the near term for tank versus tankless? And have you seen a pronounced shift there given the fact that particularly some applications for tankless but the all-in cost coming down, there seems to be, at the margin, more of a preference for it. And this, historically, over the last couple of years, there's been a better growth rate in association with it. What can you give us? Because clearly, underneath the hood, we are seeing a little bit of a different growth rate for North America. And I'll just highlight the fact that you did miss consensus numbers for third quarter, and you did take down some of the assumptions for fourth quarter. So any kind of visibility as to -- if there's a potential sea change going on there in the fourth quarter would be helpful in terms of granularity.

Kevin Wheeler

Let me try to take some of that. As far as sea change, no. But we don't see a sea change. If you look at the tankless side of the business, it's growing certainly faster than the tank type. That delta has changed quite substantially. We're down about 1.6% on tank, and tankless is up maybe in the 3.5% range. So there is -- if anything, there's a contraction between the 2. And -- so there's no meaningful change. Again, you look at this quarter-to-quarter, I've been in this industry 30 years, and I -- it's difficult to predict the swings because quite frankly, when you look at it, a couple hundred thousand, 150,000 or 100,000 units, that's a relatively small number when you bake it into the millions that we sell. So what I'll come back to is we believe our North American tank replacement market remains solid. We are still a participant in the gas tankless business and have a low double-digit share that we're continuing to improve. We're going to be filling gaps in that category, the tankless category, in 2020. So no changes. Our distributors seems to feel fairly confident going into the quarter, into next year. So overall, that was a long way to say that it's pretty much status quo what has been from the beginning of the year.

Charles Lauber

And Rob, I want to come back to China real quick here and mention about visibility into the channel inventory in China. We have pretty -- we think we have good visibility into the channel inventory. What we're a little bit struggling with is sellout and consumer demand. That's really the change in our estimate quarter-over-quarter. And just remembering that we don't control the channel inventory. It's our customers inventory. We certainly work with them to try to help them move it through the channel. We have promotion programs and work with them closely. But the delta and variable from the last outlook is really the step down in consumer demand.

Operator

Operator

And our next question will come from the line of David MacGregor from Longbow.

David MacGregor

I just wanted to ask about you filed an 8-K back earlier in October just looking at amendments to the articles of incorporation. And I was just wondering if you could just talk about the motivation for incorporating these various defensive measures.

Patricia Ackerman

If I may?

Kevin Wheeler

Sure.

Patricia Ackerman

David, this is Pat. The amendment was basically to bring our charter and bylaws up to our peers and current standard. So it was really just some benchmarking that we had done and looked at what best practices for shareholder proposals and for director nominee. So it really was benchmarking and best practices that drove the amendment.

David MacGregor

Got it. And then just a follow-up question. I asked you last quarter about the -- sort of the split between mid-price point and premium price point in China. And you said you'd get back to us with that. So just wondering if we could follow up with that question again and give us a better sense of proportion in the Chinese business and, I guess, if there's anything you could be doing longer term to improve the contribution margin on the middle price point product other than just scale.

Charles Lauber

Yes. So this is Chuck. So we don't necessarily have granularity into the change of mid-price points. We have introduced many more products -- not many more products, we introduced more products in the RMB 3,000 to RMB 5,000 range, which, like we said before, the contribution margin isn't as high as the contribution margin in the high end of before, the contribution margin isn't as high as the contribution margin in the high end of the market. But we are working on cost reduction programs like we always do. We have cost reduction programs to lower product cost as well as improve production -- productivity and process improvement. So we continue to work on that. Right now, it's just heavier mix towards the, what I'll call, the high end of the mid-price products because of the fact that the channel has more higher end products in it today than it does mid-price. But those newer models are really well received in the marketplace right now. And our customers continue to want to introduce those, at the same time, work diligently to, over time, take down the channel inventory and some of the higher-priced models that are in the market.

Operator

And we have a follow-up from the line of Jeff Hammond from KeyBanc.

Jeffrey Hammond

Just on the -- there's been the recent news article about Haier entering the North America water heater market and building a plant. Can you just speak -- I mean, clearly, the market's pretty rational, few players, good returns. Just what are you seeing out there? And what are your expectations from that new entrant?

