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PNR - Q4 2015 Pentair plc Earnings Call

EVENT DATE/TIME: FEBRUARY 02, 2016 / 2:00PM GMT

OVERVIEW:

Co. reported 4Q15 core sales decline of 4%. Expects 2016 core sales to be down approx. 2% and adjusted EPS to be $4.05-4.25. Expects 1Q16 core sales to be up modest 1% and adjusted EPS to be $0.70-0.72.

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PRESENTATION

Operator

Good morning. My name is Jordan and I'll be your conference operator today. At this time, I would like to welcome everyone to the Pentair Q4 2015 earnings conference call. (Operator Instructions). Thank you.

Jim Lucas, you may begin your conference.

Jim Lucas - *Pentair plc - VP of IR and Strategic Planning*

Thanks, Jordan, and welcome to Pentair's fourth-quarter 2015 earnings conference call. We're glad you could join us today. I'm Jim Lucas, Vice President of Investor Relations and Strategic Planning. 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 2015 performance, as well as our first-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 has an opportunity to ask their questions.

I will now turn the call over to Randy.

Randy Hogan - *Pentair plc - Chairman and CEO*

Thanks, Jim, and good morning, everyone. I'll start with the executive summary on page 4. There's no doubt that 2015 was a challenging year for Pentair and most other industrial companies, but we are encouraged that our fourth-quarter results met our expectations operationally. Overall, earnings came in higher than forecast due to a better ongoing tax rate. And our ability to forecast sales demonstrates that the quarter-to-quarter volatility in some of our served markets may finally be showing signs of stabilizing.

While our businesses serving the Energy and Industrial markets will likely face continued challenges in 2016, the two bright spots in 2015 -- Food & Beverage, and Residential & Commercial -- appear to still have more upside. In addition, we've finally seen signs of stabilizations and some green shoots of growth within our smallest vertical, Infrastructure.

We understand why Valves & Controls has been a focus of many of our investors, as our efforts to rightsize the business in the face of this significant Energy -- in the significant Energy industry reset remains a big priority. While we're now seeing sales and orders in Valves & Controls meet our forecast for the second consecutive quarter, gross margins remain under pressure due to project pricing and mix.

Our acquisition of ERICO, completed at the end of the third quarter, is delivering what we expected, and the integration is well underway. Cash flow, which has historically been a hallmark for Pentair, did come in slightly short of our forecast, as we had foreshadowed on our outlook call last December.

This is due exclusively to working capital timing. And we're fully committed to demonstrating our cash flow prowess in 2016, expecting greater than 100% adjusted net income conversion as we double down on working capital, following the dramatic top-line challenges faced in 2015, principally within Valves & Controls.

We're maintaining our 2016 full-year adjusted EPS guidance of $4.05 per share to $4.25 per share. We made good progress on further reducing the tax rate, as demonstrated in the fourth quarter. While this improved tax rate will add just under $0.10 compared to our prior forecast, we have lowered our Valves & Controls forecast by a similar amount, given the degree of margin compression the business has faced due to project pricing and uncertainty around the timing of the recovery in the short-cycle business, which slowed in 2015.

Overall, we're pleased to have met our fourth-quarter expectations, and our 2016 outlook remains intact.

Now let's turn to slide 5 for a discussion of our Q4 2015 results. Fourth-quarter core sales declined 4%, which is a modest improvement from the 5% decline in the third quarter. Valves & Controls was slightly better than our sales forecast, and the rate of decline is stabilizing in the mid-teens. Water Quality Systems delivered strong 7% core growth. Technical Solutions' core sales were flat. And Flow & Filtration Solutions showed further signs of stabilization on the top line. Overall, FX remained a headwind in the quarter, and ERICO contributed positively, and in line with our commitments.

Segment income declined 7%, and margins were down 90 basis points to 15.9%. As expected, Valves & Controls was the major contributor to the margin contraction, while Water Quality Systems had a very strong margin quarter. Flow & Filtration Solutions had another quarter of margin expansion, which is why we believe this segment is well-positioned for further gains in 2016.

Due to end-of-the-year tax adjustments, the tax rate in the quarter was favorable, and our full-year rate finished just north of 21%. We believe this is an ongoing rate, and expect further improvements to the tax rate in 2016.

Free cash flow ended the year at $643 million, which was short of our $700 million forecast. As mentioned, free cash flow has been impacted by working capital timing due to the top-line softness we've experienced so quickly. But we expected free cash flow to return to greater than 100% of adjusted net income in 2016.

Now let's turn to slide 6 to discuss Pentair's Q4 2015 performance elements. Our performance by vertical was similar to the third quarter, with solid gains in Residential & Commercial and Food & Beverage being offset by ongoing pressures in both Energy and Industrial. Encouragingly, Infrastructure was flat in the quarter, and continued to show signs of stabilization and potential return to growth in 2016.

As you can see on the right-hand side of the page, we had another solid quarter of productivity; and with price, they more than offset inflation. Our cost-out actions in Valves & Controls continued through 2015, and we still expect over $135 million in savings to read out in 2016. Negative mix impacted both Valves & Controls and Technical Solutions, but our other two segments, Flow & Filtration Solutions and Water Quality Systems, delivered improved margins.

Now let's turn to slide 7 for a review of Valves & Controls. For the fourth quarter, Valves & Controls core sales declined 15%, which was 1 point better than our forecast, an improvement from the 18% core decline experienced in the third quarter. FX remained a considerable headwind at 7%. Backlog was down 4%, which includes the negative FX translation. Core orders declined 15%, which is consistent with the double-digit rate of decline the business experienced throughout the year. Core sales declined in three of the four subverticals served by Valves & Controls, as Mining showed growth in the quarter on the result of one project shipping.

We continue to see weakness in our short cycle business, as many of our customers have cut their operational budgets in addition to their capital budgets, including scaling back maintenance turnarounds. We do not expect this trend to reverse in the first quarter, but we remain optimistic that customers will begin spending more on maintenance as 2016 progresses. As we indicated last quarter, we've seen a trend of customers delaying shipment, but there are few order cancellations at the current time.

