Pentair plc

Third Quarter 2019 Earnings Call

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PRESENTATION

Operator:

Ladies and gentlemen, thank you for standing by and welcome to the Pentair 2019 Third Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' remarks there will be a question-and-answer session. To ask a question during this session, you will need to press start, one on your telephone. If you would like to withdraw your question, press the pound key. If you require further assistance, please press star, zero.

I would now like to hand the conference over to your speaker today, Jim Lucas. Thank you. You may begin.

Jim Lucas:

Thanks Dorothy and welcome to Pentair's Third Quarter 2019 Earnings Conference Call. We are glad you could join us. 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 third quarter 2019 performance as well as our fourth 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 Stauch:

Thank you, Jim and good morning everyone. Please turn to Slide 4 titled Executive Summary. We are pleased to deliver third quarter performance, in particular a return to segment income growth and ROS expansion, and building on our performance from the second quarter. We are maintaining our full-year EPS guidance, we have seen price costs stabilize and we are encouraged to see further signs of top line stabilization in our important Aquatics business.

We continue to invest in our two key strategic growth priorities, advancing Pool growth and accelerating Residential and Commercial Water Treatment. These investments are centered around building out a consumer experience inclusive of our brand; channel, innovative products, and services.

We continue to believe we are well positioned to return to core sales and income growth in 2020 and I will talk a little more later in the call about our optimism about our long-term strategy and prospects.

I will now turn the call over to Mark to discuss our third quarter results and updated full-year outlook.

Mark Borin:

Thank you, John. Please turn to Slide 5 labeled Q3 2019 Pentair Performance. For the third quarter, overall sales increased slightly and we saw core sales decline 2%, segment income grow 1%, and adjusted EPS increase 7%. We will provide more color on the individual segment performance shortly.

Below the line we saw an adjusted tax rate of 15%, Net Interest Other Expense of $7.7 million, and our average shares in the quarter were 168.6 million. The tax rate in the quarter reflects our long-term strategy spread across a lower income base in 2019, resulting in an expected full-year adjusted tax rate of 17%.

Finally, free cash flow was just over $150 million and in line with normal seasonal patterns. We were pleased to see segment income grow and ROS expand despite the softer top line and we believe this is a reflection of price costs stabilizing following the headwinds of significant inflation we discussed in prior quarters.

Please turn to Slide 6 labeled Q3 2019 Pentair Segment Performance. This slide lays out the third quarter performance of our three segments. As expected our Aquatics segment experienced a 5% core sales decline against an extremely tough comparison. Following rather abnormal weather during the first half of the year, it appeared that weather in much of the country was more normal during the quarter and the result was an improved sell-through. Aquatics saw segment income decline 9% and ROS contracted 60 basis points, but still came in north of 25%. As we have repeated throughout the year, we remain focused on exiting 2019 with channel inventories more in line with historical levels.

Filtration Solutions reported core sales growth of 4% with solid contribution across all business lines, but particularly within the smaller Food and Beverage business as we shipped out some of our improved backlog in both beer and sustainable gas. The integration of both Aquion and Pelican remained on track and both businesses performed in line with our expectations. Segment income grew 17% for Filtration and ROS expanded 50 basis points to 16.5%.

In Flow Technologies, core sales declined 5% during the quarter. We continue to see strong headwinds in our Ag business, both OEM and aftermarket. Despite the soft top line performance, segment income grew 4% and ROS expanded 170 basis points to 17.1%. As a reminder, Flow Technologies was hit hardest by tariffs and broader inflation in the second half of 2018 and the comparison of the quarter was its easiest of the year.

While we continue to see mixed results across the three segments, we are most encouraged by signs of stabilization in price cost as well as only one more quarter of tough top line comparisons for Aquatics.

Please turn to Slide 7 labeled Balance Sheet and Cash Flow. Our balance sheet continued to strengthen and the third quarter delivered another seasonally strong quarter of free cash flow. During the third quarter we had one bond mature and we have one other bond maturing in the fourth quarter. As a reminder, we successfully issued a 10-year note during the second quarter. Between our healthy free cash flow and improved leverage ratios, our balance sheet remains well positioned to fund both organic and inorganic growth opportunities.

Please turn to Slide 8 labeled Q4 2019 Pentair Outlook. For the fourth quarter we anticipate core sales to be roughly flat. We expect Aquatic Systems to be down approximately 1% to 3% as we continue to focus on making sure channel inventories return to more normalized levels by the end of the year. We expect core sales growth in both Filtration Solutions and Flow Technologies to be essentially flat.

We anticipate segment income to be up approximately 6% to 8% as we expect price cost to further stabilize and we continue to drive productivity. We expect adjusted EPS to be in a range of $0.64 to $0.66 per share.

