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Pentair plc (PNR)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to the Q1 2021 Pentair Earnings Conference Call. At this time, all participants are in listen only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I'd now like to hand the conference over to your speaker today, Jim Lucas. Thank you. Please go ahead.

Jim C. Lucas

SVP, Treasurer, FP&A & Investor Relations

Thanks, Stephanie, and welcome to Pentair's first quarter 2021 earnings conference call. We're glad you could join us. I'm Jim Lucas, Senior Vice President, Treasurer, FP&A, and Investor Relations. 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 first quarter performance as outlined in this morning's press release.

Before we begin, let me remind you that any statements made about the company's anticipated financial results are forward-looking statements subject to future risks and uncertainties, such as the risks outlined in Pentair's most recent Form 10-Q, Form 10-K, and today's press release. Forward-looking statements included herein are made as of today and the company undertakes no obligation to update publicly such statements to reflect subsequent events or circumstances. Actual results could differ materially from anticipated results.

Today's webcast is accompanied by a presentation which can be found in the Investor Relations section of Pentair's website. We will reference these slides throughout our prepared remarks. Any references to non-GAAP financials are reconciled in the appendix of the presentation. 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 in order to ensure that everyone has an opportunity to ask their questions. I would now like to turn the call over to John.

John L. Stauch

President, Chief Executive Officer & Director

Thank you, Jim, and good morning everyone. Please turn to slide number 4, titled Executive Summary. I would first like to start by thanking the entire Pentair organization and the contributions they have made to help deliver on our commitments to all of our stakeholders. I would also like to take this opportunity to thank all of our global channel partners and suppliers for their patience and efforts in working with us and our consumers to meet our commitments, despite the effects of decreases in the south, canal blockages, supply chain constraints and of course, the ongoing pandemic. Building off the momentum from last year, we started 2021 strong, with sales up 22%, adjusted EPS increasing 56%, and free cash flow improving significantly from the comparable period last year. Our Residential businesses led the way as Consumer Solutions experienced the 34% increase in sales. Encouragingly, we saw sales in all three businesses in Industrial & Flow Technologies return to growth for the first time in over a year.

We announced the acquisition of Ken's Beverage earlier this week. This is a strategic bolt-on acquisition that provides Pentair a valuable national direct service network to expand our commercial water treatment business. We believe we will be in a position to seamlessly manage the full customer experience for product development, sales, installation and service to ensure the best-quality products are matched with the most reliable and dedicated service network for all commercial applications. We believe Ken's provides us a platform to grow from, as well as an opportunity to continue to expand our products offered to this important channel.

Our balance sheet remains in excellent shape and we are well positioned to fund organic growth and inorganic

growth opportunities and return capital to our shareholders through dividends and opportunistic share repurchases. With a strong start to the year, we are raising our full-year adjusted EPS guidance to a range of \$2.80 to \$2.95. While inflation remains high, we have instituted a number of selling price increases across the portfolio that we expect to help mitigate inflation in the second half of the year.

The strong start to the year and continued strength in our Residential businesses gives us confidence that we will have another strong year of growth for Pentair. Equally important are the signs of recovery in our Commercial and Industrial businesses. We plan to continue to invest in our strategic growth initiatives and we will remain disciplined with our balance sheet.

Please turn to slide 5, labeled 2021 Execution Expectations. As we highlighted at the end of last year, we understand the importance of delivering the core while we also build our future. The focus has been, and will remain, on consistently making our commitments. Our actual results for the past three quarters have come in significantly better than our expectations as Residential demand has been very strong. While we have experienced robust sales and EPS growth, we have also improved our cash flow and our balance sheet is the strongest it has been in years.

Building our future means focusing on the things that are within our control. We look forward to providing more depth on this topic at our June 10 Investor Day. However, this is a continuation of the hard work we have been undertaking for the past several years. It starts with our focused growth initiatives primarily in our Consumer Solutions segment

We are a leader in the pool industry and we continue to build on our leading position. Investments in this area include automation, smart and connected solutions, energy efficiency offerings and now, better filtration solutions. Within Water Treatment, we have expanded from components into systems and services within both Residential and Commercial. We have made significant investments in digitally building our brand and expanding our reach.

We recently created a transformation office as we embark on a journey to drive growth while be more agile and flexible. Transformation can have many meanings. But to us, it means that we will have the right strategy, organization, leadership and culture while accelerating growth and driving margin expansion by leveraging our internal capabilities and reducing complexity. This is not an either/or but a both/and. We recognize that we must grow and drive productivity in order to maximize our ability to deliver for customers and create value for shareholders.

We plan to continue to accelerate our digital, innovation, technology and ESG investments, and we expect to fund many of these initiatives through our complexity reduction efforts. We believe that we are better positioned to deliver consistent growth and margin expansion while also generating strong cash flow. Our goal has been and continues to be delivering consistently for our customers, employees, shareholders, and the environment.

I would now like to turn the call over to Bob to discuss our performance and our financial results in more detail, after which I'll provide an update on our overall strategic position.

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

Thank you, John. Please turn to slide 6, labeled Q1 2021 Pentair Performance. First quarter sales grew an impressive 22% with core sales increasing 19%. Consumer Solutions grew in excess of 30% and Industrial & Flow Technologies returned to growth for the first time in five quarters. Segment income was up nearly 50% as we saw strong drop-through and return on sales expanded 330 basis points to 19%. Adjusted EPS jumped 56% to \$0.81.

We saw price and productivity offset inflation in the quarter. This was the third consecutive quarter of strong double-digit sales growth within our Residential businesses. But, just as encouraging was our Commercial and Industrial businesses showing sequential improvement and some pockets of growth. We were very pleased with our first quarter performance and we believe the momentum should continue.

Please turn to slide 7, labeled Q1 2021 Consumer Solutions Performance. Consumer Solutions sales growth was 34% as both businesses delivered double-digit growth. Segment income increased 54% and return on sales expanded 330 basis points to 25.1%.

