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Flowserve Corp (FLS) CEO Robert Rowe on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-30-19 Earnings Summary

Press Release *Slides*

EPS of $0.59 beats by $0.03 | Revenue of $996.54M (4.60% Y/Y) misses by $-13.76M

Earning Call Audio

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Flowserve Corp (NYSE:FLS) Q3 2019 Earnings Conference Call October 31, 2019 11:00 AM ET

Company Participants

John Roueche - VP, IR & Treasurer

Robert Rowe - President, CEO & Director

Lee Eckert - SVP & CFO

Conference Call Participants

Joseph Giordano - Cowen and Company

Andrew Kaplowitz - Citigroup

John Walsh - Crédit Suisse

Deane Dray - RBC Capital Markets

Adam Farley - Stifel, Nicolaus & Company

Brett Linzey - Vertical Research Partners

Operator

Welcome to the Flowserve Corporation Quarter Three Earnings Conference Call. My name is Janine. I'll be your operator for today's call. [Operator Instructions]. Please note that this conference is being recorded.

I will now turn the call over to Jay Roueche, Vice President of Investor Relations and Treasurer. You may begin.

John Roueche

Thank you, Janine, and good morning, everyone. we appreciate you participating in our conference call today to discuss Flowserve's 2019 third quarter financial results. Joining me this morning are Scott Rowe, Flowserve's President and Chief Executive Officer; and Lee Eckert, Senior Vice President and Chief Financial Officer. Following our prepared comments, we will open the call for questions. And as a reminder, this event is being webcast, and an audio replay will be available.

Please note that our earnings materials do, and this call will, include non-GAAP measures and contain forward-looking statements. These statements are based upon forecasts, expectations and other information available to management as of October 31, 2019, and they involve risks and uncertainties, many of which are beyond the company's control. We encourage you to fully review our safe harbor disclosure as well as the reconciliation of our non-GAAP measures to our reported results, both of which are included in our press release and earnings presentation and are also available on our website at flowserve.com in the Investor Relations section.

I would now like to turn the call over to Scott Rowe, Flowserve's President and Chief Executive Officer, for his prepared comments.

Robert Rowe

Great. Thanks, Jay, and good morning, everyone. We appreciate you joining our call today. Flowserve again delivered good quarterly results while continuing to make progress on our Flowserve 2.0 transformation journey. As we approach the halfway point of this strategic program, I am encouraged by the increasing momentum we are seeing in our operations and in our financial results. Additionally, our employees' engagement and enthusiasm to drive sustainable changes to the parent at all levels of our organization. Ultimately, we expect to build an organization capable of performing at a high level in any business environment. We are well on the way to making this a reality.

Let's turn to the financial results for the third quarter. We executed well, delivering 4.6% revenue growth; improvements in adjusted gross and operating margins of 60 and 100 basis points respectively; and adjusted EPS of $0.59, a 20% increase over the prior year. Flowserve's reported EPS was $0.52, up $0.31 year-over-year and representing nearly 90% of our adjusted earnings. This reflects a significant improvement in our quality of earnings.

As a result of our strong performance thus far in 2019, we increased the lower end of our adjusted EPS guidance range to $2.15, while keeping the upper end in place at $2.20. We feel confident in our ability to deliver the full year within this range.

I would also like to highlight our free cash flow improvement. We continued to make progress in this area and have now delivered over $120 million more in year-to-date free cash flow than last year. Better operating income, reduced realignment spend, disciplined capital spending all contributed to the cash flow growth.

Moving now to our segments. The operational improvement in FPD continued to flow through the segment's financial performance. In the third quarter, FPD grew revenue by 5.4% year-over-year and delivered a 24% increase in adjusted operating income. Adjusted gross and operating margins both improved 200 basis points.

While this performance included a 2% aftermarket mix shift benefit, it was primarily driven by our ongoing improvement initiatives, including continued progress in legacy IPD facilities, ongoing value engineering in our product portfolio, improved planning processes, better productivity and inventory management as well as initiatives to drive lean manufacturing deeper into our operating footprint. FPD's third quarter bookings increased 6.3% year-over-year despite 330 basis points of currency and divestiture headwinds.

Turning now to FCD. The third quarter largely played out as expected and how we communicated on our second quarter call. FCD continues to be impacted by the slowdown occurring in the North American short-cycle MRO business and the distributor destockings that began earlier in the year. Third quarter revenues were essentially flat sequentially, and I am pleased that FCD's adjusted gross and operating margins improved by roughly 150 basis points compared to the second quarter, considering the mix and the market dynamics were largely the same. On a year-over-year constant currency basis, FCD grew its top line by 4.9%. However, a higher percentage of revenues were derived from larger original equipment projects as opposed to higher-margin short-cycle MRO work.

