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Pentair plc (PNR)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Pentair Second Quarter 2022 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please also note that today's event is being recorded. And at this time, I'd like to turn the conference call over to Jim Lucas, SVP, Treasurer, FP&A, and Investor Relations. Please go ahead.

James C. Lucas

Senior Vice President, Treasurer, Financial Planning and Analysis & Investor Relations, Pentair plc

Thanks, Jamie, and welcome to Pentair's Second Quarter 2022 Earnings Conference Call. We're glad you can join us. With me today is John Stauch, our President and Chief Executive Officer; and Bob Fishman, our Chief Financial Officer. On today's call, we will provide details on our second quarter performance as outlined in this morning's press release.

Before we begin, let me remind you that during our presentation today, we'll make forward-looking statements. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of Pentair. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to carefully review the risk factors in our most recent Form 10-Q and Form 10-K and today's release.

We will also reference certain non-GAAP measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures can be found in the Investor Relations section of Pentair's website.

We will be sure to reserve time for questions and answers after our prepared remarks. I would like to request that you limit your questions to one and a follow-up to ensure everyone an opportunity to ask their questions.

I will now turn the call over to John.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Thank you, Jim, and good morning, everyone. Please turn to slide number 4 titled Executive Summary. Pentair delivered another strong quarter with sales, segment income, and adjusted EPS all up double digits. We were particularly encouraged with our margin expansion, both sequentially and year-over-year, as price more than got offset continued inflationary headwinds. We're also excited to have received all of the necessary regulatory approvals related to our acquisition of Manitowoc Ice, and we expect to close the acquisition later this week.

With the significant growth of Pool since 2019 and our Water Solutions business expected to exceed $1 billion in sales on a pro forma basis including Manitowoc Ice and it'd be predominantly a commercial platform, we'll be moving to three segment-reporting segments starting January 1, 2023. The three segments will be Pool, Water Solutions, Industrial & Flow Technologies. I'll provide more details on the new segment structure shortly.

We're also introducing Q3 guidance of $0.93 to $0.95 and tightening our full year guidance to a range of $3.70 to $3.75. Bob will give more details on guidance later in the call, but we are seeing headwinds from FX translation, as well as higher interest expense with the rise in rates over the past several months. We continue to believe we are well-positioned in attractive markets. Transformation is helping strengthen our performance, and the addition of Manitowoc Ice and our new segment structure positions us to continue delivering for all of our stakeholders.

Please turn to slide number 5 labeled Building a Stronger Commercial Water Solutions Platform. We introduced this slide in March when we announced our plans to acquire Manitowoc Ice. Manitowoc Ice is an iconic brand and a great business that we expect to help our commercial water solutions business to deliver scale, end-to-end water filtration, and ice solutions for foodservice customers, along with predictive services that identify and address customer issues before they arise.

This combination will transform our current water treatment business, which historically has been roughly two-thirds residential and one-third commercial-focused. With Manitowoc Ice, we expect water treatment [audio gap] (00:04:07) on pro forma basis with commercial representing nearly two-thirds of the business and improved profitability in addition to even greater growth prospects.

Please turn to slide 6 labeled Aligning Organization for Accelerated Success. To further expand on our announced segmentation move, the addition of Manitowoc Ice will provide us with an expanded and scaled end-to-end commercial water solutions platform for important global customers. It will also reshape our water treatment business to be more commercial focused by both revenue and contribution income than our residential business.

In addition, our Pool business has nearly doubled in revenue and income since 2018, which further supports a change in our Consumer Solutions segment structure. As a result, Pool and Water Solutions will each become individual segments, and each will be focused on their respective growth and transformation plans in line with our expectations. Our existing Industrial & Flow Technology segment will remain the same.

As a result of this new structure, we have also announced a number of management changes effective January 1, 2023 when the new structure will take effect. We believe this new segment structure will help us accelerate our efforts to improve customer service, differentiate our products, and drive profitability for our shareholders.

Please turn to slide 7 labeled Transformation to Enhance Value Creation. As we have shared over the past several quarters, our transformation strategy is taking shape. We are creating new tools for our toolbox, and each business is identifying their own respective opportunities to transform their business models for future success. Overall, we are focused on four areas: pricing, sourcing, operations, and organizational effectiveness. The team has been working hard to build funnels in all four categories, and we are gaining significant traction within sourcing.

During the second quarter, we held a supplier show and gathered over 800 attendees representing over 450 suppliers. We have identified additional suppliers as we evaluate the entire supply chain. This event showcased the diversity of our product offerings; and many suppliers, both new and existing, have gained a better understanding of how to partner with Pentair going forward. We are well underway in our efforts of evaluating the larger supplier categories and are looking forward to sharing more on our progress in the future.

