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The Sherwin-Williams Co. (SHW)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. Thank you for joining the Sherwin-Williams Co.'s Review of Third Quarter 2022 Results and our outlook for the fourth quarter and full year of 2022.

With us on today's call are John Morikis, Chairman and CEO; Al Mistysyn, CFO; Jane Cronin, Senior Vice President, Corporate Controller; and Jim Jaye, Senior Vice President Investor Relations and Communications.

This conference call is being webcast simultaneously in listen-only mode by Issuer Direct via the internet at www.sherwin.com. An archive replay of this webcast will be available at www.sherwin.com beginning approximately two hours after this conference call concludes.

This conference call will include certain forward-looking statements as defined under U.S. federal securities laws with respect to sales, earnings, and other matters. Any forward-looking statement speaks only as of the date on which such statement is made, and the company undertakes no obligation to update or revise any forward-looking statement whether as a result of new information, future events, or otherwise. A full declaration regarding forward-looking statements is provided in the Company's earnings release, transmitted earlier this morning. After the Company's prepared remarks, we will open up this session to questions.

I will now turn the call over to Jim Jaye.

James R. Jaye

Senior Vice President, Investor Relations & Corporate Communications, The Sherwin-Williams Co.

Thank you, and good morning to everyone. Sherwin-Williams had an excellent performance in the third quarter, including high-teens sales growth resulting in the first $6-billion-sales quarter in company history, significant, sequential, and year-over-year gross margin improvement, record adjusted diluted earnings per share, and strong cash flow. Demand remained strong in pro architectural and North American industrial end markets in contrast to continuing softness in Europe and China.

While year-over-year cost inflation remained very significant in the quarter, we were encouraged by a modest sequential decrease in raw material costs. The industry supply chain also continued to stabilize, though conditions remained tight with some previously noted specialty resins in particular remaining in limited supply.

Throughout the quarter, our team continued to focus on growth initiatives, product innovation, customer solutions, pricing actions, cost control, supply chain improvements and business optimization activities while also taking actions and planning for a wide range of scenarios that could unfold next year.

I'd like to go through just a few of the numbers at a high level and then turn it over to John who will provide some additional color on the third quarter and our outlook. Comparisons in my comments are to the prior-year period unless stated otherwise.

Starting with the top-line, third quarter 2022 consolidated sales increased 17.5% to a record $6 billion. Pricing was in the low-double-digit range. Consolidated gross margin increased to 42.8%. This was an improvement of 120 basis points year-over-year and 110 basis points sequentially, reflective of our pricing actions.

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Gross margin improved sequentially month-to-month in the quarter, with September increasing 650 basis points year-over-year. SG&A expense decreased to 25.3% of sales. Consolidated profit before tax increased $265.7 million or 43.5%. Diluted net income per share in the quarter was $2.62 per share versus $1.88 per share a year ago. Excluding Valspar acquisition-related amortization expense, third quarter adjusted diluted net income per share increased 35.4% to $2.83 per share versus $2.09 a year ago. EBITDA in the quarter was $1.12 billion or 18.6% of sales.

Moving on to our operating segments. Sales in The Americas Group increased 21.4%, driven by double-digit volume growth across all architectural end markets, and high-single-digit price increases. Segment profit increased by $132.6 million and segment margin was 21.2%, which was about flat with last year and up 30 basis points sequentially.

Sales in the Consumer Brands Group increased 8.5%, driven by a low-double-digit price increase which offset lower sales volumes primarily outside of North America. Continued tightness in alkyd resins impacted North America stain and aerosol sales. Adjusted segment margin was 16.2%, up 150 basis points year-over-year and 500 basis points sequentially.

Sales in the Performance Coatings Group increased 13.7% and were driven by mid-teen price increases, partially offset by a less-than-1% decrease in volume. Mid-single-digit sales from acquisitions were offset by a mid-single-digit unfavorable FX impact. Adjusted segment margin increased 590 basis points to 16.4% of sales, due primarily to higher selling price increases.

Let me now turn it over to John to provide some additional commentary before we move on to your questions.

John G. Morikis

Chairman & Chief Executive Officer, The Sherwin-Williams Co.

Thank you, Jim, and good morning, everyone. As we've indicated since the start of the year, we expected 2022 would be a year of two contrasting halves, and that's exactly what we're seeing play out.

We delivered strong results in the third quarter, and I want to thank our entire leadership team and all 61,000 employees for their focus, their determination, and drive in what remains a challenging operating environment. We continue to have great confidence in our strategy.

Before moving on to our outlook, let me provide some additional color on our third quarter. In The Americas Group segment, we delivered record sales and PBT. Mid-teens volume growth and high-single-digit pricing drove sales, which were up by a strong double-digit percentage in every end market we serve. The sales growth was led by DIY which was compared to an extremely soft quarter a year ago where we prioritized our pro customers, given limited product availability.

Sales growth was next strongest in our property management, followed by new residential, residential repaint, and commercial respectively. Sales were also up by a double-digit percentage in Protective & Marine but were dampened by the ongoing limited availability of alkyd resins. We are seeing strong effectiveness from the 10% price increase we announced September 6.

TAG segment profit increased due primarily to double-digit paint volume growth and selling price increases, partially offset by increased raw material costs and higher SG&A costs related to continued investments in our long-term growth initiatives and our strategy.

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From a product perspective, exterior and interior paint sales were both strong, with exterior sales growing slightly faster and interior being the larger part of the mix. We've opened 32 net new stores year-to-date and expect to open 40 to 50 in the fourth quarter. We continue to invest in our management trainee program, expecting to hire more than 1400 college graduates that will enter this program this year and who will be the future leaders of the company.

We also added sales reps and territories in the quarter along with ongoing growth investments in innovative new products, e-commerce, and productivity-enhancing services. Our Consumer Brands Group had a much-improved quarter led by sales that exceeded our guidance. Sales in North America increased by a double-digit percentage, driven largely by price. DIY paint demand remained sluggish as inflation continued to pressure consumers, while continued tightness in alkyd resins impacted our ability to produce stains and aerosols. On a positive note, the Pros Who Paint segment again grew by a strong double-digit percentage.

Sales in China were down by a double-digit percentage due mainly to the COVID-related lockdowns. Europe was also down double-digits due to the slowing macroeconomic environment. Segment margin improved significantly primarily due to selling price increases and good cost control, partially offset by lower sales volume, increased raw material costs, and higher supply chain costs.

The Performance Coatings Group followed a very good second quarter with another strong performance in the third. Sales were up mid-teens including mid-teens pricing, and a mid-single-digit benefit from acquisitions, partially offset by a very slight decrease in volume and a mid-single-digit impact from unfavorable FX.

For the second straight quarter, this team delivered year-over-year segment margin improvement, driven by execution of our strategy including effective pricing actions. The 16.4% adjusted margin in the quarter was the highest for the segment since the acquisition of Valspar. And excluding the impact of acquisitions closed over the last 12 months, adjusted segment margin was 17% in the quarter. Although we're pleased to have reached the low end of our expressed margin target of high-teens, low 20s, we know there's a significant amount of opportunity ahead. I am proud of our team's efforts to reach this goal and know they understand the high expectations we have for continued improvement.

Sales varied significantly by region. In North America, sales increased double digits against a challenging comp and included low single-digit volume growth. Latin America sales also increased by double digits against a strong comp. Sales were up high-single-digits in Asia, driven by price as COVID lockdowns continued to impact demand. Sales in Europe were backward mid-single-digits against a double-digit comparison and continued economic slowing. Every division in the group grew, led by coil and followed by packaging, auto refinish, general industrial, and industrial wood.

We're also pleased by what we're seeing so far from the recent acquisitions we've announced in this segment. Again, these businesses added mid-single-digit growth in PCG sales in the quarter, though this was nearly all offset by unfavorable FX. Earlier this month, we announced an agreement to acquire ICA, a high-quality European business focused on innovative wood coatings.

Before moving to our outlook, let me speak to capital allocation in the quarter. We returned approximately $203 million to our shareholders in the quarter in the form of dividends and share buybacks. We invested $48 million to purchase 200,000 shares at an average price of $237.81 per share. We distributed $155.8 million in dividends. We also invested $175 million in our business through capital expenditures including $125 million in core CapEx and $50 million for our Building Our Future project.

