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APOG - Q4 2017 Apogee Enterprises Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Apogee Enterprises Fourth Quarter Fiscal Year 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would know like to introduce your host for today's conference, Ms. Mary Ann Jackson. Ma'am, you may begin.

Mary Ann Jackson - *Apogee Enterprises, Inc. - Director of IR*

Kaylie, thank you. Good morning, and welcome to the Apogee Enterprises fiscal 2017 Full Year and Fourth Quarter Conference Call on Thursday, April 13, 2017.

With us on the line today are Joe Puishys, CEO; and Jim Porter, CFO. Their remarks will focus on our fiscal 2017 full year and fourth quarter results and our outlook for fiscal 2018.

During the call, we will discuss non-GAAP financial measures when talking about Apogee's performance. You can find definitions for these non-GAAP financial measures in our press release. Our call also contains forward-looking statements reflecting management's expectations based on currently available information. Actual results may differ materially. More information about factors that could affect Apogee's business and financial results can be found in our SEC filings.

Joe will now give you a brief overview of the results, and then Jim will cover the financials. After they conclude, Joe and Jim will answer your questions. Joe?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Thank you. Good morning, everyone. Welcome to Apogee's conference call for our fourth quarter and year end. Our fiscal 2017 was another record-breaking year at Apogee. And after 5 years at the helm of this business, I'm quite pleased with our journey to be a different and better company and the results of our efforts to reengineer Apogee to meet ambitious growth goals and to outperform the market, and most importantly, to deliver terrific results.

As I said, we are a different company, thanks to our initiatives in geographic growth, where we've gotten quite a bit more business in Canada through, primarily, our M&A efforts; Southeastern United States through our NPI; and the Northeast through expansion of offices; our distribution of growth in Europe for our large-scale optical business; and in Texas through operational expansion as well.

We've also grown our framing systems significantly, and going forward, this will be our largest segment, which is less cyclical and more fragmented, both good things.

Our NPI has continued to evolve, where greater than 20% of our annual revenues come from new products introduced in the prior 5 years. This is a significant investment and improvement in Apogee's performance.

Our retrofit initiative is now a $40 million business contributor, and I contend this will be a $100 million annual revenue business in the future.

Our mid-market growth in our Viracon glass business, where we've had significant share gain, has more than offset our share loss in the massive projects. And as I've repeated many times, this segment is far less cyclical than the large Class A commercial towers.

Our new markets for our Tru Vue custom framing business, custom picture framing business, with our engineered optics and other products making this mature market continue to be a very strong, highly profitable market for us. And better project selectivity, as seen our services margins. And finally, our Lean and operational excellence backbone and the implementation of automation in our factories contributing to approximately 70 basis points of margin enhancement over the course of the year, year-after-year. All this with a strong balance sheet, which has positioned us financially to continue to make internal investments in capabilities in automation and to make additional acquisitions.

And the bottom line, I am very proud of what this team has accomplished and our track record of doing what we said we would do.

Today, we face good end market conditions and we have visibility to sustained growth. And we will be a company to count on in all parts of the cycle, thanks to the execution of those aforementioned strategies. For us here, it's full steam ahead, with a lot more to come.

All right. On to results. Turning to fiscal '17, we successfully executed our long-term strategies during the year as we delivered record revenues, record operating income and record earnings per share. Apogee revenues topped $1 billion for the first time in our history, and at $1.1 billion, we're up 14%. Operating income grew 25% for the year, and earnings per share were up 34% over the fiscal 2016 performance. Our gross margin of 26.2% was up 140 basis points and our operating margin of 11% was up over 110 basis points for the fiscal year, fifth year in a row of triple digit basis point improvement.

Our fiscal 2017 once again showed revenue growth in all 4 operating segments by leveraging our strategies focused on new geographies, new products and new markets for better-than-market growth. We also achieved margin improvement in all 3 architectural segments, and we maintained our impressive margins in our large-scale optical segment. This, through our Lean productivity, automation, project selection and pricing initiatives.

At the same time, we continue to diversify the business to better position Apogee over a full cycle. We grew our share of midsized projects in Architectural Glass; expanded our geographic presence and product offerings, especially in framing systems, which is fragmented, less cyclical and a very profitable segment of commercial construction; and further penetrated the retrofit market as mentioned earlier.

In fiscal 2017, we generated strong cash flow and used our balance sheet strategically to deliver returns to our shareholders. First off, we acquired Sotawall, a respected curtainwall manufacturer, for approximately USD 135 million, funded from a combination of cash and our revolving credit facility, which we expanded during the year to provide flexibility for our ongoing M&A activities. This $90 million to $100 million annual revenue business ideally supports our strategic growth initiatives, expanding Apogee's geographic penetration in the Northeast and Canada and adding to our curtainwall product lines.

Second, we provided additional returns to shareholders with a 12% increase in our dividend. During this year, we paid a total of almost $15 million in cash dividends. And third, we executed share buybacks during the fiscal year at a total cost of approximately $11 million to offset any dilution.