We believe transformation is a key value creator for Pentair longer term, and we look forward to updating you in more detail and sharing our detailed targets and expectations for 2023 and beyond early next year.

I would now like to turn the call over to Bob to discuss our performance and our financial results in more detail. Bob?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

Thank you, John. Please turn to slide 8 labeled Q2 2022 Pentair Performance. We delivered second quarter sales growth of 13%, with core sales increasing 12% with strong price contribution. We were particularly pleased with the top line performance, given the tough comparison to last year. As we indicated last quarter, we expected to see price outpace inflation starting in the second quarter, and it played out as anticipated. Consumer Solutions delivered core sales growth of 15% against a tough comparison, and Industrial & Flow Technologies grew core revenue 7%.

Segment income increased 18%, and return on sales was 19.3%, which represented a 70 basis point increase year-over-year and a 210 basis point improvement sequentially.

We were pleased to see the strong price contribution more than offset inflation. But many of our businesses continue to face supply chain inefficiencies, and we expect this to impact productivity in the near term. Below the line, net interest and other expense was just under $5 million. Our share count was 165.5 million, and the adjusted tax rate was 16%. Adjusted EPS grew 21% to $1.02 and exceeded our guidance for the quarter.

Please turn to slide 9 labeled Q2 2022 Consumer Solutions Performance. Consumer Solutions delivered another strong quarter with sales growing 19% and core sales increasing 15%. Segment income grew 18% and price more than offset inflation in the quarter. Pool sales grew 20% in the quarter, and we continue to see solid momentum as we continue through the 2022 pool season. There's understandably a lot of focus on the pool industry given the significant growth over the past two years. The pandemic changed consumer behaviors early on. And whether it is moving to warmer climates, investing in the overall backyard, or the emergence of new traveling like Airbnb, consumers are using pools more and more.

The industry is estimated to be roughly 60% serving the installed base, 20% major remodeling, and 20% new pool construction. New pool permits have historically run 10% of single family starts and have been a little ahead of that lately. But pool dealers remain constrained by labor availability. Remodeling activity has been strong, but the focus on new pools has kept some of the remodeling activity from occurring, leading to healthy backlogs for dealers.

Further, pool attrition has been lower as pool owners have a renewed interest in maintaining their pools. There are roughly 5.4 million pools installed, and the average age of the installed base is approaching 20 years. The near-term focus for Pool is managing the supply chain, keeping up with demand, and improving the inventory health of all product categories. While some categories like heaters, lighting, and cleaners have improved, inventory positions leading to elevated growth, other categories like variable speed pumps, automation, and sanitization still have healthy backlogs given the limited availability of chips that has impacted deliveries.

We continue to believe in the long term prospects for the pool industry, and we'll provide further updates when we report third quarter earnings in October regarding channel inventory levels as the pool season ends in September.

Water treatment grew sales 19%, which included some contribution from KBI. Residential water treatment continues to be focused on complexity reduction and improving margins. Sales were up mid single digits for the residential business with positive contribution from both affiliated dealers and components. Commercial water solutions continue to see a healthy recovery in its end markets resulting in a healthy double-digit sales growth once again. The overall industry continues to improve, and KBI has strengthened and created new relationships for the business.

Please turn to slide 10 labeled Q2 2022 Industrial & Flow Technologies Performance. Industrial & Flow Technologies grew sales 4% in the quarter, with core revenue increasing 7%. Segment income grew 4%, and return on sales was flat at 15.7% as supply chain and plant inefficiencies continued. Residential flow grew sales 6% as demand in its channel remained solid, and backlog returned naturally to historic levels as component availability improved. Price has read out quite well so far this year, and capacity constraints in the plant have slowly improved as labor challenges have been addressed. We expect more normalized seasonality to end the year, but are encouraged our sell-through in the channel remains healthy.

Commercial flow sales were down 6% as the timing of shipments impacted the quarter. Backlog remains healthy, and we expect improvements in the supply chain should result in these delayed shipments occurring in the second half. The business continued to make progress in driving complexity reduction. Industry solutions saw sales increase 9%. Backlog continued to be strong and orders were healthy in this longer cycle business, particularly within the sustainable gas solution business. Although this is a longer cycle business, it was encouraging to see healthy price readout in the quarter.

Please turn to slide 11 labeled Balance Sheet and Cash Flow. The balance sheet ended the second quarter exceptionally strong with leverage at 1 time and return on invested capital just under 19%. Cash flow improved sequentially and was impacted some by higher inventory levels and supply chain inefficiencies continue. This is a combination of opportunistic raw material purchases and products that have been close to being completed while awaiting final components that have been delayed. Resins, drives, and electronics continue to be the categories impacted by availability challenges. We expect inventory levels to come down through the second half.

