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Pentair plc

Fourth Quarter 2018 Earnings Call

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Joe Giordano, *Cowen*

Mike Halloran, *Robert W. Baird*

Patrick Baumann, *JPMorgan*

Jeff Hammond, *KeyBanc Capital Markets*

Jeff Reeve, *RBC Capital Markets*

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Brett Linzey, *Vertical Research*

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Jason Makishi for Julian Mitchell, *Barclays*

Joe Aiken, *William Blair*

Walter Liptak, *Seaport Global*

PRESENTATION

Operator:

Good morning. My name is Kathy and I will be your conference operator today. At this time I would like to welcome everyone to the Q4 2018 Pentair Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer

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session. If you would like to ask a question during this time, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Mr. Lucas, you may begin your conference.

Jim Lucas:

Thanks, Kathy and welcome to Pentair's Fourth Quarter 2018 Earnings Conference Call. We are glad you could join us today. I am Jim Lucas, Senior Vice President of Investor Relations and Treasurer, and with me today is John Stauch, our President and Chief Executive Officer and Mark Borin, our Chief Financial Officer. On today's call, we will provide details on our fourth quarter and full-year 2018 performance as well as our first quarter and full-year 2019 outlook 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 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 everyone an opportunity to ask their questions.

I will now turn the call over to John.

John Stauch:

Thank you, Jim and good morning everyone. Please turn to Slide 4 titled Executive Summary. 2018 was a very busy year for Pentair and one we are very proud of. We completed the successful separation of nVent to shareholders, we developed a detailed and executable Residential and Commercial water treatment strategy, and we overdrove our 2018 commitments despite the impact of tariffs and inflation. In addition to financial performance, we returned nearly $700 million to shareholders through buybacks and dividends. Our cash generation remains strong and our balance sheet is in great shape.

To start 2019, we announced agreements for two strategic acquisitions that will help us advance our Residential and Commercial water treatment strategy. After Mark discusses our financial performance, I will speak more about these two deals.

We are very pleased with what we believe was a successful 2018 for Pentair, and we continue to believe we are well positioned for 2019 and beyond. Please turn to Slide 5 labeled Financial Highlights.

Before turning the call over to Mark, I wanted to spend a moment reviewing some of the highlights for the quarter and the year. In the fourth quarter we saw core sales grow 6% and our adjusted EPS grow 15%. For the full year, our sales grew 5%; we expanded our return on sales 60 basis points while making a number of strategic growth investments to position us for the longer term. Adjusted EPS grew 21% and we generated over $400 million in free cash flow.

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For 2019, we expect core sales to grow 4% to 5%, segment income to increase 8% to 12%, and adjusted EPS to be in range of $2.50 to $2.60 per share, an increase of 6% to 11%. Once again, we are targeting free cash flow to approximate adjusted net income.

While we expect some of the headwinds we faced in 2018, mostly inflation, to continue, we believe we are well positioned to deliver on our commitments once again as we anticipate consistency, predictability and sustained performance to return to Pentair.

I would now like to turn the call over to Mark to discuss the fourth quarter results and provide more details on our full-year 2019 outlook before I provide an update on our key strategic growth initiatives.

Mark Borin:

Thank you, John. Please turn to Slide 6 labeled Full-Year 2018 Pentair Performance. As John mentioned, core sales grew 5% for the full year. Our Aquatic Systems businesses led the way with robust 11% core sales growth, while both the Filtration and Flow segments contributed low single-digit core sales growth for the full year. Segment income increased 8% while ROS expanded 60 basis points to 18.1%. We are particularly pleased with our segment income and ROS performance for the year given the significant inflation headwinds we faced. Adjusted EPS grew 21% to $2.35 per share, which exceeded our initial 2018 guidance of $2.20 to $2.30 per share set last February. Finally, we generated over $400 million in free cash flow. With strong core sales growth, ROS expansion and adjusted EPS growth, we were very pleased with our full-year 2018 performance.

Now turn to Slide 7 labeled Q4 2018 Pentair Performance. For the fourth quarter we reported core sales growth of 6%, ROS expansion of 40 basis points to 18.1%, and adjusted EPS growth of 15% to $0.60 per share. We will provide more color on the individual segment performance shortly.

