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Q2 2023 Pentair plc Earnings Conference Call

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CORPORATE SPEAKERS:

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Robert Fishman

Pentair plc; Executive VP, CFO & CAO

John Stauch

Pentair plc; President, CEO & Director

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PRESENTATION:

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Operator^ Good morning, and welcome to the Pentair Second Quarter 2023 Earnings Conference Call. (Operator Instructions) Please note that this event is being recorded today.

I would now like to turn the conference over to Shelly Hubbard, Vice President of Investor Relations. Please go ahead.

Shelly Hubbard^ Thank you, Joe, and welcome to Pentair's Second Quarter 2023 Earnings Conference Call. On the call with me are John Stauch, our President and Chief Executive Officer; and Bob Fishman, our Chief Financial Officer. On today's call, we will provide details on our second quarter's performance as outlined in this morning's press release.

On the Pentair Investor Relations website, you can find our earnings release and slide deck which is intended to supplement our prepared remarks during today's call and provide a reconciliation of differences between GAAP and non-GAAP financial measures that we will reference. The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company's performance in addition to the impact these items and events have on the financial results.

Before we begin, let remind you that during our presentation today, we will make forward-looking statements, which are predictions, projections or other statements about future events. Listeners are cautioned that these statements are subject to certain risks and uncertainties many of which are difficult to predict and generally beyond the control of Pentair. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to carefully review the risk factors in our most recent Form 10-Q and Form 10-K. Following our prepared remarks, we will open up the call for questions. (Operator Instructions)

Before I hand it over to John, I wanted to highlight Slides 4 through 7 in our earnings slide deck that include our strategic framework, Pentair at a Glance, a Pentair overview and our newest slide illustrating our ESG highlights and progress. These 4 slides provide a good snapshot of who Pentair is, especially for those new to our company.

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Our strategic framework states our purpose, mission, vision and values that drive our performance as a smart, sustainable water solutions company. Pentair at a Glance on Slide 5 provides a great snapshot of our company, our performance, our installed base and our 47-year track record of annual dividend increases, which places us in a small group of companies. The Pentair overview on Slide 6 provides our historical sales and ROS performance on a consolidated level and by segment. Lastly, our ESG highlights and progress shown on Slide 7 are a testament to the important work our teams do to integrate sustainability into our operations, product innovation and long-term strategy. We are very proud of our achievements to date, especially considering the early stages of program, which began just about 3 years ago.

I will now turn the call over to John.

John Stauch^ Thank you, Shelly, and good morning, everyone. Let's begin with our record Q2 results and the executive summary on Slide 8. In Q2, we achieved record sales, segment income, return on sales, EPS and free cash flow following the separation of nVent from Pentair in 2018. Specifically in Q2, sales increased 2% to nearly \$1.1 billion, Segment income increased 14% to \$234 million. ROS expanded by 230 basis points to 21.6%, driven by margin expansion across all 3 segments. Adjusted EPS rose 1% to \$1.03, and free cash flow was \$433 million. With another strong quarter of financial results, we are raising our 2023 adjusted EPS range to \$3.65 to \$3.75, which increases the midpoint of our range to \$3.70.

We also continue to strengthen our balance sheet and reduced our net debt leverage ratio to 2.2x EBITDA at quarter end, down from 2.6x in Q1. We believe our record second quarter performance demonstrates the power of our global diversified water portfolio and strong execution across all 3 segments: IFT, Water Solutions and Pool. Our strategy to help the world sustainably move, improve and enjoy water, life's most essential resource is proving its resilience.

For example, like last quarter, sales growth in our IFT and Water Solutions segments more than offset the expected sales volume declines in Pool year-over-year. Margin expanded across all 3 segments, driven primarily by price, cost actions to rightsize our direct labor and pool, the elimination of 2022 manufacturing and supply chain

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inefficiencies and continued progress on our transformation initiatives that are beginning to read out.

Lastly, I want to thank our employees across the globe for their hard work, dedication and contribution to delivering another strong quarter for customers and shareholders.

Let's move on to Slide 9, titled Q2 segment highlights. Within IFT, we achieved record sales, driven by double-digit growth across our commercial and industrial businesses. Commercial and infrastructure flow delivered strong sales growth across all categories, primarily due to our strong backlog, aftermarket and replacement sales in our pump portfolios, carryover pricing actions from 2022 and stabilization in the supply chain.

Industrial Solutions also delivered strong sales growth, driven by global key account expansion, new business partnerships and aftermarket and replacement sales in our components and membranes portfolios. Record margins in Q2 were primarily driven by price and transformation. In addition to implementing our transformation initiatives in IFT, we have also focused on capturing the right projects with improved offerings to drive margin expansion. In Water Solutions, our commercial offerings drove very strong sales growth and margin in Q2, which benefited in part from the continued recovery of foodservice and hospitality venues post the pandemic and a shift in consumer behavior from products to services. In fact, in 2023, the number of locations of the top 500 chain restaurants in the U.S. now exceeds the 2019 benchmark according to the Technomic Top 500 chain restaurant 2023 report.