FCD margins were negatively impacted by this mix shift on a year-over-year comparison as adjusted gross margins declined by 300 basis points. With more focus on controlling our costs, we were able to limit the impact on operating margins to a decline of 250 basis points compared to 2018 third quarter.

The continued slowdown in the North American MRO and distribution business also had an impact on FCD's third quarter bookings. Bookings in the quarter decreased 10% year-over-year, including approximately 2% of negative currency impact. The end markets that typically have the highest exposure to this type of work saw the biggest impact, including a 21% decrease in general industries, a 10% decline in chemical and a 7% decrease in oil and gas. Partially offsetting the decline was a 61% increase in power bookings year-over-year. We expect the North American MRO bookings to recover in time, but we have yet to see a positive inflection for the FCD business.

Turning now to our consolidated bookings and end markets. Third quarter bookings increased 1.3% to $1.02 billion, or 4.1%, excluding the impact of currency and divestitures, and represents a book-to-bill of 1.03%. This marks the sixth consecutive quarter which we've delivered bookings over $1 billion combined with year-over-year bookings growth. This level of performance continues to be driven by our growth-oriented transformation initiatives and greater collaboration across our pumps, valves and seal projects -- products as we leverage the power of pure play. On a year-over-year basis, nearly half of our bookings have come from customers who purchased more than one Flowserve offering.

Our year-over-year bookings growth in the third quarter was driven by smaller projects and upgrade work. In the quarter, Flowserve booked 2 projects above $15 million in size. There are 4 of these larger awards in last year's numbers.

We do expect the progression of energy infrastructure projects to continue. However, there is more uncertainty at the macro level than earlier in the year. Refining, LNG and chemical end markets remain encouraging as large projects in EPC backlogs continue to move toward equipment order placement. The current macro environment makes the timing of large projects awards more difficult to forecast. Whether it's the commodity pricing, trade disputes, Brexit or issues in the Middle East, the increased uncertainty and the current geopolitical situation has driven delays in capital spending. The good news is we have not seen nor do we expect significant project cancellations. We believe the opportunity set of global project will move forward, especially for refineries and chemical plants as they are driven by increased global demand.

Our original equipment bookings have grown by 13% year-to-date. We are capturing our fair share of the opportunities that are out there, and our teams are focused on building a quality backlog to drive margin growth in the markets, regions and with the customer base we pursue.

Turning to aftermarket. Third quarter bookings of nearly $500 million were essentially flat versus prior year on a constant currency basis. Our commercial intensity program, which is a critical component of the Flowserve 2.0 growth initiative, helped offset the short-cycle market slowdown in North America as we continued to increase our share of our customers' maintenance. And we fully expect to drive growth in our aftermarket franchise through the combination of our growing installed base, customers' increased focus on efficiency, regulatory changes and execution of our proven growth initiatives.

From a served end market perspective and starting with our largest market, oil and gas. Third quarter bookings decreased 6% year-over-year, including 2% negative currency impact driven by mid-single-digit declines in both FPD and FCD. The 2018 comparative period was challenging as last year's third quarter provided our highest level of oil and gas bookings of the year. Oil and gas markets remained active, particularly in the Middle East and Asia Pacific with a number of $5 million to $10 million downstream and upstream awards across both segments, driven by refinery upgrades and clean air projects, including ongoing work related to IMO 2020. North American oil and gas remains more challenged due initially to upstream spending discipline, which has impacted the region's MRO activity and distributor stocking orders. We did, however, receive another North America pipeline award this quarter, thanks to our strike zone efforts.

Our constant currency chemicals bookings increased 11% in the quarter, driven by FPD's 24% growth, partially offset by FCD's 10% decline. The quarter included a small project award to FPD in the Gulf Coast. We see a strong pipeline for near-term opportunities in the Gulf Coast region and expect similar opportunities to come in Asia and Middle East, driven by a forecasted global demand growth.

Our power markets increased 45% primarily due to the lower 2018 compare, which was our lowest power bookings total in over 5 years. While challenges in our power markets continue, we are pleased with 2 awards in the $5 million range, representing a combined cycle plant in North America and a coal-fired plant in Europe. We also remain focused on the concentrated solar power market, with the Flowserve power of a pure-play differentiating offering of pumps, valves and seals provides opportunities in a growing market. We continue to support our global fossil and nuclear installed base with maintenance, upgrades and life extensions and look to participate in fuel switching opportunities in North America and Europe as well as a limited newbuild project set primarily in Asia.

