

## Watts Water (WTS)

**\$86.38** (As of 06/03/20)

Price Target (6-12 Months): **\$73.00**

Long Term: 6-12 Months

**Zacks Recommendation:** Underperform

(Since: 06/02/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

**Zacks Rank:** (1-5)

**4-Sell**

Zacks Style Scores:

VGM:D

Value: D

Growth: C

Momentum: A

## Summary

Watts Water is likely to be affected by the Europe segment due to softness in the fluid solutions platform. Material cost inflation, resulting from potential trade restrictions due to latent trade war and the coronavirus-induced pandemic, is likely to affect the company's margins in the near term. Further, it has withdrawn its 2020 guidance due to uncertainties related to the coronavirus outbreak. Higher internal investments might impact margin expansion in the near future. Although management expects organic growth to moderate slightly in the first half of 2020, other segments are likely to witness decelerating trends. Soft economic growth in the Asian markets is expected to dent its profitability. However, Watts Water is focused on accelerating organic growth, driving margin expansion and reinvesting in growth and productivity initiatives.

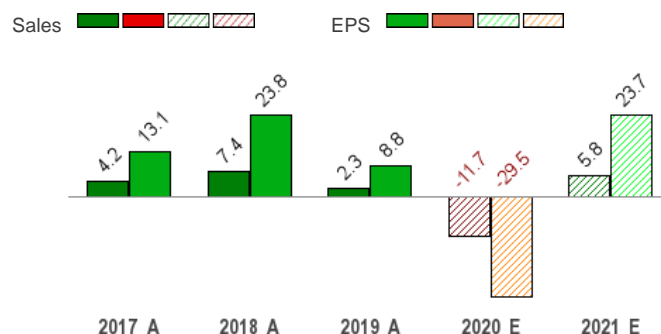
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	\$114.45 - \$69.02
20 Day Average Volume (sh)	162,860
Market Cap	\$2.9 B
YTD Price Change	-13.4%
Beta	0.92
Dividend / Div Yld	\$0.92 / 1.1%
Industry	<a href="#">Instruments - Control</a>
Zacks Industry Rank	Bottom 1% (252 out of 253)

## Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	10.5%
Last Sales Surprise	3.1%
EPS F1 Est- 4 week change	-23.0%
Expected Report Date	07/29/2020
Earnings ESP	0.0%
P/E TTM	21.2
P/E F1	30.1
PEG F1	3.8
P/S TTM	1.8

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	371 E	361 E	380 E	402 E	1,496 E
2020	383 A	306 E	341 E	379 E	1,414 E
2019	389 A	417 A	395 A	400 A	1,601 A

## EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.84 E	\$0.94 E	\$0.97 E	\$1.01 E	\$3.55 E
2020	\$0.95 A	\$0.33 E	\$0.65 E	\$0.84 E	\$2.87 E
2019	\$0.94 A	\$1.09 A	\$1.04 A	\$1.00 A	\$4.07 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 06/03/2020. The reports text is as of 06/04/2020.

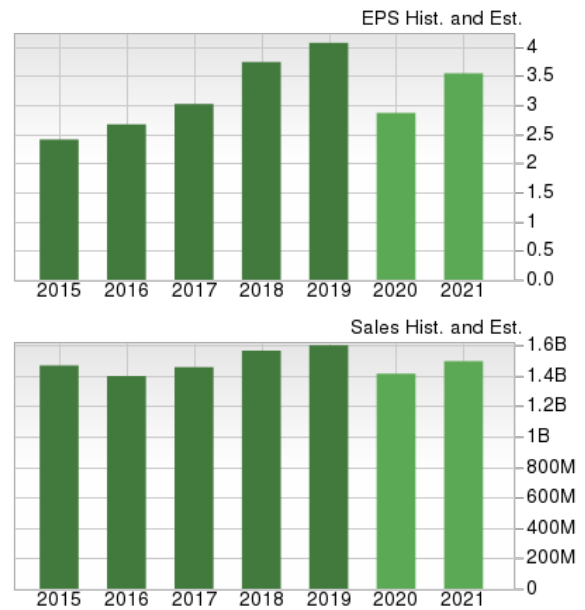
## Overview

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 (68.6% of total revenues in first-quarter 2020), Europe (28.8%) and APMEA consisting of Asia-Pacific, Middle East, and Africa (2.6%).

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.



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## Reasons To Sell:

- ▼ Material cost inflation, resulting from potential trade restrictions due to latent trade war and the coronavirus pandemic, 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.

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.

