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First Quarter 2019 Earnings Call

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PRESENTATION

Operator:

Good morning. My name is Zatania and I will be your conference operator today. At this time I would like to welcome everyone to the Pentair 2019 First Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. If you would like to ask a question during this time, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key.

I would now like to turn the call over to your host, Mr. Jim Lucas. Sir, you may begin your conference.

Jim Lucas:

Thanks, Zatania and welcome to Pentair's First 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 first quarter 2019 performance as well as our second 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. As we shared earlier this month, our first quarter 2019 reflected cold, wet weather in many parts of the country and this had an adverse impact on our first quarter sales of our high margin Pool and Specialty Ag Spray businesses. This weather pattern, combined with distribution inventory that was created to avoid our heavier than usual price increases related to 2018 tariff impacts created a significant impact to the bottom line. The slower pull-through of demand in Q1 related to weather and Pool means that we expect inventory will now be worked out in the channel in Q2 and Q3, causing the further reduction to our full-year guidance. While these two events create a unique impact on the business, we feel that this situation is isolated to 2019 and our overall thesis for our Pool business remains healthy and intact.

On a more positive note, we completed two strategic acquisitions during the first quarter that further our strategic initiative to accelerate Residential and Commercial water treatment. Both acquisitions are performing well and the integrations are on track.

I will now turn the call over to Mark who will provide more detail on Q1, Q2 and the full-year forecast. Mark?

Mark Borin:

Thank you, John. Please turn to Slide 5 labeled Q1 2019 Pentair Performance. For the first quarter we saw core sales decline 4%, segment income fall 16%, and adjusted EPS was down 12%. We will provide more color on the individual segment performance shortly.

Below the line we saw an adjusted tax rate of 18%, net interest other expense of $8.5 million, and our average shares in the quarter were 172.5 million. net interest other expense was a bit higher than planned due to the two acquisitions closing earlier than expected.

Please turn to Slide 6 labeled Q1 2019 Pentair Segment Performance. This slide lays out the first quarter performance of our three segments. Following robust growth in 2018, which we believe was somewhat elevated as distributors bought inventory ahead of price increases, as we commented on our fourth quarter call, first quarter core sales in Aquatics declined 6%. Segment income in Aquatics declined 13% as the reduced top line led to under absorption in the quarter.

Core sales declined 6% in Filtration Solutions but segment income was flat due primarily to positive mix. Within the core Residential and Commercial business, we saw two areas of softness that we believe are short term in nature. First, we experienced lower component sales as Aquion is now represented as intercompany sales and is no longer reflected as external sales. Second, Europe saw ongoing weakness but the comps are easing. While this had an impact on our first quarter sales, mostly due to timing, we continue to see positive growth prospects for the key Residential and Commercial piece of Filtration. We'd note that the Food & Beverage and Industrial businesses were on plan for the quarter.

Flow Technologies reported flat core sales but that does not capture the story of the 22% segment income decline. While price helps the Residential piece of Flow, we saw our Specialty business, which is exposed to agriculture crop spray, face significant top line pressure. Specialty is one of the most profitable product lines within Flow and the sales miss contributed to the income decline in the quarter. We are rightsizing the cost structure of Specialty to the adjusted demand levels now expected for 2019.

Please turn to Slide 7 labeled Balance Sheet and Cash Flow. Our first quarter saw cash flow usage in line with seasonal trends as we tend to build working capital in advance of the important residential selling season, primarily in our Aquatics segment. In addition, we closed on two strategic acquisitions during the quarter and saw our debt level increase as a result. While our debt level increased from the end of 2018, we expect cash flow to turn positive in the second quarter and we anticipate debt levels coming down as cash flow improves throughout the year. While we did not repurchase any shares during the first quarter, we remain committed to buying $150 million in 2019.

Please turn to Slide 8 labeled Q2 2019 Pentair Outlook. We anticipate second quarter core sales to be flat to up 1%. We expect Aquatic Systems to be flat to down 1%, Filtration Solutions to be flat to down 2%, and Flow Technologies to grow 2% to 4%. We anticipate segment income to be down approximately 5% to 7% as some of our more profitable businesses continue to see short-term top line pressure. We expect adjusted EPS to be in a range of $0.63 to $0.66 per share.

Below the line, we expect corporate expense to be approximately $14 million to $16 million. We expect our second quarter tax rate to be 22%, as we anticipate a true-up during the quarter. We also expect net interest other expense of roughly $11 million and shares to be approximately 171 million.

Please turn to Slide 9 labeled Full-Year 2019 Pentair Outlook. Slide 9 looks at the different components of our updated 2019 Outlook. For the full year we expect core sales to be flat to up 1%. We continue to expect price of roughly 3% for the full year. We expect total sales growth of roughly 1% to 2%, with roughly 3% contribution from the recently announced acquisitions offset by a 2% headwind from FX. We anticipate segment income to be flat to up 2%. Our full-year adjusted EPS range is $2.30 to $2.35 per share.

Other items embedded in our guidance include corporate expense of $60 million to $65 million, a tax rate of 20.5%, net interest other expense of $38 million and an average share count for the year of 171 million shares.

