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DOV - Q3 2017 Dover Corp Earnings Call

EVENT DATE/TIME: OCTOBER 19, 2017 / 2:00PM GMT

OVERVIEW:

DOV reported 3Q17 revenues of $2b and adjusted EPS of $1.16. Expects FY17 EPS to be $4.23-4.33.

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PRESENTATION

Operator

Good morning, and welcome to the Third Quarter 2017 Dover Earnings Conference Call. With us today are Bob Livingston, President and Chief Executive Officer; Brad Cerepak, Senior Vice President and CFO; and Paul Goldberg, Vice President of Investor Relations. (Operator Instructions) As a reminder, ladies and gentlemen, this conference call is being recorded and your participation implies consent to our recording of this call. If you do not agree with these terms, please disconnect at this time.

I would now like to turn the call over to Mr. Paul Goldberg. Mr. Goldberg, please go ahead, sir.

Paul E. Goldberg *- Dover Corporation - VP of IR*

Thank you, Paula. Good morning, and welcome to Dover's third quarter earnings call. With me today are Bob Livingston and Brad Cerepak. Today's call will begin with some comments from Bob and Brad on Dover's third quarter operating and financial performance and followed with our outlook for the remainder of 2017. We will then open up the call for questions. (Operator Instructions) Please note that our current earnings release, investor supplement and associated presentation can be found on our website, dovercorporation.com. This call will be available for playback through November 2 and the audio portion of this call will be archived on our website for 3 months. The replay telephone number is (800) 585-8367. When accessing the playback, you'll need to supply the following access code: 95679213.

Before we get started, I'd like to remind everyone that our comments today, which are intended to supplement your understanding of Dover, may contain certain forward-looking statements that are inherently subject to uncertainties. We caution everyone to be guided in their analysis of Dover by referring to our Form 10-K for a list of factors that could cause our results to differ from those anticipated in any such forward-looking statement. Also, we undertake no obligation to publicly update or revise any forward-looking statements except as required by law. We would also direct your attention to our website where considerably more information can be found.

And with that, I'd like to turn the call over to Bob.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Thanks, Paul. Good morning, everyone, and thank you for joining us for this morning's conference call.

Our third quarter performance reflected continued strong global markets, resulting in organic growth at each segment. In particular, we had strong organic growth across several platforms, including digital printing, waste handling, bearings and compression and pumps. We also had solid performances in a number of other platforms, including marking and coding, retail fueling and retail refrigeration.

In all, Dover's organic growth was 9% in the quarter. In total, our revenue and margin expansion were largely in line with our expectations. In addition, our strong bookings growth sets us up for a solid finish to this year.

I am pleased that we are firmly on track to deliver on the 3-year plan we outlined in June. We expect solid organic growth and margin improvement this year and we are positioned to deliver further growth and margin expansion in 2018.

I'm also encouraged by our portfolio work to drive long-term success and value creation. We have continued to simplify our portfolio and invest in market-leading platforms that have strong market positions and margin profiles. In addition to the planned Wellsite separation, we recently signed an agreement to sell the consumer and industrial winch business of Warn for $250 million and expect this transaction to close in the fourth quarter.

Regarding Wellsite, we are continuing the process of evaluating our options for separation. The process is moving along well and we fully expect to announce our plans by year-end. Within Wellsite, markets have remained quite constructive and we are on track to hit our 2017 forecast of $1 billion in revenue and $250 million in EBITDA. We are committed to pursuing the transaction that is best for the business and also creates the greatest value for our shareholders.

While our portfolio simplification activities advance, we have continued to build a pipeline with targets that enhance and expand our growth platforms. In all, I am very pleased with our execution on the top line this year and I'm encouraged that we've made progress on margins.

As we enter the fourth quarter and continue working on the Wellsite separation, we are actively reviewing our cost structure to rightsize our company and improve margins. This review is broad-based, excluding Wellsite, with the goal of achieving $40 million of cost savings for 2018. The goal of all of these actions is a focused and consistent portfolio with a sustainable runway for revenue growth and margin improvement.

With that, I'd like to turn it over to Brad.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Thanks, Bob. Good morning, everyone. As Bob mentioned, we had a very solid third quarter. We achieved organic revenue growth in all segments and had organic bookings growth in 3 of our segments. Leverage on this organic growth, combined with the benefits of integration, led to solid year-over-year margin improvement. Overall, adjusted margin was 13 -- 15.3%.

There were several highlights in the quarter, including broad-based revenue and bookings growth in Engineered Systems; strong revenue and bookings growth in Fluids along with continued sequential margin improvement; continued organic growth and year-over-year margin improvement in Refrigeration & Food Equipment; and lastly, strong broad-based revenue and bookings growth in Energy. Also from a geographic perspective, U.S., Europe and China markets all grew organically year-over-year.

