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Pentair Plc (PNR)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Rob and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 2019 Pentair Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the presenters' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you. Mr. Jim Lucas, you may begin your conference.

Jim C. Lucas
Senior Vice President, Investor Relations and Treasurer, Pentair Plc

Thanks, Rob, and welcome to Pentair's second quarter 2019 earnings conference call. We're glad you could join us. I'm 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 second quarter 2019 performance as well as our third 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 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 everyone an opportunity to ask their questions.

I will now turn the call over to John.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

Thank you, Jim, and good morning everyone. Please turn to slide number 4, titled Executive Summary.

We are pleased to deliver second quarter results in line with our expectations, even as weather issues lingered throughout the quarter. We continue to believe that the underlying demand trends in our businesses remain healthy and we have plenty of growth opportunities ahead of us.

Our second half outlook demonstrates progress against unprecedented inflation inclusive of tariffs, and we now believe that we will get back to our 18% tax rate for the remainder of 2019 and for 2020. Our recent acquisitions, Aquion and Pelican, are performing in line with expectations. Further, both deals help us accelerate our residential water treatment strategy, which I'll provide an update on later in the call.

We are continuing to invest in our top growth priorities, and I will provide more color on our focused opportunities after Mark shares details on Q2 and our updated guidance.

I will now turn the call over to Mark.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

Thank you, John. Please turn to slide 5 labeled Q2 2019 Pentair Performance. For the second quarter, we saw core sales increased 1%, segment income fall 6%, and adjusted EPS was down 3%. We'll provide more color on the individual segment performance shortly. Below the line, we saw an adjusted tax rate of 18% net interest/other expense of \$10.6 million, and our average shares in the quarter were 170.5 million.

We had originally expected our tax rate to increase in 2019 due to proposed IRS rule changes. Because the proposed rules have not yet been finalized and enacted, as well as actions to help mitigate the expected impact, we now believe our full year adjusted tax rate will be at the 18% level we reported in 2018.

Finally, free cash flow was well north of \$300 million and in line with normal seasonal patterns. As John mentioned in his opening remarks, we are pleased to deliver operational results in line with expectations despite the lingering weather issues.

Please turn to slide 6 labeled Q2 2019 Pentair Segment Performance. This slide lays out the second quarter performance of our three segments. As this slide illustrates, two of our three segments delivered core sales

growth in the quarter. The lone exception was Aquatics which continues to be impacted by weather delays and excess channel inventory. Aquatics saw segment income decline of 4% on a 2% core sales decline.

Filtration Solutions returned to growth, delivering 1% core sales growth. We commented that the first quarter results were impacted by a number of one-time issues and we believe that the second quarter performance shows that many of those issues have moderated. Segment income was down 4% and margins declined 250 basis points against a very tough comparison last year and negative mix during the quarter.

We saw growth in our Industrial and Food and Beverage businesses, while Residential was relatively flat in the quarter. We continue to focus on positioning Filtration Solutions to drive more consistent and predictable growth and anticipate margins mixing up over time.

Flow Technologies delivered 5% core sales growth as price continued to read out, and we also saw improvement in our Commercial and Infrastructure businesses. Although the agriculture markets continue to be down for us, Agriculture performed in line with our revised expectations. Segment income declined 6%. However, the segment margin decline was half the rate we experienced in the first quarter. This was the last tough comparison around inflation and we are expecting Flow margins to turn positive in the second half.

Please turn to slide 7 labeled Balance Sheet and Cash Flow. We are pleased with our second quarter cash flow performance and delivered \$343 million in free cash flow, which is in line with normal seasonal patterns. During the quarter, we successfully completed a \$400 million 10-year note offering, which was used to repay debt incurred to fund our first quarter acquisitions and will also be used to help fund our second half debt maturities.

With the new offering, our debt structure is now predominantly fixed and we continue to have strong balance sheet optionality. Also in the second quarter, we repurchased \$150 million of our shares, in line with our annual share repurchase plan.

Please turn to slide 8 labeled Q3 2019 Pentair Outlook. We anticipate third quarter sales – core sales to decrease 1% to 3%. We expect Aquatic Systems to be down 8% to 10% as we continue to focus on making sure channel inventories return to more normalized levels by the end of the year. We expect Filtration Solutions to be up 1% to 3%, and Flow Technologies to be flat to up 2%.