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## Risks

- 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.
  - 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.
  - 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.
  - As of Mar 31, the company had \$245.4 million in cash and equivalents and \$296.9 million of long-term debt (net of current portion) compared with respective tallies of \$220 million and \$204 million in the previous quarter. Watts Water currently has a debt-to-capital ratio of 0.28 compared with 0.51 of the sub-industry. Subsequent to the end of the quarter, Watts Water enhanced its financial flexibility by extending the existing credit facility. It has a low net debt leverage ratio of 0.5x. The company has also temporarily suspended the stock buyback program to preserve cash. The times interest earned has increased steadily over the past few quarters to 14.8 at present relative to 3.6 for the sub-industry. This shows that the company is more likely to clear its debt. Its dividend payout rate has increased sequentially from 22.1% to 22.5%, which indicates that the company is sharing more of its earnings with stockholders. It remains to be seen whether Watts Water can maintain the momentum in the coming days amid disruptions caused by the COVID-19 pandemic.
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## Last Earnings Report

### Watts Water Beats on Q1 Earnings Despite Lower Revenues

Watts Water reported relatively healthy first-quarter 2020 results, wherein the top and bottom lines surpassed the Zacks Consensus Estimate. However, it reported lower revenues year over year due to muted demand owing to the adverse impact of the coronavirus pandemic.

#### Net Income

On a reported basis, quarterly net income was \$32 million or 94 cents per share compared with \$31 million or 91 cents in the year-ago quarter. Better operating performances in all regions and lower operating costs despite top-line contraction drove the year-over-year growth.

First-quarter adjusted net income was \$32.3 million or 95 cents per share compared with \$32 million or 94 cents in the year-earlier quarter. The bottom line surpassed the Zacks Consensus Estimate by 9 cents.

#### Revenues

On a reported basis, quarterly net sales decreased 1.6% year over year to \$382.6 million, driven by lower demand due to the virus outbreak. The top line, however, surpassed the Zacks Consensus Estimate of \$371 million. Organic sales declined 1% year over year.

#### Quarterly Segment Results

**Americas:** Net sales increased 1.3% year over year to \$262.4 million. Organic sales remained relatively flat as growth in drains, water quality, heating and hot water products was offset by lower sales of fluid solution products. Adjusted operating income grew 1.6% to \$43.8 million owing to benefits from price and productivity savings. However, these were offset by lower volumes, higher investments and inflation.

**Europe:** Net sales decreased 5.2% to \$110.2 million, affected by foreign exchange movements. Organic sales were down 2% in Europe as strength in the company's drains platform was more than offset by lower fluid solution product sales. The segment's adjusted operating income was \$13.7 million compared with \$14.6 million in the year-ago quarter. This was mostly led by lower volumes, higher investments and inflation.

**Asia-Pacific, Middle East and Africa (APMEA):** Net sales decreased 25.5% to \$10 million. It witnessed a contraction with lower organic sales across all regions, except for Korea and New Zealand. Adjusted operating loss came in at \$0.1 million against adjusted operating income of \$1.3 million in the prior-year quarter. This was mostly driven by lower volumes triggered by the virus outbreak, higher investments and inflation.

#### Other Details

Cost of goods sold in the first quarter decreased 2.1% year over year to \$219.8 million, while gross profit was down to \$162.8 million from \$164.2 million in the prior-year quarter. Operating income was \$47.8 million, up 2.4%. GAAP operating margin was up 50 basis points (bps) to 12.5%, while adjusted operating margin was 12.6%, up 20 bps.

#### Cash Flow & Liquidity

Watts Water utilized \$0.9 million of net cash for operating activities in first-quarter 2020 compared with net cash utilization of \$24.2 million in the year-ago quarter. The improvement was primarily attributable to better working capital management and incremental profit. As of Mar 31, the company had \$245.4 million in cash and equivalents and \$296.9 million of long-term debt (net of current portion).

Subsequent to the end of the quarter, Watts Water enhanced its financial flexibility by extending the existing credit facility. It has a low net debt leverage ratio of 0.5x. The company repurchased about 175,000 shares for \$14.7 million during the quarter. The company has temporarily suspended the stock buyback program to preserve cash.

#### Guidance Withdrawn

The company expects near-term volatility to continue due to the coronavirus-led pandemonium despite the underlying strength of the resilient business model and the diligent execution of operational plans. With uncertainty over the impact of coronavirus on long-term revenues and visibility, management decided to withdraw guidance for 2020. Watts Water is undertaking various cost management initiatives to tide over the storm. These include cost actions through headcount reductions, furloughs and reduced discretionary spending, along with cash preservation efforts through suspension of share repurchase program and reduced planned capital spending.

Quarter Ending **03/2020**

Report Date	May 06, 2020
Sales Surprise	3.12%
EPS Surprise	10.47%
Quarterly EPS	0.95
Annual EPS (TTM)	4.08

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## Valuation

Watts Water shares are up 0.7% over the trailing 12-month period. Stocks in the Zacks sub-industry are down 19.7% over the past year, but stocks in the Zacks Computer and Technology sector are up 25.5% in the same time frame.

The S&P 500 Index is up 9.1% in the past year.

The stock is currently trading at 3.01X trailing 12-month book value, which compares to 2.34X for the Zacks sub-industry, 5.44X for the Zacks sector and 4.21X for the S&P 500 Index.

