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PNR - Q1 2017 Pentair plc Earnings Call

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OVERVIEW:

Co. reported 1Q17 adjusted core sales growth of 3%. Expects full-year 2017 adjusted core sales to be up slightly and adjusted EPS to be $3.45-3.55. Expects 2Q17 adjusted core sales to be roughly flat.

CORPORATE PARTICIPANTS

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

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

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PRESENTATION

Operator

Good morning. My name is Beth, and I will be your conference operator today. At this time, I would like to welcome everyone to the Pentair first quarter earnings conference. (Operator Instructions)

Jim Lucas, Vice President, Investor Relations, you may begin your conference.

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

Thanks, Beth, and welcome to Pentair's First Quarter 2017 Earnings Conference Call. We're glad you could join us today. 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 first quarter 2017 performance as well as our second 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-K 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.

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

Thanks, Jim. First quarter of 2017 was a solid start to the year as both of our segments came in ahead of their commitments. Our adjusted core sales increased 3%, we saw our margin expand 50 basis points and adjusted EPS grew 7% and exceeded the high end of our previous guidance.

The sale of our Valves & Controls business to Emerson is in the final stages of regulatory review and we expect the deal to close in the coming days.

We're pleased with the progress we're making on our productivity actions, including our previously disclosed cost actions. We have seen some additional material inflation, so many of our businesses are exploring additional price and productivity actions to help mitigate this higher-than-planned material inflation.

We're maintaining our full year adjusted EPS forecast of $3.45 to $3.55, reflecting the first quarter beat and the delayed closing of the Valves & Controls sale. While the first quarter was better than expected, we want to watch the all-important second quarter to see if these trends continue.

Now let's turn to Slide 5 for a discussion of our first quarter 2017 results. Our first quarter sales results came in better than our forecast as both Water and Electrical delivered solid low-single digit adjusted core sales growth. Segment income grew 3%, yet the usual leverage did not drop through. We believe this is solely a timing issue. First, our cost-out actions are still ramping, so we did not get the full benefit of those actions during the quarter. Second, as mentioned, a few of our businesses have experienced higher material inflation. There is a 1- to 2-quarter lag we experience before additional price increases offset any inflation.

Return on sales expanded 50 basis points to 15.5%, and adjusted EPS grew 7%. All below-the-line items were in line with our forecast, including our 20% tax rate and our share count.

First quarter free cash flow was a usage, in line with normal seasonal patterns, and we again expect full year free cash flow to equal adjusted net income.

Overall, the first quarter was a good start to the year, but one quarter does not make a trend. As we enter our seasonally strong second quarter, order trends remain solid and we're monitoring progress throughout the quarter before revisiting our full year expectations.

Now let's turn to Slide 6 for a look at Water performance in Q1. Our Water segment delivered adjusted core sales growth of 4%, segment income grew 15%, and return on sales expanded 180 basis points to 17%.

Within our Filtration & Process business, core sales were flat. Our Residential and Commercial business showed solid mid-single-digit growth as we saw the negative trends in the back half of 2016 reverse course. In particular, China experienced strong double-digit growth as both Residential and Commercial filtration returned to growth.

Within our Process Filtration businesses, results remained mix. We've seen some capital beginning to flow again in the beer sector following the pause in 2016 as the industry went through a round of consolidations. We faced some tough comparisons within Industrial and Infrastructure, where we continue to see nice gains in our growing biogas business, which we further strengthened earlier this year with the acquisition of Union Engineering.

Flow Technologies saw core sales decline 3% as we continued to focus on reducing complexity to drive margin and cash flow improvement. Our Residential and irrigation pump businesses experienced nice gains, but we saw continued headwinds within our Commercial, Industrial and Infrastructure sales. In our precision spray business that largely serves agriculture, we saw another quarter of growth.

Aquatic & Environmental Systems had a great quarter with 13% core sales growth. This was driven by yet another double-digit quarter growth from our Aquatics business. We do not believe that this strong a growth rate is the norm, but we do expect growth to continue on the heels of industry strength, continued dealer wins and strong new product innovations.

Now let's move to Slide 7 for a look at Electrical performance in Q1. Electrical performed better than expected as we saw several long-challenged industries return to growth. The segment overall grew adjusted core sales 3%, segment income declined 8% and margins contracted 90 basis points to 20.6%. The margin contraction was due in part to a challenging year-over-year comparison and also some higher-than-anticipated material inflation.