We anticipate segment income to be approximately flat to up 2% as we expect inflation comparisons to ease and price to fully read out, and we continue to drive productivity. We expect adjusted EPS to be in the range of \$0.54 to \$0.56 per share.

Below the line, we expect corporate expenses to be approximately \$14 million to \$15 million. We expect our third quarter tax rate to be 18%. We also expect net interest/other expense of roughly \$9 million and shares to be approximately 169 million.

Please turn to slide 9 labeled Full Year 2019 Pentair Outlook. Slide 9 looks at the different components of our updated 2019 outlook. For the full year, we expect core sales to be flat to down 1% as we continue to expect price of roughly 3% for the full year. We expect total sales of flat to up 1% with roughly 2% contribution from the recently announced acquisitions offset by 1% headwind from FX.

We anticipate segment income to be down approximately 2%. We expect full year adjusted EPS to be approximately \$2.35 per share. Other items embedded in our guidance include corporate expense of \$60 million

to \$65 million, a tax rate of 18%, net interest/other expense of \$37 million, and an average share count for the year of 171 million shares.

As we look at our 2019 second half and full year expected performance, it is important to consider the unusual circumstances we have experienced in 2018 and the first half of 2019. Starting in the second half of 2018 and through the first half of 2019, we experienced significant material inflation partially driven by tariffs of over \$120 million. In 2018, we implemented price increases in part to address this dramatic increase in inflation, and the net result was a significant increase in inventory levels in our distribution channels.

Through the first half of 2019 as these elevated inventory levels are being worked down, several of our key markets and Pools in Agriculture were hit with historically wet cold weather resulting in a delay in inventory channel levels being worked down. We believe this perfect storm of unusual external factors resulted in far from normal experience in the first two quarters of 2019. As we look forward to 2020, we expect to return to a more normalized level of performance more in line with our long-term expectations.

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

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

Thank you, Mark. Please turn to slide number 10 labeled Focused Strategies. I wanted to provide an update on our two focused growth strategies. We recently completed a comprehensive North American residential consumer segmentation which has provided great insights into how to better position two of our key businesses, Pool and Residential and Commercial Water Filtration, for differentiated growth.

The segmentation analysis gave us granularity as to our customers' needs, behaviors and key attributes. These insights allow us to better understand their buying behaviors as well as customer journey mapping and future product insights to meet their needs. These insights are critical to driving our marketing efforts and to be more targeted in the type of personas that we want to engage within the future and how to best connect them with our channel partners.

As we focus on advancing Pool growth, we have opportunities in both the new and replacement markets. While there are only about 75,000 new pools built a year, we see opportunities to increase our content per pool, particularly around automation and connected solutions as well as new products in the areas of remote monitoring, advanced energy efficiency and simplicity of maintenance. These are also similar opportunities with approximately 5 million installed in-ground pools.

We continue to look at the pool pad as a pool's ecosystem. Through this lens, we are developing more efficient treatment technologies as well as smart and IoT enabled products that seamlessly configure and operate more effectively together. These solutions are being managed by what we believe are best-in-class apps that enable a superior user experience as well as opportunities to drive improved levels of customer service.

Accelerating residential and commercial water treatment is our other primary growth opportunity. The first area we are focusing on is end-to-end residential and consumer filtration. Here, our two recent acquisitions are playing an important part. Aquion brought to us systems capabilities as well as affiliated range soft dealers. Pelican brought an online capability that expands our omni channel reach.

Similar to what we have done in Aquatic Systems, we have been looking at water treatment applications throughout the home as a system offering. Through this work, we have identified many customer back

opportunities to create differentiated water treatment products and systems. We are developing more efficient treatment technologies, tackling some of the challenges that are top of mind for consumers today, such as lead removal and delivering great tasting water at every tap in your home.

We also have been developing and will soon be launching the Pentair Home and Pentair Pro apps that bring our new suite of smart, IoT enabled products to life. These sets of apps seamlessly connect consumers, water treatment service providers and Pentair to buy product performance monitoring, control and service.

The second opportunity we see is building our Commercial Filtration business. We have enjoyed a strong presence in the food service historically and we plan to continue to focus in this area. There were other areas such as commercial office water that offer additional growth opportunities over time. We believe that these are two significant and focused growth opportunities that can accelerate our organic growth rates and create significant shareholder value.

