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PNR - Q2 2017 Pentair plc Earnings Call

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**OVERVIEW:**

Co. reported 2Q17 adjusted EPS of $1.00. Expects 2017 adjusted core sales to be up 2% and adjusted EPS to be approx. $3.50. Expects 3Q17 adjusted core sales to grow approx. 4% and adjusted EPS to be $0.91-0.93.

## CORPORATE PARTICIPANTS

**James C. Lucas** *Pentair plc - VP of IR*

**John L. Stauch** *Pentair plc - CFO and EVP*

**Randall J. Hogan** *Pentair plc - Chairman and CEO*

## CONFERENCE CALL PARTICIPANTS

**Brian Paul Drab** *William Blair & Company L.L.C., Research Division - Partner and Analyst*

**Charles Stephen Tusa** *JP Morgan Chase & Co, Research Division - MD*

**Deane Michael Dray** *RBC Capital Markets, LLC, Research Division - Analyst*

**Jeffrey David Hammond** *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

**John Walsh** *Vertical Research Partners, LLC - VP*

**Joseph Alfred Ritchie** *Goldman Sachs Group Inc., Research Division - VP and Lead Multi-Industry Analyst*

**Joshua Charles Pokrzywinski** *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

**Nathan Hardie Jones** *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

**Robert D. Barry** *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

**Ronald Drew Weiss** *Credit Suisse AG, Research Division - Associate Analyst*

**Scott Graham** *BMO Capital Markets Corp. - Head of U.S. Government Bond Trading*

## PRESENTATION

**Operator**

Good morning. My name is Hope, and I will be your conference operator today. At this time, I would like to welcome everyone to the Pentair Second Quarter 2017 Earnings Conference Call. (Operator Instructions)

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

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**James C. Lucas** - *Pentair plc - VP of IR*

Thanks, Hope, and welcome to Pentair's Second Quarter 2017 Earnings Conference Call. We're glad you could join us. I'm Jim Lucas, Vice President of Investor Relations, and with me today is Randy Hogan, our Chairman and Chief Executive Officer; and John Stauch, our Chief Financial Officer. On today's call, we will provide details on our second quarter 2017 performance as well as our third quarter and full year 2017 outlook, as outlined in this morning's 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 10-Q and today's 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 Investors 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. (Operator Instructions).

I will now turn the call over to Randy.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Thanks, Jim. We're pleased that our second quarter performance came in slightly ahead of our expectations. Sales are in line with guidance, while segment income and adjusted EPS slightly exceeded the high end of our range. We completed the sale of our Valves & Controls business during the second quarter and, with the proceeds, have significantly improved our balance sheet. Later in the call, John will discuss the balance sheet in more detail and the impact of the Valves & Controls sales closing somewhat later than our initial time line.

We've tightened our full year adjusted EPS guidance to approximately $3.50 per share, which is the midpoint of our prior guidance. We experienced higher-than-planned interest expense in the first half due to the delay in the Valves & Controls close. And we've also seen our share count increase modestly. Offsetting these 2 headwinds was our better first half operating performance, performance that we believe is carrying momentum into the second half of the year. Also factored into our tightened guidance is the fact that we will incur some incremental redundant corporate costs in the second half as we prepare to spin off our Electrical business next year. With an improving top line, continued margin expansion and a stronger balance sheet, we believe the prospects are bright for both our Water and Electrical businesses exiting 2017.

Now let's turn to Slide 5 for a discussion of our second quarter 2017 results. As mentioned, the second quarter performance was in line with our top line expectations and a little better from an income and adjusted EPS standpoint. Adjusted core sales declined 1% in the quarter, but were up 1% for the first half. This is important to mention because the pool season heated up in March this year as opposed to April a year ago, resulting in a tough comparison in the second quarter.

Segment income grew 6%, and operating margins expanded an impressive 170 basis points, with both segments delivering margin expansion greater than 100 basis points and corporate expense coming in a little more favorable than we'd anticipated. We're pleased with our strong margin expansion, which we were able to deliver despite worse material inflation and price recovery than planned. Adjusted EPS grew 14% to $1.00, which exceeded the high end of our guidance by $0.01 despite incurring a slightly higher interest expense and share count during the quarter. Free cash flow of $289 million during the quarter was in line with normal seasonality following the cash usage reported in the first quarter.