During the quarter, we completed our financing for the pending Manitowoc Ice acquisition. Given the rise in interest rates that occurred since we announced the transaction in March, we ended up with 75% of the debt variable to help mitigate some of the higher interest expense that will occur versus our original assumptions and to allow us to pay down the variable debt as free cash flow is generated.

We repurchased $50 million of shares in the quarter. Our primary focus for the remainder of the year will be on debt reduction upon the closing of the Manitowoc Ice acquisition.

Please turn to slide 12 labeled Q3 and Full Year 2022 Pentair Outlook. For the third quarter, we are introducing adjusted EPS guidance of $0.93 to $0.95, which represents a year-over-year increase of 4% to 7%. We expect total sales to grow 3% to 5% against the tough comparison as we expect seasonality for the business and channel inventory levels begin to normalize. We expect segment income to increase 5% to 7% with corporate expense coming in around $20 million, net interest expense of $6 million to $7 million, an adjusted tax rate of 16%, and a share count of 165 million to 166 million.

For the full year, we are adjusting our top line guidance to a range of 8% to 10% increase related primarily to a 1% higher FX headwind than previously forecasted. We expect segment income to increase 9% to 11% as we expect price continues to exceed inflation in the back half of the year, offset by manufacturing inefficiencies in the near term given ongoing component and labor availability. We expect adjusted EPS in the range of $3.70 to $3.75 or an increase of 9% to 10% for the year. We have reduced the high end of our previous guide by $0.05 to reflect FX and interest headwind.

Below the line, we expect corporate expense to be around $80 million; net interest expense of $21 million to $23 million as interest rates have increased, an adjusted tax rate of approximately 16%, and shares to be around 165 million to 166 million. We continue to target free cash flow to approximate net income. We are focused on bringing down inventory levels despite ongoing supply chain inefficiencies.

Our third quarter and full-year guidance does not include the impact of Manitowoc Ice, which we expect to close later this week. For the balance of 2022, we would expect the acquisition to be neutral to earnings. We had previously communicated that we expect $0.25 of accretion in 2023. However, we now expect about a $0.15 headwind from higher interest expense as a result of rates rising since we announced the transaction in March, and we would now expect approximately $0.10 accretion in 2023. We continue to target $0.40 accretion by 2025.

I would now like to turn the call over to Jamie for Q&A, after which John will have a few closing remarks. Jamie, please open the line for questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Ladies and gentlemen, at this time, we'll begin the question-and-answer session. [Operator Instructions] Our first question today comes from Andy Kaplowitz from Citigroup. Please go ahead with your question.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Good morning, everyone.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Morning.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

John or Bob, could you give us some more color into how you're thinking about Pool moving forward? I know you said you can give us more of an update in October, but I think you did suggest earlier in the year that you expect some inventory correction in the channel in Pool later in 2022. So, given the strength that you saw in Pool in Q2, but obviously more normalized inventory in the channel, do you expect a potential channel correction to be better or worse than your initial expectations? And what could that mean for 2023 pool demand?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. Thank you for the question. From our perspective, the year is playing out very much like we thought it would be when we gave our initial guide at the beginning of the year. When we look at the [audio gap] (00:19:07) business, we have a comparison to last year where, if you remember, inflation started accelerating in Q2, Q3, and Q4 of 2021, and price was still catching up. When we looked at the volume in last year's Q3 and Q4, really normal seasonality was not in play. Backlogs were high. We were shipping the products that were available to us, and revenue growth was primarily volume-driven.

As we built a guide for this year, our view was that price would start to read out quite effectively, and price offset inflation in Q1 and then read out really nicely in the second quarter, and our view is price will continue to exceed inflation in the back half of the year. As we look at the back half of the year, price remains strong for the business, and channel inventories return to more normalized levels against tougher comparisons. So, what that means is that our guide remains very consistent with what we said at the beginning of the year, and it sets us up for a more normalized pool season in 2023.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Bob, maybe I could ask you to elaborate on price versus cost dynamics and supply chain in the sense that the commodities have started to come down, but you definitely still talked about supply chain inefficiencies. So, is price versus cost or supply chain stabilizing versus your expectation? Obviously, you were in the green in Q2. Expectation in the second half, is it better or worse than you had, kind of the same? What are you seeing in terms of overall price versus cost?