Below the line we saw and adjusted tax rate of 18%, Net Interest Other Expense of $6 million, and our average shares in the quarter 174 million. As we mentioned at the beginning of the call, we bought back another 100 million of stock in the quarter.

Please turn to Slide 8 labeled Q4 2018 Pentair Segment Performance. This slide lays out the fourth quarter performance of our three segments. Aquatic Systems delivered another strong quarter with 13% core sales growth and 10% segment income growth. We do believe that some of our distributors likely pulled forward some sales in an effort to beat the impact of our price increases. We believe Aquatics remains well positioned entering 2019 and its industry dynamics remain favorable.

Core sales were flat in Filtration Solutions with segment income growing 8% and return on sales expanding 170 basis points to 17.9%. Throughout 2018, we have been refocusing our Filtration business to be less dependent on lower margin lumpy project business and instead focused on our core component and systems businesses. Although the top line trends were less favorable than in 2018, we were pleased with the income and margin performance of the segment.

Flow Technologies reported 4% core sales growth which represented its fifth consecutive quarter of improved sales performance. The segment income performance was adversely affected by rebate activity as increased volume levels in front of price increases occurred in the quarter. Overall, Flow Technologies is entering 2019 with its price realization more in line with the increased inflationary pressures that materialized in the second half of 2018.

Please turn to Slide 9 labeled Balance Sheet and Cash Flow. We are very pleased with the results of 2018 as we significantly reduced our debt levels while returning nearly $700 million to shareholders. We

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ended 2018 with our net debt to EBITDA leverage at less than 1.5 times. Shortly before the end of 2018 we announced a 3% dividend increase for 2019 which will mark our 43rd consecutive year of dividend increases.

We announced agreements for two acquisitions that, when completed, we expect to invest $280 million. Although we do see some seasonal cash usage in the first quarter each year, we believe we remain well positioned to invest in our core businesses, look at attractive, strategically aligned tuck-in or bolt-on acquisitions targets, and continue to return cash to shareholders.

Please turn to Slide 10 labeled Full-Year 2019 Outlook. Today we are introducing out 2019 Outlook. We expect core sales to grow 4% to 5%, which is comprised of about 3% of price and 1% to 2% of volume. We expect total sales growth of 5% to 6%, with roughly 3% contribution from the recently announced acquisition offset by a 1% headwind from FX and another point headwind from divestitures. We anticipate segment income growing 8% to 12% inclusive of acquisitions. While inflation is anticipated to remain a headwind, we expect price to principally offset inflation for the full year and productivity to provide to our improved performance.

We are introducing an adjusted EPS range of $2.50 to $2.60 per share, an increase of 6% to 11%.

Other items embedded in our guidance include corporate expense of $60 million to $65 million, a tax rate of 20.5%, Net Interest Other Expense of $37 million and an average share count for the year of approximately 172 million shares.

We wanted to provide some additional color on a few items. First, the increase in corporate expense is reflective of how we allocate some of our costs in addition to four quarters of our new structure as 2018 represented just three quarters given the timing of the separation of nVent last April.

Next, we are guiding our 2019 tax rate to increase to 20.5%, but this requires some further explanation. Late in 2018 the IRS proposed new regulations that, if approved as final, could present a headwind to our current tax rate of 18%. These proposed changes are not expected to be finalized until June or July, if they do indeed get approved as final. However, we are factoring in a 250 basis point increase to our full-year tax rate. We expect our first quarter tax rate will remain at 18% with any true-up happening in Q2 or Q3 if and when the regulations are finalized.

Finally, our estimated share count of 172 million does account for us buying back 150 million in shares for the full year, which is consistent with our previously communicated long-term plans regarding buybacks.

Please turn to Slide 11 labeled Seasonality Expected to Continue. We wanted to remind everyone that our business does experience some seasonality during the year. The past two years have seen similar trends that we would expect to continue. We thought this would be a useful reminder as you think about the quarterly distribution of sales and adjusted EPS.

Please turn to Slide 12 labeled Q1 2019 Pentair Outlook. We anticipate first quarter core sales to grow 4% to 5% with all three segments contributing. We expect Aquatic Systems to be up 4% to 6%, Filtration Solutions to be flat to up 1%, and Flow Technologies to grow 3% to 6%. Segment income is anticipated to be up approximately 2% to 5%, and adjusted EPS is expected to be in a range of $0.52 to 0.55 per share which would represent growth of 6% to 12%. Below the line we expect the first quarter tax rate to be 18%, Net Interest Other Expense of roughly $7 million and shares to be approximately 172.5 million. While the first quarter is our seasonally lightest period of the year, we believe we are well positioned to see our core sales growth trends continue.