Now let's turn to Slide 6 for a look at Water performance in Q2. Our Water segment delivered an adjusted core sales decline of 1%. Segment income grew 5%. And return on sales expanded a very healthy 120 basis points. Our Filtration & Process business saw core sales decline 3% as strength in our Residential and Foodservice businesses were offset by ongoing softness in global desal and muted spending in the beer industry. Foodservice was the bright spot in the quarter, growing high single digits on strength in the convenience and grocery store channels.

Flow Technologies saw core sales decline 4% as we continue to prune lower-margin product lines and focus on driving margin and cash flow improvement. We saw our Residential and Irrigation business grow in the quarter, but this was not enough to offset continued weakness in our Engineered Pump businesses serving Industrial and Infrastructure. We saw orders improve for those large pumps for the second consecutive quarter, indicating that we've reached the bottom in this business, but we're not expecting the top line to benefit from those improved orders until 2018. Finally, our Precision Spray business, which largely serves agriculture, posted another quarter of healthy growth.

Following a very strong first quarter, Aquatic & Environmental Systems saw core sales grow 1%, which yielded a first half core sales growth of 7%, in line with the growth rate seen in the past several years in the business and what we expect to continue. As a reminder, the Pool business can be impacted by timing of the season, which is what we believe happened this year between the first and second quarter. We continue to look for Aquatic & Environmental Systems to deliver another strong year of growth in 2017.

Now let's move to Slide 7 for a look at Electrical performance in Q2. Adjusted core sales grew 1% in Electrical as the strength we saw in the first quarter carried over into the second quarter. Segment income grew 1%, and return on sales expanded a robust 140 basis points due to improved mix and ramping productivity.

Within Electrical, Enclosures declined 1%, but remained a tale of 2 verticals. Our Industrial business grew mid-single digits for the second consecutive quarter, and we believe this represents momentum that will carry over into the second half. Offsetting this strength was continued softness in our smaller Telecom business, which continue the massive strength within the Industrial business.

Core sales in Thermal declined 12%. As a reminder, our Thermal business is facing a nearly $100 million top line headwind in 2017 as 3 large jobs from 2016 were completed. Excluding these large jobs, which we've called out before, we saw Thermal grow on both the projects and products side of the business. The focus continues to be on aligning the business to a smaller order size world, and the underlying improvement in the second quarter gives us increased confidence that the business should exit 2017 in a strong position.

Our Electrical & Fastening Solutions business saw core sales decline following 7% growth in the first quarter. The Commercial business remained strong, with the quarterly volatility stemming from the smaller Infrastructure-related business. As we mentioned last quarter, this piece of Electrical has faced a fair amount of material inflation to start the year, and we've continued to take select price actions to help mitigate some of this higher inflation. We expect the Commercial business to continue to grow on the back half, and we'll look at areas to help reduce the quarterly Infrastructure volatility experienced the past few quarters.

Please turn to Slide 8 for an update on our planned separation. Before turning the call over to John to discuss the financial outlook in more detail, I wanted to provide an update on the separation announcement we made in May. As a reminder, our board has approved a plan to spin off our Electrical business, which we expect to be completed in the second quarter of 2018. We've organized a dedicated project management office that is currently driving some 20 different work streams. We've made the decision on the organization structure that the director reports to the future CEOs of both companies, and the next-level work is underway. We expect to have the initial Form 10 filing during the fourth quarter. Finally, we should have further updates on the capital structure of both companies by early 2018.

Our second quarter performance was another step towards regularly delivering our forecast of the business. The second quarter performance also highlights why we believe the long-term prospects of both businesses are attractive. We're excited for Pentair's next chapter as we create 2 industry-leading, pure-play companies, one in Water, and one in Electrical. We strongly believe that both companies are well-positioned for long-term growth and value creation with the scale and strength to control their own destinies. The increased focus at both companies should help to raise the execution even further and drive higher differentiated growth. Both companies can become appreciated for the jewels that they are.

I'll now turn the call over to John.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Thank you, Randy. Please turn to Slide #9 titled Balance Sheet and Cash Flow. We ended the second quarter with a dramatically improved balance sheet after using the proceeds from our sale of Valves & Controls to retire a significant portion of our debt. Our ending debt balance was $1.7 billion, which does not include nearly $200 million of cash on hand at the end of the quarter.