We ended the year with solid fourth quarter performance in all 4 business segments, which collectively, delivered double-digit operating income growth for the year. Their performance was partly offset by increased corporate cost for insurance, warranty, compensation as well as cost related to our fourth quarter acquisition and other strategic initiatives and M&A, where we continue to be very active. In addition, we experienced higher raw material prices in the quarter, where we have already taken offsetting price action this quarter.

Relative to the fourth quarter, I'd like to note that the backlog for our Architectural Services segment did increase as we had anticipated by $60 million. And I expect the backlog for this business to continue to grow in early 2018. This is the Services segment. That said, much of this new work is for fiscal 2019 and beyond, given the long lead time for installation projects. In fact, our Services segment is looking at a particularly strong fiscal 2019.

Integration of our Sotawall acquisition is proceeding smoothly and we expect it to contribute significantly to revenues and to operating income and particularly in the coming years as we move past the amortization cost in fiscal 2018 and 2019. This is a very successful company with strong customer relationships, a stellar management team and a very experienced employee group.

In the fourth quarter, we also had some tax benefits. Jim will provide the details on them and their impact on the both quarter and the full year.

We continue to have confidence in our ability to outperform our end market and, again, intend to do what we said we would do in the new fiscal year, which is to grow revenues further and earnings in fiscal 2018 to reach, yet again, new records for Apogee.

For fiscal 2018, we are expecting revenue growth of approximately 10%, generated in part by the new geographies and new products we've talked about. Jim will take you through, segment-by-segment, our expectations for this growth.

We're anticipating earnings per share in the range of $3.35 to $3.55 as we continue to drive productivity efforts through our Lean operations and our excellence programs and we execute automation, project selection and pricing initiatives.

Our backlog, our awards, our bidding activity have us well positioned. We like our external market metrics today, and it supports our outlook for sustained growth.

Jim, would you please now cover the financials?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Thanks, Joe. Good morning. Fiscal 2017 was another record year for Apogee and our operating segments performed well in the fourth quarter, allowing Apogee to deliver full year revenues of more than $1 billion for the first time in our 68-year history with an operating margin of 11%, well above our previous peak of 8.4%.

Before I discuss fourth quarter results, I'll provide some additional color on the fiscal 2017 full year performance to add to the highlights Joe's covered. Fiscal 2017 revenues grew 14% as we leveraged our premium service levels, along with growth in new geographies, new products and markets to outperform our end markets.

Excluding partial fourth quarter revenues from the addition of Sotawall, Apogee's full year revenues were up 12%. Operating income for the year was up 25%, led by our architectural segments, as they executed Lean, productivity, automation, project selection and pricing initiatives.

Our fiscal 2017 operating margin for the full year was 11.0%. This is slightly below our prior outlook, largely due to the fourth quarter factors that Joe mentioned. And I'll provide a quick reconciliation.

First, I'll note that our prior outlook did not include the impact of Sotawall, which we indicated would initially be dilutive to operating margin due to the amortization expense. This had approximately 10 basis point impact. We had higher than what are normal levels of corporate cost in the quarter for insurance and warranty items, along with strategy and M&A support cost. These all accounted for approximately 30 basis points of the difference. And then higher-than-expected aluminum prices in the fourth quarter impacted the full year operating margin by approximately 10 to 15 basis points, affecting our framing systems segment.

Earnings per diluted share of $2.97 were up 34% for fiscal 2017. The earnings per share includes approximately $0.06 per share from a favorable tax benefit resulting from recognition of a foreign tax credit realized on cash distribution of accumulated profits from our Brazil Architectural Glass operations. We recognized this $0.06 benefit in the fourth quarter.

Our tax rate,

(technical difficulty)

[of] 30.1% for the full year, reflects this specific tax benefit. Excluding the favorable item, our rate for the year would have been 31.7%.

We had solid operational performance and strong working capital management and again, delivered strong cash flow. We ended the year with our balance sheet and financial condition well positioned to continue delivering shareholder value through M&A activity, capital investments and dividends.

Apogee generated $121 million in cash from operations during fiscal 2017 and free cash flow of $53 million after capital expenditures of $68 million, which was primarily for increased capabilities and productivity. Our debt at year end, net of cash and short-term investments, was $45.4 million, including approximately $20 million in long-term, low-interest industrial revenue bonds.

Early in the fourth quarter, we used approximately $70 million of our cash and $65 million of revolver debt associated with the acquisition of Sotawall.

We continue to have strong working capital management with our days working capital metric at 44 days in the fourth quarter, comparable to the prior year period. We feel that this performance is really best-in-class for a company like ours.

Turning to segment performance for fiscal 2017. Our 3 architectural segments each grew revenues and operating income and our large-scale optical segment maintained its solid performance. For full year fiscal 2017 in Architectural Glass, revenues were up 9% as we successfully grew our presence in the U.S. market for midsized projects. With our productivity improvements, we've driven short lead times, enabling us to increasingly serve this segment. This is consistent with our strategy to grow in the less-cyclical sectors, which should benefit us in all economic conditions.

Our full year Architectural Glass segment operating margin grew 140 basis points to 10.8% on the increased volume and through improved pricing mix and productivity. This business performed well throughout the year, benefiting from new automation equipment and Lean productivity efforts.

