

23-Jul-2024

Pentair plc (PNR)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone. And welcome to the Pentair Second Quarter 2024 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please also note that today's event is being recorded.

At this time, I'd like to turn the floor over to Shelly Hubbard, Vice President, Investor Relations. Ma'am, please go ahead.

Shelly Hubbard

Vice President-Investor Relations, Pentair plc

Thank you. And welcome to Pentair's second quarter 2024 earnings conference call. On the call with me are John Stauch, our President and Chief Executive Officer; and Bob Fishman, our Chief Financial Officer. On today's call, we will provide details on our second quarter performance as outlined in this morning's press release.

On the Pentair Investor Relations website, you can find our earnings release and slide deck, which is intended to supplement our prepared remarks during today's call and provide a reconciliation of differences between GAAP and non-GAAP financial measures that we will reference. The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company's performance, in addition to the impact these items and events have on the financial results.

Before we begin, let me remind you that during our presentation today, we will make forward-looking statements which are predictions, projections or other statements about future events. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of Pentair. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to carefully review the risk factors in our most recent Form 10-Q and Form 10-K.

Following our prepared remarks, we will open the call up for questions. Please limit your questions to two and re-enter the queue if needed to allow everyone an opportunity to ask questions. As a reminder, you can reference our Pentair Investor Overview and Investor Day presentations on our IR website. Please visit our Pentair Investor Relations website and click on Events and Presentations to find these materials.

I will now turn the call over to John.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Thank you, Shelly. And good morning, everyone. Let's begin with our record Q2 results in the executive summary on slide 4. During the second quarter, we achieved record sales, adjusted operating income, return on sales, adjusted EPS, and free cash flow following the separation of nVent and Pentair in 2018. And we delivered these results on top of a record in the prior year period. I would like to thank our 10,000 plus Pentair employees for their continued commitment towards delivering for our customers and creating value for our shareholders, who worked tirelessly and productively to deliver another quarter of remarkable income growth and margin expansion. Thank you.

In Q2, sales increased 2%, adjusted operating income increased 16%, ROS expanded by 310 basis points, driven by margin expansion across all three segments, adjusted EPS rose 18%, and free cash flow was over \$500 million. Driven by disciplined capital allocation strategy and record free cash flow, we continued to strengthen the balance sheet and we purchased \$50 million worth of stock in the second quarter.

We also continued to elevate our dividend. As a dividend aristocrat, we have increased our dividend to shareholders for 48 consecutive years. As we look to the remainder of the year, we are increasing our adjusted EPS and ROS guidance. This is driven by our strong results in the first half of this year and continued confidence in our ability to execute in a dynamic macroeconomic and geopolitical environment while implementing and executing on our major initiative, transformation, now inclusive of 80/20. Our expected 2024 EPS increased to approximately \$4.25. This represents the high end of our previous guidance. Bob will provide more details later in the call. We believe our record second quarter performance demonstrates the power of our sustainable and balanced water portfolio, as well as strong execution across all three segments: Flow, Water Solutions, and Pool.

Our strategy to help the world sustainably move, improve, and enjoy water, life's most essential resource, continues to prove its resilience. And we believe we are well-positioned to capture opportunities from favorable secular trends such as water availability with growing concerns over access to clean, safe, and reliable water. Increased awareness of water challenges led by growing concerns around human-made contaminants impacting water composition, taste, and water quality. Growing environmental concerns as consumers are looking to reduce their carbon footprint and impact on the environment. Aging commercial, public, and municipal infrastructure. Outdoor healthy living as people are interested in gathering at pools to exercise, stay cool, and have fun. And favorable housing migration to the Sun Belt states, which represents a large mix of our Pool sales.

Let's turn to slide 5. Over the last 90-plus days, we've seen reports that suggest a continuation of slower global growth throughout the remainder of the year. As we look at each of our three segments and the verticals within each, we believe that there are areas of great opportunity and some that we expect to remain slightly pressured. All in, this is where we believe our balanced water portfolio diversifies the risk and enables us to control what we can and mitigate challenges where possible. For example, in Flow, we reached record sales within Commercial and have seen higher activity from IJA funding on infrastructure projects. Higher interest rates and a slow housing market continue to impact our Residential vertical. And our Industrial vertical has experienced some delay in CapEx spending by some key customers. Within Water Solutions, our North America commercial filtration business remains strong and our commercial ice business performed as expected, while international has been impacted by economic pressures.

Residential continue to be impacted by higher interest rates. That said, we are really excited about the launch of our first commercial PFAS certified filtration product in Q2, which further expand our existing PFAS certified filtration product line. Customers showed strong interest in wanting to learn more about this product. We are proud of this new innovation and the teams that brought this product to market. With heightened awareness on water quality and interest in point-of-use filtration, we are excited to see this product line grow long term.

Lastly, in Pool, sustained higher interest rates and a slower housing market have continued to impact pool demand, predominantly in new and remodeled pools. New in-ground pools built in 2024 are now expected to be near the 60,000 pool range, compared to roughly 72,000 in 2023 and roughly 78,000 in 2019. Given this economic weakness, our recent dealer survey noted that the industry is expecting slightly lower growth than it did 90-plus days ago. However, our aftermarket business performed well in Q2, which in part drove double-digit Pool sales growth for Pentair. Despite the near-term economic challenges for the pool industry, we remain confident in Pentair's ability to drive long-term growth and margin expansion. We believe it remains a very attractive industry

with megatrends that are in our favor. A majority of our revenue is concentrated in five Sun Belt states, which are benefiting from the higher migration to warmer weather. We're also seeing a trend toward lifestyle and wellness with family and friends, gathering outdoors in pools for exercise and to have fun. As climate change remains the top concern, Pentair is well-positioned for secular trends and preferences for smart, sustainable products. We were the pioneers in introducing variable speed pumps which save energy and money.