We had a strong free cash flow quarter, in line with seasonal trends, but our first half performance trailed the comparable period last year due primarily to a couple of higher tax payments in 2017. We continue to target free cash flow equal to adjusted net income for the full year. Our ROIC continued to improve, and we ended the quarter at 11.1%.

Please turn to Slide 10 titled 2017 Cost Out Update. We provided this slide last quarter as an update on our cost out actions, which are now completed. We are now on track to realize over $80 million of net cost benefits in 2017, which is up slightly from the target we presented last quarter. We remain on track to exit the fourth quarter with benefits yielding greater than $100 million of net cost out in 2018. The reorganization activities that we began right after we announced the sale of Valves & Controls are now behind us, and we must now move forward with setting up the organization structures of 2 independent companies.

Please turn to Slide 11 labeled 2017 Guidance Update. Slide 11 is an update of what we presented last quarter when our strong first quarter operational beat offset higher interest expense due to the delayed closing of the Valves & Controls sale. While we successfully closed the transaction in the second quarter and subsequently retired a significant amount of debt, the tender process was completed later in the quarter, resulting in slightly higher-than-anticipated interest expense in the second quarter. This was offset by better-than-expected operating performance. We also have seen our share count increase as the stock has appreciated this year.

While the higher-than-expected interest expense in the first half was offset by higher operating performance, we have one other factor influencing our decision to update the full year guidance to approximately $3.50 per share from a range that included $3.50 as the midpoint of that range. As we are preparing to stand up 2 companies to be publicly traded, we will incur some overlapping costs in the second half as we prepare for the spin of Electrical in the second quarter next year. I would remind you, however, that our goal remains to have 2 public companies with minimal incremental corporate costs.

Please turn to Slide 12 labeled Q3 2017 Pentair Outlook. We are introducing third quarter adjusted EPS guidance of $0.91 to $0.93 per share, which is an 18% increase at the midpoint of the range. We expect adjusted core sales to grow approximately 4% for the third quarter, with both segments expected increase at that rate. We anticipate segment income increasing approximately 5% and return on sales to increase roughly 70 basis points and approaching 19%. The tax rate is expected to be 20%, net interest expense of $13 million, and the share count should be around 184 million. Free cash flow is expected to continue to improve in line with historical seasonal patterns.

Please turn to Slide 13 labeled Full Year 2017 Pentair Outlook. While we did see some shifting of top line growth from Q1 to Q2, we have seen improvement continue in our short-cycle Industrial businesses, and our Residential and Commercial businesses have remained healthy. As a result, we expect full year adjusted core sales to be up 2% versus our prior forecast of flat. We expect segment income to increase 6%, ROS to expand roughly 100 basis points, around 18%, and adjusted EPS to grow approximately 15%. We continue to target free cash flow to be 100% of adjusted net income.

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

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Your first question comes from the line of Steve Tusa with JPMorgan.

**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

So Slide 20 talks about your shipping days dynamics. Maybe -- I'm not sure if you called this out explicitly in the first quarter, but how much do you think it impacted kind of Q2 and maybe quantify how much it will be in kind of Q3 because I think it normalizes in the fourth quarter?

**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, it's somewhere between 1% and 2% impact, Steve.

**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

Okay. So that's kind of contemplated, obviously, in the third quarter guide?

**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, it is.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes.

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**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

Okay, got it. And then you can just quantify the higher cost in the second half? I mean, I guess from an operating perspective, relative to what you were expecting, did you actually kind of tweak up that operating performance in the second half? What are the sources of that?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes. I think as you take a look at the second half, obviously, we have some benefits from foreign exchange. It's dropping through at, call it, low double-digit benefits. And then we have the stronger organic growth, which is offset slightly by the material and more difficult pricing environment. And then operating-wise, we would have expected to deliver a little bit more income, but we're planning to have to transition to the 2 corporate structures and bringing on those costs and then certainly getting back to, hopefully, minimal incremental costs as we spin, Steve. But we have to balance all that while delivering 2017 and standing up 2 successful public companies in 2018.

