Trane Technologies - Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to the Trane Technologies Q1 2022 Earnings Conference Call. My name is Chantel, and I will be your operator for the call. The call will begin in a few moments with the speakers' remarks and the Q&A session. At this time, all participants are in a listen-only mode. To allow time for everyone to ask a question, please limit yourself to one question and one follow-up.

I will now turn the call over to Zac Nagle, Vice President of Investor Relations.

Zachary A. Nagle

Thanks, operator. Good morning, and thank you for joining us for Trane Technologies first quarter 2022 earnings conference call. This call is being webcast on our website at Trane Technologies.com, where you'll find the accompanying presentation. We are also recording and archiving this call on our website.

Please go to slide 2. Statements made in today's call that are not historical facts are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities law.

Please see our SEC filings for a description of some of the factors that may cause actual results to differ materially from anticipated results. This presentation also includes non-GAAP measures, which are explained in the financial tables attached to our news release.

Joining me on today's call are Dave Regnery, Chair and CEO; and Chris Kuehn, Executive Vice President and CFO.

With that, I'll turn the call over to Dave. Dave?

David S. Regnery

Thanks, Zac and everyone, for joining us on today's call. Let's turn to slide number 3. I'd like to open with a few comments on our purpose-driven strategy, the engine that enables us to deliver differentiated shareholder returns over time.

Our strategy is firmly rooted in our purpose to challenge what's possible for a sustainable world and aligned to the megatrends that are only getting stronger. We are seeing the impact of climate change on the world every day, including more extreme weather events and far-reaching effects on air quality, water quality, food production and human health.

The science is clear. There is no time to wait. The world must take action now to limit global warming and mitigate the effects of climate change. That's where our purpose meets our strategy. Trane Technologies is already taking action to dramatically reduce emissions through innovative solutions that drive electrification, energy efficiency and emissions reductions for commercial buildings, homes and transport.

We have set aggressive science-based emission reduction targets that continue to push our innovation further and faster. Customers continue to choose us as their partner in achieving their sustainability goals while improving performance and efficiency.

Our relentless approach to innovate, strong customer focus and purpose-driven culture enable us to consistently outgrow our end markets. This in turn helps us drive strong margin and powerful free cash flow to deploy through our balanced capital allocation strategy.

The end result is strong value creation across the board, for our customers, for our team, for our shareholders and for the planet.

Moving to slide number 4. While we'll cover the details of the quarter and our outlook throughout our discussion today, the primary message I'd like investors to take away from today's call is that the company has never been in a stronger position to deliver highly differentiated financial performance and shareholder returns over the long-term.

Our end markets are strong. And our innovation leadership is at the apex of powerful secular megatrends of energy efficiency and de-carbonization, which is enabling us to win customers at an unprecedented pace.

Our business operating system remains at the core of everything we do and is delivering strong price realization to offset the impact of inflation, which is running at multiples of even the highest historical levels. And our balance sheet, liquidity position and ability to deliver strong free cash flow provides a solid financial foundation. We have exceptional firepower and optionality to not only navigate near-term macro challenges, but to flourish as they abate.

Our strong performance in the first quarter is ahead of our initial guidance expectations on both incremental price to offset higher inflation and on volume growth. While it's still early in the year and the macro environments remain very dynamic, our performance in Q1 serves to increase our confidence that we're on pace to meet or exceed our full year guidance.

Our booking levels remain extremely high, reflecting strong share gains in virtually every area of our business, with supply chain challenges impacting throughput in the near term. The absolute booking levels we've delivered over the past year have been extraordinary.

There was a tendency to focus on bookings growth trends, but growth trends may be misleading when absolute numbers move step functions higher than any historical reference period. We encourage investors and analysts to consider both absolute bookings and bookings growth to get a fuller picture. Our first quarter provides a prime example.

Organic sales were up 12%, while organic bookings were up about half that amount, up 6%. A fairly normal reaction to bookings growth being half the level of revenue growth might be to assume that the book-to-bill ratio would be negative and that backlog would be lower as a result.

However, given our tremendous bookings growth in Q1 of 2021 of over 30%, absolute bookings in the first quarter of 2022 were still extremely high at $4.3 billion. Even with strong revenue growth of 12%, absolute revenues in the first quarter of 2022 were $3.4 billion. It maybe counterintuitive, but bookings exceeded revenues by more than $800 million.

Our book-to-bill was extremely strong at 129% and our backlog grew more than 50% year-over-year. Backlog also grew $800 million or 15% sequentially from Q4 to Q1. Given the extremely high levels of bookings throughout 2021, we believe this is an important area to watch to gauge strength as we move forward.

With $16.8 billion in bookings and $14.1 billion in revenues in fiscal 2021, the dynamic I referenced as an example from Q1 will be present throughout the year.

As I look at our business, the strong secular trends, our leading innovation, unprecedented customer demand, and record backlogs and the financial health of our company, I'm very bullish about the future. We have all the fundamental ingredients to deliver differentiated financial performance and strong shareholder returns over the long term.

Please turn to slide number 5. On Earth Day, we released our 2021 Environmental, Social and Governance Report. The report highlights our notable progress towards our science-based greenhouse gas emissions reduction targets, diversity and inclusion commitments and other sustainability goals.

I am proud of the progress we made last year. We exceeded or met nearly all of our annual targets on our glide path towards our 2030 sustainability commitments. We reduced carbon emissions, energy use, waste and

water. In addition, we increased the representation of women in leadership and workforce diversity reflective of our communities. I encourage you to read the full report. It's available on our website.

Building on the momentum captured in our 2021 report, I'm happy to announce that we recently learned that our 2050 net zero targets were validated by the science-based target initiative.

At this time, we are the first company in our industry and one of only 11 companies globally to have 2050 net zero targets validated. This is another example of how we are leading and challenging what is possible for a sustainable world, and we encourage like-minded companies to join us.

Looking forward, I am confident we will continue to innovate, take bold actions and transform the world for a better tomorrow today.

Please turn to slide number 6. Customer demand for our climate-focused innovation continues to grow. We delivered another quarter of robust organic bookings, up 6% in the first quarter. Organic revenues were also strong, up 12%. Supply constraints are impacting each of our segments, with particular tight supply as we move up the food chain on product complexity.