Over the past five years, the stock has traded as high as 3.75X and as low as 1.93X, with a 5-year median of 2.93X. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$73 price target reflects 24.25X 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	3.01	2.34	5.44	4.21
	5-Year High	3.75	4.85	5.44	4.56
	5-Year Low	1.93	1.82	3.16	2.83
	5-Year Median	2.93	3.47	4.32	3.66
P/E F12M	Current	27.37	20.17	24.69	22.29
	5-Year High	27.59	20.17	24.69	22.29
	5-Year Low	15.04	12.28	16.72	15.23
	5-Year Median	20.9	15.7	19.26	17.49
P/S F12M	Current	2.02	1.98	3.75	3.47
	5-Year High	2.23	2.42	3.75	3.47
	5-Year Low	1.09	1.53	2.32	2.53
	5-Year Median	1.56	2.02	3.11	3.02

As of 06/03/2020

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## Industry Analysis Zacks Industry Rank: Bottom 1% (252 out of 253)



## Top Peers

Company (Ticker)	Rec	Rank
Badger Meter, Inc. (BMI)	Neutral	3
Roper Technologies, Inc. (ROP)	Neutral	3
Thermon Group Holdings, Inc. (THR)	Neutral	3
Allied Motion Technologies, Inc. (AMOT)	Underperform	5
Sensata Technologies Holding N.V. (ST)	Underperform	5
Transcat, Inc. (TRNS)	Underperform	5
Woodward, Inc. (WWD)	Underperform	5
Xylem Inc. (XYL)	Underperform	5

Industry Comparison Industry: Instruments - Control				Industry Peers		
	WTS	X Industry	S&P 500	AMOT	BMI	THR
Zacks Recommendation (Long Term)	Underperform	-	-	Underperform	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	5	3	3
VGM Score	D	-	-	D	B	A
Market Cap	2.91 B	360.47 M	22.50 B	360.47 M	1.87 B	515.17 M
# of Analysts	8	2	14	2	2	1
Dividend Yield	1.07%	0.00%	1.88%	0.32%	1.06%	0.00%
Value Score	D	-	-	F	D	B
Cash/Price	0.09	0.08	0.06	0.06	0.04	0.07
EV/EBITDA	12.12	10.86	12.98	10.82	20.96	8.10
PEG Ratio	3.73	3.77	3.05	4.18	NA	NA
Price/Book (P/B)	3.01	2.49	3.11	2.92	5.58	1.48
Price/Cash Flow (P/CF)	15.75	14.22	12.18	10.79	26.26	9.35
P/E (F1)	29.82	32.33	22.19	41.84	40.59	41.13
Price/Sales (P/S)	1.83	1.52	2.40	0.98	4.37	1.34
Earnings Yield	3.32%	3.09%	4.31%	2.38%	2.47%	2.43%
Debt/Equity	0.31	0.35	0.76	1.12	0.00	0.51
Cash Flow (\$/share)	5.48	2.16	7.01	3.43	2.45	1.67
Growth Score	C	-	-	D	A	B
Hist. EPS Growth (3-5 yrs)	13.92%	12.72%	10.87%	11.80%	13.64%	1.41%
Proj. EPS Growth (F1/F0)	-29.55%	-29.17%	-10.74%	-53.17%	-1.55%	-49.33%
Curr. Cash Flow Growth	5.03%	4.02%	5.48%	19.18%	3.00%	-22.68%
Hist. Cash Flow Growth (3-5 yrs)	6.29%	6.08%	8.55%	9.30%	8.54%	4.39%
Current Ratio	2.09	3.34	1.29	2.64	3.50	3.59
Debt/Capital	23.48%	25.69%	44.75%	52.82%	0.00%	33.69%
Net Margin	8.31%	4.58%	10.59%	4.49%	11.26%	3.11%
Return on Equity	14.59%	13.73%	16.29%	15.13%	14.76%	6.80%
Sales/Assets	0.93	0.83	0.55	1.17	1.02	0.59
Proj. Sales Growth (F1/F0)	-11.66%	-5.82%	-2.65%	-5.82%	0.64%	-21.25%
Momentum Score	A	-	-	B	C	A
Daily Price Chg	3.12%	2.39%	2.42%	3.12%	2.88%	9.76%
1 Week Price Chg	4.55%	0.51%	4.60%	6.19%	0.15%	2.89%
4 Week Price Chg	6.62%	7.20%	13.40%	34.75%	12.29%	7.79%
12 Week Price Chg	-5.24%	-1.19%	12.78%	16.59%	13.24%	9.45%
52 Week Price Chg	0.69%	-0.97%	0.89%	8.34%	16.88%	-30.60%
20 Day Average Volume	162,860	94,665	2,528,787	51,531	137,800	153,368
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-23.02%	-4.94%	-0.14%	-46.85%	0.00%	0.00%
(F1) EPS Est 12 week change	-33.49%	-34.69%	-16.00%	-58.84%	-9.77%	-69.60%
(Q1) EPS Est Mthly Chg	-58.18%	-25.56%	-0.02%	-87.88%	0.00%	0.00%

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## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

### Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

### Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

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### 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.

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.

Value Score	D
Growth Score	C
Momentum Score	A
VGM Score	D

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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