Our full year EPS guidance remains unchanged. Importantly, this guidance does not include anticipated gain on the sale of Warn, fourth quarter costs associated with the Wellsite separation or any incremental rightsizing costs. We will record these items as the disposition is completed and as costs of the separation and rightsizing are incurred.

Now let's go through some details on the quarter, starting on Slide 3 of the presentation deck. Today, we reported third quarter revenue of $2 billion, an increase of 17%. Organic growth of 9% was complemented by acquisition growth of 10%. Partially offsetting these results was a 3% impact from prior dispositions. Adjusted EPS increased 40% to $1.16. This result excludes $0.02 of disposition and Wellsite separation related costs in the quarter. Adjusted segment margin was 15.3%, a 120 basis point improvement over last year, primarily driven by incremental margin on increased volume. Bookings increased 14% to $1.9 billion. This result is comprised of 7% organic growth and acquisition growth of 10%, partially offset by a 3% impact of prior dispositions and reflects strong growth in Engineered Systems, Fluids and Energy. Book-to-bill finished at 0.97. Overall, our backlog increased 18% to $1.3 billion. On an organic basis, backlog increased 12%. Free cash flow was $214 million in the quarter, a sequential increase of $64 million. We expect very strong free cash flow generation in the fourth quarter consistent with our normal pattern.

Now turning to Slide 4. Organic growth was broad-based. Engineered Systems grew 7% driven by solid activity across both platforms. Fluids' organic revenue increased 5%, principally driven by solid retail fueling and strong industrial pump and pharma and hygienic markets. Refrigeration & Food Equipment increased 2% and Energy grew 31% organically. As seen on the chart, acquisition growth was 30% in Fluids and 8% in Engineered Systems.

Now turning to Slide 5. Engineered Systems' revenue of $646 million was up 7% organically, reflecting broad-based growth. Adjusted earnings increased 5% over the prior year as volume leverage was partially offset by the impact of investments and material cost inflation. Our Printing & Identification platform revenue increased 4% organically, driven by continued strong growth in digital printing and solid activity in our marking and coding markets. In the Industrial platform, revenue increased 18%, including acquisition growth of 14% and 9% organic growth. The organic growth was broad-based with strong performance in waste handling. Margin was slightly below our expectations, reflecting the timing of investments and modest material cost inflation. Bookings increased 10% overall, including organic bookings growth of 3%. Organic growth reflects solid activity across the segment. Book-to-bill for each of the platforms and overall for the segment was 0.98.

Now on Slide 6. Fluids' revenue increased 36% to $563 million, reflecting acquisition growth of 30% and 5% organic growth. Organic revenue growth was primarily driven by strong industrial pump and hygienic and pharma markets as well as solid retail fueling activity. Earnings increased 32%, largely driven by volume growth, including acquisitions and productivity gains. Our retail fueling integration continues to be on track, supporting a strong sequential margin improvement. In all, margin was 15.5%, up 220 basis points sequentially. Bookings grew 39% driven by acquisitions and 10% organic growth. Organic bookings growth was broad-based. Book-to-bill was 1.02.

Now on Slide 7. Refrigeration & Food Equipment's revenue of $439 million included organic growth of 2%. Organic -- the organic increase was largely driven by solid activity in Refrigeration. Food Equipment results reflected continued softness in our commercial cooking equipment markets. Earnings increased 2% from the prior year or 7% when excluding the impact from a prior disposition. Margin expanded 70 basis points year-over-year, reflecting volume leverage, offset in part by business mix. Bookings decreased 11% organically, reflecting a general slowdown in our retail refrigeration markets and the timing of orders in can-shaping machinery. Of note, our can-shaping business is expected to have a very strong fourth quarter as we ship against orders booked earlier in the year. Book-to-bill was 0.82.

Moving to Slide 8. Energy revenue increased 32% to $359 million, reflecting growth in the U.S. rig count and increased well completion activity. Earnings were $52 million and segment margin was 14.5%, both significantly improved over last year. These results were largely driven by year-over-year improvements in the U.S. rig count, increased well completion activity and continued strong results in bearings and compression, which grew 9%. As Bob mentioned, our Wellsite business had a strong quarter with 39% revenue growth and we are on track to achieve their full year forecast. We expect fourth quarter segment revenue to reflect modest sequential growth. Bookings were up 36% year-over-year and 4% sequentially. Book-to-bill finished at 1.03.

Going to the overview on Slide 9. Our third quarter corporate expense included $2 million of Wellsite-related separation costs. Interest expense was in line with expectations. Our third quarter tax rate was 24.6%. This rate reflects increases due to changes in geographic mix of earnings, which were more than offset by discrete tax benefits. The net result of these items was a $0.04 EPS benefit.

Moving on to Slide 10, which shows our 2017 guidance. We now expect total revenue to increase 14% to 15% versus our prior forecast of 12% to 14%. Within this forecast, organic revenue growth is 6% to 7%. The impact from completed acquisitions is unchanged at approximately 10%. The full year impact from FX is now expected to be neutral, up 1 point from the last forecast. From a segment perspective, organic growth is largely unchanged from our prior guidance.