Below the line, we expect Corporate expense to be approximately $14 million to $15 million. We expect our fourth quarter adjusted tax rate to be around 17%. We expect Net Interest Other Expense of roughly $8 million and shares to be approximately 169 million.

Please turn to Slide 9 labeled Full-Year 2019 Pentair Outlook. For the full year we expect core sales to be down roughly 1%. We expect total sales to be essentially flat with roughly 2% contribution from our two acquisitions offset by a 1% headwind from FX. We anticipate segment income to be down around 3%. We continue to expect our full-year adjusted EPS to be approximately $2.35 per share.

Other items embedded in our guidance include expected Corporate expense of $60 million to $63 million, an adjusted tax rate of 17%, Net Interest Other Expense of $35 million and an average share count for the year of roughly 170 million shares.

While there are undoubtedly many moving pieces to our 2019 path to expected flat EPS, we continue to be encouraged by signs of top line stabilization and further price cost improvement. We are encouraged by the performance the business are delivering in light of the top line challenges faced this year.

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

John Stauch:

Thank you, Mark. Please turn to Slide 10 labeled Executing a Consistent Strategy. We continue to be focused on driving our long term strategy and we believe there's a lot of evidence that the focused investments we are making are the right investments and driving results.

Most people would agree that global water quality is a challenge. While many companies are participating in offerings to solve this global issue, we have chosen to focus primarily on the Residential and Commercial markets. There is little argument that consumers can benefit from taking ownership of their own water experience. They can do it to their own taste and with solutions that meet their individual needs and preferences. Pentair has a variety of solutions to help consumers treat, move and enjoy water. In fact, Pentair is one of the few total solution providers to residential customers.

Also, when we aligned on our strategy nearly two years ago, it started with our leading aquatics franchise. With over 5 million pools installed in the U.S. and over half of them being over a decade old, there's a large installed base to serve. We have built a strong business focused on new product development and strong dealer loyalty. The introduction of the variable speed pump nearly a decade ago created an awareness around energy savings and the result has compounded with other product categories from LED lighting to hybrid heaters. We believe the continued adoption of automation, which is small today—roughly 275,000 pools versus an opportunity north of 2.5 million pools in the U.S.—creates a new avenue of growth where we have a leading position.

Within Residential Filtration markets, the acquisitions of Aquion and Pelican earlier this year moved us from being a leading components supplier to now being a provider of systems and solutions. We have learned quite a lot in our short time owning both of these businesses, and we believe there are many paths to creating value as we help consumers solve their water challenges in their homes.

On the Commercial side of the business, we have historically enjoyed a strong position in the Food Service area. Increasingly, we are focusing on total water management with customers and we believe this presents an opportunity to better position us with many of our existing and potential customers.

Within the Commercial Office Water space, customers are increasingly looking at opportunities to decrease the use of plastic bottles, and we have a number of technologies today that can serve this space. We believe there are opportunities to further expand in this area.

Outside of the Residential and Commercial verticals, we have a number of technologies we have developed around nano and ultra filtration. As we develop new IoT products, we see even more opportunities to solve customer challenges. For instance, within the beer industry, we have approximately 150 plants globally that use our digital BMS system that enables our customers to become more sustainable, lower cost, move from static to dynamic live reporting and improve overall operating performance. We are transitioning this technology into the sustainable gas industry and we believe there are opportunities to extend this technology to other parts of our portfolio over time.

We also continue to believe there are multiple paths to drive consistent, sustainable growth, especially in our core Residential and Commercial businesses. Our recent acquisitions allowed us to move closer to the consumer and while we have built a strong Aquatics business, we believe that by better focusing on the consumer and not only the dealer, it will enable us to maintain an already healthy growth rate in one of our best businesses.

We believe that we have the right portfolio, the right strategy, the right culture and the right technologies to further our position as a leading water treatment company. With a strong core to build from and a healthy balance sheet to support both organic and inorganic opportunities, we look forward to demonstrating our strategy to our shareholders in Q4 and in 2020 and beyond.

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

Operator:

At this time, I would like to remind everyone in order to ask a question, please press star, then the number one on your telephone keypad. We will pause for just a moment to compile the Q&A roster.

Your first question comes from the line of Steve Tusa with JPMorgan.

Steve Tusa:

Hey guys, good morning.

John Stauch:

Good morning Steve.

Mark Borin:

Good morning Steve.

Steve Tusa:

Can you just break down a little more what's going on in the Flow business? The revenues were way off versus our model, but the profits kind of held in and I know there's some dispersion in the margin profile of some of those businesses, and that was one I think in the first quarter that was tough for us to kind of figure out. What's going on in that segment? I think the other two are pretty straightforward. What's going on in this segment?

