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PNR - Q2 2016 Pentair plc Earnings Call

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OVERVIEW:

Co. reported 2Q16 adjusted EPS of $1.11. Expects full-year 2016 core sales to decline 1% and adjusted EPS to be $4.05-4.20. Also expects 3Q16 core sales to be flat.

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PRESENTATION

Operator

Good morning. My name is Emily and I will be your conference operator today. At this time, I would like to welcome everyone to the Pentair Q2 earnings conference call. (Operator Instructions).

Jim Lucas, you may begin your conference.

Jim Lucas *- Pentair plc - VP IR & Strategic Planning*

Thanks, Emily, and welcome to Pentair's second-quarter 2016 earnings conference call. We are glad you could join us.

I am Jim Lucas, Vice President of Investor Relations and Strategic Planning. And with me today is Randy Hogan, our Chairman and Chief Executive Officer, and John Stauch, our Chief Financial Officer. On today's call, we will provide details on our second-quarter 2016 performance, as well as our third-quarter and full-year 2016 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. I would like to request that you limit your questions to one and a follow-up and get back in the queue for further questions in order to ensure everyone an opportunity to ask their questions. I will now turn the call over to Randy.

Randy Hogan - *Pentair plc - Chairman, CEO*

Thanks, Jim, and good morning, everyone. I am starting on page 4.

We were pleased with our second-quarter results, which came in at the high end of our expectations. The topline was consistent with our forecast and income and margins were slightly better than our expectations, driven by strong execution and continued benefit from our cost-out actions.

The integration of ERICO is meeting our expectations. We remain on track to meet or exceed the $10 million in synergies we targeted. Free cash flow was once again a positive story and we are very pleased with our performance here. For the first half of the year, we have generated $304 million in free cash, which is over $150 million better than what we delivered in the first half last year.

We are updating our full-year adjusted EPS outlook to a range of $4.05 to $4.20, which is bringing $0.05 off the top end of the range. While Valves & Controls has started to become more predictable, we are seeing the negative impact of sales mix in both Flow & Filtration Solutions and Technical Solutions.

Now let's turn to slide 5 for a discussion of our Q2 2016 results. Second-quarter core sales declined 1%, which was slightly better than our previously communicated expectations. Water Quality Systems delivered solid growth once again against a tough comparison, while Flow & Filtration Solutions felt the impact of continued difficult Agriculture markets. The decline in Valves & Controls sales moderated and Technical Solutions was flat compared to our expectation for a slight decline in the quarter. ERICO contributed positively, with sales in line with our expectations.

Segment income increased 7% and return on sales expanded 30 basis points to 16.8%. Water Quality Systems saw a 200 basis-point expansion and Valves & Controls slightly beat its second-quarter income and margin commitments, which were big steps up from the first quarter.

Adjusted EPS grew 3% to $1.11 per share and was at the high end of our guidance of $1.08 to $1.11. As I mentioned previously, free cash flow was very strong in the quarter.

Now let's turn to slide 6 for more detail on Pentair's Q2. Our sales performance was mixed by vertical, with strong growth in Residential & Commercial and Infrastructure. We saw signs of stabilization in Industrial, where the rate of decline continued to moderate, and Energy did not get worse. Food & Beverage was down in the quarter, due to ongoing declines in Agriculture, but we believe our Beverage Business remains healthy. Our largest vertical, Residential & Commercial, saw 2% sales growth, with strength in Residential and Water Quality Systems and ongoing strength in Commercial in both Flow & Filtration Solutions and Technical Solutions.

While ERICO's performance is not captured in core results yet, we would point out the Commercial markets remain solid for it, too. Infrastructure was positive once again, led by continued growth in both North American municipal pumps and improved project activity in Process Filtration globally. We have been looking for Flow & Filtration Solutions as the Infrastructure growth this year, which has played out as expected, and we are encouraged that bidding activity remains healthy as well.

The rate of decline within Industrial moderated further and we believe that this, our second largest vertical, appears to have found a bottom. Though we are not looking for a second-half rebound, comparisons ease in the second half and should help reported results.

Food & Beverage declined for the second consecutive quarter, as Flow & Filtration Solutions continued to feel the impact of Agriculture markets that declined at a double-digit rate for us.

Energy declined at a low double-digit rate for the second consecutive quarter, but we expect Energy sales to find a bottom in the second half, based on the bottoming in sequential orders we have experienced. As you can see on the right-hand side of the page, productivity remained strong and more than offset inflation. ERICO contributed strength to the bottom line and strong underlying performance and synergies.

Now let's turn to slide 7 for a look at Water Quality Systems' performance in Q2. Water Quality Systems delivered another strong quarter, with 3% core sales growth. While the growth rate declined sequentially, it was a tough comparison as the second quarter last year reflected slightly different timing in the North American pool season than what we are experiencing this year. While the timing is different, we believe the North American pool season remains very healthy.

Water Filtration grew core sales 1% as both our Residential Filtration Business and our Food Service Business faced tough comps.

Segment income grew an impressive 11% and return on sales expanded 200 basis points to 24.7%. Robust operating leverage was a key contributor to margin expansion in the quarter. Timing of growth investments may mute the rate of margin expansion in the second half, but we anticipate the prospects remain strong for Water Quality Systems.

Now let's move to slide 8 for a look at Flow & Filtration Solutions. Flow & Filtration saw core sales decline 1%. We had anticipated the segment to return to growth in the second quarter, and while the Infrastructure growth came through as expected, the Food & Beverage performance was negatively impacted by very challenging Agriculture sales. Water Technologies' core sales declined 3%, as strength in Residential & Commercial and Infrastructure pump shipments were more than offset by double-digit declines in irrigation pump shipments.

This is very similar to what we saw last quarter in this business. While we expect both the Residential & Commercial and Infrastructure businesses to see continued growth, irrigation headwinds will likely persist as comparisons remain challenging, given the drought conditions in the West that helped our sales last year.