We also saw strength in commercial filtration sales in North America. Our Manitowoc Ice acquisition continued to outperform our expectations delivering strong sales and margins that were accretive to the Water Solutions segment. Over the last few years, Manitowoc Ice has expanded its sales driven by a focus on its consumer, with a targeted go-to-market strategy, effective management of macro supply chain challenges and reliability in its supply chain to deliver product with better lead times. We are very pleased with the acquisition and how it complements our commercial Water Solutions businesses enabling us to provide end-to-end water solutions for customers from filtration to ice to services.

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Lastly, we believe that the residential water treatment is nearing the bottom of the cycle, we believe our residential business is stabilizing and lead times have improved. Awareness of PFAS or forever chemical that have been found in drinking water continues to rise. We are proud to say that we have products today for residential consumers that reduced PFAS to current certification levels. And we continue to drive new innovation and invest in R&D to be able to provide more products that are certified to produce PFAS. We believe we have positioned the company well to be a leader in this space.

Within Pool, 2023 has been a softer and difficult year as we expected, given the higher than historical demand in 2021 and '22 coupled with supply chain challenges that disrupted our lead times during those periods. Our lead times have returned to approximately 5 days on most of our products. However, the channel continues to work through higher inventory creating a sell-in versus sell-through imbalance for Pentair in 2023. Despite these lower volumes in Q2, we drove significant margin expansion from price, cost actions to rightsize labor to lower volumes, eliminated 2022 sourcing and manufacturing inefficiencies and delivered transformation savings.

We continue to expect Q3 to reflect a bottom in Pool volume for Pentair as we expect higher channel inventories to correct, allowing for sell-in to be more closely aligned with sell-through. We have noted in the past that our typical Pool sales mix reflects 40% from new and remodeled pools and 60% from the aftermarket break-and-fix replacement sales. While the number of new pools this year is lower, than the elevated number of new pools built during the pandemic, the installed base of U.S. pools has continued to grow. Despite the short-term reset in 2023, we believe Pool remains an attractive market.

Before I turn it over to Bob, let's turn to Slide 10, titled CEO Summary. We delivered another quarter of quality earnings with ROS expansion across all 3 segments. Our IFT and Water Solutions segments more than offset Pool volume declines, and our transformation initiatives are well underway. Our strong first half has resulted in another 2023 guidance increase. And we believe our Pool business is well positioned for return to growth following the channel inventory correction, which we expect to be completed by Q3 quarter end.

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All in, we are building a strong foundation to drive long-term growth and profitability across our diverse water portfolio. We are introducing Q3 guidance and raising the full year adjusted EPS range to \$3.65 to \$3.75, the midpoint of \$3.70 is up \$0.05 from prior guidance due to a strong Q2. We have also updated our segment sales expectations to reflect stronger sales in IFT and Water Solutions driven by a strong first half of 2023 and lower expected sales in our Pool segment.

We continue to closely monitor macroeconomic developments and remain mindful of an uncertain operating environment. We continue to implement risk mitigation strategies, and we are accelerating transformation funnels as necessary while focusing on investing in the long-term growth of our company. We remain confident in our diversified water business model, long-term strategy and our transformation initiatives, which we expect to continue to drive shareholder returns. We have a long successful track record of generating strong cash flow and being disciplined with capital allocation. We have achieved 47 consecutive years of dividend increases and are targeting high-teens ROIC. We have a strong balance sheet and an enviable 5-year track record in financials.

I will now pass the call over to Bob, who will discuss our performance and financial results in more detail. Bob?

Robert Fishman^ Thank you, John, and good morning, everyone. Let's start on Slide 11, titled Q2 2023 Pentair Performance.

We delivered record second quarter sales of nearly \$1.1 billion, up 2% year-over-year. This is compared to a previous sales record in last year's Q2 of \$1.06 billion post the separation of nVent from Pentair in 2018. Our IFT and Water Solutions segment continued another quarter of strong sales performance, which more than offset lower Pool volumes.

Sales growth in Q2 included strong price contribution and the Manitowoc Ice acquisition, which closed in July of 2022. The volume decline in Q2 was primarily related to our pool and other residential businesses which was partially offset by strength within Commercial and Industrial. Please note that where I referenced record results,

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I'm referring to Pentair's performance post the separation of nVent from Pentair in 2018.

Core sales improved 9% in both IFT and Water Solutions with Pool declining 28%, compared to the prior year periods, pool sales increased 19% in Q2 2022 and 49% in Q2 2021. Second quarter segment income increased 14% to a record \$234 million and return on sales expanded 230 basis points year-over-year to a record 21.6%, this improvement was driven by price more than offsetting inflation, accretive segment margins from our Manitowoc Ice acquisition, the elimination of 2022 manufacturing and supply chain inefficiencies and productivity benefits from our transformation initiatives.

We delivered record adjusted EPS of \$1.03. Net interest expense was \$33 million, and our adjusted tax rate was 15% during the quarter with a share count of 166.1 million.

Please turn to Slide 12 labeled Q2 2023 Industrial & Flow Technologies Performance. Industrial & Flow Technology sales increased 9% and year-over-year, driven by commercial sales growth of 28% and industrial sales growth of 13%, which more than offset a decline in residential sales of 4%. Segment income grew 27% and return on sales expanded 250 basis points to 18.2%, marking the fourth consecutive quarter of equal to or greater than 200 basis points of improvement. The strong margin expansion was a result of price offsetting inflation and continued progress on our transformation initiatives.