John Stauch:

Steve, let me speak to the revenue mix and then I'll let Mark in for the details. During the end of Q2 we saw a little false positive on some of the Ag orders and right out of the gate in Q3 we just saw that Ag did not recover at all, so we had anticipated a little bit more recovery sequentially in Q3 and it just flat out didn't happen. Now we've adjusted heading into Q4 and next year the fact that we don't see Ag recovering at all and I think a lot of the global data would suggest that we've probably figured it out right now, but that was a little bit of a bounce in Q3 that we had expected that didn't happen.

Steve Tusa:

How big is Ag and isn't relatively profitable? Shouldn't that have had a kind of more negative impact on the margin? What am I missing on that front?

Mark Borin:

Steve, it's Mark. That's a great question. What we saw positive signs of here were two things really: price costs getting better, as I said in my prepared comments, Flow was hit hardest by the inflation pressure so we see price costs turning positive in Q3 and then also productivity, we touched on that in Q2, that although we weren't—we didn't see the productivity reading out in Q2, we saw signs that gave us a high degree of confidence that we would start to see that in Q3 and that's really what happened.

You're right, the being down in Ag from a mix perspective would push margins down and income down but that was—we were benefited by better productivity and improved price cost.

Steve Tusa:

How big is Ag for you guys?

Mark Borin:

Ag would be somewhere in the $200 million range per year.

Steve Tusa:

Okay. Then one last one, just on Aquatics. Pool made some pretty positive comments that their channel is clear. Can you kind of validate that comment or are there other considerations? And thinking about next year a little bit, I would think you guys have some easy comps here coming up in the first half of 2020 or is there something else that we should keep in mind when thinking about kind of the trajectory in the next year.

John Stauch:

Steve, so I think you're right. I mean we do track one of our largest customer's earnings calls and we agree that inventory is definitely getting more normalized here and our goal is between now and the end of the year and make sure that it gets into that normalized pattern. I do think, though, that the pricing this year is relatively more normal, which will not suggest that any of the channel would reach to do the buy-aheads that we saw last year with a much more elevated pricing level.

Mark, I don't know if you want to add any more?

Mark Borin:

I'd agree. I mean as we've said, we continue to believe that by the end of the year we'll exit with normal levels and we think of 2020 more in line with historical normal seasonal stabilized perspective.

Steve Tusa:

Great. All right. Thanks, guys.

John Stauch:

Thank you, Steve.

Operator:

Your next question comes from the line of Nathan Jones with Stifel.

Nathan Jones:

Good morning, everyone.

John Stauch:

Good morning, Nathan.

Nathan Jones:

Just maybe thinking a little bit about where the return to organic growth comes from in 2020. I think we've probably beaten the Pool business to death and can all understand why that should return to growth, if we're having a look at the last couple of quarters' results, organic sales have been down with positive impact from prior. This quarter you're down two—with 3 points of price and volume down 5. Outside of the Pool business with what I would imagine are moderating price tailwinds and some negative volume trends here, where would you expect the growth to come from in 2020 outside of Pool?

John Stauch:

I mean, it's a good question and I thank you for asking it. I think first of all beyond Pool we also had some channel inventory in both Filtration and Flow that was built up for some of the same buy ahead patterns that happened in last year's Q3 and Q4, so this year's Q3 and Q4 have those difficult comparisons and then Q1 and Q2 of next year have much easier comparisons across both Filtration, Flow and Aquatics.

Nathan Jones:

Okay, so some tough comp issues this year for the same reasons as Pool linked to some easier ones next year. That makes sense. Can you maybe talk a little bit more about some of these? You talked about focused investments being the right investments and driving results. Maybe talk a little bit more about where those investments are, what kind of results you're seeing them drive and maybe specifically a little bit more about building out the channel for the Commercial and Residential Filtration?

John Stauch:

Yes, so we have three specific growth priorities in both Pool and Residential and Commercial Filtration. It's really about having—I'll start with Commercial first. It's about having the best commercial systems and capabilities and we're really excited about the technology that we're building to solve commercial office water opportunities. As you know, people are seeking carbonated water and they're also seeking flavored carbonated water. Really excited about the investments we made on the technology side and while we're more than a year away from launching any of that product, our product is a really better solution that we think that the market will benefit from, so we're excited there.

We're also, through both the acquisitions and also internally within Pentair, we've been having the best residential systems. You know, smarter, more innovative valves technology, smarter water softener systems technology, hooking those to automation, and then having the services piece through the Pelican acquisition to complete that last mile and we're really excited about the progress of that in-home sales capability and the buildout of what we call our mobile resource centers, which are our vans that we go out and sell with. Huge progress there.