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

John Stauch:

Thank you, Mark. Please turn to Slide 10 labeled Full-Year Guidance Update. Before I discuss our longer term outlook, this slide is meant to be a helpful look at what has changed since we provided our initial 2019 guidance. While we do not like to use weather as a reason for a sales miss, the reality is that cold, wet weather had a pronounced impact on two of our businesses, Pool and Agricultural Precision Spray. The main change from our original forecast is our very profitable Aquatics business. In 2018 Aquatics delivered higher than average growth of 11%. We anticipated that some inventory was pulled ahead of its price increases, but it is worth talking about what has happened to the start of the year.

Wet and cold weather delayed pool construction activity in several key markets such as California, Texas and Arizona. The inclement weather also impacted pool openings in other parts of the country, primarily the Sun Belt. As a result, sell-through in our distribution channels was impacted and therefore inventories were not reduced at the levels we would have expected if the pattern would have been more consistent with historical trends when weather was not a factor.

Of importance is that we have not seen any significant changes in demand trends within the key aquatics markets. Our dealers continue to report strong backlog and while weather created delays, we expect inventory levels in the channel to come down as activity resumes in the second and third quarters.

Within Flow Technologies, we saw our higher margin Agricultural Precision Spray impacted as many parts of the country were under water to start the planting season. Given these delays and the limited number of months in the season, we are not anticipating a rebound in activity, and are adjusting the cost structure of this business accordingly.

With Aquatics and the Specialty business in Flow experiencing slower top line growth rates in 2019, this has led to reduced expectations for segment income in adjusted EPS growth. We do believe this is a short term issue, but unfortunately, the weather-related delays were compounded by the higher inventory levels in the distribution channels.

Please turn to Slide 11 titled Segment Positioning. We wanted to take a moment to speak to our three segments and why we believe we are well positioned for the longer term. Aquatic Systems is a leading franchise where we believe long-term demand trends remain in place. We expect to continue to invest in dealer engagement and consumer pull. We have been expanding aftermarket products, including in the faster growing automation space. We have built a strong business, and while the growth rate in 2019 is not up to historical standards, we believe that averaging 2018 and 2019 is more reflective of the longer-term growth rate of this attractive business.

As we mentioned earlier in the call, we strengthened our Residential and Commercial water treatment business with two strategic acquisitions. Aquion brought water treatment systems capabilities and an affiliated dealer network, while Pelican brought a water conditioning systems capability and an established eCommerce platform. In 2019, we will experience some modest impact to the top line as former component sales to Aquion are now recognized as intercompany sales. We continue to focus on digital marketing and engaging consumers to build our brand.

Flow Technologies continues to be a business where we are focusing on leveraging our core PIMS competencies and improving margins. While parts of the Flow portfolio have been impacted by inventory and weather issues, we are accelerating operations, sourcing and structural changes to improve our overall cost structure to create a solid foundation for 2020.

Please turn to Slide 12 titled Long Term Value Creation Goals. This is an updated version of a chart we have referenced in the past, but an important slide as it highlights our longer term goals. With last year's separation and our emergence as a pure play-focused Residential and Commercial Water treatment company, we remain committed to delivering more consistent performance. We continue to believe that we have a portfolio capable of delivering low to mid single digit core sales growth over the cycle. With a portfolio capable of delivering positive price coupled with a relentless focus on productivity, we expect segment income to grow mid to high single digits. We generate strong free cash flow and have committed to repurchasing $150 million of our shares annually. We believe that this should result in top quartile EPS growth and disciplined capital allocation would add upside to a strong base performance.

We recognize that consistency is the key to being recognized as a top quartile performer and we remain committed to achieving these long-term goals.

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

Operator:

At this time, if you would like to ask a question, please press star, then the number one on your telephone keypad. Again, if you would like to ask a question at this time, please press star, one on your telephone keypad. As a reminder, please limit your questions to one and a follow-up.

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

Steve Tusa:

Hey guys, good morning.

John Stauch:

Hey Steve.

Mark Borin:

Good morning Steve.

Steve Tusa:

Just curious as to what really kind of changed from when you gave guidance in I guess late January, early February to today? I mean I missed it as well but Pool was very clear that they were not going to have the greatest first quarter on the planet, and with the destocking impact you guys actually had guidance above what they said they were going to guide. I don't know what that is. That's either a disconnect—there's a disconnect somewhere. What happened there? Why didn't you guys just come out in January and say first quarter is going to be weak given these dynamics?

John Stauch:

I think it's a fair question, a good question, Steve. I think the different dynamics are it's easy to sit here now and look backwards at what inventory is in the channel, but we raised prices last year, primarily related to tariffs. We knew there was a little bit of inventory in the channel being built, but that's all based upon what the expected sell-through is through our dealers into the markets that they serve. We had anticipated that the inventory would be dealt with in Q1, but the significant drop in the sell-through produced more inventory in the channel and therefore it didn't make sense to continue to sell into the channel, and that was really what happened later in the quarter, Steve.

Steve Tusa:

No, I understand that. I'm just saying is there something in the FP&A function here that you guys aren't picking up what the channel is saying? Because, again, it was a public company telling you what the growth rate was going to be, and if there was destocking in the first quarter, then you guys would have been below that growth rate instead of guiding to something like 4% to 6% and then going around to conferences and then kind of not really insinuating at all that things were weak over the course of the quarter. I think visibility here is a question that I'm getting from investors all the time and I think there's just a bit of a confidence issue that people have that you guys aren't picking up the right tea leaves in the channel.