Our Enclosures business grew core sales 1% in the quarter. Our Industrial business increased mid-single digits and experienced growth for the first time in 9 quarters. The smaller telecom business experienced a mid-single-digit decline, but we anticipate only one more tough year-over-year comparison in the second quarter before comps get easier in the back half of the year for telecom.

Core sales in our Thermal business declined 17% as a result of the 3 large jobs in 2016 not repeating. We're encouraged, however, to see MRO growth for the first time in 2 years. This does not mean that there is a recovery in the short cycle, but it is a positive sign to see growth in this profitable part of the business. We continue to be focused on sizing the business to a smaller order-size world, and Thermal's making progress in building that order funnel with activity in the smaller jobs that are out there to be secured.

Our Electrical & Fastening Solutions business had a strong quarter with 7% core sales growth. We saw continued strength in our Commercial business and saw some signs of improvement in the electrical grounding product line. This business experienced a fair amount of material inflation in the quarter and we're looking at additional price increases to help mitigate the higher inflation.

After a challenging second half of 2016, we are encouraged to see signs that the worst may be over for our Electrical segment, and although order trends remained solid to start April, we'd like to see another quarter or 2 of improvement before declaring we're in a new world.

Now let's turn to Slide 8. Before turning the call over to John to discuss the financial outlook in more detail, I wanted to provide a status update on the pending sale of our Valves & Controls business to Emerson. We have only 2 more regulatory approvals to receive and have an expectation that both should be arriving in the coming days. As a reminder, following the closure of the transaction, we plan to use the proceeds to retire debt, at which point we'll have a fair amount of balance sheet capacity again. As this balance sheet optionality returns, we will be disciplined in our capital allocation strategy.

I'll now turn the call over to John to discuss our second quarter and updated full year 2017 outlook. John?

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

Thank you, Randy. Please turn to Slide #9 labeled Balance Sheet and Cash Flow. Our free cash flow for Q1 was a usage of $112 million, consistent with expectations and reflects our seasonality Q1 cash usage. This was higher than 2016, mainly due to timing of previous year tax payments and the working capital build in our Aquatic & Environmental Systems business, reflecting their strength at the beginning of the pool season. We intend to collect that cash in Q2, consistent with our business model.

Our debt balance ended Q1 at $4.53 billion, reflecting the slight delay of collecting the expected proceeds from the Valves & Controls sale.

ROIC ended Q1 at 10.6%.

Please turn to Slide 10 titled Expected Impact of V&C Delay. Slide 10 attempts to make three points. The first point is the $0.04 of operational beat in Q1 covers the $0.04 impact expected in Q2 for the delay of the receipt of the Valves & Controls proceeds and therefore not being able to restructure the debt in line with previous expectations.

Point two is that we have not updated our Q2 through Q4 performance versus previous expectations and we will do so after we see the results from Q2 operations. This means we are still holding our full year guidance at $3.45 to $3.55 or a midpoint of $3.50 for the full year.

And the third point is that while we had a slight delay in our debt restructuring for 2017, we want to remind you that this means we will see a 4-month benefit in 2018 where we carry higher interest in the comparable period in 2017, or about $0.15 of incremental benefit in 2018 results.

Please turn to Slide 11 labeled Cost Out Update. Due to the sale of Valves & Controls, we quickly got after our organizational structure and streamlined into 2 reporting segments and a leaner Pentair enterprise support organization. We did this to produce more standard business structures with clearer functional expectations designed to serve our customers better at a lower cost structure. We are pleased to update that we are more than 95% complete against the previously stated cost-out expectations and expect that all actions will be fully implemented by the end of Q2. These efforts result in over $75 million of net cost benefits realized in 2017 with an exit rate in Q4 that yields $100 million in net cost-out heading into 2018. These costs include labor and manufacturing and operational overhead reductions designed to make us more consistent, predictable and higher performing. They do not include the net impact of material and inflation and they are before the previously communicated headwinds related to higher expected employee bonuses and compensation adjustments in 2017 versus 2016 results. This is great progress, and it's good to put the reorganization behind us and allow us to focus on driving organic growth and leaner manufacturing and shared service support.

Please turn to Slide 12 labeled Q2 2017 Pentair Outlook. As previously shared, we have kept Q2 operationally in line with previous expectations and only adjusted our Q2 EPS for the higher debt levels expected from the delay in our debt restructuring efforts. While we experienced much higher volume performance in Q1, we have not yet reflected that in Q2 results. We feel it's prudent to see how our important seasonally stronger second quarter plays out before declaring that revenue and operating results will be higher for the year. While we expect some of the Q1 sales momentum to continue, we're also monitoring increasingly higher material inflation and our ability to offset that inflation through either material negotiations or incremental pricing actions.