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We closed three acquisitions in the third quarter for approximately $440 million. We ended the quarter with a net debt-to-EBITDA ratio of 3.1 times, as we increased short-term borrowings to fund our recent acquisitions. We'll drive the ratio to our long-term target of 2x to 2.5x range in 2023. We'll use cash in the fourth quarter of 2022 to manage debt, and share buybacks will be done to offset option dilution.

Turning to our outlook. We expect to deliver a very solid fourth quarter, resulting in our second-half sales increasing by a low-double-digits to mid-teens percentage, and second-half diluted earnings per share increasing by 35% at the midpoint of our guidance. Within The Americas Group, demand is strong across all of our pro architectural markets including new residential, despite higher interest rates, with customers reporting strong backlogs that will take them through the end of the year and likely longer. We also see a unique opportunity to continue winning new business as our competitors transition their pro contractor business models, and our differentiated model has never been more on display and valued than it is today.

Within the Consumer Brands Group, we expect the North American DIY consumer to continue to face inflationary pressures, and Europe and China remain challenging.

Within the Performance Coatings Group, demand remained strongest in North America, our largest region. European demand slowed in the third quarter, and we expect continued softness in the fourth quarter. In Asia, the pace of recovery from prior COVID lockdowns in China and prospects for additional lockdowns make it difficult to assess demand trajectory.

From an industry supply chain perspective, we're largely getting the raw materials we need, though the availability of alkyd and some specialty resins remained choppy and is impacting certain product lines within consumer brands and performance coatings. While we continue to push hard, we don't expect meaningful improvement in the availability of these resins until the first quarter of next year. Some near-term inefficiencies remain in our own supply chain as we continue to take steps to overcome industry issues and serve our customers.

On the cost side of the equation, our full year raw material inflation guidance remains in the high teens. We expect to see further sequential decline of raw material costs in the fourth quarter, though they will remain elevated year-over-year. We expect the trajectory of raw material costs to continue trending favorably as we exit the year, although the pace and level of potential relief next year is difficult to project.

Additionally, along with the highest inflation rate we've seen in 40 years, we are also experiencing significant higher costs in other elements of our cost basket, including labor, transportation and fuel and other costs. We will continue to monitor these costs, fight hard to offset them, and respond with additional pricing if necessary.

So specifically, for the fourth quarter of 2022, we expect our consolidated net sales will increase by a high-single- to low-double-digit percentage, inclusive of a low-double-digit price increase. We expect The Americas Group to be up high teens to low 20%. We expect Consumer Brands to be down a mid-to-high-single-digit percentage. And we expect Performance Coatings to be flat to up a low-single-digit percentage. We expect North America, which is the largest region within PCG, to be up a low-teens percentage.

For the full year 2022, we expect consolidated sales to increase by a low double-digit percentage, inclusive of a low double-digit percentage price increase. We expect The Americas Group to be up by low double-digits to mid-teens percentage. We expect Consumer Brands Group to be down a low-single-digit percentage and Performance Coatings Group to be up by a low-double- to mid-teens-digit percentage.

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Given the many variables we've noted, we left our diluted net income per share guidance for 2022 unchanged and in the range of $7.65 to $7.95 per share. Full year 2022 earnings per share guidance includes Valspar acquisition-related amortization expense of approximately $0.85 per share. On an adjusted basis, we expect full year 2022 earnings per share of $8.50 to $8.80, which represents mid-single-digit percentage growth from 2021 at the midpoint, in what continues to be a challenging macro environment. This guidance implies a second-half adjusted diluted net income per share of $4.63 per share at the midpoint, an increase of 35% over the same time period last year. In addition, we provided updated guidance on several of our full year data points in our slide deck, including our expectations for FX, CapEx, interest expense, depreciation and amortization. We expect our full year tax rate will remain in the low 20% range.

While we're not prepared to provide any specific guidance on 2023 at this time, I would like to comment on demand trends and actions we're taking that will impact our 2023 outlook that we will provide in January.

We expect slowing new residential demand with elevated interest rates and other costs that are impacting new single-family home permits and starts. However, multifamily production has maintained strong momentum. It's also clear that macro headwinds are likely to continue and potentially worsen in Europe and China. Our base case in this environment remains to prepare for the worst and hope for the best.

I'm highly confident in our leadership team which is deep in experience and has been through many previous business cycles. We've transformed our business in many ways since the last significant downturn and we are now a stronger, more resilient company. We know what to do. To this end, we've been evaluating multiple options available to us based on a wide range of scenarios, and we are prepared to take appropriate actions beginning this quarter. These include the following.

We've continued to review our portfolio of businesses, brands, and customer programs to ensure that they are adding above-market growth and long-term shareholder value. As a result of this work, we are announcing action plans to simplify our operating model and portfolio of brands in Consumer Brands Group and to reduce cost in all regions in Performance Coatings Group, Consumer Brands, and administrative segments. These actions, once finalized, could include one-time costs or charges in the range of $160 million to $180 million over the next four quarters, and could result in annual run rate savings of approximately $50 million to $70 million once fully implemented. Additional details on these planned actions are outlined in the slide deck issued with our press release this morning. We will call out significant one-time charges and update our progress on run rate synergies on future quarterly earnings calls.

We remain committed to our strategy of providing innovative solutions that help our customers to be more productive and profitable. In challenging environments, we have the opportunity to become an even more valuable partner to our customers. We will continue to focus on new account growth and share of wallet initiatives. We will leverage our strength in recession-resilient end markets including residential repaint, property management, packaging, and auto refinish, all of which are larger than they were in previous cycles.

We will continue to invest in growth initiatives including adding stores, sales reps, and innovative products and services. We will continue to invest in our people, including our management trainee program I previously mentioned, along with ongoing training that positions our people as one of the most significant amongst our many points of differentiation. We will continue implementing appropriate pricing actions across the company to offset persistently higher input costs with a focus on regaining our gross margins back to our long-term target range of 45% to 48%.

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We will continue investing in acquisitions that can accelerate our long-term strategy and top-line growth, and expand our operating margins including our most recent announcement of European wood coatings leader ICA Group.

We will maintain our disciplined capital allocation philosophy. We will not hold cash, while investing appropriately in CapEx, paying a dividend, targeting acquisitions that accelerate our strategy and absent M&A, buying back our stock.

In sum, we expect to deliver a solid fourth quarter to complete a very strong second half of 2022, and we are also taking actions to get ahead of what could be a challenging 2023. We don't expect to be immune from any number of potentially difficult scenarios, but what we do expect is to outperform our competitors and the market. We will do this by leveraging the best team in the industry. We remain committed to creating shareholder value over the long-term.

And that concludes our prepared remarks. At this time, we'll be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question for today is coming from Vincent Andrews.

Vincent Stephen Andrews
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Just a question on TAG and the margin both sequentially and year-over-year. You saw lot more improvement in margins in the other two segments than you did in TAG, so I was wondering why that was. I did notice you called out some long-term investment spending in TAG that might have affected that, so perhaps you could talk about that a little bit as well in terms of what that is and whether it carries over not just into 4Q but into next year as well.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah. Vincent, this is Al Mistysyn. Yeah, I mean, we saw a little over 20% increase year-over-year in our segment profit. Flow-through was little, in the low-20% range, and it's typically the case. We had higher sales volumes which generally drives improved operating margin. I've historically talked about a low-to-mid-single-digit volume gain getting, in a normal-state environment, mid-to-high 20%. We had one really month of selling price increases, but these are still partially offset by the higher raw material costs that we had talked about being sequentially better but still up maybe a mid-single-digit in our fourth quarter.

And really, the higher SG&A costs that we called out are the continued investments in long-term growth initiatives. So we added 67 stores. We've put in over 80 reps. We've added head count into our stores to support the growth outlook. And as John mentioned, we're going to add and really accelerate our growth in the fourth quarter by adding 40 to 50 new stores. So what I would expect in the fourth quarter is you're going to see your normal seasonal slowdown in architectural demand, which is typical, and you'll also see a sequential decline in operating margin, but we expect stronger flow-through in our fourth quarter, really, upwards of over 30% and you get a full quarter of the 10% price increase that was implemented September 6.