Core sales in Fluid Solutions declined 3%, while Beverage returned to growth in the quarter and experienced strong orders growth as well. The Precision Spray Business was negatively impacted by the beleaguered Agriculture markets.

Process Filtration saw core sales growth of 10%, as we continue to see momentum built from our focus on Industrial Water Reuse Solutions and a return to growth in Infrastructure with some desalination investments. This business had some lumpiness, given the timing of projects, but we believe we continue to gain momentum from our focus on Industrial Water Reuse.

Segment income and return on sales contracted modestly, as negative mix weighed on the segment's results. We believe this is just a pause in the margin improvement journey in Flow & Filtration Solutions and that there is still a long runway ahead for further margin growth.

Now let's turn to slide 9 to discuss how Technical Solutions performed in the second quarter. Technical Solutions reported 33% sales growth for the quarter, consisting of flat core sales growth, a 1% headwind from FX, and a 34% positive contribution from ERICO.

Core sales in Enclosures declined 5%. We're encouraged by the stabilization in the daily order rate, which reinforces our view to easier comparisons in the back half of the year. Thermal Management delivered core sales growth of 7%, helped in part by two projects in Canada that we previously discussed that are reaching completion. We have talked this year about our Industrial Heat Tracing Business continuing to win small projects, but unfortunately we are seeing no sign of downstream MRO spending growth return yet.

While the results of ERICO are captured as acquisition contribution, the business performed in line with our expectations. As a reminder, over 75% of ERICO's sales are into Commercial end markets, which remained very healthy in the quarter. We remain on track to deliver over $10 million in synergies for the year, on top of the base business profitability, which is performing as expected.

Segment income grew 30%, but return on sales contracted 60 basis points to 20.6%. The margin contraction was isolated to our Thermal Management Business, as the growth we mentioned in projects versus higher-margin MRO product sales negatively impacted mix. ERICO has performed as we had anticipated and Enclosures is seeing signs of stabilization. The performance of these two SBGs was not enough in the quarter to offset the impact of the negative mix experienced in Thermal Management on the ROS.

We are not expecting downstream MRO spending to rebound in the second half and we expect this will undoubtedly have an impact on third-quarter margins for Technical Solutions. So with ERICO and Enclosures performing as expected, Technical Solutions remains well positioned long term.

Now let's move to slide 10 to discuss the Valves & Controls performance in Q2. For the second consecutive quarter, Valves & Controls met or beat its forecast for both sales and margins. Even more, the heavy lifting we have done to right-size the cost structure of the business read out in the nice gain in margins sequentially and orders appear to have stabilized.

Valves & Controls reported a 13% decline in revenue, with core sales down 11% and a 2% headwind from FX. Backlog was down 7% sequentially, which includes negative FX translation. Core orders were down [27]% (technical difficulty) year over year against a tough comparison, but, as stated, we did see a flattening of orders sequentially.

Core sales were down 6% in Aftermarket and down 17% in Projects. In line with our expectations, the Aftermarket Business remained weak as OpEx continued to be constrained, along with CapEx, at many customers. We believe the order funnel overall is beginning to strengthen, which reinforces our view that orders have bottomed in the second quarter and will begin to expand near double-digit rates sequentially starting in the third quarter.

The right half of the page shows second-quarter segment income and return on sales, which both met our forecast. Return on sales of 10.1% was slightly ahead of our forecast and up significantly from the first quarter, as our cost-out benefit registered in line with our previously communicated expectations.

The Valves & Controls team has done a courageous job in realigning the business to reflect the significant Energy industry reset. They've executed on the cost side, while aligning the business with the opportunities that exist today and over the next several years. We continue to believe that Valves & Controls is well positioned for an eventual recovery in its end markets beginning in 2017 and will continue to enjoy rising margins sequentially even before that.

Now let's move to slide 11 for a look at Valves & Controls backlog. Much of the backlog decline we saw has come as the result of progress we are making in reducing our past-dues. Last year, we booked roughly $100 million in orders from projects greater than $5 million. However, we have not booked even one order greater than $5 million during the first half of 2016. Yet orders have bottomed out sequentially, and as our customers sort out their spending plans, we expect to see a return of some larger projects.

So we believe that the second quarter marks the bottom for orders and we are expecting orders to improve in the second half of the year from the depressed first-half levels. For the past three quarters, the business has improved its forecasting capabilities, and with Aftermarket orders now approximating 55% of orders, that should improve the margin mix.

We are encouraged with Valves & Controls meeting or beating its forecast on sales, orders, and income for the second consecutive quarter. There has been tremendous progress made on right-sizing the cost structure of the business, and better alignment between sales and operations has improved the forecasting and execution ability of this segment. We believe the order funnel will continue to strengthen, and while the topline will not show it right away, orders bottoming and margins improving show brighter days ahead.

With that, I will turn the call over to John.

John Stauch - *Pentair plc - EVP, CFO*

Thank you, Randy. Please turn to slide number 12, titled balance sheet and cash flow.

We ended the second quarter with $4.6 billion of net debt, inclusive of cash on hand. This was an improvement from where we ended the year, as we used our strong cash flows in the quarter to reduce our debt levels.

As Randy mentioned earlier, free cash flow increased over $150 million during the first half of the year versus the comparable period last year. We continue to expect to deliver free cash flow greater than adjusted net income for the full year.

Our ROIC ended the quarter at 9.6%. Our forecast for capital expenditures remains $150 million, as we continue to invest in businesses that have earned the right to grow and drive standardization and productivity across the enterprise. We remain focused on generating strong cash flow and further debt reduction.