Overall for Q2, we expect that our adjusted core sales to be roughly flat, segment income to be up roughly 4%, ROS to expand nearly 150 basis points to around 20% and adjusted EPS to be up 14%, reflecting a 20% tax rate and slightly better interest and a share count of around 183 million shares.

Please turn to Slide 13 labeled Full Year 2017 Pentair Outlook. For the full year, we expect our overall adjusted core sales to be up slightly. We expect segment income to be up 5%, ROS to expand greater than 180 -- 100 basis points to around 18% and adjusted EPS to grow approximately 15% to around $3.50 at the midpoint. We expect cash flow to be 100% of adjusted net income.

As previously mentioned, we will update our full year outlook after we see how Q2 growth and operational performance plays out, we have the Valves & Controls cash in hand and have a better view of our a capital allocation decisions for 2017.

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

We're ready for Q&A. Beth?

QUESTIONS AND ANSWERS

Operator

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

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

So just on the kind of core trends through the rest of the year, just remind us of, in the second quarter, what the large jobs headwind is?

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

Yes, so it's consistent with what we previously shared, Steve. I mean, there's no incremental impact on the year-over-year basis versus what we guided to earlier. So we said it would be roughly $33 million and that's what we're counting on.

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

For the second quarter?

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

For the second quarter, correct.

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

Okay, got it. So that doesn't really change -- it actually gets a little bit better relative to the first quarter?

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

Yes, and the other thing that happens there, too, Steve, is the profitability gets a little bit better as we go through the year, meaning the year-over-year profit impact isn't as bad because in Q1 last year we had a lot of product sales on that project in Thermal and those bring higher margins. So the margin pressures ease as we go through the year as well.

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

And so when you guys had given your guidance in the fourth quarter, you had shown a seasonality chart on EPS that was about 30% in the second quarter. I think my math gets me to like $1.05 using the 30%. It doesn't seem like anything's getting worse, maybe there's a little bit of price cost or something like that. But adjusted for the timing of Valves & Controls is what's kind of the difference between that -- what changed between kind of that implied number and your kind of $0.97 to, whatever it is, $0.99 today? Or is it that just conservatism?

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

Well, I mean, I think -- I don't know if I can reconcile the $1.05, but I think, clearly, if we saw the volume continue at the 3% to 4% level that we saw in Q1 continue in Q2, we would expect that to produce the incremental drop-throughs associated with it. At the same time, we did have a little bit more material inflation in Q1. It wasn't significantly meaningful to the Q1 results, but we're starting to watch some of the inflation on some of the key components like copper, et cetera, start to rise. And as you probably saw from some of the distributor releases, the ability to get price right now in the end markets isn't necessarily consistent in all markets and that's what we're watching. It's what happens to that end price and the material inflation squeeze and how does it affect us throughout the quarter, Steve.

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

Okay. And just remind us, is there anything else in the second half of the year that stands out that should be getting worse? It seems that with such a tough end to last year, the comp should get, I mean, just like materially easier even excluding the large projects.

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

I'd say generally no. Nothing we expect to get worse. We -- as I said, we'll update our full year guidance after we see second quarter because it is so important to us.

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

Okay. And then one last question just on the capital allocation now that we're -- hopefully we're towards the end of the tunnel on this Valves process. Just remind us again what your -- what kind of the aim is with the proceeds. I think you guys had said -- at least, John, you had said in March that there'd be kind of a split between debt reduction, maybe a little bit of buyback, some acquisitions. Maybe just your latest thinking on how you kind of chop up the proceeds into those three buckets.

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

Well, I think that still holds and we certainly will take a lot of debt off the table. But we have acquisitions, we continue to fill the funnel on acquisitions. To the extent the prices are too high, then we'll put money to work on stock buyback. But we have work to do to decide on that split. And we will be disciplined. We want to get back to creating the shareholder value we did in the first part of this...

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

Sorry, one more question for you. Randy, you've had a really nice run. The stock has done really well under your leadership. Where are you on succession planning here?

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

Well, you know, look, it's direct, right? One of the most important things boards do is to ensure proper succession, and I think we have a robust plan and we have -- we have one that we're comfortable with. So when there's something to announce, I'm sure the board will.