Our full year forecast for corporate expense is $133 million and now includes $2 million of Wellsite costs incurred in the third quarter. Interest expense is unchanged and we expect the fourth quarter tax rate to be about 28%. Our forecast for CapEx remains unchanged and the full year free cash flow is expected to be 10% to 11% of revenue.

In summary, our full year EPS guidance of $4.23 to $4.33 is unchanged. As previously mentioned, this guidance does not include the anticipated gain on the Warn disposition, which is estimated at approximately $230 million net of tax and is expected to close in the fourth quarter. It also does not include any fourth quarter costs related to Wellsite separation. And lastly, it does not include any rightsizing costs, currently estimated to be about $40 million to $45 million. At the midpoint, our EPS guidance represents an increase of 39% over 2016 on an adjusted basis.

Please note that our guidance bridge can be found in the appendix of our presentation deck.

With that, let me talk -- turn the call back over to Bob.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Thanks, Brad. Throughout the year, all segments have grown nicely and we have gained share in several of the markets we serve. Additionally, we have made progress on several of our initiatives to drive margin expansion. For instance, our retail fueling integration is on pace and sequential margin expansion in Fluids has been strong. Retail refrigeration margins have also grown on improved productivity.

Looking forward, we have multiple opportunities to outgrow the broader market. Here are just a few. Our unique position in the fast-growing digital textile printing market is providing us a strong growth opportunity. We see the penetration rate of digital technology climbing to 30% over the next 10 years from the 3% to 4% rate of today. Our comprehensive solutions, including equipment, ink and software, positions us very well to fully leverage this technology shift.

Within retail fueling, we expect the EMV upgrade cycle in the U.S. to accelerate as our customers begin preparing for compliance with payment regulations that go into effect in 2020. Along with that, our growing offering in remote monitoring and software-as-a-service provides ample opportunity for strong growth.

In refrigeration, we expect food retailers to invest in closed-door refrigeration cases, energy-efficient systems and in specialized display cases as they look to manage operating cost and differentiate themselves in the market. In these product categories, we have a leading position.

Finally, within our industrial pumps business, the worldwide growth of plastic usage and our customers' desire for improved efficiency plays to the strengths of this platform. We have the leading position in pelletizers and other polymer processing equipment due to our higher output, faster changeovers and more compact designs. These growth drivers, coupled with our margin improvement initiatives, provides a very positive framework for the next several years. And in closing, I'd like to thank our entire Dover team for remaining focused on our customers.

And with that, Paul, let's take some questions.

Paul E. Goldberg - *Dover Corporation - VP of IR*

(Operator Instructions) So with that, let's have the first question, Paula.

QUESTIONS AND ANSWERS

Operator

Your first question comes from Nigel Coe of Morgan Stanley.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

I just wanted to hit off with ES margins. They came in -- you mentioned your margins came in more or less in line with your expectations, but just wondering about the impact, if you could maybe just define the impact of raw material inflation. On that topic, I noticed that the pricing in ES improved from 0.3% to 0.5% from 2Q to 3Q. I'm just wondering what actions you take on pricing to offset that raw mat inflation.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

The material inflation, Nigel, in the third quarter for Engineered Systems was a little bit higher than we had expected coming into the quarter. You do appropriately note the price increases, both second quarter and third quarter. And I would love to have seen more of a price increase in the third quarter and I know the guys are working on that here for the fourth quarter and going into 2018. But the -- at the end of the day, even though I'd say margins overall came in largely in line with our expectations, margins at Engineered Systems, to be frank, were a bit disappointing and they should be better.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Okay. But it sounds like you are trying to get pricing pushed through the channel?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes.

Nigel Edward Coe - *Morgan Stanley, Research Division - MD*

Okay. And then, you mentioned obviously in the PR that the process for the Wellsite is on track. Are you -- given the costs you incurred during the quarter, are you pursuing essentially a dual track process here where you're preparing for a spin but open to other options so that if you do decide to spin in December, that the process could be relatively quick from thereon?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

We are managing a dual track process. We have been -- we've got a rather robust work stream internally as well as with our outside advisers to prepare us for a spin process. And if we get to year-end and declare that our separation process will be a spin, we would expect the spin to be completed before the end of the second quarter.

Operator

Your next question comes from Steve Tusa of JPMorgan.