Please turn to slide 13, labeled Q3 2016 Pentair outlook. For the third quarter, we expect core sales to be flat and total sales to increase 7%, inclusive of FX headwinds and a positive contribution from ERICO. As a reminder, we closed on the purchase of ERICO just before the end of Q3 last year, and starting in Q4, ERICO will be included in the core. On a core basis, we expect Water Quality Systems to grow approximately 8%, while Flow & Filtration Solutions is expected to see core sales decline approximately 1%. Technical Solutions is expected to be flat on a core basis and Valves & Controls is anticipated to see core sales decline 6%.

We expect segment income to increase approximately 11% and return on sales to expand roughly 60 basis points, to 16.7%. Below the operating line, we continue to expect the tax rate to remain around 20.5%, net interest and other to approximate $35 million, and shares outstanding to be around 183 million. We expect free cash flow to continue to be strong during the quarter.

Please turn to slide 14, labeled full-year 2016 Pentair outlook. As Randy mentioned at the beginning of the call, we have taken $0.05 off of the top end of our range and our full-year adjusted EPS outlook is now $4.05 to $4.20.

For the full year, we expect core sales to decline 1%. Water Quality Systems' full-year core sales are anticipated to be up approximately 6%, which is slightly better than our prior forecast. We now expect Flow & Filtration Solutions to see a core sales decline of 1% versus our prior forecast of modest growth for the full year. Technical Solutions core sales are expected to be flat for the full year, which is slightly better than our prior forecast. Finally, Valves & Controls is expected to see core sales decline of approximately 9%.

We expect segment income to grow roughly 8% and return on sales to expand approximately 70 basis points, to 16.3%. Our revised forecast factors in slightly better operating performance from Water Quality Systems and Valves & Controls, while Technical Solutions and Flow & Filtration Solutions are expected to see margins impacted by negative mix related to unfavorable market conditions.

We anticipate full-year corporate costs to be just under $90 million, net interest and other of roughly $140 million, and the share count to be roughly 183 million. Adjusted EPS is expected to grow approximately 5%, at the midpoint of the range. Finally, we remain on track to generate free cash flow in excess of adjusted net income for the full year.

Emily, can you please open the line for questions? Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Shannon O'Callaghan, UBS.

Shannon O'Callaghan - *UBS - Analyst*

So, I guess maybe just start with the current assessment of strategic views on Valves & Controls, given news items, and also, does the fact that that is executing so much better impact your view of fit? How do you think about that currently?

Randy Hogan - *Pentair plc - Chairman, CEO*

Well, I am not going to comment about speculation. If we had anything to say, we would have said it.

But I am really pleased with the progress. There are a lot of doubters. There were doubters in a lot of places about how well our actions would read out, and I think this was a prove-it quarter. And to go from the margins we had in the first quarter to the second quarter and see the bottoming of orders, I would say Valves has a lot clearer future today than it had in the first quarter.

John Stauch - *Pentair plc - EVP, CFO*

I would add this is a great business in a difficult market condition. In 2014, we were nearly 17% margins and roughly $400 million in segment income, and what we feel like is a trough year, we are still going to be 11%, 11.5% ROS.

So, we are slugging through it. Obviously, seeing some sequentially bottom of the orders is a good sign, and seeing the order funnels start to become more robust heading into Q3 and Q4 give us excitement that we can feel like we can start contributing more and more as we go forward in Valves & Controls.

Shannon O'Callaghan - *UBS - Analyst*

Okay, and then maybe just within Valves & Controls, but even Technical and more broadly, some things you are saying are bottoming. You talked about, I think, within Valves potential double-digit order increase sequentially in 3Q. But then there are other things, like downstream. You said you assumed -- you are not expecting any recovery. I guess, where do you expect sequential recovery and where do you think markets are still going to remain depressed?

Randy Hogan - *Pentair plc - Chairman, CEO*

It is a weird time. There is such a mix geographically and between verticals, in terms of growing and not growing. And I think that reflects the greater uncertainty in the world.

We feel really good about Industrial and Commercial. We feel like Infrastructure is coming back with some momentum; as I mentioned, the orders -- not only are sales up, but order activity has remained up, and while the agriculture -- continued muted spending in agriculture mutes our Food & Beverage look, we feel really good about Food Service and Beverage overall.

So, we think a lot about what individuals are spending money on is good: residential, commercial, Food & Beverage. And even in Industrial, the fact that we are getting to the point where we are seeing flattened daily order rates in Industrial tells us that we are -- that's why we are seeing the bottom there. We just don't expect it to increase a lot in the second half yet.

Shannon O'Callaghan - *UBS - Analyst*

Okay, great. Thanks, guys.

Operator

Deane Dray, RBC.

Deane Dray - *RBC Capital Markets - Analyst*

Randy, was hoping you could expand on a comment you made in your opening remarks regarding the negative sales mix. I think you addressed it pretty clearly on the Valves & Controls Business, but I would be interested in hearing where else you are seeing a negative mix as it relates to customers in this environment. Instead of buying such and such, they are opting for either a cheaper replacement, but how does it translate into, customer behavior, a negative mix this quarter?

Randy Hogan - *Pentair plc - Chairman, CEO*

Thanks, Deane, for asking that so I can clarify. It is not -- the mix we are seeing is not mix between a customer, say, buying a lower margin, lower performing product for the same application.

It is specifically in Flow & Filtration. Our Agriculture Business has higher margins than our Residential & Commercial Business. And so when Agriculture goes down and Residential goes up, we got a negative mix. So it isn't product substitution in application. It is just a mix of what is growing and what isn't.

And in the Thermal Business and Technical Solutions, again products, MRO, has high margins; projects doesn't. So we actually expected MRO to come back and maybe that was Pollyanna-ish, probably it was. But it didn't, and therefore all the projects that we were happy about winning overwhelmed margins for Thermal.

Deane Dray - *RBC Capital Markets - Analyst*

And just to clarify, when you say and you reference Agriculture, this is irrigation pumps that you are primarily exposed to?