Pool experienced remarkable growth of almost 50% in the first quarter. Traditionally, the first quarter is preparing for the upcoming pool season, but we saw strong demand flow through the channel as we believe pool dealers continue to do their best to keep up with robust demand. The theme of consumers investing in the backyard as part of their home oasis continued.

Demand for new pools remained strong as many builders saw bookings well past the current pool season. An already strong pool maintenance space grew only stronger as the freeze earlier this year in the southern US caused many premature equipment failures due to water freezing within the equipment. Pool has experienced strong double-digit sales growth for three consecutive quarters, and this would not be possible without our operations and supply teams and their ability to continuously increase capacity and execute at historically high volume levels.

We saw strong demand for pumps during the quarter and continued to see broader adoption of our variable speed pumps as a new DOE regulation goes into effect later this year. Demand for heaters remains quite high and we have significantly increased our production capacity.

Water Treatment delivered 12% sales growth as Residential demand remained robust and the decline in Commercial volumes showed further sequential improvement. Within Residential Products, we saw strong growth in valves, tanks, pitchers and faucets. We experienced strong growth in the US, Europe and especially in China. We're in the early stages of integrating Rocean, but we believe the acquisition will greater enhance our product offerings going forward. Within Residential Services, we continue to experience strong demand and healthy conversion of leads into actual orders. We made good progress on our journey to become the trusted, nationally branded, experience, led in part by our brand transition to Pentair Water Solutions.

We are launching a number of new recurring revenue services, including preventative maintenance programs, service bolt-ons for plumbing services, cartridge change-outs, and extended warranty programs. We are seeing continued signs of these foundational building blocks coming together leading to more consistent predictable growth. We believe that commercial demand is finally finding a bottom and expect comps to get easier going forward. We continue to build a strong new business funnel, particularly for our total water management offerings. We believe the addition of Ken's Beverage will help strengthen these offerings.

Please turn to slide 8, labeled Q1 2021 Industrial & Flow Technologies Performance. Industrial & Flow Technologies sales increased 7% in the quarter, led by another quarter of double-digit growth in Residential Flow, and both Commercial Flow and Industrial Filtration encouragingly posted modest growth in the quarter. Segment income increased 12% and return on sales expanded 60 basis points to 14.5%.

Residential Flow grew at a double-digit rate for the second consecutive quarter as demand remained strong across residential, irrigation and ag spray. We also experienced strong growth across retail pro and OEM channels.

Commercial Flow returned to growth with backlog growing for the first time in many quarters. While infrastructure remained soft, we were encouraged by a growing backlog within commercial.

We were pleased to see Industrial Filtration return to growth in the first quarter and improve its backlog both year-over-year and sequentially. While headwinds remain in our longer-cycle businesses due to caution and larger capital investments, we saw solid improvement in short-cycle component demand. Within our Food and Beverage business, we are beginning to see orders for our beer membrane filtration systems, including a new system for beer stabilization. In addition, we continue to expand our IoT offering with existing beer customers. Finally, we have seen a substantial increase in backlog for our biogas systems.

Industrial & Flow Technologies remains focused on reducing complexity, selective growth and margin expansion, and we are encouraged by the improving top and bottom line to start the year.

Please turn to slide 9, labeled Balance Sheet and Cash Flow. While the first quarter is historically a period of cash flow usage due to seasonal working capital being built, we were very pleased to see only minimal usage this year and

over \$150 million year-over-year improvement. This was driven primarily by our Pool business and improved linearity. We expect another good year of free cash flow driven by strong demand and continued disciplined working capital management. We ended the quarter at 1.3 times leverage and our return on invested capital was a strong 16.3%. As we look at our cash flow needs going forward, we have a bond maturing in the second quarter and we will be paying our quarterly dividend. Beyond that, we will continue to be disciplined in our capital allocation as we continue to work the M&A pipeline and we continue to have in our plan a buyback of at least \$150 million of our shares this year.

Please turn to slide 10, labeled Q2 and Full Year 2021 Pentair Outlook. We are initiating second quarter and updating our full year 2021 guidance. For the second quarter, we expect sales to grow 13% to 16%, segment income to grow 12% to 20%, and adjusted EPS to grow 17% to 25% to a range of \$0.69 to \$0.74. For the full year, we expect sales to grow 6% to 11%, segment income to increase 10% to 16%, and adjusted EPS to grow 12% to 18% to a range of \$2.80 to \$2.95.

We continue to work through material shortages and inflation that is impacting the second quarter. We believe that our pricing actions taken in the first half will help mitigate full year inflationary pressures. We have not factored in Ken's Beverage into our forecast as we are awaiting finalization of the transaction.

Embedded in our full year sales guidance is anticipated low-double digit growth in Consumer Solutions, with Pool expected to be up mid-teens and Water Treatment up high-single digits to low-double digits. Within Industrial & Flow Technologies, we expect the top line to be up low-to-mid-single digits, with Residential above the segment average. While we are experiencing an increase in orders for the short-cycle parts of our Commercial and Industrial businesses, we have not yet seen larger capital spending materialize.

Below the operating line, we expect corporate expense to be around \$65 million, net interest to be in a range of \$16 million to \$18 million, our tax rate to be around 15%, and the share count is expected to average between 167 million and 168 million shares for the full year. Capital expenditures are expected to be around \$65 million while depreciation and amortization is anticipated to be about \$80 million. We continue to target free cash flow to be greater than or equal to net income.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Andy Kaplowitz with Citigroup.

Andrew Kaplowitz

Citigroup Global Markets, Inc.

Q

John, just focusing on your Q2 guide for a second. I think we all understand that Pool was unusually strong in Q1 versus normal seasonality, but is there any reason why Pool would be down sequentially in your usually seasonally strongest Q2? How much of a boost did you see from Texas weather-related issues in Q1? Or are you worried at all that supply constraints could get worse? Can you just give us more color because for the overall company you're still forecasting lower year-over-year growth in Q2 than Q1 despite easier comparisons?

John L. Stauch

President, Chief Executive Officer & Director

A

Andy, totally understand. I'm going to have Bob answer that one.

