

Pentair plc (Q4 2022 Earnings)

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Corporate Speakers:

- Shelly Hubbard; Pentair plc; VP of IR
- John Stauch; Pentair plc; President, CEO & Director
- Robert Fishman; Pentair plc; Executive VP, CFO & CAO

Participants:

- Joseph Giordano; Cowen and Company, LLC; Research Division, MD & Senior Analyst
- Bryan Blair; Oppenheimer & Co. Inc.; Research Division, Director & Senior Analyst
- Michael Halloran; Robert W. Baird & Co. Incorporated; Research Division, Associate Director of Research & Senior Research Analyst
- Julian Mitchell; Barclays Bank PLC; Research Division, Research Analyst
- Nathan Jones; Stifel, Nicolaus & Company, Incorporated; Research Division, Analyst
- Brian Lee; Goldman Sachs Group, Inc.; Research Division, VP & Senior Clean Energy Analyst
- Charles Tusa; JPMorgan Chase & Co; Research Division, MD
- Andrew Kaplowitz; Citigroup Inc.; Research Division, MD and U.S. Industrial Sector Head
- Deane Dray; RBC Capital Markets; Research Division, MD of Multi-Industry & Electrical Equipment & Analyst
- Jeffrey Hammond; KeyBanc Capital Markets Inc.; Research Division, MD & Equity Research Analyst
- Scott Graham; Loop Capital Markets LLC; Research Division, MD

PRESENTATION

Operator^ Welcome to the Pentair Fourth Quarter 2022 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Shelly Hubbard, Vice President Investor Relations. Please go ahead.

Shelly Hubbard^ Thank you, Kate. Welcome to Pentair's Fourth Quarter 2022 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 fourth quarter and full year 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 me 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 and today's release. We will also reference certain non-GAAP measures. Following our prepared remarks we will open the call up for questions. (Operator Instructions). I will now turn the call over to John.

John Stauch^ Thank you, Shelley, and good morning, everyone. Let's begin with Slide 4, titled Executive Summary. We closed down 2022 with strong sales, segment income and adjusted EPS, which is a direct result of the hard work and dedication of our focused employees across the world. Sales increased 9% to \$4.1 billion. Segment income rose 12% to \$768 million.

ROS expanded by 40 basis points to 18.6%, and adjusted EPS increased 8% to \$3.68. A few of our key wins during the year include strategic progress on our transformation initiatives, which we expect to drive significant margin expansion over the next several years, the acquisition of Manitowoc Ice, a complementary and accretive acquisition, which further enhances our commercial Water Solutions business and recognition for our leadership in social responsibility and sustainability.

All in, we are focused on building the Pentair in the future by investing in sustainable growth and expanding profitability through strengthening our operational and financial foundation, which we expect to create long-term value for our stakeholders.

Bob will discuss our first quarter and full year 2023 guidance in more detail, but I wanted to share some able thoughts. We are confident in our business model, diversified portfolio and our transformation initiatives, which we expect to drive long-term shareholder value and contribute significantly to 2023.

As we look specifically at 2023, we are working through near-term macroeconomic-driven challenges, which we are driving -- which is driving lower-than-expected volumes in our residential businesses. However, we expect to see more normalized demand in 2024, and view 2023 as a catch-up year for excess demand that was realized in 2020 through the first half of 2022.

Please turn to Slide 5, titled 5-year Pentair performance. Reflected in the last 5 years is a focused, smart, sustainable water solutions company. We drove strong financial performance by increasing revenue at an 8% compounded annual growth rate, increasing EPS at a 14% compounded annual growth rate, and we have also generated over \$2 billion of free cash flow and ended 2022 with nearly a 16% ROIC. These are metrics that we are very proud of and share with our incredible team here at Pentair.

This is a testament to our relentless efforts to deliver premium quality, innovative products and services to our consumers. We believe the largest opportunity is improving ROS, which did not improve materially over the last 5 years. The strong demand we realized later in 2020 through the first half of 2022 came with disruptive supply chains and unprecedented inflation that was hard to outpace.

We believe our second half of 2022 demonstrates that we have finally made progress on price versus cost. However, we still have significant opportunities to improve our operating and cost efficiencies across all of Pentair through transformation and recovery of the inefficiencies that we realized.

Please turn to Slide 6, labeled Pentair at a glance. For those of you listening today who may be new to our story, I wanted to reiterate a few important key metrics that I discussed last quarter. In 2022, we generated \$4.1 billion in sales with approximately a 50% mix from residential channels and 50% from commercial, industrial and infrastructure channels.