Please turn to Slide 13, labeled Q2 2023 Water Solutions performance. In Q2, Water Solutions sales increased 51% to \$336 million driven by our Manitowoc Ice acquisition, volume and price. Manitowoc Ice has continued to exceed our expectations. Q2 sales were approximately \$135 million, up roughly 30% compared to the prior year period. Segment income grew 130% to \$75 million and return on sales expanded 760 basis points to 22.2%, driven primarily by our Manitowoc Ice acquisition as well as efficiencies from our transformation initiatives. Within our residential business, we are seeing North America stabilized. We have also been evaluating our SKU mix and reducing complexity.

Please turn to Slide 14, labeled Q2 2023 Pool performance. In Q2, Pool sales declined 28% to \$334 million. The volume decline of 36 points was primarily due to channel

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inventory corrections in Q2. This year, a strong Q2 2022 comparison and cooler and wetter than usual U.S. weather. The pricing benefit of 8 points helped partially offset the volume decline. Despite lower Pool sales in Q2 2023, return on sales expanded 190 basis points due to price significantly offsetting inflation, rightsizing direct labor to align with lower volumes, the elimination of 2022 manufacturing and supply chain inefficiencies and benefits from our transformation initiatives.

Please turn to Slide 15, labeled Pentair Pool sell-in versus estimated industry sell-through. This slide provides an illustration of our Pool sale sell-in and the estimated comparison to industry channel sell-through since 2019. Here, you can see the imbalance of sell-in and sell-through beginning in 2020 and continuing to expand in 2021 and 2022 due to record inflation and supply chain disruption. In 2023, we have returned to normal lead times and sell-through is returning to normalized levels. We expect sell-in and sell-through to rebalance by 2024, following approximately \$150 million of channel inventory correction in 2023. We expect this 2023 inventory correction to become a tailwind in 2024.

Please turn to Slide 16, labeled transformation initiatives. Our transformation initiatives focus on 4 key themes: pricing excellence, strategic sourcing, operations excellence and organizational effectiveness. As we've mentioned in past quarters, we expect strategic pricing actions to benefit the top line of all 3 of our segments. We expect our other 3 transformation initiatives to help improve our overall cost structure. As a result, we are targeting ROS of approximately 23% by the end of fiscal 2025, expanding margins over 400 basis points as compared to fiscal 2022.

Please turn to Slide 17, labeled Transformation runway. As you look at each of the 4 key themes, you can see that the work within these transformation initiatives is in various different stages. For example, in 2023, we are beginning to see early readouts from Wave 1 within pricing, sourcing and operations. We are beginning Wave 2 within each of these 3 themes and expect margin benefits to readout in 2024. You could see how each new wave compounds on the other to drive expected margin expansion year-over-year through 2025 and beyond.

In pricing excellence, the strategic pricing playbook has been developed, which is planned to be rolled out by category within each segment. We have completed internal

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training and plan to implement these actions over the next few months. In strategic sourcing, the implementation of Wave 1 is underway, with savings currently reading out. We expect to kick off Wave 2 later this summer with readouts beginning in 2024. Incremental to our strategic sourcing waves, we have seen benefit from our rapid renegotiation process that is part of our transformed sourcing excellence work.

In operations excellence, we have completed the consolidation of 2 facilities while continuing our execution on lean transformation plans across our sites. In organizational effectiveness, we are in the earliest stages with Wave 1 and expect margin benefits to be realized beginning in 2024. Due to the staggered nature of these transformation initiatives, you can see that what we expect Wave 3 to begin to read out post 2025 in operations excellence and organizational effectiveness. Overall, we are excited about the savings. We have begun to realize from the early waves and remain confident that our teams can execute on pricing actions and savings we have identified particularly in sourcing.

Please turn to Slide 18, labeled balance sheet and cash flow. With our record free cash flow in Q2 up \$433 million, up \$144 million from the prior year period and the repayment of debt, we have lowered our pro forma net debt leverage ratio to 2.2x, down from 2.6x in Q1. As a reminder, our second quarter is typically our highest free cash flow quarter. We expect our full year free cash flow to be in line with our historical performance of approximately 100% net income.

Our return on invested capital was 14.9%, which includes debt from the Manitowoc Ice acquisition, but only approximately 4 quarters of Manitowoc EBITDA contribution. Our target ROIC is high teens. In Q2, we entered into interest rate swap and collar agreements in order to hedge our variable rate debt. Our variable to fixed debt is now 48% and 52%, respectively, with an average rate of approximately 5.3%. We have no significant long-term debt maturing for the next 5 years and the majority of our debt is in term loans going out 3 to 5 years. We plan to remain disciplined with our capital and continue to focus on debt reduction amid the higher interest rate environment.