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

QUESTION AND ANSWER SECTION

Operator: And thank you. [Operator Instructions] Your first question comes from the line of Steve Tusa from JPMorgan. Your line is open.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, guys. Good morning.

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

A

Hey, Steve.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Just thinking about the fourth quarter, I mean how are we – how do we think about kind of the comp there in Aquatics? There's a lot moving around. Obviously, you had a bit of a pre-buy last year. You're still saying it's going to be, I guess, up. What – how do we get comfortable with that?

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Steve when you say up in – time out, revenue up, income up just trying to...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yeah. I guess. I guess. Whatever, but our revenue and income I think it's up, I don't know. I'm sorry, I've been on another call so I didn't – I'm not – maybe I missed that. But I guess, just talk about how you approach the comp in the fourth quarter, I guess.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah, just to talk about Q4 overall. So with respect to Aquatics, Aquatics on the top line is – when you work out the math, its down slightly...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

...in volumes. So that is kind of acknowledging a bit of the comp from the prior year as well as are the continued working down of the inventory that we talked about previously. The other two businesses, we do see those as improving from a volume – revenue perspective some of that's driven by price and some driven by volume. And then when you look at the bottom line and think about kind of the year-over-year, we start to get – we get more help from price, where less of a headwind from inflation.

We certainly have the – the acquisitions are embedded in there, so those start to add as well. And then productivity gets better in Q4. If you remember last year, we called out some challenges in the Flow business, so we start to see some productivity improvements. They start to read out in Q3 but then continue to ramp up in Q4.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay. And when you think about the myriad of items that kind of hit the other businesses, the non-Aquatics business in the first quarter, could you maybe just discuss any changes in some of the bigger moving parts in the first quarter? The negative items like there were some weakness in Europe in Filtration, there were a few things. And any kind of changes on those front that bounced back or anything here. I mean it looks like it was a little more stable and a little better in those businesses.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah, Steve I think that's the right way to think about it. Things were a little more stable. In particular in Filtration, we did call out a number of what I've referenced as sort of unusual or onetime type items in Q1. Those stabilized and moderated in Q2. We didn't see certainly a headwind from Europe. For example in Q2 that in Filtration and across the businesses was better performance in Q2, and we would anticipate seeing something similar as we work through the balance of the year.

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

A

And the only...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay.

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

A

Steve, the only issue we had in Q2 outside of Aquatics was weather impacting our Irrigation businesses and Flow in Q2 and that didn't get better off at Q1. But other than that, there is – we don't think that's a lingering effect because the season is kind of come and gone.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And then are you guys buying back stock? Did you buy back any in the quarter? And what's your appetite for the second half?

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yes. So we bought back 150 million shares in the quarter, and that represents our plan for the year.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thanks a lot.

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

A

Thanks, Steve.

Operator: Your next question comes from the line of Nathan Jones from Stifel. Your line is open.

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

Q

Good morning, everyone.

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

A

Hey, Nathan.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning, Nathan.

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

Q

I'd like to focus a little bit on the productivity line here, it was you a headwind of \$6 million to operating income in the quarter. I know you net growth investments against underlying productivity there. So can you just give us a little more color on what led to that \$6 million headwind in the quarter?

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. Nathan, it's – frankly, it's a number of sort of small items that individually don't really amount to much but overall what drives the \$6 million. I think one of the things that we see is we do see productivity starting to build. And as you know, productivity as we start to work through it, it takes a little time to work its way through inventory. So we can see that building up in inventory, and that's what gives us confidence that we will start to see that productivity number turn as we work our way into Q3 and Q4, and we see our operational and supply productivity actions starting to read out.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Nathan, I would just add that we have significant progress on sourcing that we're making up on against the inflationary issues, and that is a positive and we feel confident about that continuing. We had one lingering productivity issue, which is our Large Pump Flow business. And we're continuing to experience headwinds there that we feel confident we've got the on time delivery back up and we've got most of the past tubing work down as we head into Q3 here. So we feel good about that turning around to a positive in the back half of the year, as Mark mentioned.

And I just like lastly mention that these two growth initiatives – we have a great Pool business and we're going to continue to invest in it despite what's going on with the weather headwinds. So we're putting a fair amount of sales, customer service support against that. And then also on the end-to-end residential solutions, which is our Pelican business, we're investing heavily to build out the brand and the marketing efforts there. So those are some negatives against what I think is a sustained positive productivity that you should see in Q3 and Q4.