Generally speaking, the more intelligent and complex the product, the more chipsets they require and the more constrained the supply in the near term. Given extremely high levels of demand and backlog more than double historical norms, unconstrained revenues would be significantly higher in every segment.

As mentioned previously, our bookings in the quarter totaled $4.3 billion, far exceeding our revenue of $3.4 billion, which were in part constrained by global supply chain and other macro challenges. With these robust bookings, our backlog grew to a record $6.2 billion.

Our Americas Commercial HVAC business continues to deliver extremely strong bookings. Over the past four quarters, bookings growth has averaged nearly 30%, and Q1 bookings were up approximately 35%.

Strength was broad-based, with applied and unitary each up more than 50%. Service bookings were also strong, up mid-teens. Demand for our comprehensive solutions remained strong and contributed to our low-teens organic revenue growth in commercial HVAC Americas.

The residential HVAC markets also remained strong. Our residential HVAC team delivered mid-single-digits bookings growth and low-teens revenue growth in the quarter. As expected, transport Americas bookings were down in the quarter on tough prior year compare and because we intentionally constrained demand in order to manage inflationary risks.

Unconstrained demand would be much stronger, but customers understand the dynamics and are working closely with us on slots. Bookings remained at healthy levels, with bookings in excess of revenues in the quarter and adding to backlog sequentially from Q4. Revenues were strong, up mid-teens.

Turning to EMEA. We continue to see strong demand for our innovative products and services that help reduce energy intensity and greenhouse gas emissions for our customers. EMEA commercial HVAC bookings were up low-teens and revenues were up low single-digits.

As expected, transport bookings were down on tough prior year compares. Similar to our America transport business, we are intentionally constraining demand in order to manage inflationary risks.

Absolute bookings remained at healthy levels, with bookings in excess of revenues and backlog up sequentially from Q4. Revenues were strong, up high single-digits. Our Asia Pacific team delivered strong bookings and revenue growth of 14%, supported by broad-based growth in China and across the region.

Now I'd like to turn the call over to Chris. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to slide number 7. Organic revenue growth in the quarter was driven by both strong volume growth and continued strong price execution.

Turning to margins. We drove strong core incremental margins of approximately 30%, on solid volume growth of 5%. Volume growth was stronger than expected due to our outstanding performance by our teams and partnership with our suppliers in what remains a choppy supply chain environment. Strong price execution through our business operating system also enabled us to neutralize the impact of higher inflation on a dollar basis, but was about 100 basis point headwind to margins in the quarter.

Productivity was significantly impacted by continued supply chain challenges, including choosing to incur expedited freight costs and spot buys, consistent with our customer-focused business model.

In addition, we continue to make strong incremental business reinvestments, supporting our sustainability-focused strategy. All in, adjusted EBITDA and operating margins declined 70 basis points. Adjusted EPS grew 11%, driven primarily from higher adjusted operating income.

Please turn to slide number 8. We discussed the key revenue and margin dynamics for the enterprise on the prior page. The dynamics impacting revenue and margins were similar across each of our business segments, with volume growth, strong price realization, incremental business reinvestments, and innovation and macro challenges impacting productivity and cost inflation as consistent drivers.

Our Americas segment delivered strong price execution, slightly ahead of material inflation and offsetting expected negative impacts from negative price/cost in both our EMEA and Asia Pacific segments.

Consistent with our prior guide, we expect price/cost to improve throughout 2022 in each region, and we expect to be price/cost positive on a dollar basis for the full year for the total company.

Now, I'd like to turn the call back over to Dave. Dave?

David S. Regnery

Thanks, Chris. Please turn to slide number 9. As we've discussed throughout the call, underlying demand for our innovative products and services have never been higher, with unprecedented levels of bookings and backlog across our businesses.

Commercial HVAC Americas has significantly outperformed the broader markets over a number of years through relentless innovation for our customers. We're driving unprecedented demand, with orders up nearly 30% over the past four consecutive quarters, which is indicative of our clear market leadership. And we're exiting the first quarter with another quarter of record backlog, up more than 70% year-over-year and more than double historical norms.

End markets remain strong, with a variety of economic indicators pointing to growth in 2022. Unemployment is low and indicators like the Architectural Billing Index, which has been over 50 since February of 2021, remain favorable. Demand remains strong in data center, warehouse, education and health care.

Every day we see customers establishing their own sustainability targets, creating decarbonization road maps and helping them to achieve their targets with our customized system-based approach. We're helping our K-12 customers deploy federal stimulus funds to improve the indoor air quality of schools. We see both decarbonization and indoor air quality as multiyear tailwind for our business, given our deep customer relationships and expertise.

Demand for our residential products remain strong. We entered the second quarter with tailwinds from record backlog and expected strong price realization. We see headwinds from lapping tough growth compares from 2021.

Turning to Americas transport. ACT projects continued market growth through their forecast horizon of 2023. I'll talk more about transport outlook in our topics of interest section. Turning to EMEA. While we have muted expectations for market growth, with a volatile geopolitical backdrop continuing, demand for our sustainability-focused systems and services remain strong, and we continue to see good opportunities for market outgrowth.

Turning to Asia. We are monitoring the COVID lockdowns in China and their broader impact on the region. Outside of Shanghai, we have a plant impacted by the lockdowns that provide equipment or components to support our customers in China and the rest of Asia. Our guidance assumes China reopens mid-May and any revenue impact due to the China lockdowns during Q2 will be recouped in the second half of the year.

For the year, we continue to see underlying strength in China's data center, electronics, pharmaceutical and health care markets. Outside of China, the picture is mixed, with COVID-related lockdown still impacting market expansion in some countries. Our direct sales model is differentiated in the region and provides good opportunities for market outgrowth in both equipment and services.

Now, I'd like to turn the call back over to Chris to outline our guidance for Q2 and full year 2022. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to slide number 10. Based on the market outlook Dave just outlined and our strong bookings and backlog, we are on track to deliver strong financial performance in 2022.

We are updating our full year organic revenue growth guidance to approximately 10%, primarily to reflect additional strong price realization to offset persistent material inflation. Our adjusted EPS outlook remains unchanged, between $6.95 and $7.15.