On the Pool side, we continue to see technology advancement, new technologies around filtration, new technologies around automation, so we're excited that that penetration rate will show up. When you look at the sell-through rates of Pool in both Q2 and Q3, they're back to the high single digits again, so once we get through this inventory channel issue and the Pool business normalizes, I think we're very positive we'll see that return to growth next year.

Nathan Jones:

On that commercial water filtration product, the flavored and bubbly water, have you guys done enough work to kind of talk about what you think the size of that opportunity is for you?

John Stauch:

I think it's really fragmented. I think the overall momentum is there. I think what we want to do is make sure that we have the systems that can give you chilled, heated, sparkling and, as you know, our Everpure filtration is a big part of that overall component. We want to be talked about in the space and we want to make sure we have the right systems that can solve any solution that basically a commercial customer has.

Nathan Jones:

Okay. Thanks, I'll pass it on.

John Stauch:

Thank you.

Operator:

Your next question comes from the line of Joe Giordano with Cowen.

Joe Giordano:

Hey guys, good morning.

John Stauch:

Hey, Joe.

Mark Borin:

Morning, Joe.

Joe Giordano:

John, I just wanted to clarify something you said earlier on Steve's question regarding Flow. I think you mentioned that there was some head fake kind of exiting Q2 about Ag that didn't materialize in the quarter. I was under the impression that once Ag, like when we had that bad weather in the first half that any recovery in Ag was taken out of guidance, so I'm just a little confused about can you kind of square that for me?

Mark Borin:

Yes. There's two forms of Ag. We have a precision Ag spray business and that we did address earlier. That is a very, very high margin offering. The other part of Ag is more the pivot Ag spray and the irrigation side of the business. That's specifically what I was referring to.

Joe Giordano:

Okay. This is the irrigation, not the precision. Okay, cool.

Mark Borin:

Correct.

Joe Giordano:

Okay. Can you talk about maybe some of the traction you're having with some of just the internal cost initiatives? Because clearly, I mean, particularly in Flow, I mean you're seeing the margins come through on the weak growth numbers, so maybe—you talked about them at a high level. Maybe if there's a couple of examples you can kind of take us through as to some things that are being done differently today than maybe a year ago, across the enterprise, maybe?

Mark Borin:

Sure. One of the things we've talked a lot about is we've separated with optimization and really looking at where did we have complexity and how could we get after complexity reduction and the Flow Technology segment was certainly one of those businesses where we saw a high degree of that SKU rationalization, things that inherently drive up cost and drive down margins, and the team really got after that as we exited 2017 and throughout 2018, and so we're starting to see those activities and actions pay off here in 2019.

Also, we've also talked about some of the factories where we've had some challenges. We've been investing in automation and in other technology to replace and improve some of the older equipment and machinery that's used in some of those factories. That's also starting to read out; early stages, so there's more of that to come as we think about 2020, but we're, again, seeing favorable signs and encouraged by what we're seeing.

Joe Giordano:

Maybe last for me, if we look—I know it's too early to talk 2020, but if we just think about a situation where there is inventory is cleaned up through your partners and we could start ramping a little bit, one, I think about free cash flow, there was a nice performance here in the quarter. Is that going to be—how much of a headwind do you see that being in '20 as things kind of ramp up and you have to start producing at a higher rate?

Mark Borin:

I think we still have opportunity to really focus on cash flow and we continue to view cash flow targeting at approximating adjusted net income, so we wouldn't change that point of view even though, as we grow, to your point there may be some working capital type things that we need to invest in, but there are opportunities in other places that we would manage and balance out to have that long-term target still maintained.

Joe Giordano:

Great. Thanks, guys.

John Stauch:

Thank you.

Operator:

Your next question comes from the line of Mike Halloran with Baird.

Mike Halloran:

Hey, good morning, everyone.

John Stauch:

Hey, Mike.

Mark Borin:

Good morning.

Mike Halloran:

A couple of ones. First, just on capital usage here, any thoughts to bringing back—being more aggressive on the buyback side again? Then, secondarily, related to that, how does the M&A pipeline look? What's the willingness, ability to bring something in, and how are the valuations looking out there?

John Stauch:

I think clearly we're focused on execution right now, Mike, and part of that was making sure we're delivering on our commitments Q2, Q3 and Q4, so that's our first focus area.

I think there is the growing opportunities to invest in the platforms that I mentioned and we're continuing to look at those tuck-in acquisitions, I would say, that feed more of what we've done already, but you can never time those. You have no idea where they're going and we just want to make sure that we're protecting the balance sheet heading into next year and giving ourselves flexibility to do what we think is going to drive the most amount of value.

Mike Halloran:

The pipeline, on that side though, John?

John Stauch:

Good.