The right half of the page shows fourth-quarter Valves & Controls segment income and margins. While we continue to drive productivity, which offset inflation, it was not nearly enough to overcome the dramatic top-line drop experienced during the quarter and the year. We have aggressively been rightsizing the cost structure, but it does take time for the benefits from those actions to read out.

In addition, we've seen higher-than-normal margin compression due to pricing pressure within the project business. Mix has also been a headwind to margins, as the higher-margin short cycle business has remained under pressure.

Now let's turn to slide 8 for a look at the Valves & Controls backlog. As you can see on slide 8, Valves & Controls backlog is broken down into four key subverticals, three of which fall into our Energy vertical -- Oil & Gas, Power, and Mining -- and one in our Industrial vertical, which is the Process business.

Orders declined in all four of our subverticals, with Oil & Gas the only business to not decline double digits. As 2015 progressed, we saw customers continue to curtail spending as they assessed their long-term plans and adjusted to the new reality of lower oil prices. Many expected Oil & Gas to fuel the pressure, but delays in project timing have expanded to other areas like LNG and petrochem.

As stated previously, it has not just been projects that have been delayed or cut, as clearly customers have been delaying maintenance spending as well. It's still too early to call a bottom. We're encouraged that orders have met our forecast for the second consecutive quarter. It's uncertain when the short cycle business will return, but maintenance cannot be deferred forever. And we're watching for some signs of improvement, beginning in second quarter this year.

Now let's move to slide 9 to discuss the Q4 performance of Flow & Filtration Solutions. Flow & Filtration Solutions had an 8% top-line decline, with core sales down 2%, and foreign exchange translation of 6% headwind. The fourth quarter showed signs of stabilization for this segment, and we continue to expect the business to return to growth in 2016.

We did see all four served verticals contract in the quarter. Food & Beverage was down, as growth in our beverage business was not enough to offset the ongoing headwinds within agriculture. We would note that our sales decline in our agriculture-related business was not as bad as the overall industry.

Residential & Commercial was down due to product line exits we made to better position the business longer-term. While Infrastructure overall was down, this was the result of a tough comparison last year when we had a large filtration project ship. We are encouraged to see further improvement in the trends within our North American municipal pump business.

Segment income was down modestly, but margins expanded 40 basis points to 11.3%. This marks the third consecutive quarter of year-over-year margin expansion, and believe it is a positive sign that the actions taken in 2015 position this segment for further gains in 2016 and beyond.

Now let's move to slide 10 for a look at Water Quality Systems. We believe that the slower top-line growth seen in the third quarter was an anomaly, and the fourth-quarter growth performance was validation that Water Quality Systems remains on a positive track. During the quarter, sales grew 4%, which consisted of 7% core sales growth, offset by a 3% FX headwind. Both Residential & Commercial and Food & Beverage grew at high-single-digit rates in the quarter. Our Aquatics business led the way once again, and pre-buy activity is a good foretoken that 2016 should be another good year for Aquatics.

Our Water Purification business saw favorable growth in Europe, but China remained weak as distributors exhibited caution in their order patterns. Food Service had another solid quarter, and saw growth return in China after a pause in the third quarter.

Segment income grew 30%, and margins expanded an impressive 450 basis points to 22.3%. This dramatic improvement was a combination of strong productivity execution and positive mix, on top of an easier comparison against last year's fourth-quarter results. Water Quality Systems has proven to be a consistently high performer, and we remain committed to getting all of our businesses to the same level of performance.

Now let's move to slide 11 for a look at how Technical Solutions performed in Q4. Technical Solutions reported 23% growth for the quarter, which consisted of flat core sales, a 6% headwind from FX, and a 29% positive contribution from ERICO. Industrial sales were down 2% overall as we saw further caution exercised by North American electrical distributors, offset partially by our Industrial Heat Tracing business. Energy was down 3%, after growth the past few quarters, as a couple of larger Heat Tracing projects began to wind down. Infrastructure saw a modest 2% growth following tough year-over-year comparison for the past two quarters.

Residential & Commercial showed strong 7% core growth in the quarter. And ERICO, which generates a large portion of its sales from Commercial, tracked with our expectations.

Segment income grew 17%, while operating margins contracted 130 basis points to a still-strong 22.6%. The principal factor contributing in the margin performance in the fourth quarter was more project shipments than product shipments within Industrial Heat Tracing, and the margin differential between them created a negative mix impact.

ERICO met our income expectations, including synergies. While 2016 will see headwinds with the absence of two Energy projects and expected first-half softness continuing in the short cycle Industrial business, we remain focused on driving productivity and have taken further cost actions to deliver in this typically high-performing segment.

Let's now turn to slide 12 for a look at our full-year Pentair results. For the full year 2015, our core sales declined 4% as performance in Water Quality Systems and Technical Solutions was not enough to offset significant challenges faced by Valves & Controls' served markets.

Segment income declined 12%, and margins contracted 60 basis points to 15.5%. Our tax rate ended the year at just over 21%, which was better than the 23% we projected at the beginning of the year. We believe this improved tax rate is sustainable, and would expect further improvement in reducing the tax rate in 2016.

We are not pleased with our free cash flow performance of $643 million, which represented only 90% of adjusted net income. But we know this is due fully to working capital timing, and remain committed to correct it in 2016.

Overall, 2015 was a challenging year where we saw two of our segments deliver strong performance, one segment stabilize, and we're addressing the reality of the other segment.

Now let's turn to slide 13 for the 2016 outlook assumptions. Before I turn the call over to John to provide additional insight on Valves & Controls, and to discuss our first-quarter and 2016 outlook, I wanted to update you on what has changed since we issued our initial 2016 outlook in mid-December.