Operator

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

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

So much for the one question, one follow-up. Maybe start with Aquatic, up 13%. Randy, I think your comment was you weren't expecting quite to see this amount of strength. You called out dealer wins, you called out some new product introductions, but how would you parse out that 13% upside between those or other factors?

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

I think the market -- I do think the market's strong. I think everyone has experienced that. I think we had an earlier year. I think a lot of -- what we might have seen in April last year, we've might have seen a lot of that in March. That's why March and April, you can see things swing back and forth. But by and large, we've got some exciting new products in controls and in heating and lighting coming out and we continue to gain new dealers. So the playbook keeps working.

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

Got it. And was weather at all a factor? February was fairly warm in the Northeast. Did that trigger any particular pull-in from maybe what you would have seen in the second quarter?

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

Well, I think right now, the industry's really optimistic and they clearly were laying inventory in, in the quarter because they're expecting a good year and I think weather probably helped that some.

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

Got it. And over on Electrical, Hoffman ending its drought of growth after 9 quarters. Which end markets were driving the uptick? Or was it just easy comps? And can you comment on orders?

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

Yes, when you take a look at the core Hoffman, it's just really general Industrial. Energy stabilized. They're part of Energy, but it's just general Industrial across the whole product range. And again, I think optimism played a role and distributors getting back to more normal stocking levels. But I don't think it was a pure stock-up, I think it was selling through as well. And so we exited with an order rate that was still sound and consistent with the first quarter.

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

Did you put a number on the order rate?

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

Mid-single digits.

Operator

Your next question comes from Julian Mitchell, Credit Suisse.

Julian C.H. Mitchell - *Credit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, and Lead Analyst for United States Electrical Equipment and Multi-Industry Group for United States Equity Research*

Just my first question is around the price raw material topic, which you mentioned a couple of times. Maybe just give us some historical context about how large that impact had been, say, 6 years ago, the last time input costs were a big factor and how you look at the ability to get pricing in the context of what your competitors are doing.

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

Yes, so overall, I mean, we got about 1% price in Q1 and that's generally aligned with where we expect to get. But what's more important is the predictability of the raw materials earlier than the pricing model works, right. So you go out with price increases and then you've got to figure out what's going to happen to materials. The materials are rising at a fairly quick rate: steel, nickel, copper. Those are our 3 main inputs to our material view. And it's just a matter of can we go out with another round of materially -- or pricing increases. Now I think we were planning on about $15 million of favorability from material as we -- material and inflation as we headed into the year, and I think now we're taking a look at maybe is that flattish. So given the upside in the revenue and also the acceleration of cost out, we feel we're fine. But before we declare victory, we'd like to see it through Q2.

Julian C.H. Mitchell - *Credit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, and Lead Analyst for United States Electrical Equipment and Multi-Industry Group for United States Equity Research*

Understood. And then if we look at the Electrical & Fastening business, you had a very nice kind of snapback, it looked like, in the first quarter versus what happened late '16. Maybe give us some sense of how the cadence of that business moved through Q1 and how you look at things today in terms of the visibility there because that business has been so volatile.

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

Yes, the fourth quarter certainly was -- it was not expected. And I do believe looking back on it in hindsight, I think a lot of distributors were just, with the uncertainty around a number of things in our economy, they just didn't stock up. Where that optimism returned, and it returned pretty quickly, and we knew -- we saw as early as January that we had returned to a more normal state, and 7% growth is better than any quarter growth last year. So we have some really differentiated products there that help with productivity in construction -- in Commercial construction, and I think we're getting good uptake on those products.

Julian C.H. Mitchell - *Credit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, and Lead Analyst for United States Electrical Equipment and Multi-Industry Group for United States Equity Research*

And then just a last quick boring one. The adjustment to the GAAP earnings guidance, is that just due to those stock comp-type issues and the restructuring that you'd mentioned?

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

The main one we have is amortization. So we showed that to you both on operating income and then what we call EBITDA, which puts the amortization back in. That's the main one.

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

The cash earnings.

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

Right. And then occasionally we have restructuring that flows through that as well, Julian.

Julian C.H. Mitchell - *Credit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, and Lead Analyst for United States Electrical Equipment and Multi-Industry Group for United States Equity Research*

Okay, so the change from before on the GAAP side is the restructuring?

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

Correct.