Full year Architectural Framing Systems revenues grew 25% as our businesses expanded their geographic penetration in the South and Northeast and introduced a number of new high-performance products and saw benefits of our retrofit initiative. Full year segment growth, excluding the addition of Sotawall partway through the fourth quarter, was 19%.

Fiscal 2017 Architectural Framing Systems segment operating income grew 40%, and the margin was up 130 basis points to 11.6%. Drivers were similar to those in Architectural Glass, with good productivity, volume and price as well as our focus on selecting projects where we can perform well to deliver strong margins.

In fiscal 2017, Architectural Services revenues grew 10%. A small amount of work that we had expected would flow in fiscal 2018 was pulled into fiscal 2017 based on project schedules, resulting in slightly greater than expected full year growth in this segment. Operating income for the year was up 58%, and the services operating margin grew 200 basis points to 6.8%. The business executed higher-margin projects and also benefited from good execution and volume leverage.

Full year large-scale optical segment revenues were up 1%. Operating income of $22.5 million was down 2% or approximately $0.5 million. The fiscal 2017 operating margin was 25.0%, down from 25.9% as the segment invests in R&D and business development activities.

Moving to results for the fourth quarter. We had good operational performance in our operating segments, with Apogee consolidated operating income and margins impacted by the higher-than-normal corporate cost. Apogee quarterly revenues were up 20%. Excluding the addition of Sotawall during the fourth quarter, revenues were up 13%. Operating income was up 3%. Gross margin was 26.2%, down slightly to the prior year period. And operating margin was 9.4%, down year-on-year, due primarily to the previously mentioned corporate cost.

Earnings per share of $0.80 were up 16%. I'll cover our quarterly segment results compared to last year. To remind you, we now provide backlog by segment since it's more relevant to our business today. Our mix of business today is different than it was when we started presenting consolidated backlog more than 15 years ago. Today, about half of our backlog is generated by our Architectural Services segment, which represents approximately 25% of our revenues, and it is a business that we're deliberately growing more slowly as we focus on project selection and margin improvement. Much of our business in the other 2 architectural segments, Architectural Glass and Architectural Framing Systems, is now quicker-turn, with more book-and-bill within the quarter.

In Architectural Glass, fourth quarter revenues were up 14% on particular strength in U.S. midsized projects. Operating income was up 14% to $13.8 million and the segment's operating margin was a strong 12.3%, comparable to the strong prior year period. Segment backlog was $66.4 million compared to $75.9 million in the fiscal 2017 third quarter. We don't need backlog growth in this segment to grow revenues, given that Architectural Glass is a short lead time business now with high levels of book-and-bill activity within quarters.

In Architectural Framing Systems, fourth quarter revenues were up 53%. We had nice volume increases in the 4 ongoing businesses in this segment. And growth excluding the fourth quarter Sotawall revenues was 31% as we grow in current markets as well as in new geographies and with new products. Operating income grew 26% and operating margin was 8.0%, down from 9.7% in the prior year period.

We experienced rapidly rising aluminum cost in the quarter that had a roughly 80 to 100 basis point impact on the segment. We have increased pricing this quarter to offset these raw material cost increases going forward. The fourth quarter operating margin was also impacted by project mix in the quarter compared to the very strong prior year period project mix.

The addition of Sotawall at lower margins due to higher acquisition-related amortization costs impacted the operating margin as expected. Architectural framing segment backlog grew $81 million in the fourth quarter to $245.4 million. The addition of Sotawall in the quarter accounted for $69 million of the increase in the framing systems backlog.

Fourth quarter Architectural Services revenues were down 14% on the timing of project activity and a tough comparison to a very strong prior year period. Operating income declined 26% on the lower volume and project mix. As we expected, segment backlog grew to $255.1 million, up from $195.5 million in the last quarter. Many of the new orders added in the fourth quarter are scheduled to generate revenue in fiscal 2019 and beyond, and we have a strong solid pipeline for additional projects for fiscal '19 and beyond. As I always note for this segment, backlog trends are uneven due to project size and the unpredictable timing of projects moving from award into backlog.

Backlog mix across the 3 architectural segments continues to reflect strong activity in the office sector with more than half of the overall work in backlog. The remaining backlog is balanced across the institutional sector, which is government, education, healthcare and multifamily projects; and then with less than 5% of the projects in the hotel, entertainment and transportation sector.

Fourth quarter large-scale optical revenues were up 22%, driven by the timing of customer orders. Operating income was up 42% and the operating margin grew to 26.0% with a mix of higher-margin products and volume leverage.

The tax rate for the quarter was 21.9% or 28.4%, excluding the tax benefits from our Brazil business that I outlined earlier. These rates compare to 30.4% in the prior year period.

Now I'll turn to our outlook. Our fiscal 2018 full year outlook reflects growth, strong margins and a double-digit increase in earnings per share based on our performance trends and the visibility we have in our markets and our businesses. We expect earnings per diluted share range of $3.35 to $3.55 per share on approximately 10% revenue growth.