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I would now like to turn the call back to John.

John Stauch:

Thank you, Mark. Please turn to Slide 13 titled Pentair Strategy Summary. We have used this page consistently in our earnings presentations to remind everyone of our strategy to be the leading Residential and Commercial water treatment company, and to share with you the areas where we are investing in growth.

Our focused areas of strategy remain on advancing growth in Pool and accelerating Residential and Commercial water treatment, which requires investment as a business and the enterprise level. Our approach to capital allocation remains disciplined and we are committed to maintaining our investment grade rating, reinvesting in our most attractive businesses and paying a competitive dividend. We also look at a balanced approach between M&A and intelligent buybacks, with our M&A decisions being informed by overall valuations and the quality of assets available, as well as our ability to integrate them successfully.

Please turn to Slide 14 labeled Two Strategic Deals. We have discussed throughout 2018 that accelerating Residential and Commercial water treatment is one of our two key strategic growth initiatives. We also discussed throughout 2018 that we were building our M&A funnel and we were very pleased to have announced agreements for two strategic acquisitions that help us further this key growth initiative. On January 7th we announced that we have signed agreements to acquire Aquion and Pelican Water Systems. We discussed last quarter that we are in the early innings of moving up the value chain from being a leading component supplier to introducing smart, connected branded products and solutions. We expect these two acquisitions to add roughly $110 million in revenue and combined have margins that are above the Filtration segment's average. Both of these acquisitions help us further our move up the value chain.

We are really excited about Aquion bringing a national affiliated dealer network which is under the RainSoft brand. Aquion also brings a diverse line of whole-home water treatment systems in addition to ozone and ultraviolet disinfection systems and Internet-enabled solutions.

Pelican is an exciting acquisition for us because it brings us a direct-to-consumer model through a proprietary ecommerce platform. Pelican also has a number of innovative water treatment systems and services that we'll be able to sell through all of our distribution channels. We still expect these acquisitions to close in the first quarter of 2019, subject to customary closing conditions and necessary regulatory approvals.

We remain excited about our opportunity to advance our Residential and Commercial water treatment strategy.

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

Operator:

Yes, sir. At this time, if you would like to ask a question, please press star, then the number one. Your first question comes from the line of Nathan Jones with Stifel.

Nathan Jones:

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Good morning everyone.

John Stauch:

Good morning, Nathan.

Nathan Jones:

Mark, I think you'd commented there that you thought there was a little bit of pull-forward in the Aquatics business. I know it's probably pretty tough to try and estimate how much that was but any kind of color you could give there, and if you think there was any kind of pull-forward in any of the other businesses that's worth calling out?

Mark Borin:

Yes, I talked about it in the Aquatics business and also referenced a little bit in Flow as well. If you think about it, it's probably about 1 to 2 points of growth in 2018 that then presents a headwind for 2019.

Nathan Jones:

One to 2 points total for the year, or just in the fourth quarter that you were talking about?

Mark Borin:

For the year.

Nathan Jones:

For the year. I would also like to talk about the productivity bar that you guys disclosed which was fairly low in 4Q and in 3Q. Can you maybe talk about what the delays are there on seeing the productivity improvement, and then I think you talked about for 2019 price offsets, inflation and productivity drops to the bottom line, so maybe any discussion about what you're expecting out of productivity in 2019?

Mark Borin:

Sure. I think as you think about it amongst the three segments and when you look at the segment performance in Q4 you can see that good performance in Aquatics and Filtration, and so really the productivity story for Q4 was driven by Flow Technologies and their main drivers of productivity there relate to some operational challenges in a couple of factories that manufacture large pumps. We saw that in Q4 the team has been focused on improving that and we see that likely turning around in the first half of 2019.

Nathan Jones:

Okay, so it's a couple of discrete things that are dragging the productivity numbers down in the second half; they get solved in the first half. Any idea what we should expect out of productivity in 2019?

Mark Borin:

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I think about as we think about kind of our overall guidance for 2019, we talked about price and inflation kind of offsetting each other, and then margin expansion coming from volume and from incremental productivity.