Let's turn to slide 6. Last quarter, I mentioned that our transformation initiatives remained on track to deliver margin expansion as we highlighted at our March Investor Day. Approximately 50% of our total revenue has adopted and implemented value-based pricing as part of our strategic pricing initiatives. We are well into Wave 2 of our sourcing initiatives, which is beginning to drive benefits in our financial results. And we have continued to drive operational footprint optimization and plan to continue this going forward.

In Q2, transformation drove record quarterly productivity. Additionally, we trained about a thousand employees on 80/20, reflecting about 50% of Pentair's revenue streams. We're starting to execute on some quick wins and continue to see larger, longer term opportunities as we expect 80/20 to further enable our transformation success. It is important to recognize that reducing complexity of low value products for lower value customers is the premise of 80/20. By doing this, resources are freed up that should allow us to perform better for the core customers who buy our core products. When we do this, we expect to see higher core growth rates in our businesses longer term. I'm excited about the initial fact-based data that we have analyzed, and I am encouraging the business leaders to move quickly to exit our complexity and focus on the core. We expect to have a further update on our progress and the impact on 2025 after we have completed the initial training and implemented the actions across the entire Pentair portfolio, which we expect to complete by the end of 2024.

Before I turn it over to Bob, let's turn to slide 7. We continue to drive strong margin expansion and operating income dollars through transformation despite economic weakness. Our transformation initiatives are well underway and our 80/20 analysis kicked off in recent months with strategic actions that are in the early stages. We have increased confidence in our long-term value creation and we expect to deliver ROS of approximately 23%, about 100 basis points higher than previously guided and about 13% adjusted EPS growth in 2024. All-in, we continue to build a strong foundation that we expect to drive long-term growth and profitability across our diverse water portfolio.

I will now pass the call over to Bob, who will discuss our performance and financial results in more detail. Bob?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

Thank you, John. And good morning, everyone. Let's start on slide 8. We delivered another strong quarter of quality earnings. Sales rose 2% to \$1.1 billion, while adjusted operating income increased 16% to \$271 million. ROS expanded 310 basis points to 24.7%, driven by sales growth and transformation. All three metrics achieved new records post the separation of nVent from Pentair in 2018.

Core sales were up 2% year-over-year, driven by 18% growth in Pool, which was somewhat offset by a 3% decline in Flow and a 7% decline in Water Solutions. Both Flow and Water Solutions reported record sales in the prior-year period due to supply chain improvement and our ability to ship a large portion of backlog orders. Sales across all three segments increased sequentially from Q1 as expected. Our second quarter sales have typically been our highest sales quarter of the year. We are very pleased to see Pool return to growth for the first time in eight quarters. All three segments drove significant margin expansion in the second quarter. Lastly, we delivered record adjusted EPS of \$1.22 post the nVent split, which exceeded the high end of our guidance by \$0.05 and was up 18% year-over-year.

Please turn to slide 9. Flow sales declined 4% year-over-year compared to a record quarter last year. Residential sales declined 10% as compared to the prior-year quarter, but reflected an improvement sequentially from Q1. Commercial sales rose 2% compared to a record prior year. Industrial sales were flat in Q2, reflecting our decision to discontinue certain projects that no longer met our profitability criteria. Segment income grew 13% and return on sales expanded 310 basis points to 21.3%, marking the first time ROS has reached or exceeded 21%. The strong margin expansion was the result of continued progress on our transformation initiatives.

Please turn to slide 10. In Q2, Water Solutions sales declined 8% to \$311 million, driven by declines in both Commercial and Residential. We expected our Commercial business to be down in light of a record prior-year comparison driven by Manitowoc Ice's ability to work through a significant portion of backlog orders. We were pleased with filtration sales strength in Q2. Segment income declined 3% to \$73 million and return on sales expanded 130 basis points to 23.5%, driven primarily by transformation, which continued to drive operational efficiency as well as mix. This was the ninth consecutive quarter of ROS expansion. Margins have expanded nearly 900 basis points over the last two years.

Please turn to slide 11. In Q2, Pool sales increased 17% to \$392 million. Segment income was \$134 million, up 27%, and return on sales increased 270 basis points to 34.1%, driven by sales growth and transformation.

Please turn to slide 12. At our Investor Day in March, we shared our updated three-year margin target. We expect 2026 ROS to expand to 24%, over 540 basis points as compared to 2022, driven by contributions from all four of our key transformation initiatives: pricing, sourcing, operations, and organization. And we have the opportunity to do even better as we discussed at our March Investor Day. In 2023, we achieved ROS of 20.8% and expect to continue to drive margin expansion to approximately 23% by year-end 2024, an increase of nearly 100 basis points from our previous guidance.