Mike Halloran:

All right. Then just thoughts on the price cost side. You talked—it seemed like you were implying that the price cost side should be a little bit more favorable moving forward from here. Maybe talk about puts and takes on the pricing side as that kind of flattens out a little bit relative to the commodity side and how you're thinking about that moving into next year.

Mark Borin:

Maybe the way to think about it we had significant price cost headwinds as we talked about coming out of last year and into the beginning of this year. Now, what I referenced in Q3 in particular was favorability because we've got—we've got favorable price and we have inflation moderating. As you move forward, that favorable year-over-year price will start to be a little bit more at a more normalized level versus the unusually high price increases that we had in 2018 that spilled over into 2019. It's more of a stabilization story rather than a benefit. It's just mitigation of what had been a pretty significant headwind.

On the inflation side, one thing to always keep in mind is inflation is not just the material or commodity inflation but we certainly also had labor inflation and we don't see that going away or moderating, so that will continue to be part of how we think about what our 2020 will look like.

Mike Halloran:

Thank you, appreciate it.

John Stauch:

Thanks.

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.

Jeff Hammond:

Can you just talk about what is informing the lower growth rate in Filtration, and then just as you look forward, we're hearing a lot about macro slowing. Just where are you seeing some signs of slowing in your business outside of that Ag space?

Mark Borin:

Sure, as I talked about, in Q3 we saw pretty improved performance in the Food and Beverage part of the Filtration business. That moderates a little bit in Q4, so that's part of the story. We do see continued stabilization and incremental improvement on the important Residential and Commercial side, both the systems and components business where the investments in those acquisitions took place.

Overall, just more of a moderated view given the performance in Q3 and then would expect to kind of, you know, moving into 2020 a similar level of performance and starting to see some of the investments that John talked about reading out in improved core sales growth.

Jeff Hammond:

Okay. Then just on Pool, what are you assuming and what are customers telling you about kind of the normal early buy situation? Then just if we look into 2020, certainly you've got some easy comps and typically this business grows mid to high single digits. Should we think of 2020 as kind of an easy comp and you can get back to those levels or above? Thanks.

Mark Borin:

On the first question and from an early buy perspective, we're seeing kind of a consistent early buy pattern. Last year was a little bit unusual because of the blend of the impact of the price increase, but what we're seeing this year is more in line with kind of the historical trends.

In terms of next year, as we've said, we're exiting Q4—you see the Q4 guide as what I would think of as back to a little bit more level of normalization, improved income performance, flattening of the top line which had been decreasing, and as we think about 2020 we're just going to really focus on getting back to what we believe would be performance in line with our long-term objectives.

Jeff Hammond:

Okay, great. Thanks, guys.

Operator:

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

Deane Dray:

Thanks. Good morning, everyone.

John Stauch:

Hey, Deane. How are you?

Mark Borin:

Good morning, Deane.

Deane Dray:

Hey, very well, thank you. How about can we put a little finer point on the working down the excess channel inventory in Pool? If we had been thinking it was around a $60 million excess, and just based on commentary about expected 4Q normalizing, how much should we think about that $60 million having been worked off so far?

Mark Borin:

As we talked, we worked down some of that inventory in line with sort of our expectations and we continue to see that coming down further in Q4 and exiting the year at levels that are in line with more historical seasonal patterns.

Deane Dray:

Okay. Then on Pool, John, you talked about some of the new product development in Filtration and Pool and automation. Just to set expectations, might you have some new automation offerings for the 2020 season?

John Stauch:

Yes, we do already and I think we're learning how to sell it better. We believe everybody can benefit from that automation capability. It's a different type of sale, though, and we have we believe the right products that can really help the user along and we have to tweak our ability to sell technology; it's not like selling a product, it's more like selling a service or capability. We learned a lot this year and I think we're encouraged by the progress we're making in Q3 and into Q4. I think those products are going to really accelerate as they head into next year.

Deane Dray:

When you say sell a service, is that something that Pentair would benefit from on a recurring basis, or is that a pool dealer that that would be part of their revenue stream?

John Stauch:

Clearly the vision would be that everybody would benefit, right, and that at the end of the day most people buy technology on a more rented basis because they believe whatever they have is going to be obsoleted. We'd have to align the channel that way, Deane, but ultimately, we think that's going to be the right answer.

We're launching in this quarter the new Pentair Home app which basically is a broad umbrella that takes all of the suite of products that Pentair offers and allows it to be connected into that Home app, and we're hopeful that as the consumer sees more and the more things that are available to either connect in with Alexa or Google Home or Apple or whatever your device is that you start to see the benefits of some of the monitoring of your water quality and then starting to buy some of the products and services that would attach to that.

Deane Dray:

That's good to hear. Just last one for me, when you talk about the commercial office water opportunity, are you thinking—and still, we agree that it's still very fragmented—are you thinking of a rental opportunity, or would this be equipment sales or both?