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

Yeah. I'll break that into the two pieces because we look at really inflation and supply availability in two different pieces. From an inflation perspective, our biggest challenges really are across metals, motors, drives, electrical, freight including fuel charges, and labor. Of those pieces, most are about the same with commodity prices, metals, copper, steel showing some improvement, which would likely read out early next year. So, our view is, inflation gets a little bit better in the back half but continues to be a challenge.

From a supply availability perspective, heaters and lighting, cleaners have all improved. The challenge remains around variable to speed pumps, automation, sanitization, really anything related to availability of chips. We also continue to have challenges around resins, drives, electronics. So, supply availability, about the same. Inflation getting a little bit better in the back half, but should read out in an improved fashion in 2023.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate it.

Operator: Our next question comes from Joe Giordano from Cowen. Please go ahead with your question.

Joseph Giordano
Analyst, Cowen & Co. LLC

Q

Hey. Thanks, guys. When we think about Manitowoc Ice in the context of a potential recession and consumer weakening, I know you cut the accretion on – just like on the interest side, but how do you just think about the underlying performance of a business like that relative to what maybe you thought when we made the announcement?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I think we're still very positive about the outlook. I mean, one of the things that gives us that confidence is Everpure, which is our commercial water solutions business. We've seen that business perform significantly well during cycles, I mean, other than COVID. And just as a reminder, we're not yet at the hospitality levels globally that we expect to get back to. And so when that global travel starts to open up, those are great markets that have been on pause for a little bit in those spaces.

So, we share some of the same accounts and we have opportunities to penetrate the complementary accounts, and we believe that the KBI services piece of it creates that ongoing service annuity around these two products. So, we think it's going to perform well.

Joseph Giordano
Analyst, Cowen & Co. LLC

Q

And then, can you just touch on the leadership changes and like kind of the flip-flop of responsibilities from one segment to another and what those individuals bring with a fresh set of eyes to those businesses?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I mean, listen, Mario has brought a lot of great leadership capability to Pentair, and I'm sad by what we're doing here from the standpoint that we're almost a victim of our own success. I mean, Pool, as we mentioned, has almost doubled since 2018. And along the way, we're now competing directly with two standalone pool public companies, and that business needs a different level of agility and focus for it to deliver to the customers' expectations and be the premier pool provider.

On the Water Solutions side, we're adding a commercial element that skews us more from a residential into a commercial aspect. So, all of the great capability that Consumer Solutions built, the stronger brand, the customer service, the connected solutions, the effortless customer experiences, all phenomenal progress over the last 8 to 10 quarters. All of that capability will be used, but I want to use it closer to the customer. So, Pool needs what it needs to do from those capabilities. And then, we need to make sure we're not losing sight of servicing the foodservice customers in Water Solutions.

So, Jerome used to run Pool, and so he's coming back to lead that segment. And within Water Solutions, Adrian's been very close to that process through the transformation work and the onboarding of Manitowoc, and I feel like he's going to bring the right capability and leadership style. And De'Mon has run our Pool business for the last three years. He's a long term Pentair employee, and I think he's going to bring great capability to IFT. And Mario and I talked, and I think this is a great opportunity for him to use the skills and either take my job somewhere else or go with a bigger segment somewhere else.

So, that's a little bit of color.

Joseph Giordano
Analyst, Cowen & Co. LLC

Q

Thanks, guys.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Thank you.

Operator: Our next question comes from Mike Halloran from Baird. Please go ahead with your question.

Michael Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Hey. Good morning, everyone. So, just a clarification on the pool inventory levels from Bob's comments, just want to make sure I understand. Essentially, you're saying you are at normal channel inventory levels for everything that really does involve chips or electronics, whereas the pieces like variable speed motors, sanitization, things like that, those are not at normal levels. Those are below normal levels from a channel inventory perspective. Is that accurate?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Well, I think – Bob, I don't want to put words in your mouth. That's an end-of-year forecasted statement, and we've got a fair amount of volume reduction in our Pool Q3 and Q4 year-over-year. That would bring us into what we expect to be normalized levels by the end of the year. Correct.

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

Yeah. That's built into the guidance that we have. So, our view is that, still catching up on the heaters, lighting – still catching up on the variable speed pumps, the sanitization, the automation. And heaters, lightings, and cleaners will be – those backlogs will come down in Q3 and Q4.

Michael Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

Okay. So, the commentary you made on the guidance piece of some destocking was primarily related to some of those pieces you just mentioned?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. So, I think – we had in our guide that we felt like we were going to – the original guide. And as Bob said, our current guide is equal to the original guide, and we always forecasted that we would see those inventory levels start to come down as our lead times started to get better to the channel. I mean, historically, we were generally at five days out for any product we made. Clearly when we were trying to catch up in 2021, that exceeded 180 days in some aspects. Those lead times are not yet back in line to the products that Bob mentioned, anything chip-related or IoT-related, and we expect that we'll begin to catch those up between Q3 and Q4 and get more normalized as we head into next year.

