Zurn Water Solutions Update

Company Participants

- Dave Pauli, Vice President of Investor Relations
- Todd Adams, Chairman & Chief Executive Officer

Other Participants

- Bryan Blair, Analyst
- Jeff Higgins, Analyst
- Mig Dobre, Analyst

Presentation

Operator

Good morning. Welcome to the Zurn Water Solutions Corporation Update call with Todd Adams, chairman and chief executive officer, Mark Peterson, senior vice president and chief financial officer, and Dave Pauli, vice president of investor relations for Zurn Water Solutions.

This call is being recorded and will be available on replay for a period of one week. The phone numbers for the replay can be found in the 8K the company filed with the SEC this morning. At this time for opening remarks and introduction, I'll turn the call over to the Dave Pauli.

Dave Pauli {BIO 6582234 <GO>}

Good morning, everyone, and thank you for joining the call this morning on short notice. While we just provided an update two weeks ago, given our announcement this morning we wanted to take some time to walk you through the transaction and answer any questions.

Before we start I would like to remind you that this call will include certain forward-looking statements that are subject to the safe harbor language contained in the 8K that we filed this morning as well as in our other SEC filings. In addition, we will -- we will refer to non-GAAP measures.

Our SEC filings contain additional information about these non-GAAP measures, why we use them, and why we believe they are helpful to investors. We will -- we will refer to certain non-GAAP metrics as we feel they assist in providing a better understanding of the transaction.

These measures are not a substitute for GAAP and we encourage you to review the GAAP information in our SEC filings. With that, I'll turn the call over to Todd Adams, chairman and CEO of Zurn Water Solutions.

Todd Adams {BIO 4654034 <GO>}

Thanks, Dave. Good morning, everyone. As Dave said, thanks for joining us on relatively short notice. We know the Monday after the Super Bowl people are generally moving a little bit slow. But it's a really exciting day for us. So we'll try to get through this efficiently and then take some of your questions.

If we could start on page one. It was almost exactly a year ago when we announced the RNP [ph] transaction of our PMC business with Regal Rexnord. The intent was to maximize shareholder value by unlocking the embedded value of PMC by merging that with a strategic partner.

But even more so it was to create a pure-play water business, and we could scale and grow both organically and inorganically. The word transformative is usually just a little cliché for my liking but in this case; I think it's fairly appropriate. We're bringing together two iconic brands that serve the same end markets with complementary products, shared values, and cultures.

And in doing so we create a clear leader in water solutions in North America. The synergy opportunity is relatively straightforward and achievable. And by the time we get to 2023, which will be only a few months away after this transaction closes, the new Zurn Elkay will essentially double the size of what Zurn is today with the same elite financial profile we currently have.

The structure of the transaction is also very unique. Ron Katz, the majority shareholder as well as other Elkay shareholders are taking stock as consideration and will be long-term shareholders of the combined business.

I want to thank Ron and Tim Jahnke, the current chairman of Elkay and former CEO as well as the entire Elkay team for believing in the power of what we can do together. A mantra we've shared throughout this entire process of finding this deal was together we can create a far better business.

I think if you're here this morning and seeing the future we're truly putting ourselves in a position just to do that -- to do just that. But finally, I want to welcome all the Elkay associates to the new Zurn Elkay Water Solutions. It's going to be a lot of fun bringing our two companies together.

If you could turn to page two. This page lays out the funnel -- fundamental aspects of the transaction. Elkay shareholders will see -- receive up to 52.5 million common shares upon the close of the transaction subject to customary lock ups and (inaudible) agreements.

The only way this really came together was that the current Elkay shareholders are truly long-term shareholders, and believe in the long-term shareholder value creation opportunity by coming together. And frankly, weren't sellers of the business for cash. In fact, one of their core values is we're in business forever.