Randy Hogan - *Pentair plc - Chairman, CEO*

There are two pieces, and they are both in Flow & Filtration, that we are talking about that have seen big negatives. One is irrigation, and year over year it held up pretty well last year because we have pretty high share where there were droughts and there was a lot of activity to drill new wells because of the drought. We don't have that impact this year.

And the second is in crop spray, where we have had -- we have actually been whistling to the graveyard a little bit because we have been not declining as fast as the market, and this is largely the OEMs and distribution where we sell these Precision Spray Systems that are used in Agriculture as well. And that market remains depressed.

Deane Dray - *RBC Capital Markets - Analyst*

Thank you, and then on -- as an unrelated topic, we had the opportunity last month to see Pentair's attractive new business in China for Residential water treatment. So this was a brand-new market for us to see, and estimates put it 20% to 30% growth annually, and you all are being recognized as one of the leaders in this business. They're basically mini RO systems for home appliances that are being bought by the rising middle class, who just can't drink the water without boiling it.

So, I haven't seen you talk about this opportunity before, but we saw it. Everyone is talking about it. Maybe you can talk about what the opportunity is, how it fits, what the ramp is, and what kind of contribution you should expect.

Randy Hogan - *Pentair plc - Chairman, CEO*

I probably should talk about it more. I'll just stop fighting fires. What is really interesting is there is much more awareness about the importance of, say, clean water among the middle class in the developing world than there is in the US and Europe.

Now, for sad reasons, there is increasing awareness in the US. We saw a bump in the US because of the concern about drinking water in cities and schools, and we can see that in our orders. And we are the largest provider of equipment for Residential water treatment and filtration in the world.

That business has been growing nicely. It is a little bit in China. We do have nice exposure there. It has been lumpy because a lot of ours goes through distribution and it has been -- as credit has been harder to get there, some of our distributors have had to slow down. But if you take a look at it over the last few years, it has been growing very, very substantially.

I moved that business to Karl Frykman and his WQS team a couple years ago because we were the largest -- we are the largest player in that business, but we weren't the best performing in that business, and we've made huge progress under Karl's leadership in taking that Water Filtration. That's part.

It is in Water Filtration; Water Filtration is made up of that, Residential & Commercial, and the foodservice piece, the Everpure brand, if you will. And a lot of the margin expansion you saw in WQS is actually because of the momentum we are gaining there. And we will talk more about it.

Deane Dray - *RBC Capital Markets - Analyst*

Thank you.

Operator

Steve Winoker, Bernstein.

Steve Winoker - *Bernstein - Analyst*

Can you maybe talk a little bit through the progress Beth is making in Flow & Filtration, and -- it is still early days in many ways, but just talk about where you are in that path and how the quarter -- as you look forward, where you think this could head, at least over the next four quarters?

Randy Hogan - *Pentair plc - Chairman, CEO*

I think Beth's progress is good. No one was more disappointed with not getting growth in the second quarter than she was. And I think we need to get more traction and she believes we need to get more traction on the things we are investing in to grow.

We shouldn't be surprised by what happened in irrigation, right? We need to be more intimate and closer to the customer. And we need to keep driving on the areas that are working, like the shift to Industrial water, and capture as much of the Infrastructure investment as possible. We still believe that there is probably more growth opportunities in the offerings that she leads and in the markets that she serves than any other business we have. There is no reason FFS shouldn't be able to grow and perform just like WQS.

Steve Winoker - *Bernstein - Analyst*

What are the biggest ones that jump out at you in that, besides the Chinese water one we all saw over the last year?

Randy Hogan - *Pentair plc - Chairman, CEO*

Well, I mean, Infrastructure globally, there is a return to investments, particularly in reverse osmosis and other water filtration on the Municipal and the Commercial scale.

We have leading positions in advanced technologies for water reuse, methane capture, CO2 capture for Food & Beverage, and we are having promising early results. We need to flood the zone and get more at-bats in those businesses. And also, just in terms of our membrane technology, I think there is too narrow a focus of where we are applying our technologies and we need to be planful about it, but there are opportunities for us to be, if you will, Pentair inside on membranes in a lot of applications, which we are -- where we would be a component supplier to high-value applications.

Steve Winoker - *Bernstein - Analyst*

Okay, and Randy, if I could just come back at that Valves & Controls answer you gave earlier. I guess I may come at it a little bit differently, which is considering how you were thinking about Valves & Controls from day one in terms of strategic fit with the rest of the portfolio, and the opportunity, to what extent is the -- forgetting price and everything else here, to what extent is the strategic fit of that segment important to how Pentair grows going forward, in your mind, and the importance to the other segments or from some other perspective that would suggest that it's really still going to be worth more to you than to somebody else?

Randy Hogan - *Pentair plc - Chairman, CEO*

Well, I see a good runway ahead for performance improvement there, and what are we good at? We are good at performance improvement. So, I think we have really turned the corner in the business. I am not going to air guitar strategy right here, but it gives us great scale and it has great scale. It is a large player in a large fragmented business, and we have speculated before on what needs to happen to the industry, but I am not going to speculate anymore right now.

Steve Winoker - *Bernstein - Analyst*

Okay. All right, that's helpful. I get it. Thanks very much. I will pass it on.

Operator

Steve Tusa, JPMorgan.

Steve Tusa - *JPMorgan - Analyst*

Thanks for the color on the Chinese water business. I appreciate that. The Tech product segment, the margins were cut there. I know you talked about mix. Is there any -- how do you look at the price/cost dynamics there and how much steel do you guys buy on an annual basis?

Randy Hogan - *Pentair plc - Chairman, CEO*

How much steel do we buy on an annual basis?

John Stauch - *Pentair plc - EVP, CFO*

A lot. I think it's a couple hundred million dollars, Steve, but I think if we take a look at the Technical Solutions margins, it is really simply that there was an expectation that we would see the MRO in the aftermarket product side, which is a very, very high-margin product line, basically not deal with gravity and it was going to -- or they were planning on it to be flat to up and it was down double digits in Q2. And, so, we are seeing a margin squeeze between that product fall-off.