Michael Halloran
Analyst, Robert W. Baird & Co., Inc.

Q

No. That makes sense. And then within the resi flow piece here, maybe just talk about what the sequential dynamics look like and what kind of dynamics you're seeing on the stocking, destocking piece is kind of where end markets are tracking now versus where the inventory levels are.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. Resi flow continues to remain strong from a demand perspective. Our bigger challenge is around supply availability and labor. So, backlog looks healthy. Inventory in the channel looks healthy and in good shape. We just need to deliver that backlog in Q3 and Q4.

Michael Halloran
Analyst, Robert W. Baird & Co., Inc.
Q

Thanks for that. Appreciate it.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Thank you.

Operator: Our next question comes from Brian Lee from Goldman Sachs. Please go ahead with your question.

Brian Lee
Analyst, Goldman Sachs & Co. LLC
Q

Hey, guys. Good morning. Thanks for taking the questions. I guess first one, just kind of going back to your comments, Bob, around – and I don't want to put words in your mouth, but you sort of suggested normal pool season dynamics in 2023. I mean, historically, is that sort of a framework of low single-digit price, mid single-digit volume, or could we expect there's still some additional price in 2023 that persists from these kind of levels? And then maybe conversely, some volume headwinds given tougher comps and maybe a slower new pool market. Just trying to get a frame of reference when you're talking about sort of the normal if there's a new normal or sort of the historical metrics you would be referencing.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Yeah. It's still very early to give our view of the 2023 pool season, but certainly what we see today suggests more of a normal environment. So, we spoke about inventory in the channels at the end of the year being more in line. And then that allows us to have some amount of price carryover from 2022, but more normalized seasonality in the business. So, that's our view right now. We'll let the Q3 and the pool season end in October, and then have a better perspective on our next earnings call.

Brian Lee
Analyst, Goldman Sachs & Co. LLC
Q

All right. Fair enough. And then in IFT, I'm not sure if you provided color on this, but this was, I guess, the second straight quarter with no volume growth in IFT. Maybe just level-set us a bit where are we in the cycle? Just kind of thoughts on volume growth in this segment moving through the rest of 2022.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Yeah. I just want to give some color, and then Bob will take a little deeper. I mean, just a reminder that in the flow on our IFT side, we struggle with some of the same challenges we're struggling with on the Consumer Solutions regarding variable speed, and the availability of those drives. So, we are still seeing a shortage of those products, and that's where we're having trouble getting the backlog out, as well as, as Bob mentioned, some of the labor and some of the premium freight associated with that lingering around the cost side.

So, Bob, I don't know if you want to provide any more color there.

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

Yeah. It's really three different business. So, we spoke about residential flow, and that business continues to have good demand. Commercial sales was down. That's primarily due to us needing to improve some supply chain inefficiencies. And then the longer cycle, Industrial Solutions business, is doing well led by sustainable gas. So, again, a mix of businesses, but overall pleased with the 7% core growth in IFT.

Brian Lee
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks a lot, guys. I'll pass it on.

Operator: Our next question comes from Saree Boroditsky from Jefferies. Please go ahead with your question.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Hi. Good morning. So, just given the significant growth in pool demand over the last couple of years, I know you're not forecasting 2023 today, but if you do see some declines in demand into next year, what kind of levers do you have to keep profitability?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. We have a number of levers. I'll start with transformation. The transformation program is really gaining momentum. We're seeing some small benefit this year in 2022, but a significant funnel being built in the transformation, and we talked about 300 basis points improvement for the overall Pentair business to 2025. So, certainly on track to deliver that. So, it starts with transformation.

Then, we have a number of inefficiencies, to be honest, in the 2022 P&L, and we're in the process of looking at those as we build out our plans for next year. But everything from air freighting product to having our labor and certain manufacturing inefficiencies in our factories. So, overall, lots of opportunity to expand margins next year through the transformation and being laser-focused on the inefficiencies this year.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Thank you. And then just given the addition of Manitowoc Ice in a couple days, could you give us an update on how you're thinking about the contribution to revenues for this year and then earnings into 2023?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. So, we have a page in the deck that talks about Manitowoc being around $325 million of revenue. If you took 5/12 of that, you can be pretty close to the revenue number. And then from an income perspective, we've talked about that being a 30% EBITDA margin business. And so, again, if you took 5/12 of that, you'd come up with roughly what the EBITDA would be for the business.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Great. Thanks for taking my questions [ph] for today (00:34:14).