Nathan Jones:

Okay, thanks. I'll pass it on.

Operator:

Your next question comes from Joe Giordano with Cowen.

John Stauch:

Hey, Joe.

Joe Giordano:

Hey guys, good morning.

Mark Borin:

Hi Joe.

Joe Giordano:

Can you guys talk on the Filtration side? I know this is a real focus for you guys. Can you talk about maybe the brand that you're building here and as you're bringing in these new businesses you're getting out of some kind of non-core assets there as well. Can you talk about the value proposition and how it's changing and also how consistent is the messaging around this one cohesive Pentair Filtration brand and where you see that going?

John Stauch:

Clearly, it's not today, and it is our goal to have a Pentair brand that represents our Filtration opportunity, and these two acquisitions that we bring in are helpful in that regard because we have to get closer to the consumer. The consumer is making choices and we have to make that a brand-based loyalty program in which then we can give the whole value chain of distribution from the products to the systems to also the services that are necessary, either through our direct channel or our affiliated channel. So, it's important as we think about building it out.

I ultimately think that most consumers just want water as a service. They don't necessarily care about the products or the components that they're buying; they want a solution for the zip code or the geography or the country they live in, and that's where this is all heading, Joe. That's why we think we think we need to have that consumer touch and be closer to the consumer to be able to bring that story forward.

Joe Giordano:

As that kind of happens, is that something that leads to like a sustainably more predictable, higher margin business, like consistently?

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John Stauch:

That's absolutely the goal. Our Residential and Commercial Filtration business today is already higher margin, but I think you mentioned the predictable and consistency part of that is the main driver, and making sure that there's more of an annuity based view of how we service that customer over time.

Joe Giordano:

Okay, that's great. Two kinds of clarifications there. Do you have any color on the margin guidance by segment into 2019, and on your comment about price offsetting inflation, is that a consistent statement across all three segments as well?

Mark Borin:

That would be consistent generally across all three segments, and no, we don't have specific guidance on segment profitability for 2019.

Joe Giordano:

Is there anything like directionally? Like we can do the math to get to it on a segment level, but is there anything we should—you could point out on an individual segment basis that we should take into consideration as we do that?

Mark Borin:

I think if you think about our overall segment growth of 8% to 12% and continued strong margins in Aquatics and the upside that we talked about on the Flow Technologies businesses that productivity in Q4 turns around, I think that would kind of frame the way to think about 2019 by segment.

John Stauch:

Joe, we expect them all to improve but we do want to maintain some flexibility for our strategic growth investments as we think about ramping up or ramping down the investment based upon how we see the organic growth. Don't want to lock into specific targets by segment but we're expecting them all to improve.

Joe Giordano:

All right. Mark, can you just get into that tax thing that you mentioned? Just, I think there's some people who aren't sure exactly what this is? What is this proposed regulation and how does it apply to you guys?

Mark Borin:

Yeah, sure. I know that's a new data point.

Right at the end of 2018 the IRS published new regulations and a lot of that related to them writing regulations around laws that were passed a year earlier. Specifically related to us is not surprisingly as part of our global structure there were regulations specifically around the deductibility of interest in the United States, and it's those new regulations and the technical interpretation of those that applied to us and that's where we see this headwind of 250 basis points, going from 18% to 20.5%.

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As I said in my prepared remarks, we've included that in our guidance for the year. The regulations are proposed right now so they're not final. As proposed, they're effective as of January 1, 2019, which is why we put them in our full-year guidance, but they won't actually get finalized, we don't think, until the end of June or perhaps early July, and so that's why we guided to 18% in Q1 because we won't have—they won't have been finalized so we won't implement them in Q1, and then we'll see what happens in Q2 and if they are revised or they are kept the same as they were originally proposed, and then that will inform the tax rate in Q2 and the true-up that would happen in Q2 to get to a full-year rate of 20.5%.

Joe Giordano:

Great. Thanks guys.

Operator:

Your next question comes from Mike Halloran with Baird.

Mike Halloran:

Hey, good morning everyone.

John Stauch:

Good morning, Mike.

Mark Borin:

Good morning.

Mike Halloran:

So, a quick question here then on just underlying assumptions for the broader environment as you work your way through the year here. It seems based on the guidance that core trends are expected to be relatively stable through the year. Just want some clarification on that and if there's anything we should know about trajectory as we work through the year on the demand side.