John Stauch:

Again, I wish it was that easy, Steve. I think we're looking at forward base of inventory on hand and there's a lot of inputs in there, and I do want to remind everyone there's more than a distributor. The pool market—and also part of this is distributors in Flow as well. It's not just all [Pool. There's lots and lots of distributors and lots of estimates that go into a forward base of inventory on hand, and I think we didn't know until late in the quarter that we were in the situation we were and as soon as we knew we went out and told people and we've dealt with it accordingly, and we've taken out the cost and we're taking all the actions we can to position ourselves the best we can for next year.

I don't want to damage a great business like Pool, and I think we're off doing all the right things to grow share and pull demand in that particular business, and I think it's demonstrated that success consistently over a series of years, and I do want to remind you that the tariff changes and the significant price increases was part of this issue as well, and those don't happen often.

Steve Tusa:

Sure. On Filtration, why was that weak? I think we were expecting some weaker sales in Flow given the flooding and all that kind of stuff, which is completely legitimate issue. Everybody is kind of seeing the weather and the flooding out there, that's definitely not specific to you guys, but Filtration was definitely weak. Can you maybe just talk a little bit more about what happened there? You guys cut guidance there as well in revenue.

John Stauch:

Yes. It definitely was slightly weaker than we expected, Steve. I think weather impacted it as well, primarily on the service and the installs. The timing of the acquisition was positive as far as the reported acquisition, but it also changed the way the intercompany sales moved from us to those to acquisitions because we sell to both of them. Then, we did experience slightly weaker European demand, which we have adjusted our full year guide to reflect.

Steve Tusa:

Okay. That also would have been helpful to know, that you were going to kind of like have a little bit less of an organic impact from these deals. That could have been communicated better probably, at the time of the deal, just some feedback.

That's about it. Thanks a lot.

John Stauch:

Thanks.

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:

I'm going to follow-up on the Pool business here. I understand it's seasonal. I would have thought that customers would have been making these decisions, spending decisions on an annual basis, and if we had poor weather in the first quarter that might defer revenue out of the first quarter into the second quarter or third quarter. Can you guys talk maybe a little bit more about the dynamics there and why you're not just going to catch that revenue up? I mean I can understand why the Sprayer business doesn't catch up, but I'm just a little bit confused on why that Pool revenue wouldn't just shift from one quarter to the other rather than disappear all together.

John Stauch:

It does. I think clearly if we didn't have the inventory situation in the channel that we have, part of the Q1 miss would be made up in likely Q2 and Q3, Nathan. I mean there is limited labor, so people don't go out and necessarily hire more; they're going to slide jobs a week or two or so in the schedule, and so they tend to do as best they can to make them up in the season. What we're really reflecting in the outward quarters is the fact that we still have to deal with the inventory in the channel.

I do think the dealers will make up the demand. I do think that our channel partners will see that demand come through, and it's more muted on us because of the inventory build that occurred from the Q1 sell-through.

Nathan Jones:

Does that mean that there was more inventory in the channel than you guys had predicted when you reported 4Q? I mean I understand you'd thought there was $30 million of pre buy in 4Q '18 ahead of the price increases. Did that end up being higher than you expected, which is part of what contributes to this 2018 was higher than it should be and 2019 was lower than it should be?

John Stauch:

Yes. What we anticipated to be about a point of headwind for overall Pentair is now a couple of points of headwind. Again, I'm reminding you that it's not just Pool; there's a little bit in the Flow Technologies distribution channel as well related to the weather.

As I was mentioning, rearward looking, as you look at days of inventory on hand forward-looking in Q4, it felt like 30. Because of the lack of sell-through that happened in Q1, that number expanded and it's got to be dealt with in Q2.

Nathan Jones:

Okay. I just want to follow-up on Steve's question about maybe looking inwardly at your own forecasting tools. Have you run a root cause analysis on this? Kind of looked at the FP&A processes to see if there's things that you guys can do to improve the predictability of results here?

Mark Borin:

Nathan, yes. As you'd expect, we have our PIMS tool kit and that doesn't just apply to how we run the operations; it applies to how we run our back office functions as well, so we are using our root cause countermeasure tools to try to understand what are the things that we could have had better visibility to and get and gotten more out in front of, but as John said, sometimes it's a little bit easier to do that when you've got hindsight information to look at, but that's the information that we need to think about and how do we put that more at the front end rather than seeing it at the back end.

Absolutely, we're working on that and looking for improvements across the board.

Nathan Jones:

Is there anything that you've found that you could share that could change, could improve those kind of processes? Or still in progress?

John Stauch:

That would be such an easy answer if that was it. There's no way we could predict the Q1 weather patterns.

Nathan Jones:

No, that's fair.

John Stauch:

California, Arizona and Texas I mentioned are such significant markets to the Pool business, and what happened there was so unusual as far as the wet, cold weather, and that stops production or stops pool builds for a period of time because they can't move machines in.

I don't know what we could do. We always run sensitivity analysis on our forward-looking analysis but that's not one we would have predicted.

Nathan Jones:

I should have qualified that question to be outside of weather effects and things that would be obviously unpredictable.

John Stauch:

The answer is no because we found out afterwards, as we shared in our Q4 call, that we felt there was inventory in the channel and that inventory would have normally burned off in Q1. The Specialty Ag business was also uniquely impacted and that all happened throughout the process in Q1 as well.