And there was an expectation that would rally in the second half and we have taken away that expectation in the second half now, in anticipation that we are not going to see any recovery in the aftermarket side and we have deferred that aftermarket recovery to 2017. And so, that product decline of double digit is really impacting the squeeze on the margins in Technical Solutions.

Steve Tusa - *JPMorgan - Analyst*

Okay, so it is (multiple speakers) -- got it. It is really the Thermal stuff. What are you seeing in the chain in Technical? Wesco reported today a pretty weak volume number and all these distributors and Rockwell talked about pushouts in their business. So what are you seeing in the -- you talked about stabilization, but (multiple speakers)? For Enclosures, for the core Enclosures business?

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, for core Enclosures, we did see -- we have seen stabilization in our daily order rate, and it is interesting. There is quite a mix of what we are learning from what Mr. Peters is saying. Clearly, ones that are deeply Industrial facing are facing more challenges than the ones that are more balanced or skewed towards Commercial. And we do serve multiple end markets, so maybe that's why we are seeing the flat.

Steve Tusa - *JPMorgan - Analyst*

Okay, and then one last question just on Valves. Does the order -- I know things have bottomed sequentially, but historically, I think seasonally Q2 in every single business in the world is better than first quarter, so I'm not sure what that tells us. I think you said a double-digit increase sequentially in the third quarter. I still think the order comp year to date is probably (multiple speakers) -- sorry?

John Stauch - *Pentair plc - EVP, CFO*

Double digit (multiple speakers)

Steve Tusa - *JPMorgan - Analyst*

Yes, double digit (multiple speakers). Okay, so that brings the year to date probably year over year to down, still down double digit. Does that change the complexion of how you are feeling about 2017 or do the sequential dynamics now really make you feel maybe a little bit worse in 2Q, but better in 3Q? Make you feel like you are still on track for that kind of flat EBIT type of a hope for 2Q?

John Stauch - *Pentair plc - EVP, CFO*

Yes, Steve, so --

Steve Tusa - *JPMorgan - Analyst*

Sorry, 2017, for 2017.

John Stauch - *Pentair plc - EVP, CFO*

Yes, I hear you. I think what we feel is that we have got a fairly high past-due backlog that we are still working on from the standpoint of on-time delivery roughly 70%, not great by any standard. Not horrible in the industry, but not great by Pentair's standard. So we're working the past-due backlog through and that is helping revenue.

When we take a look at the orders and what Randy mentioned of not getting any large orders, it means that our conversion ratio is going to be higher, so we feel like as we head into 2017, even ending the year with lower orders in 2016, we think our conversion ratio is going to get back to historical norms, which is around 51% of orders that are booked in the year shipped in that year. That troughed last year at around 43%.

So I think -- we feel like we are starting to get that mix up, as we mentioned, with more aftermarket standard, and so we feel like right now 2017 is an up year versus 2016 from an income side, for sure, and orders will continue to rally in 2017 from this point is the way we are looking at it.

Randy Hogan - *Pentair plc - Chairman, CEO*

Exactly, and the only thing I would add is that we've really -- the funnel of what we are looking at has been cleansed.

Steve Tusa - *JPMorgan - Analyst*

Lot of (multiple speakers)

Randy Hogan - *Pentair plc - Chairman, CEO*

And it is high quality.

Steve Tusa - *JPMorgan - Analyst*

Pretty attractive for any buyer out there. Thanks a lot, guys.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - *Goldman Sachs - Analyst*

I am going to ask Steve's question slightly differently. And so, if you look at your expectation for double-digit sequential order growth, that would imply that your orders for the second half of the year are down, call it roughly, mid-single digits. Comps would get you to down mid-teens, and so there is underlying improvement embedded in that number, and I'm just wondering. Did things get much better as the quarter progressed and what is giving you the confidence in the underlying improvement in the order number in the second half of the year?

John Stauch - *Pentair plc - EVP, CFO*

I hit on this at analyst day last year, and then we have had several sessions with the business since, but we had a fairly sizable project contribution as we worked our way through the 2014 and 2015 time frame. And as Randy mentioned, not having a single order greater than $5 million over the last several quarters means that we have got a rich backlog or a rich funnel of shorter-cycle orders.

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Randy Hogan - *Pentair plc - Chairman, CEO*

(multiple speakers) higher-margin funnel.

John Stauch - *Pentair plc - EVP, CFO*

Higher margin. So I think where we are is that we do believe we are going to start to see some projects, and we are working on those in the funnel and those will be a contribution. But if you look at the order rates and the order levels absent of those large project orders, it is actually a pretty good contribution. And so when you think about that as a base and that base moving fairly stable, any orders on top of that gives you great excitement that we're going to start to see a ramp from here.

Joe Ritchie - *Goldman Sachs - Analyst*

Got it. Okay. But is there any specific end markets that are driving this improvement?

John Stauch - *Pentair plc - EVP, CFO*

Yes, we are starting to see the downstream investment again. The OpEx has been turned off for some period of time. We are starting to see a fair amount of aftermarket consolidation, so our customer is spending with the scale providers, which gives us great excitement as being the largest valve supplier in our space that we're going to see a lot more aftermarket consolidation and that's a big growth opportunity for us.

And then, we also are back in the game in the Middle East and we are starting to see order contributions in the Middle East, where we have been out of that game for some time.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, all right. Maybe my one follow-up. [Luke] has done a really nice job on the Tech Solutions side. I guess the question I have is you saw a little bit of margin degradation this quarter on flat growth. Your expectation for the back half of the year is for growth to be down, but for margins to flatten and actually improve versus 2Q. And so, maybe just talk through some of the puts and takes there on the Tech Solutions margins in the second half.

