

## Watts Water (WTS)

**\$88.97** (As of 08/06/20)

Price Target (6-12 Months): **\$102.00**

Long Term: 6-12 Months

**Zacks Recommendation:**

**Outperform**

(Since: 08/06/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

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

**1-Strong Buy**

Zacks Style Scores:

VGM:F

Value: F

Growth: F

Momentum: F

### Summary

Watts Water reported relatively healthy second-quarter 2020 results, with the top and the bottom line surpassing the Zacks Consensus Estimate. The company is committed to boost its long-term strategy of growing business organically and through acquisitions. The recent acquisition of Australian Valve Group Pty Ltd is expected to boost its profitability. It is focused on driving organic growth and reinvesting in productivity engines with a balanced cash allocation strategy. Watts Water's operating margin is likely to be driven by higher volume and productivity increment efforts in the upcoming quarters. Geographic expansion and differentiated product offerings augment its market position. However, the company is likely to be hurt by near-term volatility due to the COVID-19-led pandemonium. As a result, Watts Water withdrew its guidance for 2020.

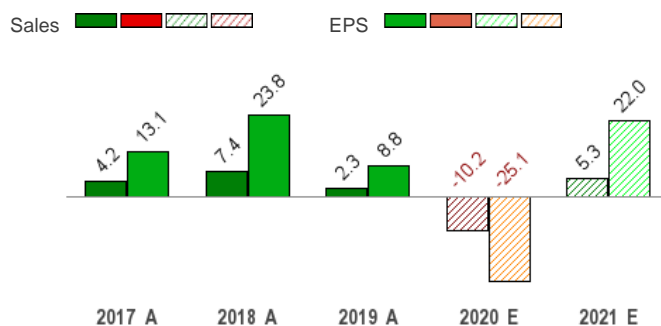
### Price, Consensus & Surprise



### Data Overview

52 Week High-Low	\$114.45 - \$69.02
20 Day Average Volume (sh)	130,953
Market Cap	\$3.0 B
YTD Price Change	-10.8%
Beta	0.90
Dividend / Div Yld	\$0.92 / 1.0%
Industry	<a href="#">Instruments - Control</a>
Zacks Industry Rank	Bottom 16% (211 out of 252)

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



Last EPS Surprise	89.7%
Last Sales Surprise	6.8%
EPS F1 Est- 4 week change	6.8%
Expected Report Date	11/04/2020
Earnings ESP	6.3%
P/E TTM	23.9
P/E F1	29.2
PEG F1	3.7
P/S TTM	2.0

### Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	381 E	377 E	388 E	391 E	1,514 E
2020	383 A	339 A	350 E	374 E	1,438 E
2019	389 A	417 A	395 A	400 A	1,601 A

### EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.89 E	\$0.91 E	\$1.01 E	\$0.99 E	\$3.72 E
2020	\$0.95 A	\$0.74 A	\$0.74 E	\$0.87 E	\$3.05 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 08/06/2020. The reports text is as of 08/07/2020.

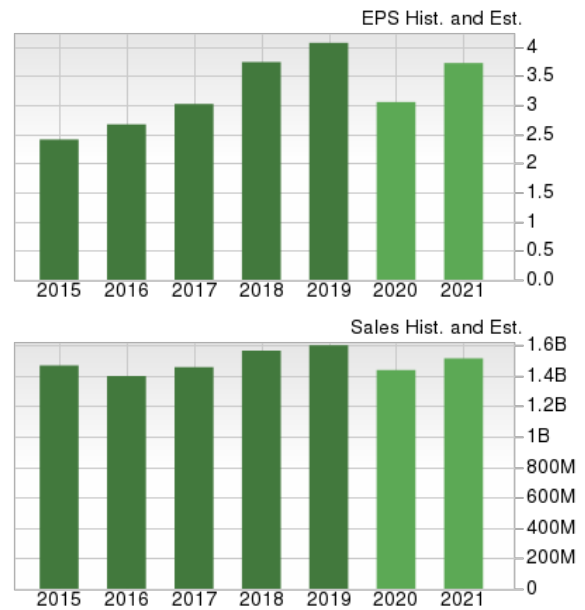
## Overview

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 (70.1% of total revenues in second-quarter 2020), Europe (26%) and APMEA consisting of Asia-Pacific, Middle East, and Africa (3.9%).