As you can see on this slide, the majority of our key assumptions remain unchanged. We continue to expect solid performance from our businesses serving Residential & Commercial and Food & Beverage. We've seen signs of stabilization within Infrastructure. Industrial is expected to continue to have a challenging first half of the year. But comparisons become less difficult in the second half, and we are encouraged that distributors may begin ordering once again in the back half of the year.

Foreign exchange has been tracking to where we planned. We all know that this can change at any time. The one area that has worsened is Energy, particularly the further declines seen in the price of oil. We've seen several major energy companies announce capital expenditure plans that call for additional 20%-plus cuts, following similar reductions in 2015.

Further, the delays in the short cycle business give us pause. Don't expect any signs of improvement in the first quarter, and we will watch of the second-quarter trends closely to see if customers stop deferring their maintenance spending.

The other bright spot we have is the improvement in our tax rate. This added structural improvement provides an offset to the further weakening in Energy, and gives us increased confidence in maintaining our full-year guidance.

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

John Stauch - *Pentair plc - EVP and CFO*

Thank you, Randy. Please turn to slide number 14, titled V&C update. We thought it would be helpful to provide an update on our Valves & Controls business and the further deteriorating conditions in its space since issuing our initial [2016] guidance last December.

We continue to see pressure on incoming orders, and now expect orders to be down as much as 5% for the full year of 2016. The well-publicized decline in oil prices is just one of the factors that leads us to remain cautious about the timing on order stabilization. But, even more, we are watching the short cycle business for signs that customers will begin to accelerate maintenance spending.

As a result, we have modestly lowered our full-year revenue forecast for 2016. We continue to see pricing pressure on the project side of the business, and this shows up as margin compression. While we have aggressively implemented cost-out actions, we expect industry uncertainty to persist, and we plan to remove additional cost from the business.

When forecasting where we see sales and orders, coupled with further anticipated margin compression, we now are forecasting return on sales in Valves & Controls to be 100 basis points lower than our original forecast at 10.5%.

Please turn to slide number 15, labeled non-cash goodwill impairment. We performed step one of our goodwill impairment analysis, as required by the accounting rules, and concluded that the fair value of Valves & Controls is below its carrying value. The carrying value was determined when we completed the Flow Control merger in 2012, when oil was over $100 that year.

Since 2012, the Energy industry has reset significantly, and uncertainty remains around the timing of any recovery. We are finalizing the analysis, but we currently estimate there will be a non-cash impairment charge in the range of $400 million to $600 million to be recorded at the time of our 10-K is published.

Please turn to slide number 16, labeled balance sheet and cash flow. Our balance sheet changed significantly with the closing of the ERICO acquisition. We ended the year with $4.6 billion of net debt, inclusive of cash on hand. While our balance sheet leverage, at 3.75 times, is higher than our targeted 2.5 leverage ratio, we expect to bring that leverage ratio to around 3.3 by the end of 2016.

Our ROIC ended the quarter at 9.9%, as our operating income came under pressure with the top-line challenges experienced within our Valves & Controls segment. Although free cash flow ended the year at roughly 90% of adjusted net income, this was due exclusively to working capital timing, and we expect a 100% conversion rate in 2016.

Please turn to slide number 17, labeled Q1 2016 Pentair outlook. For the first quarter, we expect core sales to be up a modest 1%, and total sales to grow 7%, inclusive of FX headwinds and the ERICO acquisition. On a core sales basis, we expect Valves & Controls to be down roughly 7%, which is a slower rate of decline than we experienced throughout 2015.

Flow & Filtration systems' core sales are expected to be up 4% on an easier year-over-year comparison and project shipment timing. Water Quality Systems' core sales are anticipated to increase approximately 5% on continued strength in aquatics. Finally, Technical Solutions' core sales are expected to be up 4%, as industrial heat tracing and electronics help to offset ongoing sluggishness in enclosures.

We have not made any changes to our ERICO forecast or expectations around synergies. We are expecting segment income to decrease modestly, and return on sales to contract 110 basis points.

Below the operating line, we expect an improved tax rate of around 20.5%, net interest and other around $33 million, and the share count around 183 million. Our first-quarter adjusted EPS guidance is $0.70 to $0.72, which is roughly a 7% year-over-year decline. We expect historically typical free cash flow usage in the first quarter, but turning positive as the year progresses and we continue to focus on improving our working capital performance.

Please turn to slide number 18, labeled full-year 2016 Pentair outlook. We are maintaining our full-year adjusted EPS outlook of $4.05 to $4.25, although the components have changed some from our initial outlook provided in December.

For the full year, we expect core sales to decline approximately 2%. Valves & Controls' core sales are now anticipated to be down 8%, which is 3 points worse than our original forecast, as I highlighted a few slides ago. We now expect Flow & Filtration core sales to be up modestly for the full year. Water Quality Systems' core sales are anticipated to grow approximately 4%. And Technical Solutions' core sales are expected to decline 4% for the full year.

We expect segment income to be up 9%, and return on sales to expand 100 basis points to 16.5%, with three of our four segments delivering full-year margin expansion. We expect overall corporate cost to be approximately $90 million; net interest and other to be around $135 million; our full-year tax rate to be around 20.5%; and the share count for the full year to be around 183 million. Adjusted EPS is expected to be up 5% at the midpoint of the range.

Finally, we expect a strong year of free cash flow, expected to be approximately 100% of adjusted net income, with our working capital opportunities providing potential upside.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Nigel Coe, Morgan Stanley.

Nigel Coe - *Morgan Stanley - Analyst*

I'm sure there's going to be plenty of Valves & Controls questions, but just wanted to switch to the other segments. And you've raised organic outlook by about 1 point across the board. You called out Infrastructure looks a bit better in 2016 than perhaps back in December. So maybe just comment on what you're seeing in Infrastructure that makes you feel more confident. And perhaps within TS, given the midstream CapEx outlooks getting cut, what could you comment that that would be better than back in December?