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I would tell you that price increase is going even a little better than what we had seen in the past, the fourth quarter sequential moderation in raw material costs and an easier comp. So you're going to see bigger year-over-year improvement in our operating margin in the fourth quarter, and you're going to see that SG&A growth into the first half of next year. And we'll give you more color on that in January.

Vincent Stephen Andrews
Analyst, Morgan Stanley & Co. LLC

Q

And just as a follow-up, we talked a lot about raw material shortages for a year now, and part of what you were doing this year was trying to get your TAG inventory back to a comfortable level to service your customers. Are you there now? And given that maybe a lot of that was done over the last quarter or two when raws were peaking, should we be thinking about you carrying sort of peak COGS inventory into next year spring season? Or how should we think about the cadence of sort of lower raw material costs flowing through in TAG specifically?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Vincent, I'll take the inventory piece first, and I'll throw it to Al to talk to the accounting. Yes, we're in a very good place right now for the majority of our products. I mentioned earlier the issue that we continue to face with the alkyd resins and some of the specialty resins. We'll fight through that. It's getting better, as I mentioned earlier. We expect to have the majority, if not all of that, behind us at the end of the first quarter. But for the most part, the remaining portion of our product line is available for our customers.

You should, and I know you do know, Sherwin-Williams, our model is not to unlock the door and hope that people are finding their way back into our stores to buy in them. Our sales reps and store managers are very aggressive in the hunt of pursuing customers, both existing and new, to share with them the fact that we have these products available for them.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah. And, Vincent, we actually built a little bit of inventory from our second quarter to our third quarter, which is typically not the case, but to meet the strong demand that we're seeing specifically within TAG with the mid-teen volume growth in our third quarter and low-double-digit we expect in our fourth quarter, I think what you're going to see us do is try to manage our architectural inventory by year-end, maybe up another 4 million gallons. The reality of that is we're going to monitor that very closely as the quarter progresses and look at demand trends, specifically going into our first half next year, and we may adjust that number a little bit, and that's specifically to the DSCs.

Our store-level inventories are in great shape. We are meeting our strong demand with high service levels, and we expect to continue to do that. But as you can imagine, as our inventories get in better shape, we'll get back to managing our working capital. Our working capital into the third quarter is over 12%. We're going to target to try to drive that down between 11% and 11.5% by year-end, but still a very strong inventory position going into next year.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

And, Vincent, this ties also back to your first question on the SG&A, to Al's earlier point. We are continuing to invest in people to provide the service in the stores, so as the product becomes more available, you may recall in the last couple of quarters we talked about the new account activity at record levels and active accounts, so now

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we've got a lot more people coming into our stores, new accounts coming in, we've got product available. We want to make sure that we have the service to deliver on our promise. And so they're all interrelated, and they're all working very well.

Vincent Stephen Andrews
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great to hear. Thanks, guys.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You bet.

Operator: Your next question is coming from Truman Patterson.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Hey. Good morning, everyone. Thanks for taking my questions. First, clearly there are a lot of moving parts on raw material inflation between suppliers, the petrochems, oil. But, John, you mentioned the trajectory of raw material costs its trending favorably as you exit the year. Can you just help us understand at this point in time what the gross margin basket or the raw material basket might look like exiting the year sequentially versus kind of third quarter levels?

James R. Jaye
Senior Vice President, Investor Relations & Corporate Communications, The Sherwin-Williams Co.

A

Yeah, Truman, this is Jim. I'll take that one. So if you look at our third quarter, the raw material basket was up by mid-teens percentage year-over-year. I think as we get into the fourth quarter, we're looking at that being more like a mid-single-digit year-over-year number. I think, as John said in his prepared remarks, the trajectory is good and heading in the right direction. I think it's hard to project exactly what it's going to do next year. We're trying to still formulate that, and we'll come back to you in January with our full year guide to give you some more color on that.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Truman, I'd just add to that. As we typically do in our planning for the upcoming year, we work with our suppliers closely on looking at demand trends, looking at volume trends by region, and it gives us a better line of sight as we get through the end of the year. And that's why January, we are able to give you a much better outlook on the raw material basket and other input costs, quite honestly, because as we've talked about, labor rates have been up high-single-digits and in some cases across our supply chain low-to-mid-teens in an effort to reduce turnover which is very expensive, but the expertise that goes with that turnover, and then freight and other transportation costs. So we'd like to talk about the full basket as we get into January, and we'll have a better line of sight to that.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay. Okay. Perfect. And then you all mentioned some of the cost-control initiatives in PCG and CBG in preparation of a slowdown, right, savings of $50 million to $70 million annually. I'm hoping you can walk through

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those in a bit more detail. And then also, assuming volumes turn negative or remain negative through 2023, how does that impact your thoughts on kind of decremental operating margins for both of those segments?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Truman, I want to be careful about getting into too much detail on this call. I mean, we're making these decisions in our fourth quarter and going forward. And as we talked about on our second quarter earnings call in July, it's part of our normal operating process that we continue, and as John talked about, we continually assess this portfolio of business brands and customer programs and their ability to drive above-average market share growth and the operating margin and cash flow targets we set for them, and if we don't see that happening, we take action similar to what we did with exiting the ACE private-label business, the sale of our Australia New Zealand business architectural.

I would say on the run rate savings, more of that is due to the portfolio review than what I would call more purely cost reductions, and that's relative to the macroeconomic headwinds we're seeing. And it's probably a 60/40 split. And why I think that's important is because we're not overreacting to the macro environment. It means that we are driving operating margin improvement across consumer brands, across the PCG. And I would even venture to say that, within PCG, yeah, as John talked about, we hit the low end of the high-teens of 17%. We have more work to do.

These actions we're taking in the coming quarters is not related to our long-term high-teens low-20% operating margin. This is really in response to the slowdown we're seeing in Europe and Asia so we have opportunities to grow with platform consolidations. As we integrate these acquisitions going into next year, they'll start to be accretive as we get to the second half. So if we see additional slowdowns in demand, we have more levers to pull to offset any decremental operating margin, so.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Yeah. And, Truman, I'd answer this point as well. When you heard Al talk about not overreacting, I think your question's a good one, but I'd also point out that there are many areas of our business that we're actually continuing to invest and, in some, accelerating investments. And so the leadership that we have, the ability to view and see where those opportunities are, I think, comes with great deal of experience in what we're doing.

And so we just talked about adding stores as an example. We'll add 35 new stores in the fourth quarter – I'm sorry, 40 to 50 this year, this fourth quarter, compared to 35 last year. And if you look at the staffing that we just talked about investing in, the digital programs that we're investing in, so we are making, we believe, the appropriate steps and reducing where we need to, but we're also investing in those areas that are appropriate.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

The only other comment I'd make, Truman, related to that on the one-time costs, we'll call those out, as we have typically done in the past, specifically with the Valspar integration. So we didn't put them in the guidance in the fourth quarter. They're estimates. The timing is uncertain. We're pushing the teams pretty hard to take action and get these done, but we'll call them out over the next quarterly calls, and we expect to get it to approximately 170 over the next four quarters.

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Truman Patterson
Analyst, Wolfe Research LLC

Q

Perfect. Thank you, all, and good luck in the upcoming quarter.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Thanks, Truman.

Operator: Your next question for today is coming from Josh Spector.

Joshua Spector
Analyst, UBS Securities LLC

Q

Yeah. Hey, guys. Thanks for taking my question. A question on the Performance Coatings guidance. I guess when I look at things sequentially, normally, it's relatively stable. You guys maybe have a 10% decline, understanding things are kind of getting worse in some of the regions. But I think when I look at some of the competitor guidance, things were already pretty bad in 3Q, and generally things stay bad into 4Q. Your guidance implies things are getting worse, so I'm wondering if you can maybe dig into some of the details there about what's getting worse, or if maybe your 3Q was helped by some items which go away.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Josh, I think where we're seeing maybe a little bit more of a slowdown would be in Europe and Asia. And I think our largest region, North America, we've talked about being up in the low-to-mid-teens, and price will start to annualize, so you don't get as much of a tailwind on price.