Moving to Slide 19, titled Q3 and Full Year 2023 Pentair Outlook. For the full year, we are raising our adjusted EPS guidance to approximately \$3.65 to \$3.75, increasing the midpoint to \$3.70. Also for the full year, we expect sales to be roughly down 2% to flat,

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which is unchanged from our prior guidance in Q1. Segment income to increase 10% to 12% as compared to up 7% to 10% in prior guidance, with corporate expense of approximately \$80 million, net interest expense of roughly \$125 million, an adjusted tax rate of approximately 15% and a share count of 165 million to 166 million.

Our assumptions on corporate expenses, net interest expense, adjusted tax rate and share count remain unchanged from guidance provided last quarter. For the third quarter, we expect sales to be down approximately 7% versus last year's near record Q3. This is mainly attributable to lower year-over-year Pool sales as we expect the channel inventory correction to be completed by quarter end. We are also introducing adjusted EPS guidance for the third quarter of approximately \$0.84 to \$0.89. We expect segment income to decrease 1% to 6% with corporate expense of approximately \$21 million, net interest expense of roughly \$31 million and adjusted tax rate of approximately 15% and a share count of \$165 million to \$166 million.

Moving to Slide 20, titled Full Year 2023 guidance at midpoint. At the midpoint, we continue to expect total Pentair sales to be down approximately 1% to approximately \$4.1 billion. Due to strong Q2 performance in IFT and Water Solutions we have updated our segment sales assumptions as follows: we now expect IFT sales to be up approximately mid-single digits, up from low single digits; within IFT, we expect residential to be down approximately mid-single digits; and commercial and industrial to be up low double-digits. Water Solutions sales are expected to be up high teens versus mid-teens. Commercial is expected to rise approximately 50%, with residential sales down roughly 10% and the expected Pool sales range remains unchanged at approximately down mid-teens, although we now expect sales to be down at the higher end of this range due to a softer Q2.

As we have discussed in prior quarters, our Pool sales consist of approximately 40% from new and remodeled pools and 60% from aftermarket. Within our current Pool guidance, we now expect new pools and remodels to be down approximately 25% to 30% versus previous assumptions of down approximately 25% and inventory in aftermarket to be down roughly 20%, unchanged with approximately 2/3 of the decline relating to inventory corrections. We expect price to be up roughly mid-single digits. We expect Pool sales to return to more normalized sell-in, in 2024 after absorbing significant inventory correction headwinds in the current year. Segment income is now

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expected to increase approximately 11% at the midpoint as compared to 9% previously with ROS expansion of over 200 basis points to 20.9%, up 40 basis points from our Q1 guidance.

Overall, we are excited about the future. We believe the diversification of our portfolio has proven that we can weather challenges in 1 segment while continuing to grow total Pentair sales and expand margins across all 3 segments, despite significant volume declines in our residential businesses. We are seeing progress in our transformation initiatives, generating strong free cash flow and further strengthening our balance sheet with the repayment of debt.

Before I turn the call over for Q&A, I wanted to highlight why we believe that Pentair is a compelling investment opportunity. Please turn to Slide 21. There are 6 distinguishing characteristics that we believe sets Pentair apart. We are an industry leader with a diversified brand portfolio and a focus on driving innovation across all 3 segments. We have a transformation strategy that is expected to drive operational efficiencies and margin expansion.

Our ESG focus is on making life better for people in the planet with our smart, sustainable water solutions. We recently published our 2022 Corporate Responsibility Report, highlighting progress towards our strategic targets. We have favorable secular trends driving end market growth. We have a strong balance sheet and cash flow, which we expect to drive additional value creation and we are a dividend aristocrat with 47 consecutive years of increased dividend.

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

Operator^ (Operator Instructions) Our first question here will come from Julian Mitchell with Barclays.

Julian Mitchell^ My first question, I suppose, was really around -- when we're looking at a couple of the guidance increases in the non-pool divisions, just wanted to try and understand the cadence of sales a little bit better through the back half. If I look at the Water business, for example, it looks like the guide implies a pretty heavy sequential

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declines in Q3 and 4. I just wanted to make sure I understood that right. And then also within IFT the guides implying year-on-year growth evaporate in the back half. Is that just a function of comps or something changing in the end market sell-through?

John Stauch^ I think we would describe it as more moderating, Julian. I think clearly, our Manitowoc performance from a year-over-year basis, there's a huge acquisition component year-over-year, but there's also the organic growth of nearly 30%, as Bob mentioned in his comments, those are the result of industry demand and our ability to fulfill those industry demand. And eventually, we start to moderate and compare against year-over-year comps that are more normalized. In the IFT side, I think what we're seeing is really strong growth in commercial and industrial, again, backlog related that will again moderate in the back half of the year. Moving to what I would say is more normalized on growth rates that we would expect on a longer-term basis, Julian.

Julian Mitchell^ Understood. And then just my quick follow-up on the Pool segment. On that point on inventories. So, it's obviously the sort of the weather impact early in the second quarter, which have been very well flagged for months now. Is your point that maybe delayed the requisite inventory depletion early on. But what's happened, say, so far in Q3, that's why you feel confident that the inventory depletion is on track to be finished by the end of September. Maybe just any color on how your conversations with channel partners and what you see on the sell-through, how has that evolved in the last 2 to 3 months?