Third quarter bookings in general industries declined 1% year-over-year, including 2.5% of currency headwinds. FCD's 21% decline was largely offset by FPD's 11% growth. FCD continues to build its global distribution channel, and the third quarter included solid growth in Europe, Middle East and Africa markets. As many of you know, about 40% of FCD sales go through the distribution channel, and much of that is categorized in general industries. So the distributor destocking activity we've experienced was the primary cause of the decline in general industry category. In addition, FCD's percentage decline was also impacted by a large $6 million marine project that was booked last year that did not reoccur.

Lastly, representing our smallest market, water bookings increased 7% in the third quarter, including two desalination awards, which totaled over $20 million combined, and two awards for water management in North America, each in the $5 million range.

Turning now to bookings by geography. The strength in the Middle East and African markets continued with 38% growth in the third quarter and is up over 40% for the year, driven by significant refining and chemical investment. North America and Asia Pacific both delivered low single-digit booking growth, while Latin America was flat. Europe remains our most challenged region overall, with bookings down 19% year-over-year.

I'll now turn the call over to Lee to cover our financial results in greater detail. And then I will return for some closing remarks before we open the call to Q&A. Lee?

Lee Eckert

Thanks, Scott, and good morning, everyone. Our financial results for the third quarter reflect the progress we are making in our Flowserve 2.0 transformation journey. Adjusted earnings per share of $0.59 increased 20% year-over-year and about 10% sequentially. On a year-to-date basis, our adjusted earnings per share has increased approximately 32% to $1.54 per share. Our reported EPS for the quarter was $0.52, which included $0.06 of realignment and transformation charges and [indiscernible] mainly negative below-the-line currency impacts.

Looking at the first 9 months of 2019. Our reported EPS of $1.40 increased $0.97 or over 3x the EPS from last year, and it represents over 90% of our adjusted 2019 EPS. On a year-to-date basis, we have reduced after-tax adjusted items by $78 million versus prior year. This reduction demonstrates our continued focus on improving the quality of our earnings.

Revenues in the third quarter were $997 million, an increase of 4.6% versus the prior year. Excluding the impact of foreign exchange and divestiture headwinds, organic revenue grew 7.4% year-over-year. Third quarter aftermarket sales increased 6.7%, or 9.4% on a constant currency basis, to $488 million and represent 49% of total sales, essentially the same percentage as the prior year.

Turning to our margins. Third quarter adjusted gross margin of 33.8% increased 60 basis points year-over-year and 130 basis points sequentially. FPD's 200 basis point improvement year-over-year was a key driver as we continued to deliver operational and productivity improvements, including the further leveraging the combination of our pumps business that we implemented earlier this year. Partially offsetting FPD's strong performance was a decline in FCD's adjusted gross margin year-over-year to 32.8%. As Scott discussed, FCD has faced market headwinds for much of this year, consisting of strong growth in larger project-oriented work offsetting a cyclical decline in MRO activity. FCD, however, did improve its adjusted gross margin sequentially by 150 basis points in the third quarter on a modest sequential revenue decrease.

On a reported basis, Flowserve's gross margins increased 110 basis points to 33.5%, driven by essentially the same factors I discussed as well as approximately $5 million of lower realignment spend in 2019.

We remain focused on managing our cost structure and are pleased that our third quarter adjusted SG&A was essentially flat with prior year at approximately $220 million, even as we delivered bookings and revenue growth in the quarter. As a percentage of sale, adjusted SG&A decreased 50 basis points to 22.1%. On a reported basis, third quarter SG&A decreased approximately $16 million, driven primarily by the lower adjusted items versus prior year.

At the operating level, our adjusted operating margins improved 100 basis points to 12% as a result of our strong adjusted gross margin and tight cost management. FPD's 13% adjusted op margin increased 200 basis points year-over-year, which was partially offset by FCD's 250 basis point decrease. On a sequential basis, both segments' adjusted operating margins improved, including FCD by 150 basis points. Reported operating margin increased 450 basis points year-over-year, which benefited from continued operating improvements and sales leverage as well as approximately $33 million reduction in adjusted items.

Our adjusted tax rate was 25.9% at the low end of our prior full year adjusted tax rate guidance of 26% to 28%. Considering our adjusted tax rate through 9 months was 25.8%, we revised our full year tax guidance yesterday to a new range of 25% to 27%.