Those two things led to the Q1 challenges and we've not sensed—not put in a forecast of the recovery in Pool and we've not put any recovery of the Specialty Ag in the outlook. Then we've adjusted demand to be what we think are on the lower ends of our forecast models, and then we're working the cost actions to go build the foundation for 2020, and that's the only way I could think of reacting to this situation.

Nathan Jones:

Okay, fair enough. I'll pass it on. Thanks for taking my questions.

Operator:

Your next question comes from Joe Giordano with Cowen.

Joe Giordano:

Hey guys, good morning.

John Stauch:

Hey, Joe.

Mark Borin:

Morning, Joe.

Joe Giordano:

I don't want to keep asking the same question, but there's one thing that's confusing to me a little bit. Heading into the quarter when you had your look at inventory in Pool, I totally understand that that changes because on weather on a days basis because the demand side of it changes, but on a gross level of inventory, that number is a fixed number, and so if we're saying that this is largely going to shift quarters on the revenue side, that's where I don't get why the overhang doesn't fix itself sooner, because, yes, we could change what we thought was 40 days is really 50 or something like that because the denominator changes, but the top, the actual amount of inventory was a fixed number of units. That's kind of where I struggle with; I don't understand that.

John Stauch:

That's fair. I think the one thing I'll remind you that if it was just a product sale and it was not dependent on the labor required to install it, I do think you'd see a quicker recovery. The labor is not exceptive, right? It's not like you're going to go out and add more labor to build more pools in the short term. It will come through the channel, clearly, and we do think that that will spread itself over Q2 and Q3, but the Q1 hit to us is going to be reflected as an inventory reduction in Q2 and Q3. It won't affect the channel that same way.

Joe Giordano:

How much is that actual construction element laying down? We talk about this business being that's not really a big piece of it at all, so I was just curious as to how that (inaudible)?

John Stauch:

Well, every dealer is out there either installing a new pool or they're also out there doing the aftermarket aspects, scheduling the aftermarket pool product install. They generally are the same people and they're going to do their best to get those pools in place, and so there will be a delay on both ends, the aftermarket and the new pools.

Joe Giordano:

Then on the forward guide for that business, 2Q buys more of a seasonal, sequential ramp than normal, which I get may be a little bit of a shift in that demand, but the second half guide is essentially flat year-over-year versus last year and we keep talking about how much pull-forward there was and that was a plus 12 comp, so how comfortable are you with the back half being flat year-on-year, and what kind of visibility do you have to that?

Mark Borin:

Q2 and Q3, as we talked, will be impacted by the inventory coming down, and then Q4 we expect kind of just to look at it sequentially; it will pick up and get better and we'll see some of that recovery coming through, and when we look at it for the full year we're confident that the full year expectation is appropriate, and as John said we factored in everything that we know today as we look at the out quarters.

Joe Giordano:

Okay. Then if I could just shift quick to the last one on Filtration, just to follow on what Steve asked initially. To me, that was the biggest surprise was the magnitude of the miss there. It's not Pool, it's not Flow and it was a pretty sizeable miss versus the initial guide. Your comment on lower component sales now being intercompany makes sense, but those I assume were kind of factored in because you announced those deals before you gave the initial guide. Can you maybe talk through what some a little bit more detail there?

John Stauch:

Yes. Let me just frame that. The intercompany sales are roughly about a point overall of the total Filtration Solutions for the year, which will give you an impact on kind of what it is per quarter. Keep in mind we did not have the acquisition as a contribution in Q1. We had it closing after Q1, so these two things, you're seeing the benefit of the acquisitions but we had not forecasted in the quarter the impact of the intercompany sales.

But the real impact that we saw was a little bit of slowing in Q1 where the weather impacted us. We do expect to catch that up in Q2, and then the European trends are not where we want them to be and that's really the reflection that we added to the full year forecast. I don't think we know that. I think we're anticipating it and we're planning for it.

Joe Giordano:

Great. Thanks guys.

Operator:

Your next question comes from Mike Halloran with Baird.

Mike Halloran:

Hey, good morning guys.

John Stauch:

Good morning, Mike.

Mike Halloran:

A question on the margins on the Flow side. Talk a little bit about the inefficiencies in the mix side, please, and then also when do you think that can normalize back to what your previous run rate suggestions were, and how long do some of these headwinds linger?

Mark Borin:

Sure. The biggest contributor to the margins in Flow is the mix impact from the decline on the Specialty Ag Spray. It's a higher profit component of the overall portfolio, so that's the biggest driver. Then the other driver is just the timing and how price works its way in throughout the year as all their price actions take hold.

We had talked last quarter about a couple of factories. Those are stabilizing and we see those not having a negative impact to margins during the year and improving as we get through the balance of the year.

Mike Halloran:

Sounds good. Then when we think about the second half of the year here, could you just frame what's changed now versus your previous guidance? Obviously on the Aquatics side the assumptions on the top line have come in a little bit. Obviously we're adjusting a little bit for some of the costs on the Filtration side that are no longer external sales. Anything else you would point to that's changed in the back half of the year versus the previous guidance?