We have decent profitability to 18.6%, but as I mentioned previously, we have a lot of opportunity to improve this. We believe our large installed base is an advantage and an opportunity for us. For example, [75%] of our products are replacement inside a large installed base that benefits from over 75,000 focused trade partners. We believe these relationships with our trade channel partners drive resiliency of revenue and create a great opportunity for continued growth as we introduce new products and technologies.

We have a long successful track record of generating cash flow and being disciplined with our capital allocation. In fact, we have increased our dividend for the 47th consecutive year, putting us in a very small group inside of the S&P 500, and we are especially proud of our high-teens ROIC, demonstrating that we continue to be good stewards with your invested money. We believe we have a very solid foundation, and we know there's still more we can do.

Please turn to Slide 7, labeled our impact, making better essential for people and the planet. Our work on ESG and social responsibility continues to be at the forefront of how

we operate and how we work to make the planet better. At Pentair, we take great pride in the products we developed that are providing solutions to some of the world's largest challenges, including safe and healthy drinking water, climate change and water shortages to name just a few.

We also seek to make better essential for people and the planet. For example, our products and solutions improved water efficiency, reduce in capture carbon emissions and avoid the need for single-use water bottles.

Here are a few highlights. 71% of Pentair's solutions support water efficiency, 15.9 million tons of CO2 emissions have been avoided by U.S. consumers using Pentair's energy-efficient pool pump since 2005 and nearly 8 billion single-use plastic water bottles have been avoided in 2022 due to Pentair's water filtration products.

Furthermore, our leadership in social responsibility is being recognized by third-party organizations, including Forbes and others. We look forward to continued progress and plan to share additional details in our 2022 Corporate Responsibility Report, which we expect to publish this spring.

Please turn to Slide 8, labeled strategic framework. Our purpose, mission, vision, values and impact are critical components of our strategic framework. Our purpose matters. It is to create a better world for people in the planet through smart, sustainable water solutions.

Our mission, as a company, is to help the world sustainably move, improve and enjoy water likes most essential resource. And we do this in residential, commercial, agriculture and industrial applications. As of January 1st of this year, we have split our Consumer Solutions segment into pool and water solutions. This creates 3 focus segments as IFT remains unchanged.

We expect this to not only improve transparency, but further improve customer service, differentiate our products, measure our success externally and drive greater profitability for our shareholders. Our 3 segments are now Industrial & Flow Technologies, Water Solutions and Pool. We continue to see great opportunity in all 3 of these segments and the businesses that each of them lead.

Our Industrial & Flow Technologies segment helps move water where you need it, when you need it more efficiently in our pump businesses. The segment also focuses on transforming waste into value through our sustainable gas and membrane businesses.

Our Water Solutions segment, which includes our most recent acquisition, Manitowoc Ice, is a leading platform to provide water and ice to our food service and residential customers. These businesses improved water by providing great tasting, higher quality water and ice while helping our customers use more -- water more productively. Our pool business helps enjoy water by using less energy and chemicals.

In North America, it also has a large installed base of approximately 5.4 million pools with an average age of 20 to 25 years. The industry is approximately 60% break and fix, 20% major remodeling and 20% new pools. Only about 50% of all in-ground pools have some form of automation, which we believe is a long-term opportunity for Pentair. I will now pass the call over to Bob, who'll discuss our performance and financial results in more detail. Bob?

Robert Fishman^ Thank you, John. Good morning, everyone. Please turn to Slide 9, labeled Q4 2022 Pentair performance. I will also be discussing our full year performance on Slide 10. We delivered fourth quarter sales growth of 1% with core sales declining 3%, as strong price contribution was not enough to offset volume decline.

Consumer Solutions core sales were down 11%, as expected and previously communicated, due to residential channel inventory levels rebalancing and as a result of our lead times beginning to return to more normal levels. Industrial & Flow Technologies reported strong 11% core sales growth with strength in commercial flow and industrial solutions. For the full year, sales grew 9% with core sales up 6%.

Consumer Solutions delivered 4% core sales growth and Industrial & Flow Technologies saw core sales growth of 10%. Fourth quarter segment income increased 10% and return on sales expanded 130 basis points year-over-year to 18.2%, driven primarily by price significantly offsetting inflation. Productivity was negatively impacted by lower volume in the quarter. Adjusted EPS of \$0.82 was down 6% versus the prior year, but exceeded our guidance for the quarter. Net interest and other expense was \$28.2 million, which represented our first full quarter of new financing post the Manitowoc acquisition.

And our adjusted tax rate was 12.7% during the quarter with a share count of 165.2 million. For the full year, segment income grew 12% and return on sales expanded 40 basis points to 18.6%. Adjusted EPS increased 8% for the year to \$3.68. Our tax rate ended the year at 14.5%, and our share count was \$165.6 million.