We continue to expect a stronger second half, with an improving supply chain and product redesigns coming online that will help us serve our customers better and provide added resiliency to our supply chain. Our updated operating leverage outlook of approximately mid-teens contemplates both additional price realization and additional material inflation.

We continue to expect price/cost to be slightly positive for the year on a dollar basis. We expect free cash flow to remain strong and equal to or greater than 100% of adjusted net income. Our outlook includes capital expenditures of approximately 2% of revenues and high ROI projects in support of our profitable growth objectives and our sustainability commitment. These high ROI projects include manufacturing automation, supply chain resiliency as well as investments to further decarbonize our operation.

Our free cash flow outlook also includes modest investment in working capital, with particular focus on strategic inventory to support continued growth.

Please turn to slide number 11. While we traditionally provide annual guidance, given the dynamic macroeconomic environment, we believe it may be constructive to provide an outlook for the second quarter based on what we see today.

For the second quarter, we expect core organic revenue growth of approximately 10% to 12%. As mentioned previously, our second quarter Asia Pacific revenues are expected to be negatively impacted by the lockdowns in China by approximately $80 million to $100 million, a headwind of approximately 2% to 3% for the total company.

Our guidance assumes China reopens mid-May and any revenue headwinds due to the China lockdowns during Q2 will be recouped in the second half. Net, we expect our organic second quarter revenues to be up high single-digits and expect continued strong price realization.

At this stage, we expect to offset inflation with price on a dollar basis, which carries a heavy margin headwind for the quarter. We see macro supply chain challenges continuing to hamper productivity. We also expect continued expedited freight costs and spot buys as we focus on meeting our customers' needs for sustainable solutions.

As we discussed on the prior slide, our full year outlook contemplates a stronger second half, with an improving macro environment. We'll continue to update our full year outlook as the year goes along.

Please go to slide number 12. We remain on track to deliver $300 million of run rate savings from business transformation by 2023. Importantly, we continue to invest in these cost savings and high ROI projects to further fuel innovation and other investments across the portfolio. We've highlighted some of our innovation for decarbonization on slide 21 of this presentation for your reference.

Please go to slide number 13. We remain committed to our balanced capital allocation strategy, focused on consistently deploying excess cash to opportunities with the highest returns for shareholders.

First, we continue to strengthen our core business through relentless business reinvestment. Second, we're committed to maintaining a strong balance sheet that provides us with continued optionality as our markets evolve. Third, we expect to consistently deploy 100% of excess cash over time.

Our balanced approach includes strategic M&A that further improves long-term shareholder returns and share repurchases as the stock trades below our calculated intrinsic value.

Please turn to slide number 14, and I'll provide an update on our capital deployment in 2022. In the first quarter, we deployed $506 million in cash, with $350 million of share repurchases and $156 million to dividends. Our board also authorized an additional $3 billion for share repurchases, bringing our total remaining share repurchase authorization to $4 billion as of the end of the first quarter.

Turning to M&A. We completed a small channel acquisition in April, and our M&A pipeline remains active. All in, we're on track to deploy approximately $2.5 billion in cash in 2022, inclusive of $1.9 billion between M&A and share repurchases. Our strong free cash flow, liquidity and balance sheet continue to give us excellent capital allocation optionality and dry powder moving forward.

Now, I'd like to turn the call back over to Dave. Dave?

David S. Regnery

Thanks, Chris. Please go to slide number 16. Global transport markets are expected to remain healthy through 2023. ACT has recently moderated their expectations for transport growth in North America for 2022, largely driven by expected OEM trailer supply chain constraints.

European forecasts have moderated somewhat also, reflecting current OEM supply constraints and uncertainty related to the conflict in the Ukraine. Weighted average transport market growth in America is 8%, down about 4 points.

EMEA market transport growth is forecasted to be flat, down about 3 points from our previous outlook. After clear share gains in truck, trailer and APU globally in 2021, we're expecting global outgrowth in 2022 as well.

Please go to slide number 17. We've updated the transport growth outlook slide for North America in the slide deck for reference and additional transparency. ACT continues to call for a nine-year average for North America trailers, in the mid-40,000 unit range through 2023, with the pandemic in 2020 being the only significant outlier.

Please go to slide number 18. Energy efficiency, decarbonization and sustainability megatrends are only growing stronger. We are uniquely positioned to deliver leading innovation that addresses these trends, and accelerates the world's progress, supported by our business transformation and our engaging uplifting culture.

Despite a number of persistent macro challenges, Q1 was a record quarter for us, which provides a solid foundation as we move into the rest of the year. While it's still early in the year, our first quarter performance and our outlook for the second quarter have us well positioned to meet or exceed our full year guidance.

We're seeing unprecedented levels of demand for our innovative products and services. And our backlog has never been stronger. We're executing our business operating system well. And expect to continue to successfully navigate macro challenges with a customer-first mind set.

We believe we have the fundamental ingredients to deliver strong performance across the board in 2022 and beyond, and to continue to drive differentiated shareholder returns over the long-term.

And now, we'd be happy to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator

Our first question comes from Scott Davis with Melius Research. Your line is open.

Analyst: Scott Reed Davis

Question – Scott Reed Davis: Hey. Good morning, everybody.

Answer – David S. Regnery: Hey, Scott. How are you doing?

Answer – Christopher J. Kuehn: Good morning.

Question – Scott Reed Davis: Good. Thank you. Kind of a big picture question here I mean, this – the energy independence theme in Europe is center stage or I think taking – or getting a lot of attention here. How does that change the HVAC landscape? I mean, are you seeing more incomings related to trying to drive a little bit more energy efficiency there? Is that a real driver yet of demand?

Answer – David S. Regnery: Absolutely. I mean, we're seeing unprecedented demand right now as you saw our results in the first quarter. And a lot of it has to do with our new innovations around products that are helping our customers decarbonize, which is just a massive opportunities in the future.

Question – Scott Reed Davis: Yeah. I think actually – I mean, I think what I've kind of meant, Dave, is it incrementally make it – I mean, demand has

been strong in Europe. But is it incrementally increasing just in the last few months since the Ukraine invasion?

Answer – David S. Regnery: We're still seeing strong growth in Europe. I think you also have some regulation that's starting to come through there where fossil fuels are just not going to be permitted in certain countries. We see that continuing to grow with – I think Germany was the latest country to adopt that type of legislation.