Nathan Hardie Jones

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Well, I wouldn't call growth investments a negative even though that does negatively affect that productivity number. But maybe I could push you a little bit further on this, because I did go back and read the transcript from the third quarter last year and there was talk about productivity improvements coming from sourcing improvements that would come at a later date. There was talk about some of this inventory – the productivity improvements building an inventory, and three quarters later we're still seeing a negative number here in productivity.

So any color you can – any more color you can give us on where the confidence comes that we are going to see a turnaround in that number in the second half of the year when it's been quite a long time coming here?

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. Nathan, all I can say is that as I said we do start to see it actually reading out in inventory, which would then come through and we'd see it through the P&L. And the funnels that give us the confidence are built at a very detailed granular level, action start to build up and we see them starting to anniversary and carry over. So I can't comment on sort of the relationship to last year, but certainly when we look at this year and the activities that the teams are working on we feel confident about the Q3 and Q4 trajectory there.

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

Q

Would you be prepared to give us a number that you'd expect out of that productivity line in the second half of the year?

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

We wouldn't specifically comment on that other than to say that it certainly is going to improve over the – the number that we see for Q2.

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

Q

Good enough. Okay thanks for the help. I'll pass it on.

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

A

Nathan I share your energy and passion around this. I think we feel good about the sequential run rate of our cost structures as they go forward. When you look at the year-over-year – I mean and you take back at Filtration Solutions Q2 of last year and the ROS that they had, you saw a pretty high ROS. So we've got some year-over-year comparables in this Q2 that aren't the same comparables as we had in the Q3 and Q4. And growth is such a huge component of this drop through that – that's why Mark is not – couldn't give you an exact number at this time.

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

Q

Fair enough. I'll pass it on. Thank you.

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

A

Thank you.

Operator: Your next question comes from line of Joe Giordano from Cowen. Your line is...

Joseph Giordano
Analyst, Cowen and Company

Q

Good morning, guys.

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

A

Hey, Joe.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning, Joe.

Joseph Giordano
Analyst, Cowen and Company

Q

Hey. So I just wanted to start just – on Aquatics just talking to the progression throughout the year. So we make – the last quarter we kind of readjust everything. We have some – you have some tough comps coming through in the back half of the year. And so what when you look at that landscape today is different versus three months ago outside of like some of the weather impacts, when you think about second half specifically for the revenue side of things for Aquatics?

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. Really, Joe, the underlying fundamentals continue to be similar to what we commented on at the end of the first quarter. It's really the impact of continued wet cold weather in April and May that significantly impacted sort of our ability to bring down those inventory levels, and so the inventory reduction has slid to the right and now that's what's affecting Q3 and Q4. So that's really the story for Aquatics both on the top line and then when you think about the drop through onto the bottom line as well.

Joseph Giordano
Analyst, Cowen and Company

Q

Okay. And then when I think of – you mentioned in the slides commercial office water. I'm not sure I remember hearing too much about that in the past. Is that something new that you guys are working on? Can you kind of talk to that opportunity, what that landscape looks like?

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

A

Yeah. Thank you for bringing it up. I mean it really is we have a good food service relationship, and when you think of water and food service it's really critical and important to our end consumers either in the form of making coffee, pizza dough, making sure they got safe, clean water and good tasting water for their restaurant customers. We also have all those products that we sell into the commercial office water space. And what we're seeing with office space is being reconfigured and re-done is people want the good tasting water more at the tap or the capability, and then we feel we have superior technology around carbonation capability and also mineral dosing or flavor dosing capability.

We could bring that either through OEM partnerships. We can bring that through our existing channels or we're looking for ways to accelerate that through service or total water management in the commercial office water space. So, it's an area that we've been strategically working on for the last 18 months and we really feel like we've got great technology and great products to bring to market there, and just wanted to highlight it as an area that we're going to be focusing on.

Joseph Giordano
Analyst, Cowen and Company

Q

Good. Thanks.

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

A

Thank you.