Charles Stephen Tusa - *JP Morgan Chase & Co, Research Division - MD*

Can you just talk about -- I heard you say something about $40 million and I believe it was cost savings for next year, but obviously there's some stranded stuff if you spin or sell. You mentioned that you're going to spend some money here in the fourth quarter that's not yet in guidance. Can you maybe just kind of tie those things together and just remind us what's new and what's not on the bridge?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Okay. Well, I'll let Brad deal with the bridge. So the -- first off, I would -- let me respond to your comment about stranded costs. If we were to assume that the separation plan for Wellsite is a spin, Steve, the cost connected with Wellsite as it operates today within Dover and the segment cost are going to move almost 100% with the spin. So the stranded cost to me is actually a de minimis number. That said, I look at -- as we look at moving into 2018 absent Wellsite, it is a smaller revenue base. On a pro forma basis, we expect and we'll deliver improved margins in 2018 over 2017. And we're looking -- as my prepared comment pointed out, it's a very broad-based review of all areas of Dover, excluding Wellsite. And we have -- today, we believe we've got rough line of sight to about $40 million of savings that would show up in 2018. And I think Brad commented on the cost that we would incur to execute on capturing those savings and it's about $40 million to $45 million. Here's the problem I have with the $40 million to $45 million, and it's one of timing. We still have some projects to approve here over the next 2 to 3 weeks. We have internal communications to roll out. I'm not sure sitting here today that we'll end up booking that entire $40 million to $45 million of cost into the fourth quarter. Some of those costs may very well bleed into the first quarter.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Yes.

Charles Stephen Tusa - *JP Morgan Chase & Co, Research Division - MD*

Got it. Got it. So -- yes.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

So Steve, just to clarify the bridge, because it's still a work in progress, I think we're confident on the $40 million of benefits. We're not as confident as the split on the cost side, but the lion's share of it will be in the fourth quarter based upon what we know today and it's not in the bridge so...

Charles Stephen Tusa - *JP Morgan Chase & Co, Research Division - MD*

And that's above and beyond what you're getting from the base restructuring you're already doing?

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Absolutely.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

So the base restructuring, previously we've been talking about $18 million to $20 million. We're still -- that base restructuring is still ongoing, which gives us over 40 -- that generates benefits for us in the current year of about $47 million. There'll be some carryover into '18 on that as well.

Charles Stephen Tusa - *JP Morgan Chase & Co, Research Division - MD*

Okay. Just one quick question on -- to follow-up on Nigel's question on the -- I think it's engineered business. Anything in kind of the distribution channel in product ID that may be influencing margins there? I know your peer reported and margins there were not -- maybe just a little bit mixed. Anything going on in PID that kind of stands out from a margin perspective?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

No. The -- from a marking and coding perspective, we had a very good third quarter with marking and coding. We are continuing to make some investments within our digital print business, and that's for 2017. Help me with this number. I think it's about $5 million or $6 million of incremental investment that will not continue and will not repeat in 2018. But with respect to marking and coding, it was a pretty solid quarter. And no -- to answer your specific question, no issues with distribution.

Charles Stephen Tusa - *JP Morgan Chase & Co, Research Division - MD*

I'm sorry. One last quick one. Sorry, Paul. I know you're going to kill me for this. But Bob, with all this movement around the portfolio, you've obviously had a nice run here. You've done a lot at the company and changed quite a bit. Is there any kind of a step -- further step forward in kind of succession planning? I mean, clearly, the company has changed a lot. You've done a lot of heavy lifting. Anything to discuss on the succession planning side?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

The answer is no, other than I would repeat what I've said before with other questions on this topic. The board and I run and have been running a rather robust process around succession planning. I think the board feels quite comfortable with it. We are -- we do not anticipate a near-term change.

Operator

Your next question comes from Scott Davis of Melius Research.

Scott Reed Davis - *Melius Research LLC - Research Analyst*

I just had -- I was curious. Your comment about dual tracking in the Energy business is interesting, but is there a scenario where you could sell pieces of Energy and spin the rest? I mean, there is some real gems in there that could command some pretty high multiples.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes. I won't say no to anything, but I don't see that -- truly, I don't see that being one of the outcomes.

Scott Reed Davis - *Melius Research LLC - Research Analyst*

Okay. And then, on the Refrigeration business, you showed like a book-to-bill of 0.82. I mean, I think most of us knew that market was getting a little bit softer, but is some of that reflected in the fact you guys have just been cutting your SKUs that -- kind of redefining your market a little bit? Is there any way to parse that out?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

No. Look, we've actually been asking that question ourselves. I don't think that's having an impact with our customers or with the business. It's been a very odd year, Scott, within this segment. We typically have, my goodness, for years have historically seen the second and the third quarter being the high points for this segment, with the 2 shoulder seasons, the first quarter and the fourth quarter, being light. We saw the change starting to occur with this segment in the order rates in the fourth quarter of last year. We had very strong organic growth in the first 2 quarters of this year. And the questions on every call this year so far have been, well, why aren't you raising your guide on the Refrigeration segment with respect to the top line? And part of our concern is that we knew we were a bit front-loaded in the first half of this year with respect to some customer activity, most notably around some of the cutover on the DOE regulations. We just did not know what we were going to see definitively in the second half. I fully expect 2018 to return the segment to a more seasonal and normal pattern that we've seen over the last several years.