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

Yeah. While we're pleased with the Q2 guide vs. the prior year, it's not lost on us that with the demand that we're seeing in the overall business, not just Pool, why couldn't we have done as well sequentially versus Q1. We look at that and we do face some material shortages in key components, resins, motors, circuit boards. And while we have shown an improvement over the last couple of weeks, it is an impact to the second quarter. We're also facing some inflationary pressures in the second quarter. And while we have increased prices, most of that will read out in the back half. So we're doing everything we can to catch up and basically satisfy this increased demand, but there are some supply challenges that we are facing in the second quarter.

Andrew Kaplowitz

Citigroup Global Markets, Inc.

Q

Thanks for that, Bob. And then just focusing maybe on that inflation, looks like you've got a nice uptick in productivity in Q1, and productivity plus price is more than offsetting inflation. It seems you've been able to get over the labor availability issues you talked about in the past. And we know your guidance in the past was for pricing and productivity to offset inflation. But is it possible for you to actually stay ahead of inflation despite all these constraints?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

That is certainly our goal. Obviously in the second quarter, we had the inflation challenge, but for the back half of the year, what you just mentioned is our goal. I did want to congratulate the operations team, the supply chain. A lot of the issues that we saw in 2020 as we ramped up production, we really addressed head-on and did a nice job. So, a lot of that productivity improvement is driving the leverage over a fixed cost base and driving the efficiencies in a really cost-effective manner.

Andrew Kaplowitz

Citigroup Global Markets, Inc.

Q

And, Bob, are you able to get the labor you need to meet this ramp-up?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

Labor continues to be a challenge, and it's something that we need to address. It's in many places of the business, it's a challenge to be totally honest, but we – our guidance should not be impacted by that. But it's certainly on our radar screen.

Operator: Your next question is from the line of Brian Lee with Goldman Sachs.

Brian Lee

Goldman Sachs & Co. LLC

Q

You alluded to this, John, during the prepared remarks, but can you quantify a bit what your exposure is to Texas. We know it's one of the top three pool markets in the country. But specific to kind of your, I guess, indexing there versus other parts of the country, can you give us some sense. And it sounds like that's driven some near-term demand, just the winter freeze and the fall out of that. But do you see kind of with pool backlogs and how busy dealers are that some of that's even having to push into 2022 for people that are needing to go to their pools in Texas and fix things or outright replace them?

John L. Stauch

President, Chief Executive Officer & Director

A

Yeah. I think it's fair to say that there's an industry capacity constraint in overall pool that we're always working to – the dealers, the pool builders, the availability of that as it relates to the consumer demand – as far as Texas goes, we did get a little nearer term on some of the break and fix that happened in Q1, but most of that will also be satisfied here in Q2 in the normal course of shipments.

What I also alluded to in – Texas was more related to material supply chain challenges and many of the resins are produced in that area of the country and those – that capacity is coming back on line. It's getting better every day, but that's what Bob was referencing as well. So net-net, I can't call Texas a win for either Q1 or Q2, and I think it just goes into the overall demand being a large pool state that we always serve.

Brian Lee

Goldman Sachs & Co. LLC

Q

Okay. Fair enough. That's helpful. And then, I guess, just second question here and I'll pass it on. Clearly, we've seen a good housing market here. We've seen the new pool number steadily ticking up for the past several years, especially here recently. Can you give us a sense of – I know you're heavily aftermarket levered, but percent of new pool mix vs. retrofit, how much has that changed here of late, and do you have kind of an expectation on that trend continuing to shift maybe a little bit toward new pool even through the balance of the year and into next year?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

Yeah, I can take that one. Our mix remains fairly constant, roughly 20% new pool, 20% remodel, and roughly 60% aftermarket.

John L. Stauch

President, Chief Executive Officer & Director

A

And the new pools are definitely up largely on a year-over-year basis and we still see that trend continuing, but as an overall impact to the business, it's not as beneficial as continuing to build the aftermarket growth and the

remodeling growth for us. That being said, every new pool that goes in, we want to convince those consumers and the pool dealers to put all the new content in and make those smart automated pools. And that adds to the aftermarket opportunity later as well.

Operator: Your next question is from Mike Halloran with Baird.

Michael Patrick Halloran

Robert W. Baird & Co., Inc.

Q

So just some questions on the guide here, the first one at least. Obviously, good answer to understand why Q2 may be a little bit more muted relative to what Q1 would imply from a pool perspectives. But inventories lean in the channel, I mean, how do you think that plays out through the balance of the year then? I mean, it seems like you're implying that there's some pushouts into the second half of the year. Supply chain constraints are kind of rampant throughout the industry. Not like that demand goes away. So maybe just help with some of the cadencing and how you're thinking about the year and what all of these challenges can equate to as you move over the next few quarters, not just Q2.

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

In terms of the year, when you look at the – what we guided for in Q2 and what that implies for the back half, it has slight revenue growth over some pretty big compares. So business did well in the back half last year, so – but pleased to see growth. Can we do better? Potentially. For us, we're also focused on margin. And while we will win the price/cost war, there are continuing to be an element of strategic growth investments in the back half that are putting a little bit of an impact on our overall margin expansion. We think it's money well spent that that'll benefit 2022 and beyond, primarily in the Pool space and the Water Treatment side. But that does have an effect on our overall margin expansion.

Michael Patrick Halloran

Robert W. Baird & Co., Inc.

Q

Just a point of clarification on the first part of that. Are you implying pretty normal sequentials from Q2 into the back half of the year on the Pool side?

John L. Stauch

President, Chief Executive Officer & Director

A

I think, Mike, we're – the way I'd say right now, we're still trying to catch up. I mean, the inventory in the channel is relatively low. We've been catching up since last year. We made – I think you can see that we probably met sell-through demand in Q1 and we've got to do our best in Q2, Q3 and Q4 to catch up with the demand in the channel, as well as continue to rebuild those inventory levels.

Michael Patrick Halloran

Robert W. Baird & Co., Inc.

