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# EDITED TRANSCRIPT

PNR - Q4 2017 Pentair plc Earnings Call

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## OVERVIEW:

Co. reported 2017 adjusted core sales growth (excluding impact of certain items) of 2%. 4Q17 adjusted core sales growth was 4% and adjusted EPS was \$0.93. Expects 2018 adjusted EPS for full Co. to be approx. \$4 per share.



## JANUARY 30, 2018 / 1:00PM, PNR - Q4 2017 Pentair plc Earnings Call

### CORPORATE PARTICIPANTS

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

**John L. Stauch** *Pentair plc - Executive VP & CFO*

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

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

### PRESENTATION

#### Operator

Good morning. My name is Karina and I will be your conference operator today. At this time, I would like to welcome everyone to the Pentair Q4 Earnings Conference Call. (Operator Instructions) Mr. Jim Lucas, Vice President of Investor Relations and Treasury, you may begin your call.

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

Thanks, Karina, and welcome to Pentair's Fourth Quarter 2017 Earnings Call. We're glad you can join us. I'm Jim Lucas, Vice President of Investor Relations and Treasury. 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 fourth quarter 2017 performance as well as our first quarter and full year 2018 outlook as outlined in this morning's press release.

Before we begin, let me remind you that any statements made about the company's anticipated financial results are forward-looking statements subject to future risks and uncertainties, such as the risks outlined in Pentair's most recent 10-Q and today's press release. Forward-looking statements included herein are made as of today, and the company undertakes no obligation to update publicly such statements to reflect subsequent events or circumstances. Actual results could differ materially from anticipated results.

Today's webcast is accompanied by a presentation, which can be found in the 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.



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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. I'd like to thank everyone for joining us today. 2017 was an exciting year for Pentair as we saw organic growth return; strong margin expansion; robust cash flow, as usual; and the announcement of our plan to separate our Water and Electrical businesses into 2 publicly traded companies.

We had 2 goals in 2017: first, to deliver on our 2017 commitments; second, to prepare to stand up 2 independent companies. We accomplished both and believe the momentum we have exiting 2017 will continue into 2018. Our top line continued to gain momentum driven by improving end markets and also by growth investments in both of our businesses. We saw very strong margin expansion in the fourth quarter and for the full year. I will discuss the specifics around this in just a moment.

We're also introducing our 2018 outlook today, which is approximately \$4 per share for the full company, expecting double-digit EPS growth once again. The \$4 per share represents approximately \$2.25 per share from Water and roughly \$1.75 per share from Electrical for the full year. John will discuss the outlook in more detail later in the call.

We remain on track to spin our Electrical business in the second quarter and are targeting April 30 for completion of the spin. 2017 was the year that saw predictability return to Pentair, and we believe that both Water and Electrical are well positioned as we approach our separation into 2 focused growth companies.

Now let's turn to Slide 5 for a discussion of our full year 2017 results. In 2017, we saw adjusted core sales increase 2%, which excludes the impact in 2016 of 3 large jobs in our Electrical business and 1 large job in Water that did not repeat. We saw the growth rate increase throughout the year, particularly within Electrical, as Industrial end markets continued to recover. Segment income increased 7% for the year and return on sales expanded an impressive 100 basis points to 18.2%. We achieved these results as the cost actions we took in 2017 read through and positive leverage from sales hit the bottom line, all while still making growth investments in the business. Adjusted EPS grew 16% and our free cash flow was over \$600 million. This was 100% of adjusted net income when excluding a onetime tax payment.

Overall, we were very pleased with our results in 2017 and we're optimistic that this path of improvement is sustainable.

Now let's turn to Slide 6 for a discussion of our fourth quarter 2017 results. Our fourth quarter results showed strength across almost all financial metrics. Adjusted core sales grew 4% in the quarter with Water up 3% and Electrical growing 5%. Segment income increased 11% and return on sales expanded 80 basis points to 18%. Although material inflation remained a headwind, we continued to drive productivity and pricing actions to help offset the impact. Adjusted EPS grew 19% and met our guidance of \$0.93. Free cash flow was over \$200 million in the quarter. So we ended the year on a positive note, indeed.

Let's turn to Slide 7 for a look at Water's performance in Q4. Our Water segment delivered adjusted core sales growth of 3% and 6% growth overall. Segment income grew 15% and return on sales expanded 160 basis points to 19.2%. Our Water business delivered margin expansion of over 100 basis points every quarter in 2017 due to strong productivity and improved product mix. We don't expect this rate of margin expansion to continue, but we believe the cost structures are right and mix should remain favorable.