Our comps are still pretty strong in our fourth quarter relative to last year, and so I don't know there's a significant step change that we're seeing other than I think we've got to be prepared and try to look at based on our history and what we've seen over the last two years is maybe a little bit wider range on sales as we go into the fourth quarter with the holidays and things of that nature. So I don't want you to read too much into that other than maybe a little less price as we get into the fourth quarter and then a little bit worsening outside of North America.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

But I do think, to Al's point, if you look at the comps, if you take for example our Packaging business, we had a high-single-digit growth this past quarter versus strong double-digit comp. If you go into next quarter, fourth quarter comps last year were up over 30%, so we've got a lot of momentum here in this business. We expect it to continue, continue to win with our customers and grow with them.

If you look at coil, had a similar situation. Fourth quarter last year, comps were up 20% coming off of a strong double-digit growth year as well. So there are some really strong performances here up against some really strong comps, and we think that these teams are continuing to grow in a pretty challenging environment.

Joshua Spector
Analyst, UBS Securities LLC

Q

Okay. Got it. Thank you.

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John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Thanks, Josh.

Operator: Your next question for today is coming from Jeff Zekauskas.

Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

Thanks very much. In the fourth quarter, should your average prices in TAG be up about 6 percentage points sequentially?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

No, Jeff. I think what's going to happen is we're going to get the full quarter of 10%. We're going to annualize the August 2021 7%, we're going to annualize the September 4% of last year's surcharge, so when you net them all together, it's about flattish quarter-to-quarter or high-single-digit.

Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

I'm sorry. The fourth quarter of 2022 relative to the third quarter of 2022, since your prices are lifting, you increased prices 10% in early September, shouldn't you capture that all sequentially? No?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

We are, but we're also annualizing some of the price we took last year, so from quarter-to-quarter, our dollars will be higher. I agree with that, but it's still in the high-single-digit range for TAG.

Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

Okay. And then in terms of raw materials, can you frame the alkyd resin sales and EBITDA penalty for 2022? And are TiO2 prices going down sequentially in any area other than Asia?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Yeah, I'll take the TiO2 piece, Jeff. What we did see in the quarter was some inflation that's happening. I think as we go forward, it'll depend on some of the softening demand that we're seeing, and I think it's part of our overall view that TiO2 should start to be part of that basket that starts to moderate. And the alkyd piece I'll let Al answer.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Jeff, I think the alkyd impact, I mean, it could be around 1% on top line. We're having to make choices. So as an example why it's difficult to pinpoint it, there's a broad basket of alkyds, and some we're getting fully what we need. Others we're not. And it's just trying to look at ordering and reorders and things like that. So I think it's about 1% on the top line. The bottom line, I don't think we've quantified or really going to quantify at this time.

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Jeffrey J. Zekauskas
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thank you so much.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Thanks, Jeff.

Operator: Your next question for today is coming from Ghansham Panjabi.

Ghansham Panjabi
Analyst, Robert W. Baird & Co., Inc.

Q

Thank you. Good morning, everybody. I guess first off, starting off with TAG and the various sub-verticals within there, residential repaint has been a very strong grower for you for many years. And I think part of that has just been due to higher home prices and consumers accordingly investing in what typically is your biggest asset. So just based on that, how do you think that category evolves as higher mortgage rates start to impact housing prices perhaps on the downside going forward?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Well, Ghansham, I'd say it remains positive. If you talk with our contractors, they look at the backlog ahead, and they feel it's a terrific opportunity for them to continue to grow. The LIRA, if you look at the forecasting they have, is for double-digit growth for the remainder of 2022 going into 2023. I would agree that there's some projections that remodeling may slowdown mid-2023, but I'll also remind you that painting represents a terrific project to have high impact at a relatively low cost, and while rates are moving, house price appreciation has also moved as has the aging of housing.

The aging stock home price or values – I'm sorry. Let me redo this. The aging home continues to require more remodeling, more updates, people aging in place, and we see that. You see it in the NAHB, which has slowed just a bit but still well above 50, and while existing home sales have slowed against strong comps, it's largely because of lack of inventory. And when people have a tendency to stay in home, they'll continue to invest in those homes.

Res repaint we've often talked about is the largest segment in the professional subsegment space. It's a great opportunity for us. These customers respond very well to our personal approach of selling with our store managers and our sales reps. Our focus here is pretty simple, and why we have confidence is we focus on the services and the solutions that allow these customers to be more successful. And I mentioned just a moment ago about the new accounts and share of wallet. These are accounts that are responding well to us

And I mentioned earlier the innovation. I thought I'd just share one really quick one with you as an example, because here in Cleveland, we've just experienced a pretty dramatic swing from cold weather to warm weather. And we've introduced a product called Latitude with ClimateFlex technology, and it's a terrific product that fits, and I think it is a great example of why we continue to grow. We're responsive to these customer's needs, and this is a product that can be applied anywhere from 35 degrees all the way up to 120 degrees with the same application, same flow, same hiding, same appearance.

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And so what you end up is with customers that understand we're really focused on making them successful, launching products that help them on projects longer, allowing them to work later into the season and this product with very minimal warning, if it starts to rain, usually within a few hours, not even, about 30 minutes actually, the product is resistant to moisture. So these are just small examples, but it really allows us to demonstrate how we're moving the needle and why we have confidence in continuing to move the needle in this space.

Ghansham Panjabi
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. Thanks for that, John. And just for my second question, just on your comments on pricing effectiveness, which sounds like it's better than your initial expectations, what do you attribute that success towards in context of just the visible sort of plateauing of some of the inflationary numbers out there with oil prices stabilizing, et cetera?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Well, it's really simple. It's not a 30-minute discussion. We don't win or lose our price increase on how well we talk to them about the price increase in a pricing meeting. It's everything that I just talked about. Every day, we earn the value that our customers are willing to pay us for our products and services. And so the fact that we're out there helping them to be more successful, more profitable, when our costs go up, they understand that we're doing everything we can.

Every customer that does business with Sherwin-Williams should know we're doing everything we can to drive our costs down in both raw material and every other item in that basket. But when we're with them in a meeting to talk about pricing, it's because we need it, we've done everything to offset it. But what's most important is we're helping them to be successful and we're partnering with them in their business. And so, yeah, we're more effective now because we're helping our customers to win.

Ghansham Panjabi
Analyst, Robert W. Baird & Co., Inc.

Q

All right. Thanks, John.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You bet.

Operator: Your next question is coming from Kevin McCarthy.

Kevin W. McCarthy
Analyst, Vertical Research Partners LLC

Q

Yes. Good afternoon. John, last year I think you spoke about adding 50 million gallons of architectural coatings capacity. Can you provide an update on that? Has any of it come on line? And if so, what percent is loaded these days?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

It is online. It's allowed us, as Al mentioned earlier, to build inventory at a time where we typically would have been running flat with the demand. It's out of Orlando, a terrific team. I got to hand it to our entire supply chain

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team for the great work they did in getting that capacity up and running as quickly as they did. It's pretty well utilized. We don't talk to the specifics, but we run a 10-year model out on capacity, and this capacity was needed. It came in perfectly at a great time, and it's allowed us to be responsive to our customers. We've got more capacity coming in in Statesville which will allow us to further meet the growing demands that we're projecting. And again, I hope that you see exactly what we see, which is confidence in our ability to deliver in the investments to support the demand that we're going to create.

Kevin W. McCarthy
Analyst, Vertical Research Partners LLC

Q

Okay. That's great. And then secondly, if I may, wanted to talk a little bit about the acquisition activity that you've done. I think you mentioned three bolt-ons closed during the quarter. What is the aggregate sales contribution that you would expect from those in 3Q and 4Q? And based on your margin comments and performance, it sounds like maybe the acquisitions feature significantly lower margins. Is that correct? And if it is, maybe you can talk about the game plan to raise those to the company average or beyond over time.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Yeah, let me start with the latter part of your question, and I'll throw it to Al to talk about the first piece. You're right. When we split out the acquisitions, it was to highlight to our investors our ability to reach the commitments that we've been talking about. In fact, when we first announced the Valspar acquisition, we painted a picture that we were proud of the performance of our TAG business and that we expected to drive this industrial business in that direction, citing our desire to get into the high-teens, low-20% operating margins.