Mark Borin:

I mean I think you read it right. We're expecting about 3 points of price in this outlook and we've got 1 to 2 points of volume, and we are basically seeing the same core trends throughout the year. As we mentioned I think given the substantial price increases that were put into place in Q3 and Q4, we do think that distributors and dealers took advantage of buying a little bit ahead, so we'll probably expect a little slower start in the Q1, and if you recall, we had a very strong Q1 last year, and we'd probably expect to have a stronger Q2/3 outlook as we did not have such a great Q2. We're going to see that type of movement, I think, as we go through, but overall core trends remain stable.

We're not necessarily a new housing install. We tend to be more of the aftermarket served. Certainly in the Residential and Commercial space we're close to 85% in the aftermarket side, and so all those trends feel pretty much the same as they were last year.

Mike Halloran:

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Any regional variances you would point out that you're seeing right now?

Mark Borin:

No, I think we're aware of them; we're hearing that China is slower. I mean, a good news/bad news story for us in it's less than 4% of our overall revenue so we're not big enough to really matter in China, and our opportunity to continue to grow our business there is because we're not starting from a big base, so we have an opportunity to expand our revenue.

Other than that, I think Europe remains the way it generally was last year. It wasn't a huge, contributory factor to '18 and we don't think it's a huge headwind to '19.

Mike Halloran:

Then just one clarification. The Aquion and Pelican acquisitions, those are assumed in your guidance and based on the divestiture acquisition contribution first quarter versus the rest of the year, it seems like those are soon to be coming in at the beginning of the second quarter, late first quarter? Is that about right?

Mark Borin:

That's right. We expect them to close sometime here in the back half of the first quarter and we've added them to guidance on that basis.

Mike Halloran:

All right, great. Thank you for your time. Appreciate it.

Mark Borin:

Thank you.

John Stauch:

Thank you.

Operator:

Your next question comes from Patrick Baumann (phone) with JP Morgan.

Patrick Baumann:

Hey guys, thanks for taking my call. Had a few questions, but maybe first just on the cadence of the year. The first quarter segment income growth of 2% to 5% versus the full-year 8% to 12%, I think you mentioned the pull-forwards impacting the top line a little bit in the first quarter, but what's impacting the margins? Is it just inflation still a drag in the first half and it gets better in the second half? Just curious if you could help understand the underlying factors behind the profit growth in the first quarter versus the full-year guide being a little bit lighter.

Mark Borin:

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Sure. John had mentioned before that Q1 last year was a really strong quarter so certainly the year-over-year comps are part of that. I talked about the guidance around the corporate investment being up slightly year-over-year and a fair bit of that comes in the first quarter, in particular because of the timing of the separation last year and our standalone structure was in place from May going forward. Those are really the key drivers. The underlying operating performance is not that significantly impacted as you look quarter-over-quarter.

Patrick Baumann:

Got it. That was actually my second quarter—I missed the first part of the call—around corporate going up so much. That's probably because of that standalone structure not being in place until May 1st. You had said that I guess earlier.

Mark Borin:

That's right, and that's overall kind of the way we allocate to the businesses.

Patrick Baumann:

Got it. Just on interest expense, is that just going up because of the deal?

Mark Borin:

That's right. That includes an assumption around the interest associated with the two acquisitions.

Patrick Baumann:

Then on tax rate, if finalized, can you just confirm the normalized rate for 2020 would be that 20.5%.

Mark Borin:

That's right, 20.5% would be our new run rate.

Patrick Baumann:

Are there things you can do capital structure-wise to offset some of that? Or is it kind of it is what it is?

Mark Borin:

We're always looking for opportunities to effectively manage our structure, just like any company, so the tax team will be looking to be as efficient as possible, but based on our distinct structure the 20.5% is our estimate for 2019 and it would be our run rate going forward.

Patrick Baumann:

Got it. Sorry, one last clean-up. For the first quarter, you're going to get the 3 points of price starting in the first quarter; does that layer on more in the back half of the year, so you start a little slower there?

Mark Borin:

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Most of the price was driven by the increases that we announced in Q3 and Q4 of 2018, and so it's pretty evenly spread throughout 2019, a little bit lower in the first quarter and then slight ramp but for the most part pretty balanced.

Patrick Baumann:

Okay, great. Thanks a lot guys. Good luck.