Filtration Solutions saw core sales declined 2% and remains a tale of 2 stories: our Residential and Commercial Filtration sales, which represents nearly 2/3 of the business, remained strong especially in Foodservice. These are higher-margin businesses and are a contributing factor to the positive mix comment made earlier. Smaller Process business continued to be hampered by low global desal activity and muted spending in the beverage industry. Although we've been disappointed with the top line performance of that part of Filtration Solutions in 2017, we expect the business to face easier comps in 2018 and we believe the higher-margin Residential and Commercial business is well positioned to keep growing as we continue to invest in this very attractive space.



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Flow Technologies saw the top line grow for the first time all year as core sales were up 4%. We saw a broad-based strength across this business for the first time in quite some time with Agriculture, Residential and Commercial all up. Our smaller Engineered Pump business saw some short-cycle recovery and the longer-cycle backlog continues to improve, which we believe foretells improvements in 2018 and 2019.

Aquatic Systems ended the year on another strong note with core sales up 5% in the quarter and delivering 7% growth for the full year. We saw normal early buy activity and overall demand remained strong as we continued to gain ground from advanced product adoption and ongoing dealer gains amidst market optimism.

Now let's move to Slide 8 for a look at Electrical's performance in Q4. Adjusted core sales grew 5% in the quarter and were up 7% overall. Segment income grew 6% and margins were down modestly as price and productivity were not enough to offset inflation. While we expect material inflation to continue, there's a road map to productivity accelerating in 2018 while price headwinds moderate.

Enclosures core sales grew 8% in the quarter and the strength was broad based. The uncharacteristic productivity shortfalls are isolated to Enclosures. Recent plant closures and a distribution center relocation resulted in some near-term delivery challenges compounded by very strong demand. We see this demand remaining strong and expect the issues that impact the productivity in 2017 to abate in the first half of 2018. With the stability of these capacity investments and a strong outlook, we believe Enclosures is poised to stabilize margins and grow income in 2018.

Core sales declined 3% in Thermal, but this was due solely to the top line headwind of the 3 large energy jobs last year in Canada that we outlined at the outset of the year and I mentioned earlier. Excluding these large jobs, Thermal grew once again on both the small project and product side of the business with particularly strong sales in the Industrial MRO business. Even more positive is that the business dramatically improved its margins in 2017 as a result of its realigned cost structure and better overall mix from higher-margin product sales, making this an even more attractive business for Electrical.

Electrical & Fastening Solutions saw core sales increase 7% as Commercial remained strong and Infrastructure showed growth for the first time all year. More important, price/cost within EFS has gotten back to a more favorable position than we saw at the beginning of the year.

Now please turn to Slide 9 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 our planned separation. We made tremendous progress preparing to stand up 2 companies in 2018. The nVent Form-10 has been filed and the review process is ongoing. The leadership teams for both Pentair and nVent are now complete and the new teams are coming together well. Enterprise separation activities such as finance, treasury and IT are all on or ahead of schedule.

As we prepare for the separation, we expect to have both capital structures determined by the end of the first quarter. We're looking forward to sharing our excitement for the prospects of both companies at the Investor Days we're hosting in New York on February 13. There, both management teams will present their strategies and discuss their futures in more detail.

We remain excited for Pentair's next chapter as we create 2 industry-leading pure-play companies in Water and 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 raise the execution even further and drive higher differentiated growth. We believe that our performance in 2017 has demonstrated our ability to better forecast our business and execute against our commitments.

Both companies can become appreciated for the jewels that I believe they are.

I will now turn the call over to John.

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### **John L. Stauch** - Pentair plc - Executive VP & CFO

Thank you, Randy. Please turn to Slide #10 titled Balance Sheet and Cash Flow. We ended the year with our balance sheet in the best position in over 2 years. Our ending debt balance was \$1.4 billion, which does not include just over \$100 million of cash on hand at the end of the year. Our free cash flow for the year was over \$600 million and represented 94% of adjusted net income. However, when excluding a onetime tax settlement



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payment from a prior year in 2017, free cash flow once again equaled adjusted net income. Our ROIC continued to improve and ended the year at 11.6%.

Please turn to Slide 11 titled 2018 Outlook. Today we are introducing our 2018 adjusted EPS outlook for all of Pentair of approximately \$4 per share, comprised of core sales growth of 2% to 4% and margin expansion of roughly 20 basis points. Embedded in our guidance is corporate expense of \$100 million, interest expense of \$50 million and an effective tax rate of 18%. While we recorded a fourth quarter gain of roughly \$85 million related to U.S. tax reform we believe the expanded -- the expected 18% go-forward tax rate to be an improvement over our current 20% tax rate and sustainable. The share count for 2018 is expected to be 183 million shares inclusive of completed share buybacks and before any incremental repurchases.