John Stauch:

Today it's about having the right systems and likely us selling them. Deane, as you know, the market does rent them, the end solution providers do rent units. Don't know yet if that's the space that we want to be in. But, you know, we were—we introduced carbonated water some 8 to 10 years ago. We were probably early in the market. We have all the technology and we deliver that for food service, and so how do we bring that into a commercial officer environment in a productive way, if that's what people want? As you guys know, there's a lot of fickle drinkers.

The first one is get tea and coffee. Most all tea and coffee needs to be filtered so you don't scale the units or cause damage to those units, and our filtration plays a big part in that. If we expand that filtration into other forms of water, we think there's a huge opportunity for Pentair.

This is forward-thinking. We believe we have the technology where it's probably not a '20 launch; it's probably somewhere into 2021.

Deane Dray:

Understood. Thank you.

John Stauch:

Thank you.

Operator:

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

Josh Pokrzywinski:

Hey, good morning, guys.

John Stauch:

Good morning, Josh.

Josh Pokrzywinski:

A quick question on price cost. I guess with working down channel inventory and kind of generalized market weakness, some of that related to weather earlier in the year, I would imagine it's harder to get price. Certainly, probably more room for incentives than to try to raise prices in the channel. Is that something we should expect to start expanding more rapidly from this point now that we've kind of cleared the season, cleared the channel overhang from an inventory perspective?

Mark Borin:

I think the best way to think about it, as I said before, is just more of a normalized level of price. As you know, a big chunk of the price that we see overall comes from the Pool business that they had unusually high price last year in response to inflation. This year they had a price increase that would have gone into effect in September, which is the normal timeframe that those price increases go into place and I'd call that more in a more normal historical level, and something similar in the other businesses.

We're not seeing—we didn't see any unusual reaction to price this year as a result of channel inventories, but we do see just going to a more normalized level given that last year's higher price was really driven by that incremental inflation.

Josh Pokrzywinski:

Got it. Then I guess as it pertains to the aquatic season, just as we kind of wound it down there in the third quarter, obviously you had a slow start with weather, particularly in some of the warmer regions that would have been bigger contributors in the first quarter. Did any of that get made up later in the year, just with the season maybe stretching out longer? Not even weather-related but just thinking of folks are always going to be busy kind of May through August, but maybe they do an extra job in September. Is that something that you guys noticed and maybe sets up a comp we should think about, at least in sell-through next year?

John Stauch:

I think some of it will—I don't think first of all the comp is meaningful enough, but yes, those pool builders will continue to work as long as they can in those areas and they'll fill in jobs in the slower season that they would have otherwise not done, but they will also probably likely celebrate the holidays that exist in Q4, so you're not going to see that same level of build that you tend to see in the more summer seasons.

Josh Pokrzywinski:

Understood. Thanks, guys.

John Stauch:

Thank you.

Operator:

Your next question comes from the line of Saree Boroditsky with Jefferies.

Saree Boroditsky:

Good morning.

John Stauch:

Good morning.

Saree Boroditsky:

Could you provide some color on what you saw geographically? I believe last quarter you talked about Europe and China being positive. Did that continue? Any expectations as we look forward towards the end of the year?

Mark Borin:

Sure. It did continue. We had commented earlier in the year that we saw some weakness in Europe, particularly on the Filtration side. As we moved through the year and again in Q3 and we really see through the balance of the year, we saw improvement there. Europe now is back to moderating growth and China as well is returned to a reasonably good growth level.

Saree Boroditsky:

Great. Then just on a more longer-term question on Aquatics, how should we think about the impact from the variable speed pump legislation that goes into effect in 2021?

John Stauch:

We believe in 2021 it should help our overall sales. Variable speed pumps for us today are probably just over half of our total pumps sold. They do sell at a higher sell-through value, so we do believe as the transition happens, those of us who have been through these transitions before always have to question when are those dates really going to happen, will there be slippage? Also, how does the inventory work its way through?

We're not putting anything into 2020, obviously, and we'll see if there's a relatively bump in 2021, but overall it should be positive to our business.

Saree Boroditsky:

Great. Thanks for taking my questions.

John Stauch:

Thank you.

Operator:

Your next question comes from Julian Mitchell with Barclays.

Julian Mitchell:

Thank you. Good morning. Maybe just following up on that geographic point, you'd emphasized some of the weakness in Ag and we've talked a lot already about residential trends in the U.S. in the past few months. Just wondered if you could give any detail around what you're seeing in some of the more commercial or industrial markets in the U.S., if there's been any particular shift in demand from month to month since July?

Mark Borin:

Nothing significant from a month-to-month perspective. Eighty percent of our business overall is driven by the residential and commercial end markets and as we move through the balance of the year we've talked about sort of the inventory impact, but beyond that the underlying demand has remained positive and we continue to see that kind of reading out through the balance of the year.