Please turn to slide 13. As we mentioned at our March Investor Day, we expect 80/20 to enable and accelerate our transformation initiatives. It's another tool in our toolkit to help our businesses enhance the customer experience and reduce complexity. The 80/20 analysis uses a quadrant-based strategy to assess customers and products. Simplistically, the first quadrant reflects the combination of customers and products, which drive a majority of revenue and profit.

Conversely, the fourth quadrant reflects customers and products that represent roughly 4% of revenue, but includes 15% to 25% of total cost to serve. We expect to focus on customer segmentation over product segmentation to enable us to implement customer strategies based on each quadrant. As a result, we can take specific actions tailored to each quadrant to drive higher and more profitable growth over time. To date, we have assessed about 50% of our total revenue using 80/20 and are currently evaluating this analysis and developing action plans. 80/20 is about treating our customers fairly but differently depending on the circumstances. The objectiveness of the data frees the organization to make the right decisions. We expect to see the largest benefit from 80/20 and operations. However, we also believe G&A and new product introductions will be impacted by the fourth quadrant due to the effort required to serve. We expect this to benefit our organizational excellence efforts as well. We believe the 80/20 analysis is a great complement to our transformation program. We expect to see a noticeable contribution in 2025 as these plans are rolled out. I'm excited about the process and the findings, and I expect it to lead to larger transformation opportunities.

Please turn to slide 14. In Q2, we achieved record free cash flow of \$522 million. We deployed capital to lower our long-term debt, restart share repurchases, and pay our quarterly dividend. During the quarter, we repurchased approximately 600,000 shares for a total of \$50 million. We have an additional \$550 million available on our share

repurchase program. Our net debt leverage ratio was 1.6 times, down significantly from 2.2 times in the prior year period. Our ROIC was nearly 15%. Long term, we continue to target high teens return on invested capital. We plan to remain disciplined with our capital and continue to focus on debt reduction amid the higher interest rate environment and share repurchases. As I mentioned last quarter, with the net debt leverage ratio within our target range, we have additional flexibility to strategically allocate additional capital to areas with the highest shareholder returns.

Moving to slide 15. For the full year, we are increasing our adjusted EPS guidance to approximately \$4.25, which is up roughly 13% year-over-year and is at the high end of our previous guidance range. Also, for the full year, we expect sales to be approximately flat to down 1% driven by a continued sluggish economy. The second half of 2024 reflects the anticipated reality of a continued higher interest rate environment and its impact on the global economic landscape.

For Pentair, this means we are lowering the back half revenue expectations by about \$120 million at the midpoint of our guidance. About \$30 million of this is in Pool, which reflects the expectation of primarily slower pool builds and remodels. About \$30 million is in Water Solutions and is in lower margin commercial services and global water treatment end markets, and about \$60 million in Flow is primarily related to Residential, delayed Industrial projects, and being more focused around standardized offerings and recurring revenue to drive higher profitability.

We now expect Flow and Water Solutions sales to be down approximately low-single digits and Pool sales to be up approximately mid-single digits for the full year. Within Flow, we expect Residential to be down approximately high-single digits, Commercial to be up approximately mid-single digits, and Industrial to be roughly flat as we continue to be selective around certain projects. Within Water Solutions, we expect Residential to be down approximately low to mid-single digits, and Commercial to be down approximately low-single digits primarily due to services. We're also updating expected adjusted operating income to approximately increase 10% to 11%. We are pleased to be able to increase our adjusted EPS guidance despite the lower revenue. We are increasing expected transformation savings to approximately \$100 million for 2024 as compared to \$75 million in our previous guidance, driven by higher productivity. We expect to improve our mix of higher margin businesses and continue our focus on pricing initiatives to offset inflation.

Due to a continued sluggish economy, we expect sales to be down approximately 2% to 3% for the third quarter, but adjusted operating income to increase 10% to 12%. We are also introducing strong adjusted EPS guidance for the third quarter of approximately \$1.06 to \$1.08, up roughly 14% at the midpoint. Before I turn the call over to the operator for questions, I want to say how pleased we are with our second quarter record performance. Our teams have been working diligently and effectively to mitigate uncontrolled risk, like continued global economic pressures while working to deliver strong financial results and executing our major initiative transformation, which now includes 80/20. We are very proud of the hard work and dedication of our entire Pentair team.

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

QUESTION AND ANSWER SECTION

Operator: Ladies and gentlemen, we'll now begin the question-and-answer session. In the interest of time, once again, that we do ask that you please limit yourselves to one question and one follow-up. [Operator Instructions] And our first question today comes from Andy Kaplowitz from Citigroup. Please go ahead with your question.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, everyone. Nice quarter.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Thank you.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Thank you.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

John or Bob, can you give us more color regarding what you're seeing in Pool on your assumptions for break and fix and remodeling? I think you mentioned a strong aftermarket, weaker remodeling. We obviously know what you're thinking for new pools. But could you talk about your sell-in assumptions in the channel? How concerned are you or what are you baking in for inventories in the channel at this point for 2024?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. I'll go ahead and start with that one, Andy. Thanks for the question. Again, from our perspective, we started the year saying Pool would grow approximately 7% full year. We've now guided that to up mid-single digits. As a reminder, a significant piece of our growth is coming from the fact that last year's inventory correction will not be happening this year, plus a couple of points of price and then an assumption that says the overall market down roughly mid-single digits. And so that's how we get to our mid-single digit growth for the year. From our last earnings call, we have seen a little bit of pressure on new pool builds and remodels, and that was the reason why we brought our guide down for the pool season.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Andy, I would just add that, as a reminder, we had a really easy compare in Q2 versus a really low number last year. And so the growth rate in Q2 is more reflective of last year's performance than it is of anything that is outsized performance in this year.