Operator

Your next question comes from Andrew Kaplowitz of Citi.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

Bob, so during the quarter, actually, you mentioned the potential for $0.04 of hurricane impact, but it seems like your businesses were able to absorb the impacts pretty well. So did you see -- did you end up seeing less impact than you thought? And if there was any impact, what particular businesses absorbed the most impact?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Well, we -- goodness, it sounds like a huge number, Andrew, but with respect to Harvey in Texas, our Energy businesses that have operations there in the Houston area, we actually lost 4,000 work hours due to the storm and due to the factories being shut down for 5 or 6 workdays. And at the middle of September, we were looking at a bit of a challenge in closing the quarter to hit the top line plan and believe that we would incur some missed earnings that could amount to $0.03 to $0.04 for the quarter. The guy -- the teams there did an outstanding job in recovery activity in the second half of September, but I would still tell you that the cost for the incremental overtime and extra work that was done to take care of the customers, I think we incurred probably $0.01 to $0.02 of cost that was related to the storm. It's included in our EPS results for the third quarter. And to a much lesser degree, much lesser degree, when the hurricane came up the East Coast, we had 2, if not 3, of our larger operations on the East Coast that were shut down for 1 to 3 days, but the biggest impact was Harvey.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

Bob, did you see any positive impact from the hurricane in terms of replacement in any of your businesses? Any step up as you've gone through October here?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

We're seeing a little bit of an increased activity in the Houston area with respect to glass doors to replace some of the damaged doors there, especially in the smaller-footprint stores. And I think it's possible, though we haven't booked a specific order yet, but it is possible that we see some order activity here in the fourth quarter as a result of the storm. But if it happens, it's not in our guide and we haven't seen the orders yet.

Andrew Alec Kaplowitz - *Citigroup Inc, Research Division - MD and U.S. Industrial Sector Head*

Got it. And can you give us a little more color on your fueling and transfer markets? You mentioned last quarter that it was actually your rail business that was a big weight on the business this year. Was that still the case in Q3? And do you see any stabilization there? And do you see a moderation in EMV-related activity that you expected this quarter?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Okay. So let me be real specific here on transportation. Within our Fluids segment, that part of the business, and Paul, what is it? About $100 million in revenue?

Paul E. Goldberg - *Dover Corporation - VP of IR*

Yes.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Roughly $100 million in revenue. I think it was down almost 20% year-over-year in the third quarter. Our retail fueling business...

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Stable at that level.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

But it's stable, yes, okay? Within our retail fueling business, the organic growth for retail fueling was 4%, 3% to 4% in the third quarter. Activity, whether it be dispensers, hanging hardware or underground components, activity in Europe and China continues to be quite strong and solid. With respect to the U.S. market, dispenser activity in the U.S. was down in the third quarter as we expected. The only other color note I would share with you is that in the last 2 weeks of September, and it's continuing here so far in October, the order rates -- the incoming order rates for dispensers has actually picked up comfortably. I mean, it's a nice pickup. If that were -- if those order rates were to continue to hold or even expand as we go through the fourth quarter, I think this group has the opportunity to outperform on the revenue performance for the fourth quarter. EMV, I'll give you a comment on EMV. It was subdued in the third quarter, again, as we expected and spoke about in May and our June conference. We've been -- we've had engagement with 3 of our top brands, customer brands in this space just in the last few weeks with respect to discussions on their EMV rollout in 2018. And I think we'll have a firming of opinion on what EMV activity will look like in 2018 in another 2 to 3 months.

Operator

Our next question comes from Andrew Obin of Bank of America.

Andrew Burris Obin - *BofA Merrill Lynch, Research Division - MD*

Just a question on Engineered Systems. So it does seem that margins have disappointed in the quarter. Often, when we have these situations, it took several quarters for the ship sort of to right itself. How fast do you think Engineered Systems can get to sort of normalized operating leverage?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

I think you will see an improvement in their margins here over the next 2 quarters.

Andrew Burris Obin - *BofA Merrill Lynch, Research Division - MD*

Terrific. And is it more operational or is it more pricing?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

It's -- I would say there will never be an absence of operational opportunities, but I would tell you that the disappointment for the third quarter was around material inflation and pricing offsets.