While we have not yet finalized the capital structure of both companies heading into the separation, we continue to target investment-grade metrics for both companies and our interest expense forecast reflects this target.

We are also introducing 2018 adjusted EPS guidance for Water or RemainCo of \$2.20 to \$2.30 per share on core sales growth of 2% to 4%. While we have continued to make growth investments, we believe return on sales should expand approximately 40 basis points. I would remind you this follows 140 basis points expansion in 2017. Corporate expense for Pentair RemainCo should approximate \$55 million and interest expense is expected to be around \$20 million.

For Pentair Electrical or nVent, we are introducing 2018 adjusted EPS guidance of \$1.70 to \$1.80 per share based on core sales growth of 2% to 4%, flat return on sales, corporate expense of \$45 million and interest expense of \$30 million.

Both companies will have more details on their 2018 outlook at the upcoming Investor Days on February 13 in New York City.

While 2017 was a year of many changes for Pentair, both businesses have seen improving fundamentals and improving growth rates. As a reminder, the key rationale of the separation was to create 2 focused growth companies, which will require some dedicated growth investments in 2018 which should result in improved top line growth, EPS expansion and robust cash flow to be allocated in a disciplined manner to create shareowner value.

Please turn to Slide 12 titled Seasonality Present in Both Businesses. We wanted to remind everyone that both businesses, particularly Water, do experience some seasonality during the year. The past 2 years have seen similar trends that we would expect to continue. We thought this would be a useful reminder as you think about the quarterly distribution of sales and income for both businesses.

Please turn to Slide 13 titled Q1 2018 Outlook. We are targeting that the first quarter should represent the last time we will report earnings as one company. With Q1 as a launch point for both companies, we are estimating core sales growth at 3% in both businesses for the first quarter. Segment income is expected to increase about 6% and return on sales is anticipated to be flat at 15.5%. Also, we are expecting a tax rate of 18%, net interest of around \$13 million and shares to be roughly 183 million. Overall, adjusted EPS is expected to be up over 20%.

We exited 2017 continuing to build top line momentum. And while we will continue to make growth investments in both Electrical and Water, Electrical is also correcting its productivity issues and dealing with significant inflation challenges. We believe both businesses are positioned to deliver strong overall results while preparing to stand up as 2 well-positioned, industry-leading companies.

I would now like to turn the call over to Karina, after which Randy will have a few closing remarks. Karina, please open the line for questions.

## QUESTIONS AND ANSWERS

### Operator

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

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

So first of all, just on kind of the top line trajectory in '18, your growth this quarter was okay, but not great in the context of the economy. I mean, I think 2% to 4% seems reasonably conservative. Is there anything, maybe in the Electrical business, that you'd want to point out that could potentially be an upside to price in the next year, whether it's Enclosures or anything else? Maybe just talk about the profile of some of the subsegments to be set up in the next year especially in Electrical.

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

Yes, I think our outlook is realistic, but there's more upside than downside. I mean, we have, what do people call it, synchronous growth, first time I've seen it in 30 years. The markets are good, we're gaining momentum and Electrical specifically we've got some of the disappointing execution in Enclosures that we have, we've got that stabilized. It's not productive yet. But now that's stabilized, I would hope that we could gain even more share and get back our rightful share that maybe we lost a little bit of at Enclosures.

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

So how fast do you think the Enclosures market is growing?

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

I don't have that number right in front of me. But I'd say...

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

High singles.

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

Yes.

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

Okay. So you think that it's possible to kind of -- if that trend line slows maybe a tad next year, you think it's possible to kind of work your way into that something above mid-single digits at some point here in the near term as those issues get remedied.

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

For Enclosures, yes. Yes.

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

And what exactly are the issues again?

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

We had a number of plant moves and a new -- a consolidation of a distribution center that we started in 2016, it took a little longer to get them done and then the market took off. And that just -- the additional demand just basically overwhelmed the moves. They weren't stable. So we're getting to the end of that, but that's why the first quarter outlook is what it is.

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

Okay. And just on the margin side of Electrical. You guys give pretty good bridges as far as price, inflation, et cetera. Can you just give us a little bit of color on how we get to the margin you're guiding to for next year with regards to Electrical? And if you're not kind of prepared to do that, maybe just a little bit of color on what you're assuming -- what you're assuming on kind of the price cost side there?