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**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

Right. Okay. And then just on this price cost stuff. Can you maybe just give us some color and quantify what you were expecting at the beginning of the year and then where you are now and what kind of price for the kind of enterprise are you looking at?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes. Just overall, Steve, I mean, for both Water and Electrical, I'd say that we're looking at somewhere between a $15 million and $20 million headwind for the full year. Some of that realized in Q1 and Q2, and then Q3 and Q4 related to a little less benefit from pricing and a little stronger impact from inflation on the sourcing side.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

That's both of them together.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Both of them together, yes.

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**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

Okay. And then just on the pricing side for the enterprise, what do you expect for the year?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Just under 1 point.

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**Charles Stephen Tusa** - *JP Morgan Chase & Co, Research Division - MD*

Of positive price?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Correct.

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**Operator**

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

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**Jeffrey David Hammond** - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Just back on price cost, can you just talk about what's driving maybe a little more challenging environment on the pricing side? Are there certain businesses where you're struggling to get price? Or is it just a timing issue?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, Jeff, I mean, I think we started the year anticipating the fact that as inflation rises, both of our businesses, Water and Electrical, have historically been able to take advantage of those situations and raise price in the industry and have that price accepted and, therefore, mitigate almost all of the material inflation. I think we were concerned about one issue this year, which was we've never had that experience with a stronger U.S. dollar. And we're seeing the fact that most of the channels that we participate are fighting on price and, therefore, asking us to absorb and become more productive in serving them. And that's the way it's playing out. The good news is there's a lot more growth, and I think we're all experiencing that growth and we're able to offset that impact. But it's generally across the board, Jeff.

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**Jeffrey David Hammond** - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. And can you talk about what your plans are for your second half free cash flow? And as you get closer to the spin, how you're thinking about leverage within the 2 companies?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, Jeff, we haven't -- we're thinking about that, but we're not in a position to share that yet. We're running different scenarios and planning for what the capital structures will be at both companies, but we don't have that information yet.

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**Operator**

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

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**Deane Michael Dray** - *RBC Capital Markets, LLC, Research Division - Analyst*

Maybe start with Aquatic. You called out the tough comp in the second quarter. We know weather is the big factor there. And first half, looks like you're on track. But is there anything else other than weather that contributed and was a factor in the second quarter for Aquatic?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes. I mean, really, when you look at -- we had such a strong quarter last year, and the season started late. It didn't start until mid-April. This year, it started early, so we got -- we had a great March. And that really explains all the difference. When you -- when we look at the sell-through in the channel and we look at the activity and the end market, we think the business is every bit as strong as it has been, hence my comments about it. The 7% growth in the first half is more representative of the kind of growth we expect in the industry. So it's really just timing.

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**Deane Michael Dray** - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. You also called out a pipeline of new product introductions. Maybe some color there. Would any be launched this season? And would they move the needle this season?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

They'll be introduced this season, but they won't move the needle this season. We continue to be the innovator in the industry, so we're not going to give up that mantle.

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**Deane Michael Dray** - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And then over on Electrical, maybe if you expand on the Infrastructure volatility, what are you actually seeing? Is this shorter cycle?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

It's really rail-related. I mean, when you take a look at Commercial and what I would call more traditional Industrial, it's just fine. But the Infrastructure, it's -- there's an anticipation that we would be spending on roads and bridges and -- here in Minnesota, it looks like we are. But broadly, in the rest of the country, it doesn't -- it hasn't picked up as much. And then rail spending is off. And that's for our EFS business, that's the biggest part of the Infrastructure.

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**Operator**

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

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**Scott Graham** - *BMO Capital Markets Corp. - Head of U.S. Government Bond Trading*

Just wondering if you guys could give us a little bit more on the third quarter sales improvement that you're talking about, maybe just kind of give us something on the business lines which you think are going to be the bigger contributors.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes. I think just to mention this, this dynamic between Q1 and Q2 that Randy mentioned is roughly $20 million of revenue in Pool that shifted amongst the 2 quarters. And so when you take a look at Q3 and where we're shooting for the core organic growth rate, I mean, it's not -- that one item generally explains it and then a little bit easier comparisons in some of our businesses like Enclosures in Electrical and then ultimately, Water Technologies in Water. So it's really about keeping the same general shipment rate that we saw in Q2 and then just the comparison year-over-year in Q3.

