Watts Water (WTS)

$100.54 (As of 02/03/20)

Price Target (6-12 Months): **$106.00**

Long Term: 6-12 Months	**Zacks Recommendation:** (Since: 10/11/18) Prior Recommendation: Outperform	**Neutral**
Short Term: 1-3 Months	**Zacks Rank:** (1-5) Zacks Style Scores: Value: C | Growth: B | Momentum: B	**3-Hold** VGM:B

Summary

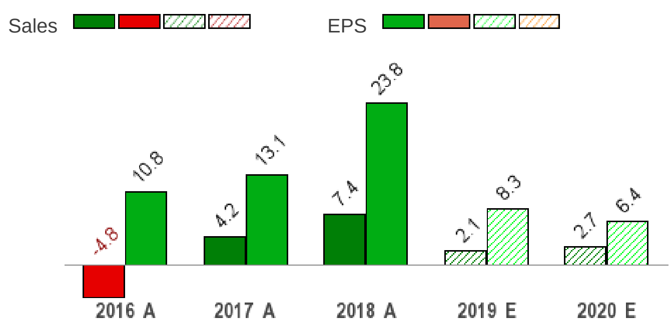
Watts Water remains focused on executing its balanced cash allocation strategy and enhancing shareholder value, while following a long-term strategy of expanding the business through a holistic growth model. It aims to maintain stringent quality control and testing procedures at each manufacturing facility, while striving to invest in product innovation. Higher volume and productivity improvement efforts contribute to the expansion of operating margin. Product development, key account management and geographic expansion are the primary growth drivers. However, softness in the fluid solutions platform exposes Europe segment to organic sales volatility. Material cost inflation due to various trade restrictions is likely to affect its margins in the near term. Increased organic investments also continue to weigh on Watts Water's revenues.

Price, Consensus & Surprise

Data Overview

52 Week High-Low	$103.10 - $72.35
20 Day Average Volume (sh)	110,667
Market Cap	$3.4 B
YTD Price Change	0.8%
Beta	1.15
Dividend / Div Yld	$0.92 / 0.9%
Industry	Instruments - Control
Zacks Industry Rank	Bottom 28% (183 out of 254)
Last EPS Surprise	1.0%
Last Sales Surprise	-0.8%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	02/10/2020
Earnings ESP	0.4%
P/E TTM	25.5
P/E F1	23.4
PEG F1	2.9
P/S TTM	2.2

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2020	401 E	430 E	407 E	410 E	1,641 E
2019	389 A	417 A	395 A	398 E	1,598 E
2018	379 A	408 A	391 A	388 A	1,565 A

EPS Estimates

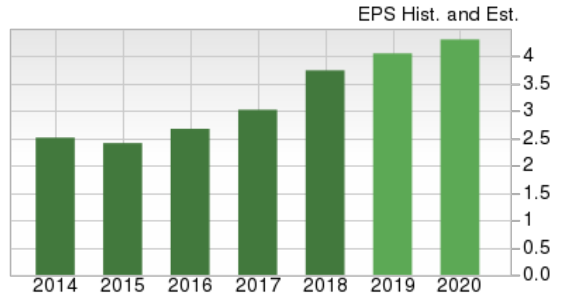
	Q1	Q2	Q3	Q4	Annual*
2020	$1.00 E	$1.15 E	$1.08 E	$1.03 E	$4.31 E
2019	$0.94 A	$1.09 A	$1.04 A	$0.99 E	$4.05 E
2018	$0.82 A	$1.05 A	$0.99 A	$0.88 A	$3.74 A

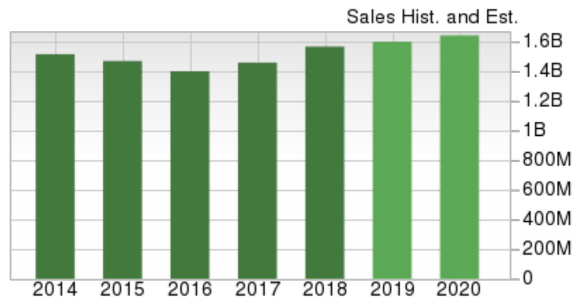
*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 02/03/2020. The reports text is as of 02/04/2020.

Overview

Headquartered in North Andover, MA, Watts Water Technologies, Inc. designs, manufactures and sells various water safety and flow control products for the water quality, water conservation, water safety, and water flow control markets. The company reports its business under three geographic segments: Americas (68.5% of third-quarter 2019 revenues), Europe (27.3%) and the newly formed APMEA consisting of Asia Pacific, Middle East, and Africa (4.2%).