So, a lot of the products that we have, and I think we're now on our – I was just over in Europe a couple of weeks ago. And we're on our fifth generation thermal management system, which is really the combination of a boiler and a chiller into a system which allows the customer to accelerate their decarbonization efforts by eliminating fossil fuel.

So, we're excited about the opportunity. It keeps growing. We keep innovating for it. And I would tell you it's not just unique to Europe. We're seeing it really on a global basis.

Question – Scott Reed Davis: Okay. And given your stock price and just market dynamics overall, should we expect a big tick-up in buybacks in 2Q?

Answer – Christopher J. Kuehn: Hey, Scott. This is Chris. What I would say is, we see a lot of value in our shares today. And frankly, we saw a lot of value in our shares three months ago. We take a long-term view in terms of stock valuation and looking at our intrinsic value.

As we noted on the prepared remarks, we have a lot of firepower with respect to repurchases. $3 billion new authorization provided by our board here in the first quarter puts total capacity around $4 billion here at the end of the first quarter.

So, we really like the position we're in. The balance sheet has got a lot of capacity to do both M&A and repurchases. So, we're not limited. The guide on the year is $2.5 billion roughly of deployment, with about $1.9 billion of share repurchase and M&A. And we'll continue to execute that quarter-by-quarter as we go through the year.

But our priorities remain consistent in how we allocate our funds and our cash. We see a lot of value in the shares. We have a lot of firepower. And look, I think we're really on track for the full year here to deploy that cash.

Question – Scott Reed Davis: Okay. Sounds good. Thank you. Good luck, guys.

Answer – David S. Regnery: Thanks, Scott. Appreciate it.

Operator

Our next question comes from Joe Ritchie with Goldman Sachs. Your line is open.

Analyst: Joe Ritchie

Question – Joe Ritchie: Thank you. Good morning, guys.

Answer – David S. Regnery: Hey Joe, how are you?

Answer – Christopher J. Kuehn: Good morning, Joe.

Question – Joe Ritchie: Doing well, guys. Thanks for the questions. So, the first one, I've been asking this to basically every company. But the China lockdown exposure, the $80 million to $100 million, just how has that progressed in 2Q? And clearly, like you're assuming the reopening in mid-May. That's not too far away. Just give us kind of like your confidence that you feel like that's pretty well ring-fenced at this point.

Answer – David S. Regnery: Yes. I mean, let me just take a higher level first. I mean, we've had a manufacturing strategy for years of in region, for region. So, the factory that we're – is in lockdown is in the Shanghai region.

But understand that about 90% of our supply chain tends to follow our manufacturing strategy. So, think of it as a manufacturing plant, you'd have about 90% of that located in that same region.

We anticipate the factory will be back online in the quarter. The pause, as we said earlier, will result in approximately $80 million to $100 million in revenue moving out of the quarter. We plan on making it up in the back half of the year. We're starting to see some positive signs where we see some movement happening in the area again. So, we'll stay tuned. But right now, our guide has us reopening in the second half of the month that we're in.

Question – Joe Ritchie: Okay. That's helpful, Dave. And I guess maybe my follow-on there is, just the recoup of the backlog in the back half of the year

and then also the pricing that is in your backlog today that you're building. How do you get comfort that, number one, you will be able to recoup and there isn't potential lost revenues there, or lost backlog there?

And then secondly, on the pricing dynamics, just given the inflationary backdrop that we're in right now, that you guys are pricing accordingly and the margins will come through accordingly?

Answer – David S. Regnery: Yes. I'll start with being able to recoup. We have a lot of capacity in our facilities there. So, we're pretty confident we'll be able to – once we get turned back on, we'll be able to turn back on.

We also have a smaller workforce in our facility today with obviously a proper permission for them to be there to making sure that all of our equipment is in fact, being run. Some of these precision machines, you need to make sure they stay fine-tuned. So, we're proactively doing that. So, when the word is go, we're ready to go. So, we'll be able to – we're pretty confident we can recoup this in the back half of the year.

Chris, do you want to talk about pricing?

Answer – Christopher J. Kuehn: Yes. Sure. And I'll talk about the firmness of the backlog, too, Joe. We don't see any risk right now on the backlog, everything appears to be firm. From a pricing perspective, we're on our second round of price increases here in 2022. We wound up with three rounds roughly of price increases in 2021.

Certainly, from say 90 days ago, material inflation in the quarter in Q1 and certainly on a full year basis is going to be higher than what we thought 90 days ago. But we're seeing stronger price realization. The second round of price increases is giving us confidence that we've got the opportunity to be flattish in the second quarter and be price/cost positive on the full year.

On the backlog in terms of pricing, as we think about our longer cycle businesses, let's say, applied systems orders, those orders, given that they're 6, 9, 12 months out, will generally have a price escalation clause inserted in there. So, some protection in that regard.

In our residential business, not only through price increases we've done, same on the commercial side but the price increases we've done we've also repriced the backlog. So, it has given us an opportunity to reset that pricing when we see a material change in inflation.

And then last, but not least, on the transport portfolio, we've had price increases as well there. But we're also really intentionally managing the demand and the bookings, making sure we're only opening up the bookings for a quarter when we've got good line of sight to what the cost is going to be in that quarter.

So, we're intentionally kind of limiting demand at this point. And I would say, for example, we don't have order books mostly open for the fourth quarter of this year, would be an area where we're kind of pausing until we get closer to understand the cost environment.

But we're not seeing demand destruction at this point at all with the price increases we've had to put in place. In fact, we really look at them as inflation-based price increases. We're really not out here to price guess, we're just trying to offset the inflation that we've got. Hopefully, that helps.

Question – Joe Ritchie: Yeah, very helpful. Thanks guys.

Answer – David S. Regnery: Thanks, Joe.

Operator

Our next question comes from John Walsh with Credit Suisse. Your line is open.

Analyst: John Walsh

Question – John Walsh: Hi, good morning and thanks for taking the questions here.

Answer – David S. Regnery: Good morning, John.

Answer – Christopher J. Kuehn: Good morning.

Answer – David S. Regnery: Hope all is well.