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

Let me give you an overview and then Beth will go into more detail on the 13th, I think it's fair to her to let her to do that. But basically, we were very cautious on price while we were having these delivery changes because of the operational faux pas. And so price is still going to be a headwind in the first part and we're not counting on productivity in the first 5 months or so -- 4 months of the year.

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

And inflation? And inflation?

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

Kind of run rate, yes, continues, about where it is.

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

For Electrical.

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

So you could see in the walk in the fourth quarter, we didn't get any productivity in the...

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

Okay. And then one last question. Your ForEx up 1%, what rate is that based on?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Roughly \$1.20 of the euro. Obviously, lots of currency, Steve, but that's the main one.

**Operator**

You next question is from Deane Dray from RBC Capital Markets.



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

Maybe start with John, if you could give us some insight into the puts and takes in tax reform, you can count us among the people that were pleasantly surprised to see you actually benefiting more than what we expected. So on top of this whole separation, you also had to flow through tax reform. But just give us a sense of how it turned out that it's as favorable as it is.

**John L. Stauch** - Pentair plc - Executive VP & CFO

Yes, so I mean, I think when the legislation emerged, we thought, just like you did, probably thought we have a slight headwind. And a couple of things went favorable for us, one is there's less of a border adjustment tax impact on us or the U.S. manufacturing tax than originally assumed. And then also we were able to carry forward our deferred tax assets related to debt and debt restructuring for an infinite period of time, which allows us to utilize those in the future. Those were the 2 main changes.

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

Got it. And then going back to the Water discussion in Randy's prepared remarks, and I'm not sure if Randy answered this or John, but the idea of the mix being more favorable on Residential and especially on Foodservice's side remained strong, and Randy said where you look to invest in this business going forward. So what are the kinds of opportunities for investing? Is this internal growth or are these acquisitions?

**John L. Stauch** - Pentair plc - Executive VP & CFO

Well, I think we'll talk about this definitely at length on the 13th. But first and foremost, we have a lot of organic growth opportunities. I mean, one of the reasons we wanted to separate both these companies is they both have the ability to focus on organic growth. But organic growth is delivering that growth muscle for us is key and what that means is we're going to focus on where we're really good, which is Residential, Commercial water treatment. That is our strong position globally and we want to continue to invest in that area and maybe deemphasize a little of the other piece of the portfolio.

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

That's helpful. And just last question for me. Is there any news or development on the hurricane impact, the rebuild especially on the Aquatic side?

**John L. Stauch** - Pentair plc - Executive VP & CFO

No, I mean we continue to see the order rates continue in that area, both in Florida and the Houston area, so as they -- as both those states continue to rebuild outside of that hurricane damage that they suffered.

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

The optimism, I mentioned this in the prepared remarks, the optimism in this business is as highest I've ever seen it. It's -- growth is really, really solid there.

**Operator**

Your next question is from Jeff Hammond from KeyBanc Capital Markets.



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

Just on -- back to Electrical margins being flat in the guide. Outside of this Enclosures issue, which sounds like it'll be cleared up by 1Q, what are the other kind of headwinds to not getting more leverage out of Electrical?

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

I want to see more yield from price, right, and I'm taking a bunker attitude here, which is don't shoot until you see the whites of their eyes. In other words, let's see some delivery here. This is a business that just delivers. So it's -- I expect it to be an anomaly, what we're seeing now.

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

Okay. And then on Thermal, I mean, it looks like the big projects you're lapping kind of the big project comp, we're at \$65 oil, it sounds like aftermarket's been better. Can you just maybe carve out where you think the outlook is for that business into '18?

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

A shout-out to the Thermal team, they did an incredible job this year. If you look at their overall and the top line coming down because of those big projects, they not only rightsized cost structure, but they actually made investments. They made investments against driving MRO and driving product sales only, much higher margins than the products that were coming down. So we saw a nice increase in margins in that business, and frankly, with a little bit of mojo behind the capital spending in energy, that's going to bode well for the smaller projects and the product sales and our investments we made in MRO, I expect another dazzling year for Thermal.

**Operator**

Your next question is from the line of Mike Halloran from Baird.