Andrew Burris Obin - *BofA Merrill Lynch, Research Division - MD*

Got you. And just a follow-up on free cash flow. Your previous outlook was 140% conversion. You're now saying 130% if we look at -- sorry, cash flow statement. What's driving this? Is it working capital, but you also have sort of other items chewing up cash and there's a tax item that's chewing up cash? Can you give us more visibility as to why cash conversion is now a little bit lower?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Brad, can walk you through some specific details. But #1, I would tell you that working capital in the third quarter was actually 100 bps better than it was year-over-year, but it was still less than we were looking for and expected. It's not inventory. We -- inventory came in as we expected, if not a tad better. And it's not a payable issue. We did see -- I think you have to help me here. I think, sequentially, from the second quarter to the third quarter, I think we actually saw almost a full day increase in DSO. But part of this is the working cap -- the absolute dollar increase, which comes back to cash, the absolute dollar increase in working capital just to support the strong organic growth that we've had in the last 2 quarters.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Yes. So what Bob's saying in the -- is our metrics are actually quite good in terms of working capital metrics. What we're seeing is the increase in accounts receivable specifically as we've had this strong revenue growth. So we're expecting strong collections in the fourth quarter to support a strong fourth quarter free cash flow and put us in that range of 10% to 11%.

Operator

(Operator Instructions) Your next question comes from Deane Dray of RBC Capital Markets.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Can we spend a moment talking about life after the Wellsite separation?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Life after Wellsite? Yes?

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Yes. Just how does your oil and gas exposure change and gets -- I mean, most of it's going to be in Fluid, bearings and compression, likely into Engineered Solutions. But if you looked at it, percent of revenues, but also the upstream, midstream, downstream will change significantly, likely more midstream. But can you take a pass at that, please?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Well, we have looked at this. We have the data on this and it's been 3 or 4 weeks since I looked at it, and I'm struggling with recall to give you specific numbers. Obviously, it is down. Our Wellsite exposure is down, but I would first call out the comment that I made earlier on transportation. We would label this $100 million business in transportation to be Energy-related. It may not be all upstream. Some of it is midstream, but I would truly label it as Energy-related. And in bearings and compression, it's -- there is some upstream connection to bearings and compression, but it's not the -- there's not the correlation or the size that we have in the Wellsite businesses. And the bulk of it, other than bearings and compression, is connected into the Fluids segment.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And then, as a follow-up on the material cost inflation in ES, just could you size that for us? And I'm surprised. If you -- if I had to guess where you would have seen some pressure, it might have been in Refrigeration with copper being up as much, but maybe you just size the impact there.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

I will let Brad give you some numbers on this, but let me comment on your Refrigeration note. We actually started to see material inflation raise its head in Refrigeration in the first quarter and the second quarter. I don't remember the numbers now, but I actually think our material inflation headwind in the first quarter just within Refrigeration, I think, was $9 million. There were prices -- there were price increases put in as we exited the first quarter in Refrigeration. We didn't have -- we didn't cover it all in the second quarter, but the gap on material inflation significantly reduced in the second quarter. And I'm not viewing that -- given our early position on raising prices in Refrigeration to cover the material, I'm not looking at pricing -- price inflation to be a decremental for Refrigeration in the second half of the year.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And Brad was going to size the...

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

You want to size it, I'll let Brad do it.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

You want to size it. Coming out of the second quarter, we said we would see about $34 million of net impact on materials for the year. That was in our last guide. It's now up to $38 million. And I would say all of that $4 million delta is in DES because what Bob is referring to, fundamentally on

DRFE, we had a first half impact as they were putting the prices in place, and it neutralized itself in the back half. That's still true today for the most part, very minor change. Our DE business is seeing some steel increases. They've also put in place some price increases here in October. So it really is, fundamentally, a move within DES. And these guys -- our guys are working on this. They're working on price increases and more productivity. That's just going to take a period of time to offset.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And just lastly, and this is not a question, but a comment. Off-road Jeep enthusiasts like me are sorry to see the Warn business leave the portfolio today. Let that be noted.

Paul E. Goldberg - *Dover Corporation - VP of IR*

Comment noted, Deane.

Operator

Your next question comes from Julian Mitchell of Crédit Suisse.

Julian C.H. Mitchell - *Crédit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, & Lead Analyst for US Electrical Equipment*

Just a question, firstly, on the Warn business that you just touched on. I think when you bought that, you paid about 2x, 2.5x sales. Just wondered if you could give any color on the sale multiple, and what kind of lost operating earnings we should dial in for next year.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

So earnings for the business that was sold for next year, Brad, I'm going to say $0.10?

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

That's the impact of lost earnings.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

That's the impact, lost earnings, $0.10. Look, please note that I was very specific here in my scripted comments. We did not sell the entire Warn business. We sold the winch business, both the consumer and the smaller industrial winch business that was part of Warn. What we kept was actually the OEM component business for the auto industry. And the business activity that was sold from a revenue perspective, Brad, I think was $130 million? Am I close in that?

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Yes, roughly that number.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes.