Question – John Walsh: Yes. Thank you. So, I guess if we could focus on the strength in the Americas. One of your competitors had some issues around light commercial and other ones seemed like they had some supply chain issues with controls. I guess can you kind of talk about if you're seeing any market share shifts or maybe what you think you outgrew the market or what the market did, blended for the Americas?

Answer – David S. Regnery: Yes. I mean, I'd tell you, if you think about the Americas, our commercial HVAC business continues to see very healthy end markets. Very low unemployment. Positive Architectural Billing Index for 14 months in a row now, which is just a great indicator for six to nine months.

Applied and unitary bookings were both up over 50% in the quarter, 50%. So, we're seeing tremendous demand right now and we believe that that's going to continue. We're seeing broad-based growth, too. So electronics, data centers, education, health care, office.

I mean, as I looked across the verticals last week, I was – I couldn't find a vertical that was down. So, we're continuing to see very strong demand there. Decarbonization of the built environment continues to be a tailwind for us. Indoor air quality continues to be a tailwind. So, a lot of strength in the commercial HVAC business in the America.

If you go over to res, it's only about 20% of our business, but we saw a strong quarter. The team did well there. 6% order growth, and that comes against a very tough compare, where last year, we were up – the exact number was north of 40%. So, very strong growth there.

And as far as share goes, it's hard for me to say in a constrained environment. You could look at order share and shipping share and get two totally different answers. Our product is obviously – and our backlog is more weighted towards our applied complex products.

And as we said in our opening remarks, think about that as where the constraint tends to be more. The more intelligent your product is, the more chipsets that are required, the more constrained in the short term. But long term, we're very, very bullish about our market share gains. And we're very bullish, too, about what we're seeing in the market and hitting the spots with our innovations.

Question – John Walsh: Great. Thanks for that answer. And then maybe if we think about the guidance construct. I think a couple of times you said meet or exceed. Obviously, still a lot of year left. You put the FX headwind now in the numbers. So what's kind of maybe coming in a little bit better to offset that as you think about the portfolio? Thank you.

Answer – Christopher J. Kuehn: Yes. Thanks, John. You're right. For the full year adjusted EPS, we held at $6.95 to $7.15. We did incorporate about

$0.05 of headwind from FX in that guide as well. So we're feeling confident we could offset that.

Look, we're in the first quarter of the year. It's traditionally the lightest quarter of the year when we think about HVAC companies. So we're happy with the results, where we are in the first quarter. It turned out stronger than we thought when we guided 90 days ago or so. So, it's giving us increased confidence on the full year basis.

We took the full year revenue up to 10% or approximately 10%, given what we're seeing an increased price realization. So right where we sit, we were in the first quarter, we've got three more to go and we're certainly going to update you and the group when we get to the Q2 earnings release, because we'll be halfway through the year at that point. We'll have a much better sense on where things are shaking out on a full year basis.

With the performance in the first quarter and the guide in Q2, we've really de-risked a bit of the back half of the year. We got out ahead of price here in the first quarter. That's a good sign. We thought we'd be okay there, but a little bit stronger than where – we landed a little bit stronger than where we thought. So, it's just giving us more confidence also on the full year basis that we should be price/cost positive on a dollar basis.

Question – John Walsh: Great. Thank you and good quarter. I'll pass it along.

Answer – David S. Regnery: Thanks, John. Appreciate that.

Question – John Walsh: Thank you.

Operator

Our next question comes from Andy Kaplowitz with Citigroup. Your line is open.

Analyst: Andrew Kaplowitz

Question – Andrew Kaplowitz: Hi. Good morning, guys.

Answer – David S. Regnery: Hey, Andy. How are you?

Answer – Christopher J. Kuehn: Hey, Andy. Good morning.

Question – Andrew Kaplowitz: Good. How are you? So, maybe you could just give us a little more color into how you're looking at resi HVAC in 2022? You said strong quarter. You said in the past, resi new construction would be up low single-digits. And I think, using your words, Dave, you said replacement won't fall off a cliff. But bookings were up mid-single-digits and revenue start of the year up low-teens, as you said. So, can you give us a little more color on your outlook now and how you're thinking about inventories in the channel?

Answer – David S. Regnery: Yes. It's a good question. Not to reiterate but order rates remain strong in the first quarter, up 6%. And that was a bit of a surprise to us considering we were up 40% the prior year. So, the demand continues to be strong.

Our independent sell-through was strong. The inventory in the channel is about where we expect it to be. In the first quarter, we had growth in the new construction channel, although it's a smaller portion of our business. We'll watch interest rates there and see what happens.

But to use your words, we don't see it falling off a cliff, the replacement cycle. Again, resi is about 20% of our business. So even if the replacement cycle did drop 10%, which we don't see it happening, it would be about a 2% drop for the enterprise. And the amount of opportunities that we are seeing in the decarbonization opportunities in both our commercial HVAC business and our Thermo King business on a global basis will far exceed that.

Question – Andrew Kaplowitz: Thanks for that, Dave. And then, I think, you said last quarter that you would be upside down on price versus cost by $30 million to $40 million in Q1. But it turns out you were relatively flattish. I think you mentioned the accelerated price realization. Was this really just going in and repricing your backlog? Wasn't the mix help you at all? And then does it really give you more confidence in sort of staying ahead in terms of that sort of modest green for the year in price versus cost?

Answer – Christopher J. Kuehn: Yes, Andy. It does give us confidence on the full year basis. You're right we guided negative price/cost in the first quarter, and we wound up realizing flattish.

Certainly, some additional volume coming through allows for maybe a little bit more price to come through. But I would tell you that the price execution by our teams has been very strong. I know these are not easy conversations to

have with customers. We hear that all the time from our businesses and our leaders.

The fact is though we're trying to just offset this persistent inflation. So, in the quarter, it was a little bit more inflation, a little bit more price. We got it to flattish. And given our comp on the first half of the year, very strong price a year ago with moderate inflation is where our thoughts were, we could have some headwinds in the first half of the year, it's giving us confidence we're going to be flattish in the first half of the year on a dollar basis for price/cost.

Answer – David S. Regnery: Yes. Really, our business operating system is really being leveraged across the enterprise right now. We see what's coming around the corner, and the teams are being very proactive. Andy, you also asked a question about mix. Yes, mix helped us a bit in the quarter. We are seeing mix up. And that really – that's a good news story because that's where a lot of our innovation is.