John Stauch^ Yes. I think just on the Q2 numbers for Pool, I mean, it's solely in my opinion, related to more inventory coming out of the channel than we expected. I think the channel has done an amazing job of working and moving and migrating the inventory around branches to where it's needed, and they are aggressively working to eliminate that extra inventory from the channel. I think as we talk to our channel partners for Q3 and Q4, we continue to believe that all of the inventory or the excess inventory will be worked out in Q3, reflecting our current guide, and we would be talking on more normal early buy discussions as we ramp into Q4 as we anticipate the 2024 demand, and coming back to a more normalized seasonal performance. That being said, Pool is, in our opinion, really low in Q3 from our revenue forecast as it deals with that volume decline for us related to that inventory and channel correction.

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Operator^ Our next question here will come from Andy Kaplowitz with Citigroup.

Andrew Kaplowitz^ John and Bob, maybe give us a little more color into the progress on transformation because if you look at the segments, obviously, IFT, for example, 18.2% seems quite a bit ahead of plan. So what has gone right for you guys here over the last couple of quarters? And would you expect that progress to continue?

Robert Fishman^ I would say we're very pleased with Wave 1 across the board, particularly pleased within sourcing. As a reminder, Wave 1 consisted mainly of motors and drives, casting, electronics, logistics, packaging and then Wave 2, you can think of that as being metals, resins, purchase finished goods and a component of indirect spend. We've seen a lot of benefit within the transportation area within Wave 1 and 2024 is setting up for benefits in the other components of the Wave 1 spend.

One of the areas that we've done a really nice job is capturing deflation, particularly across resins, plastics, motors, metals and castings where our team went in and did an expedited response to what they saw in the global marketplace. We're able to strengthen relationship with suppliers and actually take advantage of pricing that was coming down in the number of different commodity groups. I would say within kind of the ocean space, the expedited air on the air consumption, that's down over 50% from where it was last year. And ocean rates are down some 65%.

The final thing I would say is that we've done a really nice job of rightsizing to the volumes that we expected from a direct labor perspective, and that's all about having headlights into the business and taking the corrective action. And then finally, there were a lot of inefficiencies in 2022. Spot buys, expedites, partial truckloads, partial completion of products where we'd have to push a 90% complete product off the line and wait for a part to come in. We had overtime attrition. We've done a really nice job of addressing those inefficiencies as part of the transformation as well. So across the Board, we're very pleased and I'm very thankful to the team that works on this every day.

Andrew Kaplowitz^ Bob, it's good color. And then maybe somewhat related question around pricing and particularly in Pool. I know it's one of your initiatives there, too. But - - maybe you could talk about your ability to hold price given the way the markets are.

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Have you seen any deterioration? Obviously, your margins were still good, and how would you think about Pool margin moving forward?

John Stauch^ Yes. So I think as we head into 2024, we're certainly pleased with the way prices held up in 2023 in relationship to what Bob said. And I think that's indicative of the way that ROS expansion has unfolded. I think we're going in a more normalized pricing environment now, Andy. And I think that -- that means that we have to rely on those price increases and work hard on the productivity aspects to drive the margin. And I think we're going to see normal and then I think it depends on how these industries fare as to what would be the expected hold rate or the realization rate of those price increases in 2024, and it's way too early to tell.

Operator^ And our next question here will come from Bryan Blair with Oppenheimer.

Bryan Blair^ I wanted to ask about transformation, obviously driving pretty strong results already, and you've noted that you're early stage and the respective waves of those initiatives. As we look to your 2025 gross target to level set, what are you baking in for core growth between now and then? And then what level of reinvestment is contemplated? The reason I ask is that just the simple math, if we assume any core growth in kind of moderate realization of the sourcing opportunity that you've identified that seems to drive ROS above the targeted range and then the other levers imply pretty solid offset.

John Stauch^ Yes, I think that's fair, Brian. I think I would talk about, as Bob mentioned, we're really pleased on the early indications of transformation. As a reminder, we're using outside partners to give us benchmark looks at what's possible and working with us to give us breakthrough thinking and putting in establishing core processes to drive this transformation. So we feel like it's going to be consistent and predictable. The one thing I would share with you, though, as you look at our targets is they're also inclusive of investments and we have a lot of energy around investing in our channels, our obsession around customer experiences, improving those customer experiences and investing in innovation. And those are offsets to the transformation benefits that we would expect. And as you can imagine, Pool has been an innovation leader for many years. It's been playing a little bit of defense lately. And we want to put our foot to the

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pedal there and really drive both product innovation and go-to-market innovation. So expect us to invest back in our businesses.

Bryan Blair^ Understood. That all makes sense. Appreciate the color. I know your attention focused on debt reduction since the Manitowoc Ice closed. But your balance sheet starting in pretty solid shape. You're generating really robust cash flow given your financial position and clearly successful integration of Man Ice, just wondering if your team will get back to bolt-on or tuck-in M&A over the near term?

Robert Fishman^ I would say that the focus for this year continues to be on debt pay down, where interest rates are. We think that's the wisest use of the capital. And then that creates optionality going into 2024 around share repurchase and M&A.

Operator^ Our next question here will come from Mike Halloran with Baird.