Q

Thanks for that. And then switching gears to a different part, the more cyclical parts of your business where you've had a few more headwinds. How are you thinking about the recovery curve as we sit here today. Obviously, prepared remarks implied that trends are starting to get a little better, aren't seeing the bigger stuff yet, but at least we're starting to see some progress. Maybe just some thoughts on that cyclical progression and what level of optimism there is right now.

John L. Stauch

President, Chief Executive Officer & Director

A

Yeah. And I think the biggest level of optimism we referenced is it's nice to see Commercial Filtration starting to at least move sequentially better. And I think we said for this particular full year, it's still not going to catch up to where it was, but it is good to see the openings and things starting to drive that Commercial Filtration space again. So that was encouraging in the quarter. We saw some sell-through better than Q4 and we think that continually sequentially gets better throughout the year.

As far as Industrial & Flow, I think we saw more break and fix and certainly the recovery of some of the break and fix in those spaces. But we also started to see quote activity, order activity and backlog start to really move sequentially, Mike. So I think those are definitely where I was referring to encouraging and we weren't ready to call that earlier, and I think we're now saying that we're sequentially seeing ourselves come off the bottom in the IFT side.

Operator: Your next question is from Steve Tusa with JP Morgan.

C. Stephen Tusa
JPMorgan Securities LLC

Q

Congrats on the execution in kind of a challenging supply environment, I guess. Just first of all, what are you assuming for a price for the year?

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

A

We should see an improvement in price to, call it, 2.5% to 3%. I think earlier in the year, we were probably down in the low-2s. So, we are seeing a nice uptick there.

C. Stephen Tusa
JPMorgan Securities LLC

Q

Okay. And when is the timing of that increase going in? Is there kind of a – are there a couple bites at the apple here or are you kind of one and done in the spring, like what's the timing of the price increases?

John L. Stauch
President, Chief Executive Officer & Director

A

Yeah, Steve. I'll take the first part. I'll have Bob give you a little bit more of the details. But we've increased those prices across the board where we're going to. But we're still servicing some backlog on the old pricing that works its way through in Q2. So we don't expect to realize those price increases fully until Q3 and Q4.

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

A

Yeah, I would agree with that. We'll start to see them, Steve, in Q3.

C. Stephen Tusa
JPMorgan Securities LLC

Q

When are you putting it through though? Like, when would that guy – when would the guys ...

John L. Stauch
President, Chief Executive Officer & Director

A

We have put it...

C. Stephen Tusa
JPMorgan Securities LLC

Q

When would the [ph] guys (00:29:14) be in the channel?

John L. Stauch
President, Chief Executive Officer & Director

A

We already have put it through, Steve. But we're still – people bought – we are still servicing the backlog...

C. Stephen Tusa
JPMorgan Securities LLC

Q

Right.

John L. Stauch
President, Chief Executive Officer & Director

A

...and the product that – yeah, we took orders pre-price increases. So we're still servicing them in Q2.

C. Stephen Tusa
JPMorgan Securities LLC

Q

Okay. And then just on the second half, I mean, it kind of looks to me at the midpoint like you guys are just kind of flat across the board, right? Like, flat on sales, flat on profits. I mean, actually, margins might kind of be a tick lower year-over-year. I mean, with that kind of price coming through in the second half, I would think things would be better with that on the margin front or is that – is there just a – maybe just for the year give us what the kind of price productivity you expect that to be neutral for the year, that kind of price productivity – sorry, inflation/productivity equation. Maybe just give us the annual what you expect there, productivity versus inflation.

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

A

Yeah. For the back half of the year, so the headwind we are facing is continued higher inflation. But when you look at what we've done with price and the productivity that we're seeing, we will offset the inflationary headwind. So really, what it comes down to is if the higher end of our guidance does show some revenue growth, but the margin expansion is really impacted by the strategic growth investments that we're making in the back half.

C. Stephen Tusa
JPMorgan Securities LLC

Q

Got it. And then one just last one for you. I guess this kind of complexion of the second half if you're going to be reasonably flat, the toughest comps are obviously in Consumer. So if your business is flat, should we think about the IFT businesses being up and Consumer being down? Is that kind of the right profile for second half?

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

A

Yeah. For the second half, overall, again, if you take the higher end of guidance, you will see Consumer Solutions grow. And then IFT, as we mentioned, will grow in the back half and for the full year, which is good to see. The question, I think, we have right now is can we drive a better back half. And so, again, not wanting to get ahead of ourselves, we have the natural demand that continues in many of our businesses. So at this point, I think our guidance is very prudent on the top line and the question is can we do better.

C. Stephen Tusa
JPMorgan Securities LLC

Q

Yeah. Yes. Yes. Great. Thanks a lot, guys. Appreciate the details.

Operator: Your next question is from Josh Pokrzywinski with Morgan Stanley.

Joshua Charles Pokrzywinski
Morgan Stanley & Co. LLC

Q

So, I guess, maybe just to start off here on the Pool front, no surprise. Any way to talk about kind of what's happening under the surface with whether it's kind of replacement versus new or wallet share versus like-for-like is – 50% is a lot of growth. I can appreciate that the last year has been kind of a unique environment and comps play into it as well. But at the end of the day I don't know if we've seen that much more kind of utilization and breakage. In theory, this stuff's always kind of out there spinning around somewhere. How much of the strength that you're seeing right now kind of speaks to that upsell of the pool pad that you guys have been talking about versus the volume side of the equation?

John L. Stauch
President, Chief Executive Officer & Director

A

Yeah. That's good question, Josh. I mean, it's mostly on the upgrades candidly. I mean, we've got two things happening. We've got the sale of homes in warm weather. Climates have done really well, right? So, we've seen a change and a big push to get to warm weather climates. And I think people are not traveling as much and using their backyard more as their vacation destination spots so they become more aware. Without a doubt, and we've shared this, we've seen a lot better heater penetration than we've ever seen before as people want to extend the season and make sure that their pool water is at the temperature that they want.