The fact that we've reached, adjusted, backing out to your point, the last 12 months of acquisitions up into the 17%, there's no unpopping corks here. We're not done. We know that. And it's one quarter. We understand that as well. But it clearly demonstrates what it is that we're out to do and how we're doing it. The fact that we've reached 17%, we think, is an indicator of where we are. And I will tell you where we're going is higher.

The fact that we backed out these acquisitions should, in fact, indicate that we believe in these acquisitions. Some of them are as little as 30 or 60 days old, and we've not had the opportunity to drive the synergies that we know we can drive into these acquisitions. We're making these acquisitions with a long view in mind. We're not trying to add on the first 30 days of their joining our family that we expect them to be contributing on what it is that we expect them to do. We buy them with a goal of bringing our synergies and plugging them into our platform, driving more volume out and cost reductions and synergies in.

So we're excited about these wonderful companies, the people that have joined our company as well as the technologies they bring, and we will drive those in the right direction, and they will contribute to our profit.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Kevin, the acquisitions that we've had to date have added a little over 1.5% in the third quarter. Expect it to be similar in the fourth quarter. When I look at PCG, they would add about a mid-single-digit percentage. And just to highlight John's point, I mean, we've spent about $630 million for the year on acquisitions, most of that or two-thirds in the third quarter.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

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The offset, as we talked earlier, two of those acquisitions is in FX, so about even if you're looking just at the scoreboard.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.
A

Yeah.

Kevin W. McCarthy
Analyst, Vertical Research Partners LLC
Q

That's helpful. Thank you.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

You bet.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.
A

Thanks, Kevin.

Operator: Your next question is coming from John McNulty.

John McNulty
Analyst, BMO Capital Markets Corp.
Q

Yeah. Thanks for taking my question. So there's been a tremendous number of price hikes and announcements throughout the year at different times. So I guess can you help us to think about if no further price hikes were announced, how should we be thinking about what the pricing in 2023 is year-over-year? Just to kind of help us to level-set a little bit, just given how much you've been putting through.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.
A

Yeah, John, with all of the annualizations, you'd expect mid-single-digit price effectiveness as you roll off the February 2020 increase and you annualize this last increase along with each of the price increases we went out with through the other regions and segments. Right now, that's our estimate.

John McNulty
Analyst, BMO Capital Markets Corp.
Q

Got it. Okay. No. That's helpful. And then earlier, I guess, in the prepared remarks, you spoke to some of the e-commerce investment that you're making. I guess can you give us an update as to some of the investments that you're making there and how that market seems to be evolving at this point? We know it's still relatively early in that process, but I guess an update there would be helpful.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

Yeah, John. I think what's important to understand is that our e-commerce initiative is not just a transaction. It's more than selling paint. The ability to transact over a platform like that is table stakes, and ours goes well, well

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above that. It's a much broader approach towards trying to tie in the entire ecosystem that we bring, so that last-mile delivery through our local store is something that we want to be able to deliver in, but we're reaching in to the contractor base that we have relationships with, and we're beginning to conduct more and more business along with the rep and the store manager in a very unique and differentiated way.

We want these customers living on our platform, running their business on our platform and seamlessly doing business with us as a result of that, and it's working quite well. We've got a number of painting contractors as well as a lot of national accounts that are really dialing into our platform. There will never be a finish line to this. We're investing pretty heavily right now, but that as we're ramping up is part of our plan, that'll stabilize and diminish over time. But right now, we think we're in such a unique position with our store platform and the ability to conduct business in a way that no one else can and we're excited about it. We're leveraging it, and more and more people are using it.

John McNulty
Analyst, BMO Capital Markets Corp.

Q

Great. Thanks very much for the color.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You bet.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thanks, John.

Operator: Your next question is coming from Christopher Parkinson.

Christopher Parkinson
Analyst, Mizuho Securities USA LLC

Q

Good morning. Can you just hit on your broader expectations, whether it's 4Q or 2023, on what you're hearing in your General Industrial businesses, perhaps just parsing out various content from geographies and then also more consumer versus core industrial businesses? It would be particularly helpful. Thank you.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

So, Chris, our Industrial business, I would say, I talked just briefly about our packaging, but our packaging non-BPA coating is continuing to gain great traction. I mentioned that we're investing in this business. We've got great relationships with our customers here, and we are investing alongside with them with great agreements that allow us to really collaborate well and to grow with them.

There's strong growth, for example, in beverage in both North America and Europe as the preference more and more moves away from other containers into aluminum cans. The Euro Food Safety (sic) Authority opinion in Europe is also driving an increased demand for non-BPA coatings. We think that continues through 2022 and 2023. So this is a really, really unique technology, great customers. We've got a wonderful team here that's really executing very well. We're excited about this business.

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The Coil business has been up double-digits in seven of the last eight quarters. I mentioned earlier that we're facing some tough, tough comps here with a 20% comp in the fourth quarter. But we're not running for the quarter. We're running this for years to come. And we're really excited here again about this leadership team as well as the technology. Our solutions here have allowed us to be much more responsive to our customers, quicker turns, smaller batches, works well in the face of adversity for our customers, and that's where we're headed, allowing them to be more responsive to their customers. So it's working very well.

Our Industrial Wood business is another area that we believe where we're growing share. The kitchen cabinets is a big part of this business. It's still positive now, but we do expect to see a little bit of slowdown in this business as new residential slows down. Furniture, same way. We're growing share, but as new residential slows down, that'll have an influence on Industrial Wood.

There are other opportunities though. We see a terrific opportunity in Industrial Wood flooring to continue to grow. Building products, our share position there offers tremendous opportunity. We do have a good position here in Europe, and so as Europe impacts Industrial Wood, we'll feel that in our Industrial Wood business.

Auto refinish, I would say there's very high-demand, and we're really pleased with this team and the job we're doing here. We know we're growing share here particularly in North America where our shop count is growing dramatically. There's a shortage here of body techs and parts that's having a material impact on backlogs, but our results in this business are terrific. And this is another one where we have a very similar model in our Automotive as we do our TAG business with our controlled distribution, so our ability to serve and be responsive to our customers, along with the shift that we're seeing very positive mix shift towards our premium products gives us great confidence in this business. The combination of the Valspar and Sherwin technology that came together is really helping us win in auto refinish.

GI, General Industrial, strong demand here in heavy equipment expected through 2022 and 2023, especially large in ag and construction and certainly, as you would expect, that's being positively impacted by the infrastructure opportunities that exist.

And then finally, in Protective & Marine, we're really pleased with what's happening here. Demand is strong in all end markets, oil and gas, water, wastewater. Again, same issue here as far as an opportunity in multiple high-value infrastructure opportunities. Solutions here go a long way as well. Our customers are willing to pay for products that help get them off the job quicker, either with less coats, quicker recoat times, whatever it might be. We've been investing in this business, in the flooring business. We're putting together a nice portfolio of technologies, services and capabilities that we believe will again further help us to differentiate.

Our model here again is also differentiated particularly in North America where we have our store platform to use as distribution, where many of our competitors are trying to drop-ship in the large orders. Our customers can work with our teams and leverage the local Sherwin-Williams store to source product and have it there when they need them, and our teams are working really well and together on that.

So a lot of momentum here. We clearly see some pressures in the market, as you look at Asia and Europe, what's happening in those. We're not going to be immune to those, but we absolutely do believe and we expect and hold our teams accountable to outperform the market, and we have a lot of confidence that we'll be able to do that, and we're making investments to help support in doing that. So we're feeling pretty good about this.

Christopher Parkinson
Analyst, Mizuho Securities USA LLC

Q

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That's very helpful color. Just as a very brief follow-up, there's been a lot of debate regarding pent-up demand in both resi and commercial repaint. Can you just quickly assess what you're currently hearing from your customers in terms of backlog, longevity, scope? I mean, there's been kind of some rumors about the scope of certain projects, especially on the resi side, actually expanding for people that are waiting a lot of time. Could you just give us your latest assessment on what you're hearing from your customers and how that drives your confidence at least until year-end? Thank you so much.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

So, Chris, hold on one second. Just before you disengage, are you talking about new residential?