Randy Hogan - *Pentair plc - Chairman and CEO*

Well, Infrastructure is looking better, but also Aquatics is looking better. The Water Quality Systems of Aquatics is the Pool business, and it exited the year with a lot of -- with really good tailwind. But in terms of Infrastructure, we've seen the order rate pick up, and our backlog pick up in both pumps and in filtration. So, it's been a while building, and we expect that to actually lift growth for mostly flow and fluid solutions next year.

Nigel Coe - *Morgan Stanley - Analyst*

Okay, great. And then TS, Randy? What gives you more confidence there?

John Stauch - *Pentair plc - EVP and CFO*

Nigel, what gives us a little more confidence in Technical Solutions.

Randy Hogan - *Pentair plc - Chairman and CEO*

Oh, Technical Solutions.

John Stauch - *Pentair plc - EVP and CFO*

We are waiting to see where we ended the year with the backlog in the Industrial Heat Tracing Solutions business, primarily around the projects. And it ended stronger; and, therefore, the shippable backlog had [end since] 2016 slightly higher. And that was the only change.

Nigel Coe - *Morgan Stanley - Analyst*

Okay, I see. Okay, I'll leave it there. Thanks.

Operator

Deane Dray, RBC.

Deane Dray - *RBC Capital Markets - Analyst*

Wanted to touch on Valves & Controls first. And maybe you can update us on what the 2016 customer CapEx decline assumptions that you are making -- we know with -- since December, oil has worsened, and you cited customers' CapEx plans at 20%-plus down. But how are you thinking broadly, if you divide that up between upstream, midstream, downstream?

John Stauch - *Pentair plc - EVP and CFO*

Well, I'd say, first and foremost, I don't think we see a lot of upstream activity. And a lot of these projects were in the process of being cut throughout the year, Deane. So we look at front log, which is the things prior to coming into the quote funnel. So what are the opportunities we might be quoting in any given year? And that front log, this year, is significantly low as it relates to upstream activity.

When we get into midstream, midstream still has a fair amount of the front log activity, and we are still quoting a significant amount of midstream activity. And then the downstream business, we would have expected that to be a productivity-based investment. And we've seen delays in the quoting activity there.

So we've got an order outlook next year, as we suggested, that's down further than what we anticipated. And then we expect the conversion ratio -- how many of those orders that we convert within the year -- to be down further. And, hence, that's why we've taken down the Valves & Controls forecast even further.

Deane Dray - *RBC Capital Markets - Analyst*

Yes, what I'm actually looking for is your broad market assumption about how much will your customer CapEx declines be in 2016? So we've seen estimates as high as down 35% in the upstream side. So I just want to know, what assumptions are you making for your customers on their CapEx plans for 2016?

Randy Hogan - *Pentair plc - Chairman and CEO*

Deane, we haven't in the past shown a really good relationship between the CapEx numbers -- the big CapEx numbers, and then what really happens to our orders numbers. We've had -- as we've gotten better at forecasting our sales, what we focused on is what John called that front log. We've seen a lot of projects that were being thought of that are no longer in that front log, are things that we're chasing.

So we're focusing on what's in our backlog and what we can ship, and what is in that -- what real projects are in that front log, and what's our probability of getting them? And that's how we come to it.

Deane Dray - *RBC Capital Markets - Analyst*

Okay, that's fair. And then just on the pricing side, you called out pricing pressures on projects. We've seen that now for a year and a half. Maybe you can give us some sense of how much pricing is down, and size that. And then we started to see pricing pressure on the short cycle. Look, everyone is seeing this maintenance deferral. We are seeing that sector-wide. But give us a sense of what that is impacting on pricing on short cycle as well.

John Stauch - *Pentair plc - EVP and CFO*

Yes, so the short cycle pricing, Deane, is called out on our Valves & Controls walk, because we list prices, part number to part number; and, therefore, the standard product is a like product. So you get a sense of where that price is, and right now that's roughly around 1% today. We are anticipating that to get a little bit tougher as we head into 2016.

The majority of what we call margin pressure is around the project side, and the fact that the projects are coming through at a slightly lower margin. But we're also experiencing a mix differential between less standard product on the short cycle and more of the projects coming out of the backlog.

And that caught us by surprise in Q4, especially around December. And we have loaded in those expectations continuing into Q1, and ramping a little bit better as we get the cost benefits reading out in Q2, Q3, and Q4 from our efforts.

Deane Dray - *RBC Capital Markets - Analyst*

Got it. And then just last question for me. On the free cash flow, you talked about this in December, so it's not a surprise that you came up short on the 2015 target. But just to clarify, was there any extension of payment terms for customers at year-end? We saw this in some of the other flow names that -- to help customers at year-end. Was that a factor in this? And then, real specifically, when do you expect to recoup those receivables?

John Stauch - *Pentair plc - EVP and CFO*

The short answer is no to the first question, Deane. It's not something that we've done, or needed to do. And as we think about recovering this year, we felt like we had realized the impact of the working capital builds right when I took over in the interim role. And we've been after reducing those inventory levels, and therefore getting after those receivable collections. So we are very focused on getting the cash in here in Q1 and Q2, and we feel like we're going to make very good progress.

Deane Dray - *RBC Capital Markets - Analyst*

That's good to hear. Thank you.

Operator

Steve Tusa, JPMorgan.

Steve Tusa - *JPMorgan - Analyst*

That chart that you guys gave -- I think it's slide number 10 from your Investor Day, where you talked about Valves & Controls backlog and orders. First of all, the scheduled backlog of 990. Is that still intact, or has there been some movement in that? And also, how do I reconcile the orders down 8 in that slide, and the orders of flat to down 5? Is that just short cycle orders you are talking about?

John Stauch - *Pentair plc - EVP and CFO*

So, real quickly, we're down about $40 million to $50 million on the starting backlog position, Steve. And that would represent movements out of 2016 into 2017, and that's what we know today.

Steve Tusa - *JPMorgan - Analyst*

Okay.

John Stauch - *Pentair plc - EVP and CFO*

The orders on the slides, they are still the same number. I apologize; one is core, and one is inclusive of FX, so roughly the same. And what we're having a little bit of change to our forecast on is we usually convert about half of those orders within a year. But we're expecting the orders to be a little bit more back-end loaded; and, therefore, we won't be getting as many of the orders shipped in 2016 as we originally anticipated.