Turning to cash. Operating cash flows through the first 9 months of 2019 increased $118 million versus prior year, driven by our earnings growth as well as improved working capital management. While we've demonstrated incremental progress in our working capital management, we expect to deliver more improvement over time and are confident in our ability to achieve our goals. A key enabler to truly embedding sustainable systemic improvement within our inventory and order cash processes will be implementing enterprise-wide systems and processes. It is a journey, but I am pleased with the results we've delivered thus far.

At September 30, our cash balance was approximately $550 million or roughly $15 million higher than last year's third quarter [indiscernible]. This year-over-year improvement comes after approximately $140 million of certain third quarter cash expenditures. For example, during the quarter, we retired $75 million of debt, returned about $30 million of capital to shareholders through dividends and share repurchases, invested $19 million in capital expenditures, and contributed $14 million to our U.S. pension plan.

Turning to our outlook for the remainder of the year. We are pleased with our strong results for the first 9 months of the year and expect solid performance again in the 2019 fourth quarter. As such, we increased the low end of our full year adjusted EPS target range by $0.10 and now expect between $2.15 and $2.20 per share for 2019. This range excludes approximately 2019 realignment and transformation expense of approximately $50 million as well as global line foreign currency FX and the impact of potential discrete items, which may occur. We also increased our reported EPS range between $1.85 and $1.90 per share.

We expect these results based upon full year revenue growth of approximately 2.5% to 3.5%, including increased full year headwinds now expected from currency of approximately 2.5% and roughly 0.5% due to last year's business divestitures.

Turning to our expected cash usage in the fourth quarter. Following year-to-date debt payments of $105 million and pension contribution of $20 million through the first 9 months, we have already met our commitment in these areas and do not expect any further payments this year. We do anticipate returning approximately $35 million to shareholders during the fourth quarter through dividends and share repurchases. And we'll continue to invest in our business through capital expenditures during the fourth quarter, although we have reduced our full year expected spend to $75 million to $85 million as we remain disciplined in our approach.

Now let me turn it back to Scott for his closing remarks.

Robert Rowe

Thanks, Lee. I'd like to wrap up by spending a few minutes on outlook and the progress of our efforts. As our guidance indicates, we expect to finish 2019 on a strong note. We are confident in our ability to deliver to the new guidance range, which represents adjusted EPS growth of over 20% year-over-year and nearly 60% better than 2017, my first year at Flowserve.

Year-end 2019 will also mark the halfway point of our multiyear Flowserve 2.0 transformation journey. I am extremely encouraged by the progress we have made to date, but even more optimistic about the opportunities that remain in front of us. We have made significant investments to drive cultural and enterprise changes and our employees have truly risen to challenge, embrace the changes, and they continue to drive results. I am impressed and encouraged by the level of excitement and the progress that we are making within our global operations.

To maintain the momentum, we will continue to have a dedicated transformation team throughout 2020. I expect significant progress in 2020 with our operational initiatives, while continuing to focus on growing the company. We are laying the manufacturing foundation to significantly improve our deliverability of products and dramatically reduce our cost to produce. We are well on the way to fully transforming Flowserve, and I look forward to continuing to deliver increased value to our employees, our customers and our shareholders as we continue the transformation journey.

Operator, we have now concluded our prepared comments. I would now like to open the call to questions.

Question-and-Answer Session

Operator

[Operator Instructions]. And our first question comes from Joe Giordano .

Joseph Giordano

So good quarter and I see the stock down more than the industrial sector. So I'm assuming that a lot of that has to do with really negative short-cycle comments we've heard from other companies over the last couple of days, today as well. But our sense is that there's just this -- there's this belief that orders next year have faced this real cliff. So I know you guys have been very kind of dogmatic about making sure what you say publicly is something you're very comfortable delivering on. But as we stand today looking forward, is order growth of like flat to up next year? Like, is that within the realm of realistic possibilities? I think that's a major thing that people are struggling with right now.

Robert Rowe

Yes. Well, I'll start with a very short answer, and I'll give the commentary to it. I think it is absolutely something that we can do. And if we had to pick today, and we're in the middle of our budget process right now, but if we had to pick today, I'd say Flowserve grows in the bookings range -- or in bookings next year and grows over 2019.