Mark Borin:

Sure. I think overall when you think about it not a lot has changed would be how I would characterize kind of the headline. We talked before about just the timing of inventory and how that works off, and then Specialty, the business that we referenced, the softness there we had not projected that that is going to improve as we work through the balance of the year. Those are probably the two biggest factors when we think about what's different, but overall, really the back half of the year is not significantly different than what we had previously been thinking.

John Stauch:

We have also not assumed any benefit from tariff relief in this outlook, so that's consistent with the previous outlook. We've also, most of the operations and sourcing and the targeted actions this year are not expected to have 2019 benefits, but they generally are expected to offer contributions in 2020, meaning we're driving the activities this year and assuming it's going to take a longer time to realize it, and therefore really driving them as a 2020 foundational benefit.

Mike Halloran:

In other words, if you hit your plan, your expectation is that the run rate exiting 2019 was slightly lower than what you were originally expecting, but not meaningfully lower like the front half trajectory would imply?

John Stauch:

That's correct.

Mike Halloran:

Thanks guys, appreciate it.

John Stauch:

Thank you.

Operator:

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

Deane Dray:

Thank you. Good morning everyone.

John Stauch:

Hey, Deane.

Mark Borin:

Good morning, Deane.

Deane Dray:

I might have missed this but are you able to separate and quantify the impact of weather this quarter from the inventory dynamics?

Mark Borin:

We didn't specifically quantify it earlier, Deane, but think of it as $30 million to $40 million. If you think about the majority of the Q1 impact is really driven by weather, which as John said delays the bleed off of that excess inventory that then happens in Q2 and Q3.

Deane Dray:

Got it. I just wanted to make sure that part had been quantified. Is there any ripple effect on pricing? I know you called out the 3% pricing assumption but with an incentive to work inventory down is there going to be any compromise on pricing, and what might the dynamics be there?

John Stauch:

No. No, the overall pricing profile stays the same. As you referenced, we talked about 3% for the year, and so nothing changing from a price perspective.

Deane Dray:

Got it. Just last one from me, it's more of a business model question, and maybe it's just an observation. As Pentair has refocused the portfolio to a water pure play, you've lost that benefit of earnings diversification that you had when nVent was part of the company. Now we see this vulnerability to weather that really maybe just is magnified versus what the company structure was before. Is this variability or vulnerability just something that comes with the more focused portfolio? Has that been part of the framework that you're looking at for the company, Pentair as it is today.

John Stauch:

Deane, I think it's a great observation. The answer to the first question is yes. I mean that has definitely exposed more vulnerability on weather impacts. Now what we've got to do is build more diversification into our portfolio to account for that. I mean we did see spots of it. We did have a good China quarter. I think things in China have improved. We had that little bit of softness in Europe. Normally that wouldn't have happened, but I think the diversification of the portfolio is something we ill focus on and ensure that we do not subject ourselves to these types of weather patterns and the variability that they can cause.

Deane Dray:

Got it. Thank you.

John Stauch:

Thank you.

Operator:

Your next question comes from Scott Graham with BMO Capital Markets.

Scott Graham:
Hi. Good morning.

John Stauch:

Good morning.

Mark Borin:

Good morning.

Scott Graham:

Kind of a follow on to that question. Would it be fair to say that even though Aquatics is really the flagship, the best business, the highest margin and all that, that the business will be built more going forward through organic means—aftermarket, consumables, that kind of thing—and then your acquisitions would be more focused on the other two segments?

John Stauch:

Yes. I mean I think the Pool business is well positioned and I think we have a lot of organic growth runway remaining. I think we continue to innovate there from a new product perspective and we continue to have good intimacy with our channels and our consumers, and understand what they have. I think that's going to be more of our organic strategy as we go forward.

As evidenced by the two acquisitions that we just did, our goals in Filtration Solutions is to build out a closer to the customer model and also make sure that we're doing our part to drive demand in the channel.

The overall penetration rate of Filtration Systems in homes is relatively low, and although it's better in the commercial office space and/or commercial restaurant space, it's still not where we think it should be or can be, and so most of our acquisition activity will be focused about how do we drive that demand and how do we get closer to the customer to drive that demand in Filtration.

Scott Graham:

Okay. Thank you for that, John. That helps. My follow up is really not to beat the horse even deader here but would you be able to maybe answer this question? You indicated that there doesn't seem to be much of a change in demand on the pool side. I'm not quite sure what you meant by that, and maybe the question specifically would be what was sell-through by your dealers in the quarter?

Mark Borin:

When we see, when we talk to our dealers and we hear from the builders and understand sort of what's going on out in the market, backlogs remain high, business remains solid. When we talk about we're not hearing anything from an underlying perspective that the market is slowing it's based on those discussions and that insight. That's really kind of what informs the way we're thinking about that.

Sell-through from the information that we have access to, remains strong and I think I would expect an impact in Q1 from weather, but as we said that starts to turn around as we move into the heavy season here in Q2 and Q3. Again, underlying trends and demand, we're not seeing anything that would indicate softness there.

Scott Graham:

From I think I'm gleaning from this is that you're distribution channel is kind of normalizing right now.

John Stauch:

I can't speak to that but I can tell you what Mark is saying is the sell-through is accelerating, right? I mean the March sell through was definitely towards the end high from the dealer channel, and then we also know the dealer channel is going to make up, as we mentioned, most of that weather loss in Q1, they're going to do their best to make that up in Q2.