Michael Halloran^ So a couple of commercial questions here. First, on Manitowoc Ice. Can you just give some context to what's going on in the channel right now? I guess a little from an inventory perspective, but more from what are the customers saying from a demand perspective, how do you think about the sustainability of what you're seeing underneath the hood? And then some comments on how Man Ice is performing well to peers would be great.

John Stauch^ Yes. I think if you look back at the 8 years prior to 2019, 7, 8 years, like this has historically been a 5% to 6% steady grower with some years that might be slightly higher, slightly lower based upon how the restaurant and hospitality market unfolds. Clearly, if you take '19 as a starting point to where we expect '23 to finish, think about being high single-digits. What we want to remind people is there's a significant catch-up to the significant downturn that hospitality industry has faced and that's a big part of the start-up and the demand.

As I referenced in my note, we're now back slightly above the 2019 restaurant numbers. So I think we're going to see more of the historical trend pattern as we look forward in this business going forward. Our ability this year to grow faster was the share capture that was really based upon -- having gone through the supply chain work that we're doing elsewhere in Pentair, ironically and completely coincidentally, Manitowoc is using

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the same outsource partner that we're using on the rest of Pentair and started that sourcing initiative 3 to 4 years earlier than us. And so they were able to put the supply chain into place that allow them to be prepared and ready to partner to get these increased demands, and that's been a big benefit to the Manitowoc business. It's also very encouraging for us on what the rest of Pentair can realize as well.

Michael Halloran^ Good point. Kind of answer I was going to ask on the commercial question for the second part there and on the outlook side. So let me pivot to the IFT piece. It's nice to see the margins kind of tranche higher in these last couple of quarters. And I was just hoping to get a little bit more context to how you think about what that progression forward looks like for the segment specifically, how much impact the mix is going to have? Clearly, the transformational piece is a core part of that progression. And if there's any moving pieces below the hood that we should think about as you look to the back half of the year there?

John Stauch^ Yes, special call out to our commercial and infrastructure team on just getting to margins in ROS is that, quite frankly, Mike, I didn't think were possible, right? And I think they're doing it while they're growing, which is extremely encouraging.

That being said, I think as we go forward, it's going to be about how we continue to win projects and jobs that have aftermarket and service (inaudible) to them, how we can grow at mid-single digits, while maybe more likely maintaining these margins. Because as you know, when you get these tailwinds in the industry, it's easy to be selective -- it's harder to be selective when the jobs get tougher to find. And I think that's the discipline we're putting into the group.

But it's really encouraging to see the progress they made. I think they still see opportunities to expand the ROS. But again, this is an area we want to invest in. And as you know, one of the things that has always talked about is blue water, right? So we're really strong on the fire pump side, and we've been able to find synergies by bringing the clean water side to some of the projects we've worked on, and we've been able to do that at the appropriate margins. So it's really encouraging to see that growth and the margins at the same time.

Operator^ Our next question here will come from Brian Lee with Goldman Sachs.

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Brian Lee^ A lot of mine have been covered, but I had a couple of maybe modeling specific ones. I guess on the record ROS, when I look at the full year guide, I know this might be a little bit timing related or -- and maybe a little bit of nitpicking, but it seems like the implied ROS is down here in 4Q. Can you kind of walk us through some of the puts and takes just exiting the year? As you think about driving more expansion into '24 as your comments suggested?

Robert Fishman^ The guidance that we've given actually has us expanding ROS year-over-year, both in Q3 and even more significantly in Q4. So that is one of our rallying cries to continue to expand ROS year-on-year again, a little bit less in Q3 because of the headwind of the Pool business. But overall, transformation continues to read out in the back half of the year.

Brian Lee^ Okay. Understood. Yes, we'll go back and take a closer look at the model. And then maybe just on Pool. It sounds like you're pretty confident around trends bottoming here, inventory sell-through, sell-in normalization. So I know it's probably too early to tell, but any initial thoughts around what all of that points to the rest of this year kind of goes according to plan and pool. Are we thinking about a reasonable base case back to like mid-single digit volume, maybe low single-digit type pricing tailwinds in '24? Just sort of what's the setup as you think about what the normalization and how quickly it plays out, gets you to in terms of a reasonable base case to get back to normal growth trends in '24, potentially?

Robert Fishman^ One of the reasons why we added that extra chart was to try and give some view of the headwinds this year and what could be a potential tailwind for next year. So we did quantify the inventory correction at about \$150 million. And so that will not repeat next year. So in itself, that's a \$150 million good guide in 2024. We're not giving any view as to what aftermarket might grow, still too early from that perspective. But from an overall pricing perspective, price has been sticky from our perspective and that we do expect price increases as we go into next year.

Operator^ Our next question here will come from Andrew Krill with Deutsche Bank.

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Andrew Krill^ I wanted to go back to Water Solutions. Here, the margins were very strong in the second quarter. And historically, they've had a nice sequential step-up going into 3Q. So I know Manitowoc kind of changes the mix a bit. But I mean, do you still expect a meaningful increase sequentially there for the margin?