Julian Mitchell:

Thanks, and then on your sort of segment income bridge, I guess, on Slide 5, when we're thinking about the productivity portion of that in aggregate, it looks like it's probably, I don't know, maybe a $20 million tailwind or something for the year as a whole. If you could just sort of clarify if that sounds about right. Then, when thinking about next year, do we think about some of those measures that you've accelerated around productivity pushing that number up, or is that a pretty good run rate for the current demand environment?

Mark Borin:

I think what you're seeing in Q3 is more in line with the level that we would anticipate, and I think to remember kind of what makes that up, there's multiple elements. There's material productivity, which is where we're working on trying to mitigate some of the inflation headwinds. There's operating cost productivity. We'd think about that as looking at opportunities to reduce G&A cost, and then there's factory productivity. But then what offsets that is also the investments we're making in the growth areas around R&D and Selling and Marketing, investments in Technology and things like that.

As we think about this year and into next year, we'll continue to look for increasing levels of productivity but utilizing some of that to continue to invest in the areas where we see the biggest growth opportunities.

Julian Mitchell:

Thanks very much. One last quick one for me. Looking at the Filtration operating performance, you had pretty healthy sales growth there in Q3. The incremental margin was around 20% or so. Is that a reasonable sort of placeholder for that business with its current mix, or do you see anything sort of one-time within that figure?

John Stauch:

I wouldn't call it one-time but this is where we do have the residential systems and also the consumer services and we are significantly investing in those businesses, right? So, we're very encouraged by the top line growth we have and we continue to add back both digital marketing, advertising, branding and R&D spend to really accelerate the long-term growth there, so I think this is a more normalized pattern. As we head into 2020, as benefitting from the growth and then reinvesting a portion of that income back in to fuel more growth.

Julian Mitchell:

Makes sense. Thank you very much.

John Stauch:

Thank you.

Operator:

The next question comes from the line of Walter Liptak with Seaport Global.

Walter Liptak:

Hi. Thanks. Good morning.

John Stauch:

Good morning.

Walter Liptak:

I'm wondering if you—thank you. I wanted to ask the geographic question and just ask your comments about the EU Filtration kind of moving up to moderating growth and China doing okay now. I wonder if we could just get a little bit more detail about why, as when we look at macro numbers Europe continues to get worse; China, the GDP numbers continue to weaken. What's going on with your sector, with your market share that's helping us reach these?

John Stauch:

Yes, let me talk about China first. Our China business, we've said before, and China, Southeast Asia overall is Residential, Commercial, Filtration primarily. Think about that being just north of $100-and some million on an annual basis, so the growth rates we're talking about really about us starting from a relatively low base in a very enormous market in which we have a dedicated China team and we have a dedicated factory, dedicated R&D lab, and we've really invested a lot in new product growth and marketing. We're winning in a space that may or may not overall be growing, but we have a lot of runway left in that area.

In Europe, Mark gave you overall numbers and that is appropriate. Within those overall numbers there's things that are doing well in Europe and there's things that aren't doing so well in Europe. As we look at some of the global industrial product lines we definitely saw slowdowns, and when you take a look at some of the more installed base Residential and Commercial aftermarket businesses they're doing okay. In now way would we call it a robust market environment?

Walter Liptak:

Okay. Can you help with the size of the EU industrial business?

Mark Borin:

Yes, it's 100? Roughly $100 million.

John Stauch:

One hundred total for the year?

Mark Borin:

For the year. Right, not for the quarter.

Walter Liptak:

Then to switch gears over the R&D, hearing about the investments, in 2020 is it similar levels of R&D but more focused around some of these growth opportunities, or should we expect some kind of a step-up in R&D spend?

John Stauch:

I think you're going to expect to step up. I've said many times that we have the ability to invest a lot more in R&D, and we'll feel better about that investment when we feel Marketing has done the work to product the roadmap of where our R&D will be best utilized. We're really excited about our automation platforms and we have a global innovation center around automation, a One Pentair solution that we worked across the enterprise. Really excited about that roadmap.

Then, around our treatment and the water treatment innovation center, really excited about the nano and ultra filtration technologies out of the CPT acquisition, our X-Flow business, and expanding those into both Residential and Commercial. Very excited.

Then, as I mentioned earlier, building systems capability that takes that technology and gives the overall solution, those are the double downs for me and the team and I'm going to accelerate that investment in 2020 and probably 2021 and we're encouraged and excited by the products at the other end of that investment.

Walter Liptak:

Okay. All right, sounds great. Thank you.

Operator:

Your next question comes from the line of Brian Lee with Goldman Sachs.