Watts Water classifies its wide range of products under four universal product lines –

- Residential & commercial flow control products — includes products typically sold into plumbing and hot water applications such as backflow preventers, water pressure regulators, temperature and pressure relief valves, and thermostatic mixing valves.
- HVAC (heating, ventilation and air conditioning) & gas products — includes hydronic and electric heating systems for under-floor radiant applications, hydronic pump groups for boiler manufacturers and alternative energy control packages, and flexible stainless steel connectors for natural and liquid propane gas in commercial food service and residential applications.
- Drainage & water re-use products — includes drainage products and engineered rain water harvesting solutions for commercial, industrial, marine and residential applications.
- Water quality products — includes point-of-use and point-of-entry water filtration, conditioning and scale prevention systems for both commercial and residential applications.

These products are sold to wholesale distributors, original equipment manufacturers (OEMs) and major do-it-yourself (DIY) chains.

Reasons To Buy:

- Watts Water is focused on accelerating organic growth, drive margin expansion and reinvest in growth and productivity initiatives. Watts Water aims to launch smart and connected products, which are likely to provide it with further differentiation in the marketplace. Moreover, the company is committed to enhancing shareholder value and executing a balanced cash allocation strategy while following its long-term strategy of growing the business organically and through acquisitions. It has started to realize the expected benefits of portfolio rationalization, footprint optimization and global sourcing while simultaneously reinvesting for future growth. The company focuses on augmenting growth through new product development, geographic expansion and key account management. These initiatives are anticipated to be conducive to top-line growth and margin expansion in 2020 and beyond.

> Watts Water is committed to enhancing shareholder value and executing its balanced cash allocation strategy, while following a long-term strategy of expanding the business through holistic growth.

- Watts Water's operating margin expansion will likely be driven by higher volume and productivity increment efforts, including restructuring savings. The company continues to reinvest a portion of the productivity savings in selling and marketing, R&D and IT systems to fund future growth. The company believes Asia-Pacific segment's margin will expand primarily driven by higher volume. Furthermore, operating margin in the Americas segment will expand driven by volume leverage and productivity initiatives. Watts Water expects that its pricing actions should also help to partly mitigate commodity inflation. Thus, the company's pricing actions and restructuring benefits are expected to drive margins in 2020.

- Watts Water strives to invest in product innovation. Focus on differentiated product offerings provides greater opportunity to augment its market position. The company consistently looks for strategic opportunities to invest in new products. It also remains focused on maintaining stringent quality control and testing procedures at each manufacturing facilities. Over the past years, Watts Water has consistently invested in sales and marketing, and R&D to bring new products into the market. The acquisition of California-based manufacturing company Backflow Direct LLC is expected to cater a wide range of customers by leveraging broader product portfolio and R&D efforts.

Reasons To Sell:

Raw material inflation due to the potential imposition of tariffs, increased internal investments and product rationalization costs are likely to impact Watts Water's margins in the near term.

- Material cost inflation due to various trade restrictions is likely to affect Watts Water's margins in the near term. Transportation cost is also rising due to oil price increases and labor shortages. In case the company is unable to pass on increases in raw material to its customers in the future, its profitability will be affected.

- Watts Water's Europe segment remains exposed to volatility in its organic sales primarily due to softness in the fluid solutions platform, owing to decline in water, plumbing and heating, ventilation, and air conditioning (HVAC) products. In addition, the underlying trends in the Eurozone economy remain unclear. This might affect the company's growth trajectory and profitability going forward. Also, increased internal investments is likely to impact margin expansion in the near term.

- Management expects organic growth to moderate a bit in the first half of 2020, with all segments witnessing decelerating trends. In addition, margins are likely to remain under pressure due to adverse foreign currency translation with continued dollar strength. Soft economic growth in the Asian markets are further expected to erode the profitability of the company. With about a quarter of the raw materials reportedly sourced from China, continued bitter bilateral trade relations are further likely to increase the operating costs of the company.

Last Earnings Report

Watts Water Q3 Earnings Beat, Revenues Lag Estimates

Quarter Ending	09/2019
Report Date	Oct 30, 2019
Sales Surprise	-0.75%
EPS Surprise	0.97%
Quarterly EPS	1.04
Annual EPS (TTM)	3.95

Watts Water reported healthy third-quarter 2019 financial results, wherein both the top line and bottom line increased on a year-over-year basis. The results were primarily driven by strong operating performance, significant organic sales coupled with the acquisition of Backflow Direct LLC.