Robert Fishman^ Yes. We -- sequentially, we will be roughly in line, I would say, to maybe slightly down because we just won't drive that amount of volume and necessarily get the leverage that we saw from an Ice perspective. But overall, when we look at the different pieces, the filtration as well as the residential piece within Water Solutions, we continue to see transformation playing a big role. So I would say year-on-year, significant ROS expansion in Q3 for Water Solutions, a little bit of pressure as you go from Q2 to Q3 just because -- to John's earlier point, seasonality that's start to return to more normalized levels.

Andrew Krill^ Okay. Great. Makes sense. And I guess, to the extent you're willing to comment on weather, it seems like it's normalized so far in July. Any comments you can give on July trends so far for Pool and then maybe just for the broader company as well?

John Stauch^ Yes. I hate to bring the weather word into the focus. And as I said earlier, I don't think it played as much into our Q2 Pool softness as the inventory correction did. Weather usually intends to work its way out eventually throughout the period. So I would say right now, we're seeing heat trends that have some positives in certain areas to driving demand. And at the same time, when it gets this hot, you don't necessarily need heaters. So I don't -- I would not bring weather into our forecast at all. I think everything we know today from our weather forecasting has been included in our guide, and we don't expect weather to be a big part of our discussion going forward.

Operator^ Our next question here will come from Steve Tusa with JPMorgan.

Charles Tusa^ Not too bad. I'm not going to ask you about the assumptions that underlie your weather forecast. Yes. So just on the kind of phases of this transformation, you mentioned logistics? I mean obviously, the logistics prices in general are down, how do you like disaggregate what you guys are doing versus just like the normal deflationary cycles that are happening in these types of materials?

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Robert Fishman^ From our perspective, and I'm not trying to be flipping here, but even in the deflationary environment, there's work to be done. We need to go back to the suppliers and point out commodity prices that are coming down. So our view is that either through our negotiation process, either through the structured [11 gate] process within Wave 1 and Wave 2. We have to understand the market, first of all, make sure we're asking for price decreases or longer-term price stability and so it's all part -- from our perspective of that strategic sourcing initiative.

John Stauch^ But Steve, just to add on that, I agree with everything Bob said, and we're happy, but it is a benefit of the deflationary, the work we do to negotiate. But also, we have reduced our carriers by almost 2/3. And we did do a series of route optimizations and choose partners that are best to serve the routes and the lines that we need, and that was a big part of the work that's generating the savings.

Charles Tusa^ Right. That makes sense. Can you just remind us what the benefit from transformation is for next year? I'm not sure if you mentioned that earlier in the call.

Robert Fishman^ We did not.

Charles Tusa^ Can you just update us on what you expect that to be?

Robert Fishman^ What we've said up until now is we'll go from what will be roughly a 21% ROS this year to 23% by 2025. And our view is that roughly linear as we get to that 23%. So -- and transformation plays a big piece of that margin expansion.

Charles Tusa^ What percentage?

John Stauch^ Larger than that increase because we're also putting back investment, Steve. So I think the next wave that we'll start to realize is the significant Wave 1 benefits of the purchasing savings and the direct material that we're doing. And you could assume that, as Bob said in prior comments that, that's a double-digit savings against about 1/3 of the material buy.

Charles Tusa^ Sorry, one more on all this. Where will that show up in the bridges? Will that show up as -- in all parts of the bridges or productivity? So it won't be part of like

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inflation. If you if you execute better on some of those purchasing initiatives, maybe that shows up in net inflation? You're saying that the transfer -- all the transformation will be bucketed in that productivity bar?

John Stauch^ Price bar and productivity bar, correct.

Charles Tusa^ The price bar as well?

John Stauch^ Well, price is the transformation work we're doing on the strategic price initiatives, right? So it's a piece of the price contribution and then the productivity of the transformation is a piece of the productivity contribution.

Operator^ Our next question will come from Jeff Hammond with KeyBanc.

David Tarantino^ This is David Tarantino on for Jeff. Maybe just to attack the margins a bit different. Margin's been pretty impressive the last couple of quarters. Could you parse out what the price cost tailwinds just kind of from carryover and normal pricing actions and what was kind of the early benefits from the transformation program?

Robert Fishman^ Yes. When you look at -- price has read out nicely in the first 2 quarters, that will moderate in the back half and basically land around that mid-single-digit price benefit for the year. We are taking advantage primarily of carryover pricing with that advantage. And just as a reminder, there were many years or at least a couple of years where we were catching up and price versus cost was a headwind. It has been a tailwind over the last few quarters. But think of that as mainly carryover pricing decisions we made last year that benefited the first half.

David Tarantino^ Great. And then maybe just a cleanup one on Pool, maybe outside of the destock, how would you describe the sell-through in the channel versus expectations? It seems like trends were maybe a bit softer and then on that kind of -- maybe could you level set us on what you would expect the magnitude of the prebuy, like what's implied in the guide, given we've had an unusual recent couple of years?

John Stauch^ Yes, I'll take the first one. I think sell-through as a whole this year through the first couple of quarters is slightly behind our original expectations. And I think that

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is a combination of some of the prebuys that happened in previous periods. It's also probably discretionary items that are being pushed out as consumers are dealing with the rest of their finances. And then as has been mentioned, from the industry. I think some of the finance Pools are slower than they were originally anticipated.