Andrew Kaplowitz

Analyst, Citigroup Global Markets, Inc.

Q

Helpful, guys. And then obviously, your transformation impact is impressive and raising the productivity to \$100 million. But you talked about 80/20. How much of it all is that sort of helping 2024? It seems like it's early days. And you've got the 23% target for this year and 24% target for 2026. So does it give you a little bit more confidence towards maybe that upside case as you go into 2026? Any thoughts on how 80/20 could impact 2025, for example?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. So first of all, 80/20 was not in our 2026 Investor Day longer-term targets. Very little of it is included in our 2024 update guidance. We've completed the training sessions and the fact-based analysis on roughly half of our revenue streams, and we'll have the other half done in roughly the next 90 days. So we're very encouraged of what we're learning and finding, and it does give us confidence that we can continue to improve margins as we go forward.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

And we were very pleased to be able to increase the transformation savings from \$75 million to \$100 million. Think of that as primarily coming from our sourcing savings with also our manufacturing and org excellence piece helping as well.

Operator: Our next question comes from Bryan Blair from Oppenheimer. Please go with your question.

Bryan F. Blair

Analyst, Oppenheimer & Co., Inc.

Q

Thank you. Good morning. First of all, great quarter.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Thank you.

Bryan F. Blair

Analyst, Oppenheimer & Co., Inc.

Q

To follow up on transformation, obviously, benefits accelerated in the quarter. You have stepped up the full year guide. Just mentioned that's primarily from sourcing. So should we think that there's somewhat of a weighting to the Pool segment in the back half in terms of contribution? And just overall, with that step-up, how should we think this Q3, Q4 weighting?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. From our perspective in terms of the guide we gave for Q3 and then the implicit guide for Q4, we'll see significant ROS expansion in both quarters. We do think that the main beneficiaries in the back half will be the Pool business and Flow, followed by Water Solutions.

Bryan F. Blair

Analyst, Oppenheimer & Co., Inc.

Q

Understood. And I was wondering if you could parse out the Commercial Water Solutions revenue decline in Q2 across Everpure, Man Ice and KBI, and then what you're anticipating in the back half by business line. We know, Man Ice had, in particular, a very challenging comp in Q2. Just curious what you're seeing there and what's factored into the outlook now.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I mean, most of the decline that we're seeing in Water Solutions is coming from not participating in low value service contracts within our KBI services arm. And we're adjusting our revenue down to reflect that. It'd be roughly a \$20 million adjustment for the year. The rest of it is – filtration grew double digit in Q2 and they're having a really strong year. And the Manitowoc Ice business continues to perform to expectations. And as a reminder, we were just under \$450 million of revenue last year. We'll be just in the low \$420 million this year. So we're managing through a really decent execution despite having those record backlogs last year that we ended up shipping. So I feel really good about the Water Solutions business. We are tweaking our global residential water treatment business, reflecting some of the lower revenue streams and non-US related businesses. And that's a small adjustment here, but I think it's reflected that we don't think that those will improve in the back half of the year.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. And just as a reminder, the North America filtration business, the ice business, those are very profitable ROS businesses for us. So the mix certainly works in our favor.

Operator: Our next question comes from Steve Tusa from JPMorgan. Please go ahead with your question.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Hey. Good morning.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Hey, Steve.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Can you just maybe talk about the pricing environment that you're seeing out there and how that should trend over the course of the year? It looks like, I don't know, you're assuming maybe 1 to 2 points for the year?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

That is correct, Steve. And I don't think we should expect that we're going to outperform that between now and the rest of the year. I think we're – there's pockets of being able to recover some of the incremental inflationary areas, but we don't feel that inflation is significant enough to go out with another round of pricing. So we're generally doing the best we can and that the original list prices and I think so far so good.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Do you at any point in time see price going like flat to down in Pool at all?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

No. We do not see that happening. At the halfway point, we have – of the year, we have 2 points of price reading out and I expect something similar in the back half.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Okay. Great. And then just on the bridge, the productivity was pretty solid this quarter. What are you guys expecting for the year now on that number? I think it was like \$75 million before. Some of these numbers move around. But what do you guys expect for the year?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

\$100 million now in my prepared remarks, and you can think about that as roughly split between – evenly between Q3 and Q4.

Operator: Our next question comes from Brian Lee from Goldman Sachs. Please go ahead with your question.

Brian Lee

Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys. Thanks for taking the questions. Good morning. I guess maybe a follow-up on the last one. You raised the kind of transformation benefits from the \$75 million to \$100 million. I know you don't have much, if any, of the 80/20 in 2024. But can you give us some sense, any sense of sort of how it would compare just your initial read on 80/20 impact into 2025 when you kind of compare and contrast it to what you've been able to do with the transformation initiatives this year, going from \$75 million to \$100 million?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. Let me hit the transformation real quickly. I think it's fair to say we always had an internal funnel that was higher than what we had confidence with in the beginning of the year on the external side. And I think \$100 million now reflects that most of the programs that we had in the internal funnel are now being realized. And so that's where our confidence level is as we exited Q2. As a reminder, we had a difficult year-over-year in transformation Q1 and we had a very strong Q2. And now, we feel confident in what that full-year expectation is.