But where we've been excited is we've seen the upgrades around the energy-efficient lighting, the automation and also, the self-chlorination and the self-saltwater capability. So, the maintenance of the Pool side as well, Josh. So, it's been a really good situation because the more we made those consumers aware, the more they were able to expand the offering. And we think the more that expands, the more people talk about it. And I think we believe that's a trend that's going to sustain.

Joshua Charles Pokrzywinski
Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then maybe question or a toss-up between you and Bob on the supply chain element for Q2. Might be a little hard to answer, but if you guys could get infinite supply, what is that worth, like how much is that bottlenecking holding back near-term results?

John L. Stauch
President, Chief Executive Officer & Director

A

Yeah. So I think we'll tag team that one, Josh. I mean, first of all, I just want to thank our supply team, and we've been doing everything we can to just, first and foremost, just try to access material and the raw materials that we need. And so, I mean, I'm bringing that up because I think we're seeing two things happen. I mean, we're doing everything we can to get the volume out. And we're not really spending time on negotiations as much as we're spending time on trying to get the available material, which leads into the inflation issues that Bob referenced earlier. And then Bob will give you the art of possible here.

Yeah. Where we started with was the \$866 million that we just did in Q1. And with the backlog we're seeing and the demand, the question is why couldn't we see that our top end of our guidance is closer to \$830 million. So, we really view it as – in that space, that the \$30 million to \$35 million as the art of the possible, if the supply shortages weren't there.

Now, again, I'll echo John's comments and congratulate the supply team because two weeks ago, that number was double and they are doing a nice job of improving the allocation that we're getting for those materials. So that's how I view it. Then on top of that is the inflationary headwinds that we're seeing in the second quarter.

Joshua Charles Pokrzywinski

Morgan Stanley & Co. LLC

Q

Got it. That's awesome detail. I really appreciate the color there, guys.

Operator: Your next question is from Rob Wertheimer with Melius Research.

Rob Wertheimer

Melius Research LLC

Q

So a lot of things went right in the quarter. I know managing through this isn't easy. I just wanted a little bit more breakdown on Water Treatment which is growing nicely. I don't know if you can characterize or split resi and commercial stabilizing [indiscernible] (00:36:32) and just whether you're on a sustainable path there on penetration, etcetera, just talk about the drivers there. Thank you.

John L. Stauch

President, Chief Executive Officer & Director

A

Yeah. I appreciate it, Rob. Thank you. I mean, I think Water Treatment has been doing really well and also was residentially exposed. I would say our R&I flow business has also seen a nice pop on the IFT side relative to demand. And obviously, they're being overshadowed by the strength in Pool and the success of Pool. So it's great to talk about it, Rob. I mean, I think we've got several things going on. We've definitely spent a lot of time upgrading our capability around our products to sell to the independent dealer channel. And people are more aware of the water in their home these days and they're doing things to try to make it better either to – either for taste reasons or trying to improve the overall benefits regarding their water.

So we've got a lot of interest and we've been expanding our portfolio to be more consumer friendly. We've also, through the acquisitions that we purchased through Pelican and RainSoft, have the direct access to the consumer through the affiliated channel and/or building out the services network ourselves. And so, thank you for noticing that growth. We feel we're making great progress there and we're excited.

And that's why we're excited about Ken's. I mean, we just now put a services extension on top of our ability to sell products into the food service space where we've always had a nice product offering. And that allows us to create end-to-end solutions inclusive of the service and the ability to take care of the customer when the customer needs us to show up. So really building out that part of the portfolio and we really like the momentum and we're seeing the fruits of the work.

Operator: Your next question is from Jeff Hammond with KeyBanc Capital Markets.



So a lot of moving pieces around inflation, supply chain, investments. Can you just remind us how you're thinking about incrementals in Consumer Solutions before and how you're thinking about them now kind of given all that – those moving pieces. Is it same, better or worse?

John L. Stauch

President, Chief Executive Officer & Director



It's generally the same, Jeff. We're comfortable in that 35% drop-through which we actually did in Q1. And it might vary a little bit based upon the price/cost squeeze. And then the only thing that's different in the back half of the year is those accelerated investments, as Bob mentioned. So that's it. You might ask why is those investments delayed. It's not like we did anything differently. We're trying to get those people in place and the assets [indiscernible] (00:39:17) to digital, IoT, smart connected solutions, I mean, those are tight labor markets with a lot of people chasing the same skill set. So, it's just been more of a timing issue to put them in. And then, we're also expanding the markets that we're serving. And so, that's the investments that we're really talking about in the back half of the year. But think about that 35%-ish drop-through and then it's only muted by any incremental investment, as Bob mentioned.

Jeffrey D. Hammond

KeyBanc Capital Markets, Inc.



Okay. Great. And then, it seems like the early buy shifted for the industry from Q4 to Q1. Is that more a function of just the demand environment we're in today or do you think this is kind of a new paradigm or a new structure where you kind of persistently do the early buy a little bit later? And just on the...

John L. Stauch

President, Chief Executive Officer & Director



Yeah. So...

Jeffrey D. Hammond

KeyBanc Capital Markets, Inc.



...\$35 million, is that just shifting to Q3 as you catch up?

John L. Stauch

President, Chief Executive Officer & Director



The answer to the second one is yes. We're hopeful we catch up throughout the quarter. And if we're not, we're expecting that to be early Q3 when we get that supply chain. As Bob said, the supply chain issue is getting better every single day. It's just a matter of have we muted them or mitigated them enough to be able to solve it by the end of Q2.

As far as the early buy, I mean, just to remind you, I mean, this is a seasonable business. It's not necessarily cyclical where we do the early buy in Pool. And we're trying to manage our capacity levels so we're not spiking our labor and then laying the labor off. So, we work to trying to fulfill those labor outlets. And basically, when you get this type of demand, there really isn't room for that early buy because you're full out trying to meet the ongoing demand and you're working through that season, Jeff. So you're right, I mean, it feels like it didn't necessarily happen. And I would just say that it didn't shift, it just got to the need to sell to the market need.

Operator: Your next question is from Saree Boroditsky with Jeffries.