So I'll just give some of the color there, right? I mean there's no doubt, we are in a challenging and uncertain market environment. But when we look at 2019, I mean we've made incredible progress, right? Our original equipment and our project bookings are up 16% on a constant currency basis. We've been able to grow the overall aftermarket by 5%. But we're also dealing with this North American upstream correction that's impacting the valve business and clearly hurting us on that distribution channel and driving some adverse mix there. And then you look geopolitically, we've got uncertainty at almost -- not going to say at all-time high, but it is certainly at a high level, where you've got Europe with Brexit and some of the Spanish stuff going on. You got U.S.-China trade, you've got Middle Eastern tensions and then you've got the Latin America stuff as well.

But I think when we think about 2020, I'd say the best way to characterize it is we think we're going to grow, but we don't think we can grow at the rate that we grow in 2019. And so I would just say it's a growing environment, but it's decelerated from where we are now. But we still think 2020 is a growth year.

And so when you look at our project pipeline or our funnel, we've got good opportunities in refining, petrochemical and LNG. We just moved -- we moved to our full force CRM almost 1.5 years ago so now we've got good visibility to that. And I'll say our 12-month funnel has come down in the last kind of 4 to 6 months, but it hasn't come down significantly. It's only come down a little bit or very modestly. So we still feel good about the project funnel.

On the aftermarket side, we must continue to grow that. We've got to continue to capitalize on the installed base. And then within the transformation, right, we've got 2 major initiatives around growth, and one is commercial intensity. Basically, that's making sure that we get our entitlement on the installed base and basically defining our playbook to capture that installed base and working with our customers. And then the other one's strike zone. And in strike zone, we've had tremendous wins. We booked over $100 million on pipeline awards. We expect pipeline to continue into 2020. We do have other strike zone initiatives as well. So as those kind of play through, we've got the ability to take market share and grow with that.

And so again, I feel reasonably good about our ability to grow. I just don't think it will be at the rate that we grew in 2019.

Joseph Giordano

That's really helpful commentary there. Lee, you mentioned cash, and that's been a really nice improvement there for you guys for a couple of quarters now. How much of this is still you guys manually doing the work every day, which -- and how -- where are you kind of in that systematic journey?

Lee Eckert

Thanks, Joe. I think we're making significant progress. It's still obviously a manual effort, but there are a number of, I would say, capabilities that are coming online. The one I'm particularly excited about, for the first time, we're launching, I'll say, a new tool where I can see roughly 90% of my invoices in one system. So as you know, we've got over 40 ERPs. And so we basically launched in the last month, a new tool that now give us access to our customers and other invoices averaging across our business. So now we have a tool. Now we got to execute and use it. And so we launched change management and training sessions so people can understand what's there and how to date them on and figure out what's past due and how to collect.

In addition, we're continuing to move collections efforts to our shared services operation in Hungary, and that also is driving more efficiency. Scott, you want to talk about inventory at all?

Robert Rowe

Yes. On the inventory side, again, it's not a perfect world, but I'd say probably the best way to describe it is, both on AR and inventory. We've driven a significant process change, and now we're in kind of the process adherence phase and then the next phase will be automation. While we've got some tools that are starting to automate and give us better visibility, I feel very good that we are using different process that's going to absolutely drive results, and we're getting procedure adherence now around the world. And so I think this is an area we've made really good progress. And I would say we can continue to make progress as we're adhering to process and we start to automate more and more.

Joseph Giordano

If I could just sneak in one last quick one. I mean given the short-cycle weakness that we've already seen hit FCD on the distribution side, if that accelerates, if there's more of weakness and those markets get worse, how much of the -- how much margin do you think you can neutralize at this point? You've already had a lot of the impact. If we see volume decline further, can you offset that negative impact?

Robert Rowe

Let me just kind of set the scene for everybody on that. And I'm going to talk probably more about our ability to get orders, then I'll go to margins. But -- so basically, our valves business is about 40% through distribution. And a big chunk of that is in North America. And so what's happened with the upstream side of the business with the upstream pulling back, we've got distributors that have carry -- and these are -- I'm talking about destocking distributors that carry our valves in the upstream side and the downstream side. And so basically, as they get the signals where rig count comes down and production and completions start to come off, they really begin to clamp down on their inventory levels.

And so we saw that really start in Q2 and then in earnest in Q3. Now that destocking though actually has decelerated. And then what we need is, if the environment stays the same, then our business actually has some tailwind because they've got to order product to deliver that. And so I actually feel okay that I don't see this another step down unless activity in North America took a dramatic change to even worse. And I don't think anybody's predicting that. I think most people are saying that 2020 will be similar to the activity that we're in now. And if that's the case, I actually would get a little bit of a tailwind in terms of bookings for FCD. Let's just say that, that doesn't happen and things get worse. I would say that the valve business or FCD is taking the appropriate cost actions within North America, and that the facilities that deliver product there. And we would continue to do that. And so the team is well versed on the levers to drive cost control. We'll continue to pull those as the market goes down. But I would just say, I don't see that as a likely scenario. I actually see flat to slight growth in the MRO business of FCD.