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

So on the kind of comparable question you guys have been answering on the Electrical side, maybe similar puts and takes on the Water side for the margins in the next year, just how you're looking at the price cost curve and also how you're looking at productivity. And then for the cumulative company, also some thoughts on the restructuring side, how much benefit for both Electrical and Water you're assuming in numbers for next year?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes. So Mike, on the Water side we had a strong productivity year in 2017, but we have to get back to investing in organic growth. So for 2018, we've got some \$25 million of incremental investments in primarily, sales marketing and innovation technology into the outlook for 2018. And we want to get back to investing to control our destiny as far as the future and begin to build an organic growth muscle. So we're excited about the opportunity to focus on where we think we're strong, which is Residential, Commercial water treatment, and then starting to invest in the longer-term growth trajectory. So other than that, price cost for us is not as big an issue as it is in Electrical. We deal with the trades channel and usually have the ability to take the price and cost and mitigate them through our channel. So we're a little bit blessed in that regard. And Randy, if you want to answer Electrical piece of it.

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

Well, I just did on the margin side. I think I've...

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

Yeah. No. No. I was comfortable on the Electrical side. Was there any restructuring benefits for either the 2 pieces in the next year?

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**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Oh yes, significant. Both groups have taken the opportunity to optimize the portfolio and both sides are looking at some tailwind associated with 2017 restructuring.

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

And kudos to John and Beth, both as they built the structures. As you recall, when we first said we were going to separate, we thought we might have a \$20 million headwind in the corporate costs and we actually came out with a neutral. No headwind. That was a lot of good work, too.

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

And any willingness to give a dollar number on those or too early and you just want to leave it up to the individual companies over time?

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**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, too early.

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

Too early for that.

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

Okay, that's fair. And then on the Engineered Pumps side, first positive commentary in a while there. Maybe just some thoughts on what you're seeing in the market and sustainability of what could be an early turn toward something more positive.

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**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, the market's definitely recovering and has been recovering throughout 2017 and we have built the order backlog for the break-and-fix side of primarily Municipal. So I think we're now moving from what used to be a headwind to, let's say, a slight tailwind.

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**Operator**

Your next question is from Scott Graham from BMO.

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

A couple of questions for you. We were talking in 2017 about what's felt like about a 1%, maybe 1% to 2% headwind to sales from businesses that were sort of, I'll just call it, being run off, so to speak. Can you tell us kind of what that is in Water and if there's any in Electrical, as we stand today, still happening?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, so what we were referring to is we shipped some projects in 2016 that had a headwind and we looked at those as being somewhere around a point of headwind on the Water side and then larger impact in the Electrical side, primarily all in Thermal, which was the large jobs that had completed in 2016 that had no revenues in '17. That's all behind us now, and as we look forward, we no longer have those challenges. And each of the businesses will produce the organic growth or the core growth that will be just reflective of no longer having those year-over-year challenges.

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

Right. I guess, John, I was referring to what I thought, and correct me if I'm wrong, that you were even in some of like the lower-margin Water businesses, Residential, maybe you were walking away from some customers there. Did I have that wrong?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

No. I mean, it was more about more geography prioritization. We, as 2 smaller focused companies, can't afford to be in every geography in the world and it gets very difficult to have a small scale and compete in Russia or small scale and compete in Brazil and so both sides we're looking at optimizing those opportunities. But those will be some rounding headwinds next year, Scott, as we look to move the revenue that we have to a distribution or an alternative channel, but we removed the costs associated...

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

Cost structure of being local.

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

The cost structure of being local there.

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

Got you. Last question for me. As these companies take their each independent paths, have you -- I know that there's a lot of work going on behind the scenes in terms of what you want to be and all that and the separation mechanics themselves. But have you thought about M&A pipelines? I know you mentioned, John, where you kind of want to be just now, but have you started to identify some things on the Water side? And on the Electrical side, is there one of the 3 platforms you maybe wanted to develop a little bit further?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

So I'll handle the Water side. I mean, clearly, disciplined capital allocation is important for both sides and I think in the near term we think we have a significant amount of organic growth opportunities. And I'd like to see our businesses demonstrate the organic growth that they have and then tuck in behind it the M&A. So yes, we're identifying them. I think you know where we have strong organic growth and they probably have a readiness and an ability to move sooner. But I really want to see the discipline around a steady, consistent organic growth and then putting the fuel behind them with a bolt-on view. Randy, if you want to answer Electrical?



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

Yes. In Electrical, there's quite a few parts of the business. If you look at all 3 of what will be the segments, they're actually all 3 very attractive from a profitability standpoint and they all have opportunities on the M&A. But I would say 2018 is a prove-it year from an operational standpoint and a continuation year from driving the organic growth that they're really building great momentum on. At the same time, there have been and there will be opportunities, I think, to do a little plug-and-play acquisitions, particularly on EFS side, Electrical & Fastening Solutions side, and maybe some in Thermal, too. But again, I think Beth can talk more about that on the 13th.