Please turn to Slide 11, labeled Q4 2022 Consumer Solutions performance. In addition to the fourth quarter performance for Consumer Solutions, I will also be referencing the full year performance on Slide 12. In the fourth quarter, Consumer Solutions sales declined 1% with core sales declining 11%, comprised of 15 points of price, offset by 26 points of volume decline.

This was in line with our expectations. The volume decline was due to difficult year-over-year comparisons and the anticipated inventory correction across many product lines in our residential channels. Segment income grew 7%, and return on sales expanded 150 basis points to 23.1% as strong pricing measures continue to play out along with the contribution from Manitowoc Ice.

For the year, Consumer Solutions sales grew 12% with core sales up 4%. Segment income grew 10% and return on sales declined 40 basis points to 23.3%. Our pool business had sales growth of 4% for the year. Water treatment saw sales growth of 28%,

led by contribution from the Manitowoc Ice acquisition, which was completed at the end of July.

Please turn to Slide 13, labeled Q4 2022 Industrial & Flow Technologies performance. In addition to the fourth quarter performance for Industrial & Flow Technologies, I will also be referencing the full year performance on Slide 14. Industrial & Flow Technologies grew sales 5% in the quarter, partially offset by a 4% FX headwind with core sales increasing 11%.

Segment income grew 21% and return on sales expanded an impressive 240 basis points to 17.4%, marking the second consecutive quarter of greater than 200 basis points of improvement. The strong margin expansion was a result of significant price contribution and moderating inflation. For the year, sales increased 6% with core sales increasing 10%.

Segment income grew 14% and return on sales increased 110 basis points to 16.1% as strong price more than offset inflation and FX headwinds. IFT saw sales growth across the segment with residential flow up 3%, commercial flow up 6% and Industrial Solutions up 10%.

Please turn to Slide 15, labeled balance sheet and cash flow. As a reminder, this slide reflects the closing of the Manitowoc acquisition at the end of July. We ended the quarter with pro forma leverage of 2.5x, and our return on invested capital was at 15.7%, declining slightly due to the acquisition of Manitowoc Ice. I would like to remind you that given the rising interest rate environment, we are comfortable being 2/3 variable as we were less inclined to lock into higher rates for longer.

We have no significant long-term debt maturing for the next few years, and the majority of our debt is in term loans going out 3 to 5 years. We generated \$283 million of free cash flow from continuing operations in the year, which was in line with our messaging on the Q3 earnings call. Working capital was a significant headwind this year, primarily inventory, which has led to a timing issue on cash flow. Our inventories were higher largely due to inflation by ahead and inefficiencies in the supply chain.

We expect to benefit from working capital improvement in 2023 and generate free cash flow in line with our historical performance of 100% of net income. In 2022, we returned roughly 2/3 of our free cash flow to shareholders through dividends and share repurchases. We plan to remain disciplined with our capital, and we'll continue to focus on debt reduction amid the higher interest rate environment.

Please turn to Slide 16, labeled segment structure beginning in 2023. As John discussed, we moved to 3 reporting segments effective January 1, 2023. We have included realigned historical information for these segments from 2019 to 2022 in the supplemental data section of our earnings presentation. Our Industrial & Flow Technologies segment had roughly \$1.5 billion of revenue in 2022 with a ROS of approximately 16%. This business grows sales at roughly single digits over the long term in a very large industry.

Water Solutions consists of residential and commercial and was roughly \$1.2 billion of revenue on a pro forma basis when including a full year of Manitowoc Ice. This is a mid-single-digit sales growth contributor, over the long term, operating in a very large industry. Finally, pool was roughly \$1.6 billion of revenue in 2022 and is our highest profitability segment that we expect will grow sales mid-single digit plus over the long term.

Please turn to Slide 17, labeled transformation expectations. We have moved transformation from funnel to execution, and we expect more material benefits to contribute to our longer-term margin expansion targets. In 2022, we made strategic progress on our transformation initiatives with a primary focus on 2 of our 4 key themes: pricing excellence and strategic sourcing. Overall, we believe transformation will be a key driver in value creation over the next 3 years.

For example, through our transformation initiative, we have identified over 400 basis points of targeted margin expansion by 2025, up from the 300 basis points that we discussed at our previous Investor Day. A significant portion of that is due to a focus on material costs, which represent roughly 40% of our sales. By driving transformation excellence through pricing and sourcing, we believe this will have the most significant impact on overall cost efficiencies.

With the work we have completed in 2022, we believe that we can expand return on sales to approximately 23% in 2025. In pricing, we have completed wave 1, which has established a new strategic pricing playbook. This creates a foundation for pricing across our different go-to-market strategies and includes looking at our dealer and distributor programs to better optimize them.