Mark Borin:

Thank you.

Operator:

Your next question comes from Jeff Hammond with KeyBanc Capital Markets.

Jeff Hammond:

Hey, good morning guys.

John Stauch:

Hey, Jeff.

Mark Borin:

Good morning.

Jeff Hammond:

What's informing the better growth profile in the organic for Flow Tech?

John Stauch:

We have been building the backlog primarily around the commercial infrastructure, Jeff, and so we were able to build that backlog up and that's helping a lot in volume. We also had some build-up in the residential and irrigation side. We had, as we mentioned, last year we had one kind of global destocking incident that happened in the Middle East with a distributor. We switched over a system and identified they had too much inventory, so those headwinds are gone as we look forward and that's helping, Jeff.

Jeff Hammond:

Okay. Then just on the price/cost dynamic, are you contemplating a move in the List 3 from 10% to 25%? How is that captured in your price?

Mark Borin:

Our inflation assumption includes the increase from 10% to 25% in List 3 that's scheduled for March 1st, so that is built into our inflation assumptions for the year.

Jeff Hammond:

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Okay. Then last one, just on the acquisitions. Can you talk about the long-term growth rates of those businesses and what you're kind of putting in the outlook or expecting for those businesses in terms of growth in '19?

Mark Borin:

We see the Aquion acquisition being somewhere in that 3% to 5% longer term growth range, and then we obviously see Pelican, which has been historically growing at very strong double digits, close to 20%, as being at least for the near term the expectations that we have on it. It's really about how do we think about these all at the right time, and after we get our regulatory approvals behind us we'll take a look at the better longer-term outlooks for these businesses.

Jeff Hammond:

Okay, great. Thanks guys.

Mark Borin:

Thank you.

John Stauch:

Thank you.

Operator:

Your next question comes from Deane Dray with RBC Capital Markets.

Jeff Reeve:

Good morning. This is Jeff Reeve (phon) for Deane Dray. Just sticking to the deals, will the new ecommerce capabilities from the Pelican deal have any meaningful conflicts with your dealer channel?

John Stauch:

Don't expect them to. It's a different segmentation of the overall consumer market, and it's very specific and targeted to areas in which they feel like they can help more zip code by zip code, and so we're excited to be able to explore deeper, again, after we get the regulatory approvals, and then we're hopeful that we can maybe take that capability and expand it and really help our dealer channels as well.

Jeff Reeve:

Got it. Thanks. Maybe just more broadly, can you give us an update on your M&A pipeline?

John Stauch:

We have a really well thought-through strategy that we align with our Board on, and I think it was an exhaustive global strategy that we feel really good about being aligned on, which really gives us a better visibility to the types of deals that we're looking at. We're always looking at building the funnel, but it's also about do they meet the strategy and then ultimately are they cultural fits and are they financial fits.

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Right now I'd say we have a strong funnel, but what makes it a final acquisition stage also has to get through that cultural aspect and also the financial aspects.

Jeff Reeve:

Great, thank you.

Operator:

Your next question comes from Brett Linzey with Vertical Research Partners.

Brett Linzey:

Good morning guys.

John Stauch:

Good morning.

Mark Borin:

Good morning.

Brett Linzey:

Just want to come back to inflation. It sounds like that is an all-encompassing number with the tariffs included. If I just assume 3 points of price and you're going to offset commodities and inflation fully, that's about $85 million to $90 million. If you could just bundle what is commodity inflation in that number and then how much is tariff related?

Mark Borin:

We've been hesitant to try to unbundle the two because there's the direct impact of tariffs but then there's really the indirect impact of tariffs and that's been the trick is to be comfortable identifying that. When we think of our kind of inflation number in total it's really the combined impact of both of those things, and the direct impact to tariffs is not really that relevant; it's really more important to think about the total.

John Stauch:

Yes, and also, just keep in mind about just a little under about 30% of that number as you do the math next year is also wage inflation, which is globally, you know, wages are up as well.

Brett Linzey:

Okay, that's helpful. Then Filtration, just want to understand the demand backdrop there and what you're seeing. I mean the business shows some signs of life in Q3, softened in Q4 and the Q1 guide implies a little bit of a slow start here. Maybe just a little color on demand and what you're seeing from a regional perspective as well.