Why that's muted to Pentair is because there is that inventory in the channel that needs to be worked out before we're going to see the benefit of that recovery of the channel shift.

Scott Graham:

That makes sense. Thank you.

John Stauch:

Thank you.

Operator:

Your next question comes from Josh Pokrzywinski with Morgan Stanley.

John Stauch:

Hey Josh Pokrzywinski.

Josh Pokrzywinski:

Hey, good morning guys.

Mark Borin:

Good morning, Josh.

Josh Pokrzywinski:

Just a follow-up, just a finer point on Pool that I think Mark raised earlier. I want to not miss it in passing, that the business should normalize by the fourth quarter. I guess just given everything we've seen from tariff pre-buy and even your callouts given the inventory position exiting the year, I guess mathematically looking at guidance you do have to pick up the growth rate by the fourth quarter. Is that explicitly something that you're calling for, and I guess why not take a more conservative track just given some of the surprises this quarter?

John Stauch:

I think we have, Josh. I think if we take a look at what our new estimates are of that sell-through demand throughout the year, we are assuming taking inventory down to at or below normalized historic levels, right? It is still a growing market and it is still a growing industry, and so you'd expect inventory to actually be accelerating through this period. I think what we wanted to do was make sure that we forecasted it on the downward end, and I know it looks like Q4 is out of the norm, but we would expect our normalized patterns to continue and Q4 is usually a pretty good quarter for Pentair.

Josh Pokrzywinski:

Got it. Then I guess just following up a little bit on Deane's question on pricing, looking holistically at price, cost, productivity, I know you kind of think about those three different legs of the stool, I would imagine there was some drag there from all the disruption this quarter, but thinking about that total bucket the rest of the year, how should we think about that gap, closing, improving or getting worse? I would imagine something happens in the world as it pertains to rebates or pricing power given volume, but just thinking about it holistically, should that get better or worse from here?

Mark Borin:

I think you hit on it. It does get better as we move through the year, which is in line with how we expected it to move, just with the timing of when price is impacted with rebates and other things, but as we said on our earlier guidance, we continue to believe that effectively price and inflation will offset each other. We continue to view that as the overall way to look at the guidance, and that's a full year statement so we see that and we sort of see that starting to turn as you get into Q2, Q3, and Q4.

Josh Pokrzywinski:

Got it. If I can just sneak one more here, more of a question philosophically on how you guys get impacted from a weather perspective. If I think back to 1Q of '18, I think some other folks in the broader construction ecosystem called out weather then, in January. Was there anything in the comp that would have said 1Q of last year wasn't particularly smooth sailing on the weather front?

John Stauch:

No, Josh. Last year's Q1 was actually one of our stronger organic growth quarters of the year. I think we benefited from some of the tax changes that occurred and demand was strong out of the gate. I'd say we don't think that weather had a significant impact on Q1 of '18 at all.

Even, usually if it happens early in the quarter it's not as big of a deal because those things can get made up. I mean really what we're talking about is the end of January and February was significant weeks in a row of a consistent pattern in the states where it matters to us.

Josh Pokrzywinski:

Got it. All right. Thanks, John.

Operator:

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

Brad Vanino:

Hey, good morning. This is Brad on for Jeff. Just to clarify something. In the first quarter it seems like cash flow is predictably weak. I understand some of the abnormalities going on there, but just on a full year basis what's your confidence in hitting target?

Mark Borin:

Q1 cash flow, as you referenced, is traditionally our weakest quarter. As a reminder, Q1 of last year was when we were going through the separation so there is noise in '18 and sort of the visibility to what a run rate level of Q1 cash flow for the separate Water business would look like. This I think in many respects is sort of the new view of what Q1 looks like and we'll start to turn that in Q2 and turn positive in Q2, and then continue that through the balance of the year.

So, remain confident in our ability as we target cash flow to equal adjusted net income.

Brad Vanino:

Okay, that makes sense. Then just on the strategic initiatives and investments you have going on, you talked about in the last call some flexibility to kind of throttle those back should demand kind of weaken a little bit. Just given what happened in the first quarter, have your strategic investments changed and plans for those for this year and does that have any kind of trickle down impact over the longer term?

John Stauch:

No. I think we're focused on still building out a portfolio that we think has a lot of runway around organic growth. A couple of small additions that we're looking to do, again, on the tuck-in side on the Residential and Commercial Filtration side to continue to build out our portfolio. Then from an organic standpoint, continuing to make the consumer aware of what Pentair can bring to the table and then how we bring that to our channel partners and how we give the consumer what they want, that's what the strategic investments are, and we're going to continue to invest in the high priority areas throughout 2019.

Brad Vanino:

All right. Thanks for the color.

John Stauch:

Thank you.

Operator:

Your next question comes from Brian Lee with Goldman Sachs.

Rebecca Yuan:

Hi guys. This is Rebecca again on for Brian. Thanks for taking the question. Aside from the weaker demand in Europe that you pointed out, have you seen any slowdown in your end markets and can you maybe speak to the growth trends you're seeing or any broader macro comments?

John Stauch:

No, we haven't. We did, as evidenced by our particular outlooks for the year, adjusted to what we've called the low end of the ranges for some of our revenue forecasts so that we could get ahead of the cost curve and work on the foundational aspects. As I mentioned, I think we're starting to see a stronger China as we move forward here in 2019, and we think we've got maybe one more quarter of headwinds in Europe. Some of the slowdown started in Q3/Q4 last year for us in our particular markets, and overall, we think that our end markets continue to be solid and I think our position in those end markets is solid.