And in this scenario, they have demonstrated that value in spades by partnering us in the way they have. From the headline evaluation perspective, those shares after the close of Friday were worth 1.56 billion, which implies a transaction multiple of 14.2 times on 2022 EBITDA before synergies and 9.8 times pro forma for the expected synergies of $50 million.

As a result of the merger, we end up with an even stronger, more flexible balance sheet with leverage at approximately one times by the end of 2022. The combined cash flow of the business will be outstanding, and puts us in place to continue to invest organically, inorganically, and return cash [ph] to shareholders through a disciplined capital allocation strategy.

Upon the close, we plan to significantly increase the dividends to 7 cents a quarter initially and with room to increase it over time. We'll be expanding our board to 11, adding two members from the current Elkay board. And Elkay will continue to be run by its current president Ted Hamilton.

We expect the close to be sometime in late Q2 or early Q3 of this year. And we'll reflect the significance of this transaction and our new name Zurn Elkay Water Solutions. If you could just turn to page three. I think the headline here says it all.

The combined business will have over 75% of its revenues from fairly clear number one market positions and approximately 95% from a number of very strong number two market positions. In 2022 stand-alone Elkay is projected to do around 700 million in revenues with over half in clean drinking water solutions and growing as a percentage of the total.

They are also the number one manufacturer of sinks in the country for both commercial and residential applications, which fits extremely well within the hygienic and environmental sector of our current portfolio. We've often discussed the importance of specifications in our efforts to continue to grow Zurn's spec share.

Elkay has employed that same approach around product specification throughout the years, and has a very strong spec share within both drinking water and sinks. Making it -- a combined Zurn Elkay a clear leader in terms of specifications. The history of Elkay in many ways mirrors our own.

A family business started in Chicago by Ron's father over 100 years ago with amazing leadership positions in the marketplace, with a stellar reputation for quality, innovation, and customer service. Our shared values and cultures provide an ideal backdrop to integrate the two businesses.

Leveraging the Zurn business system to create a common language and drive a philosophy to continue its improvement in every aspect of our business. As we alluded to in the release, the strategic merit to this combination is off the charts. And starting today we'll turn our efforts to rigorously plotting the integration to turn the power of this combination into a reality.

I'm now on page four. Across the board, the pro forma combined business is materially larger and better with even more room to grow, even more balance from the new construction, and retrofit perspective. Our end-market mix tilts more strongly to the resilience and growing institutional end market, specifically within the education and healthcare verticals.

Largely as a function of the Elkay drinking water exposure where Elkay is clearly the market leader and without question considered the gold standard. The benefit to the marketplace and our customers is that the specified content per square foot we can bring to the market is unparalleled.

Which results in us being by far a more cost-effective solution in both new build -- in the new build process, as well as our ability to bring holistic solutions to manage water inside non-residential buildings.

We can leverage our connected solutions more expansibly [ph] to include the Elkay portfolio with our bright shared [ph] solution, and also see one way to grow the filtration aspects of the drinking water business, and to a larger recurring revenue opportunity.

I'll move on to page five. What you see on the right, we expand into clean drinking water and it will be approximately 21% of the combined business. And that will grow considerably as a percentage over the next few years to at least 25% of the total. And it grows faster than the (inaudible) growth rate.

Elkay has seen their clean drinking water sales grow at 12% compounded over the last 10 years. Hygienic and environmental solutions will comprise about a third of the business, and this is where we still have ample room to take share and its, frankly, the area where we don't currently have the number one position in certain product categories.

But at a strong true [ph] organic plan that continues to advance and we have significant opportunities leveraging our connected solutions. And finally, 45% of the business will be in water safety and control, and flow solutions where we have very high relative market shares, and continue to expand into adjacencies.

As this transaction closes we end up covering the entire gamut of water solutions for health, human safety, and the environment within public and private spaces advancing the ESG goals of our customers in meaningful and tangible ways.

I'm now on page six. There probably aren't too many people in the country that wouldn't recognize Elkay's presence in drinking water. The bottle filler is becoming ubiquitous in virtually every building they're in. Whether it's an office building, school, healthcare facility, airport, stadium, or hotel this is a category that's simply booming.