Operator

Our next question comes from Andrew Kaplowitz.

Andrew Kaplowitz

Scott, so just following up on your comment about expecting overall order growth in 2020. Again, not to tease up too much, but how much incremental visibility do you have from your project pipeline versus your own initiatives? You did suggest that your funnel has come down, but maybe you can comment on your conviction on the conversion of funnel that you're seeing today versus your internal estimates. And how additive has strike zone in commercial intensity into bookings now and expected in 2020?

Robert Rowe

Yes. So no doubt, the funnel has come down again slightly, it hasn't come down dramatically. But I just think as we kind of mature with the transformation and our process adherence, one of the things that we're trying to do is develop playbooks and develop competency in all of our functions. And I've actually been really, really impressed in kind of the last 2 years of how our commercial teams and our operations teams are working together. And what I'd say is we're still kind of middle innings on that, and we still have significant opportunity to do better sales and operational planning. Do a better job at reducing our lead times, do a better job of driving costs down, do a better job of getting the right products in front of the right people. And so I just say there's still a lot of self-help that we can do here. We track wins and losses, we track these opportunities. I'd just say, unfortunately, that list is far longer than I wish it were. And there's -- every quarter, we've got things where we go, "Gosh, if we've just done some things a little bit differently, we could capitalize on that."

So the project -- so back to the question, right? The project funnel still looks good. It's a huge number out there. I still believe we can drive market share wins. And if you combine those two together, we feel comfortable in our ability to grow in 2020.

Andrew Kaplowitz

Great. And sort of a related question, the sort of feedback around FCD margin in terms of its sort of pullback here in Q4 as possible. If I step back and just think about the mix issue that you have now and that you could have as OE continues to ramp up in FPD, how easy can you offset that mix headwind as you go into 2020 with these initiatives? You've talked a lot about lean. What kind of impact are you already having in the business from lean?

Robert Rowe

Yes. No. It's a really good question. I think the headwind is real, right? And so just go back to what I said on we've got OE bookings that have grown 16% constant currency. Our aftermarket is growing at 5%. And so by definition, we've got higher margins in aftermarkets than our OE business. And with those -- the verge in growth rate, it absolutely puts pressure on the margin. What we've got to do is offset that with the things that we're in the transformation, with supply chain savings, the value engineering the manufacturing productivity, lean and all that stuff. And so I think thus far, we've done a really good job of that. So even with the mix changes, we're still continuing to be able to drive margins, certainly on the upside. And then FCD has gotten hit a little bit harder with the -- that mix change. But I think we still have a huge opportunity set in the transformation. In my prepared remarks, I said we're about 50% complete with that. As we turn into the second half of transformation, a lot of the initiatives around operations and driving costs down and which will ultimately help us on margin side.

Operator

Our next question comes from John Walsh.

John Walsh

So I just wanted to touch a little bit again on capital allocation and kind of the forward look. I think you said in the prepared remarks, $35 million to return in Q4. Kind of given where your dividend sits, that seems like we're going to see some more share repurchase, which is something we hadn't seen in a while. If I caught that comment correct?

Robert Rowe

Yes. I'll let Lee -- let's go ahead, Lee.

Lee Eckert

Yes. John, that is correct. We bought about 100,000 shares in the third quarter. And our goal is basically to offset some of the dilution that's happening with our long-term incentive plan. So that's the main focus as we were looking at the share count. And we wanted to normalize a little bit for some of the dilution that's been taking place.

John Walsh

Got you. Okay. And then I guess maybe, Scott, can you talk a little bit about what you're seeing on [indiscernible] costs? Obviously, last couple of quarters, you've gone out selectively in certain product categories to get price. Kind of an update on what you're seeing there.

Robert Rowe

Yes. So just as a reminder, we did 2 pretty significant price increases in 2019. One was at the beginning of the year, and then one kind of in the end of Q1. And I feel reasonably good about our ability to stay on the positive side with this. But obviously with FPD margins pressures, we've got to do more there. And so we're -- we continue to relook our pricing. We will put another annualized increase at the end of this year. And what I'd say is it's a combination of tariff and inflation. And so we've got to make sure that we offset that. And so part of the transformation is a pricing work stream and bringing that analytical rigor to how we price and how we think about pricing. So I think we'll continue to do good things there.