Operator: And our next question comes from Bryan Blair from Oppenheimer. Please go ahead with your question.

Bryan F. Blair
Analyst, Oppenheimer & Co., Inc.

Q

Thanks. Good morning, guys. So, help me get off with a little more detail on underlying trends in commercial water treatment prepared remarks. And pretty bullish on trajectory there; just curious if there's any discernible shift in underlying demand as Q2 progressed or what you're seeing in the early part of Q3.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I mean, it's a steady mid single-digit grower normalized, and we continue to see it flipping along at that rate. I think there's always a little bit of headlines on restaurants that are challenged, but then you always see or don't hear about the new restaurants that come online. And so while restaurants might not be able to fill out their capacity levels because of labor constraints, it doesn't mean that they're necessarily using less water. And that water in most of our restaurants is filtered to a high quality standard. So, I mean, we're seeing good progress there, and we're continuing to be bullish on that particular space.

Bryan F. Blair
Analyst, Oppenheimer & Co., Inc.

Q

Yeah. Appreciate the color. And just to level-set, are there any operational factors that are restricting Manitowoc Ice accretion this year or lowering the 2023 outlook? Sounds like it's strictly interest expense. I just want to make sure that that is the case.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Just interest, the business is tracking well, and our goal is to be focused on synergies next year in addition to that.

Bryan F. Blair
Analyst, Oppenheimer & Co., Inc.

Q

Got it. Thanks for taking my questions.

Operator: Our next question comes from Nathan Jones from Stifel. Please go ahead with your question.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Good morning, everyone.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Good morning.

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

Good morning.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Question on the inventory comments. You talked about looking to take inventory down in the second half of the year despite supply chain challenges. Is that more related to the seasonality in the business that you're looking to take inventory down? Or is there a move at the moment to structurally reduce inventory that you may have been carrying because of the supply chain challenges?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Both. I mean, I think Bob mentioned that we're going to have a normal seasonality next year. Just to be clear, regardless of what the Pool outlook is for 2023, we think it will be back in line with the historical patterns of peak performance in Q2, a little lighter in Q1 and Q4 regarding that pattern, and that's what we think to happen. And what we expect to [ph] the add (00:36:56) is that we're back to more normalized inventory that we reflect no more further significant supply chain issues.

We need a couple more [indiscernible] (00:37:06). We're still short, as you've heard from some of our key customers. And they need those variable speed pumps, they need the sanitizers. And when we finish those out and get those to them, they can get to close the pool pads out, and then that brings the inventory back in line.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Makes sense. And one on the transformation, you guys have been talking about the funnel of opportunities for transformation continuing to build. But I noted in your press release today that there's no expected expenses for transformation in the second half of the year. Can you just talk about releasing self-funding now? Or why are there not expenses related to transformation but you're talking about a building pipeline of opportunity?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. We typically would not forecast transformation expenses. We do forecast the amortization on intangibles going forward, but we would not forecast that. You can expect us to continue at about the same rate as what you saw in Q1 and Q2 in the back half of the year as we spend money on third-party consultants to help us drive primarily pricing and sourcing.

Nathan Jones
Analyst, Stifel, Nicolaus & Co., Inc.

Q

That makes more sense. Thanks for taking my questions.

Operator: Our next question comes from Julian Mitchell from Barclays. Please go ahead with your question.

Matthew Shaffer
Analyst, Barclays Capital, Inc.

Q

Hi. It's Matthew Shaffer on from Julian Mitchell's team. My first question was, for IFT, you guys had good margin expansion year-over-year in 2021, but that seemed to run out of steam in 2022. What are your expectations for margin expansion in the division for the remainder of the year? And then can you just remind us too of the IFT complexity reduction initiatives and the expected impacts there?

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc
A

We are pleased with the IFT ROS improvement in the business. We do expect to finish the year with return on sales higher than the prior year. You'll remember that last year, they started benefiting from complexity reduction in the back half. That trend has continued, and we continue to have momentum in that business. So, overall we were flat for Q2, but do expect in the back half of the year to see ROS expansion in that business.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

And as I said in my comments, we had a supplier show, and you probably heard me talk about all the great opportunity to partner differentially with supply partners. You should read into that a lot of complexity of product, both in the form of castings as well as semiconductors and PCB boards and etcetera. And so as we go forward, the opportunity to consolidate those designs is a big piece of how we think we're going to drive longer term margins in IFT. And Consumer Solutions, of course, but we'll see it in IFT as well.