Saree Boroditsky
Jefferies LLC

Q

So just a follow-up on Ken's. Could you provide us with some more detail. You said it's not built into guidance, so maybe some color on the sales and margins in the business. You talked about the service benefit, but any other commentary on what you're excited about there?

John L. Stauch
President, Chief Executive Officer & Director

A

Yeah. I'll let Bob give you the details. I do want to say one more thing. We've had a partnership with Ken's for some time, and Ken is someone we admire and his ability to have worked with his customer set and built intimacy around real needs for food service customers, and the projects and the services that he provides. And he's built this business over his career, and we're excited that he's going to come and partner with us and be a part of our team and help us expand this.

And as I mentioned in my prepared remarks, it's not just growing his service levels which I think we can do, it's also about then having the insights as to what other products those customers need and expanding our offering beyond just our water treatment that we sell to those customers. So, I'm really excited strategically. And some of the best deals take the longest to get over the finish line. And we're just really happy that he trusted us and he's willing to be part of the Pentair family. And, Bob, do you want to give the...

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

A

Yeah. We mentioned in the press release that we spent about \$80 million – or will be spending \$80 million for Ken's. Think of that as about one times sales. And then from a EPS contribution perspective, it's – in 2021, it's minimally accretive. We need to invest in the growth platform in that business. We really do believe it's foundational for bigger things in the future, so – but that's how we're thinking about Ken's contribution in 2021.

Saree Boroditsky
Jefferies LLC

Q

That's helpful. And then maybe could you just update us on what you're seeing on the food service side. We've actually been hearing some pretty positive comments, too, from the restaurant space as things have opened up. Thank you.

John L. Stauch
President, Chief Executive Officer & Director

A

Yeah. I mean, the percentages seem exciting, right? And I – that's why I keep reminding us that we're not anywhere near where we were pre-pandemic levels. But sequentially, as things open up, we're seeing things definitely feel better. And I think sometime in the 2022 timeframe, we expect to be back to where we were.

While restaurants are opening across the United States that – they're a little bit slower to open in Europe, they have been opening very rapidly in China – but we have not yet seen the hospitality play and that's the one that we'd also like to see, the hotels opening to the levels that they were before. But sequentially, definitely better and working our way towards hopefully getting back to where we were sometime next year.

Operator: Your next question is from Joe Giordano with Cowen.



So, I just wanted to touch on Industrial. I mean, it's good to see backlog building and you've made a lot of changes to that business over the last couple of years. Do you feel comfortable that throughout all of that, share's being maintained because the – and I feel like, just listening to other companies' talk, it sounds like a little bit more like spending is coming back. So I know you guys are being cautious here, but just curious how you feel about share maintenance as you've transitioned that business?

John L. Stauch

President, Chief Executive Officer & Director



Yeah. So first of all, I'm really proud of Jerome and team for the discipline because, as I said many times, I mean, we could chase growth here for some of the lower-margin projects, and that's not what we want to do. We want to use our configure-to-order and specification capability to win projects that either meet our margin potential or provide the aftermarket opportunities that we want to invest in. So we're trying to be disciplined and I don't want to say we're muting because we're focused. And there's a lot of growth to be had around our core capabilities and skill sets. And I think where we have the right to compete and the right to win, that's where we're focusing. And I think that's going to produce a better set of business opportunities for us that produce the margin profiles that we desire.

We've seen these businesses that are more cyclical in nature come back really strong, and then all of a sudden you get all these projects and then your cost to serve gets higher than your actual quote, and that's not what we're doing here. These are projects that we feel confident with and comfortable with, and that they meet our skill sets and that will lead to the product – profitability profile, if you want.

Joseph Giordano

Cowen & Co. LLC



Yeah, that's fair. Last for me, just I think some of the deals you've done here seem interesting, very strategic and make a lot of sense for what you guys are trying to accomplish, fairly small. So when I look at your balance sheet, just curious of what your appetite is for larger M&A. And, like, what's the target environment out there, are there larger assets out there that kind of meet – fit in with your strategic profile right now?

John L. Stauch

President, Chief Executive Officer & Director



Maybe. I mean, I think my focus has been and our team's focus has been that we've carved out some specific areas that we think we want to grow. And we think we got the organic capability to really grow. Now, we always have to trade the make versus buy, right? Are we better off doing it ourselves? Are we better buying the capability needed? Sometimes you don't have the channel reach, sometimes you don't have the brand or the skill sets.

When we look at our spaces, there isn't really a large one that we need and there's not really a large one that's available. And so, I kind of like the path we're on and I'm hopeful that more of these start to accelerate and that they add to our capability but don't distract us from the strategy that we're embarking upon.

Joseph Giordano

Cowen & Co. LLC



And so, just quick follow on that, if that's like the – yeah, how comfortable are you, like, getting leverage down? Like, do you – at what point do we think about more aggressive buybacks just to kind of – from a capital allocation standpoint?

Yeah. I mean, I think we're really pleased with the cash flow generation progress we've made. I think Bob mentioned in his prepared remarks we had a couple – we have a bond maturing and we had a little bit of cash flow need, and we usually utilize cash in Q1. But given where we sit right now, I think we're committed to the buyback that we said we would this year. And I think that still gives us capacity to do any strategic bolt-on deals that become available in the nearer term.

Operator: Your next question is from Dean Dray with RBC Capital Markets.

Deane Dray

RBC Capital Markets LLC

Q

Hey. Would love to get an update on the Pool app soft launch that you talked about last quarter, what's been the acceptance rate, how many installations. And is it really pulling through the products that – at a rate that you were expecting?

John L. Stauch

President, Chief Executive Officer & Director

A

Yes. I mean – just to clarify, Deane, I mean, we've always had our Pool ScreenLogic app that's been out there and we've – I'm pleased with the progress on the Pool side. And it's – where we've launched that new app was on the Water Treatment side. And, yeah, we've got a couple of new exciting products. We got the under sink Easy Flow and we've got the salt sensor that we've launched, and we feel good about those and the connectability.

Growing pains, yes, right, servicing a new customer and we've got a tweak. So, I think the soft launch, I would describe, is successful. But now, we've got a little bit of work to do to make it the ultimate product that the consumer desires.