And then kind of the project side of that, we are seeing, I'd say, a little bit more discipline on the pump pricing. And so as pump providers and the bigger ones that provide the project stuff, I think everyone's getting a touch more disciplined. I'm not going to say we're getting unbelievable discipline in pricing, but I do think it's improved with the capacity levels coming up.

And then where I say the concern still is, is on the valve side. And so the engineered valve side in particular, is just area, that price is not where it needs to be. And so we're focused on that, but we're probably more focused on how do we take cost out to make sure that we're not eroding too much margin there. But overall, I feel reasonably good at our ability to get price. We've been able to move it up this year. And we'll do -- we'll be pretty aggressive at the end of the year and the first part of 2020 on it.

Operator

Our next question comes from Deane Dray.

Deane Dray

Lots of good color. If you just step back a year ago plus, as to what issues you were addressing on the call, you're now -- it's just getting to be such a more refined story, and you're really pushing the team. And you can hear it in the cadence of both the answers, but also on the outlook. And on that point, I was really interested in you say--

Robert Rowe

Definitely. It definitely feels better, Deane. There's no doubt about that.

Deane Dray

All right. Good. So I love hearing the fact that you do kind of a post mortem on business lost. And in reference to the answer on the valve pricing, when you look at like a Pareto chart of the business that you've missed, is it price? Is it product specs? Is it delivery? Just where do the biggest issues on what has to change?

Robert Rowe

Yes. I don't want to give a road map to our competitors. So I'm going to be a little careful on the answer here but I would say it's a little bit of everything. But the ones that frustrate me are the self-induced ones, right? Where we're not communicating or we didn't do the right thing or we over-spec something that our products at a higher cost than it needed to be to our competitor. Or we do got super conservative on lead times, and we weren't able to deliver on that. But I would say the list, unfortunately again, is longer than we would like, and there's lots of reasons there. Our focus, though, is to mitigate the ones that we can control and making sure that we've got tight correspondence and cooperation between our sales and our operations team. And just by doing that, Deane, we've got pretty significant opportunities. And so we're going to keep working that. And again, as we mature with our playbooks and moving through the Flowserve people I know, I have no doubt that we continue to make progress in our ability to capture more market share as we go forward.

Deane Dray

That's really helpful. And like a year ago, there was lots of consternation about past due backlog, and that doesn't seem to be an issue anymore. Is that all been put to bed?

Robert Rowe

Yes. We're never satisfied, right? And I'll say, we're not delivering on time 100% of the time, but it is not the issue that it was when I came to Flowserve. And so the operational teams are doing a really good job. We're definitely focused on our deliverabilities. But I would say, like there's more work to do there, right? And so as we kind of get better at on time deliveries, and we shipped our focus to lead times and making sure that we'd be even more competitive on lead times than we are today. But in terms of talking about it on an earnings call, past due backlog is not a topic for discussion, but it's always something that we're going to work on to continue to get better at Flowserve.

Deane Dray

All right. That's good to hear. And just last topic for me, I wanted to go back to one of Joe's questions about destocking. And this really has to be one of the most overused terms that we've heard companies talking about or blaming the short-cycle pressure that they're seeing. To us, when we hear destock, it means the sell-in to the distributors is less than the sell-through. And this typically can't happen for multiple quarters. If it does, there's usually a falloff in demand. But your answer really was calibrated where you're looking at the sell in versus sell through. So if you just clarify, for this quarter, do you think that has been at a stage where they have to replenish and what kind of volumes might you see out of this replenishment?

Robert Rowe

Yes. So Q3 was definitely down for us through the distribution channel. And I'm speaking predominantly on the valve business. And so there's no doubt that there's destocking in the third quarter. And to your point, that can't continue in a reasonably stable environment. And so we think at some point, we start to get more orders. And I would say we are getting orders from our stocking distributors. They're just not as high as we've seen before, and they're significantly down from even the early run rates in 2019 or certainly on the year-over-year comparisons. But I think if you go -- think about the North American activity, and if we've got stability in terms of production completions in both the gas and the oil side, then that's going to be a little bit of a tailwind for us, hopefully in kind of a Q1, Q2 time frame in 2020.

Operator

Our next question comes from Nathan Jones.

Adam Farley

This is Adam Farley on for Nathan. Turning to midstream. I know it's strike zone focus for you guys. I think you guys mentioned a pretty nice project award there. Could you provide any color on how that market is doing? Are you seeing any deceleration in projects or any projects getting pushed to the right?