Operator

Your next question comes from the line of Mike Halloran, Robert W. Baird.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

So on the cost-out update, obviously good execution so far in what you've laid out. What's the next step for you guys? Obviously, the two pieces are -- it's now two segments and historically there's been some pieces within each segment you've been focused on. Is it more of the same in driving the improvement in those pieces? Is there's some other program that you guys are contemplating? Maybe just thoughts on the next step from here.

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

Well, we really -- the going to the 2 segments was, as John said, it was to allow us and give us the leverage to take the costs out, and more than the stranded cost of the exit of Valves & Controls, and it let us really to streamline and simplify a lot. And so now, we still have the same priorities. We have, on the Electrical side, some very attractive high-profitability businesses that all have opportunities to grow. We want to get to organic growth and then we could augment that with bolt-ons. And then in -- particularly in the Filtration area, in the Aquatics area of Water, same thing. And we really have been more on the sidelines on a lot of that acquisition because of where we were with Valves & Controls and our debt levels. So we'll be disciplined. We're not going to rush to the trough. But we're excited to get back to growth because we want to show you -- we know we can and we want to show you we will.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

On that acquisition side, maybe just talk about the quality of the funnel out there. Obviously, had to start rebuilding it a little bit, or at least to some extent, after the Valves & Controls sale. What's it look like today? How full is it? I know you said it was filling up. And from a multiple perspective, are you shut out at this point? Or are there enough attractive things out there?

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

Well, shut out, we have -- when we say disciplined, we don't believe in doing a deal just because it's "strategic." We have to be able to make it make financial sense. And so on the Water side, things are pricey; on the Electrical side, not so much. But we can be creative. We still have our ownerships, our structure, our European structure. That's helpful. So we have -- we still have some bullets in the gun, or we're putting bullets back in the gun.

Operator

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

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

So could you give us a little bit more end-market detail on Flow as well as -- Flow Technologies that is as well as the Electrical & Fastening? You gave us the pluses in Flow. Can you give us the larger minuses, obviously ag, and then on the Electrical & Fastening side, sort of the puts and take there as well?

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

Actually, ag was up in Flow for us, both on the spray side and the irrigation side. It's really the larger pumps, that's the Industrial pumps, fire protection and the break-and-fix municipal that are the slow pieces both in Europe and the U.S.

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

And that's slightly down is the way I would answer that, Scott. Obviously, Residential and Commercial is doing well. I think it's doing well everywhere, but what we would call rural pump, rural submersible. We're seeing much more urban development and we're seeing that through the Water Filtration business. We're seeing that through our Foodservice offerings. So Residential and Commercial, as Randy mentioned, even Electrical, Caddy very strong, which is in the EFS business that we have. Municipal, it's okay. I mean, I think everybody expected a big push in the Infrastructure. We're not seeing headwinds there, but we're not seeing the tailwinds of growth either. And then Industrial, through what Randy mentioned in our Hoffman order take, up mid- to high single digits on orders, which we haven't seen growth in that space in a while, so that was nice to see, the recovery. So overall, I would say, Food & Beverage continues to get better. We had the large headwinds last year as we saw the mergers take place and some of the capital be delayed, but that's returned. So overall, right now, the verticals are moving forward in a very positive way, and our only caution is that we have a lot of work to do this year. And one quarter behind us is good, but we have to now deliver on the commitments for the next 3 and that's what we're working on.

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

Okay. Good, good, good progression. The other question I had for you was essentially on pricing, and obviously there's a couple of questions here on price cost and you guys called it out. I'm a little curious about that because steel prices really started to rise last summer and then kind of reaccelerated several months back. And copper, nickel, for sure, have been more recent inflation issues. But you have market-leading businesses across most of the portfolio. A lot of your business is shorter cycle. Is there any reason why you're not out with price increases maybe more broadly already?

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

Yes, Scott, and I'll be real quick and I'll let Randy answer. I mean I think, first of all, we have good discipline around locking material. We don't like to gamble or play the hedge bets here, right, so we go out and we lock our material in a disciplined way. What we're up against a little bit though, and we shared this before, is euro. And certainly, the stronger dollar allows for potentially European-based competitors to enter the market and they're getting the benefits of the -- their weaker currency, and that's a dynamic we haven't seen in the last several years. So it came about last year and we're monitoring that. Now where we think we have the opportunity to raise price, we will, but at the same time, we're not going to lose share and we're going to manage the sourcing end of the material inflation as well.