John Stauch:

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We have three different businesses underneath Filtration. One is Food and Beverage. We have also a business focused on the industrial filtration side and then the third one is our Residential and Commercial filtration where these two acquisitions fit. The Residential and Commercial has been relatively steady. It's a global business and it's been growing in the low to mid single digits for the last year or so. We've had a little bit of volatility as we mentioned earlier on some projects on the Food and Beverage side; we expect those to be behind us at the end of Q1. Don't want to continue to use those as an excuse but we went out and really de-backlogged our large projects on the Food and Beverage side and really moved more to a component strategy which has also been a big lift to the margins in Filtration Solutions overall.

Once we get through Q1 we have that year-over-year impact behind us and then we're moving forward.

Brett Linzey:

Okay, great. I'll pass it along.

John Stauch:

Thank you.

Mark Borin:

Thank you.

Operator:

Your next question comes from Brian Lee with Goldman Sachs.

Rebecca:

Hey, good morning. This is Rebecca on for Brian. Just following up on those Filtration margins that picked up this quarter, I was wondering how much of that was shifting away from lower margin products versus if price helped at all, and then how we should think about this trend for 2019.

Mark Borin:

Sure. Price has a smaller impact in the Filtration business overall, as John just talked about, those three businesses and price, we really just see that in the Residential and Commercial side of the business. It's less about price; it is about the mix, as you reference. Then, also just core productivity in the segment as they have opportunities to get after some of the lower productivity and lower margin businesses and improve that. So, it's less price and more productivity and mix.

John Stauch:

Yes, and sequentially we would expect the performance this year to roll into next year. Obviously the year-over-year impact will start to shrink as we realize that benefit of the mix in 2018.

Rebecca:

Thanks. Then just following up on that question about the ecommerce channel, can you provide a little more color on your strategy heading into 2018 in terms of the dealer channel and then how much

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wholesale change do you expect for Filtration in the US and how you're straddling any potential customer channel conflicts?

John Stauch:

Yes. All our—we're after the end consumer and we believe by being closer to the end consumer we can bring those leads back to not only the acquisitions that we're looking at closing—and again, we need the regulatory approval to close them—but also those leads can be also served by our independent dealer channel and think it gives us an opportunity to give to the customer the right solution that they're looking for, and so that's where we're going with the ecommerce platform is to make sure we've got a targeted solution by zip code that meets the consumer's needs, and then ultimately bring in the right solution through all of our channels to that consumer. We'll continue to build that out over time and we'll share more information when it's available.

Rebecca:

Okay, thanks. I'll pass it on.

Operator:

The next question comes from Damian Karas with UBS.

Damian Karas:

Hi. Good morning everyone.

John Stauch:

Good morning.

Damian Karas:

In Aquatics, could you elaborate a bit on your outlook for the 5% to 7% core growth there? I think you still have some solid price that's carrying over from the September increase, so could you maybe just talk a little bit about the drivers there and how much recent growth investments are expected to contribute in 2019?

Mark Borin:

Sure. You're right. Aquatics is our strongest segment from a price perspective, so price certainly makes up a big chunk of the core sales growth for Aquatics. The remainder are coming from volume, and I mentioned in earlier questions around the impact of the pull-in, so thinking of 1% to 2% impact overall for the business and a lot of that coming from the Aquatics business. That's factored in to the way we think about our volume assumption for the year.

Damian Karas:

Okay. I wanted to ask about China. Obviously it's been a key strategic focus area for you. Could you maybe give an update on how the region performed in the quarter and what kind of growth expectations you have for China and Southeast Asia for 2019?

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John Stauch:

Again, it's less than 4% of our revenue, and I'm not apologizing for that. It's just why it's going to be a strategic growth investment and why we need to get behind it and grow it at a much faster rate.

2018 was a really solid year from repositioning. We were able to get four or five new products launched here in the back half of the year and through the Ministry of Health approvals in China. We also were able to make some pretty bold moves through our distributor channel and move more direct so that we can participate in the ecommerce platforms in China. I think we repositioned and did all that in 2018. We were lower on the growth side in Q4, probably closer to low single digits. As we head forward, we're expecting double-digit growth in 2019 to continue, and we would be very disappointed if we weren't closer to 15% to 20% because, again, we're starting from a relatively low base.

Damian Karas:

Makes sense. Thank you very much.

Operator:

Your next question comes from Julian Mitchell with Barclays.