When we look at 80/20, I think it's important to note that the way the math works is that what we call quad four, which is the lowest performing quadrant. These would be less desirable products to lesser desirable customers. That's roughly usually around 4% of revenue. So just to think about that, that frames on a \$4 billion-ish revenue stream, what the walkaway revenue number would be and its worse possible scenario. That same quadrant generally used to flex about 25% of a company's cost structure.

Now, you're not going to get all that 25% out because clearly, you're utilizing pieces of people's work efforts. But it starts to tell you about how it's non-profitable it would be in quadrant four. So as you release yourself from the

products that you're spending a lot of time on, you should ultimately be able to reduce your labor and reduce – or redirect your NPI and your sales and marketing efforts to your quad one to generally overserve or create a better service level to your top customers, which gives you an overall better core rate. So we don't have that figured out for all the businesses yet, but the math is not going to be any different for Pentair than it is for everybody else who goes through the program. And it's really encouraging and gives us a lot of optimism that there'll be a whole another list of transformation ideas as we head into 2025.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. From my perspective, it brings tremendous focus to the things that really matter, allows us to be – seek perfection in quadrant one with our best customers and best products and really to reduce complexity and simplify the business in quad four.

Brian Lee

Analyst, Goldman Sachs & Co. LLC

Q

Okay. Super helpful. I appreciate the color. And then, Bob, you mentioned on the guidance walk on revenue, the \$120 million at the midpoint, that's coming out versus prior guide. Is there any percentage of that which is being driven by exiting some of these less profitable business lines, just a more proactive approach to kind of how you're structuring the revenue goal for this year versus it all just being market driven? Thanks, guys.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

I would say in the revenue reduction, there's nothing significant relating to 80/20. There happens to be a lower profit revenue streams as we're more selective within Flow, as Commercial services comes down. Those would be helping the overall mix. But nothing yet directly related to 80/20.

Operator: Our next question comes from Jeff Hammond from KeyBanc Capital Markets. Please go ahead with your question.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Good morning, everyone.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Hey, Jeff.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Just on Water Solutions, a couple of questions. One, the commercial filtration you called out as strong. Is that just attachment synergies from Man Ice or is it something more broad than that? And then just speak to commercial foodservice in general, we're seeing kind of a weaker consumer, mixed results out of Starbucks, et cetera. What you're seeing in general there?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. I would say we're starting to see the synergies coming from that Manitowoc Ice acquisition really benefiting our North America filtration business. Again, we have the opportunity to visit distributors and dealers and talk about the breadth of our offering. We have the opportunity to cross-sell products. And we have an opportunity to go to market in a different way, whether it's setting up at a tradeshow and selling both Everpure and Ice. Those are all the benefits that are accruing to the filtration business this year.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

And I think this is – Jeff, to answer your question, I mean, we do a lot of quick serve and even though that the traffic may be a little more challenged from time to time, it's relatively a stable industry when it comes to the replacement side and the sell-through for our related products.

Jeffrey D. Hammond

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then just to put a fine point on Pool, just give me a sense post some of the pre-announcements, just what feedback you're getting on inventory levels, kind of this absence of destock. And if it's a little bit less or just a little more color on that.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I'd say, first of all, I mean we're disappointed in the new Pool builds for the year. I mean, we're almost near historical lows and pretty close to where we were in the 2008-2009 financial crisis, Jeff. So I mean, we're looking for the movement in interest rates to really start to spur the remodeling side and hopefully begin to get people to move homes and think about pools as part of that attachment. Overall, and the way the segmentation works, we do really well in the high end and high end is still strong. That's generally a cash buyer. And they're utilizing retirement income to – or retirement funds to drive – to buy their dream home in the Sun Belt states. It's really the mid-market and some of the remodeling that we believe has slowed. And so as we mentioned in our remarks, our dealer pulse would suggest that it's a little less optimistic here as we enter the second half of the year than we saw in the first half of the year, which is why we adjusted our guide downward by a couple of points.

Operator: Our next question comes from Deane Dray from RBC Capital Markets. Please go ahead with your question.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Good Morning.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Hey. It's – you mentioned in prepared remarks that Flow was seeing some of the government stimulus coming through. Can you provide any color there?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I mean, I think it's just overall, we – really pleased with the fact that there's been a fair amount of infrastructure spend. And we focused our activity there, had some solid marketing programs to focus on where that growth and expansion is. And I think we feel really pleased that we're participating in that segment right now.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Got it. And what kind of contribution are you expecting for the second half in that stimulus?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. It's not much at all. It's modest. I mean, we called it out as a particular area of the economy that continues to be invested in. And I'm sure you're struggling with some of that road construction and infrastructure spending as well as we all are here in the summer construction season. But it's been nice to participate in that and see a little bright spot from the government funding in that area, which offset some of the lack of interest rate benefits we're getting elsewhere.

Operator: Our next question comes from Saree Boroditsky from Jefferies. Please go ahead with your question.

Q

Good morning. This is [ph] James (00:40:58) on for Saree. Thanks for taking questions. So I kind of wanted to touch on Pool here. So like a very strong growth in 2Q. Can you kind of break that down by like what's the contribution from [indiscernible] (00:41:10)? What's the sell-in and sell-through?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. Sell-in and sell-through, about flat in the quarter for us and the rest of what happened in Q2 with the year-over-year comparison, really, what didn't happen, which was last year, there was a sizable, as Bob said, inventory correction this year, generally sell-in match sell-out.