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

And I would just add, we -- one of the marks of an attractive business to us is, and it's a true tell, is do you have any kind of pricing leverage in your industry. So it's -- if you do, then you probably have some differentiation; if you don't, then you probably don't. And it's a simple test that we use. And so yes, we and all of our businesses have pricing capability. What we want to do is make sure that we don't get out of whack with market share and so we're trying to be more nuanced about it and -- because we haven't grown enough.

Operator

Your next question comes from the line of Nigel Coe, Morgan Stanley.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Since we've seemed to abandon the one question, one follow-on, I've got 5 questions here. Just kidding, only four questions. So John, you mentioned municipal's soft, not getting worse, not getting better. I mean, if you look at the [put-in-place] data, it does feel like Water, wastewater, is significantly weaker since the election. I know it's not that big for you guys, but is that one reason why you're a little bit more cautious perhaps than 1Q would suggest? Or was that too small to really move the needle?

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

Yes, too small to really move the needle. I just think that we're not counting on any huge tailwind there from any reinvestment from the government, et cetera, and never have. And even when we see the big programs get invested on, we've not yet -- we've never really saw the realization of those investments. So it's not big enough to matter, Nigel.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Okay. And then, Randy, you alluded that there were some channel rebuilds driving that Electrical plus 7% performance. Is that based on just sort of conversations with customers? Or is it based on POS data? And I'm wondering, was inventory a factor elsewhere across the portfolio?

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

Yes. I think we need to do a better job of getting real sell-through from a lot of -- in all of our businesses. But from the indications we have, it is selling through. But I think -- there was a real sense of -- a real surge of optimism frankly after the election. If you look at the timing of it, it didn't really hit in December. But certainly when people got back from Christmas, you just saw business start to flow again. And some of that was restocking, but most of it, we believe is flowing through. Distributors are much more effective at keeping their stocks low and counting on manufacturers to deliver quickly there to refill. And that that's across the board, that's in every industry.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Okay, that's great. And then, just finally, we've sort of shadowboxed around this already. But on the refi post Valves & Controls close, John, can you maybe just give us any additional color in the sense of gross proceeds that you're planning to play down debt with and any kind of breakage fees that you'd expect on the early refis?

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

Yes, so we'll be approaching somewhere around $3 billion in net proceeds is what we think we'll be bringing in. And obviously, our breakage will be minimal, so let's say less than $100 million. And so, we've got a lot of cash to work with on the refinancing and we'll run out of -- in some cases with our cash generation this year, what we're saying is we'll run out of debt to actually pay down, and so that forces us to consider...

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

It's a high-quality problem.

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

It's a high-quality problem, but that's where the M&A and the buyback discussions start to come in because we wouldn't want to be sitting on cash and not putting it to work. But we have to do it in a disciplined way and we have to monitor the right acquisitions or is it time to go out and buy back a little bit of stock.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

But to be clear, your guidance doesn't assume any buybacks?

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

That's correct.

Operator

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

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

So just a quick question. Look, your sales number was better than we expected this quarter. But this thought process around giving an adjusted core sales number, are you guys trying to signal that the large project business is basically going to de minimis? Or like what is kind of like the thought process behind giving that number?

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

Yes, I've told our businesses, no more. There's no more of this. This is the last time.

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

These are 3 large oil sand projects that were won and they really represent the end of the reset in the Energy market, and they completed in 2016, and this year we have a headwind. But really, what we're trying to do is give you both, right. So we're giving you the volume and price and then we're sharing with you what those jobs are. And what we want to do is make sure that we take a look at what we're going to be exiting from an organic growth rate and what we should expect in these businesses as we go forward into 2018.

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

Got it. And then I may have missed it earlier, but the impact from large projects for the rest of the year clearly was a big impact in Q1, but what's the impact for Q2 to Q4?

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

Yes, as we said, Q2 was around $33 million, which is $30 million in Electrical, and then we're about $27 million in Q3 and we're $10 million in Q4. And all of that was listed in the Q4 earnings where we give the guidance for 2017.

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

Okay, cool. That's helpful. And I guess, just a couple of quick ones. The Electrical margins got off to a little bit of a slower start than we expected. I know there's been a lot of discussion here on price cost, but you have that ramping back up to 23% for the full year. And so maybe talk a little bit about some of the puts this quarter and then where you really start to see a pickup in Q2 through Q4?