Steve Tusa - *JPMorgan - Analyst*

Okay. And then the start to the year in Valves & Controls, the 6.5% margin, I don't recall it being that seasonal, historically. Is there something -- I guess it's a function of the timing of the cost saves ramping throughout the course of the year. Anything unusual here in the first quarter to have that? I mean, that's kind of an unusually low margin rate.

John Stauch - *Pentair plc - EVP and CFO*

Yes, I think there's three things, Steve. One is we have an unusually low shipment number of 385. We haven't been below 400 in this business in some time, and that reflects the shippable backlog. But it also reflects the number two issue, which is we're expecting the standard product to be slow again in Q1, as we wait for our customers to get their expense budgets aligned and decide where they're going to spend the expense and maintenance dollars. So we have a low mix ratio related to that, and also a lower expectation.

And then the third element is exactly what you said. We recognized about $11 million to $12 million on a quarterly basis, and the cost take-out of the $150 million. And that ramps throughout the year. And the first quarter reflects what we have to do with the inventory accounting, and putting that into the inventory, and then shipping the old inventory first before we can recognize the benefits. So those are the three unusual aspects to Q1.

Steve Tusa - *JPMorgan - Analyst*

Okay. One last quick one. You mentioned weakness in LNG. I know it's a slow-moving train here over the course of the next couple years, and should roll down dramatically towards the end of the decade. Are you surprised at how early you are seeing some weakness there? Is that just -- are they canceling some projects? Is there a destocking going on there?

I know that some of the compression orders at others have been very, very weak on that front. I'm just trying to understand the timing, because while it (multiple speakers). Yes, just curious on the timing of the LNG stuff, what you are seeing there.

Randy Hogan - *Pentair plc - Chairman and CEO*

Yes, our view is, ultimately, LNG is something -- it's going to play a bigger role in the Energy mix worldwide, and the US will be -- and should be a net exporter. There were a lot of projects in pre-feed, in planning. They have all been pretty much put on the shelves. And some of the other ones, that actually were in design, have been slowed down.

So that was the reference that we're talking about. Because we are really looking at things we were expecting to be happening in the near term, versus they may still happen; but they may be two or three years out now, instead of 2016, 2017.

Steve Tusa - *JPMorgan - Analyst*

Right, right.

John Stauch - *Pentair plc - EVP and CFO*

Steve, I think we were hinting at Analyst Day that although people were bullish about that activity because of low feedstocks, you've got to look at global demand. And the global demand just isn't there at the rate that would support all of those projects coming through. So, I guess to answer your question, are we surprised? In this whole Energy reset aspect, no, we're not surprised.

Steve Tusa - *JPMorgan - Analyst*

No, I get that. I'm just trying to get an idea. I think LNG is going to be kind of a debacle at some point in the next couple of years. But I just -- the timing is hard to nail down, just because of the -- how big these projects are, and the multi-year nature of them. So I'm just -- more of a timing question than anything else. Thanks, guys.

Operator

Steve Winoker, Bernstein.

Steve Winoker - *Bernstein - Analyst*

Can you maybe comment on Resi and Commercial construction a little bit further? It sounded like you are still bullish here. But maybe a little more of what you're seeing out there, and the kind of rate of deceleration, or a finer point on what actual growth do you expect in that vertical this year.

Randy Hogan - *Pentair plc - Chairman and CEO*

Well, this year we're expecting mid-single-digits in the US. And actually we've seen some life in Europe as well. We actually saw some growth in the fourth quarter in Water Quality, and a little bit in the Aquatics business -- excuse me, in the Water Purification part of Water Quality, both of those both being Water Quality Systems. So, stronger Europe than last year, and continuing strength in the US -- multifamily, and then continuing as home prices increase.

The Pool business is back. And there's a -- the innovation, the switch to Energy-saving products and more sustainable products are still -- that conversion is still happening, and we're the leader in that. So, all of the things that's been working for us in aquatics is still working.

Steve Winoker - *Bernstein - Analyst*

Did you think there's upside to the $0.40 number from ERICO, then?

Randy Hogan - *Pentair plc - Chairman and CEO*

You know what, I want to get that $0.40 number, and then we'll talk. But I was pleased with the fourth quarter and the order rate, the execution rate. And there's some clear sales synergies that we weren't counting on, that are being worked, that I'm hopeful we'll see read out, even this year.

John Stauch - *Pentair plc - EVP and CFO*

And Steve, I would just add on that we're really impressed with the talent that we got with ERICO. It's a great sales and marketing capability. And really excited about the opportunities across the channels that their selling team and our selling team combined can bring to bear.

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Steve Winoker - *Bernstein - Analyst*

And just one more comment on -- or question on the impairment, the non-cash goodwill. The $400 million to $600 million impairment, what's your sense that this is the last impairment that we'll see here?

John Stauch - *Pentair plc - EVP and CFO*

Well, I think the goal of any impairment is that it should be the last that you see.

Steve Winoker - *Bernstein - Analyst*

Yes. But I guess when you were quantifying this in the first level, were you taking a look at -- were you assuming that the Energy headwinds would tail off, and come back by 2017? Is that embedded in the valuation?

Randy Hogan - *Pentair plc - Chairman and CEO*

No. No, it's -- if that were the case, there wouldn't be one.

Steve Winoker - *Bernstein - Analyst*

Okay, all right. All right, thanks.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - *Goldman Sachs - Analyst*

So maybe going back to Steve's question earlier around the V&C margin ramp, post-1Q. It looks like you guys stepped up your cost-outs to $150 million. Should we be thinking about the benefits coming through in a linear fashion, starting in 2Q? Or is there a ramp as the year progresses?