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 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.

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.

▲ 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. The company also acquired Australian Valve Group Pty Ltd (AVG) in an all-cash transaction on Jul 3.

▲ As of Jun 28, the company had \$148.7 million in cash and cash equivalents with \$262.5 million of long-term debt compared with the respective tallies of \$245 million and \$297 million at the end of the previous quarter. Watts Water currently has a debt-to-capital ratio of 0.28 compared with 0.51 of the sub-industry. This signifies that the company is more likely to fulfill its debt obligations in the near term. Also, it has a low net debt leverage ratio of 0.5x. Contrary to the prior practice of suspending the stock buyback program, Watts Water restored the share repurchase program effective Jun 29. The times interest earned (TIE) ratio is 12.8 compared with 3.7 of the sub-industry. This shows that the company is more likely to meet its financial obligations. It is to be seen whether Watts Water can sustain the momentum in the coming days amid disruptions caused by the COVID-19 crisis.

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## Risks

- 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.
  - On a year-over-year basis, management expects organic revenues to decline at a rate of 8-12% in third quarter 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.
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## Last Earnings Report

### Watts Water Q2 Earnings and Revenues Surpass Estimates

Despite coronavirus-induced adversities, Watts Water reported relatively healthy second-quarter 2020 results, with the top and the bottom line surpassing the Zacks Consensus Estimate. However, it witnessed top-line contractions due to lower demand triggered by the adverse impact of the coronavirus pandemic.

#### Net Income

On a reported basis, quarterly net income was \$20.2 million or 59 cents per share compared with \$36.4 million or \$1.06 per share in the year-ago quarter. The year-over-year decline was primarily caused due to top-line contraction.

Second-quarter adjusted net income was \$25.2 million or 74 cents per share compared with \$37.3 million or \$1.09 per share in the year-earlier quarter. The bottom line surpassed the Zacks Consensus Estimate by 35 cents.

#### Revenues

On a reported basis, quarterly net sales declined 18.7% year over year to \$338.7 million, driven by lower demand due to the virus outbreak. Nevertheless, the top line surpassed the Zacks Consensus Estimate of \$317 million. Organic sales declined 18.6% year over year.

#### Quarterly Segment Results

**Americas:** Net sales fell 17.3% year over year to \$237.4 million. Organic sales declined 18% due to weak demand of drains and heating, plumbing and hot water products. Adjusted operating income dropped 30% to \$35.5 million as benefits from price and productivity savings on the back of cost saving initiatives were more than offset by higher investments and lower volumes due to COVID-19 impact.

**Europe:** Net sales declined 22.2% year over year to \$88.1 million, affected by foreign exchange movements. Organic sales were down 21% with major declines in all regions and product lines owing to the global pandemic. The segment's adjusted operating income was \$8.9 million compared with \$14.1 million in the year-ago quarter. This was mostly led by lower volumes and higher investments, partially offset by productivity and cost-saving initiatives.

**Asia-Pacific, Middle East and Africa (APMEA):** Net sales dropped 20.5% to \$13.2 million. Organic sales declined 18% due to lower demand in most regions owing to COVID-19 pandemic. Adjusted operating income came in at \$1.7 million compared with \$1.2 million in the prior-year quarter. The year-over-year improvement was mainly driven by productivity initiatives and higher affiliate volume. However, it was partially offset by higher investments and lower third-party volume due to COVID-19 impact.