We continue to have an outlook for good architectural end market conditions. That said, we have different growth outlooks by segment, with expected Architectural Glass and Architectural Framing Systems growth more than offsetting expected decline in Architectural Services, and I'll cover the outlook by segment. Overall, based on the visibility of project schedules we have, we expect the second half of the year to be a little bit stronger than the first half of the year, including a sequential decline from the fourth quarter we just completed into Q1 of fiscal 2018.

Moving to the full year segment outlook. For Architectural Glass, we're expecting roughly mid-single digit revenue growth, a little better than our outlook for end market growth.

For Architectural Framing Systems, we're expecting approximately 25% growth, including the full year impact of Sotawall, as the segment also continues to demonstrate strong growth from premium service levels, new products and expanded geographic penetration.

Architectural Services revenues are expected to decline approximately 10%, driven solely by the timing of projects awarded, with some project awards that moved project timing and revenue out to fiscal 2019. As we've noted, we have a pipeline for the Architectural Services segment expected to deliver strong growth in fiscal 2019.

Our large-scale optical segment is expected to be roughly flat for fiscal 2018.

For the year, we're expecting a gross margin of approximately 28% and an operating margin of approximately 12.5%, as Apogee businesses continue to deliver cost and productivity savings through our Lean and operational excellence initiative. The operating margin outlook by segment also varies, largely due to expected growth rates, which I'll cover.

For Architectural Glass, we anticipate approximately 50 to 100 basis point operating margin increase.

For Architectural Framing Systems, we anticipate 150 to 200 basis points of improvement in the operating margin, with volume leverage and productivity more than offsetting lower margins for the Sotawall business due to the acquisition-related amortization costs that we have discussed.

At Architectural Services, we expect a decline of approximately 50 to 100 basis points in operating margin. Continued positive project margins will be offset by the fixed cost in this segment which are needed to support fiscal '19 growth on lower fiscal '18 volumes.

And at large-scale optical, operating margin is expected to be approximately flat to fiscal 2017.

In summary, we feel well positioned for another year of growth and significant improvements to our gross and operating margins as we continue to leverage our initiatives and continuous improvement activities. For fiscal 2018, we expect depreciation and amortization of approximately $49 million. We anticipate that our fiscal 2018 tax rate will be approximately 32.5%.

For fiscal 2017 and fiscal 2018 specifically, we continue to expect mid-single-digit growth in U.S. commercial construction markets as market activity, the Architectural Billings Index, office employment and office vacancy rates all show a positive momentum. Specifically, the ABI has been at 50 or better for 20 of the last 24 months, indicating sustainable growth in architectural activity. There have now been 78 straight months of private sector employment growth in the U.S., driven by office-occupying jobs, health care and hospitality, all sectors that are important to us. And they're balanced office markets without overbuilding. U.S. office vacancy rates, as reported by CB Richard Ellis through the first calendar quarter, continue to be stable at low levels.

We feel good that our internal visibility from backlog, awards and bidding, combined with external market metrics, support our outlook for sustained growth into the future. We have good momentum and solid strategies that we believe continue to position us to perform better in any economic environment.

I'll turn the call back to Joe.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Okay. Thanks, Jim. Before I take your questions, team, I'd like to underscore that we feel very good about the future opportunities for Apogee, again, based on our bidding, awards and backlog as well as our external metrics that Jim just highlighted. The ABI, office employment and vacancy rates all sustained -- support sustained growth for architectural businesses. And with our visibility, we feel good about multiyear growth.

At the same time, the strategy we are executing around geographies, new products and new markets are making Apogee a more diversified and stable company than we've ever been historically. We are specifically benefiting from our focus on midsized architectural glass projects, the retrofit market and framing systems growth, which generally serves small to midsized projects. In addition, our disciplined, reliable, repeatable business processes, we are driving improved margins. Have you -- as you have heard, we are anticipating yet another year with triple digit basis point improvement in operating and gross margins.

In summary, we're better positioned for the long term as we leverage to current market strength.

And with that, Kaylie, I would like to open the call up for questions from our guests.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Eric Stine with Craig-Hallum.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst in the Equity Research department*

So I just wanted to dig into the revenue guidance a little bit, just to get more color. If I back out Sotawall, looks like it's looking at a little over -- or between 4% and 5% year-over-year growth. So just to clarify, I mean, that is solely based on timing in the installation business. I mean, is there anything -- just color, is there anything going on in terms of pricing of those projects? Since I know one of your initiatives is certainly to be much more clear or regimented in the type and profitability profile of the projects that you do take.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes, Eric, this is Joe. I'm going to have Jim give the specifics on the numbers in a moment. But let me just say the 10% growth, approximately 10% growth, on revenues year-over-year that we articulated certainly includes the impact of the full year of Sotawall versus approximately 1 quarter in the comp period. But when you peel back the onion, you'll see solid growth in our glass segment; substantial growth in our framing systems segment, even excluding Sotawall; flattish in large-scale optical; and a decline in services, which should be no surprise anyway. And based on the kind of the timing of how orders entered backlog, we had 3 quarters in a row of reduced backlog in the services business. We highlighted that would come back. It did come back with a vengeance in Q4. I articulated earlier in the call that I'll go out on a limb again and say that we will start fiscal '18 with continued momentum as to positive backlog performance in services. We have a hole for F'18 that Jim can describe, but I believe fiscal '19 will likely be a record year for our services business, which is our installation segment. Jim can repeat some of the specifics for your model.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

I think, Eric, to your point, I mean, it's really the relative low growth rate, given the inclusion of the Sotawall business, is really just driven by the decline in Architectural Services, as Joe just described. The other architectural businesses, we are projecting to grow better than our end markets.