Jason:

Hi. It's Jason on for Julian. Just one quick question on the pricing tailwind, that 3 points expected in 2019. Would the correct way to think about this be since its contingent, a portion is contingent upon offsetting a 25% rerating of tariffs that-

John Stauch:

No.

Jason:

… That if that never happens the pricing could come in a little bit lower as not all of that would be necessary to offset the rest of the inflation? Or is that 3% sort of locked in and you would just see the inflation side of the equation come down and you would just enjoy a nice tailwind from that?

John Stauch:

First of all, just in terms of determining price, as I said, the majority of that is from actions that have already been taken and then some still to be taken, but it's not going to be dependent upon what happens with the status of the List 3 moving from 10% to 25%. How that all ultimately shakes out, if and when that changes or who knows what else may happen with respect to tariffs, that's yet to be seen. Right now our guidance is based on the assumptions that I talked about earlier and we wouldn't expect that to change.

Jason:

Definitely. Then just a quick one on the core sales guidance and Filtration Solutions. You've given a lot of helpful color around Q4 and the Q1 trajectory, just given the wide range of outcomes that seem to be embedded in that 1% to 4%, could you kind of just talk to what it would take maybe in terms of the

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underlying demand environment to get closer to that 3% to 4% on the high end of that organic sales guidance and how that differs from the Q1 environment right now?

John Stauch:

I think it's a good catch. It is our most global business and we have a wider range on Filtration Solutions because we do have more than half of our revenue coming from outside of the United States. We see that the U.S. economy remains strong and we feel like there's no real reason why we see slowdown in Europe right now. As we mentioned earlier, we do see some volatility in China. I think the range is there because of its global aspects and also some of the industries that they're serving – food and beverage and also the industrial investments being tied somewhat to just—just industrial and oil and gas.

Again, there's more volatility in those spaces and so we just included a wider range to capture that.

Jason:

Understood. Thank you very much.

Operator:

The next question comes from Joe Aiken with William Blair.

Joe Aiken:

Hi. Good morning, just a quickquestion,looking at our model. Do you have any expectations for gross margin, at least directionally, in 2019?

Mark Borin:

I'd say we talked about the segment income margin assumptions and we wouldn't go beyond that and talk about the gross margin assumptions.

Joe Aiken:

Okay, got it. Thank you.

Operator:

The next question comes from Walter Liptak with Seaport Global.

Walter Liptak:

Hi. Thanks, good morning. Good year guys. Wanted to ask about you're sticking with this price situation and it sounds like you've got most of the price cost covered for this year. How would things play out if inflation were to ignite? What would be the timing of price increases? Did you learn anything last year that might help you with price in 2019?

John Stauch:

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We'll continue to monitor the inflationary environment but we feel like what we've got reflected in our outlook is certainly what we see the landscape looks like and pricing actions are in place. We're going to remain nimble but right now we think we've got the right assumptions built into our expectations.

Walter Liptak:

I wanted to ask, the pools business, if I recall, last year you were kind to your pool installers in not jamming them with a price increase. Wonder how is the price increase—how is it accepted so far? You said there was a little bit of pull forward but predominantly is this something you expect to see flow through or are you getting pushed back on some of the price?

John Stauch:

The comments last year on the timing of the price increase was really related to the pool season and the hesitancy to do an early price increase that would have put a price increase in the middle of the pool season. That's disruptive to the dealers and installers. But a timed price increase that coincides with the pool season is what we talked about and we don't get push back from our distributor or dealer channel as a result of that, so there hasn't been any blowback because of that.

Walter Liptak:

Okay, great. All right, thank you.

Operator:

There are no questions at this time. I will now turn the call back over to our presenters for any closing remarks.

John Stauch:

Thank you for joining us today and I hope you agree that we had a solid 2018, as we demonstrated our ability to use agility and prioritization to meet our commitments. By building up a track record of meeting and exceeding commitments, we hope to earn the trust and right to pursue a compounding growth strategy that allows us to not only achieve core growth in earnings but to also utilize our strong cash flow and capital structure to pursue strategic targeted and accretive bolt-on and tuck-in acquisitions such as the two we announced a few weeks ago and discussed on today's call.

Thank you for your continued interest. Kathy, you can conclude the call.

Operator:

Thank you. This concludes today's conference call. You may now disconnect.

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