John Stauch - *Pentair plc - EVP and CFO*

There's a ramp as we progress. We had a full annual rate, right around Q3. And it really is more about the manufacturing cost-out having to work its way through the inventory side. The benefits on the selling and marketing and the benefits on the G&A are linear, and we've got most of those behind us. And so those are going to be experienced in Q1, 2, 3 and 4 pretty evenly. And the manufacturing side has to work its way through the inventory, and we have to move the old inventory out first. And we don't have the quickest inventory turns in this business, so that's why it takes until the end of Q2 to really get on a full run rate for Q3 and Q4.

Randy Hogan - *Pentair plc - Chairman and CEO*

We also believe the mix between short cycle and projects -- short cycle and then aftermarket and projects is going to improve.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, got it. Randy, if for some reason it doesn't improve, and especially in V&C, if the orders turn out to be worse than flat to down 5, are there other areas within the cost structure that you guys can continue to take cost-outs? Are we getting closer to the maximum amount that you could actually take out before you start to impact the new service levels?

Randy Hogan - *Pentair plc - Chairman and CEO*

Well, I never like to say never. But I think we'd have to think differently about -- the team there has done a heroic job of adjusting the cost structure to one of the most precipitous drops in sales that I've ever seen. And they are executing well. We're going to have to think about it more creatively, if we need to do anything else in terms of costs. But that's just conjecture at this point.

I think as the forecast that John showed you -- it's one line. I understand the first quarter is lower than was expected. But it really is that mix, and it's the cost readout and the overall volume level, as John said.

There hasn't been a shipment volume below $400 million in our records.

Joe Ritchie - *Goldman Sachs - Analyst*

Yes, we didn't have it in our numbers, either. Maybe one broader question on the Valves & Controls, and as you think about the portfolio longer-term, clearly when you bought this asset back in 2012, it turned out to be a lot more cyclical than you guys initially anticipated. How do you guys think about the long-term opportunity for Valves & Controls within this portfolio? And is there an opportunity to maybe think about whether Valves & Controls should actually even be part of the broader portfolio?

Randy Hogan - *Pentair plc - Chairman and CEO*

It may be hard for people to believe, but we still believe this Valves & Controls business is a high-quality business, with good people, and a lot of the product lines are real crown jewels. Not all of them, but a lot of them are. Right now, it certainly is a boat anchor to the rest of the business, which is rising. And so we want to correct that. We wanted this diversity, this exposure to Energy.

I would say this is much more than just a cyclical turn. This is -- there hasn't been anything as deep as this since the 1980s. So, I think it's too early to conjecture.

John Stauch - *Pentair plc - EVP and CFO*

Yes, I think, either way, what Randy has asked me to do is think about this business being much more -- how do we think about it as more predictable, consistent earnings stream? Meaning a lot less project-dependent and a lot more aftermarket installed base dependent. And then making sure we understand what our customers value of what we sell, and what they don't value of what we sell. And then thinking about the fact that when you lose this amount of revenue, what's more important is your income and your margin dollars as you think forward.

Either way, we've got to make this a really good business. And I think we have the opportunity to take what Randy's direction is and have it contribute value in the future.

Joe Ritchie - *Goldman Sachs - Analyst*

Got it. Thanks, guys.

Operator

Shannon O'Callaghan, UBS.

Shannon O'Callaghan - *UBS Equities - Analyst*

In terms of this watching the short cycle in Valves & Controls, and the maintenance spending -- there's been a view, from you guys and others, that you can't defer maintenance forever, and this should come back. But we're probably a few quarters past where a lot of people thought it would have started to come back already.

So, do you have any more visibility into -- could this really continue to get pushed? Are people finding other ways to actually operate without doing the typical maintenance, just because (multiple speakers). Go ahead.

Randy Hogan - *Pentair plc - Chairman and CEO*

We have real examples of people servicing a valve instead of what they would have replaced before; insourcing service to keep their people busy, if they have them, versus where they would have usually contracted it. That sorts itself out; it laps itself. We saw -- it was worse in the second half than the first half, and it was worse in the fourth quarter than the average of the second half. And that can't continue.

These are mission-critical products that are part of processes that are precision, and can be -- well, by law, they have to be serviced. So they can't do it forever.

Right now, as I think you know, crack spreads have been great. So the longer you can run a refinery, the better. But, ultimately, you have to maintain them. So that's the other thing. Those two things. One, there's a shift to lower-cost ways of servicing. And then there's the fact that they can run them a little bit harder when the crack spreads are high, and make money on the refining side.

Shannon O'Callaghan - *UBS Equities - Analyst*

Okay. And then a similar question on the Industrial side. As you look at Hoffman, anything changing there on the margin? Do you think we have worked our way through any more of the destocking dynamic, or just general malaise? Anything on the margin there that you think -- things changing?

Randy Hogan - *Pentair plc - Chairman and CEO*

Our assumption for the first quarter and the first half is this is going to be like it was in the fourth quarter. And in terms of you just look at the stocking in North America distribution, in the fourth quarter it was down.

I think the whole uncertainty around CapEx is -- distributors always freeze a little bit more. So I think we aren't seeing anything for this first half. It's different than the fourth quarter, but the fourth quarter was not good.

Shannon O'Callaghan - *UBS Equities - Analyst*

Okay. Great. Thanks, guys.

Operator

Mike Halloran, Robert Baird.

Mike, your line is open.

John Stauch - *Pentair plc - EVP and CFO*

Mike? I guess we'll go to the next one.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

If I could just look at the mix issue that you are talking about, Randy. I understand that short cycle orders -- well, probably short cycle revenues drop off before project revenues do. But I would have thought that eventually project revenues will decline more than the short cycle revenues, and you will actually flip that mix from being a headwind to a tailwind.

Can you talk about how that progresses through the year or into next year, and what kind of impact you would expect that to have on margins as we progress through that mix shift?

Randy Hogan - *Pentair plc - Chairman and CEO*

Yes, you've got to look at it business [by business]. In Valves & Controls, actually, the short cycle held up much better than projects. And it was really in the fourth quarter where the decline was about the same. So, we would expect that to -- we don't think it gets better in the first quarter. That's why I was saying that we're watching to see whether there's improvements. And we're certainly taking actions to help improve that in Valves & Controls.