John Stauch - *Pentair plc - EVP, CFO*

Yes, we were finishing a job in Q2 that was a fixed bid job in Thermal and we had some overruns on the labor side on that project, so that job is ending early Q3, and so with that behind us, we are back to more of our normal project margins and our normal product margins. So, it was one large job that we worked through last year and we have the final labor runs going through Q2 and early Q3, and then it is behind us.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, what was that impact, John?

John Stauch - *Pentair plc - EVP, CFO*

It was a project order and it was a fixed hourly or fixed fee, and we overran the labor to install and complete the job, and so it ended in Q2 and Q3, so it is finishing up here in July, and then we're going to see those orders -- or see that margin rate get better from here.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, I can follow up on impact later. Thank you, guys.

Operator

Mike Halloran, Robert Baird.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

A couple Flow & Filtration questions. First, on the water reuse side, obviously going to see some lumpiness on your Process Filtration piece in general. Maybe you could just talk about the underlying momentum there, what the core trends from the industry look like, and then how your positioning is and how you are doing on a relative basis.

Randy Hogan - *Pentair plc - Chairman, CEO*

Just the Process Filtration piece?

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Yes, then I will have a second one on the Agriculture side.

Randy Hogan - *Pentair plc - Chairman, CEO*

I think we have a lot of capability and we have not fully achieved ignition in the marketplace on them. Infrastructure, we have pretty good reach globally to basically the components that go into large projects and we do pretty well there. Our hit rate when we compete for Industrial is pretty good. We need to get more at-bats on that. And similarly, I think that there is a vast opportunity for us to sell membrane bundles and not just modules and systems. So I think we're early days in terms of all the growth opportunities that Process Filtration has.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

And then on the Agriculture side, obviously some challenging comps year over year and some challenging trends industrywide. Talk about the sequential trends. Are you seeing any signs of stability in that industry relative to what a normal sequential would look like, and what's the thought process going forward?

Randy Hogan - *Pentair plc - Chairman, CEO*

You are talking about Flow & Filtration in total? Oh, Agriculture.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

In Agriculture.

Randy Hogan - *Pentair plc - Chairman, CEO*

Given the lack of good predictability that we had going into the second quarter, I will be less confident in answering. We expect to see some improvement in crop spray coming, but irrigation, I think, is going to be -- this is irrigation season, so the fact that it wasn't up now means it won't be up in the third quarter. It tracks pretty closely with farm income, unless you have an issue like we had with the drought.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Right, but I guess I am more asking, is stability emerging yet on that side for you guys with all the headwinds there or do you think that there is still some worsening ahead?

Randy Hogan - *Pentair plc - Chairman, CEO*

Not worsening; not bettering, though, to be honest, I would say.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Great. Thanks, guys.

Operator

Nigel Coe, Morgan Stanley.

Nigel Coe - *Morgan Stanley - Analyst*

So the $200 million of steel purchases you called out, is that just for TS or was that Pentair wide?

John Stauch - *Pentair plc - EVP, CFO*

Pentair wide.

Nigel Coe - *Morgan Stanley - Analyst*

Okay, that's what I thought. Just want to clarify that point.

So nice job on V&C margins. Can you maybe just help bridge us to the -- from 2Q to 15%? Do we still have a FIFO tailwind into the second half of the year or is the gap between low doubles to mid-teens, is that primarily cost saves at this point?

John Stauch - *Pentair plc - EVP, CFO*

There is a small little tailwind from the variances associated with the last year productivity working its way through Q1 and Q2, but most of it is the momentum on the incremental cost saves on the operational side and also some momentum around material savings working its way through the shipments.

Nigel Coe - *Morgan Stanley - Analyst*

Okay. And I guess the fact is there is no pricing degradation in the margin bridge. It is borderline shocking. I think we were all expecting there to be a pricing headwind this year. Is that because the pricing umbrella in the markets is -- we just haven't seen price cuts because the end market conditions are so awful or was this primarily a function of Pentair walking away from lower-priced projects, maybe a bit of a mix issue there as well? Any color on pricing would be helpful.

John Stauch - *Pentair plc - EVP, CFO*

Nigel, just to be clear, and thank you for asking the question, our price that shows up in the Valves & Controls chart is a like product to a like product (multiple speakers), so it is standard product and it is an aftermarket, usually, and it is a like to like.

We are seeing, as we have talked about over the last several quarters, the project margin headwind that works its way into the growth in the FX bar on the right as far as segment income, so we are seeing that project mix to that project pricing work its way through that and that is stabilized, but it is still on a year-over-year basis pretty large, as you can see there.

Nigel Coe - *Morgan Stanley - Analyst*

Okay, and then a quick clarification. FFS, the three-point delta, the truedown on the full year or core growth, is that all the Agriculture issues or is there something else there?

John Stauch - *Pentair plc - EVP, CFO*

It is pretty much just the Agriculture issues, the majority (multiple speakers)

Nigel Coe - *Morgan Stanley - Analyst*

Great, okay. That's perfect. Thanks a lot.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Just to follow up on Nigel's question there, we have heard companies talking about demand is so lousy in some of those Oil & Gas kind of markets that there is no point in cutting price. Would you expect there to be any increased pricing competition as orders do rebound, as folks do compete for that volume?

John Stauch - *Pentair plc - EVP, CFO*

Yes. I don't know if it gets worse from here, Nathan, but I don't think we are planning on it getting too much better from here on those projects. I personally believe that a lot of that reset in pricing was the foreign-exchange resets. It is a lot of these valve producers are outside the United States, and the euro going down made their products more affordable and I think the big EPCs took advantage of that.

And so, I think it is stabilizing now as most people have taken out capacity, but I don't think it is going to recover to the levels that it used to be at, either.

Nathan Jones - *Stifel Nicolaus - Analyst*

But you wouldn't expect to see, say, in the back half of the year if order rates improve any additional pricing pressure as people compete for that volume?