We are gaining insight into profitability by customer and product category and using this data to better drive our forecast. We believe pricing remains a big opportunity. We are building capabilities and starting to see benefits materialize. We expect future waves to include the implementation of a pricing playbook across all categories. We are furthest along in our strategic sourcing initiatives.

We have completed Wave 1 that focused on key categories like electronics, motors and drives, castings, packaging, logistics and MRO. Wave 1 included roughly 35% of material spend and has generated over 12% in savings opportunities. We expect to unlock value through supplier dedicated resources, supply base reduction, inventory solutions, enhanced supplier executive-level relationships and rebate programs. We expect to reduce complexity across our entire organization and to see close to 80% supplier reduction in some of our commodity groups.

Over 75 Pentair team members attended 3,000-plus hours of formal classroom instruction and workshops and supply chain topics. As we institutionalize our Wave 1 learnings, we expect this will drive future waves as we look at additional categories. Wave 2 is scheduled to start in 2023, and is planned to cover another 35% of material spend for

commodity groups such as metals, plastics and molding, purchased finished goods, transportation and indirect spend such as IT, fleet management and office supplies.

We expect this will create a funnel of savings for 2023 and 2024. In operations excellence, we are focused on reducing complexity and driving lean processes across all our operations. In 2022, we made a few small strides on footprint optimization. We believe this presents longer-term opportunities, but not until 2024 and beyond as we build out the funnel.

Lastly, in organizational effectiveness, we are focusing on sales and functional excellence to simplify our organization. From an organizational standpoint, we believe ample opportunities remain for complexity reduction across the entire portfolio and a realignment of needed skills within our top priorities. We continue to believe that our transformation initiatives will be a large value creation opportunity for Pentair.

Please turn to Slide 18, labeled Q1 and full year 2023 Pentair outlook. For the full year, we are introducing adjusted EPS guidance of approximately \$3.50 to \$3.70, which represents a year-over-year range of down 5% to up 1%. We expect sales to be roughly down 3% to up 1%.

We expect segment income to increase 5% to 10% with corporate expense of approximately \$80 million, net interest expense of roughly \$125 million and adjusted tax rate of approximately 15% and a share count of \$165 million to \$166 million. We are targeting free cash flow of approximately 100% of net income as we expect working capital to improve and inventory levels to come down. For the first quarter, we are introducing adjusted EPS guidance of approximately \$0.76 to \$0.78, which represents a year-over-year decrease of approximately 8% to 11%.

We expect sales to be roughly flat to up 1% as the contribution of Manitowoc Ice helps offset expected volume decline from the rebalancing of residential channel inventory. We expect segment income to increase 5% to 8%, with corporate expense coming in around \$21 million, net interest expense of roughly \$33 million, an adjusted tax rate of approximately 15% and a share count of \$165 million to \$166 million.

Please turn to Slide 19, labeled full year 2023 guidance at midpoint. The chart on Slide 19 shows a lack of sales and segment income at the midpoint of our full year 2023 guidance. From the sales walk on the left-hand side, you will see that we expect sales to be down roughly 1% at the midpoint.

We expect volume to be down approximately 10%, primarily due to our residential businesses. We expect price benefit of approximately 5% and a benefit from acquisition divestitures of roughly 5%, primarily due to a full year of Manitowoc Ice, partially offset by exits in the residential businesses and Water Solutions. We expect pool sales to be down low double digits at the midpoint in 2023 after growing 14% in 2020, 40% in 2021 and 4% in 2022.

We believe 2023 will be an inventory rebalancing year across the pool industry. We do think that there was a higher-than-normal level of demand in 2020 and 2021 that led to timing and supply chain disruptions in the industry, and therefore, created a larger-than-normal impact between sell-through and sell-in reflected in our results.

We estimate that from a sell-through perspective, the overall industry grew about 4% on a volume basis from 2019 to 2022, roughly in line with historical levels. As we have discussed, our pool sales consists of 20% from new pools, 20% from remodels and 60% from the aftermarket. At the midpoint, we expect that new pools and remodels will be down approximately 20% in 2023, and the aftermarket business, including inventory corrections in Q1 through Q3 will be down approximately 15%.

We expect price carryover for pool will be up roughly mid-single digits. We do expect the industry and our pool revenue to return to more normalized growth later in 2023 and in 2024, reflecting a more even balance of sell-through and distribution buying patterns. As a reminder, even with an expected full year of down double digits in 2023, we expect to grow at a double-digit CAGR in pool from 2019 through 2023.

We expect our Water Solutions segment sales to be up mid-teens at the midpoint, including up approximately 40% in our commercial business, with a full year of Manitowoc Ice and down approximately 10% in our residential business.

We expect IFT sales to be up slightly at the midpoint with the commercial, industrial and infrastructure businesses up approximately mid-single digits and residential down approximately double digits. On the segment income side, we expect segment income to grow approximately 8% at the midpoint and to expand ROS roughly 150 basis points. We expect price to slightly exceed inflation.