And in the framing systems, even excluding the impact of the acquisition for the full year, is still double-digit growth in that segment, excluding that impact.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst in the Equity Research department*

Okay. And maybe just turning to the materials cost. It sounds like you have kind of rectified that situation. Just wondering if there's been any pushback from your customers or if that's something that fairly standard people get, and that, that is -- that you'll maintain passing that on.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes. So Eric, we have -- you're a little newer to us than some folks on the call, and I'm going to provide a little bit of background and repeat for a lot of people. We have a lot of aluminum usage, some of which is our projects business, where we forward-buy everything as soon as we're awarded a project. So we have very limited exposure to short-term pricing in aluminum in our services segment and in our large window and wall framing system business. But we're a significant user in our storefront and entrance system, which is housed in our framing systems segment. And that is a very, very quick book-and-bill business, order turnaround in less than a week. And we are exposed to short-term spikes. Traditionally, our industry has been horribly slow to pass on price -- cost increases in the form of price. We bucked that trend 2 years ago in the calendar fourth quarter of 2015. Our competitors followed. And we were equally slow to pass on cost reductions as well and benefited in those times. We made a very quick action when it was obvious that this -- these increases in our fiscal fourth quarter were not going to go away. We implemented a price increase within the last 30 days. We are seeing competitors do similar. We're confident we've implemented enough price increase to completely offset that cost increase for the fiscal year. And I think it's reflective of a better discipline, a better pricing discipline, in our framing systems business.

Eric Andrew Stine - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst in the Equity Research department*

Okay. Perfect. That is the color I was looking for. And then lastly for me, just on the product size, the oversized glass capabilities, is that still the plan, to start shipping that in May? And just any color on the demand that you're seeing in advance of that in the market would be helpful.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes, we began shipping in the middle part of this calendar year. The project is a little bit ahead of schedule, it is on budget. We are slightly ahead of the orders projections that we had justified the project. Our Board of Directors approved this project based on volume projections. We are slightly ahead of that and full steam ahead. We're feeling very, very good about that substantial investment in our glass business, which is coupled with automation investment as well, which is equally important for us.

Operator

Our next question comes from the line of Chris Moore with CJS Securities.

Christopher Paul Moore - *CJS Securities, Inc. - Research Analyst*

Can we talk a little bit more maybe about the purchase accounting effects for Sotawall in -- for fiscal '18? Just trying to get a sense as to how significant some of that amortization is and kind of looking at the 8-K from the end of February, you had some pro forma numbers. And trying to understand what '18 would look like so that we can model '19 as it flows through and that stuff -- those purchase accounting costs go away.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes, sure. Chris, thanks for joining us. First off, this is Joe. As much as I love purchase accounting, I'm going to allow Jim to steal all my thunder on this. Jim, fire away.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

So Chris, I mean, first of all, as you know, I mean, the pro forma in the 8-K has accounting aspects of it which are not necessarily representative in terms on how amortization is handled and we actually kind of close the books. But I think the key point when you look at it is we're going to see in fiscal -- and our Form 10-K will be out at the -- should be out at the end of this month, and you'll see more of the details. But included in there, what you'll see is an increase in the amortization expense from fiscal '17 to '18 of close to $10 million. And then as we project, like, assuming all else equal, going from fiscal '18 to '19, you'll see that start to ramp down to more of a $5.5 million annual amortization level in fiscal '20. So heavy burden in fiscal '18 into the first half of fiscal '19.

Christopher Paul Moore - *CJS Securities, Inc. - Research Analyst*

Okay. All right. On the framing operating margins. Obviously, there's a couple of things going on there. The Sotawall's in there, there's the aluminum pricing and then I'm trying to get a feel for -- then the rest of it is -- was just project mix?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Yes, on a year-to-year comparison. In the fourth quarter of last year, just both mix of businesses within the sector and project mix within those businesses was quite strong Q4 of last year, and just didn't have the same lineup of favorable-margin mix within that on a quarter-on-quarter basis.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes, across the board. Chris, last year, we had -- our fourth quarter was our most powerful year. So we had really challenging comps. We made 9.9% operating margin for the year. We achieved 11% in the fourth quarter. So unfortunately, in the construction industry, we don't have -- although we grow 140 basis points, we don't necessarily get it in the steady flow each quarter. So we had incredibly strong results to comp. We had a very solid fourth quarter. Our framing systems business, to elaborate a little bit more on the Sotawall, that's an extremely profitable business. With the amortization in the first 1.5 years, 2 years, it drags it down to slightly lower than our extremely strong framing systems margin today. It's approaching that level, but it's a little below. When we get past this early amortization, it's actually accretive to the framing -- to the already strong framing systems margins. But in these early periods, it is a bit of a dilution. It's still strong.