Robert Rowe

Yes. No. It's a really good question because at some point, you're not going to keep spending the capital that they are. But we've got good visibility into kind of Q4 and early 2020 on this. So I feel reasonably good about our ability to continue to get midstream work, both the pipeline side and the storage side. And what I'd say is we're starting to win the work with our entire portfolio. So you're really bearing the power of the pure-play, leveraging the efficiency technology that we have with the pump side. And this is a space that we really weren't in before. And so we're absolutely taking market share. But we feel very good about our ability to do that and win work and I would say expect more works for us. But I'm not naïve to think that this does slow down at some point. But I would say for the next 6 months, we still see pretty significant opportunities in pipeline. And then I think you're going to see some storage build out and kind of -- if you go one more step downstream, you start to see some capital spending there.

And then the other thing I'd add is we hadn't really focused on the midstream side globally. We are more -- the initiative on strike zone is very much a North American-focused initiative. We're now starting to migrate that around the world. And again, I think we're looking pretty good for some midstream pipeline awards globally here as well.

Adam Farley

Okay. That's helpful. And then just shifting to your water business and specifically, desalination. I know it's a small part of the business portfolio. Obviously, it's not tied to the energy markets. Maybe just some color on how you view the business. What are the opportunity sets there? Just any color would be great.

Robert Rowe

Sure. Yes. So we had a press release about a week ago on two [indiscernible] awards in the Middle East, the Taweelah and the Rabigh project in the Kingdom of Saudi Arabia. And so for us, desalination is a nice market and where we have the technology is in the pump side. And so our efficiencies allow operators to keep their energy costs down, which is the largest cost of doing desalination. And so we got some preferred technology there, and it works real nicely. What we're trying to do is do more of a pure-play opportunity with desalination. And so we've got pressure exchange technology. We've got valve technology. And what we want to do is ultimately start to put more products and services around desalination. But as you know, water and particularly drinking water is a huge issue for the entire globe. And we feel very good about the outlook with desalination projects. And so where we're going to keep working hard, this is one of our strike zone initiatives, and we'll keep working hard to win more than our share on desal.

Operator

Our next question comes from Brett Linzey.

Brett Linzey

I just wanted to come back to the pump combination of the two segments. It sounds like you've made some very good cost traction on all of those initiatives. What did you realize from a savings standpoint year-to-date? And how much more savings do you think you can bring out of that as we look into 2020?

Robert Rowe

Okay. So I missed the one part. You said on a savings standpoint?

Brett Linzey

Correct. Just cost.

Robert Rowe

Yes. Okay. Yes. No. I'll just start. The reason we brought the pumps together really wasn't the cost side. It was more about the customer. And so what we're seeing now is a concerted front with our pump team, talking to customers properly and really balancing the supply and the demand more appropriately than we were. And so I'd just say with the two different platforms, we did not have the collaboration and the cooperation as you would expect from 2 entities even within the same company. So that's now completely changed, and that team is working incredibly well together. We are definitely seeing cost savings, right? So there's no doubt, right? We have one team versus two, and so we got immediate SG&A savings there. And I'd say probably the bigger prize will be kind of in 2020 and beyond as we really start to rationalize more of the engineering function and more of the footprint to operate. And so I think we've definitely captured savings, but I'd say there's more savings that will drive gross margin expansion here as we look into the future.

Brett Linzey

Are you able to quantify what you're targeting there for 2020?

Robert Rowe

No. I really don't want to do that in particular. We'll come out with guidance as we always do at the end of the fourth quarter. And then we'll talk about what 2020 looks like from a margin perspective.

Brett Linzey

Okay. Great. And then just one follow-up. Good to see a positive free cash flow here in Q3. Conversion is still running a little bit light, I think about 50% as a percent of adjusted net income. In terms of the 75% conversion target for the year, any change in that thinking there?

thinking, though?

Lee Eckert

Brett, this is Lee. No. We are -- we still have a line of sight to the 75% that I communicated earlier in the year, and that's what we're working to. Just in general, there's a significant more focus on cash and the importance in cash. And so this is a metric that we look at very closely, and we still feel good at 75%.

Operator

We have no further questions at this time.

Robert Rowe

All righty. Well, we really appreciate everybody joining us today. And certainly, if you have follow-up questions, don't hesitate to call Mike Mullin or myself. And we look forward to seeing you at some investor conferences in the weeks and months ahead, and thank you all again.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.