Net Income

On a reported basis, quarterly net income was $32.3 million or 94 cents per share, an increase of 2.5% from $31.5 million or 92 cents per share in the year-ago quarter. The improvement was mainly driven by higher prices, increased productivity and reduced non-operating expenses.

Adjusted net income was $35.6 million or $1.04 per share compared with $34 million or $99 cents per share a year ago. The bottom line beat the Zacks Consensus Estimate by a penny.

Revenues

On a reported basis, quarterly net sales increased 1% year over year to $394.7 million, driven by pricing actions and organic volume in the Americas and Europe. The top line lagged the Zacks Consensus Estimate of $398 million.

Organic sales witnessed growth of 2% year over year. Regionally, organic sales in the Americas increased 3%, driven by significant growth in plumbing, heating and water quality products. Organic sales improved 1.3% in Europe owing to strength in drains business. Asia Pacific Middle East and Africa (APMEA) organic sales increased 1.2%, primarily driven by stronger sales in China, partially offset by continued softness in Korea and Middle East.

Segmental Performance

The Americas: Net sales increased 2.9% to $270.3 million from $262.7 million in the year-ago quarter, driven by incremental price and higher volume. Adjusted operating income increased 8.7% to $48.8 million.

Europe: Net sales decreased 3.3% to $107.9 million from $111.6 million in the year-ago quarter, affected by negative foreign exchange momentum. The segment's adjusted operating income was $12.1 million compared with $12.8 million in the year-ago quarter, down 5.5% as the benefits from incremental price and productivity were subdued by increased investments and costs.

APMEA: Net sales decreased 0.6% to $16.5 million from $16.6 million. Adjusted operating income came in at $1.4 million compared with $2.5 million in the prior-year quarter, driven by a significant reduction in volume, investments and sales mix.

Other Details

Cost of goods sold declined 0.1% year over year to $226.1 million. Gross profit increased 2.5% to $168.6 million driven by top-line growth. Operating income was $48.8 million, up 4.1%. GAAP and adjusted operating margin came in at 12.4% and 13.3% respectively, both up 40 basis points.

Cash Flow & Liquidity

During the first nine months of 2019, Watts Water generated $94.9 million of net cash from operating activities compared with $66.6 million in the year-ago period. The increase was primarily driven by higher income and decrease in inventory and tax payments. As of Sep 29, 2019, the company had $173.7 million in cash and cash equivalents with $238.5 million of long-term debt (net of current portion).

Watts Water repurchased about 48,000 shares for $4.5 million during the reported quarter. It repatriated $7 million in cash during the quarter and used it to pay down revolving debt.

Going Forward

Watts Water is focused on accelerating organic growth, drive margin expansion and reinvest in growth and productivity initiatives. Adjusted effective tax rate is expected to be 28.5% for the fourth quarter. Operating cash flow and free cash flow are anticipated to improve due to normal seasonality. The acquisition of California-based manufacturing company Backflow Direct LLC is expected to cater a wide range of customers by leveraging broader product portfolio and R&D efforts. The company is also committed to enhance shareholder value and execute its balanced cash allocation strategy by driving the business organically and through acquisitions.

Valuation

Watts Water shares are up 33.3% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer and Technology sector are up 13.9% and 24.5% over the past year, respectively.

The S&P 500 index is up 17.7% in the past year.

The stock is currently trading at 3.62X trailing 12-month book value, which compares to 3.49X for the Zacks sub-industry, 5.49X for the Zacks sector and 4.44X for the S&P 500 index.

Over the past five years, the stock has traded as high as 3.7X and as low as 1.9X, with a 5-year median of 2.9X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our $106 price target reflects 29.28X trailing 12-month book value.