Operator: Your next question comes from the line of Deane Dray from RBC Capital Markets. Your line is open.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

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

A

Hey, Deane.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey let's stay with commercial office water opportunity cause it does seem like a natural fit for Pentair. That whole sector is seeing a disruptive change getting away from that 5-gallon jug business. But it does beg the question how do you approach this from a growth ambition? How much should be organic? Are you looking at M&A in this opportunity? Some folks have approached it with rentals, other outright sales through dealer networks. But some additional color would be helpful as well as a timeline if you could.

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

A

Yeah. Deane, I appreciate it. Clearly, the market from a service or delivery perspective is highly fragmented, which has always been a challenge to kind of break through and make sure that your products and capabilities are there. I won't mention them by name, but several large OEM producers are looking to get in this market primarily around delivering the flavored and/or carbonated water needs, as well as there's other partners that are thinking about how we bring heated water for tea and coffee to bear.

So, I think the movement of having fresh new differentiated technology advanced products is a great opportunity for Pentair to certainly partner and bring those products through. As far as going to the services end or doing the last mile, Deane, as you mentioned, I think that would have to be more likely an inorganic strategy which is not what I was addressing today, but I was talking about bringing those products to market.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Certainly, that makes sense. We'll be watching that space carefully. And then going back to the Aquatics and the inventory in the channel, you had sized it previously at \$60 million excess. Where do you think that stands today?

And then just remind us on what – the weather impact, because that has – you get lower utilization of pools, fewer starts and some of those starts just don't happen. They get pushed out to next year. But just share with us the ripple effects of the weather and how that's reflected in your guidance.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah, sure. As I mentioned, when we look at Q2 we had assumed some level of inventory reduction. And because of the weather impact continuing from Q1 into Q2, we didn't see that. So the overall level of inventory did not go up. It's not that we built inventory in Q2. It's just that the planned reduction did not happen at the rate we had anticipated. And so now, that inventory level that existed is got to be worked down further in Q3 and Q4. So think of it, if you think about the level in which we adjusted the guidance for Aquatic Systems revenue, that's reflective of the further need to reduce inventories driven primarily by weather.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Deane, if I could just add that I mentioned 75,000 pools, new pools being built. If you put that in context, I think we estimated at the beginning it would be close to 80,000 which is generally what last year was. So clearly we're staying in your point the 80,000 going to 75,000 being the labor constraint on that pool construction build and that's likely a slide to the right.

Now, we're confident based upon the demands in the area that we think we're going to see those pools get built actually next year based on the overall demand. But weather had to have an impact, we think, on pushing some of those pools outside of this year's building – build cycle.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Thank you.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Thank you.

Operator: Your next question comes from the line of Josh Pokrzywinski from Morgan Stanley.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Hey, Josh Pokrzywinski. How are you?

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

Well, thanks. How are you guys doing?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Good.

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

So just to continue down the Aquatics path here. John, just between the absence of de-stocking and you talked a little bit about the about the weather push-outs. And I know individually you probably don't want to make too big of a deal out of each one of those as maybe positive drivers for next year. But if you add all these things up plus some of the commercial initiatives, is Aquatics a business that instead of being a mid-single digit grower can go to something more like high-single digit next year just as you start to sell the underlying demand versus de-stock and maybe catch up on some of these weather anomalies, whether it's push out or just kind of an unseasonably rainy year?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Yeah. Normalized, this business has grown mid- to high-single digits, Josh, if you go back. I think fundamentally, overall demand in the aftermarket on the \$5-million pools needs to have more penetration of the new pool pad which is what I'm really pushing here to say that if you put more content into the new pool and you expand your average pool content, you will build your aftermarket capability to basically replace those with like-for-like product. If that like-for-like doesn't exist, then you're looking at a channel that needs to go sell your products or upgrade the consumer for you.

So, I think, we got to take advantage of a shift in focus here and make sure we're spending as much time building out the new content in those 75,000 pools and then benefit from that aftermarket revenue stream as we go forward.

The big shift we're having here and where I think we're going to see a huge penetration is on the connected pool side itself, Josh. But I am – challenged the team that said that's a different sale, right. I mean it's a technical sale and it requires a little bit more customer and consumer support. So we're very bullish about what this business can continue to do because we see substantial opportunity in front of it.

I cannot guess what weather is going to do next year, and if we learned one thing from all of this it's that we've got to have contingency plans against it whether or not unfolding the way we want it to.