Question – Andrew Kaplowitz: Appreciate it guys.

Answer – Christopher J. Kuehn: Thanks, Andy.

Answer – David S. Regnery: Have a good day.

Question – Andrew Kaplowitz: Thank you.

Operator

Our next question comes from Julian Mitchell with Barclays. Your line is open.

Analyst: Julian Mitchell

Question – Julian Mitchell: Hi. Good morning.

Answer – David S. Regnery: Hi, Julian.

Question – Julian Mitchell: Hi. Maybe just wanted to start off perhaps with the volume outlook, I think you talked initially a few months ago about volumes being kind of flattish in the first quarter or even down and you ended up, I think, plus 5% or so.

And so, just wanted to understand kind of what drove that volume upside? And then as you look at the balance of the year, what are we expecting in terms of kind of volume versus price? Do you see that 5% of

volume slowing down, for example, because of resi HVAC or things like transport with the ACT adjustment?

Answer – David S. Regnery: Yeah. Let me start, and then I'll ask Chris to comment a little bit on the pricing side. As far as the volume is concerned, what we saw in the first quarter, it's not – our volumes are constrained by supply, okay? So, with our backlog, if we had unconstrained supply right now, we'd be shipping much more and we'd be invoicing much more.

So, in the first quarter, we opportunistically bought some for lack of better explanation, chipsets on the open market and spot buys, which we think is a good investment for retaining our customers. So, we wanted to take care and we saw an opportunity, and we executed on it. And we saw more volume come through in the first quarter as a result of that.

Now, can that continue through the rest of the year? Supply chain, as we said in the fourth quarter, is going to be choppy through the first half of the year. We have more confidence in the back half of the year, working with our suppliers closely, understanding their constraints, understanding their commitments to us. Also, some help – self-help redesigns that we have coming online in the third quarter. So, that gives us confidence in the back half of the year. I don't know if you want to talk a little bit about pricing?

Answer – Christopher J. Kuehn: Yeah. I would add, Julian, to Dave's point on being aggressive and opportunistic, that will probably continue here into the second quarter. We'll see what's available and see if we can do better there.

On pricing, look, the realization came in stronger on the first quarter. We've got a second round of price increases that we've already announced for this year. And we're remaining nimble depending on what happens with material inflation and freight inflation for the year to respond appropriately.

I think as Dave mentioned, in the second half, with the self-help initiatives, the redesigns that we have, that gives us confidence the second half is going to have stronger volume growth. And with that, comes stronger incrementals and, ultimately, hopefully with some less inefficiencies in the plants and otherwise that have really been pervasive for us in the second half of last year and really so far this year.

Question – Julian Mitchell: Thanks a lot. And just on that second point, yes, just looking at kind of what's implied for the back half. As you said, it looks like

you're looking at sort of maybe 40%-plus kind of half-on-half operating leverage, year-on-year, something like in the 30s for the back half on leverage. Just wanted to check those numbers were roughly okay.

And then to your point, Chris, that's a mix of what price/cost, is the assumption that the margin headwind on price/cost by Q4 is about zero? So, that's part of it and then you also have some of those volume inefficiencies cleaning up?

Answer – Christopher J. Kuehn: Yes. I'd say on the second half, certainly, we expect incrementals to be stronger than the first half. We'll see where it kind of plays out on the second half of the year, Julian.

But given the volume coming through, let's say, 30% plus incrementals, we'll see where productivity, other inflation falls out. I do think, on a full year basis, we're going to see the price/cost equation, even if we're positive on a dollar basis that can – it's still going to present some challenges on the margin in terms of being able to get that positive. I just think that math may be challenging throughout the year.

But we do expect leverage to be stronger in the second half. We see on a full year basis that organic leverage being around the mid-teens range based on what we see today. And then we'll update you and the team here in the next quarter earnings release based on another quarter of performance. And we'll see where that kind of falls out for the year.

But again, in the first quarter, we've been really pleased with what our teams have been able to do around procurement and engineering to find solutions. And I know that they're still trying to do that today.

Question – Julian Mitchell: Thanks very much.

Answer – Christopher J. Kuehn: Thank you.

Answer – David S. Regnery: Thanks Julian.

Operator

Our next question comes from Josh Pokrzywinski with Morgan Stanley. Your line is open.

Answer – David S. Regnery: Hey Josh.

Answer – Christopher J. Kuehn: Hey. Good morning, guys.

Answer – David S. Regnery: Good morning.

Answer – Christopher J. Kuehn: Just kind of continuation of Julian's question there on what sort of the margin kind of cadence maybe is from here. I know you guys have talked about kind of longer-term 25% incrementals.

But as we kind of work through maybe the worst of this kind of inflation wave where price and costs are both high and drive down margins and some of the supply chain interruption, do we get to have this period of kind of above-trend incrementals for a while? Or are you still kind of sticking with 25% as the longer term number?

Answer – Christopher J. Kuehn: Well, we like 25% as a long-term number. Last year, we were able to drive 30% incrementals. And part of that was getting out in front of price earlier. We had good volume last year. So, those really contributed to above the long-term target. This year, it really is a price/cost dynamic that's just having that headwind on the margins on the first quarter and likely in the full year.

I do think, depending on where direct material inflation falls out, Josh, this is an industry that typically holds on to price fairly well. If we start to see deflation, which we don't see right now on a full year basis in 2022, but if you do see deflation, supply chains continue to recover and we get our strong incrementals on volume, we can offset price/cost. We'll see where that plays out. That may be a good formula for us. But long-term, we like the 25%.

One thing I would add, in the quarter and also for Q2 in the guide, we continue to invest incremental investments into our innovation and new product development. That's not something we're all relenting on. And again, we'd like to save 5 points of incrementals. Let's say, let's take 5 points of that incremental, let's invest it back in the business to get us to that 25% long-term target.

Analyst: Joshua C. Pokrzywinski

Question – Joshua C. Pokrzywinski: Got it, that's helpful. And then on the applied orders, Dave, I think you mentioned that those were up more than 50%. Any way to sort of break down that on the replacement side? I would

imagine that's even stronger still. And how much of that is sort of higher building material or kind of scope versus higher volume?