Julian C.H. Mitchell - *Crédit Suisse AG, Research Division - Head of Global Capital Goods Research Team, Director, & Lead Analyst for US Electrical Equipment*

Very helpful. And then, my second question, just you saw obviously the big drop in organic bookings in Refrigeration & Food Equipment in Q3. Maybe give a bit more detail around the retail refrigeration softness? And whether the cost cutting that you talked about, the $40 million, is a lot of that weighted into this segment? Or do you think that, that retail softness or that broader booking softness in Refrigeration & Food will reverse soon?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Okay. So let me deal with the cost savings initiative first. As I said, it is rather broad-based, but I do exclude Wellsite from that comment. And I would not hang more than its fair share -- pro rata fair share of activity on Refrigeration. There has been activity in the second half of last year and through the first 3 quarters of this year with a focus on productivity and cost takeouts. There will be some more within that segment during the fourth quarter and going into 2018. But Julian, this is -- when I say broad-based, I mean across the segments and across corporate and across our regions. It's going to be quite broad-based. With respect to bookings, I'd also punt you back to my earlier comment about how strange or odd of a year it's been with respect to the -- I'll call it the quarterly waterfall within this segment being quite different than what we have seen historically. That's part of what's showing up in this softer bookings here in the third quarter, but it was not all within the Refrigeration business. We also saw soft year-over-year bookings within our can-shaping business following a very, very strong order pattern we had in the second quarter. And we've got a fairly healthy, maybe even record revenue quarter scheduled for the can-shaping business. And even some of the orders that have been booked in the last couple of quarters, we actually feel within the can-shaping business that we're well positioned now for 2018.

Operator

Your next question comes from Mig Dobre of Baird.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Just to follow-up on Julian's question on Refrigeration here. If we're looking at comps, they're getting significantly tougher as we go into 2018 for Refrigeration. And if bookings, as you say, remain relatively soft here, I recognize that there is a seasonal issue, but I'm wondering, on tougher comps, do you believe this business can actually grow next year? And if volumes aren't picking up, how should we think about margins?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Number one, I would tell you that the segment leadership team as well as the operating business leadership teams truly are convinced they can grow this business next year. If you look at it on a quarterly basis, again, given the change in 2017 on how strong the first quarter was relative to historical comps, as we move into 2018, it's going to be impossible for just the Refrigeration platform to have positive organic growth in the first quarter as you comp it against the first quarter of '17, but I -- we are convinced that we'll return to a more seasonal pattern in 2018. And I think you'll see the positive comp show up in the second half of the year.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Bob, do you have the sense that there are enough levers in this business where, if your expectation for bookings growth doesn't materialize, there are things that you can do to address that from a margin standpoint?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And then, my follow-up on P&I. So I know your comment is that there is quite good growth over there, but my sense, again, looking at comps here, is that your business slowed even though your comp has gotten a lot easier organically sequentially. So I'm sort of trying to understand the dynamics here. Are we talking about different growth in textile versus your marking and coding? Is there some lumpiness that I'm not getting? Anything would help.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes. Well, there's a different growth profile between digital and marking and coding. I don't know what that difference was in the third quarter, but the growth in digital textile was pretty healthy in the third quarter. With respect to [MI], I don't have that number in front of me. 3%?

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

3%.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

3% organic growth in the third quarter for marking and coding.

Operator

Your next question comes from Nathan Jones of Stifel.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

I'd like to talk a little bit about the pumps business in Fluids. You've seen some pretty decent -- pretty good organic growth there in the last couple of quarters against what are fairly easy comps. The comps do get a bit more difficult here. Is the growth here just a result of the easy comps? Have you seen that business fundamentally improve? And what markets are driving it?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Okay. So yes, I don't disagree with you. If we look back on the comps, we had -- the revenue for this business for the pumps group or platform in 2016, we were clearly still feeling the downdraft from the down cycle in the upstream oil and gas activity. We have seen -- with respect to upstream oil and gas, we have seen a nice recovery in those applications throughout the year. And by the time -- I think the fourth quarter, the comps probably aren't as easy as they were in the first and second quarter this year, but we are also still showing fairly strong organic growth for the pumps business in the fourth quarter. But the other, I'll call it 2 areas of pumps outside of our distribution activity is our hygienic and pharma business continues to perform very, very well and strong growth rates, and those comps are not easy because they had strong growth rates last year as well. And the -- our plastic and polymer business within pumps, a bit more of a project business, so you get some noise when you look at quarter versus quarter and on a year-over-year basis, but we'll have strong growth in the plastics and polymer business for 2017 and we'll have quite solid growth in that business in 2018.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

So it sounds like you're thinking this is more of a fundamental recovery in the business than it is just a matter of comps and that the business overall should grow in '18.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

I'm not denying that for the industrial applications related to oil and gas, the comps are in our favor, but that's not what is driving all of the recovery in growth in our pumps business.

Operator

Your next question comes from Scott Graham of BMO Capital Markets.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

Just looking at the full year organic sales guidance and trying to triangulate toward a fourth quarter number. Please correct me if I'm wrong on the math, but it looks like you're essentially implying low to mid-single organic. And a, is that about, right? And b, is that wholly due to Refridge down there?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

So organic for the fourth quarter, I'm probably rounding to the nearest integer, but it's 6%. Now the important question there, Scott, okay, is how much of the 6% is Dover remainco ex Wellsite? I don't have that data, but it is positive. For your comment about Refrigeration, even with the difference in the customer buying activity within the Refrigeration platform in 2017, organic growth in the fourth quarter for Refrigeration is at 1% or 1% and a fraction, even with our lower expectations.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

Okay. So that's better than I sort of was calculating. Great. The other thing is that...