### **Operator**

Your next question is from John Walsh from Vertical Research.

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

So one question about the Q1 top line guide. In prior slides, you'd called out a day's comparability issue on a year-over-year basis, we obviously looked through some of that in 2017. I think the last update I saw Q1 '18 actually has 1 less selling days from your prior slides. Is that still the case? Or how should we think about that?

### **John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, but I would say it's a rounding error. I mean, a day is not all that meaningful and that's reflected in what we have in the core guide for Q1.

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

Okay. And then, clearly, good cash conversion execution here. I like -- or applaud that you do it on the adjusted net income. As we think about next year in working capital, I mean, clearly, as you execute on that, it does get harder to keep getting gains out of that line. Any particular cash items you have visibility in the next year that give you confidence in that 100% conversion on the adjusted net income, whether it's on the inventory line or payables or anything like that?

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

Yes, the first thing I'd like to state, and maybe it's clear already, is both Water and Electrical have and will convert at 100% level. So the capability is on both sides. There's a seasonality in Water that John talked about that's important, but for the year both will deliver. I believe that Electrical does because of the distribution -- short-term distribution -- challenges that I just talked about will have some inventory opportunities as well as we really only begun to scratch the surface on EFS opportunity on inventory.

### **John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, I think the biggest tailwind opportunity for both companies as we go forward is the reducing of the separation-related costs and the severance and restructuring costs. I mean.

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

On the gross cash, right now.

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**John L. Stauch** - Pentair plc - Executive VP & CFO

Both companies will start to get into more of a stabilized mode and no longer have these large restructuring actions that have hurt us on the cash flow side.

**Operator**

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

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

John, on the Water side, you talked about focusing on the areas where you're seeing good growth, where you're having strong positions and maybe deemphasizing some of the other businesses. Given the opportunity you have with the split, is -- have you given a thought and consideration to perhaps disposing of some of those assets using that capital to bolster the businesses where you have better and stronger positions?

**John L. Stauch** - Pentair plc - Executive VP & CFO

Yes, I don't know if we're there yet. I think it's really about the fact that it's prioritization. And we've been -- we have a lot of great growth opportunities across all of Water, but we have to focus our energy and focus our actions. And so it's about not chasing the large jobs that are one and done. It's about focusing on the aftermarket, the annuities, the stability of our customer base and that's really what it's about at this point, Nathan.

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

And then I know you guys said you're looking at investment-grade balance sheet for both companies. But judging by the interest expense line that you have there, Electrical is going to get more of the debt on what is a somewhat smaller company. Does that indicate that you guys believe that the Water business has more opportunities for M&A?

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

Well, obviously, that reflects roughly what we think we'll do. As you recall, now that we've retired all -- retired the debt with the proceeds from Valves & Controls, while money is fungible, the debt that remains is really around EFS. So I just think, by rights, it's sort of an Electrical debt, which is a guiding principle. I think there are more opportunities on both sides. But Water's been on the sidelines first because of Valves & Controls, and secondly, because of the EFS acquisition for a while. So those are the guiding principles that I gave the team to use as they put this together. Still have to finalize things more.

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

Okay, fair enough. And then the \$25 million of incremental investments, I think that was related to Water. Can you quantify what incremental investments are related to Electrical? And then maybe talk about some of the major initiatives, some of the major investments that you're making to drive growth here in the future?

**John L. Stauch** - Pentair plc - Executive VP & CFO

Yes, about 50 basis points from the Electrical side. And again, I mean, those are 2 further off the optimization, get the delivery and quality issues and also to be creating the one nVent opportunities across the portfolio for some of the key initiatives that they have, like rail and data centers. So



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I mean, I think each of these companies feel that the incremental investment in 2018 is really going to create a sustained and more predictable organic growth in '19, '20 and beyond. And so obviously, if it doesn't materialize then that's an opportunity, but it'd be disappointing if we weren't able to invest ahead of future growth.

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

Is that a number that you think is a run rate number? This \$25 million in Water, 50 basis points in Electrical, is this a step-up for 1 year that will step down again? Or a step-up to a level that you would imagine sustaining as we go forward investing in growth opportunities?

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

We like to sustain it, yes. I think we need to build the business model to be able to sustain that so we can keep it going. John made a good point earlier about these large projects that are one and done. And I mentioned earlier about Thermal basically redirecting and restructuring their costs to go after smaller, sustainable MRO and product. That's really an opportunity in Water as well, as John said. But those investments should sustain -- those investments should give us more reliable, organic growth.

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**Operator**

Your next question is from the line of Josh Pokrzywinski from Wolfe Research.