Q

Got it. Thanks. And wanted to kind of understand the Pool guidance a little bit better. So you delivered a lot of like pre-buy in second quarter 2024. So how should we think about the pre-buy for 4Q of this year? Like what does the guidance assume for the pre-buy, kind of pre-buy? Yeah.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I hear you. So as a reminder, the pre-buy starts in Q3 and Q4 of the previous year. And we take those orders ahead of the price increases for the next Pool year. Right now, we have what we'd say is a modestly down to normalized environment as we look forward in 2025, reflecting that we think that we won't really see benefits from lower interest rates across the Residential businesses to probably second half of 2025.

Operator: Our next question comes from Andrew Buscaglia from BNP Paribas. Please go ahead with your question.

Andrew Buscaglia

Analyst, BNP Paribas Securities Corp.

Hey. Good morning, guys.

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Good morning.

A

Andrew Buscaglia

Analyst, BNP Paribas Securities Corp.

Just wanted to – you're talking more about those 80/20 cost or transformation costs accelerating. Where, like, specifically within each segment in Pool in particular, are you finding this beneficial to one segment versus any other? And then, if you just talk more about details maybe specifically for Pool in that regard?

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Yeah. I mean, I – it is got the same math base equation for every revenue stream we look at, I just want to start there, and it is roughly 45% of your revenue falls in that lower right quadrant, which is, again, the less desirable products to the lesser desirable or lesser profitable customers. It won't be any different. It is straight math and it will be the same. It's harder for Pool to execute on because they're quadrant four, reflective of their overall margins is a significantly higher margin than what we're seeing in some of the other businesses. So it gets a little bit more challenging to exit quickly because you fall in love with the fact that you still are making money in that quadrant in a business like Pool.

A

The reality is that by serving that quadrant, you're taking away from your performance to your top customers and you're taking away from your ability to produce new products and new sales and marketing programs around those top products. So it will have the same impact across the entire organization. I would say right now Pool is a little bit more challenged in how to deal with quadrant four and the other businesses who are in a lower profitability standpoint can move faster to eliminate quad four. Does that answer your question?

Andrew Buscaglia

Analyst, BNP Paribas Securities Corp.

Yeah. Yeah. No, very helpful. Okay. Yeah, that's interesting. And then your cash flow was really strong this quarter and seemingly a little more profitability as we exit the year. What are you thinking about in terms of capital allocation at this point? Has anything changed there? Any thoughts on a buyback and/or M&A?

Q

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

Yeah. Again, very pleased with our free cash flow generation in the quarter, over \$500 million. What that's allowed us to do is pay down close to \$300 million of debt in the first half of the year – excuse me. We've been able to restart our share repurchases in the second quarter and now also continue to pay the dividend. If you think back about when we closed the Manitowoc Ice acquisition back in July of 2022, our leverage was in the high 2s. We've now delevered down to 1.6 times and created a lot of optionality for the company to drive shareholder value. So

A

paying down variable debt continues to make sense that the interest rates that we see continuing to offset dilution. But we'll obviously have a nice problem to have come the end of the year where we're below our target net debt to EBITDA. So again, lots of options around accelerating share repurchases or potentially bolt-on M&A.

Operator: Our next question comes from Nathan Jones from Stifel. Please go ahead with your question.

Nathan Jones

Analyst, Stifel, Nicolaus & Co., Inc.

Good morning, everyone.

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Good morning, Nathan.

A

Nathan Jones

Analyst, Stifel, Nicolaus & Co., Inc.

I wanted to ask a couple of questions on the 80/20 initiative. You guys, one of the comments you made was you're going to focus on customer segmentation versus product segmentation. Can you just talk a little bit more about what goes into that decision, how it manifests itself at Pentair? Is it a little bit easier to focus on customers versus products? So just what goes into that decision?

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Yeah. I appreciate the question. No, it's harder actually. And I think it's the right way to do it and the only way to really do 80/20 is because ultimately, your customers are determining what part you're selling and why you're selling those parts. Nathan, we talked about this, usually self creates your own complexity. I mean, we did design and introduce all these parts, so we have to take accountability for that. But really, as Bob said, we're going to treat our customers fairly, and you know me, basically differentiate how we serve them. And so not all our customers are buying quantities and not all our customers are buying the same levels of transportation and expectations.

A

So it is harder. It takes longer because we have to have honest and fair and transparent pricing across the customer base. And then we have to work the rebates and the volume discounts accordingly, which takes time to work its way through. And that's what we're doing and we're going to do it, obviously, legally and compliantly, but we're making sure that we notify everybody that at the end of the day, we can't give everybody the same on-time delivery. We can't give them the same volume purchases because it gets really complex to someone who's not buying the right quantities.

Nathan Jones

Analyst, Stifel, Nicolaus & Co., Inc.

Makes sense. I guess, next question, 80/20 typically will create some near-term headwinds to revenue. It may increase the revenue growth in the long term, but that point for getting that forward for out usually creates a near-term headwinds to revenue. We've also got FY 2024 guidance, that's flat to down a little bit. Should we start to think about a base case where the 2026 target there reached with lower revenue and higher margins and get to somewhere around the same point but with the different pathway than originally targeted?