Replacing traditional water fountains and water coolers on a day-to-day basis. Or as we say in Wisconsin, we're replacing bubblers. Water has quickly become the beverage of choice. With continuous filtered water being by far the superior choice to bottled water from both a conservation and health perspective.

Since 2010, Elkay bottle fillers have saved an estimated 37 billion plastic bottles from ending up in landfills while dispensing nearly 5 billion gallons of clean drinking water.

So the dynamic here is there is a large, fast-growing market around water as the beverage choice. More and more bottle fillers are being installed to meet that demand and there's an installed base of traditional fountains and bubblers that need to be retroplaced -- retrofit or replaced.

There's a predictable three to five-year replacement cycle for bottle fillers. On top of that, the filtration of that water is something that we believe we can capitalize in a big way over time, providing users and building owners confidence that the water people are drinking is both safe from contaminants and the right choice for both the health and environmental perspective.

If you could move to page 7, please.

I'll touch briefly on the synergies we expect from the combinations. We're targeting $50 million initially, with half in the first full year of 2023 and the remainder in 2024. These are cost synergies alone. And believe the sales synergy should be on top of this. We're not going to talk about that now, but suffice it to say we certainly expect this transaction to be accretive for our individual growth rates.

If you look at it from a quantitative perspective, Zurn standalone EBITDA margins for -- in 2021 were 25.8 per segment level. In 2022 we expect the Zurn Elkay margins to be in the 16% range. If you were to apply all the synergies to Elkay which won't be the case, but for simplicity sake let's use that, pro forma margins in 2022 were at [ph] 23%. So clearly, well within something we've achieved and very much in line with what you'd expect by putting these two highly complementary businesses together.

What that translates to from a return on investment capital perspective is that this transaction delivers a 10% return on investment capital by the end of 2025 to essentially the first full year three.

The realities to -- the reality of these two highly complementary businesses that serve the same end markets, coupled with leveraging the Zurn business system to drive the combined strategic plan, leverage proven processes across a larger platform and drive superior customer satisfaction and associate engagement give us a lot of confidence. The synergy benefits we've outlined will improve the bottom line and make this transaction a home run from a financial perspective.

Just quickly on page 8.

Doubling the business with a similar financial profile we have today is something we felt was very achievable over a few years when we announced the R&P [ph] just a year ago. The reality is, it's going to come a little quicker that maybe even we anticipated.

But if you follow the way we've chosen to grow our business, which is to continually cultivate proprietary opportunities while executing a long-term organic strategic plan, implementing [ph] capital on the exact timeline of our choosing.

The thing that's so compelling about this combination and ability to create value for shareholders is it's truly -- is that it's truly core to what we do today. It's focused in and around what we do. It's highly complementary from a product perspective and we go to market in similar ways.

When you pair that with the talent, culture and values of the combined organization and the power of leveraging ZBS, we're truly building something special and unique. And all of us can't wait to get started on the integration.

I'm moving to the last page and then I'll stop talking.

Everything we've done and do is to create a sustainable competitive advantage to drive sharable value, delight our customers, create an environment for our associates to thrive and grow and do it in a way that promotes ESG stewardship for our customers while accomplishing our ESG goals and accolades [ph].

The concepts around ESG are nothing new to Elkay. And even as a private company have a well-established ESG program that targets around analyzing and reducing greenhouse gas emissions, enhancing product transparency, improving diversity and inclusion and protecting and improving the health and safety of their employees.

The momentum around ESG that Elkay has built will only further ESG related initiatives we've been driving within Zurn. The combination of Elkay essential with each and every one of those areas in both tangible and intangible ways.

It's been long [ph] and (inaudible) to find another company and family that sees things in the same way and is willing to believe in it enough to become long-term shareholders. It's a testament that Ron, Jen and the entire Elkay family for walking the talk and coming together to create a bigger, stronger business in Zurn Elkay Water Solutions.