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

That's fair, but I guess mathematically just selling the underlying demand next year gives you a few points head start anyway, right?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

We do think the labor constraint that – the fact is this year we'll be in catch up mode and we do think we'd be entering next year with a relatively healthy backlog. Correct.

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

Got it. And then just one more on the more of Commercial Filtration initiatives, what's your sense on the channel penetration or kind of that channel build out, your presence with dealers? Because I know you have a great business on more of the national accounts side, but in markets that are perhaps a little bit more fragmented are – it sounds like there's been a lot of investment on the product, but is the product in the right dealer's hands and is that dealer base something that you can penetrate easily?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Yeah. That's our opportunity, Josh. And I wanted to call it out today because we are focused on building out the acquisitions around the residential side, but we don't want to forget the fact that we have a really good commercial offering and we're also simultaneously working on that.

And what that means is getting back to what we used to be great at and what we are going to be great at, which is selling the spec and working with our global partners to convince them that we have a superior product and that they should be designing and specking that product into their expansions. Think of global hotel chains, think of all the hospitality efforts, think of anybody who's moving their stores overseas. Those are great opportunities for us to make sure that we're designing in our Everpure product in all of those instances.

Joshua Charles Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

Thanks, John. I'll leave it there.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Thank you.

Operator: Your next question comes from the line of Jeff Hammond from KeyBanc Capital Markets. Your line is open.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Good morning, guys.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning, Jeff.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Just wanted to go – kind of touch on price cost and productivity. It looks like you kind of got price matching inflation this quarter, how should we think about that delta in the second half? And then on productivity, I think you were nicely positive in 1Q and went negative. I know you mentioned the one large pump business, but what's the change there?

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. So you kind of hit it on price cost. We do expect as we sort of thought throughout the year that the price that we referenced, about 3 points of price should offset inflation, so that that continues to be the point of view.

And then just on productivity. As we talked about, there are some negatives that affected us in this quarter. John referenced the fact that last year was a pretty solid quarter for us, so the comp is there and that kind of read its

way through year-over-year productivity. And then we've got all the actions in place that have been worked, and we are starting to see readout through inventory that will then find their way into the P&L starting in Q3 and Q4. So we got good visibility to the actions and the things that are going to take place in the Flow and Filtration businesses that should drive that incrementally improving productivity.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

So price versus inflation you still think is neutral in the second half? You don't get a net positive with some of the deflation?

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

No. I mean, no, because you get the deflation and also just the timing of price. So net-net it continues to be kind of a push.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

I think, Mark, you're putting labor inflation in there as well.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah, total inflation, not just the adjustments from internal inflation.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

And then just last one on Aquatics, if you kind of are successful kind of getting inventory down with in line with kind of this new guidance, where do you see inventories entering 2020 versus normal? Thanks.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. Our plan and what our updated guidance is reflective of is inventory levels being brought to a more normalized level. So – and when we do that we look at sort of days on hand on a forward basis and think of it that way. So we're looking at it what it was historically and then bringing the inventory levels down to sort of that more normalized historical level on a day's basis.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Thanks, guys.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Thank you.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Thank you.

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

Brian Lee

Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys. Good morning. Thanks for taking the questions. Just maybe on Filtration again, can you elaborate a bit on the trends you're seeing there? It seems like you had a nice rebound off of 1Q, you had the one-time issues there. But you mentioned Food and Beverage was up, Resi is down in the quarter, but maybe any more color there and also the trends you're expecting heading into the second half.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Sure. Yeah. So just thinking about the different businesses, Residential and Commercial think of them as sort of flat in the quarter. And then as I mentioned, Industrial was strong and Food and Beverage was moderating. We see those trends kind of continuing, we start continue to see Residential and Commercial improving as we work our way through the year. Within Residential is where those two acquisitions exist. So those as we referenced are performing in line with expectations, but we're really seeing some exciting opportunities from a growth perspective there and starting to see the rationale for why we did those deals starting to read out and really giving us some confidence that there's some great ideas there that are going to help us continue to grow those businesses, but then also help us think about the broader Residential portfolio. So, overall, we're seeing the trends going in the right direction and seeing that continue through Q3 and Q4.