Deane Dray

RBC Capital Markets LLC

Q

Good to hear. And then how about the new product introduction expectations for the year that you had talked about a number of new IoT products. Any updates there on launches and any impact on 2021?

John L. Stauch

President, Chief Executive Officer & Director

A

Yeah, Deane, and I appreciate it. I mean, I'm really excited about one in Pool and this might be where you were focused. We launched a side stream filtration product in a soft launch basis. So we're seeing amazing results as far as the clarity of the pool water by putting what was the CPT X-Flow membranes on the side of a regular pool filter application. And that smart filter capability that we have in the soft launch applications has really demonstrated superior results. So that one I'm really excited because that's a category that we haven't really seen new product introductions in Pool for some period of time.

And then on the Consumer Solutions side, it's really about connecting to that app that we mentioned around the smart product launches, the technologies. And then the most exciting one we have is this acquisition, Rocean, that we purchased and more of a countertop POU unit that will be launched either later this year or early next year.



Great. And how about any sneak preview on format, topics for the upcoming Analyst Day?

John L. Stauch

President, Chief Executive Officer & Director



Well, we're going to make you wait because we want you there on June 10. But I think you can expect that we're going to talk about the fact that we think we have great well-positioned businesses. I want to talk a little about the strategic growth investments we're making, Deane, and why; why do we feel good about these investments and show you a little bit of the progress along the way.

I'm going to give you some insights into how I think the transformation office that we're leading and how that transformation can create value and help fund this organic growth. And then, I'm probably going to share with you that we've got a strong balance sheet as previously highlighted here and give some indications of how do we use that balance sheet to create incremental value as well. So that's probably what we're going to talk about. And of course, no Investor Day would be fulsome without Dr. Phil sharing you with some sneak previews of where we're going to bring the technology of Pentair and why we're excited about the longer-term technology investments.

Deane Dray

RBC Capital Markets LLC



Looking forward to it. Thank you.

Operator: Your next question is from Bryan Blair with Oppenheimer.

Bryan F. Blair

Oppenheimer & Co., Inc.



I was hoping that you could parse out the core decline in commercial water treatment in the quarter and give us a sense of how the monthly sales cadence progressed through Q1.

John L. Stauch

President, Chief Executive Officer & Director



Yeah. I mean, I – I don't know, Bob, if you got that exact. I mean, we're still down single digits in Q1 in the commercial water treatment. I think we're expecting to be inching hopefully – I mean, we got an easier compare in Q2 candidly. I mean, just to remind you that Q1 impact last year was muted as far as COVID and then this is our first year-over-year comparison and Q2 is where commercial filtration took a deep steep decline. So you're going to see a pretty nice growth rate for them in Q2, but it's nowhere near where the 2019 levels were, but getting better off with Q1 run rate.

Bryan F. Blair

Oppenheimer & Co., Inc.



Okay. And just to level set on performance scale for commercial water treatment. As demand continues to normalize and gets back to pre-pandemic core volume, then layering in KBI, is that 275 plus at that point?

John L. Stauch

President, Chief Executive Officer & Director



Regarding – when you say 275, you're talking about the actual commercial water treatment piece?



Yes, commercial water treatment revenue at that point?

John L. Stauch

President, Chief Executive Officer & Director



Yeah. I mean, that's – I'd say that's directionally correct, yes.

Operator: Your next question comes from Julian Mitchell with Barclays.

Julian Mitchell

Barclays Capital, Inc.



Maybe I just wanted to circle back to the investment spend. You've mentioned it a bunch of times and you gave some good color about some of the areas those funds are being disbursed towards. But perhaps maybe just help me understand the scale of that investment spend in the second half. Or is it just a sort of toggling function to sort of solve for that incremental margin that you're looking for? That's what I wanted to sort of better understand and whether that deferral of investment spend, is that pushing much into next year as well or do you think the catch-up this year gets you to the right level medium term?

John L. Stauch

President, Chief Executive Officer & Director



Yeah. Let me tell you where we're spending it and strategically why. So in Pool, it's really around how do we be a destination site through our Pool brands on the pad to bring you into Pentair, help you understand what's available and then connect you to our channel. So there's no desire to work around our channel. We want to go directly through our dealers and our distributors to continue to service you. But we want you to come and learn what's available to you to help Pool demand. And that's where the investments been going in Pool, as well as making sure that we've got a consumer services mindset around both services that you might need, as well as making sure there's someone to answer the phone or chat with you upon your particular challenges and then connecting you with the dealer to solve that for you.

And we've been steadily seeing more consumer inquiries into our service network than we've traditionally seen the dealer network. So we've had to augment that and build that up. In Water Treatment, it's about accelerating our residential services offering, building our brand and, again, be more effortless to do business with, which you should read into as digitally transacting. And that's where those investments have been.

And then on the IP side, as we mentioned before, we believe we've got a nice biogas upgrading capability and sustainable gas, and we want to shift the investments to North America which traditionally been on the European side. And we think that we've got a nice run rate ahead of us to grow that sustainable gas offering over the next several years. So that's where the investments are focused, and then obviously one of those categories we just filled in with the acquisition of Ken's which was a buy investment platform instead of trying to do it on our own.

Julian Mitchell

Barclays Capital, Inc.



And [indiscernible] (00:56:01)

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

Yeah. Just to help you quantify that. On our last call, we talked about that spend being roughly 1% of revenue. We spent a little bit of that in the first quarter, but as John mentioned, it does ramp as we head towards the back of the year. So think about a little bit more in Q2, but the majority of that spend in Q3 and Q4.

Julian Mitchell

Barclays Capital, Inc.

Q

I see. And then at that point, you're at the right level sort of medium term, or does it go up again next year?

John L. Stauch

President, Chief Executive Officer & Director

A

No, I think at that level. We would expect to see that more flatten from a year-over-year standpoint because then we've jump-started these programs, got the right people in and then we're more of a percentage of sales basis.

Julian Mitchell

Barclays Capital, Inc.