Christopher Parkinson
Analyst, Mizuho Securities USA LLC

Q

No. Resi repaint and commercial repaint. I apologize.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Okay. Got it. Well, commercial and res repaint, I'd say the underlying demand on commercial is strong. Projects are resuming and starts are positive. If you look at the Dodge Momentum Index, it's a strong positive for every month in 2022. And the ABI, the Architectural Billing Index, and I'm sure you all know that's the index that really is a metric for how architects are billing, has been positive for 20 straight months, so that typically means projects in the next 9 to 12 months are going to be coming out of the ground, and the fact that they remain positive we believe is a good sign.

Customers here are positive. They're still reporting delays resulting from some labor and material shortages, but we are seeing a terrific opportunity for our products. Infrastructure spending here as well is strong in schools, airport spending, hospitals and also areas such as data centers are positioned here as strong. Again, we really leverage our platform. We leverage our specification teams. We're calling on architects and continuously drive new products for customers that allow them to be more productive on the job.

The combination of those local stores, reps and a really great, great stable of products, I've got to hand it to our innovation team that continues to do that. I know they've been gathered just in the last couple of days talking about how they can continue to add more to our success, and they're doing a wonderful job doing that, so I want to call out to them as well.

As it relates to the residential repaint side, as I mentioned earlier, it's still positive. We see contractors in our stores every day. They're talking about strength through the balance of the year and turning the corner into next year, still a pretty good backlog. I'd say that if we talk to them about bidding and what's in the pipeline and really dial into our CRM to understand that, I'd say what we've been witnessing is more and more the project scope has increased, so the size of the projects continue to grow.

I think some of that might just simply be I finally found a contractor that'll come give me a quote and I'm not going to let him out just doing my living room. I'm going to have him do the entire house or expanded areas that they may not have planned on in the past. The quality of the leads seem to be going on, so our contractors would refer to it as less tire-kicking. There's people that are interested in projects, interested in getting quotes and starting these projects right away. So we're very aggressive in pursuit of these customers. We feel as though our right to

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win and our value proposition is strong and getting stronger, and we're looking forward to continuing to leverage this.

One last point I would make is that our head's not in the sand here. The call out that we're making for adjusting our expenses and everything that we're doing, I think, highlights exactly the fact that we're grounded in reality. I will say this though, that when we exited the last slowdown and the last recession, we did a postmortem and really tried to understand what is it that coming out of the next slowdown we want to be prepared with, and how would we be better positioned to withstand the next slowdown.

And so throughout the period, the 2008-2010 period all the way to now, we've been working strategically on how do we better position the company. And when you look at residential repaint, it's a much larger percentage of our business now. And that's because, when we went through the last one, new residential, while we've been successful and we've been growing in our success there, we wanted to offset this and diversify our business a little bit more so we've been hard at work driving more and more residential repaint, and now it's a larger percentage of our business, and we think it's going to allow us to weather storms much better than we have in the past.

Christopher Parkinson Q
Analyst, Mizuho Securities USA LLC

Thank you as always.

Allen J. Mistysyn A
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

Thanks, Chris.

Operator: Your next question is coming from David Begleiter.

David Begleiter Q
Analyst, Deutsche Bank Securities, Inc.

Thank you. Good morning. Al, should gross margins be up in Q4 sequentially?

Allen J. Mistysyn A
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

Yes. Yes. And part of that, David, is the full impact of the 10% price increase. We do have a softer comp, but really, you also have the strong low-double-digit volume in TAG, which is our highest margin segment, so we should see a nice, more better flow-through, if you will, in our fourth quarter relative to our third quarter in TAG, which will help drive that gross margin up. So yes, I'm expecting sequential and a bigger year-over-year improvement in our fourth quarter and possibly even getting to that low end of that long-term 45% to 48% range.

David Begleiter Q
Analyst, Deutsche Bank Securities, Inc.

Very good. And, John, just on the Home Depot PPG relationship, have you seen any negative impacts in your business in terms of business losses or share losses?

John G. Morikis A
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

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Well, I would say this. Our belief is that we're in a really, really good position. We've been working hard developing our approach towards a controlled distribution model that allows us to differentiate. When we're doing our job, we would expect people to react and change their models, and when they do that, we like to take advantage of that change. We think we're executing really, really well. We think people are reacting exactly the way we'd expect them to react, and we'd say that we're capitalizing on that, and we will continue to capitalize on that.

David Begleiter
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you very much.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thanks, David.

Operator: Your next question is coming from Arun Viswanathan.

Arun Viswanathan
Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my question. Good morning. I guess, first off, you noted that there could be some challenges in 2023. Could you just describe that a little bit more? Is that continued slowdown in Europe and China and potentially that spreading over into North America and the TAG business? Or is it mainly still kind of more likely in PCG? I'll start there. Thanks.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Arun, I think we've talked about it. We do expect a continued slowdown in Europe and Asia. I think as we get into North America architectural demand, I'd prefer, as we've gone through or are going through our normal preparation for the coming year and the operating plan, to give you a bit more color on that in January. We'll have a few more months under our belt. There's a lot of moving macro trends and things that are happening, and they're moving daily, so rather than try to give you an outlook for 2023 on arch in the regions, I'd prefer we'd be better prepared to do that in January.

I think the fourth quarter, like we talked about, strong high-teens low-20% in TAG and low-double-digit volume likely to carry over into first quarter, and then the price of high-single-digits that we've got certainly carries over into the first quarter. I think that's as far as I think we can go on color.

Arun Viswanathan
Analyst, RBC Capital Markets LLC

Q

Okay. That's helpful. And just as a follow-up then, have you seen your customers change their order patterns at all? And maybe some different market segments, is the backlog actually growing? Or is it they're getting to jobs that maybe that were deferred during 2021 because of lack of availability to raws and labor? Maybe you can just comment on that. Thanks.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

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Well, there's certainly some of that. And I would say that two things. One is I think we're working much closer with our customers. Adversity brings out the best. Sometimes you have to find it. The fact that we've gotten through this challenging time with raw materials with a closer relationship with our customers, we better understand what projects they're on. In the past, they'd just walk into the store, and they knew they could have it, whatever it was. When they needed it, it was there. As we went through that process of working through the raw material shortages, we were more responsive or better responsive when we understood what the needs of the customers were.

So I'd say the pattern, first of all, for us is, it's a closer pattern. We're working better with them. We do see some, I would call it, maybe more fluid. They're moving the projects when they become available, and if its weather changing or getting outside when they can, the fact that they're racing with a pretty sizable backlog, they don't want to take any time off that they don't need to. That's why I mentioned that product that I mentioned earlier. It extended the painting season for them.

But I'd say as it relates to the pattern themselves, on the architectural side, we're seeing more frequency, I would say. We're seeing people in our stores more. And on the industrial side, I'd say we're probably seeing small orders more frequently – smaller orders more frequently, as our customers are trying to prepare for cash management while being responsive with their teams, with their customers. And again, that works to our advantage given our model of responsiveness.

Arun Viswanathan
Analyst, RBC Capital Markets LLC

Q

Thanks.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thanks, Arun.

Operator: Your next question for today is coming from John Roberts.

John Roberts
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you, and nice quarter. One of your longest lead time planning items is new store openings. I assume you have your sites for 2023 selected. Can you give us some insights into what new stores might look like next year?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You're right. We do have that planned out. And I'd say that we're probably at this point going to tell us it's going to be in the 80 to 100 range. And you'll see those in a combination of metro markets where we're continuing to feed in locations as well as in some markets where we want to supplement some of the previous investments with added locations for our customers. But you're right, John. As we go into the year, a good portion of those are already identified, and the deals are just getting finalized, and we're working through those. So we're prepared and, again, confident, confident in our model, confident in the differentiation of Sherwin-Williams adding stores while others are closing stores and taking advantage of the market opportunities that exist as a result.

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John Roberts
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And on a one-year comp, the DIY in your stores was obviously very different than the DIY in your Consumer segment, because a year ago, you were prioritizing the pro painter over DIY in your stores. If you looked at a two-year comp, is the DIY in your stores roughly up the same amount as the DIY in the Consumer segment on a two-year stack?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

I think it'd be up higher than that, John. I think we had really nice strength in that DIY customer within TAG. And the fact that we've been able to do, turn on super sales again to bring them in has really helped drive that growth.