We expect approximately 35% ROS from our acquisitions and divestitures. Our transformation initiatives and productivity should deliver over 200 basis points of margin expansion, and we expect drop-through of roughly 30% on the decrease in volume. We expect our greater than 200 basis points of transformation and productivity benefit will be the result of volume rightsizing actions that we undertook in the fourth quarter of 2022, inefficiencies in our 2022 results that will not repeat in 2023 and our transformation initiatives.

Our comments are based on the midpoint of the range. The lower end of our range would be reflective of higher interest rates, impacting housing demand and our residential sales and increasing our interest expense. As we think about the higher end of our range, our main drivers would be a better outcome in the residential businesses, primarily pool and overdriving some of the transformation benefits.

In closing, we expect the lower pool year in 2023 to be offset by the strength of our diversified portfolio and our transformation initiatives.

We are confident in the expected benefits from our transformation initiatives, and we believe we are gaining continued momentum to not only drive savings in 2023, but to build a strong funnel for 2024 and 2025 with significant ROS expansion. We also expect ROS expansion as our residential businesses returned to more normalized growth in 2024 and beyond. I'd now like to turn the call over to the operator for Q&A -- after which, John will have a few closing remarks. Please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) The first question is from Joe Giordano of Cowen.

Joseph Giordano^ Going to start not on pool. Can you talk about the residential portfolio that you have within your Consumer Solutions group?

You've made a couple of acquisitions over the years, (inaudible), small deals, but now we're talking about some exits that you're making. So maybe just give us an update on where that portfolio is, where is it maybe versus what you thought it might look like when you started making those deals and kind of like an update on the strategy going forward from there?

John Stauch^ Yes. I mean, first of all, I think about it as roughly still 40% of the overall Water Solutions segment. And think of all the core that we were focused on for the last 5 to 10 years, which is really about the trade and the professional channel, all being a big part of our strategy and still performing.

What we did, exit was our attempts of the direct-to-consumer side of the business, which we felt were not going to gain the traction that we originally hoped they would, but also they were confusing the trade channel as far as our partnership to support them. And so now we're focused on being back to where we were, which is pulling demand through our professional trade channel and ensuring that we're winning with the best products and solutions, Joe.

Joseph Giordano^ That makes sense. And then just a follow-up on the 2025 margin target. Can you maybe walk us through the relative contributions from the 3 segments? Like, I guess, pool doesn't have as much upside given how strong it's been, but if you could kind of help us read that out.

Robert Fishman^ Yes. Joe, we were pleased to be able to increase the ROS expansion due to the -- what we're seeing in the transformation initiatives. We still have work to do to break it out by segment, but overall, we would expect each of the segments to be contributors to that ROS expansion.

John Stauch^ So when you think of the increase in the target, as Bob mentioned, 100 of that comes from candidly, the fact that we're mixing up with the Manitowoc acquisition, and then we felt like stepping up the expectations on the transformation was helpful for 2 reasons. One is, we believe that we're making progress with the actual work we're doing;

but the second one is, we have inefficiencies that we have covered over the last couple of years of being challenged by the supply chain, which we want to make sure are included in the transformation journey that we're on.

Robert Fishman^ And just to bridge the gap, when we had our Investor Day, we talked about going from 18% to 21% in 2025. We then acquired Manitowoc, so that gave us another approximately 100 basis points to bring us to 22%. And then we found another 100 basis points in the transformation initiatives to get us to the 23%.

Operator^ The next question is from Bryan Blair of Oppenheimer.

Bryan Blair^ Just to confirm, your 2023 guidance implies mid-single-digit core growth in commercial Water Solutions. Is that correct?

John Stauch^ Yes. Yes. It does.

Bryan Blair^ Okay. Having owned Manitowoc Ice a bit longer, any update you can offer on the commercial synergies that you've seen to date? Or what's expected between Everpure, Manitowoc and KBI?

John Stauch^ Yes. We're really pleased with the start. I think these all come together nicely, and I think we continue to see significant opportunities for our customers to benefit from the end-to-end solutions that we now provide in commercial Water Solutions.

Robert Fishman^ And just to provide a little more detail, the Water Solutions does have commercial (inaudible) approximately 40%. Residential down approximately 10%.

John Stauch^ Right. He was asking for quarter, given the quarter of mid-single digits.

Operator^ The next question is from Mike Halloran of Baird.

Michael Halloran^ First follow-up to Joe's second question. Just what kind of volume assumptions are embedded in those margin targets, if any? Or are those exclusive of volume expectations over the next few years? In other words, is there a level of revenue or volumes you need to get to be able to achieve these targets?