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

So John, just to follow up on something you said about emphasizing versus deemphasizing points within Water. Does deemphasizing, could that mean outright sales of businesses? And can you kind of ring fence, maybe not the exact lines of business, I don't want to spoil the fun on Analyst Day, but the rough size of businesses that could be in that [deemphasization] bucket?

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

Josh, let me take it, and of course, probably it will come up again on the 13th. The fact that is, is that we have always focused on capital allocation. Look at all the things we did, I mean we sold the pipe business right after we bought Tyco. We ended up making different [calls] on Valves. I mean, we have trimmed and pruned the business as well as replanted it. That's sort of, I think, almost in the DNA of the business, to think that way and I would expect both businesses to continue to do that.

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**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Josh, I mean, to put it into context, 85% of what we do falls into one bucket in Water called Residential, Commercial water treatment. I want the focus to be there. We moved to more of an enterprise model where we have the ability to look at marketing across the enterprise and innovation across the enterprise. And we want the extra energy to be focused on where we think we can differentiate against the competition and differentiate on behalf of the customer. One of the big areas that we have to invest in is digital marketing to pull the consumer through our professional channel and that's going to be done first on the Residential, Commercial side. The technology is transferable. I mean, when we take a look at what we have and what we do, Industrial Filtration, that technology is useful in Residential, Commercial. It hasn't been used that way in the past. And so it's more about a redirection as we go forward than it is necessarily an asset sale.



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

Got you. So when you think about that, the 15% that doesn't fall into the core, we shouldn't think about Pentair long term as maybe parting ways with those as we add in other things that are closer to the core, that's not necessarily in the agenda?

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

That's correct.

**Operator**

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

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

So back to Water, if I could, just for a second. You mentioned the pace of margin improvement in Water shouldn't continue. You are guiding up 40 bps for '18, and this is really good operating margin in Water in the back half of the year here and really for the whole year. I guess, my question is just can it continue to kind of track up above 20%? And as I look back at the old reporting structure, Water Quality was of course sustaining margins above 20, but Flow & Filtration was well below that and I'm just wondering, if combined, what is the longer-term trajectory for this combined business?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

Yes, what Randy meant was even though we delivered 140 year-over-year this year and we're up 100 every single quarter, we did not make those future investments in the growth that we're doing in 2018. So if you add back that \$25 million of incremental growth I shared with you, it suggests that these margins are continuing to expand before that growth and I would just look at it that way. The other thing we did, and we used a playbook that's been proven in the PIMS for some period of time and we did a lot of product rationalization, SKU rationalization and reprioritizing some of the lower-margin product and really didn't suffer all that much in the top line, we significantly expanded margins. So I mean, there's a ton of opportunities still remaining in these businesses from an operational standpoint, but we want to invest in future growth.

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

Okay, but we shouldn't think about 19.6 or wherever we are as a ceiling. In 2019, 2020 we can continue to move up?

**John L. Stauch** - *Pentair plc - Executive VP & CFO*

No, and our peer group demonstrates that, too. I mean, if you take a look at some of the other water peers, they have nice margins as well.

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

Yes, for sure. And then, if I could, just a couple of questions on Thermal. Are you starting to see demand specifically in the petrochem market? There's a talk -- a lot of talk of second wave of investment there and over the next few years. Could that be a tailwind for you?

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

Yes, we're seeing it pretty broad based, as we mentioned before. Particularly now with the tax law change, I would expect the investments in petrochem on the chem side, right, on the plastics and monomer side is going to be quite substantial here. With low-cost natural gas in North America, the whole industry should be here, the whole world should be here. So with the tax law change, I think we could have a sustained capital spending even at this oil price level. That would be pretty exciting.

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

Right. Okay. And then just one last quick one. You mentioned MRO again is picking up steam in Thermal in the Americas. And can you kind of break that down into what your -- go ahead.

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

It's not just Americas, it's also in Europe, it's everywhere. The thing is, again, now -- if you want to go back and just look at the energy side, now they're back to \$65, you're back to a more normalized maintenance level and this is a business that has a wonderful MRO flow. And our focus now in our investment as we took down the elephant hunting, forgive the metaphor, of the large projects, we invested at the same time to more aggressively focus on getting that aftermarket and serving it and we're enjoying that. So I expect it to continue.

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

Okay. So my question was going to be -- thank you for that, but my question is going to be within the Americas, are you seeing the same kind of momentum in Canada versus the U.S. and kind of broad based across end markets? Or are there any specific pockets of strength?