There's clearly work to do to get to the close, which we hope is sometime late Q2 or early Q3, but I hope what you take away from this morning is that it's going to be worth the wait and we're excited to get started.

So we'll turn it back to the operator and take a few questions.

Questions And Answers

Operator

(Operator Instructions)

Our first question is from Jeff Higgins with Keybanc Capital Markets. Your line is open.

Q - Jeff Higgins {BIO 17870878 <GO>}

Hi. Good morning, guys.

A - Dave Pauli {BIO 6582234 <GO>}

Good morning.

A - Todd Adams {BIO 4654034 <GO>}

Good morning, Jeff.

Q - Jeff Higgins {BIO 17870878 <GO>}

So if the Packers were in the Super Bowl we'd be talking about this on Wednesday or?>

A - Dave Pauli {BIO 6582234 <GO>}

That's a big if.

Q - Jeff Higgins {BIO 17870878 <GO>}

All right, just a -- just a couple here on the deal. One, do you anticipate any regulatory issues where your overlaps high? I know you had done like the Just deal where, I think there's some overlap.

Then just on the shares, I think you say up to 52.5, so I just -- I just want to understand better, is there something that drives variability in that share count when the -- when the deal closes? Thanks.

A - Todd Adams {BIO 4654034 <GO>}

Yes. I mean with respect to any anti-trust, we're obviously going to follow the profits [ph]. But from our -- our research we don't feel like there's any significant risk to that. But again we're just going to let the process play out and do all the regulatory filings. We don't anticipate any significant issues.

Then with the respect to the up to 52.5 weight, obviously to the degree, there's any net debt the adjustment will come in the form of some shares being -- not being issued, to the degree that there's net debt on the balance sheet at the time of the ultimate close. So, 52.5 million is sort of the top and we'll see where all the net debt-like items play out from now until the close.

Q - Jeff Higgins {BIO 17870878 <GO>}

Okay. Great. Then you mention, I think 12% growth over the last 10 years for Elkay. Is there much difference in the growth rate between the drinking fountain and the sinks and faucets? And just as you think about revenue synergy opportunities, where is kind of the -- where is some of the most obvious revenue synergy opportunities? Thanks.

A - Todd Adams {BIO 4654034 <GO>}

Yes, so the -- so the growth rates have been I would say relatively close together between the two categories over that timeframe. In terms of synergies, obviously the ability to drive spec [ph] share within key verticals is going to be the key. I mean and obviously leveraging some of these products into the (inaudible) solution will also be very important.

And so, when you think about it, it's for -- it's really more deeply penetrating certain verticals, driving higher levels of specification, leveraging the portfolio and further connected products. Then there's a few more, that I think we'll save as we get towards the close and we actually come together.

Q - Jeff Higgins {BIO 17870878 <GO>}

Okay. Congrats, guys. Thanks.

A - Todd Adams {BIO 4654034 <GO>}

Thanks.

Operator

(Operator Instructions) Your next question is from Bryan Blair with Oppenheimer. Your line is open.

Q - Bryan Blair {BIO 18982985 <GO>}

Thank you. Good morning, guys.

A - Todd Adams {BIO 4654034 <GO>}

Good morning, Bryan.

Q - Bryan Blair {BIO 18982985 <GO>}

It looks like a great fit overall. Pro forma balances of reconstruction and retrofit going forward certainly attractive. In terms of the conversion from water fountains and coolers to bottle filling stations, we've obviously seen that take place and accelerate over the recent years. Where are we in that process?

That be the three to five-year replacement cycle that's referenced, I assume that's more of a normalized basis when you have a multi-year period of a surge, or however you would want to term that, in replacement, that ring right now? Just it seems me to kind of mirror of the story with your touch-less and sensor portfolio.