Q

Thank you. And then just one quick follow-up. If I look at sort of across the multi-industry group, Colfax, another company announcing a sort of separation into two pieces fairly recently. Just wanted your latest thoughts on the portfolio, overlaps between the two divisions, or is it more the view that the synergies are there now that you're sort of three years as a standalone company and when you sort of look around at public peers like Hayward and so forth, there isn't kind of obvious value creation from any kind of separation anyway?

John L. Stauch

President, Chief Executive Officer & Director

A

I understand the question that we get asked that all the time. But here's the way I look at it. We move – we help you move, enjoy and improve your water. And the move side is the billion dollars on the IFT side that directly correlates with that phrase. And very important, I mean, it's hard to produce any water application without moving the water through some type of pumping application. And we like our portfolio there. We have an opportunity to improve it, focus it and really expand the margins, which I'm comfortable that Jerome and team is working on.

And then we've got a really nice set of industrial assets and there is some cross-utilization. The membranes that we talk about on the industrial side are the membranes that are servicing this pool filter that I mentioned, and also hopefully will be the foundation for our salt-free softener that we'll introduce in Water Treatment in the next several years. So, I think there's cross – a lot more cross synergies. I think with the IFT side, it's about focusing it, returning its ROS to historical levels and making sure that we're disciplined with where we grow and how we grow.

Operator: Your next question is from Scott Graham with Rosenblatt Securities.

Scott Graham

Rosenblatt Securities, Inc.

Q

I wanted to maybe square for my mind what you're saying maybe more specifically on price/cost. I apologize for beating this up. But raw materials prices increased throughout the first quarter. So what we see in the first quarter for inflation of 240 basis points, I'm just thinking that that number probably goes up from here. And you're saying, to Steve's question, pricing plus 2.5% to 3% for the year with the emphasis on the second half. And are you

John L. Stauch

President, Chief Executive Officer & Director

A

We need price and productivity both to offset inflation for the full year. That's what we said. And in Q2, as you imagine, when you're catching up in the channels we are, most of your orders, they're at pre-new price levels and that's what we're still fulfilling. And the material supply has risen pretty rapidly here from a cost perspective. Everything sold in Q3 and beyond carries a new selling price with it. And therefore, we see more of a positive contribution in Q3 and Q4 than we see the headwind in Q2.

Scott Graham

Rosenblatt Securities, Inc.

Q

Yes. Understood that. Thank you. So, also, the productivity jumped in the quarter. And I'm wondering is that the G&A initiatives, is there something more than that and can sustain that level?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

It's really a combination of a number of things. I mean, our OpEx spending from Q1 of the prior year had not come down. And so we're benefiting from the efficiencies that we drove in the last half of last year and into this year. We're also driving a lot more volume and the team is doing a really good job to create leverage. But also a number of the issues from last year around expedites and inefficiencies as we ramped production lines, we're much better at driving that extra production. So it's really across the board that's driving that productivity benefit in Q1.

Scott Graham

Rosenblatt Securities, Inc.

Q

Got it. Last question from me, with the large competitors IPO, how do you think that changes things in the market? Obviously, they now have more resources and they can get more resources on top of that. What are you thinking about Hayward going forward as a competitor?

John L. Stauch

President, Chief Executive Officer & Director

A

I mean, I think they're – have always been a formidable competitor. And I think, to your point, they may be a more formidable competitor. I think the way I look at it, Scott, is it works its way through the way we think about our transformation. And we have to treat our Pool business as if it was this independent business that's got to compete every single day with the agility and the flexibility against a set of competitors. We can't slow it down. So, we're really working with our Pool leadership team, and Mario is doing this in Consumer Solutions to make sure they have what they need to continue to stay in front. And so, we welcome the challenge. I think it's going to make us better. And you want strong competition because that generally makes you a better company, and I ultimately think this will certainly put a kick on our butt and we'll start moving forward at a faster rate.

Operator: Your next question is from Nathan Jones with Stifel.

Adam Michael Farley

Stifel, Nicolaus & Co., Inc.

Q

Yeah, good morning, this is Adam Farley on for Nathan. Going back to the capacity and labor management within Pool, is this – is there any permanent capacity additions or is it mainly just running additional shifts? And does the Pool business require any additional investment to increase capacity?

Robert P. Fishman

Executive Vice President, Chief Financial Officer & Chief Accounting Officer

A

It's a combination again of things. We've added second shifts. We've also increased the number of production lines, for example, in heaters, investments that we made last year. So to satisfy demand certainly for the current year, we're in good shape to – going forward as we look out a couple of years that there would be some investment required.

Adam Michael Farley

Stifel, Nicolaus & Co., Inc.

Q

Okay. And then shifting over to I&FT within the Industrial business, I think you called out some strength in short cycle, but could you provide some color on what specific end markets are seeing some improvement?

John L. Stauch

President, Chief Executive Officer & Director

A

Yeah. I mean, I think – and simply put, our industrial more capital-intensive businesses that need that capital investment to spur the demand. So, it's really more on the industrial side are seeing a pop. And then, we're seeing some movement in the infrastructure side on our – in the commercial and industrial side of our Flow business. Those would be the two areas that were encouraged by the trends.

Operator: Thank you, There are no additional questions at this time. I would like to turn it back over to John for closing remarks.

John L. Stauch

President, Chief Executive Officer & Director

Thank you, Stephanie, and thank you for joining us today. We believe Pentair is in the right space for the future. We believe we have great well-positioned businesses. We're accelerating investments in focused higher-growth strategic priorities. This includes our leading Pool business and our growing Water Treatment business. Transformation is important to us and we believe that our focus on our transformation efforts will drive higher levels of accountability and performance. Transformation should help us better allocate our resources, as well as drive longer-term margin expansion. Our balance sheet remains quite strong and we believe this provides an additional lever of value creation. Thank you for your continued interest, and we look forward to sharing more of our story at our investor day on June 10. Stephanie, you can conclude the call.

Operator: Thank you. This concludes today's conference call, you may now disconnect. Speakers please hold the line.

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