Operator

And our next question comes from the line of Brent Thielman with D. A. Davidson.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Joe or Jim, on the services segment, how are you thinking about your ability to potentially fill in some of these holes in schedules in early fiscal '18? And kind of what would prevent you from being able to do that?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Well, it's a long -- this is Joe. It's a long lead time business, Brent. But I can assure you the team is looking at some smaller projects that would have a quicker turn. A typical turn time from award or entry into backlog to revenue is anywhere from 12 to 24 months, depending on the project size and schedule. We -- as we've seen from the obvious strong book-to-bill in the quarter, my comment that we'll have an equally -- we'll have a very strong first quarter early part of the year, we are setting up well. The team is working very hard to try to fill the gap that we've built our plan around. So we have in fact built our annual operating plan, and the numbers Jim provided for guidance do assume this gap in fiscal '18 revenue. The team will manage it well. We need to keep the people on for these incredibly strong volumes we'll see in FY '19. But the team still has a little bit of time to try to find some small orders that will turn quickly and fill the gap. And I can assure you max efforts go into that every day.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

But Brent, also the primary gap that we have in that business is actually the first half of fiscal '18. So what you'll -- what we see based on the schedules that we have in front of us, the second half of the year will be comparable or maybe even a little growth over the second half of fiscal '17. And so the gap that we have as we saw these orders that we are working on in fiscal '17 move out in time, they kind of move the opportunity from the first half of fiscal '18 out into the future. And as Joe said, it's -- that shorter-lead-time work is tough to fill in, in that business.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. So I guess, the gap kind of reflects the worst-case scenario. And potentially to pick up some work to meet in the first half, there might be some upside to that. Is that fair?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Well, the upside would be if we fill in more in the second half of the year.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. And then I'm sorry, Jim, I didn't catch it, but the margin expectation for the glass business for fiscal '18?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Yes, well, what we had talked about for fiscal '18, is about a 50 to 100 basis point improvement in margin over fiscal '17.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. And I guess, just curiously, I think pricing's up, bid margins are up, been on the right trajectory. Kind of what are the thoughts on the long-term potential of that business? I mean, are we peaking in terms of profitability?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Peaking in the services segment?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Glass.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Glass.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

In glass? We're -- we continue to make investments to improve our cost position. So our productivity, our investments in automation, will continue to give us opportunity to improve our margins. As we continue to expand in the mid-market segment, we'll continue to hopefully have volume leveraging as that business grows. So I would never accept that we can't continue to improve our cost structure.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Yes. Pricing is -- on an apples-to-apples basis, has, I'd say, leveled out to certain degree. But then it really comes down to really project mix. And we always talk about those 2 together whenever we're able to move towards differentiated products, oversized products, those types of things that have higher-margin profiles. But so maintaining good pricing, moving to better mix, but as Joe said, continuing to see the benefits in productivity.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. And then can you give us an update on what you're seeing from some of the foreign competition that, I think, has gone after the higher-profile work? Is any of that starting to ease with the dollar softening a bit here?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

We have not seen a lot of change. We have -- the momentum certainly leveled off for the other side. Not certain it's retracted yet, the slight improvement in the exchange rate between the euro and here. But again, I tell my troops, bring on the competition. We should be able to compete with anybody in the world. We are the most capable glass fabricator in the United States, and we're willing to take on competition. I would say it's certainly leveled off, but I'm not sure that it's retracted yet.

Brent Edward Thielman - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. And then just on LSO, nice quarter here in terms of growth, but the expectation for flat growth in this coming year, current year. Why not something better than that, just given some of the gross -- growth initiatives you've kind of put in place there?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Yes. We're trying to offset a very kind of a stagnant custom framing market. We do have significant growth opportunities. I hope to -- I hope we can grow that business. We built a plan around flattish. We'll continue to make smart investments. We have a new engineered optics product line that gives us opportunity to do exactly what you said, which is to project growth in the fiscal year. We've got some new acrylic products for our custom framing. We're all -- we're working very hard to try to spark some growth in a mature industry and continue to feel very, very confident about our cost position that allows for these strong margins. We successfully implemented a brand-new ERP system in that business in the last quarter. Don't have to talk about it because I've been through many ERP implementations. This is the smoothest one I've ever been part of. And I'm confident we have the opportunity to do better than our plan.