John Stauch - *Pentair plc - EVP, CFO*

We don't think so, no.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay, then my other question on Water Quality Systems. You talked about growth investments in the second half. Can you give us some more color on what those growth investments are and maybe what the impact on margins is in the back half of the year, and if those are continuing investments or discrete investments?

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, before I get into the specific investments, what we meant was that we had such a nice increase in margins. I just don't think people should expect it to be that good, and we gave you some insights into what we expect the margins to be.

The investments are basically in two. One is product innovation and the other one is in channel and geography investments and sales coverage. So, maybe it is 50 bps a quarter in investment increase, and one is it is a business that as the conversation about China and the conversation we talked earlier about in the Pool Business, it really is a business that is yielding to innovation, so product innovation pays. And then, as I mentioned, we are applying some of the Pool playbook to water purification to get more intimate and closer to the customer, and those are the geography and channel investments we are making.

Nathan Jones - *Stifel Nicolaus - Analyst*

So it sounds like continuing investments, but you reap the rewards on the topline?

Randy Hogan - *Pentair plc - Chairman, CEO*

Right.

John Stauch - *Pentair plc - EVP, CFO*

Right.

Nathan Jones - *Stifel Nicolaus - Analyst*

Thank you.

Operator

Jeffrey Hammond, KeyBanc.

Jeffrey Hammond - *KeyBanc Capital Markets - Analyst*

Not to beat this too hard, but the 10 -- I'm just trying to get a better sense of where you are seeing this sequential improvement visibility, that 10% improvement, what sub-verticals, and is it your customers telling you or actually in the order rates?

John Stauch - *Pentair plc - EVP, CFO*

You're talking about Valves?

Jeffrey Hammond - *KeyBanc Capital Markets - Analyst*

Yes.

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, okay, go ahead.

John Stauch - *Pentair plc - EVP, CFO*

Listen, we have had a fairly sizable front lawn for a period of time and I think, as Randy mentioned, we scrubbed it. We have discounted the larger projects from the expectation that those would close this year.

But what we did when we reorganized the sales force is put a lot more energy and effort around the Aftermarket side. And one of the things we bring to the table to a lot of the larger customers is the ability to service a vast majority of valves. And the way that we are servicing those right now is on an aggregated buy basis from those customers and then also working inside their factories or their plants to be able to benefit from that.

So, that's a big piece of it. The second one is that there has been some pent-up demand on the downstream side and especially the MRO downstream. And as we always said, we don't think that could be deferred forever, and we are starting to see that start to come in.

So, listen, we are not declaring victory yet. I think what we are saying is that we believe that Q2 represents the bottom of the orders and we are starting to see the increase from here. A double-digit increase off of Q2 is still a modest level of orders versus what we are used to, but it is at least a sign that we're going to see that downstream investment start to come back.

Jeffrey Hammond - *KeyBanc Capital Markets - Analyst*

Okay, helpful. And then, just, free cash flow came in a lot better. How are you thinking about upside to free cash flow for the year?

John Stauch - *Pentair plc - EVP, CFO*

Right now, we are committed to the 100% of net income. We are tracking, as we said, $150 million better than last year, but we are focused on this and obviously getting our debt paid down (multiple speakers)

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, we are not only $150 million ahead of last year; we are ahead of where we thought we would be at this point in time.

John Stauch - *Pentair plc - EVP, CFO*

But Jeff, I think we've got to see another quarter or two before we -- obviously if we see two, we will have it, but I think we need to see another quarter before we're going to declare that there is upside to that number.

Jeffrey Hammond - *KeyBanc Capital Markets - Analyst*

Okay, thanks, guys.

Operator

Scott Graham, BMO Capital Markets.

Scott Graham - *BMO Capital Markets - Analyst*

I have a question on Water Quality Systems first, not Valves & Controls. You are looking for a nice bump up in organic in the third quarter. I was just hoping you can give us a little color around that.

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, there are a couple factors. One is the Europe comp in Water Purification in the second quarter was tough, so we didn't show any growth there. We think that gets better.

And then, we talked about the pool timing. And the pool market, and you can look at -- there is a few comps you can look at -- the pool market is really quite strong and we think that more of that will read out, too. You'll see that more because the timing comp won't -- the timing won't mess up the comp.

John Stauch - *Pentair plc - EVP, CFO*

Yes, the weather can have an impact on the timing of the pool season, Scott, and last year there was a very, very strong Q2, and we are now back to more of a normal trend on a year-over-year basis in Q3. And as we shared, our Aquatic & Environmental Systems Business has been growing nearly double digits now for four or five years in a row. So, we feel fairly good about the visibility to this number and feel very good about the growth rate for Q3.

Scott Graham - *BMO Capital Markets - Analyst*

Yes, it makes sense. Thank you. The other question I had was simply on the shrinkage of the footprint. In the past, you have given us some metrics of improvement where it was, whether it was facility or people or otherwise. Anything you are willing to share this quarter?

John Stauch - *Pentair plc - EVP, CFO*

No, we have a few more factories in the works to reduce, so we are just under 100 total factories for Pentair and we expect to have reduced it by around five or six by the beginning of the year to the end of year. So, we're modestly addressing it where we feel we have excess capacity due to the end markets that we are serving, but we are not aggressively reducing the factory footprint at this time.

Scott Graham - *BMO Capital Markets - Analyst*

All right. Very good. Thank you.

Operator

Joshua Pokrzywinski, Buckingham Research.

Randy Hogan - *Pentair plc - Chairman, CEO*

That was close. That was a new one.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

You know what? I have heard them all at this point. I will put them on the roster with the rest of them.

Randy Hogan - *Pentair plc - Chairman, CEO*

Josh Pokrzywinski, go ahead.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Just to come back to Tech products, I understand some of the mix issues that you're talking about in Thermal, but we have heard a lot of companies call out particularly price/cost. Obviously, it is a steel-intensive business. I would have imagined a bit more support from price/cost in this quarter, particularly on the Enclosures side and maybe a bit more tone around headwind in the second half, and I guess all the questions or responses around Tech products seem to be focusing more on Thermal than on Enclosures or ERICO.