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**Scott Graham** - *BMO Capital Markets Corp. - Head of U.S. Government Bond Trading*

Okay. And then further on that, John, within Water, I know that you guys are, let's just say, quietly deemphasizing some of the businesses there. Was there a 0.5 point or a 1 point drag or nothing discernible?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, I'd say it's somewhere around 0.5 point is a fair estimate. I mean, Randy has asked both Beth and I to look at the types of things that maybe we could have done in a $5 billion company that might not make sense in a $3 billion and a $2 billion company. And so we're both actively looking at our infrastructures and support, primarily in fast-growth regions.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

And initiatives.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

And initiatives and trying to make sure that those pet projects are eliminated and also that we're adjusting how to serve each of the regions that we serve in a more effective way.

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**Scott Graham** - *BMO Capital Markets Corp. - Head of U.S. Government Bond Trading*

Got you. Last question is on the incremental separation close you're talking about within the guidance. Are we going to see that roll through corporate? Or is that going to be within the lines?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Actually, most of that will roll through what we have in the Electrical business, Scott.

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**Operator**

Your next question comes from the line of Julian Mitchell with Credit Suisse.

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**Ronald Drew Weiss** - *Credit Suisse AG, Research Division - Associate Analyst*

It's Ronnie Weiss on for Julian. On the free cash flow, big cash inflow from the working capital as sales ramp in Q3 and Q4. Do you guys kind of assume the same kind of benefit going through and just talk a little bit about the improvements being made there?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

We're seeing normal seasonality. We see that because, particularly Water is so seasonal, the cash flows are following the normal pattern with the negative cash flow in the first quarter, big pickup in the second quarter and then continued building in the third and fourth. So I wouldn't expect the pattern to be any different.

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**Ronald Drew Weiss** - *Credit Suisse AG, Research Division - Associate Analyst*

Got it. And then just on the margins for Q3, guided up 70 basis points, a lot stronger in Q2. Is all of that contributed to some of the stronger material cost headwinds you're seeing? Or is there some mix issue in there as well? Just talk a little bit about that.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes, there's a little bit of mix issue. I mean, it is not the strongest Pool quarter. And our Aquatics business has got a pretty good margin. So that's the only mix issue, and the rest is just Q2 performance carried over to Q3.

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**Operator**

Your next question comes from the line of John Walsh with Vertical Research.

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**John Walsh** - *Vertical Research Partners, LLC - VP*

Just wondering if we can get a little finer point on the full year Electrical margin. So we're now at 22%. You talked about a couple of different items impacting that. Just want to know if we can deconstruct those buckets. It looks like there's some overlapping costs that sit there. We had the commodity discussion. Maybe there's a mix impact as well, but kind of maybe if you can talk about it from that 23% to the 22% in that kind of walk.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Where's the 23% coming from?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

[Last quarter].

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Okay, got it. Yes. So I mean, it really is just one item. And it's the fact that we are now projecting for the rest of the year what we believe the real realized price and the real realized material inflation will be, and that is the only difference between the 2 forecasts.

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**John Walsh** - *Vertical Research Partners, LLC - VP*

Okay. And then just kind of one point of clarification for the models. Is the large project impact for next quarter is $27 million? Is that the right ballpark number we should be using?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Wait, what? You're talking about for the -- in Electrical?

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**John Walsh** - *Vertical Research Partners, LLC - VP*

Yes, for the entire -- yes, I guess it's primarily Electrical, but for the entire company, just so we can walk back to the adjusted quarter?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Got it.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, for Q3, that's about right, and then slightly less than $10 million in Q4.

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**Operator**

(Operator Instructions) Your next question comes from the line of Josh Pokrzywinski with Wolfe Research.

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**Joshua Charles Pokrzywinski** - *Wolfe Research, LLC - Director & Diversified Industrials Analyst*

John, can you just talk about some of the seasonality in -- I suspect it's Thermal in the fourth quarter or just the uptick in the Electrical growth in the fourth quarter. I get the comp is easier, but it still seems like there's a lot of push out in especially some of these larger Energy projects. So can you talk about maybe the 3Q to 4Q walk there and maybe the seasonality of margins that gets attached to that as well?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes. I'll start it, and then I'll have Randy add some color. But I mean, one of the things we're finally realizing, and we saw it happen in Q2 is we're finally moving in the positive territory on the MRO and the aftermarket...