Kevin Wheeler

What I can tell you is what's been publicly announced is that they are going to -- they've indicate an announcement they're going to enter the electric water heater market and that they have investment in South Carolina of about $60 million. We have not seen any product in the market, and we don't know quite frankly much more than what they published. What I would -- now what I would tell you is that regardless, we always have competition. And A.O. Smith has a long-standing relationship with customers. We have the broadest portfolio of products in the market, technology, high service levels. And we have long-term relationships with -- and meeting market share. So at the end, there'll be a -- it looks like another competitor with a partial [one]. And if and when that starts to materialize, they're talking about next year, Q4. We'll deal with it as we have with all of our other competitors. So that's -- there's not much to say other than what you've read. And I think what we bring as value in our market share and our broad products of both residential, commercial, tankless and so forth that we're in good position to continue to move forward and be successful in this -- in our markets.

Jeffrey Hammond

Okay. Great. And then just back to the water treatment. Chuck, was the 9% that -- did that exclude that large customer? Or that would've included that tough comp?

Charles Lauber

Yes. That excluded the load-in of ramp-up of the large customer because we had an unusually high ramp-up of a customer. So the 9%, we view as more as kind of the baseline growth of the base business.

Operator

And we have a follow-up from Robert McCarthy.

Robert McCarthy

Yes. No. I mean I guess a question I would have is can you give us any kind of updated embedded expectation for the relationship with Lowe's? And has anything changed there in terms of what is kind of translated into your guidance for this year and thinking about next year?

Kevin Wheeler

No. Really, we can't. I -- we're not going to talk about specific customers going forward, particularly on performance. Overall, our water treatment business, as we said, continues to improve, and that's in all categories, whether it be our dealer network, our direct-to-consumer, retail and wholesale. So overall, the business is improving. We're becoming more productive. Margins are moving up, and the business is moving in the right direction as we continue to penetrate these market segments.

Robert McCarthy

And then just a follow-up on the entrance of GE and Haier. I mean I guess it stands to reason though that it worked through a material price increase several years ago. It worked out. But that was in the context of, I guess, to pass an oligopoly. I mean clearly, do you think going forward, if it gets to a more competitive environment with more players, that does lead to lower return thresholds and definitely could put a cap or put some pressure on the North American margins? How do you think about trading profitability versus growth in North America going forward if the market changes?

Kevin Wheeler

One, I don't think they are mutually exclusive, and we don't trade. But let's just take this from a much more macro picture, okay? And I'm not going to get into specifics regarding this potential competitor. But if you look at the investment that they're -- they've announced making $60 million, I can tell you from our perspective, we're 10x that. It takes a lot of investment, engineering and relationship, sales organizations to be a major player in this market. And we feel we're in great shape. We've invested, as I said, about $600 million in building this business over the last 60 to 70 years. And it's one that we feel good about going forward. And we think we have the pillars to -- whether it be product, manufacturing, engineering and so forth, to compete down the road. And that's what we're going to do. That's what we've done for the last 60, 70 years. And we'll continue to do that in the future.

Operator

And we do have a follow-up from David.

David MacGregor

We haven't talked much on this call about raw materials, and you did indicate in your prepared remarks and in your press release that it had been a positive influence on the North American margins. Can you just talk about, I guess, the extent to which that contribution could grow going forward? I mean steel markets, from a price standpoint, has come down pretty substantially. Not clear to what extent your contract versus spot exposed in the U.S., but in -- your indirect is probably coming through favorably as well. How should we think about the margin contribution from raws as we move through 4Q and into the first half of next year?

Charles Lauber

Well, for Q4, we'll just talk about those steel costs are set in advance. We kind of have the 90- to 120-day lag on when we see those steel costs, whether they go up or down. So you kind of can look back and look at Q4, and it's our best cost position in Q4 on steel for 2019. So -- and keeping in mind though just on the margin side, so we do have some large retail customers that have formula pricing that also moved the other way. So while there's some margin expansion certainly opportunity when steel goes down, there's also that corresponding headwind on pricing that offsets it. So looking through the end of the year, it is our best steel position in Q4.

Operator

And I'm not showing any further questions at this time. I'd like to turn the call back over to Patricia for closing remarks.

Patricia Ackerman

Thank you all for joining us on our call today. We will participate in several conferences over the course of the fourth quarter. The first is the Baird conference in Chicago. We will be there on November 5 and in the morning of November 6; and we will participate in the Stephens conference in Nashville on November 14. Have a great day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.