The table below shows summary valuation data for WTS

Valuation Multiples - WTS

		Stock	Sub-Industry	Sector	S&P 500
P/B TTM	Current	3.62	3.49	5.49	4.44
	5-Year High	3.68	5	5.61	4.54
	5-Year Low	1.93	2.84	3.13	2.85
	5-Year Median	2.89	3.49	4.23	3.62
P/E F12M	Current	23.19	16.95	22.16	18.61
	5-Year High	25.32	18.35	22.16	19.34
	5-Year Low	15.04	13.12	16.87	15.18
	5-Year Median	20.92	15.75	19.28	17.46
P/S F12M	Current	2.07	2.35	3.63	3.45
	5-Year High	2.12	2.42	3.63	3.45
	5-Year Low	1.09	1.53	2.3	2.54
	5-Year Median	1.53	2.04	3.02	3

As of 02/03/2020

Industry Analysis **Zacks Industry Rank:** Bottom 28% (183 out of 254)

Top Peers

Allied Motion Technologies, Inc. **(AMOT)**	Neutral
Badger Meter, Inc. **(BMI)**	Neutral
Roper Technologies, Inc. **(ROP)**	Neutral
Sensata Technologies Holding N.V. **(ST)**	Neutral
Thermon Group Holdings, Inc. **(THR)**	Neutral
Transcat, Inc. **(TRNS)**	Neutral
Woodward, Inc. **(WWD)**	Neutral
Xylem Inc. **(XYL)**	Neutral

Industry Comparison Industry: Instruments - Control

Industry Peers

	WTS Neutral	X Industry	S&P 500	BMI Neutral	THR Neutral	WWD Neutral
VGM Score	B	-	-	C	A	B
Market Cap	3.41 B	439.77 M	23.66 B	1.73 B	784.06 M	7.23 B
# of Analysts	7	2	13	2	1	5
Dividend Yield	0.92%	0.00%	1.82%	1.14%	0.00%	0.56%
Value Score	C	-	-	D	B	C
Cash/Price	0.05	0.05	0.04	0.02	0.05	0.01
EV/EBITDA	14.50	14.89	13.87	27.65	11.71	15.78
PEG Ratio	2.98	2.06	1.97	NA	NA	1.63
Price/Book (P/B)	3.62	3.24	3.24	5.36	2.21	4.18
Price/Cash Flow (P/CF)	19.32	16.09	13.40	25.03	10.98	15.80
P/E (F1)	23.80	21.41	18.48	33.83	17.73	21.41
Price/Sales (P/S)	2.15	1.79	2.60	4.11	1.83	2.44
Earnings Yield	4.28%	4.67%	5.40%	2.96%	5.64%	4.67%
Debt/Equity	0.25	0.36	0.72	0.00	0.57	0.50
Cash Flow ($/share)	5.20	2.28	6.92	2.38	2.18	7.38
Growth Score	B	-	-	B	A	A
Hist. EPS Growth (3-5 yrs)	12.50%	10.56%	10.80%	11.40%	-2.97%	14.30%
Proj. EPS Growth (F1/F0)	6.30%	10.44%	7.46%	8.64%	13.45%	11.60%
Curr. Cash Flow Growth	13.26%	18.54%	10.59%	17.43%	19.66%	26.08%
Hist. Cash Flow Growth (3-5 yrs)	6.66%	7.68%	8.55%	12.69%	4.39%	13.42%
Current Ratio	1.80	3.20	1.21	3.26	3.41	1.80
Debt/Capital	20.20%	25.79%	42.91%	0.00%	36.12%	33.37%
Net Margin	8.11%	6.96%	11.76%	10.95%	5.81%	8.89%
Return on Equity	14.70%	14.78%	17.24%	14.85%	10.91%	18.97%
Sales/Assets	0.95	0.85	0.55	1.04	0.65	0.75
Proj. Sales Growth (F1/F0)	2.68%	3.38%	4.22%	5.19%	2.91%	3.84%
Momentum Score	B	-	-	B	C	B
Daily Price Chg	0.83%	0.26%	0.67%	0.81%	1.01%	0.23%
1 Week Price Chg	-1.72%	-4.86%	-2.60%	-5.32%	-7.17%	-2.59%
4 Week Price Chg	1.22%	-5.16%	-0.76%	-6.38%	-10.37%	-2.70%
12 Week Price Chg	5.29%	-0.13%	2.84%	-0.25%	-11.27%	5.20%
52 Week Price Chg	33.79%	5.58%	13.93%	10.40%	3.10%	29.33%
20 Day Average Volume	110,667	60,286	1,915,782	173,936	86,289	686,649
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.03%	0.00%	0.00%	0.00%	0.00%	-1.27%
(F1) EPS Est 12 week change	0.03%	0.00%	-0.13%	0.00%	0.00%	-1.24%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	NA	0.00%	-3.26%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Value Score	C
Growth Score	B
Momentum Score	B
VGM Score	B

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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