John Stauch^ Well, I mean we're making significant impact in 2023 even with the down volume. So I think the jump start in 2023 reflects the aggressive efforts to get the labor in line with the volume and also to recover those inefficiencies. As we go forward, we'd be looking at the normalized growth rates of each of the segments being included in our efforts to get to the ROS targets that we implied.

Michael Halloran^ Okay. That makes sense. And then just from a guidance perspective, could you help with the cadencing a little bit through the year? When you think about normal seasonality and there's a lot of moving pieces, particularly in pool, some of the

destocking. How are you guys thinking about what the normal seasonal cadence looks like by segment within the guidance?

Robert Fishman^ We are starting to move back to a more typical seasonality where Q2 is typically our our largest quarter followed by Q3. I would say that we expect to see slightly less than 50% of our EPS in the first half, primarily because interest expense is a little bit higher in the first half and transformation initiatives play out a little bit more strongly in the back half, but we are returning to more traditional seasonality than what we saw during the COVID years.

John Stauch^ And I would just add that you should assume that most of the residential channel challenges will come through Q1, Q2 and Q3, and we have easier comparisons in the back half of the year as we look at what those year-over-year impacts would be.

Operator^ The next question is from Julian Mitchell of Barclays.

Julian Mitchell^ I just wanted to understand your sort of conviction level around the price tailwinds. You had 5 points of price dialed in for this year after sort of low teens ending last year. So maybe sort of give us some more color on the price confidence and how you see the sort of needed inventory liquidation in a lot of pool products perhaps weighing on that?

John Stauch^ Yes. So I'll start and Bob can bring some more in. I think, first of all, the price that we're anticipating is actions that have already been taken. And we feel good about the decisions we've made, and we feel like we have, as we said, stickiness in the channel.

I do think it's fair to assume that as we get through the year, we have to anticipate that there might be ideas from the channel to participating in rebates and discounts. We've assumed a little of that in our guide, but we're hopeful that our balanced view of the revenue projections that we have don't encourage us to think that we need to do significant discounting to achieve our expectations.

Julian Mitchell^ And you're seeing sort of competitors acting in a disciplined fashion to -
- for the time being.

John Stauch^ I don't know about that. I mean we don't have any information to the contrary.

Operator^ The next question is from Nathan Jones of Stifel.

Nathan Jones^ I'm going to ask about pool. You talked about in the prepared comments, Bob, 2019 through 2023, double-digit growth in pool in the guidance for '23. I think historically, that had been more like 7% or 8%. Can you talk about what was price versus volume in that?

How much higher was priced than you would normally have? I'm just trying to get an idea in a sense of are we kind of back to a normalized volume growth if you take that period from '19 to '23 where we pulled forward demand early, we're giving some back in now. How we kind of back to that normal trend line?

John Stauch^ We think if you looked at it, Nathan, on a sell-through basis, we'd be normalized sort of volume from a sell-through basis. Obviously, we got a little disconnected on the sell-in versus the sell-out, but overall, we believe we're tracking to historical volume levels with where we end up. So you should assume that we've had a significant price benefit over the last 4 years that we've realized.

Nathan Jones^ Okay. That makes sense. So on volume level were back to normalized, that's good to know. With the change in the reporting structure, is there a change in the way you're managing any of those businesses? And if so, how do you think that benefits the customer experience of buying to Pentair? Just any color you can give us on the change in reporting strategy, if there's a change in the actual business management structure.

John Stauch^ Yes. We've put in a lot of effort and resources to run at what we call the category level, which is the products that go to the market and serve the customer streams. So that's our focus.

And the new segment lineup allows us to be aligned pool for pool, and then we've been able to split the Water Solutions businesses to the residential commercial where we have the varying go-to-market channels, and IFT remain the same. So we feel really good about our customer-centric efforts both on sales, marketing and NPI. And we're very encouraged on how the new segments will help enable the focus on the growth journey of these three different areas.

Operator^ The next question is from Brian Lee of Goldman Sachs.

Brian Lee^ Maybe just shifting back to the margin outlook here. I appreciate the updated view through '25. I guess just sort of drilling into '23 a bit here, you mentioned the 100 basis points from the Manitowoc. And when I look at your Slide 19, can you kind of give us a sense if that's your sort of entire transformation contribution in '23? And maybe just walk us through some of the pieces, including how much of that 100 basis points from Manitowoc is embedded into '23?

Robert Fishman^ Yes. Let me do that. I would say, roughly 50 to 60 basis points comes from Manitowoc of that 160 basis point increase. So the way that you should think about Manitowoc is, we had roughly \$150 million of revenue in our P&L in 2022, [50] in Q3, [90] in Q4. And as we mentioned before, we drive about 30% of ROS on that Manitowoc business. We'll increase to about 370 of revenue in 2023.