Rebecca Yuan:

Okay, thanks. Then just as a follow-up for some of the long term goals that you highlighted, can you maybe give us an idea of the timeframes, whether they're like three years or five years?

John Stauch:

We'll continue to move rapidly to build out the portfolio in those strategic growth areas. I mean yes, this is a three- to five-year vision and we want to move aggressively and fast as we can to achieve that vision, but that's a combination of organic growth efforts that we're doing with marketing and sales and new product development organically, as well as a series of tuck-in acquisitions that we would do over time. You can never time those, and obviously we continue to try to grow the funnel, but executing them is not always within our control.

Rebecca:

Okay, thanks.

Operator:

The next question comes from Walter Liptak with Seaport Global.

Walter Liptak:

Hi. Thanks. I wanted to ask capital allocation question. The share repurchase, it looks like there was no share repurchase done in the first quarter, and with the shares that you guys talked about it looks like 80 million in the second. Have you started on the share repurchase yet this quarter?

John Stauch:

We can't really comment on the timing of when we're in the market doing share repurchases, but as I said in comments we're committed to the $150 million for this year and would expect to execute that from now through the balance of the year, and you're correct, we did not do any purchases in the first quarter. Generally that's because, as we talked about cash flow, we utilize cash in the first quarter and so we think it's most prudent to manage the planned buybacks in Q2 Q3 and Q4.

Walter Liptak:

Okay. With the share repurchase, can you be opportunistic with it? Could you do a bigger amount in the second quarter, or do you have to spread it through the rest of the year?

John Stauch:

The short answer is yes.

Walter Liptak:

Okay. All right, great. thank you.

Operator:

Your next question comes from Julian Mitchell with Barclays.

Julian Mitchell:

Good morning.

John Stauch:

Good morning.

Julian Mitchell:

Maybe just a question on something below the top line for a change. You talked on Slide 13 about optimizing the cost structure and the operational footprint, and it was notable that your SG&A to Sales rose quite a bit year-on-year in Q1. Is there any way that you could quantify the scale of the savings program when we're thinking about the sort of base number for 2020? Then also, looking at the sort of operating profit in Q1, the GAAP profit was about 30% lower than the adjusted segment profit. It looks like there was an asset impairment charge in there, so maybe just give some background on that charge.

John Stauch:

Sure. I'll handle the first one and I'll let Mark handle the second.

I think when we talk about going forward what our actions our, I mean first and foremost making sure that our sourcing activities are connected to our business units, and quite frankly the product lines, is the number one priority because we have to have the anticipation of what's happening in the commodities that we're buying and be able to make the determination of either costs found in the sourcing side or value-added, value engineering on the cost side, or being able to price appropriately and give our distributor partners enough heads up that those pricings would come.

The second one is the operational footprint. Some of our businesses have way more capacity than they need and that capacity might not be in the right regions, and so getting after the operational footprint is the second largest priority.

The third one on the operating structure is making sure that we're adjusting our cost investments to the priorities of the Company and not what we feel is the priorities of the individual product lines of the businesses and that is a huge opportunity for us. As Mark mentioned, we're going to rightsize the areas that are affected by what we call more cyclical trends where they're not going to recover any time shortly.

That's really the cost efforts. I don't want to quantify it yet because they're fairly sizeable targets internally that we expect to go after and get as a foundation for 2020, and at the appropriate time we'll share what those benefits are.

Mark, do you want to handle the second part?

Mark Borin:

Sure. The asset impairment items, think of those as relating to the optimization. Some of the actions and activities that we talked about in 2018, part of that was exiting certain businesses. In this case, these are a couple of cost based investment businesses, so they're not businesses that are part of what we're running as Pentair but small investments and we wrote those down in Q1 based on an updated view of what we would be able to sell those assets for. So, it's not something new; it's really just a continuation of some of that work that we talked about last year, and as we finalize that and get those things behind us that was an adjustment that we had to record.

Julian Mitchell:

Thanks for the color. My follow-up would be around the top line in the Flow Technology. The core sales were sort of flattish in Q1, guided to grow 2% to 4% in Q2. It sounds like Ag is still going to be weak, so maybe just talk a little bit about how much of a reacceleration in the resi parts of Flow you expect and what types of products were really affected by the excess channel inventories in Flow?

John Stauch:

Sure. Maybe a couple of things. In Flow, there's really three parts of that business, the Residential and Irrigation, and Commercial and Infrastructure and the Specialty business. As you said, Specialty pulls numbers down, but then we do expect to see the Residential Irrigation and Commercial Infrastructure parts of the business start to pick up as we move through the balance of the year. Some of that comes from price. A lot of the price impact that we're projecting for the year is coming from the Flow business and particularly in the Residential side. That starts to read out as we move into Q2, Q3, and Q4. Those would be the biggest drivers.

The Residential Irrigation business would have been impacted in Q1 somewhat by the channel inventory and weather, and that starts to correct itself as we get into Q2, Q3 and Q4.

Julian Mitchell:

Thank you very much.

Operator:

The next question comes from Brian Drab with William Blair.