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

And the small projects.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

And the small projects on the Thermal side. And so we've seen a really good uptick in our Thermal revenue and Heat-Tracing side, especially related to the downstream maintenance that we've anticipated for some period of time. So that's a big positive. And then as we move into Q3 and Q4, that is the season that Thermal certainly benefits from the industry in the anticipation of the cold weather.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes, on both Commercial and Industrial, particularly as winter cools off, I guess, or winter heats up, or it's a better term. That's really Thermal's biggest season. So -- and the nice thing is the smaller projects and the products, MRO, it's a better mix of business. So I'm pretty pleased right now with the progress we're making in Thermal.

**John L. Stauch** *- Pentair plc - CFO and EVP*

So each side, Water's seasonal business is obviously the Pool; and on the Electrical side, the business that really experiences seasonality is Thermal. And then everything else is more steady-state throughout the year.

**Joshua Charles Pokrzywinski** *- Wolfe Research, LLC - Director & Diversified Industrials Analyst*

Got you. So this is just a small project MRO phenomenon? There's really -- there's nothing else that you guys have anticipated in the backlog?

**John L. Stauch** *- Pentair plc - CFO and EVP*

No.

**Randall J. Hogan** *- Pentair plc - Chairman and CEO*

No.

**Joshua Charles Pokrzywinski** *- Wolfe Research, LLC - Director & Diversified Industrials Analyst*

Okay. And then just one more from me. Square away some of the -- you made -- put a finer point on the corporate headwinds or, I guess, cost headwinds related to spend versus where we're coming out on currency versus where we're coming out on inflation. I know the walk that you guys gave in the deck, had some high-level comments, but it seems like everything I just mentioned would be more of a second half dynamic that didn't really get bridged out per se.

**Randall J. Hogan** *- Pentair plc - Chairman and CEO*

So, Josh, just if you want to us to square -- are you an old navy guy? Square away? That's pretty good. Anyhow, so as we set up -- we're really standing up 2 companies. We have an open CFO job. We have 2 open CHRO jobs. We want to get these jobs hired. We want to get these -- so there's going to be some overlapping as people come and go, but those all go to the P&L. So -- and those are just a couple of examples. But as John said, our objective is to minimize any leakage, if you will, at the corporate cost level, in other words, minimize any additions once we're on a separate run rate in the 2 companies.

**Joshua Charles Pokrzywinski** *- Wolfe Research, LLC - Director & Diversified Industrials Analyst*

So I guess, maybe from a high level, should we think about currency and inflation as being a push then?

**John L. Stauch** *- Pentair plc - CFO and EVP*

Yes, a couple of things. I mean, keep in mind, we're raising our income $10 million, and that's going to cover...

**John L. Stauch** *- Pentair plc - CFO and EVP*

And shares in the back half of the year. We -- if you think about it, we have some benefit from foreign exchange, as I mentioned. That's low double digits; call that roughly $10 million. We have some operational benefits and revenue benefits, and then we're offsetting the combination of the slightly higher material cost and the incremental transition cost of the corporate side. And all that nets to positive $10 million in the outlook. So I don't want to quantify because we don't know it, right? But we have to manage it while delivering 2017 and also stand up both public companies in 2018.

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**Operator**

Your next question comes from the line of Joe Ritchie with Goldman Sachs.

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**Joseph Alfred Ritchie** - *Goldman Sachs Group Inc., Research Division - VP and Lead Multi-Industry Analyst*

Maybe just kind of staying on inflation for a second. One of the kind of the emerging themes we've been hearing about this quarter is rising steel costs and the inability for a lot of the companies that we cover to pass on those costs. You guys are talking about a little bit more inflation in the back half of the year. Can you maybe just touch on that topic? And how much of your business is impacted by steel?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes, we buy roughly a couple of hundred million dollars of steel. The end markets that utilize the steel are probably somewhere around, well, $1.5 billion, Randy?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

So I mean, material is not the highest cost of our -- I mean, it's the highest cost, but it's not the huge percentage of the revenue. But it's a phenomenon that usually, when inflation comes, we could pass it along. And I think this year, as we said earlier, and I made this comment, we had never dealt with a stronger dollar before. And there are competitors out of Europe who have a better cost position than they did have a year before. And so you're hearing these things about price transparency and the Internet and everything else like that. I don't think our products are really installed in that way or affected by it. But I do ultimately think that we've got a cost-conscious end user, and that challenge is being pushed on our channel, and we're being expected to absorb the majority of the cost this year. And it's reflected in our guidance. And I think that as we go forward, we'll look at the opportunities to adjust that appropriately as we head into '18.