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

I'll answer your question quickly. That is a possibility, Nathan. I don't know that yet, obviously. I mean, we framed it and I shared with you that the nearer-term impact of walking away from quadrant four could be 45% total revenue. What we don't know yet is usually, in any short-term period, there would be a little bit of a pull back, but you would get the cost out and therefore the margin lift. What we would hope that this leads to, though, is a faster core growth rate because we're able to give the products and the customer experiences to our top customers and grow greater than our historical growth rate. Bob and I don't know what that math looks like yet and go across the portfolio. I do think it increases our confidence level of what ROS could be and certainly, we feel like this will be additive. At the same time, you're probably not wrong. And the fact that some of our dollar growth that we might have forecasted in 2026 could be lower.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. I would agree with that. I think we end up with higher quality revenue, higher margin revenue. We remain fanatically focused on quadrant one and we improve lead times, quality, on-time delivery. We have our best service teams working with our best customers. How can that not help drive growth in quadrant one? So our view overall is we end up net better on the top line and then continue to drive ROS expansion through reducing the cost in quadrant four.

Operator: Our next question comes from Julian Mitchell from Barclays. Please go ahead with your question.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe just a first question around some of the operating profit levers. So just to understand, I think, it's \$30 million a quarter of productivity savings in the second half and then the assumption would be you've still got good transformation waves into next year plus the 80/20. So that \$30 million a quarter run rate is a sort of reasonable placeholder starting out next year. I just wanted to check if I had that right. And sort of unrelated price net of inflation was a headwind to our profit year-on-year in Q2. Is that quantum of headwind expected to remain steady through the back half?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. I would say, I'll take the second one first. I mean, at the turn year-to-date, we're slightly below price versus inflation. Prices read out around \$40 million, inflations at \$47 million. So inflation continues to be running a little higher than what we thought. I would say in the back half, our goal is to catch up and end the year, roughly speaking, price equaling inflation. On the run rate going into next year for transformation, too early to kind of give a calendarized view of that, but transformation will be significant next year and in 2025 and certainly help us accelerate our ROS expansion goals.

Operator: Our next question comes from Damian Karas from UBS. Please go ahead with your question.

Damian Karas

Analyst, UBS Securities LLC

Q

Yeah. Good morning, everyone. Congrats on the transformation progress.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Thank you.

A

Damian Karas

Analyst, UBS Securities LLC

So first, just a follow-up to some of your earlier comments on Pool. The business being up year-over-year for the first time in a few years. But underlying market still kind of down for the rest of the year, which would kind of suggest like an extended three-year down cycle, more or less. I'm just curious, given channels being kind of more or less normalized now, what you think the market recovery looks like for Pool presumably in 2025?

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Yeah. Too early to tell yet. I do think I agree with all your earlier comments. It has been a three-year cycle. And quite frankly, when you look point to point, it's one in which we don't yet agree that there's been any type of pull-in or anything related to COVID. We definitely think that we'll start seeing new Pool builds increase from this level as we head forward in 2025 and beyond. And we're hoping to get more to that historical level, which would be just somewhere around 90,000 – 80,000, 90,000 a year kind of led and aided by the interest rates starting to ease. I think, overall, still pleased that we're growing year-over-year despite the challenges. And I think from this point forward, we think we're returning to growth.

A

Damian Karas

Analyst, UBS Securities LLC

Okay. I appreciate your thoughts. And then you've called out the launch of your first commercial PFAS product, as well as the expansion of the existing PFAS product line. I know you haven't necessarily put a number around the PFAS opportunity, but maybe you could just speak to that. Would you say that's firmly in your mid-single digit sales target over the medium term or is there maybe some upside there?

Q

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

No. I think it helps. I think it's slightly in that. I mean, it's going to be in that mid-single digit. It gives customers a reason to want to continue to partner with us and our strong brand and our value proposition to the industry. We've been working hard to make sure that all of our foodservice-related customers understand the value of a high-quality water and I think that segment of the market definitely understands it. But as we start to expand our ice footprint and certainly expand our water drinking footprint, we want to make sure that all the other adjacencies also understand the value of a higher filtration capabilities. So we're very excited about the offering and we're starting to make sure that we tile that value proposition to the ones that aren't directly serving a customer who's coming in for food-related drink or beverage. I think schools and institutions, think about that as the backdrop.

A

Operator: Our next question comes from Andrew Krill from Deutsche Bank. Please go ahead with your question.

Andrew Krill

Analyst, Deutsche Bank Securities, Inc.

Hey. Thanks. Good morning, everyone. I don't believe it's been touched obviously. But for 3Q and the guidance for sales, down 2%, 3%, just anyway you can help us with expectation by segment there for the sales growth, just I think the inflection from growth to being down that much was a little surprising, [indiscernible] (00:55:43) maybe

Q

Water Solutions and Flow, still kind of down that low-single digit area. And then Pool is really what's flowing into the third quarter. Thanks.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

For Q3 – and that's down 2% to 3% guide, we expect Pool to be up slightly. And for Flow and Water Solutions to be down slightly.

Andrew Krill

Analyst, Deutsche Bank Securities, Inc.