In the case of Technical Solutions, where we have the Industrial Heat Trace projects, which are a lot of them are not Oil & Gas related; they are other industries. And the backlog is good there. There's the Hoffman business being down and -- versus those projects. That gets better in the second half, just by comparison, because Hoffman was down in the second half. And we don't think it's -- as we get to lapping that, we don't think we will see further down. So there should be a mix improvement in Technical Solutions in the second half.

John Stauch - *Pentair plc - EVP and CFO*

But Nathan, I think you're right, long-term, is that as you work the backlog off and you work the large projects off, those do have a lower margin, and mix overall, over time, should be a mix benefit. Now, that being said, as Randy was just saying, we ship about $900 million a short cycle. So it would take a lot of incremental short cycle sales to make up for the project sales that are declining. And we've got to fill the factories as well, as you know, and work our way through this.

I think it's a short-term issue on the mix challenges, and I think the business will sort its way out. And I think there's still productivity opportunities. And I think it's into 2017 before we see that turning favorable.

Nathan Jones - *Stifel Nicolaus - Analyst*

Is it possible to quantify what the positive mix impact will be, or what the negative one has been thus far?

John Stauch - *Pentair plc - EVP and CFO*

Well, we did give a hint that the negative one so far, which is total standard margin, has come down about 600 basis points over the last two years.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. And you did make a positive comment on the North American municipal pump business. Can you give me some more color on what that's up, how it's progressing, what your expectations are for 2016 and beyond?

Randy Hogan - *Pentair plc - Chairman and CEO*

Yes, I think I made a positive comment about that. No, the order rate has picked up, and so that's gone into the backlog. So we're expecting improvement -- we saw an improvement in the fourth quarter, and after it was down in the first half, flat in the third quarter, up in the fourth quarter. The backlog is good. I think as governments healed a little bit with tax revenue, they were able to get back to spending.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. Thanks for the help.

Operator

Jeff Hammond, KeyBanc.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Just quickly back to the ramp in V&C margins. What do you think the exit rate for margins would be if you get this short cycle normalized, and then all the cost savings in?

John Stauch - *Pentair plc - EVP and CFO*

Jeff, help me with that question one more time. The exit rate, what do you mean by that?

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Exit rate in 2016, where you think the margin is going to exit.

John Stauch - *Pentair plc - EVP and CFO*

I think we're looking at a full-year rate of around 10.5%. I think we'd be closer to 15% on an exit rate.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. And then any update on a new Valves & Controls leader, and when that would be wrapped up?

Randy Hogan - *Pentair plc - Chairman and CEO*

We will announce it when we're done. We're finding -- we're looking for the right leader. John's doing a good job right now.

John Stauch - *Pentair plc - EVP and CFO*

But we are actively still working through it.

Randy Hogan - *Pentair plc - Chairman and CEO*

Yes.

John Stauch - *Pentair plc - EVP and CFO*

And we're looking for the right fit, and the right type of individual to lean into this type of situation, and lead with positive energy and get us to where we need to be.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay. Thanks, guys.

Operator

Brian Konigsberg, Vertical Research Partners.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Just coming back to the free cash flow, so with the working capital disruption you mentioned in 2015, I would have suspected you would have had some early collections in 2016. So, why -- I'm making the assumption that that's not coming through in the first quarter, and maybe just expand on that. Why wouldn't the full year be better than 100%?

Randy Hogan - *Pentair plc - Chairman and CEO*

We certainly will attempt to do that. The first quarter is always a negative quarter for us because we pay taxes; we pay bonuses; we're building working capital in the businesses that didn't do a bad job in working capital, which is the water businesses -- and as getting ready for their seasonal highs in the second and third quarter. So, that's why.

Brian Konigsberg - *Vertical Research Partners - Analyst*

But what do you -- with the working capital that was pushed, are you expecting that in the first quarter, or is that (multiple speakers) sometime later in the year?

John Stauch - *Pentair plc - EVP and CFO*

Brian, if you are asking, will the Q1 usage be better than the Q1 usage last year? The answer is yes. We believe it will be better. But our seasonality is, we do use cash in Q1. And we start to deliver significant cash in Q2, Q3, and Q4.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got it, okay. And then just the commentary about maintenance starting to improve, are you confident that this is not more of a secular change about insourcing or internalizing some of that maintenance? Do you just provide a superior economical offering where that's probably only temporary, where your customers are able to do it themselves, but maybe over the long-term it's not worthwhile for them to do it? Why are you confident (multiple speakers)?

Randy Hogan - *Pentair plc - Chairman and CEO*

Well, part of it is we start lapping the declines, and it will be flat year-over-year, number one. Number two, ultimately when they really want to adjust costs, they should outsource it. So, right now, this is in major industry changes. And before you'll see people insource work to bridge a soft spot, if you will. And then when they realize that there's a structural change, they start looking at their cost structure. Look at BP's announcement, for instance. And then when they don't have the people, they have to go outside (multiple speakers).

John Stauch - *Pentair plc - EVP and CFO*

But Brian, just to clarify, we did not say it's improving in Q1. Matter fact, we said it is not improving in Q1.

Randy Hogan - *Pentair plc - Chairman and CEO*

I think he meant -- yes.

John Stauch - *Pentair plc - EVP and CFO*

The maintenance (multiple speakers). And in the future, we do believe it gets better than the current outlook. I think it's still not robust.

Randy Hogan - *Pentair plc - Chairman and CEO*

Right.

Brian Konigsberg - *Vertical Research Partners - Analyst*

If I can just sneak one last in. I think you also mentioned that petchem actually was a bit weaker than you thought it would be. I guess the project work on that front still seems to be pretty decent. But you did experienced delays and some weakness there?