So think of revenue going up about 220 in Manitowoc at that 30% income level. We also get -- by exiting the residential businesses, we'll lose about \$25 million of revenue in

2023, but gain about \$10 million of income. Those were loss-making businesses in 2022. So when I talked about acquisitions and divestitures benefiting about top line and roughly 35% from a ROS perspective, that was the breakout.

Brian Lee^ Okay. That's great. And then just a quick question on the pool side. I don't know if you quantified this, but you're talking about the channel inventory sort of coming down, maybe normalizing in the 2Q, 3Q timeframe. Can you quantify sort of where you see inventory levels, sort of weeks, and then, I guess, months and where you would need to get to you to sort of get to a normalized level?

John Stauch^ Yes. I'm looking at it slightly different than that. I think we've shared with you that we think we're down about 20% each on new pool builds and also the aftermarket remodel side. So think of that as each of those 2, 20% -- is down 20%.

And then we grouped the aftermarket and the inventory piece, and we assume that what we're going to see is lower pull-through from the sell demand because as Bob mentioned, we think some of the aftermarket demand was serviced earlier. And because of that, we feel like we've got to balance the shipments into the channel and the industry to serve that lower demand. And most of that, we think happens over Q1, Q2 and Q3.

Operator^ The next question is from Steve Tusa of JPMorgan.

Charles Tusa^ Just the inflation number, I'm not sure if you said that so far. What's the actual number? I mean it could kind of eyeball the chart there, but just curious what the actual inflation headwind is for '23.

Robert Fishman^ It would be about 4.5% is how we view it at this point.

Charles Tusa^ Okay. So on an absolute basis, what does that kind of convert to?

Robert Fishman^ Well, if you think about prices being above 5%, so call that \$200 million benefit. I think about inflation at 4.5% has been around [\$180 million].

Charles Tusa^ Okay. So moderately positive. When you think about the pricing in the other businesses, anything going on there? Any kind of surcharge or anything moving around in the non, I guess, the more industrial businesses?

John Stauch^ No, no real surcharges, Steve. We're back to more normalized price actions and having to go out and compete competitively from a standpoint of making sure that reporting those jobs by anticipating the impact of inflation and then winning the future sourcing inflation as we satisfy the industrial projects.

Operator^ The next question is from Andy Kaplowitz of Citigroup.

Andrew Kaplowitz^ So supply chain inflation obviously look better in Consumer Solutions in Q4, but I think you mentioned productivity was negative because of a

decline in revenue. I know you said, you expect inefficiencies to lessen as you go into '23. So just sort of what happened in Q4? Was it just lower revenue? And do you still see that sort of \$50 million of incremental improvement for manufacturing and efficiency getting better in ['22 versus '22?]

John Stauch^ We do.

Robert Fishman^ Absolutely. So the significantly lower volume in Q4 while we put actions in place, that's what primarily drove the negative productivity. As we look at 2023, those inefficiencies, whether it was air freighting, spot buys with whether it was supply chain challenges, those will reduce significantly and obviously, help our productivity. Those are one area. And then just the actions we took in Q4 around adjusting for the lower volume will benefit us. And then in addition to that, the transformation initiatives that are starting to benefit us in 2023.

Andrew Kaplowitz^ Very helpful. And then Bob, maybe the conviction level to get back to free cash flow conversion of 100%. And if you do get there, obviously, you've got some leverage here, but we've seen recent announcements, a little bit of consolidation and call it, the water equipment space. So where does Pentair go from here on the M&A front?

Robert Fishman^ I'll definitely take the first one. The -- we have high confidence in our free cash flow. We will benefit from working capital coming down in 2023, primarily inventories. We've established targets and are starting to chart progress. So I'm confident around the inventory space.

We'll also see benefits versus 2022 in terms of accruals and cash being paid out. So overall, there's 3 or 4 different areas that give us confidence in the free cash flow. Historically, we do drive 100% of net income. And when we've had a challenging year, we've turned around the next year and get back to our typical path. So high confidence there.

John Stauch^ Yes. And as far as the M&A, I mean, short term, we're going to service the debt just because of the high interest rates. We love our strategy. We believe the move and proven enjoy gives us a lot of flexibility to add to our existing portfolio, but we're going to be smart. I mean, call me old fashioned, but I think ROIC matters in the long run, Used to be how we measure performance. I still think it matters, and I think we have to be disciplined with your capital, and we need to make sure if we put that capital work that we can make these acquisitions deliver to the expectations.

Operator^ The next question is from Deane Dray of RBC Capital Markets.