As we go forward, and you look at early buy, we talk about normalized early buy. And about half of our Q4 shipments fall into those early buy categories. And the rest of the Q4 shipments are generally more standard orders. And we work those programs through the end of Q3 into Q4. And generally, we know what those orders are and wouldn't know what those orders are at the Q3 earnings call.

Operator^ Our next question here comes from Damian Karas with UBS.

Damian Karas^ Maybe in the spirit of the summer, a couple of follow-up questions on Pool. That business is obviously operating at a really healthy level of profitability despite the demand pressures you're facing now. Just curious how you're thinking about..

John Stauch^ Your breaking up just a little bit.

Damian Karas^ I apologize. Could you hear me?

John Stauch^ If you wouldn't mind repeating the question, please?

Damian Karas^ Yes, absolutely. So I just wanted to ask you about Pool margins. I mean it's very profitable right now despite the volume pressures, so how are you thinking about what that trajectory should look like next year as the inventory headwinds reverse and you get a demand recovery?

John Stauch^ Do we have another question?

Operator^ We'll move on to our next question from Nathan Jones with Stifel.

Nathan Jones^ I will ask one on IFT. Volume has been pretty flat overall for the last couple of quarters. But you've talked about being more selective on projects. I'm

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wondering if you could talk a little bit about how much the growth is where you want to grow versus maybe how much the declines are where you're not looking to grow?

John Stauch^ When you think of Flow, Nathan, you got to remind us that we've got a residential business around pumps, and that has been slow and down soft, right? And that's reflecting the residential trends in the Water Solutions as well as Pool. And so when we talk about Flows and overall growth, what we're really seeing is growth in infrastructure, commercial. As a reminder, commercial buildings aren't just office buildings, they also include data centers.

They include warehousing. They include any type of infrastructure that would require or need fire pumps as well as water coming into that building and wastewater exiting that building. And so that has been a strategic point of ours, and we want to grow in those spaces. We're strong in those spaces. And so really what you've got is a residential, commercial and infrastructure mix here.

Nathan Jones^ Okay. Maybe then just one more on the Water Solutions business. I think you -- there's basically inventory destocking going on there as well that you had expected to probably end in 2Q. Is that the case in where kind of a bit more back to sell-in matching sell-through in that business?

John Stauch^ Yes. We're actually through most of the inventory challenges in the residential Water Solutions side of the business, Nathan. And what we have as a reminder is we exited direct-to-consumer businesses that we had, and we did that in Q4 last year, and so we're working through those year-over-year comps related to those decisions. And so the underlying growth of our core systems -- in our core components business is moderating, but it doesn't yet have inventory challenges or doesn't have inventory challenges.

Operator^ Our next question here will come from Joe Giordano with Cowen.

Joseph Giordano^ So yes, we kind of touched on this, but IFT so like more than 100% of the growth is priced right now and the volumes were modestly negative. As you look into the second half, price moderates, like does volume from where we are today, do

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you expect that as the year progresses to further deteriorate? Or does that start to pick up some of the likely moderation of price?

John Stauch^ We continue to believe on the Flow side, and remember, IFT is an industrial solutions business as well as Flow. I mean Flow has traditionally, we would think it is a low single-digit to mid-single-digit contributor and we're moderating back to those growth rates as we get to the second half, which we believe is normal. And then what we've got to do is make sure the mix of the business is start to contribute more to the margin expansion side. And we've gotten a lot of productivity and a lot of strategic projects out of C&I. But as a reminder, R&I tends to be the higher margin side of that business. And so we would expect that contribution get more normalized as we go forward.

Joseph Giordano^ Meaning volumes like don't necessarily reflect higher in the second half. Is that -- am I reading that right?

John Stauch^ That's correct. Yes.

Joseph Giordano^ Okay. And then you guys -- you commented on Pool that you've done well and like adjusting headcount appropriately to the lower levels here. You have sizable revenue declines and margins up nicely. How do we think about margins as the volume start to come back, like as you need to add headcount? Like is this a good level to build off of, just like 30%, 70% rate? Or could there be kind of like -- for like -- a better way to say, like a lack of incremental margin expansion on revenue growth as that inflects?

John Stauch^ It's a good basis to build off of. As we grow from here, we begin to get volume leverage on the on the overhead structure of the business. The only thing that would be an add-back is rebasing commissions that would be relative to selling the product throughout the channel. But when you think all that, growth is a really good thing and this is a really good level to model off of. With that, I'd like to provide some closing comments.

Thank you to everybody for joining us today. And I wanted to reiterate our earnings call key themes: first, we had solid execution within our diversified portfolio along with

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price and transformation. These initiatives drove Q2 sales growth with margin expansion across all 3 segments; second, we continue to expect strength in our IFT and Water Solutions segments as well as transformation efficiencies to offset lower Pool volume in 2023; third, we raised our 2023 guidance due to strong Q2 and our confidence in the sustainability of our performance, driven by a diversified portfolio; and fourth, our transformation initiatives are reading out and expected to drive greater benefits beginning in Q4 and beyond as we implement actions towards identified savings. And finally, we expect to continue to deliver value creation beyond this fiscal year. Thank you, everyone. Have a great day.

Operator^ The conference has now concluded. Thank you very much for attending today's presentation. You may now disconnect your lines.