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

As I mentioned, it is broad based. It is Europe. It has come back in Canada. It has -- it is strong in North America. And so everywhere.

**Operator**

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

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

Maybe going back to Electrical for a second and your commentary earlier around price cost. So if I kind of take a look at 2017, it looks like you've been running last few quarters about \$10 million, \$11 million price cost negative last few quarters and it sounds like that's going to continue now at least through next 4, 5 months. On top of that, you've got strategic investments, call it, \$2 million to \$3 million a quarter in Electrical. So what I'm trying to do is I'm trying to bridge to flat margins. Is there an expectation then as we get into the back half of the year that price cost reverses? Or are there other things that are coming through on your bridge to get to a flat margin guidance for '18?

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

Yes. The productivity -- the stabilization then leads to positive productivity and that's more in the third and fourth quarter as opposed to certainly not the first quarter, a little bit the second is how to think about it.



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

Okay. But is there an expectation also from a pricing standpoint? I guess, my understanding was that, and I could be wrong here, with typically you guys put price increases through at the end of the year or early part of the year and so I'm just wondering whether there's an opportunity for you to get additional pricing as the year progresses?

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

Let me say this carefully, but I hope there is an opportunity. We haven't broken that process. But this business -- I mentioned it's an anomaly, it's most -- in the Enclosures business for this kind of performance. So controlling your destiny means controlling what you can. So there's been a price increase, but we count on that or we count on the productivity that we own and we drive. You count on what you own and drive, that's what controlling your own destiny means. If price reads through, that would be good. But we want to deliver on our commitments in any case.

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

Got it. And maybe then just kind of following on what you can control, which is partly the cost angle. Do you guys plan to -- do you typically hedge any of your commodity costs? Or are we just kind of going to roll through because we've seen a little bit of an increase in copper and steel and just wondering like whether we should -- what kind of headwind we should be expecting from that?

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

What our process is we're not commodities traders, so what we'd like to do is we like to lock in our price so that we can have good operating plans and predictability in our business. So we typically are locked out about 6 months on those commodities and copper's one of them.

**Operator**

Your next question is from the line of Steven Winoker from UBS.

**Christopher Belfiore** - UBS Investment Bank, Research Division - Equity Research Associate Analyst of Industrials

It's actually Chris on behalf of Steve. Can we just go back to the price cost and then the productivity kind of topic. But you guys said that you control your own destiny with regard to productivity. Are you seeing customers being more reluctant to accept price? Is that kind of something that you're seeing kind of with your customer base right now?

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

Well, again, talking about Enclosures, it's really hard to actively set price when you can't deliver, right? And so we got stable now and we'll see whether they accept it. But I mean, people are seeing inflation. So I mean, material inflation that typically in that business has led us to be able to achieve some price.

**Christopher Belfiore** - UBS Investment Bank, Research Division - Equity Research Associate Analyst of Industrials

Okay. And then I know you said you're not -- the elephant hunting is a thing of the past. But in terms of just project activity in general, I mean are you -- is there more activity or is there anything you guys are seeing there? Or is the growth going to continue to be kind of shorter cycle in nature, more MRO kind of mix there?



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

Yes, in this kind of a robust economy, there will be larger projects, but we want the projects to come to us and we want to own the other parts of the business. And so it's a different -- we certainly will accept them as they come. And we will -- but we're not going to have the major effort that we had in the past and the cost structure associated with that.

### **Christopher Belfiore** - *UBS Investment Bank, Research Division - Equity Research Associate Analyst of Industrials*

Okay. And if I could just add one more. On Electrical & Fastening, I know there was easier year-over-year comp, but that strong sequential acceleration there. Is there anything more to that? And how should we kind of expect that to flow through '18?

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

Well, the Caddy business, the Caddy brand product line, which is largely Commercial, is seeing -- it saw some variable growth in EFS. But Caddy was pretty solid -- it was really solid in the fourth quarter. And then the Infrastructure business was -- really came back. And I think, again, in this economy with what's happening, I would expect Infrastructure to continue with some strength.

### **Operator**

There are no further questions on the line at this time. I now turn the call back over to the presenters.

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

Thanks for your questions and your attention. Just to wrap things up, we remain on track for the separation to be completed by April 30, but there still remains work to be done. Both businesses are well positioned entering the new year with improving top line fundamentals, and we expect both companies to have strong balance sheets upon launch. We look forward to updating you further on February 13 with Pentair and nVent presenting their strategies. And we hope you share our excitement for the future of both companies. And again, thanks for your continued interest. And operator, you can conclude the call. Thanks.

### **Operator**

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

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