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

It's the ramp of the cost and it's in the first quarter. And it was really, John mentioned it earlier, the project -- the big projects we just talked about. It was shipping all products and so the margins on that were very high in Q1 and then the margins fell off in Q2, Q3 and Q4. So that was really the two -- that were the pressures in the Electrical side and we expect them to get better. So we expect the margins to look better going forward.

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

Got it. So you just have easier comps as you kind of head through to the year and -- okay, that seems to make sense.

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

And the cost-out will read out.

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

And the cost-out. Okay. And then I guess maybe just lastly, you touched on Valves & Controls, but maybe just a real quick update on untangling those assets and your kind of confidence in being able to close by month end?

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

I have great confidence. I'm really grateful of the Pentair team and the Emerson people who worked on it, too. I'm grateful and proud of the work they did. They -- we've been ready to close this for a while, both sides, so I have high confidence that we can close when they tell us we can close.

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

Okay. But is it -- I mean, are you guys still planning to close this week? Or is this something that can push out a little bit further into May, June?

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

In the coming days. We're waiting for 2. We're waiting for Mexico and the United States and we feel good about them, but we can't close until we get the official word.

Operator

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

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

Just on the Electrical 2Q guide, I just want to get a better sense of kind of where the caution still lies. Just it sounds like the order rates in Hoffman are better, MRO's picking up in Thermal and it seems like ERICO 1Q is maybe the better trend versus 4Q. So what gives you the most pause?

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

Just execution, Jeff. I mean, I think we want to see -- we haven't grown at the mid-single-digit rate, as Randy mentioned, in a couple of years. And when that happens, you've got to get your delivery and your execution done. We were moving a factory and we still are moving a factory and we've received significant volume into that factory. And so we delayed it from Q1 into Q2 and we're in the process of closing that factory, exiting it. And so we're managing a lot of things simultaneously. That's all it is, Jeff.

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

Okay. But there's no indication that there's any delivery issues or...

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

No, no.

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

Okay. And then just on the Water guide for 2Q, does that reflect any kind of timing or pull-forward that you think might have happened in the 1Q results?

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

Yes, it does. I mean, I think we usually know the pool season, but we can't always time it by the precision of the month. And so we did have a strong Q1 and therefore we think it'll be a slightly less strong Q2, still strong but a little less strong as we see how that sell-through gets managed and that inventory is managed by our distributors.

Operator

Your next question comes from John Walsh, Vertical Research.

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

A lot of ground covered, so just 2 quick cleanup ones for me. In terms of the $21 million of restructuring, does that all have at least a one-for-one payback and maybe you can characterize what those actions are?

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

Yes, that $21 million is reflecting what we're talking about as the $75 million. So it's better than one-to-one and that's the cost efforts -- or that's the restructuring actions that are leading to the net cost-out that we're referring to.

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

Got you, understood. And then as we think about the ability for additional capital allocation, maybe kind of level set us what the number of capacity you have is? I mean, if you go back, you used to talk about running the business 3x levered. Is that still right? Is it closer to 2? How should we think about that to just kind of level set us all in what the actual capacity...

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

Think about 2.5 as the steady-state. We can go above 3 occasionally, but 2.5, 3 at the top.

Operator

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

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

You guys took the organic sales number up 1 point. Can you maybe split that out between the impact of raw material inflation and assumed price increases and volume increases?

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

I don't know if I understand it. I mean, you said...

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

Price and volume.

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

Price and volume, okay. I mean, all we did was take the Q1 number and we let it ride it through the year and we kept Q2, Q3 and Q4 exactly the same, adjusting only for the debt and Valves & Controls. So the -- I think I would answer your question, it was all volume.

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

Okay. So in your guidance for the rest of the year for the top line, there's no impact from assumed price increases in response to these raw material increases?

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

No, there is not.

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

And then on the 4Q call, you guys had guided to $39 million of large project headwinds and that shook out at $49 million. Can you reconcile those two numbers?

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

Yes, there's an incremental $10 million related to project accruals that we took in Q1 that were anticipated project settlement costs that we had related to those projects last year. So it took down the revenue number in Q1 by approximately $10 million.

Operator

Your next question comes from Brian Drab, William Blair.

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

I wanted to ask on the raw materials again. I don't know, John, if you could give us any sort of sense for how COGS breaks down in terms of ROS, overhead, labor, just -- and then within the materials, how big a percentage is steel versus copper? And the main thing that I'm still just trying to figure out is how do you deal with a 50%-ish increase in steel and these other raws and only increase -- have to increase price 1 to 2 points to stay flat in terms of that headwind or tailwind that you mentioned went from 15% to flat on ROS.