Answer – David S. Regnery: Yes, I don't have the direct split yet on the retrofit versus new. But I would tell you that it was strong across all verticals, okay. Data centers, electronics. And it really just speaks volumes to the innovations that we've been able to put into the market.

And we have customers that we're winning today, because of the solutions that we're able to provide. And it's not just about the chiller. It's about the control system that goes with it. It's about the building controls. It's about being connected to the product. It's about being able to run AI algorithms against data that's in a data warehouse to improve the efficiency of buildings and data centers and hospitals. And it's all of that system of things that's just really – we're in high gear here and you could see it by the order rates that we're taking in.

So, we're – the team is really excited. I've never – I was out in one of our sales offices a couple of weeks ago, and I would tell you that the teams there have never been more pumped up about, number one, the innovation that we're providing them to go to talk to customers about and to win customers, but just the whole – the strength that they're seeing within the marketplace.

So, it's an exciting time right now. We're hopeful that the – and we believe it will at the back half of the year from a supply constraint will get better and we'll take some of this massive backlog that we have right now. $6.2 billion of backlog. I never thought I would say that. $6.2 billion of backlog, which 90% of it is on our commercial HVAC business. We'll start shipping it, and we'll start taking care of customers.

Question – Joshua C. Pokrzywinski: Great. Thanks, guys. Best of luck.

Answer – Christopher J. Kuehn: Thank you.

Answer – David S. Regnery: Thanks, Josh.

Operator

Your next question comes from Steve Tusa with JPMorgan. Your line is open.

Analyst: C. Stephen Tusa

Question – C. Stephen Tusa: Hey, guys. Good morning.

Answer – David S. Regnery: Hey, Steve. Good morning.

Answer – Christopher J. Kuehn: Good morning.

Question – C. Stephen Tusa: First of all, thank you so much for opening the books a bit and with more precision on the price/cost impact. That's super helpful for the models, for sure. So, that precision is much appreciated.

Answer – David S. Regnery: No problem.

Answer – Christopher J. Kuehn: Yeah, no problem.

Question – C. Stephen Tusa: Second of all...

Answer – David S. Regnery: Steve, I thought you were going to thank me for delivering such a strong first quarter.

Question – C. Stephen Tusa: Why would I thank you for that? Yeah. So, on the commercial HVAC orders, I thought you said applied and unitary were both up. Did you say north of 50% or north of 15%? I didn't quite catch that.

Answer – David S. Regnery: 50%, 5-0.

Question – C. Stephen Tusa: So, then, if they were – if commercial HVAC orders were up 35%, does that mean that, like, I guess, you're talking about services in there as well would have been below that...

Answer – David S. Regnery: Yeah, remember...

Question – C. Stephen Tusa: Yeah.

Answer – David S. Regnery: Exactly. So, services, think of it services as 50-50, right? 50% of our business is services. Our services were up double digits, so low teens.

Question – C. Stephen Tusa: Okay. And then what are you guys assuming for orders? How does that order trend, as we move throughout the year? Not necessarily asking for precision. But like does the 6% accelerate? Does it go to flat? Are you expecting any kind of negative order comps here in the next couple of quarters?

Answer – David S. Regnery: Yeah. I mean, again, if you – the comps get tough, right? Remember, last year, our order rates were up over 30%, and virtually almost every quarter. So they get difficult.

But I think you could be looking at – if you look at a global basis, think about commercial HVAC is probably a bit positive, think about Thermo King, again, where there's different dynamics going in, in that space, where we're actually constraining some of the incoming order rates purposely just to manage inflationary risks. That could be down a bit. So, flattish, maybe plus or minus 1% or 2% on a global basis. Chris?

Answer – Christopher J. Kuehn: Yes, Steve. If you kind of think there a scenario, if bookings are flattish in 2022 versus, say, 2021, that's the $16.8 billion that Dave referenced before. We've got about 10% revenue growth approximately on a full year basis. Kind of do that math. It would tell you that the backlog should grow by over $1 billion here just by the end of 2022.

So, we entered 2022 with record backlog. And we thought, well, maybe that could moderate or even come down. I think the way we could see it today is that, that backlog could be even higher by $1 billion or more as we go into 2023. So, it's looking like it should be a very strong year through the balance of this year and then ultimately as we start 2023.

Question – C. Stephen Tusa: Great. I won't say thank you, but I will say a good execution, congrats.

Answer – David S. Regnery: Thanks, Steve.

Answer – Christopher J. Kuehn: All right. Thanks.

Operator

Our next question comes from Nigel Coe with Wolfe Research. Your line is open.

Analyst: Nigel Coe

Question – Nigel Coe: Thanks. Good morning, everyone.

Answer – David S. Regnery: Hey, Nigel, how are you?

Answer – Christopher J. Kuehn: Good morning.

Question – Nigel Coe: Yeah. Good, thanks. Good, so obviously, you covered a lot of ground. I do want to have a crack at the, obviously, the extraordinary growth in the commercial HVAC backlog. In times gone by we've seen some larger multiyear orders coming through. And I'm just wondering if we are seeing some of these mass retrofit large orders coming to the backlog here. Or are these just a broad base of smaller orders?

Answer – David S. Regnery: Yeah. There's nothing like a big ESCO job that booked. So, this is just broad-based growth across many different verticals. And you think about what's happening with decarbonization, think about what's happening in the education vertical, think about what's happening with indoor air quality. In many verticals, it's nice tailwinds. We've been saying that for a while, and you're seeing it in our order books.

Question – Nigel Coe: And is the conversion really gated by, obviously, supply chain and capacity? Or are customers putting in orders for multi-years here or getting in line longer than they normally would?

Answer – David S. Regnery: Yeah. Longer than they normally will just because of our extended lead times. But nothing that I would say is extraordinary. It really is a supply constraint.

Question – Nigel Coe: Okay.

Answer – David S. Regnery: If we had unlimited supply, we'd be shipping a lot of product right now.

Question – Nigel Coe: And then my follow-on question is really around the supply chain. It seems like you've got a pretty good handle on the chip supply. But I think one thing we've seen is a lot of quarterly volatility. Rockwell yesterday got tripped up, and JCI. As you ramp up into the stronger 2Q and 3Q periods, how much paranoia and visibility do you have on that supply? I'm just wondering, obviously, we're now into April. You've got visibility on May. What gives you the confidence that you're not going to get tripped up by, I don't know, something happening in the next couple of months?