Randy Hogan - *Pentair plc - Chairman and CEO*

Yes, it's decent, but it's not as decent as it was expected to be. And there's even delays there. And you can just imagine, if you're a company that is integrated -- Oil & Gas, petrochem.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got it. Thank you.

Operator

Josh Pokrzywinski, Buckingham Research.

Josh Pokrzywinski - *Buckingham Research Group - Analyst*

Just from a high-level perspective, I want to make sure I'm understanding this correctly. So, maybe versus mid-December -- and, John, I think you put up the slide about normal EPS seasonality. And that would've read out to something in more like the high 70s versus the low 70s for the first quarter. And if I'm understanding this right, a lot of the issues in Valves & Controls just come from being below threshold in the first quarter on shipments.

But I guess I'm not really seeing a lot of the incremental caution that you are talking about, whether it be from price or from delayed maintenance spending readout. Is that the right way to think about it? Or are those happening, and then just some of these pockets of surprise growth versus a month ago, and the other segments are offsetting that? If you were just to zoom out and look at it from the highest level.

John Stauch - *Pentair plc - EVP and CFO*

Yes, so let me go back to that seasonality. I agree that we put that up. I think we have two elements that I'd draw attention to. One is our corporate costs are going to be significantly higher in Q1 than the rest of the year. That's related to vesting schedules of options and restricted stock -- directors, officers, chairman -- as well as just general corporate spending. And that's about $0.04, Josh, to that level. And that is different this year than it has been in prior years.

The other element is that we feel that the shippable backlog, and the ability to do better than the shippable backlog in Q1 in Valves & Controls, is at its weakest opportunity in Q1. And those are the only two things that we're reflecting differently than the normal seasonality schedule that we shared with you.

Josh Pokrzywinski - *Buckingham Research Group - Analyst*

Okay, that's helpful. And just as a follow-up from an earlier question on midstream as it pertains to -- I guess both Valves & Controls and Technical Solutions. I lost the answer somewhere in there, between the quote log and the shippable backlog, and what your customers are seeing and how those all interplay.

But is your expectation that that market is okay this year? And how should we think about that from a timing schedule into 2017 or beyond, just given some of those big cuts that we've seen at some of your customers?

John Stauch - *Pentair plc - EVP and CFO*

Yes, I think it all reflects. And if you think about the front log of what I say the projects that we're looking at, or the opportunities before we're even quoting, you should think about that being down at least 25% versus normalized levels. We then have to then quote, and we're going to get our fair share of products where we are automatically specced in, or we're the likely player. And that's what represents the quote log, and then the orders are an output of that. And as you can imagine, that is a moving funnel of opportunities, where every single quarter you are converting each of those.

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So, I think the news that we are sharing today is that we still think we're going to get our fair share of what our opportunities are, but the opportunities are lower. And we think that continues through 2017.

Josh Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. Okay, thanks.

Operator

Christopher Glynn, Oppenheimer.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Just a question about the capital structure, and what are the shifts in urgency and priority bias right now? Because we've clearly seen that leverage is out of fashion in terms of its impact on equity values. And maybe it's a more durable dynamic than to say merely out of fashion. And would you say the bar has raised on what qualifies as a viable deal prospect?

Randy Hogan - *Pentair plc - Chairman and CEO*

I would say so. Right now, cash flow and our focus on our balance sheet is number one. And the Board and management are unified in that.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Okay. That's all I got. Thanks.

Operator

Brian Drab, William Blair.

Brian Drab - *William Blair & Company - Analyst*

I just wanted to ask about the progression of EPS and organic revenue growth in 2Q, 3Q, 4Q for -- going to do about $0.70, $0.71 in the first quarter. How do we think about EPS in 2Q, 3Q, 4Q? Is this going to be more like a $1.10, $1.10, $1.25? Or any direction there would be helpful.

John Stauch - *Pentair plc - EVP and CFO*

Yes, I think we gave out seasonality before. And we took a look at what Q1 is. And as we mentioned, there's a reason -- two reasons that Q1 is slightly lower. But we would then expect that our normal seasonality, which is reflected in last year's delivering of that EPS, to be appropriate.

Brian Drab - *William Blair & Company - Analyst*

Okay. Then for organic revenue growth, 2Q, 3Q, 4Q?

John Stauch - *Pentair plc - EVP and CFO*

Ramping throughout the year, as we suggested, our year-over-year comparisons get a little easier in Q3 and Q4. So we have the trends out of Q4 continuing through Q1 and into 2Q. And then we begin to get a little easier comparisons in Q3 and Q4.

Brian Drab - *William Blair & Company - Analyst*

John, that's a little confusing to me, just because in first quarter you're going to be up 1% in core sales. And then for the balance of the year, you are forecasting down 2%. So there's got to be -- you're going to be down from 1%, so it's not really progressing up throughout the year.

John Stauch - *Pentair plc - EVP and CFO*

Yes. I get that. I'm sorry. We had some projects that are running out, and those are in the Technical Solutions side. And so absent the Technical Solutions projects, my point is that Q2 is our seasonal quarter, and then Q3 is down due to the fact that we tend to have the August.

But on a year-over-year basis, everything other than the projects in Q3 and Q4 are about the same. And Brian, I'm just not going to give you Q2 EPS guidance on this call today. That's where I'm going with this.

Brian Drab - *William Blair & Company - Analyst*

Yes, I'm just trying to actually be helpful, given that you probably -- I'm expecting (multiple speakers) EPS guidance all over the place.

John Stauch - *Pentair plc - EVP and CFO*

No, I appreciate that.

Brian Drab - *William Blair & Company - Analyst*

(multiple speakers) relative to the guide.

John Stauch - *Pentair plc - EVP and CFO*

Thank you.

Brian Drab - *William Blair & Company - Analyst*

Okay. Thanks a lot.

Operator

There are no further questions at this time.

I will turn the call back to our presenters.

Randy Hogan - *Pentair plc - Chairman and CEO*

Okay. Thank you all for your interest and questions.

And I will turn it back over to you for the replay, operator.

Operator

This does conclude today's conference call. You may now disconnect.