Brian Lee

Analyst, Goldman Sachs & Co. LLC

Q

Okay. Fair enough. And then just maybe a follow-up on – since you bring it up, on the new acquisitions. I noticed that – a subtle tweak here but it seem like you're taking down the full year contribution from 3% to 2% in the updated guidance. Maybe if you could comment on what's driving that as well?.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah. Sure the – we haven't talked about it necessarily but we did announce earlier in the quarter that we were getting out of what we refer to as the Aquaculture business. So that wasn't actually reflected in our original plan or guidance. And so that's the slight tweak, so it's not that the acquisitions aren't performing at a level of expectation, it's that we've included an additional divestiture that – right, that's pulling down the top line acquisition number.

Brian Lee

Analyst, Goldman Sachs & Co. LLC

Q

All right. That makes sense. Thanks, guys.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Thanks.

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

A

Thank you.

Operator: Your next question comes from the line of Julian Mitchell from Barclays. Your line is open.

Jason Makishi
Analyst, Barclays Capital, Inc.

Q

Hi, guys. This is Jason Makishi on for Julian. How are you?

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

A

Good. Good morning.

Jason Makishi
Analyst, Barclays Capital, Inc.

Q

Doing all right. Just a couple of quick ones on Filtration and Flow general trends, I know you guys just said that the residential and commercial trends are improving throughout the quarter. I just kind of wanted to clarify that that is sort of an underlying demand commentary and not a reversal of maybe sort of one-time issues that you saw in both of those businesses in Q1. And if so, is there any sort of bifurcation in the differences of strength between the residential and commercial underlying markets?

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

A

Let me hit part of that first. I mean as you recall when we talked about putting in the price increases last year in September relative to the tariff and the inflationary impacts, we did see some inventory pull ahead in the Residential and Commercial Flow and Filtration space as well. We felt like we worked through all of those in Q1 and worked those inventory issues behind us. So we had already started in a better inventory position in Q2, and that is continuing to read out here as we head into Q3 and Q4, meaning that we don't have those same challenges that we had in Aquatics. Mark, I don't know if you want to add.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

No. I think that – I mean, I think you picked up on that correctly. So it's not – it's underlying fundamentals rather than reversal of anything specifically one-time other than the things, John, that you mentioned.

Jason Makishi
Analyst, Barclays Capital, Inc.

Q

But I guess just as a quick follow up. Would you characterize the underlying demand as sort of improving? Or is this sort of just an inventory issue that was being worked through as a result of pricing increases across last year? I guess what I'm trying to get is sort of, are the customer conversations getting better? Or is it the issues that were present in Q1 are just completely behind you, and now Q2 and Q4 tell sort of the different story?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

On Filtration, Residential and Commercial are improving. We're excited about the awareness of the products and the offerings available in the channel, and the migration towards more of those making into the consumers' hands.

In Irrigation Flow, I'd say no. The weather patterns did not read out in Q2, and we think we're going to be relatively experiencing the shipment demand as we head into Q3 and Q4 as well because those are submersible wells.

Jason Makishi

Analyst, Barclays Capital, Inc.

Q

Understood. Thank you for your time.

Operator: Your next question comes from the line of Walter Liptak from Seaport Global. Your line is open.

Walter Liptak

Analyst, Seaport Global Securities

Q

Hi. Thanks. I've got a question, you commented about the perfect storm and the channel inventory, and I wonder first, is it – is it not far enough behind us where we could do a post-mortem on the situation with the inventory build from tariffs and weather? And then – and I don't mean to Monday morning quarterback but have you learned anything from it, like what could you have done differently? Because I don't think that the tariff issues or weather are going to go away, what is about the channel that you can do to keep this from happening again?

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Yeah, we're hopeful that this goes in the category of like 2008, 2009 financial crisis, the learning that we don't have to ever use again. When you think about 10% material inflation over the course of a couple of years and then raising prices to mitigate that impact, we did not anticipate that the channel would buy so much ahead of that demand.

When we realized that and we corrected course as you – now, what did we learn from that? I think we have a lot of sell through metrics. We have a lot of information available to us that we're now looking at to make our own assumptions of what's in the channel, so that we rely on partners, that's one thing, but we also want to make sure that we're triangulating that information and ensuring that we feel like the sell through is reflecting what we know it to be. So, there's always a learning and I'd say that's the learning and I think we're more informed now and we have a better idea of what our actual end sales are through the channel versus into the channel.