A - Todd Adams {BIO 4654034 <GO>}

Yes, so the three to five-year replacement cycle, Bryan, is on sort of bottle fillers as a standalone category. When you think about the install base of water fountains and things like that, bubblers as we say that's about 8 million. So I would say we're tracking very early in the overall conversion cycle when you really step back.

And even though you tend to think about seeing these virtually everywhere, I would say that the install base of those traditional water fountain in schools, in commercial buildings and things of the like, it's still very early in the overall conversion. So, there's millions -- I mean 8 million of these installed base that we'll have the opportunity to retrofit over time.

Q - Bryan Blair {BIO 18982985 <GO>}

That's exciting. In terms of the portfolio, you called it the growth rate with drinking water, how much overlap is there with Zurn's existing portfolio within hygienic and environmental on the sink side?

A - Todd Adams {BIO 4654034 <GO>}

It’s frankly surprisingly low. So I think the -- in addition to having clean drinking water, Elkay is the clear number one commercial drink [ph] applications along with some paired faucets. So there’s very little in terms of the overlap with our existing our capable business [ph]. Very, very little.

Q - Bryan Blair {BIO 18982985 <GO>}

Okay understood. Is there a meaningful delta is run rate margin between the drinking water and sinks of faucets side of Elkay?

A - Todd Adams {BIO 4654034 <GO>}

Say that again.

Q - Bryan Blair {BIO 18982985 <GO>}

Is there a meaningful difference in the margin -- run rate margin between the drinking water and the sinks and faucets side of the Elkay portfolio?

A - Todd Adams {BIO 4654034 <GO>}

There is. Drinking water is at a level that looks a little bit closer to the current germ fleet [ph] and little danger [ph] in below. So I think that's where we're going to look to leverage the Zurn Business System, think about 80-20 in a pretty serious way.

But clearly from a manufacturing brand and share perspective that's a great position, and we think that there's an opportunity to take the margins if that part of the dig [ph] goes up, continuing to grow the margins on the drinking water side, and then leveraging the shared synergies I'll say between the current Zurn business and the Elkay business in things like the way we go to market, our rep networks, our functional areas, and all those different things.

So its really sort of a three-fold view of what we think we can do together, but something that we think when you take a giant step back and as I said in my remarks if you were to apply all those synergies to the current run rate of 16% then you get the sort of 23% versus the 25%-26% that we need today. Although it will all come in that form or fashion, but just form a -- with the past [ph] -- the giggle fest, I think the answer is it absolutely does.

Q - Bryan Blair {BIO 18982985 <GO>}

Got it. It all makes sense. If I can sneak in one more, what should we expect in terms of reporting structure? Once the deals close [ph]?

A - Todd Adams {BIO 4654034 <GO>}

Yes. I think we'll get -- we'll get more clarity on that as we get closer, but that's something that we'll have to sort through, and I think that'll sort of be dictated and driven by the integration climate we're going through [ph] between now and the close. Then obviously we're going -- we're going to -- if you think about sort of end of Q2-Q3 if we're to think about this as the run rate of everything really starts in 23, which will only be a few months will have to be closed, so we'll sort all that out as we get closer.

Q - Bryan Blair {BIO 18982985 <GO>}

Okay. Understood. Thanks again.

Operator

Our next question is from Mig Dobre with Baird. Your line is open.

Q - Mig Dobre

Thank you. Good morning, gentlemen.

A - Todd Adams {BIO 4654034 <GO>}

Morning, Mig.

Q - Mig Dobre

I'm wondering if you can give us maybe a little more color on the replacement cycle here? You're talking about three to five year replacement cycle. I'm kind of trying to understand what exactly happens here. Are there -- is it that the entire unit gets replaced or are there just portions of the units that are sort of experiencing wear and tear that needs to be replaced?

And you mentioned there's a consumables opportunity here, too. Can we maybe flush that out a little bit more, too?