Operator

Our next question comes from the line of Sam Eisner with Goldman Sachs.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

So just going back to the glass comments here. I mean, you guys are guiding to 50 to 100 basis points of margin expansion. I think through the back half of fiscal '17, you only had about 50 bps, and certainly, you're flat exiting the year. So I guess, what gives you confidence in margins expanding from here, particularly given that you have this new initiative over the last few quarters or going into kind of the mid-market? Maybe you can talk through price mix, raw materials. Just help us get more comfortable that you can achieve the, I guess, the 70 basis points -- or 75 basis point midpoint for that.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Sam, 2 ways. One is we have visibility to both backlog and the commitments in terms of the margin profile of the business that supports it. And you've seen the improvements that we've made in that factory and we still have runway to go in terms of recognizing the benefits from the automation that has been put in place, that we continue to put in place, and the various other productivity initiatives.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Sam, the automation you got to peek at when you were down there few quarters ago goes live in about 60 days.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

Got it. That's helpful. And so the impact of moving from large projects into mid and small projects, is there a way to assess the ASP differential, the margin differential? Just to have a better understanding of this move arguably into smaller projects, what that means from a mix and ultimately price perspective for you guys.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Very similar margin profile and cost profile, Sam. These are the same customers we've been dealing with for 40 years. We just never were quite capable of delivering in the shorter lead times. So the margin profile is the same, it's capability that has allowed us to penetrate this segment where we now are consistently delivering glass and custom coated glass in 5 or 6 weeks lead time. And that is something our international competitors would never be able to do.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

Got it. On -- maybe transitioning over to Sotawall. I think if you look at the information that you guys provided in that 8-K, I think through the first 11 months of this year, the EBIT margins for that business were 32%, 33%. But the year ago, it was 10%. I think the gross margins are up from 31% last year, up to 39%. So what's causing the substantial step up in the profitability of Sotawall? If I read those numbers correctly. And I guess, how do we think about the look of that going forward? Obviously, you mentioned that, the very strong EBIT margin business, the amortization impact will bring that down. But because there's such a big differential between those 2 years, I guess, what's the best way to think about it?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Sam, I don't have specifically the information in front of me. I mean, in the 8-K, there were 2 sets of documents, 1 were some historical financials that were accounted for according to kind of Canadian GAAP accounting, if you will. The pro forma reflected the business as it has been operating and as it has been coming into our business. And it's an attractive operating business and looks to continue to be so. I can follow up with you and reconcile in the documents you're referring to.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

Yes, that would be great. Because I think the income before taxes was almost $40 million through November 30 of this year. Last year, it was only $10 million. So that's a pretty substantial step up in terms of the profit that you guys generated, or at least that Sotawall generates. I'm just curious, was there some product timing for that business? Was there something related to new wins, improvements? Just want to better understand the history of Sotawall.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Yes. So I mean, it's a projects-related business. It has different timing in terms of where the maturity of the project is when you recognize the upsides to it. And then also the numbers that I think you're referring to were in Canadian dollars as well.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

Got it. That's helpful there. Maybe just a few other questions here. Just on the services backlog, obviously a really nice order quarter in line with, Joe, your comments here. I think if you look in aggregate, the $125 million of orders that you received this quarter is basically the sum of the prior 4 quarters here. So -- and now you're guiding even stronger orders next quarter. So what happened? What's the release? What's the catalyst to allow all these orders to come into your backlog? Is there something market related that's allowing for that? Or...

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Sam, it's just the world we live in. Project timing, when they release, it's -- every project is run by a different general contractor and being let at different times. I've said repeatedly we don't cut corners on Ts and Cs, terms and conditions, just to get something over the finish line. Obviously, when I said we would have a substantial increase in orders, I was aware of what was about to cross the finish line. It's nothing more basic, Sam, than the timing of when things flow in the projects. The handful of projects we're actively pursuing, I would say our win rate was good. There are times where you're the bridesmaid, at a few weddings in a row, and then you can have a win streak. We did nothing different with our pricing or our Ts and Cs to make that happen. It's simply part of being in the projects world in commercial construction, Sam. It's unfortunately that simple. I wish it was a smoother flow by quarter. It is one of the frustrating things of being a public company and having that business in the portfolio, which is why we want to maintain our focus on margin expansion. We're doing extremely well in that front, as you've looked over the last 4 years. And the steady growth, I submit in that business, you have to look at trends over a longer period of time than a quarter, for certain.

Samuel Heiden Eisner - *Goldman Sachs Group Inc., Research Division - VP*

Maybe just one last housekeeping question, Jim. The 14 weeks for this quarter, 13 weeks last quarter -- or last year, there's been a number of days differential there. We get 3, is that correct? Just trying to confirm the impact of the additional selling days.

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Yes, I think that's about right.

Operator

And our next question comes from the line of Jon Braatz with Kansas City Capital.

Jonathan Paul Braatz - *Kansas City Capital Associates - Partner and Research Analyst*

Jim, you mentioned in the quarter, it was an additional corporate cost. And one factor you talked about or you mentioned was increased warranty cost. What's that related to? And was it substantial at all?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

Well, overall, the items that I talked about, kind of insurance and warranty, was substantial. I think about 30 basis points full year impact is about $3 million. And then warranty is just -- we normally have warranty reserves. And in the quarter, we had a few older projects that was a higher than normal activity to some degree related to some disagreements with customers that we're dealing with. But got that behind us, we believe.

Jonathan Paul Braatz - *Kansas City Capital Associates - Partner and Research Analyst*

Okay. So there were sort of, you want to call it, true-ups to these projects?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

That's our view on it, yes.