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**Joseph Alfred Ritchie** - *Goldman Sachs Group Inc., Research Division - VP and Lead Multi-Industry Analyst*

Got it. Okay, that's fair. I guess maybe my one follow-on question, I don't think we've touched on it yet, is really on the Enclosures business. So you called out good Industrial strength within the quarter. Core growth is still down slightly. And you mentioned that telecom headwinds are going to alleviate as comps get easier after 2Q. So can you just maybe talk about the trajectory from here, when you expect that -- this business to drive to positive organic growth?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes. We expect a better second half for sure. Actually, the telecom side, we had some big projects there that are just -- they haven't reloaded yet, and we're hopeful they will, but they haven't. So that's why it was negative in the second quarter. I think in the fourth -- in the third and fourth quarter, that will be -- that will still be a drag, but it won't be as bad. And in Industrial, despite the more challenging price environment, the volume is good. And that's a really profitable business for us on the Industrial side, what many of you know as our Hoffman brand. So that's the big driver, Hoffman doing better.

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

So we'll have -- we expect to have low single-digit core growth in Q3.

**Joseph Alfred Ritchie** - *Goldman Sachs Group Inc., Research Division - VP and Lead Multi-Industry Analyst*

Got it. And just to follow up real quickly on that, on the pricing side, do you expect pricing to get better in this business as well in the second half?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

No. We think that the pricing dynamic in Q2 continues to move forward into Q3 and Q4.

**Operator**

Your next question comes from the line of Brian Drab with William Blair.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner and Analyst*

I just wanted to step back to the Thermal business for a second. And you said Thermal MRO is picking up. Can you comment specifically on whether you're seeing that in a particular end market, oil and gas versus power gen or general Industrial?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

It's really -- what's happened in capital spending across those, it's normalized, right, in oil and gas, there was this huge decline and basically, it was rough justice. They cut everything. And now they're up capital levels, so they returned finally to normal. So it's actually oil and gas and Industrial. It's chemicals. It's really across the board. Now CapEx is better in petrochemical, the petrochemical side, and in some of the other Industrial side. So we talked about Hoffman being up in Industrial. [It's up to in] general Industrial.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner and Analyst*

Okay. Okay. And then -- so on the petrochem side or in any other end market, are you -- and in any other geography, are you starting to see any large projects in the pipeline?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

No, and it really hasn't been our focus. As I mentioned, we really are -- we do really well when large projects happen. And so we're not focused on those. We know we'll do well when they come back. Our focus is in making sure we're getting more than our lion's share in the smaller projects, and I'm really pleased with the progress we're making on that, and that's really around the world.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner and Analyst*

And then I did want to ask, because you made the comment that you're doing some work to realign the Thermal business for the world of smaller orders, can you comment more specifically on what is being done to drive that realignment?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Well, I mean, it was a reduction in force and redeployment to areas where there's business from where there isn't.

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**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner and Analyst*

Okay, got it. And just one last very broad question. As you step back and look at these 2 separate operating companies and kind of the world that we're in today, for example, for Thermal, it's a very challenging operating environment. But what do you think the long-term growth rate is for each of these businesses at this point across the whole cycle?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Well, right now, we've got some really great work defining strategies of each of Water and Electrical. And when that whole strategy work is done, we will tell you exactly what we think the growth rates that we believe we will achieve as 2 separate companies will be. But I'm not going to presuppose that for Beth and John.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Brian, I just want to clarify one thing. The Thermal environment is actually improving significantly for us. I mean, we have these large projects year-over-year, which we're calling out. But inside of the actual Thermal business, we're seeing substantial margin increase, and we're getting back to record -- in fact, we've cleared what we call record highs of margins that this business never experienced before. Again, part of that is the focus that Randy shared with you. But if you take those projects out, we're growing nicely and we're expanding margins significantly.