A - Todd Adams {BIO 4654034 <GO>}

Sure. Something I think it's somewhat dependent on the application. Now clearly these are high-use items. So there is a demand in wear and tear on them. And depending on a little of the choice [ph] of the building owner [ph] at times the whole unit is simply replaced because it may be -- it may be functionally easier to do from a contractor perspective where there are a significant amount of kits that can be used to replace portions of an existing unit. So it's a little bit of both, and it really comes down to the preference and the application and owner of choice.

In terms of the reporting revenue opportunity, a very high percentage of these are filtered and chilled. So when you think about the filtration opportunity here I think it's sort of in its infancy. The Elkay business does extraordinarily well today but if you think about a more planful way to think about what's being filtered, how is it being consumed, and how do we understand where things are in their lifecycle so that we can provide any visibility to when the event could take place that needs to be changed or frankly even drive towards more of a subscription opportunity around the filtration.

And that's something that I think we're going to jointly flush out, but together we believe that it is clearly an opportunity that is clearly in its infancy and something that can be much larger over the next few years.

Q - Mig Dobre

And in those kinds of revenues are captured by Elkay in terms of the filtration revenue right now, right? That's...

A - Todd Adams {BIO 4654034 <GO>}

That's right. Yes.

Q - Mig Dobre

Okay. And as far as the installation of all this, is it Elkay's service team that does it or are there third parties? How does that work?

A - Todd Adams {BIO 4654034 <GO>}

In terms of the bottle fill units themselves?

Q - Mig Dobre

Yes, yes.

A - Todd Adams {BIO 4654034 <GO>}

They get installed just like all the other plumbing and mechanical equipment in a nonresidential building, so its the same installation channel if you will that exists today.

Q - Mig Dobre

Understood. I wanted to ask about the international component of the business. I was just going on the website -- Elkay's website this morning, and it seems like they have exposure outside of the US. How are you thinking about that as an opportunity more broadly for Zurn?

And there's also a couple of other businesses in there that look interesting. The interior systems and commercial systems. I wonder if you can talk at all about that and do you view those businesses as, again adjacency for broader Zurn business?

A - Todd Adams {BIO 4654034 <GO>}

Yes. So the interiors business is being spun out to existing Elkay shareholders, so that's not part of the transaction just to be clear. Obviously there will be ongoing business owned by current Elkay shareholders.

And your first question was regarding international. Look, I think that the international piece looks a little bit like the Zurn international piece where we're, I think, more near and dear to North America with some opportunities outside, but clearly one area that together particularly with the clean drinking water exposure we can grow over time.

I don't know that it'll ever been a massive part of the business but clearly there's opportunity to grow as water becomes increasingly scarce, more important, and this is solves both conservation and health concerns in a meaningful way. So particularly clear the interiors business is going to stay with existing Elkay shareholders.

Q - Mig Dobre

Understood. Last question is sort of one on the supply chain. I think this is -- this is one area where you guys have really differentiated Zurn over time, and I'm curious as to what the early learnings there are about how Elkay is set up and what you might be able to the table in that regard for that business?

A - Todd Adams {BIO 4654034 <GO>}

Well look, I think we're going to -- we're going to leave no stone unturned in terms of what we explore with respective areas to save money, reduce lead times, and make us more competitive. I will tell you that Elkay is I would say more vertically integrated than Zurn in a couple areas, but we believe that the competitive advantage that they have there is really the scale and the efficiency that they established.

And so, nothings off the table with respect to how we ultimately mange our supply chain and maybe its a combination of adding more components or kitting or things like that, but I think they do a really good job today. There's opportunities in the way we distribute our products, warehousing, freight.

So there's a lot of supply chain opportunity here, but I wouldn't -- I wouldn't rule out that we keep a lot of the manufacturing that they keep today because they are at scale, highly efficient, and we think there's opportunities to build on that and certain parts of the supply chain we think combined we can certainly do better.

Q - Mig Dobre

All right. Good luck, guys.

Operator

We have no further questions at this time, and this will conclude today's conference call. Thank you for participating. You may now disconnect.

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