Jonathan Paul Braatz - *Kansas City Capital Associates - Partner and Research Analyst*

Okay, okay. So nothing that would reflect something going forward change in your warranty expense?

James S. Porter - *Apogee Enterprises, Inc. - CFO and EVP*

We do not believe so.

Jonathan Paul Braatz - *Kansas City Capital Associates - Partner and Research Analyst*

Okay, okay. And Joe, the other question is obviously, we've all talked to a lot of businesses since the election, and there seem to be a little bit of a sentiment change, a little bit more optimism. Whether in fact it takes place -- or whether in fact things do get better or not, who knows? But in your conversations with architects, with your end markets, customers, did you get any type of sentiment change from your customers after the election? Are the animal spirits developing a little bit more than they have in the past? What are you hearing from your customers?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Jon, we've asked -- we've been on that issue, and I would say there's no question, in general, I wouldn't say specific to architects or general contractors or glazing contractors or fabricators. But across the board in general, there has been -- since the administration change, there's been a little bit more upbeat feeling on a business-friendly agenda. And I would say that things were going along fine. We felt good about a few more years of sustained growth before any flattening out. And I would say what we hear from our constituents that we just talked about is that, that sustained growth probably pushed out another year or 2. And that hasn't changed. So there's no question that it's been a slight positive, certainly, emotionally. Obviously, in this world we live in, things change in a hurry. But I think it pushed out any slowdown or downturn. And I would be very clear on my anticipation, is that the next slowdown in our end markets will be far more muted than what people have in their memory from 6, 7 years ago in that no buildings are going up now that don't have high tenant occupancy commitments. That is substantially different than the buildup before the last crisis, let's call it. I do feel confident that the next downturn, whenever it comes, will be far more muted and normal. But we do believe, based on the confidence and the business-friendly environment that may be coming, that we've got a few more years of growth because of that.

We got time for one more, operator. So please.

Operator

Our next question comes from the line of Scott Blumenthal of Emerald Advisers.

Scott Benjamin Blumenthal - *Emerald Research - Senior Research Analyst*

Okay. Joe, is there anything more to your comment that framing is ultimately going to be Apogee's largest business? And the addition of Sota, you may be seeing something in architectural design trends? Or maybe something other out there in the market that led you to make that comment?

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

No. It's just a fact based on revenue dollars at F'18, it should be bigger than our glass segment. Of course, it's 5 businesses housed in that segment versus glass is -- as glass is our largest individual operating business unit run by a leadership team, is certainly the big dog in the kennel. But the combination of our framing systems businesses will be the largest-revenue segment. That is certainly not by accident. We've done several acquisitions. We bought a custom window business 3 years ago, 2.5 years ago. We bought Alumicor 3 years ago now. We've had the Sotawall acquisition. All in that space. Why? It's fragmented, it's profitable, there is substantial room to grow. I should be able to grow in that segment regardless of the end markets because of the fragmented customer base. And it's not indication that we are less focused on glass or services or LSO, it's simply the smart place to make some big investments due to that fermentation. And we highlighted on this call, we have many irons in the fire, I think, between continued M&A potential and organic growth. The opportunity just happens to be most significant in that segment.

Scott Benjamin Blumenthal - *Emerald Research - Senior Research Analyst*

Okay. Got it. That's really helpful. And since you are on the subject, one more if I may. Can you give us anything with regard to the acquisition pipeline? Maybe the magnitude of some of the deals that you're looking at or maybe your expectation or probability that you might be able to get another one done this year.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Well, Scott, I could try. I can tell you that we have a disciplined, reliable, repeatable business process around M&A pipeline. I like to say we look at 100 properties, do diligence on 10 to get a deal done. We will not do a bad deal, I'll walk away from 10 good ones before I do a bad 1. I was trained to do that. We do have a lot of -- we have some irons in the fire. I feel good about our opportunities. Our debt-to-EBITDA ratio is still extremely low, and we continue to be under levered. I'm okay with that. You've heard me say I have no desire to get drunk and disorderly. We have the bandwidth to do more. I've got the management capability to get it done. And as you've seen with our track record with Sotawall, we're buying great companies with great leaders. I'm not foolish enough to think we're going to buy a broken business and use our intellectual prowess to turn around something that's not working. We have a process and a way of going about finding good properties at an attractive value where we can leverage our core businesses to share best practices back and forth and make 1 and 1 be more than 2. I do feel confident in our pipeline. Stay tuned.

Operator

I'm showing no further questions. I'd like to turn the call back to Mr. Puishys for closing remarks.

Joseph F. Puishys - *Apogee Enterprises, Inc. - CEO, President and Director*

Thank you. We're out of time. So I'm going to wrap up quickly here and simply say thank you. I hope we've answered all your questions. It was a powerful quarter and a powerful year. And Jim and I have given you guidance on a triple digit basis point improvement coming for us in F'18 with strong revenue growth. And hopefully, you'll have confidence in us as we do ourselves. And have a great day, everyone. We'll look forward to talking to several of you individually. Take care. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a wonderful day.