#### Other Details

Cost of goods sold in the second quarter fell 15.9% year over year to \$203.8 million, while gross profit was down to \$134.9 million from \$174.6 million in the prior-year quarter. Operating income was \$31 million, down 42.9%. GAAP operating margin was down 380 basis points (bps) to 9.2%, while adjusted operating margin was 11.1%, down 220 bps. The company recorded \$6.7 million of restructuring and impairment charges.

#### Cash Flow & Liquidity

For the first six months of fiscal 2020, Watts Water generated \$47.3 million of net cash from operating activities compared with \$19.7 million in the year-ago quarter. Free cash flow came in at \$25 million in the first half of the year compared with \$5.4 million in the prior-year period. The improvement was primarily attributable to lower working capital requirements. As of Jun 28, the company had \$148.7 million in cash and equivalents and \$262.5 million of long-term debt (net of current portion).

Watts Water has a low net debt leverage ratio of 0.5x. The company repurchased about 79,000 shares for \$6.4 million during the quarter. The company restored the share repurchase program effective Jun 29, 2020. Impressively, the company repatriated nearly \$56 million in the reported quarter and leveraged a significant chunk of the amount to reduce its debt load.

#### Moving Ahead

Although the company has not provided a definitive financial outlook for third quarter 2020, 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. Notably, the company has acquired Australian Valve Group Pty Ltd (AVG) in an all-cash transaction on Jul 3.

As stated in the previous quarter, management decided to withdraw guidance for 2020 owing to uncertainty over the impact of coronavirus on long-term revenues and visibility. Nevertheless, Watts Water expects sales and margins to improve in the next quarter compared with second quarter 2020. On an organic basis, revenues are expected to witness a year-over-year decline of 8-12%. Further, the company has undertaken various cost-management initiatives to tide over the storm. These include cost actions through headcount reductions, furloughs and reduced discretionary spending.

Quarter Ending **06/2020**

Report Date	Aug 03, 2020
Sales Surprise	6.84%
EPS Surprise	89.74%
Quarterly EPS	0.74
Annual EPS (TTM)	3.73

## Recent News

On Jul 8, 2020, Watts Water announced that through its partnership with Planet Water Foundation it has funded the installation of AquaTower water filtration systems at two schools in Aguascalientes, Mexico. This will provide clean drinking water for children and families in need.

On Jun 30, Watts Water announced that it has published its 2019 Sustainability Report. The report highlights the company's key achievements in environmental, social and governance (ESG) practices such as reduced consumption of natural resources, adopting eco-friendly portfolio of products and solutions along with providing clean water access to underserved communities.

## Valuation

Watts Water shares are down 5.9% over the trailing 12-month period. Stocks in the Zacks sub-industry are down 15% over the past year, but stocks in the Zacks Computer and Technology sector are up 34.3% in the same period.

The S&P 500 Index is up 13.5% in the past year.

The stock is currently trading at 3.1X trailing 12-month book value, which compares to 2.75X for the Zacks sub-industry, 6.29X for the Zacks sector and 4.54X for the S&P 500 Index.

Over the past five years, the stock has traded as high as 3.75X and as low as 2.02X, with a 5-year median of 2.94X. Our Outperform recommendation indicates that the stock will perform better than the market. Our \$102 price target reflects 32.90X 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	3.1	2.75	6.29	4.54
	5-Year High	3.75	4.5	6.29	4.56
	5-Year Low	2.02	1.9	3.16	2.83
	5-Year Median	2.94	3.46	4.41	3.73
P/E F12M	Current	26.79	20.82	26.36	22.69
	5-Year High	28.86	20.82	26.36	22.69
	5-Year Low	15.04	12.28	16.72	15.25
	5-Year Median	20.94	15.7	19.47	17.55
P/S F12M	Current	2.03	2.16	4.08	3.63
	5-Year High	2.23	2.42	4.08	3.63
	5-Year Low	1.09	1.53	2.32	2.53
	5-Year Median	1.6	2.03	3.14	3.04