Answer – David S. Regnery: Well, I'm not very paranoid as a person, so I won't use that term. But it really has to do with working with our suppliers. And it's just amazing open communication, understanding what their constraints are, understanding what our needs are.

We have some of our, what we're calling self-help redesigns. We're simplifying some of our designs to help our suppliers have more throughput to us, whether it be with wire harnesses is a great example. And those are the kind of things that we've been executing on. A lot of those are going to come on in the back half of the year.

So, we've seen surprises before, but we're pretty confident that the back half is going to be better than what we've seen here, at least in the first half, which remains choppy. And our team is just doing an excellent job to managing this day-to-day. And if they have a problem, they triage it, they overcome it. We have incredible processes that we've set up now. And we're getting really, really sophisticated at executing when a problem does arise.

Question – Nigel Coe: Okay. Thanks, Dave.

Answer – David S. Regnery: Sure, Nigel.

Operator

Our next question comes from Andrew Obin with Bank of America. Your line is open.

Analyst: Andrew Obin

Question – Andrew Obin: Hi, guys. How are you? Thanks for fitting me in.

Answer – David S. Regnery: Hey Andrew. How are you?

Answer – Christopher J. Kuehn: Good morning.

Question – Andrew Obin: Just a question on, sort of, thinking about interest rates and the business model. Just sort of talking to folks in the channel, it seems that low interest rates impacted people's ability to carry more inventory, right, because floor financing is relatively inexpensive despite significant pricing on the resi side, right. A lot of folks are offering financing. Once again, rates are low. So, instead of buying outright, you sort of finance, you feel better about your purchase on the resi side.

With interest rates going up, how do you guys think about changes to the business model? And how much impact is low interest rates have had on the channel over the past several years? An open-ended question, but just wondering if you guys have given any thought to that? Thanks.

Answer – Christopher J. Kuehn: Yeah, Andrew. I would say the short answer is, in the last three, six months, we're not really seeing much of a change in terms of demand based on changes in interest rates. There are financing options that are out there selling to the consumer and maybe coming at a little bit of a higher cost to a distributor today. But it's not changing the idea around the record demand and ultimately serving customers.

So, I would say we don't see that changing the business model. Looking backwards or even looking out over the next year, we don't see that really changing.

Answer – David S. Regnery: Yeah. And Andrew, I would just add that even with interest rates, and I guess, we'll find out at 2:00 at least East Coast time today what the Fed, they're still pretty low rates comparably to historical norms.

Question – Andrew Obin: Right. No. That makes sense. And just a follow-up question. And look, clearly, execution stands out this quarter, and maybe we know why there were no chips left in Milwaukee. But just in terms of – sorry, I lost my train of thought. Just in terms of thinking about [ph.] SEER (01:02:12) transition, where are we? How much more visibility do we have into the year? And then how much pull-forward do you think we're going to get from 2023 on that? Thanks a lot.

Answer – David S. Regnery: No problem. As far as the SEER transition, we don't see a big pre-buy. I think it really has to do with the way this year change is being executed with the south, at least at the AC level. It's an installed base. So it's not a manufacturing date – the north has a manufacturing date.

So, think of it more as a phase in, phase out of inventory that we'll see in the South. We're actually really good at this with all of our innovation. We're constantly doing phase in, phase outs within our own plants. So, we're taking those chapters out of our business operating system and helping our distributors manage their inventory in a proactive way. We don't see a big pre-buy and we're certainly more than ready for this transition to higher SEER products.

Question – Andrew Obin: Terrific. Thanks a lot.

Answer – David S. Regnery: No problem.

Operator

Our next question comes from Deane Dray with RBC. Your line is open.

Analyst: Deane Dray

Question – Deane Dray: Hey. Thank you. Good morning, everyone.

Answer – David S. Regnery: Hey, Deane. Good morning.

Answer – Christopher J. Kuehn: Good morning.

Question – Deane Dray: Just a quick clarification, if we could. And we've seen your competitors do this, but not opening the 4Q order book till you get a better read on the material cost. Was that a TK specific?

Answer – David S. Regnery: Yeah. Specifically to Thermos King.

Question – Deane Dray: Right. And then what happens to customers in that situation? Do they just – do you risk losing an order there? Do they wait – just what are the competitive dynamics?

Answer – David S. Regnery: No. I think it's more about explaining to the customer that we're trying to ensure that, one, we can price it properly. But they're probably also getting constrained on another – from another OEM as well, whether it be a trailer or a tractor. So, we're trying to help them marry that demand up. So, slotting in this industry is not new. And it's not only Thermal King. It's also trailer as well as tractors that we're seeing some of that happen.

So, we're working with our customers. They know these are – we have some pretty loyal customers in our Thermo King business, as you can imagine, with the innovations that we have in our products.

So, we haven't seen customers move away from that. They understand the reason why, and they're working with us as that dynamic continues to persist.

Question – Deane Dray: That's helpful. And just lastly, are you still executing the laddered purchasing of steel, copper, aluminum in the quarter where you would have 100% purchased ahead of time in the current quarter, 80% next quarter? Is that still the dynamic? And are you able fill those goals?

Answer – Christopher J. Kuehn: Yeah, Deane. For copper and aluminum, we are laddering out purchases and locking in quantities. But think of it as one

quarter out, we're probably around 75%, 80% locked copper and aluminum, two quarters out. You're probably in that 60-ish, 50-ish percent range. And then three quarters, four quarters, that drops to about 25%, 30%.

So, we've continued to execute that through that here in this environment the last several years. We think that's a good process for us now to speculate on steel with our forward buy and our mill by programs. We're generally locking in price for about six months. So, looking out, any changes in price today would really have an impact for us really in the fourth quarter.

Question – Deane Dray: That's real helpful. Thank you.

Answer – Christopher J. Kuehn: You're welcome.

Operator

We have run out of time for the Q&A session on today's call. I will turn the call back over to Zac Nagle for closing remarks.

Great. I'd like to thank everyone for joining on today's call. As always, we'll be around to answer questions in the coming days and weeks. And we look forward to helping you to see you soon on the road, and be safe. Thank you.