John Roberts
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thanks, John.

Operator: Your next question is coming from Mike Sison.

Michael Sison
Analyst, Wells Fargo Securities LLC

Q

Hey, guys. Nice quarter. Just one question for me. You sort of mentioned thinking of sort of managing the business on a worse-case scenario. What would that look like for the stores? Would demand be flat? Down? Down a lot? And in the event sort of that unfolds, what can you do to help mitigate some of that potential volume decline?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Yeah. Mike, trying to guess how bad, bad could be is not something that we're going to do on this call. And the reality is that we prepare for a number of scenarios. Our view is that, particularly in that stores business, that when things get tough, we go hunting. And the reality of really difficult time in stores might include scaling back on some of the staffing if we didn't have the transaction count or other expenses that we might feel are appropriate.

But I would say this, that in the 37 soon to be 38 years I've been with the company, our approach has been to take advantage of these situations. I mentioned earlier the work we've been doing to grow res repaint as a percent of our business. Coming through COVID, I think it's a great demonstration of what we do in really difficult times. We go find customers. Those customers need to paint to put food on their plate and feed their families. We grow share. We grow active accounts. And we outperform the market. And I'd say that's what you should expect us to do in difficult times.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

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Mike, I would just add to that. To kind of how I frame it, so to speak, is if you go back and look at new residential in 2008 and 2009 where there was a lot of housing speculation and things of that nature, our new res was down in the low 22% range. And as John talked, as we've come out of that, and back then, res repaint and new res ratio was 1:1.

Fast forward that to today and our residential repaint versus new res is 2:1. And when I look at also property maintenance over that same time period, you look at the combination of res repaint and property maintenance that are more recession resistant, we're probably over 50% of our sales relative to just over 40% back then. So when he talks about how we've remapped the company to help us mitigate a recession, those are the types of things and the metrics I look at to say, okay, I don't believe it can be bad as 2008 and 2009, but if it is, we're much larger in other segments to help offset it.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

And again, not to keep everyone here all day, but the res repaint is an important part of it. The Pro Who Paints is another piece, when we think about the residential that is a new focus for us, as well as in that industrial side where packaging, auto refinish, these are growing parts of our business that weren't as strong in the past. So we don't wait for bad things to happen. We try to make good things out of it.

Michael Sison
Analyst, Wells Fargo Securities LLC
Q

Great. Thank you.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

You bet, Mike.

Operator: Your next question is coming from Mike Harrison.

Michael J. Harrison
Analyst, Seaport Research Partners
Q

Hi. Good morning. You guys noted that you're working through some inefficiencies in your supply chain still. Presumably, that means that you're starting to get back to playing a little bit more offense when it comes to procurement, so I'm curious. When you're talking about raw materials coming lower sequentially, is that really just a decline in market prices and that's mostly what you're talking about? Or does it also include this greater supply chain and procurement efficiency that you should see over time?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

Yeah, Mike, I think what we're speaking to there has been our willingness to serve our customers, even at a cost. And so I think it was Ghansham, it might've been, that asked about the supply or the capacity that came on, the 50 million gallons. As our raw materials have become available, we don't want to turn those down. We may need finished product in one part of the country, but the raws, because of the supplier base, might be available in another part near another plant. We've manufactured that product and shipped it to our customers to serve them.

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We have worked with our suppliers at times where they've been unable to ship raw materials to us. We've used our own tank wagons or our own vehicles, our 18-wheelers, to secure product and get it to our plants when needed. So there's an advantage of doing business with Sherwin that starts with the customer in the store or the rep in a plant, but it works all the way through to the raw material and manufacturing piece. And we'll do what we have to keep our customers in business and producing, because we know in the long run, the better job we do at keeping them in business, the better supplier we are to them, and that's in our best interest long term.

Michael J. Harrison
Analyst, Seaport Research Partners
Q

All right. And then looking at the restructuring actions, it looks like a good portion of those are targeted at the Asia-Pacific region. Is that a region where you're still investing for growth and still seeing a lot of opportunities? Or is there kind of a retrenchment going on there? Maybe talk just a little bit about your strategy in the APAC region.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.
A

Yeah, Mike, I'd say on the industrial side, we are investing and continue to grow. Nearly every one of our PCG businesses has a good and growing business there, and we expect that to continue. As you would expect, we are taking the appropriate actions based on slowdowns. And as I would say is our custom, we continue to evaluate our businesses and, as Al mentioned, not only our businesses, our programs, our customers, relationships, everything we can to ensure that they reach their hurdle for us to continue to invest in those.

I think it is safe to say that we're doing a deep-dive review of our architectural business in China, and based on how that review comes out, we'll decide what will we do in the future. The industrial side, we know we can demonstrate the value for our customers that can allow us to win there.

Michael J. Harrison
Analyst, Seaport Research Partners
Q

All right. Thank you very much.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.
A

Thanks, Mike.

Operator: Your next question is coming from Greg Melich.

Gregory Scott Melich
Analyst, Evercore ISI
Q

Hi. Thanks. Thanks for the insight on the gross margin going forward, guys. I'd like – basically ask the same thing on SG&A. I think it was up almost 12% year-on-year in the third quarter. Should we assume a double-digit growth in SG&A as well in the fourth quarter?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.
A

Yeah, Greg, I think what you're going to see in our fourth quarter, with the TAG stores that we've invested in and then opening another 40 to 50 and our fourth quarter along with the reps to support that, we'll continue to grow or control our SG&A pretty tightly. I do expect to get leverage still in our fourth quarter on SG&A. But as you typically

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see with the seasonal slowdown in our architectural demand, SG&A as a percent of sales will be up. I don't expect our SG&A to be up as much in our fourth quarter just because some of the actions we've taken on holding new positions, reducing travel, things of that nature will help offset some of those additional investments.

Gregory Scott Melich
Analyst, Evercore ISI

Q

Got it. And then I guess my follow-up is, given that we've tend to focus on getting on top of raws, and clearly it seems like you're there now, but given all the other costs that are going up, is it possible next year that there could be another round of price increases even if raws are flattening out?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

You know what, Greg, I think we've got to get through our normal planning process here. We'll evaluate the merit increases and different other inputs like labor and transportation. And you know us. If we need to go out again, we will, but we're not in a position today to talk to that specifically.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

And if we need to go out, we will have wrestled everything we can to the mat to try to avoid having to go out. But I think we've demonstrated an ability and a willingness if we have to. But we don't take that lightly. Our goal is not to have to, but there's some inflationary areas of wages or whatever it is. We also want to make sure that we retain the best talent, and so we know we need to be competitive as well.

Gregory Scott Melich
Analyst, Evercore ISI

Q

That's great. And then my last is really a follow-up on gross margin. Could you help us? If gross margins end up being, I guess they're up 110, 120 bps this quarter, and let's say they're up 300 bps or more in the fourth quarter, is that going to be more from price versus raws? Or more just from volume increases? I think last year you called out that was hundreds of bps of help. Could you just help us on that?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, I think it's going to be the strong volume through TAG of double digits pricing and then the raw moderation in that order.

Gregory Scott Melich
Analyst, Evercore ISI

Q

Got it. Thank you, guys, and good luck.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thank you. Thanks, Greg.

Operator: Your next question is coming from Adam Baumgarten.

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Adam Baumgarten
Analyst, Zelman Partners LLC

Q

Hey. Good afternoon, everyone. Just maybe sticking on DIY. I know you mentioned that volumes in TAG were really strong there. Were North America DIY volumes positive in Consumer Brands in the quarter?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

North American volume was up strong single-digits.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, I'd say on the volume side, we're up low-to-mid teens in the third quarter. Volume was up low-single-digit.

Adam Baumgarten
Analyst, Zelman Partners LLC

Q

Okay. Got it. And then just as we're thinking about the raw materials, if we were to keep current basket at the levels where they are today and flow that through to next year, what would that look like from a raw material inflation perspective if everything just stays stable where it is?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Adam, I think if everything stayed exactly the same, which we know it won't, you're still talking probably low-, mid-single-digit by the time you annualize everything. That's a hard answer today. Like we talked about, let us get through our planning cycle. Let us get through our demand outlook with our suppliers, and let us give you a better view of our full basket of input costs, raw materials, labor, freight transportation on our January call. I think it's too early to be speculating too much on 2023 costs at this point.