Matthew Shaffer
Analyst, Barclays Capital, Inc.
Q

Great. Thank you very much on that. And then the second half sales growth might be low single digits, mid-single digits for the company. How much in that growth will be from price versus volume? Or any detail there would be very helpful.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

We expect price to continue to be strong at that double-digit rate. So, we did 10% in Q1 and 14% in Q2. So, think double digits in the back half is our assumption. And then if that continues to be the headwind on a year-over-year basis and you can back into the volume, which is a comparison to higher levels in Q3 and Q4. And then also, as we mentioned, our views of what the inventory correction will be in the channel due to supply chain catching up.

Matthew Shaffer
Analyst, Barclays Capital, Inc.
Q

Great. Thank you, guys.

Operator: Our next question comes from Jeff Hammond from KeyBanc Capital Markets. Please go ahead with your question.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.
Q

Hey. Good morning, guys.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Good morning.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, just – can you give us – like, what's your assumption for the volume decline in Pool in the second half? And then just on the third quarter I think you're saying 3% to 5% growth. What's kind of – is there much differentiation between the two segments?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. We don't really want to get into all the specific pieces for each of the different segments. I would say that overall, for that company, we've talked about price reading out double-digit, you can think about acquisitions, roughly offsetting FX, and then the rest is volume. So, think about volume as being down low single digits to mid single digits in the back half.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then, can you give us any color on how to think about Manitowoc Ice seasonality? Is it pretty ratable quarter-to-quarter or...

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. Pretty flat quarter-to-quarter.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then, just last on transformation, just you guys have been talking about it for a while. What do you think is the timing where you start to kind of spike out kind of the different buckets and cost savings, etcetera?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

I think early next year. In accordance with when we provide the guidance, we would expect to give you the transformation expectations and break out some of the components of how we're going achieve that.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Appreciate it.

Operator: Our next question comes from Scott Graham from Loop. Please go ahead with your question.

Scott Graham
Analyst, Loop Capital Markets LLC

Q

Yeah. Hi. Good morning, John, Bob, Jim. Yeah. I wanted to ask you [ph] to loop (00:43:00) and maybe to develop your answer to a previous question, I think, about one business for July. How are things in July in general? Is there any big change, one segment versus another versus the second quarter? Just maybe whatever you can tell us about July would be helpful.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Off to a good start in July. A lot of it comes down to the allocation of key product, and so we're on track to deliver the quarter based on the start of July.

Scott Graham
Analyst, Loop Capital Markets LLC
Q

Got it. Thank you. And forgive me for not having to put pen to paper on your last answer on down low to a mid-single for the second half in volumes, but is the second quarter pricing – is that kind of the peak and then we kind of moderate a little bit because the second half of last year you start to see the ramp?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

That's exactly right. Still double digits, but starts to moderate.

Scott Graham
Analyst, Loop Capital Markets LLC
Q

That's great. Thanks. If I could just squeeze in this last one. You've got a pretty healthy incremental margin implied in your third quarter guidance. Is that mostly a widening of the price-cost gap or is there something else?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Price-cost stays about the same, and I think the Q3 ROS is roughly in line with the first half.

Scott Graham
Analyst, Loop Capital Markets LLC
Q

Very good. Thank you.

Operator: And our next question comes from Rob Wertheimer from Melius Research. Please go ahead with your question.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Yeah. Hi. Good morning, everybody.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc
A

Good morning.

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc
A

Good morning.

Rob Wertheimer
Analyst, Melius Research LLC

Q

So, I had two questions. One is simply on gross margin where you've noted obviously prices catching up and mostly so to some of the cost increases you've seen. Is there still 100 bp or more tailwind? Does that continue to happen and you revert back to higher gross margin levels? I know there's issues of mix, I know there's issues of you don't necessarily get margin on pricing. So, just – is there still continued tailwind on gross margin?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I'll take the first part, and then Bob will give you a little bit more color. I'm looking at 2019, and I'm looking at my gross margins in 2019. And as you recall, we took a small dip in 2020 as COVID started to unfold, and we've been catching up ever since. And so our gross margins are still down from 2019, and we still believe when we look at our transformation savings that we're using that historical point and then seeking to drive significant gross margin expansion from there. So, as we think of pricing, as we think of sourcing, it's not just about getting back from – back to that level. We want to be back to that level and then some, which would get after the right pricing dynamics that we're seeking in each of our industries, as well as getting real sourcing benefits from our supply partners and from, as I mentioned earlier, reducing the complexity of our designs through our centers of excellence.

But, Bob, I don't know if you want to bring more color.