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

Yes, so real quick. I think we don't want to overdo this. I think our material is 38% of sales, right, roughly for Pentair. And our largest commodity purchase is around $200 million and most of the other commodities we're talking to is about $100 million, $150 million on an annual basis. So these big increases are also mitigated by the locks that we talked about earlier. But the timing of when we lock versus the timing when we price is sometimes disconnected. So we're identifying maybe $10 million to $12 million material risk in the back of the year. And if the volumes continue, we feel like we've got enough to offset that right now even if we didn't get incremental price increases. But we're monitoring all this as we go through the year. We're listening to the same earnings call as you are, and we're hearing that price isn't easy to come by in the end markets and that's why we're not as confident that we can just push through another price increase. And so that's what we're managing. And right now, I just want to clarify, we have not adjusted Q2, Q3 and Q4 and we're admitting that there might be some upside volume, but we're also sharing with you that there could be some upside material risk or downside material risk.

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

Okay, okay. Got it. And then I think I just missed this earlier, but did you talk about prebuy activity in the Aquatics business, first quarter '17 versus first quarter '16, and maybe what the difference in incentives were between those periods?

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

There was really no difference actually. The higher growth was really just normal business. It wasn't early buy.

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

The product going through.

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

Which is -- yes, it's just standard orders, which is a bullish sign on us in a bullish business.

Operator

Your next question comes from Robert Barry from Susquehanna.

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

Would you mind giving us some color on how you expect each of these sub-segments to track this year, within Water and within Electrical?

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

Well, we talked about the segments, that's what -- is that what you're asking about?

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

Well, like the general outlook for growth in Enclosures versus Thermal versus Electrical and Filtration versus Flow versus Aquatic.

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

Yes, I think that's a little bit more granular than we'd want to go to at this point for a forecast. I mean, what I said was what we gave on the -- whatever we gave for guidance in Q4 into Q1, the only thing that's changed is the Q1 performance. And we haven't assumed any updates to the forecast of any of these throughout the year, and that's why we're waiting is to see how Q2 comes out and then we would update all this information.

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

Got you. And the $15 million of favorability on price or cost, was that -- that went to flat. Is that a net number, price net of cost?

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

It's material sourcing net of inflation.

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

Got you. And then...

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

Just to be clear. The $15 million was assumed and what I'm saying is a worst-case scenario would be close to flat.

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

Okay. So flat is not in the outlook?

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

Flat is not currently in this outlook, no.

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

I see. And then just finally, earlier, John, I think you'd made a comment that it's kind of easier or harder to get price in some places than others, I guess, just depending on that end market dynamics. And where are the areas that are a little more challenging to get price now?

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

Basically, fast-growth markets is always a challenge. That's the most challenging place. And as John said, we're dollar denominated in most -- to the most part and so the dollar is strong, so any place where we're competing with the euro-based competitors.

Operator

Your next question comes from Steve Tusa, JPMorgan.

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

On the proceeds, you had said $3 billion or something like that. Is there any change in the amount of net proceeds you're going to pull in here? Or is it still the same? I think you had initially said $2.6 billion, maybe you're just rounding.

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

I see that you're listening to me. It was originally $2.7 billion. We are approaching closer to the $3 billion mark. We believe that tax is going be a little bit more favorable to us than originally estimated and then we also have timings of the accruals and the working capital and the cash performance of the business.

Operator

This ends the Q&A session of the call, and we'll now turn it back over to Randy Hogan for final comments.

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

All right. Thank you. Thanks all for your interest and your -- and all the questions. As we communicated last quarter, 2017 is a transition year for Pentair and we believe that our first quarter performance was a solid start. We're days away from the expected closing of our sales of Valves & Controls and look forward to regaining a stronger balance sheet. Of course, we're going to remain disciplined in our capital allocation strategies.

When we have more that, we will announce it. We're even more confident in our ability to drive double-digit EPS growth for full year 2017, and we continue to position the company for continued long-term success. Thanks, again, for your interest in Pentair.

Operator

Thank you for participating in today's Pentair first quarter earnings conference call. The call will be available for replay beginning at 12 noon Eastern Standard Time today through to 11:59 p.m. Eastern Standard Time on May 25, 2017. The conference ID number for the replay is 55576170. The number to dial for the replay is (800) 585-8367 or (855) 859-2056 and internationally (404) 537-3406. Thank you. You may now disconnect.