Brian Lee:

Hey guys, good morning. Thanks for taking the questions. Maybe just first one on price, going back to that topic to clarify a bit. I know 2019 was a bit abnormal with the 3 points here, and I know it's early for 2020, but do you think it's reasonable to assume we just settle back to somewhere around a point in price for next year like we've seen in past years, or was the pricing this year late enough in the year where there's still some spillover into the early part of next year?

Mark Borin:

Yes, I'd think about it as slightly higher than that. One percent that we've seen sort of prior to 2018 for the few years prior to that, it had been right around 1%, but I'd call that historically low, so something in the 2% range is probably a little bit more in line with what would be historically normal.

John Stauch:

With a rounded range on that, 50 basis points-ish. I mean I think it's too early to say. The businesses that went out in September, as Mark said, I mean we were out in that range that Mark said and we saw all those pricing stick and were generally well received by the overall customers and those are more normal. Then, we'll see how the others do.

Brian Lee:

Okay, great. That's helpful. Then just a second question going back to Flow for a second. I know you kind of walked back the core growth outlook for that segment through the year and you sort of did the opposite last year in walking it up through the year. How de-risked is the view here for 4Q, just given how lumpy it's been all year, and then as you think about 2020, is this a segment you'd expect to grow year-over-year along with the overall business? Thanks.

John Stauch:

I can't call it de-risked. I can tell you that it represents the last multiple quarter's trends, and doesn't produce any incremental upside sequentially from things growing off of how they did the previous quarter. There is some year-over-year benefit, as you look at Q1 and Q2 in this business next year and then we'll see how confident we are when we come out with a guide of being able to drive organic growth in Q3 and Q4 of next year.

Brian Lee:

Okay, fair enough. Thanks, guys.

John Stauch:

Thank you.

Mark Borin:

Thank you.

Operator:

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

Brett Linzey:

Hi. Good morning, guys.

John Stauch:

Good morning.

Mark Borin:

Good morning.

Brett Linzey:

Just wanted to come back to Aquatics. You had talked about some of the technology and growth priorities you have there in Pool. As we think about those incremental costs and price moderating but also some relief on (Indiscernible) and other spending, what's the right incremental margin range we should be thinking about next year as you maybe see a more normal top line?

John Stauch:

This business has a fairly sizable drop-through because it's sales (inaudible) material and a really efficient manufacturing process, so good drop-throughs. I'm not going to give you an answer because this is a huge value contributor to Pentair and I want to invest in this, and I think we have some really exciting technology in the pipeline here as well and we'd like to put some investment back in the Sales channel, primarily around the aftermarket side. I think we do a really nice job with our dealer channel covering both new pools and remodeled pools. I think our opportunity is in being farther down the aftermarket cycle with the services channel and making sure we're the company of choice for consumers in that services play, and then also making sure that we go back to our roots and I still say we are the technology leader, but we used to be significantly more advanced than we are today and we believe we have those technologies in the pipeline and need to drive them through that new product development phase, and that will be an investment thesis for 2020 as well.

Brett Linzey:

Okay, great. Then shifting to restructuring, you took I think $6 million this quarter, $7 million last quarter. Are you budgeting more spending in Q4? Then, just thinking about the payback, did most of that get realized in the quarter or do you see some of that rolling over into 2020 and from a savings standpoint?

John Stauch:

We don't include in our guidance an expectation around restructuring but I would anticipate there would be some incremental restructuring again in Q4. The investments in restructuring that we've made this year really wouldn't see those necessarily reading out now but those would be part of how we think about 2020.

As Mark mentioned, we're attacking some of the factories and some of the efforts within the factories. Those tend to have a little bit longer payoff than just structural changes to the business. They're the right investments. We do have a larger footprint than we need and it isn't always geographically perfect, so we've addressed some of that, especially on the Flow side, as Mark mentioned, and while we're seeing the margin improvement I think there is still an opportunity for more margin improvement down the road.

Brett Linzey:

Okay. Geographically, where were those costs focused? Restructuring.

Mark Borin:

A little bit everywhere.

John Stauch:

Yes.

Brett Linzey:

Okay. All right, great. I'll pass it along. Thanks, guys.

John Stauch:

Thank you.

Operator:

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

John Stauch:

Thank you for joining us today. We are encouraged by our third quarter performance and we continue to see further signs of stabilization in our core business. We saw a further productivity improvement in the quarter and we continue to build on our strong culture. We have been investing and will continue to invest in our key growth strategies as well as digital enterprise capabilities to better serve our customers. We have a strong capital structure, solid free cash flow 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. Dorothy, you can conclude the call.

Operator:

Thank you. Ladies and gentlemen, that does conclude today's conference call. We thank you for your participation and ask that you please disconnect your lines.