Walter Liptak

Analyst, Seaport Global Securities

Q

Okay, great. And then switching gears over to your comments about segmentation, we've seen other companies like IDEX do a really incredible job with segmentation and it sounds like you're doing product segmentation. I wonder if you're doing channel or customer segmentation too.

And then as a follow-on on the product question the R&D spending, what are you doing to track some of the incremental R&D? How much is R&D going up? Just some – looking through some data or details about the kind of return you are expecting from some of these investments.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Well, first of all thank you for noticing the segmentation comment. It is in fact a consumer and user segmentation. And it was pretty exhaustive and a particular piece of marketing that we are using significantly. And you can sense by our confidence level that that gives us extreme confidence. Because as we start to target these personas or we start to understand these personas better and we've used our marketing campaigns, we're actually seeing the results from it. And these personas and the consumer needs, attributes, and behaviors that we're spending time to understand are true and they're ringing out. And now we're building product sets and customer support around those that we can continue to grow faster. So, thanks for noticing.

On the R&D, I'm a big advocate that we need to spend more and have the right differentiated and innovative product. I think these marketing insights that we're creating will give us a better connectivity to what's needed. So I don't know in the short run if it's spending more or it's spending more wisely and having the right products available to the right customer set.

Walter Liptak

Analyst, Seaport Global Securities

Q

Okay. All right. Thank you.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Thank you.

Operator: [Operator Instructions] Your next question comes from the line of Brett Linzey from Vertical Research Partners. Your line is open.

Brett Logan Linzey

Analyst, Vertical Research Partners LLC

Q

Hi. Good morning, all.

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

A

Good morning.

Mark C. Borin

Chief Financial Officer & Executive Vice President, Pentair Plc

A

Good morning.

Brett Logan Linzey

Analyst, Vertical Research Partners LLC

Q

Hey. I just want to come back to Q3. If I just assume normal incremental margins in progression, you talked about in Flow, in Filtration basically implies you need some margin expansion in Aquatics in Q3 to get to the mid-point of the guide. That's why I want to make sure I'm thinking about that right.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Yeah, maybe slightly. But that – but not the margin decline that we've seen in the first quarter and the second quarter.

Brett Logan Linzey
Analyst, Vertical Research Partners LLC

Q

Okay.

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

A

Think about, what we had is half a month worth of price benefit last year and we're getting a – that's – we're getting the carryover this year of that price. And what we're seeing is the price and inflation headwind year-over-year is significantly positive across all three businesses.

Brett Logan Linzey
Analyst, Vertical Research Partners LLC

Q

Okay. So despite the lower absorption you expect to see – you think you can overcome all that?

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

A

Yes. Yes.

Brett Logan Linzey
Analyst, Vertical Research Partners LLC

Q

Okay. Good. And then just geographically maybe just walk around the different regions. We didn't really talk about China. I think last quarter you said Europe was a little bit weaker than you had expected. How was Europe specifically in the quarter, and then maybe any color on China and what you're seeing there?

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Sure. Yes. So overall we saw Europe kind of get back from some of the negative commentary made in Q1 to growth in Q2. So Europe was a positive story, and we think that that's going to continue through the rest of the year. China continues to grow. I mean, so as we've talked before it's not a huge market for us overall, but we see strong growth in China, that's a continuation from the trend that we saw in Q1 continuing in Q2 and we expect to see that as well continuing through the balance of the year.

Brett Logan Linzey
Analyst, Vertical Research Partners LLC

Q

Okay, good. Thanks. I'll pass it along.

Mark C. Borin
Chief Financial Officer & Executive Vice President, Pentair Plc

A

Thank you.

Operator: There are no further...

John L. Stauch

President, Chief Executive Officer & Director, Pentair Plc

All right. Thank you for joining us today. We continue to believe that we will exit 2019 positioned to deliver more normalized performance in 2020. We're accelerating PIMS and sourcing and strengthening our productivity culture. We are funding the two key strategies discussed earlier in the call and we hope you share in our excitement for these two key growth strategies. We have a strong capital structure, solid free cash flow generation, and we will continue to invest in our strategy to be the leading residential and commercial water treatment company. Thank you for your continued interest.

Rob, you can conclude the call.

Operator: Thank you, sir. And ladies and gentlemen, thank you for your participation today. This does conclude today's conference call, and you may now disconnect.

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