Brian Drab:

Good morning. Thanks for taking my questions. Just a point of clarification. I'm not sure that it was clear. What exactly was the weather impact on the Filtration business and which markets were you seeing that in the most?

John Stauch:

It's just as you think about the installs of water treatment and water conditioning systems, they were affected by some of the weather patterns and those are like base, right? We pushed—they didn't get to do it in a day so they pushed out their installs weeks or so and that's why we feel that that will recover in Q2.

Brian Drab:

Okay. Just made it harder—even though these are primarily inside jobs, right? I mean you're installing food & beverage filtration system, you're installing something—it's in a factory, it's in a facility.

John Stauch:

Yes.

Brian Drab:

You're just saying that the weather in general just kind of dampened—sorry about the pun, just kind of dampened that activity. Is that what you're saying?

John Stauch:

It was minor in Filtration, but yes.

Brian Drab:

Okay. Then can you quantify at all what the growth or decline overall you reported in Europe and in China for the first quarter?

John Stauch:

Yes, I mean China had a recovery and was up double digits, and in Europe we're talking about modestly down.

Brian Drab:

Okay. You broke up a little bit on my end on China. You said it was—what did you say on China?

John Stauch:

Double digits and then we were modestly down in Europe.

Brian Drab:

Okay. Thank you very much.

Operator:

Your next question comes from Andrew Obin with Bank of America:

Andrew Obin:

Hey guys, good morning.

John Stauch:

Good morning.

Andrew Obin:

Just a simple math question. If I look at the guidance on Aquatic systems before for the year and where you ended up, it seems there is 8 percentage points difference, which I think for the year is a little bit over $80 million. If I look at the delta for first quarter versus what you were guiding versus what you reported, it seems $30 million. If I think that $30 million is a combination of a little bit too much inventory and weather, that sort of implies that non-weather related stuff is $60 million for the remainder of the year, is that how I should think about it?

John Stauch:

On the outer end, yes, you've got it right. Meaning the inventory did not get worked down in Q1, as we had said, and that inventory will be worked down in Q2 and Q3, and so yes, you've got it right. The weather impact for us, you've got it quantified correctly. The rest of it is the inventory burn that we're expecting in Q2 to Q3, and you're using the outer end of the lower end of the projections as you do that math. So, yes, you've got it right.

Andrew Obin:

I'm just struggling with the concept. You said if you can't do pools in Q1, you can hire people to dig pools in Q2 and Q3. Because it seems you say there are labor constraints and I'm just struggling to understand the concept. I apologize.

John Stauch:

Again, we're talking about a couple of things. Certainly they will do their best to work as fast as possible to build those pools in Q2 and Q3, but as I've said, we're not going to benefit from that because we have to work our inventory down through our distributors and dealer channels, and so that will recover in the industry but because Q1 demand was so soft and the inventory did not get reduced in Q1, we are planning on reducing our inventory in Q2 and Q3 as all that activity that you mentioned gets happening in the outer end of the market.

Andrew Obin:

Got you. Thank you so much for taking my call. My question, sorry.

John Stauch:

Thank you.

Operator:

Your final question comes from the line of Damian Karas with UBS.

Damian Karas:

Hi. Good morning everyone.

John Stauch:

Good morning.

Damian Karas:

A follow-up on Aquatics. You highlighted some of the areas in the U.S. that were most impacted by the colder weather and the inventory destocking. Just thinking about expectations for the further destocking over the next one to two quarters here and then what ensues, could you give us a sense on whether you're really expecting a similar level of activity across all these regions or could there be some dispersion or any unique regional circumstances that you're perhaps factoring in?

John Stauch:

We're not factoring any unique dispersion or circumstances. What we're doing is trying to get below this and get to the bottom of the range. We're assuming that the inventory gets worked out. Obviously, it's not perfect. The inventory is not ideal or perfectly balanced by region or all those other things, but we feel like we need to get work to get this inventory out of the channel. We have a great business. It's a business that has performed historically at the upper single digit growth range and we believe it's going to perform again to mid to upper single digit growth range.

What we want to do is get it rightsized from the inventory perspective, work on our demand pull to the consumer, our new product development and all our great marketing and sales activities, and make this business the great business it used to be in 2020 and beyond. That's what we're doing.

Damian Karas:

Okay. Sounds good, makes sense. Just on cap ex, you guided that $10 million higher. Just wondering if you could give any additional color on what led you to up the budget there, and just any color on where you're planning to spend this.

John Stauch:

I think we've gone out and made sure that our businesses understand that capital is an important factor in driving productivity. It doesn't matter if it's on the software or the front end, marketing and sales related activities, as well as automation in the factories and capital investment in the factories to drive productivity. Just a philosophy of Mark and myself that we need to use capital to help drive productivity and we wanted to make sure that the businesses have the capital they need to do that.

Damian Karas:

Got it. Thanks for clarifying.

Operator:

I would now like to turn the call over to Pentair for any closing remarks.

John Stauch:

Thank you for joining us today. We continue to invest in our prioritized growth initiatives around advancing Pool growth and accelerating Residential and Commercial water treatment. We are driving operations, sourcing and cost out actions where appropriate, particularly in our Flow Technologies segment.

We have a strong capital structure, solid free cash flow generation and we will continue to invest in our strategy to be the leading Residential and Commercial water treatment company. Thank you for your continued interest. Zatania, you can conclude the call.

Operator:

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