Deane Dray^ And we also, John, agree ROIC matters. And on Manitowoc, just can we circle back on this. One of the obvious upside was the whole cross-sell opportunity, making sure every one of those ice machines has a Pentair filter. Just can you share with

us on the take rate there? Any initiatives that you have to make sure that, that process happens smoothly.

John Stauch^ Yes, Dean, first of all, I still think we think across all the synergies we said that we're going to experience those. And we do believe, as we said, there's certainly account management and making sure that we can service the key accounts across all 3 platforms, KBI being one of those platforms as well on the service side.

We do believe that every ice machine should have a filter, and we would hope that it's our filter since we think we are the best filtration company, but that has been a choice support is made by the distributor and the end market. And I think we can help them be aware of why our filters will be better, and we do believe that take rate is going to be serviced over time.

Deane Dray^ Got it. And then for Bob. The idea here is, you've got this whole working capital normalization happening. Wouldn't it be fair to expect that the cash conversion would be well above 100% at some point in '23, just given the kind of cash conversion that you'd expect from working capital alone.

Robert Fishman^ We've looked at the free cash flow and certainly, don't want to get ahead of ourselves. One of the pacing items is the transformation piece. So we expect to spend less on transformation and restructuring in 2023 than we did in '22, but we still have to invest to drive the benefits.

So those will be good payback items that we spend the money on, but that is one of the items that contains the free cash flow slightly. The only other thing I wanted to echo your first question relating to score keeping for Manitowoc is that as we drive synergies, it's all within Commercial Water Solutions, but some of the benefits goes to commercial filtration as they sell filters. Some of it goes to our beverage as they drive more services relating to the ice machine. So all of the synergies are not necessarily captured in just Manitowoc Ice.

Operator^ The next question is from Jeff Hammond of KeyBanc Capital Markets.

Jeffrey Hammond^ Just back on pool on the destock, and I'm just wondering, one, kind of how you think of inventories on your balance sheet versus those at the distributor channel? And then just if any early buy kind of played in any part and kind of the pacing of destocking?

John Stauch^ No to the second one. And really, when we think of inventories, a reminder that some of our inventories across the entire portfolio. Our project businesses, our electronics, the tougher to get componentry is where a lot of our inventory resides, Jeff. It's not like we're sitting on finished goods inventory ready to go out. No, it's not that simple.

Jeffrey Hammond^ Okay. Just on res pool, I think you put -- around pool, you've got 28% margins in '22. How should we think about decrements as you go through this transition and kind of where you think those margins bottom out?

John Stauch^ We expect to drive margin improvement in 2023, Jeff. I mean, as a reminder, our volume in pool was down roughly 30% in Q4, and that's one of the reasons we didn't get to get that leverage up. As we take a look at 2023, when we get the costs in line and balance out against these new production levels, we do believe we're going to drive margin improvement in pool in 2023.

Operator^ The next question is from Scott Graham of Loop Capital Markets.

Scott Graham^ Just a couple of questions, one on pool, one on the commercial water treatment. I know you said for commercial water to expect sort of a mid-single-digit growth this year. I'm curious, does that include Manitowoc Ice.

John Stauch^ No, and I'm sorry that we weren't clear. I thought we -- the question was, what was core growth of Commercial Water Solutions, and I said, mid-single digits. Inclusive of the acquisitions, it's much higher than that, which is on the chart as mid-teens.

Scott Graham^ Right. That certainly -- yes, that I certainly understand. What would you think that the growth would be in Manitowoc Ice pro forma?

John Stauch^ Mid-singles.

Scott Graham^ Okay. The other question is around pool. So there's a pretty big change in your assumption. I think you were looking at thinking last quarter that aftermarket would be about flat, and now you're kind of looping that together with the continued destock. And I'm just curious because there are more pools in the ground. So I would have almost thought that naturally that aftermarket might have even been up this year, so is that essentially saying that the destock is kind of more than 100% of the decline? Or am I thinking about that right?

John Stauch^ Yes. I think it's really the result of the significant growth in '20 and '21, and first half of '22 that the industry saw. And if you think about a more normalized growth, it would suggest that key items like heaters and lighting were probably pulled into those earlier years, and that is probably challenging the aftermarket assumptions.

Now all of that's great because we're adding to content in existing pools, and there will be some replacement of those products down the road. So I think long-term trajectories are fine. We just think that some of the demand was pulled into the earlier years.

Operator^ This concludes our question-and-answer session. I would like to turn the conference back over to John Stauch, President and Chief Executive Officer, for closing remarks.

John Stauch^ Thank you. Thank you for joining us today. We are excited about the future of Pentair and focused on creating a better world for people and the planet through smart, sustainable water solutions. Our focus on driving superior shareholder value is fueled by our mission to help the world sustainably move, improve and enjoy water, life's most essential resource. Kate, you may conclude the call.

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