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Yes. You should remember there's some disposition impact in there that you have to take into account.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

(inaudible) Fine. Okay.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

Yes. No, I get it. The other thing is that should we see -- and maybe the better question is on the ES margin, could you -- and I know there's a question around this earlier. Could you kind of give us sort of the buckets for -- you had an adjusted drop of 130 basis points. Could you kind of tell us -- obviously materials is the biggest issue here. Kind of give us the puts and takes and maybe the sizings of kind of what happened there.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes. Well, Brad can probably provide more specific numbers that I can, but I would say that better than 1/3, maybe approaching 40% of the drop had to do with material inflation.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

We gave -- which we gave you the number.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Yes. And another 1/3 of it -- and again, it may have been slightly more than that -- another 1/3 of it was the increased investment that I spoke about with respect to our digital print activity and then a little bit of noise just around product mix. But that always happens, a little bit of noise around product mix. But that's -- I would say 30% to 40% on material inflation, 30% solid on increased investment in digital print and the rest of it was product mix. Would you want to clarify that?

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

No. I think that hits it.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Okay.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

Yes. And if I could sneak another one in here. Just very simply, you made a comment, Bob, that you're confident that the refrigeration market will improve next year. Could you give us a little bit more behind that thinking?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Well, I'll start first with a roll-up with discussions with customers. And we do expect our activity to be up next year. I don't have a final number. We are going through our planning process. We'll actually kick that off in about 10 days to solidify our operating plans for 2018, but we know we have been awarded some new business. We haven't received the orders yet. I don't know exactly what the order level will be in 2018, but it will be incremental. And on top of that, even if the revenue line were to hold constant in '18 versus '17, we see a clear path and opportunity for improvement in margins.

Operator

Your final question comes from Charley Brady of SunTrust.

Peng Yao Wu - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

This is actually Patrick Wu standing in for Charley. Just it sounds like even though you guys are going through the portfolio rationalization process, M&As, the pipeline is still pretty robust. You guys sound pretty optimistic about that. Can you talk a little bit more about which areas you're looking at and sort of how valuations are right now? And are there any areas specifically where you guys would have a big appetite in terms of if valuation is on the high side still?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

We still are interested in expanding in a general way across different verticals our pumps play within Fluids, and we are always looking for opportunities. We've seen some to expand both in our marking and coding as well as in our digital print area. But the areas we're looking at wouldn't be any different than we've been focused -- than we've been sharing, even at the June investor conference. So there wouldn't be any different there. Your question about valuation, that's interesting because we have walked away -- well, we have been unsuccessful on a couple of recent opportunities to meet the sellers' expectation on valuation. And we just felt it was a little bit into the discomfort range for us. And we just went pencils down and withdrew and we'll wait for the next opportunity.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

At least with bolt-on, add-ons.

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

Bolt-ons. Nothing large, nothing significant.

Brad M. Cerepak - *Dover Corporation - Senior VP & CFO*

Nothing that we walked away from that was -- directionally would change the way we think about the platforms.

Peng Yao Wu - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay. Got it. And then, just one more on Refrigeration & Food Equipment. You guys answered a lot of those questions already. But if we ex out the sort of around $6 million in inefficiencies from Hill PHOENIX the last year, if you look at that number year-over-year, it's I think down by like around 50 bps or so. How much of the Hill PHOENIX -- how much of a drag is Hill PHOENIX still inherent in that business? Is that pretty much all gone now? And then also, Walmart has recently sort of talked about online grocery pickups and stuff like that. I think they opened to a tune of around 400 locations this year. Has that been any -- has that incrementally benefited you guys at all?

Robert A. Livingston - *Dover Corporation - President, CEO & Director*

So let me deal with your Walmart question or comment first. I would say that, that activity on their pickup rollout has been minimal, a minimal impact to our business. I know that we've had an order here, an order there, but it hasn't been notable with respect to creating any change. The -- within the Refrigeration segment, the opportunity, the greatest opportunity for margin improvement for the segment resides in Hill PHOENIX and Anthony, primarily Hill PHOENIX.

Operator

That concludes our question-and-answer period. I would now like to turn the call back over to Mr. Goldberg for closing remarks.

Paul E. Goldberg - *Dover Corporation - VP of IR*

Thanks, Paula.

This concludes our conference call. With that, we thank you for your continued interest in Dover and we look forward to speaking to you again next quarter. Have a good day.

Operator

That concludes today's Third Quarter 2017 Dover Earnings Conference Call. You may now disconnect your lines at this time and have a wonderful day.