Q

Great. Very helpful. And then for – sticking with Pool margins in second quarter, over 34% were very impressive. Just do you expect that you can maintain that level of margin in the back half of the year? I know seasonally, they tend to trend a bit lower, but you have all the transformation savings coming through. I'm trying to see how those two factors might offset each other. Thank you.

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. We do expect to have a similar ROS expansion story for Pool in the back half of the year. So again, they're executing very well. They'll get some slight growth in the back half. And so should be able to see, again, impressive ROS expansion story.

Operator: Our next question comes from Scott Graham from Seaport Research. Please go ahead with your question.

Scott Graham

Analyst, Seaport Global Securities LLC

Q

Yeah. Hey. Good morning. Two questions. Most of mine have been answered. On the price cost to catch up to sort of get to parity for the year, do you have to increase prices anywhere to get there, is that [indiscernible] (00:57:18) for the second half, does that work to increase – to get to parity?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

Yeah. Again, a couple of points of price in the back half gets us very close to what we think inflation will read out. Again, remember, inflation is about \$47 million at the turn. That's around 3% of the cost base. And so we think something similar will play out. Again, we're seeing inflation in the commodity space, the freight space. But overall, our goal and we should be very close to price equaling inflation.

Scott Graham

Analyst, Seaport Global Securities LLC

Q

At price plus 2, I think, percent. Yes?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

That price, we're running about to 2%. That's right.

Scott Graham

Analyst, Seaport Global Securities LLC

Q

Thank you. And the second question, this is an easy one. You used the wording, we restarted share repurchases. I don't know what that means more than that you just did some this quarter for the first time in a while. Is the second quarter share repurchase number, is that maybe a good number to use from here? Does that maybe go higher?

Robert P. Fishman

Executive Vice President, Chief Financial & Accounting Officer, Pentair plc

A

We think for modeling purposes, that's a good number to use. Again, our stated goal is to offset dilution. So \$50 million a quarter is kind of what we've built into the overall guide for the balance of the year.

Operator: Our next question comes from Joe Giordano from Cowen. Please go ahead with your question.

Joseph Giordano

Analyst, TD Cowen

Q

Hey, guys. Good morning.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Hi.

Joseph Giordano

Analyst, TD Cowen

Q

So just curious on the level of productivity you're getting in Pool. Does that seem the calculus around like your desire on – or like willingness to put volumes out in pre-buy? If anything, are you willing to maybe give up a little bit of future price because of how much cost you're taking out of the organization and you know that you can keep margins on a good trajectory anyway? So just to give you more flexibility to like release more than you otherwise would have to protect volumes and maybe taking share.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. I just want to make sure. I mean, early buy is done and it's just really more to level load the factory. Otherwise, we'd have – all of our revenue in Q2 and Q3 and very little in Q3 and Q4 – or Q1 and Q4. So we make that decision as we head in the year based upon what level of revenue we're comfortable with to still maintain a decent profit level and also make sure that we can keep a consistent employment level. So that's how we make that decision. It's too early to make that call right now. And as the season approaches, that's the discussions we have with the full team.

Joseph Giordano

Analyst, TD Cowen

Q

Fair enough. And then just on the PFAS solution here, just want to clarify, is this like a secondary treatment, like is this another product on top of like an Everpure that a commercial customer would have? Or is this kind of an integrated solution that's doing multiple – removing multiple contaminants?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yes. The answer is yes. That is a add-on to what we currently have.

Operator: And our next question is a follow-up from Steve Tusa from JPMorgan. Please go ahead with your follow-up.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Hey, guys. Sorry. Just wanted to like touch on this whole inflation and price thing. It looked like the kind of the stat comp pricing in Pool went down sequentially and I think there's a follow-up to the other question, just wondering, can you just maybe delve into what was so inflationary for you guys? I mean, like trying to disaggregate a sourcing benefit versus cost increases that would just be more basic in nature? Just wanted to maybe – I guess just delve into what you're seeing by category in that inflation number, like what's really driving that?

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Yeah. So Steve, we do have some stubborn commodity inflation around a couple of the raw materials that everybody is experiencing, that is a little higher than our overall expectations. Also, this year, labor inflation still remained high especially in the non-core US areas. Mexico being one of the areas that saw significant labor inflation. So those are the what I'd say the abnormal inflation in the year. As far as the pricing aspects, we do feel like when you look at in a full-year basis, it all levels out. But within periods, because we do give rebates to dealers and we also give discounts to distributors, you could have a little bit of abnormality as you work through the quarters. But overall, it usually comes right in on the forecasted number.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Okay. That's super helpful. Thanks a lot.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

A

Thank you.

Operator: And ladies and gentlemen, with that, we'll be concluding today's question-and-answer session. I'd like to turn the conference call back over to John Stauch, President and Chief Executive Officer, for closing remarks.

John L. Stauch

President, Chief Executive Officer & Director, Pentair plc

Thank you for joining us. In closing, I wanted to reiterate our key themes. First, solid execution across our balanced water portfolio, drove significant margin expansion for the ninth consecutive quarter. Second, we are increasing our 2024 ROS and adjusted EPS guidance, which reflects continued confidence in our strategy and our ability to mitigate risk where we can and maintain agility in a dynamic environment. Third, we expect our transformation in 80/20 initiatives to continue to drive strong margin expansion. And finally, we believe our focused water strategy and solid execution are building a foundation to continue to deliver value creation beyond the 2024 fiscal year. Thank you, everyone, and have a great day.

Operator: Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.

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