Adam Baumgarten
Analyst, Zelman Partners LLC

Q

Okay. Got it. Thanks.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thank you.

Operator: Your next question is coming from Garik Shmois.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Oh. Hi. Thanks. I'm curious if you could speak to any mix impact in TAG. Or are you seeing any signs or anticipating any signs of a trade-down?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

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No. Actually, we see the opposite. As customers are facing labor shortages and trying to get through projects as quickly as possible, they have a tendency to move up in quality. We're actually even seeing that in our new residential as well as we've introduced new products, a new one, Painters Edge Plus that's an ultra-flat product that hides imperfections, as an example. So you get in some of these projects where the drywall contractors are struggling to hire and find experienced drywallers, they're passing drywall on that may not be as perfect as the painter might have liked, and so we're helping them with products that hide some of those imperfections. Our customers are willing to pay for those; 85% to 90% of their cost is labor, so shifting up in quality helps them on the overall profitability of the project.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Got it. Thank you. Follow-up question is just one more on DIY. It sounded a bit more sluggish coming out of 2Q. Just curious. Are you seeing a sequential strengthening there?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

I'd say some of what you're seeing in our DIY, first in our stores, and Al was right, we've seen more DIY in our own stores, but it's a relatively small percentage of our business. We're mainly focused on the painting contractor through our own stores. But the comparisons there, where we were shifting product away from DIY products into contractors, is a portion of the benefit that we see. And then also, on the Consumer Brands side, as we've reached a more level state, if you will, of raw materials, we've been able to benefit from some of the pipeline filling into other customers that we've not been able to in the past, just because of availability, so we're seeing some benefit there as well.

Garik Shmois
Analyst, Loop Capital Markets LLC

Q

Got it. Thanks again.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You bet.

Operator: Your next question for today is coming from Steve Byrne.

Stephen Byrne
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. Are the equipment sales that your paint contractors sometimes buy from you, these spraying machines and so forth, are they still a good leading indicator of paint demand for you? Or does that depend on which of the businesses? I was just curious. If it's still useful, how would you characterize those sales in recent months? And on the same theme, John, you talked about having visibility for the pro backlog through the end of the year. Here we are almost November. Would you normally have a view of a backlog beyond year-end at this time?

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

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So let me answer the first question. You're right that the spray equipment sales on any given time of the year, could vary as how much of a leading indicator it would be. So residential repaint as an example, I don't think many of us would appreciate a repaint contractor coming into our homes where we're living with an airless sprayer trying to spray the inside of the home. And as exterior slows down, they're less likely to purchase spray equipment. So I'd say that, for the most part right now, spray equipment is riding along as you would expect with the sales volume of paint that we're experiencing.

And then the second part of your question, Steve, was?

Stephen Byrne
Analyst, BofA Securities, Inc.

Q

Just whether you were seeing more of backlog beyond a couple months at this time of the year.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Oh, I'd say right now, as we'd be talking historically to our customers, the outlook that we have is pretty much in line with what we would normally hear from them. Commercial contractors generally have a longer view. These are larger projects that go out to bid as far out as a year earlier. Residential repaint would be on the other end of the spectrum, and those contractors could get contracts or agreements that could start in weeks, others in months. So I'd say it's pretty much in line with what we would normally see if you put them all together and look at the backlog. It's pretty consistent with what we'd see.

Stephen Byrne
Analyst, BofA Securities, Inc.

Q

And then with respect to the Consumer business in China, is that basically the Huarun brand? And I was just curious whether that brand that you acquired with Valspar just hasn't worked out as well as you had hoped.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

It is the Huarun brand. And if I'm talking on a call about a deep dive, it's probably safe to say it's not worked out as well as I had hoped.

Stephen Byrne
Analyst, BofA Securities, Inc.

Q

Okay. Thank you.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

You bet.

Operator: Your next question for today is coming from Eric Bosshard.

Eric Bosshard
Analyst, Cleveland Research Co. LLC

Q

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Good afternoon. Two things for you. First of all, Al, in terms of production and inventory from here, could you just clarify what the plan is as you head into what you've characterized as a bit uncertain in volume in some areas? What is the plan through 4Q and into 2023?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Yeah, Eric, I talked about building some inventory in our fourth quarter on architectural specifically. I think of those as maybe some of the, if you rank products A being your fastest mover, rebuilding some inventories in Bs and Cs and Ds just to make sure we got the full spectrum of products covered going into next year's selling season. That being said, as John talked about, we're going to stay very close with our customers on what their backlogs and outlooks are, and we'll adjust production accordingly. I don't want to get too far out in front of demand knowing that we were able to keep up with demand through the summer season with the additional capacity we brought online that we talked about earlier. So I think it gives us more flexibility to manage inventory lower if need be going into the summer. But I think those are things that we're going to be very cautious about.

Like I said, I want to get our working capital back down towards that 10% to 10.5% of sales where I would like to run the company. We think we can get down there around 11% to 11.5% by the end of this year knowing we're going to carry a little bit more inventory into next year. I shouldn't say it that way. I should say we'll be back to a more historical level of inventory than we were a year ago, obviously. But I think that's something we'll manage pretty tight.

Eric Bosshard
Analyst, Cleveland Research Co. LLC

Q

Okay. And then secondly, John, I understand your comments of how the portfolio is different with more resi repaint versus new. In the last cycle, the industrial business is also, I'd say, notably bigger than it was before as well. I'm curious how that influences the gross margin path. Al, you talked about getting to the low end of the 45% to 48% in 4Q. But how does the gross margin recovery path behave in this cycle? Should it behave like in prior cycles? Or is the inclusion of industrial changed the arc of that path?

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Eric, I think what you see is that mix shift on the industrial side is a little bit better for us from a gross margin standpoint. And then you've got to kind of look at it, even within architectural, the mix shift is a little bit better for us. So I get your question. We didn't have packaging through the last cycle. It's a larger portion, a much larger portion of industrial, even now than it was two years ago. So I think when you look at margin profiles, we might have a little bit more positive shift when you get into these slowdowns. We're seeing some of that, I would argue, with a slowdown in Asia and Europe across some of our businesses within industrial, so as North America hangs in there and has better demand, our margins will be a little bit better.

John G. Morikis
Chairman & Chief Executive Officer, The Sherwin-Williams Co.

A

Yeah. And you have to weigh in segments like our auto refinish and coil. It's a very good question, Eric. I think if you look at the overall, we think we're not only better positioned from a demand standpoint. We talk about res repaint, but you also would have to include property management in there, the auto refinish, the packaging, all of these are really better positioned. But we're going to be, I think, in a better position to grow volume as well, more absorption through the plant than we may have through the last cycle as well, and there's a lot that we bring in our approach even with existing segments. The strategy work that we've done to allow us to better focus on the

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subsegments and those customers within there that are willing to pay for the solutions that we bring is where we're focused, and we think that's going to benefit us.

Eric Bosshard
Analyst, Cleveland Research Co. LLC

Q

Thank you.

Allen J. Mistysyn
Senior Vice President-Finance & Chief Financial Officer, The Sherwin-Williams Co.

A

Thanks, Eric.

Operator: There are no further questions in queue. I would like to turn the floor back over to Jim Jaye for any closing remarks.

James R. Jaye
Senior Vice President, Investor Relations & Corporate Communications, The Sherwin-Williams Co.

Thank you, Holly, and thank you, everybody, for joining us today. As you heard, we're looking forward to delivering a very solid fourth quarter that'll result in 35% growth in our second-half adjusted earnings per share. We're also very focused on preparing for any number of scenarios that might unfold next year. Our team is very deep and experienced, as John said, so very confident heading into next year, and we're looking to execute – continuing to execute at a high level.

I will be available along with Eric Swanson for your questions afterwards. And again, thank you for joining us today. Have a great day.

Operator: Thank you. Ladies and gentlemen, this does conclude today's event. You may disconnect your phone lines at this time and have a wonderful day. Thank you for your participation.

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