So just trying to dimension out within, I guess, Hoffman or ERICO specifically how you see mix evolving there, how you see some of the margin read out, particularly as it pertains to price/cost?

John Stauch - *Pentair plc - EVP, CFO*

We have done really well on the price/cost at both ERICO and Enclosures, so we did single out the Thermal business, Josh, primarily because -- and that is not really steel related; it is more of the heat tracing cable versus the labor and the integration cost to bring that project to bear.

So, when we take on the projects and we're doing the design, the engineering, and the install, and then we are bringing the cable along, we're going to have a compression of margins when the product side is down. And as we mentioned, the aftermarket MRO sometimes goes to distribution or it will go direct to the end site and get installed, and that's the part that has been down double digits. So we're up significantly in the project side, we are down in the product side, and we are experiencing an overall mix issue, even though we're up in revenue.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

But just to be clear, on Enclosures and ERICO, no change, increase, decrease in the margins versus 1Q? For the full-year outlook?

John Stauch - *Pentair plc - EVP, CFO*

No change, and we have -- probably experiencing a little bit modest headwind Q3 and Q4 and I would say of a couple million dollars in the rising cost of the steel, but not anything significant.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. And then, just shifting gears real quickly to Water Quality, I think -- I know you mentioned the easy comp in Europe. Is that a low mix dynamic where you wouldn't see a lot of pull-through to profitability on that? I guess having just said there was light start to the pool season, maybe that spills over into the third quarter. You got a strong volume quarter coming. I would imagine that margin would have looked a little bit better than what you showed -- or what you are showing in guidance?

Randy Hogan - *Pentair plc - Chairman, CEO*

It is Water Purification in Europe. Pool isn't that big in Europe, but the Water Purification side is, but margins are not bad. Is there a little mix shift there (multiple speakers)

John Stauch - *Pentair plc - EVP, CFO*

I think there is -- Randy mentioned there is the desire to do significant growth investments, and this is a business that absolutely deserves to do these growth investments. And we've factored them in as the business views spending them. The likelihood that they would actually spend them would --

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Randy Hogan - *Pentair plc - Chairman, CEO*

Spend them all.

John Stauch - *Pentair plc - EVP, CFO*

-- would be low.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. But there is no bluebird in the second quarter, apart from just good mix?

Randy Hogan - *Pentair plc - Chairman, CEO*

No, not at all.

John Stauch - *Pentair plc - EVP, CFO*

Not at all.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. All right, thanks, guys.

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Operator

Christopher Glynn, Oppenheimer.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

So the Tech Solutions trends overall showing a little revenue upside with some negative mix on the Thermal side. Would the intuition be for 2017 to have some favorable mix reversion on margin and a little bit of net organic pressure or would you see Thermal more likely to compound the growth?

John Stauch - *Pentair plc - EVP, CFO*

Too early to call that, but I think your intuition is about right.

Randy Hogan - *Pentair plc - Chairman, CEO*

Yes, I would certainly start with that. We haven't started that yet, though.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Okay.

John Stauch - *Pentair plc - EVP, CFO*

But I think your intuition, if we were doing it now, is correct, Chris.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Okay, and then just a comment on how to size the corporate line in the second half.

John Stauch - *Pentair plc - EVP, CFO*

I think you should look at around $43 million-ish divided equally between Q3 and Q4.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Great, that's all I got. Thanks.

Operator

Robert Barry, Susquehanna International Group.

Robert Barry - *Susquehanna International Group - Analyst*

So I wanted to clarify in Valve the improvement you expect in the second half. Is that on the Aftermarket?

John Stauch - *Pentair plc - EVP, CFO*

Yes, we have got a little bit more short-cycle product shipments and also getting out the past-due backlog, so we see that we are expecting to get slightly higher standard margins as we move that through the shipments, and we also, as we mentioned, we took in a fair amount of deferred variances from last year, which means we spent more than we should have on the labor side, and we had to bleed that off the first couple quarters this year, so we had a little tailwind associated with that.

Robert Barry - *Susquehanna International Group - Analyst*

Got you. And I think in an answer to an earlier question you alluded to some of the deferred maintenance starting to show up. Is that refinery maintenance you are seeing come through?

Randy Hogan - *Pentair plc - Chairman, CEO*

That was from refinery. We are seeing more of the petrochem spending come through, which has been actively being bid.

One thing that seems pretty clear is that now that the rapid decline in capital spending has happened, our customers have really sorted out not only who is working on -- who is still working for them, but which projects they're going to go forward with. We skew to little projects. We talk a lot about big projects because they are the things that move the needle a lot, but our average project size is well under $1 million. So, those are small outage turnarounds, just maintenance-related activities. And so, I think we are going to get into a more normalized, albeit lower, level of how they are deployed.

Robert Barry - *Susquehanna International Group - Analyst*

That's good to hear. Just lastly, you've been making a lot of changes to the sales organization in valves. At this point, are all of these changes net net helping or hurting the order growth?

John Stauch - *Pentair plc - EVP, CFO*

I think the structure itself is the right structure. I think when you make this level of change where you have Project-oriented sales people trying to call on the Aftermarket, you're going to find areas where that is the wrong skill set, and I think that's where we're going to have to continue to migrate the sales force to the right skill set over time. And to say we are optimized at the moment I would say is not accurate, and I think we think the structure is right. And what we now need to do is get the processes and the support for the structure operating fully, and then we think we can benefit going forward.

Has it hurt us? Probably here and there, but not dramatically.

Robert Barry - *Susquehanna International Group - Analyst*

Great. Thank you.

Operator

There are no further questions at this time. If you would like to listen to a replay of today's conference, you may dial 1-800-585-8367. Again, if you would like to listen to a replay of today's conference, you may dial 1-800-585-8367.