As of 08/06/2020

## Industry Analysis Zacks Industry Rank: Bottom 16% (211 out of 252)



## Top Peers

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

Industry Comparison Industry: Instruments - Control				Industry Peers		
	WTS	X Industry	S&P 500	AMOT	BMI	THR
Zacks Recommendation (Long Term)	Outperform	-	-	Neutral	Underperform	Neutral
Zacks Rank (Short Term)	1	-	-	3	5	3
VGM Score	F	-	-	F	C	C
Market Cap	3.00 B	406.73 M	23.20 B	406.73 M	1.91 B	463.71 M
# of Analysts	7	3	14	2	2	1
Dividend Yield	1.03%	0.00%	1.78%	0.29%	1.04%	0.00%
Value Score	F	-	-	D	D	C
Cash/Price	0.09	0.09	0.07	0.06	0.05	0.10
EV/EBITDA	12.33	11.36	13.21	11.70	21.23	9.70
PEG Ratio	3.65	3.64	2.94	4.72	NA	NA
Price/Book (P/B)	3.05	2.51	3.12	3.22	5.60	1.33
Price/Cash Flow (P/CF)	16.23	14.13	12.27	12.16	26.79	8.41
P/E (F1)	29.17	29.13	21.69	47.16	43.75	28.10
Price/Sales (P/S)	1.98	1.58	2.48	1.12	4.60	1.33
Earnings Yield	3.43%	3.43%	4.39%	2.11%	2.29%	3.56%
Debt/Equity	0.27	0.36	0.77	1.02	0.00	0.51
Cash Flow (\$/share)	5.48	2.22	6.94	3.43	2.45	1.67
Growth Score	F	-	-	D	A	C
Hist. EPS Growth (3-5 yrs)	13.92%	12.85%	10.46%	11.80%	13.89%	3.96%
Proj. EPS Growth (F1/F0)	-24.96%	-28.79%	-6.80%	-53.17%	-6.83%	-33.33%
Curr. Cash Flow Growth	5.03%	4.02%	5.39%	19.18%	3.00%	-22.68%
Hist. Cash Flow Growth (3-5 yrs)	6.29%	6.29%	8.55%	9.30%	8.54%	-1.48%
Current Ratio	2.39	3.13	1.33	2.69	3.56	3.59
Debt/Capital	21.04%	26.17%	44.50%	50.43%	0.00%	33.69%
Net Margin	7.67%	4.18%	10.13%	4.14%	11.15%	1.26%
Return on Equity	13.15%	12.03%	14.39%	13.36%	13.93%	4.46%
Sales/Assets	0.89	0.81	0.51	1.12	0.97	0.54
Proj. Sales Growth (F1/F0)	-10.17%	-5.53%	-1.51%	-5.82%	-5.24%	-21.20%
Momentum Score	F	-	-	D	F	B
Daily Price Chg	-0.78%	0.00%	-0.04%	5.32%	1.45%	-3.83%
1 Week Price Chg	-0.55%	-0.72%	0.14%	4.26%	-0.89%	-5.38%
4 Week Price Chg	12.85%	8.83%	7.78%	29.23%	6.34%	8.08%
12 Week Price Chg	21.18%	19.68%	17.48%	48.17%	20.14%	7.25%
52 Week Price Chg	-5.99%	0.85%	0.68%	15.94%	19.55%	-40.19%
20 Day Average Volume	130,953	76,779	2,057,775	22,605	149,746	143,384
(F1) EPS Est 1 week change	4.24%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	6.84%	0.00%	1.36%	0.00%	-5.36%	0.00%
(F1) EPS Est 12 week change	-9.44%	-2.41%	1.57%	0.00%	-5.36%	31.58%
(Q1) EPS Est Mthly Chg	14.95%	-1.62%	0.54%	0.00%	-3.75%	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	F
Growth Score	F
Momentum Score	F
VGM Score	F

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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