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**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner and Analyst*

Yes, thanks for the clarification, John. I guess I was just referring to the large projects kind of not being in the picture anymore.

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

We're looking forward to not talking about it.

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**Operator**

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

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**Nathan Hardie Jones** - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Couple of questions on the Water business. You talked about softness in the Pump business there. Can you talk about what you're seeing in terms of end-market demand in the municipal water market, whether you think you're performing in line with the market, better, worse?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Well, I think the market is definitely improving. We're seeing the backlog begin to build. The break in fix is certainly being invested in, and I think we expect to get back to core revenue growth there, as Randy mentioned, towards the tail end of this year and definitely into 2018. Are we performing with the end market? I would say no. I think there's an opportunity here for us to commit to where we think we should be and play consistently in those spaces. And I think we've been chasing the opportunities around the world, and we need to get back to our core knitting and be better at what we do, and I think it's a huge opportunity for this business.

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**Nathan Hardie Jones** - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Maybe you could talk a little bit more about what you need to change there in order to get back in line with the market, maybe where you're playing that you shouldn't be, where you should be focused?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

When you're everywhere, you don't seem to have focus. What Randy has been challenging the team on and which I'm going to take the baton and continue to drive is focus, focus, focus. I think this is a business that's good at North American Infrastructure, and we're good at Global Fire. And that's where we need to spend our time and Energy on the engineered side, in those 2 areas, and continue to be good at those 2 things.

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**Nathan Hardie Jones** - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

That's helpful. And then just a question on the new products pipeline, you talked about that continuing to grow. Can you maybe give us a little more color on what kinds of things are in the pipeline, when they're expected to come to market and maybe what kind of impact that could have?

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes. I think most of -- just to give you some color, and I don't want to get ahead of ourselves here, but a lot of the products that Randy mentioned are related to home automation, certainly, and the way that we can play within that space and provide the types of things that our end consumers are looking for utilizing that capability. We've always been the leader in pool innovation, and we've got some exciting new product lines coming out to take advantage of those home automation themes and that the way that people want to continue to use their backyard and benefit from that experience. So I think we're -- we'll start to roll that out certainly around our Analyst Day and commit to our expectations. And I think we got some exciting things in the pipeline.

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**Operator**

You next question comes from the line of Robert Barry with Susquehanna.

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**Robert D. Barry** - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

So I wanted to clarify the update to the P&L segment income, now up 6%. So is that the net impact of better core growth offset partially by the weaker price cost, and that's a net $10 million improvement? Is that how to summarize it?

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**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Yes.

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**John L. Stauch** - *Pentair plc - CFO and EVP*

Yes.

**Robert D. Barry** - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Got you. And then just to follow up on the working capital question. I mean, bottom line is working capital, a source or a use of cash this year on continuing ops?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

It's a slight use.

**Robert D. Barry** - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Okay. And then just to clarify the interest, you talked about higher interest expense. I think the outlook for interest is the same at $85 million?

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

That's rounding, Rob. It was a little higher in the first half, as we talked about, but it's rounding.

**Operator**

There are no further questions at this time. I would now like to turn the floor back over to Mr. Randy Hogan for any closing remarks.

**Randall J. Hogan** - *Pentair plc - Chairman and CEO*

Thanks, Hope. 2017 has been another eventful year for Pentair as we've successfully divested our Valves & Controls business, significantly strengthened our balance sheet, and with those proceeds, delivered on our first half commitments and announced that we're separating our Water and Electrical businesses into 2 standalone companies. We remain confident in our ability to drive double-digit adjusted EPS growth for the year as our focus remains on delivering the second half of 2017 against our commitments while standing up 2 public companies.

Thank you for your continued interest in Pentair, and we'll talk to you soon. Bye.

**Operator**

Thank you for participating in today's Pentair Second Quarter 2017 Earnings Conference Call. This call will be available for replay beginning at 11 a.m. Eastern Standard Time through 11:59 Eastern Standard Time on August 25, 2017. The conference ID number for the replay is 55516215. The number to dial for the replay is 1 (800) 585-8367 or (404) 537-3406. You may now disconnect.