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

Yeah. All of our transformation initiatives are focused on sustainable gross margin improvement. So, when we talk about 300 basis points of ROS, you can basically equate that to 300 basis points minimum of gross margin.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Perfect. And then from here, is that more pricing catching up or is that more just like reducing all the inefficiencies and then doing all the things you're talking about transformation to get there?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I think in our distribution- and dealer-based businesses, we're pretty confident having been through the cycle before that our customers understand that labor is a big piece of the price that the price efforts that we've put into place, we would expect to be more sustainable levels. When you get to more project to the OEM-related businesses, I mean, there is a dynamic where we would expect to see pricing headwinds in those businesses, and we'd need to capture more sourcing savings to drive those gross margins as we go forward. So, it is different depending on what business you're looking at, but it's a combination of both of those things.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Perfect. And then if I can, I mean, there's a lot of questions on – really on the consumer, obviously, the big thing in the quarter. And you have some natural strength [ph] in Pool (00:47:14), has a lot of stability too, a lot of backlog, a lot of different things. I mean, curious if you're able to look through all that in whether consumer water treatment or anything else on just what the current mood is, if you're seeing any downturn or any inflection on near-term purchases that would indicate a change in trend, and I'll stop there. Thank you.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I think it's hard to see the immediate reactions. I mean, it's logical to think that higher interest rates are going to put a pinch on consumer spending. And I would say that we break those into two categories, what's the discretionary piece and what's the non-discretionary piece. We don't see pool owners, in particular on the high end, really changing behavior at all. Houses still continuing to transact. Some of those are – or most of those, I should say, are cash-based. And they're still going to seek those pool.

I think where we may or may not see it as we look into 2023 and 2024 is on remodeling, home remodeling, and/or what is a non-discretionary purchase of a higher end water softener or water treatment system, etcetera. That's where we'd see it. We have not seen it yet, but that's where we would expect to see and measure the consumer sentiment regarding our products. The rest is break and fix, and I'd call that non-discretionary. And you need a pump, you need a pump. You need a filter replaced, you need a filter replaced.

Operator: Our next question comes from Damian Karas from UBS. Please go ahead with your question.

Damian Karas
Analyst, UBS Securities LLC

Q

Hey, hey. Good morning, everyone.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Morning.

Damian Karas
Analyst, UBS Securities LLC

Q

Just have a follow-up question on price. You mentioned you're expecting up double digits in the second half. Is that primarily just coming from prior price actions? And how should we be thinking about what your refreshed pricing that usually hits in September is going to be aligned?

I mean, is there some incremental price that's likely to happen? And just we're talking lower relative to actions from the past year or given material deflation that we've been seeing recently, is it possibly just more of a pause on kind of the September price refresh?

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

So, to answer your first question, the price reading out in the back half of the year is based on all of the price actions that we have taken over the last couple of quarters. So, those are locked in. As we think about price moving forward in the back half of the year, price increases, I would expect at this point that there will be some price increases. Labor continues to be high. While we are seeing some relief in commodity, we continue to see pressure on other pieces of the supply chain. So, definitely moderating, but at least at this point suggesting some small price increase.

Damian Karas
Analyst, UBS Securities LLC

Q

Okay. That's helpful. And, Bob, you talked about the higher interest expense and variable debt. Could you maybe just give us your updated thinking on capital structure and your capital deployment priorities post the closure of the Manitowoc deal?

Robert P. Fishman
Executive Vice President, Chief Financial Officer & Chief Accounting Officer, Pentair plc

A

So, from a capital allocation perspective, maintaining our investment grade is extremely important to us. So, I typically start with that. In terms of paying our dividend, we've increased our dividend 46 years in a row. That's important as well. Near-term focus will be on debt reduction as we bring down that interest cost. And then from an M&A perspective, we are entirely focused on the successful integration of Manitowoc Ice and driving the synergies that we've discussed previously. So, from a capital allocation perspective, those would be the key priorities.

Damian Karas
Analyst, UBS Securities LLC

Q

Got it. Thanks very much. Best of luck.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

A

Thank you.

Operator: And ladies and gentlemen, with that, we'll concludes today's question-and-answer session. I'd like to turn the floor back over to John Stauch, President and Chief Executive Officer, for any closing remarks.

John L. Stauch
President, Chief Executive Officer & Director, Pentair plc

Thank you for joining us today. It's exciting time for Pentair. We are prepared to make the most of it. We expect Manitowoc Ice and our new segmentation to be accelerators for all of our stakeholders, and we look forward to updating you on our progress in the future.

Jamie, you can conclude the call. Thank you.

Operator: Ladies and gentlemen, with that, we'll conclude today's conference call. We thank you for attending today's presentation. You may now disconnect your lines.