Trane Technologies at Morgan Stanley Laguna Conference

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COMPANY PARTICIPANTS

David S. Regnery – Trane Technologies, Chairman and CEO

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OTHER PARTICIPANTS

Joshua C. Pokrzywinski - Analyst

Joshua C. Pokrzywinski

All right. Good morning, everybody. Thanks for joining us here again. Next Fireside chat up with the conference will be Trane. So we have Chairman and CEO, Dave Regnery; and Chris Kuehn, EVP and CFO. Guys, thanks for joining us. Pleasure to see you, as always, and welcome back in-person.

Just a reminder for folks in the room and on the webcast, we have questions about our research disclosure. Please visit the related website or ask your salesperson.

Dave, like I said, thanks for coming. Pleasure to see you. If you wouldn't mind just spending a couple of minutes giving us context for what's going on in your world and what you guys are focused on.

David S. Regnery

Yeah, no problem. Well, first of all, thanks for having the conference back in-person. It's great to be here. It's been a long time since we were back here in California. But it's always nice. Your team does a great job, so congratulations to you and thanks for hosting us.

At Trane Technologies, our focus is to challenge what's possible and to innovate for a sustainable world. It's fundamental to our strategy and it allows us to drive differentiated returns to our – for our shareholders over time. The megatrends around decarbonization and sustainability continue to increase. Unfortunately, the rate of global warming continues to accelerate. And as a world, we need to act and we need to act now if we're going to bend the curve on global warming. And at Trane Technologies, we are scaling technologies that exist today, technologies that exist today that can dramatically reduce the carbon footprint for the built environment. We're

also relentlessly innovating for future technologies to continue to improve on that.

We had a very strong second quarter. Our order rates were up 7% and that's on top of a very difficult compared to prior year where order rates were up 30%. On a two-year stack in the second quarter, our order rates were up 37%. Our revenue was strong, up 11%. Our book-to-bill was 111%.

Like the broader industry, we continue to have challenges with the supply chain. We see that supply chain challenges are improving, slower than we would like, but they're improving. We're much better than we were three months ago. We're much better than we were six months ago and nine months ago. That gradual improvement will continue in the future.

With a backlog of $6.5 billion at the end of the second quarter, which is close to double what would be normal, we are well-positioned to drive value in 2022 and beyond.

With that, Josh, glad to take your questions.

QUESTION AND ANSWER SECTION

Question – Joshua C. Pokrzywinski: Excellent. Thanks for that overview. Maybe to sort of zoom in first before we talk about some of the longer-term stuff, I mean, the last six months have been pretty choppy out there in the macro; and certainly, Russia-Ukraine has done nothing to soften that. I think on one hand, like most industrial companies, seem to be seeing a good amount of underlying demand strength, but you have had a lot of this macro chop. Is that showing up in the business at all? Even if it's kind of below materiality, like are you seeing kind of a change in maybe some of the real economy versus some of the longer-term megatrends?

Answer – David S. Regnery: Yeah. And specifically, in Europe, I think you could argue that the markets are flat there. Our business is up. Our order rates in the second quarter in our Commercial HVAC business were up mid-teens. I think everyone in Europe is understanding how dependent they are on fossil fuel coming from a country that may not be very friendly. And we've developed solutions where you don't need fossil fuel for heating in the built environment. I mean, our thermal management systems allow us to eliminate fossil fuel for buildings regardless of the climate that you live in, and these are very sophisticated systems. It's more than just a heat pump, it's a very sophisticated system that can support that, that is highly controlled. But this is

a – it's a tailwind for us as to what's happening in the built environment, specifically in Europe. You know, we have technologies that exist, thermal management is one of them, that can dramatically reduce the carbon footprint. It's about the education and the economics. Well, the education is now – is really increasing as to what's possible specifically in Europe and we see it as a tailwind for us.

Joshua C. Pokrzywinski : So if I had to think about Trane as a whole, there's sort of these TAM on TAM on TAM kind of discussions where you have stuff like what's going on in Europe where there is a big electrification opportunity or energy efficiency of a broader building modernization. I mean, have you guys given some thought about what this does to your addressable market? Because a lot of things seem like they changed overnight, and I think those are generally positive things for your business. But any sense for what that's worth?

David S. Regnery: Yeah, I mean, it's difficult to size, especially with some – or a lot of the policy that's been instituted lately. I mean, there's tailwind after tailwind after tailwind that's adding to the economics of our business. We see those continuing in the future. The decarbonization of the built environment is – it's happening, but we need to make it happen at a faster rate. And we have solutions today that can make that happen. I mean, 15% of all global greenhouse gas emissions comes from heating and cooling of buildings and homes. And we could dramatically reduce that carbon footprint and that's a tailwind that's happening. How do you size it? I mean, it's difficult. We said that in Europe, we thought it was a $1 billion opportunity. We may be underestimating what that opportunity is, but we do know that as you implement these thermal management systems, the need to leverage your service business is no longer just when it's very hot outside. It's also when it's very cold outside. So you can leverage the assets that exist in your service business.

Question – Joshua C. Pokrzywinski: I think sort of a similar story in the US with some of this infrastructure and school modernization and indoor air quality that now that no one is wearing masks and sort of like all sitting in the same room. Maybe we don't think about indoor air quality quite as much anymore but like your customers probably still are very much, like, has that played out or is it starting to play out as you would have hoped call it a year or two ago? Because I think everyone got excited about the opportunity initially, but it's maybe been a little bit quieter since then.

Answer – David S. Regnery: Yeah. I think you've read less about it in the media, but I would tell you that our customer base still asks a lot about indoor air quality and it used to be concentrated really in the health care vertical. But I would tell you that it is across all verticals now where customers are asking about it – what about the indoor environment where my employees have to come to work? How can I improve it? So you're not reading as much about it. I would tell you that it's still going to be a tailwind for our business for the foreseeable future. And everyone now is very educated as to what it means to have a clean, fresh environment to work in, a healthy environment to work in.

Answer – Christopher J. Kuehn: Josh, so think of – on the indoor air quality, when you think about last year, it's easier to separate those revenues and that's where we called it out, contributing to 2% of revenue growth last year. But over time it just became embedded as part of a system. And so it is contributing to the 40% global Commercial HVAC bookings growth we saw in the second quarter and 45% growth in the Americas.

Question – Joshua C. Pokrzywinski: Got it. That's helpful. Maybe the last piece of the fiscal discussion that is more recent is on Inflation Reduction Act. Resi seemed to get a lot of support in that, I mean, it seems like the government consumer wants to buy everybody a heat pump. How do you guys see it? Like, we – I sort of came up with kind of the simple math of everyone who's buying straight cooling in a lot of cases gets sorted of at least, the difference to a heat pump, covered or mostly covered, which might get you a double-digit benefit, when it's all kind of annualized. Like, is there a lot of nuance in there that would detract from that? How do you guys see it?

Answer – David S. Regnery: Yeah. We see it as a tailwind. Again, it's one of those we're working through the detail of the IRA and it's quite a lengthy document. I think there's some pieces of it that are very clear on the tax side. I think the rebate is a – we'll see how that plays out, because it's going to be orchestrated by the states. But at the end of day, it's going to be a tailwind. And Josh, you hit it. It's going to promote more sustainable products for our homes and on the Commercial space as well. So, it's going to be good for the environment and we do see it as a tailwind long term for the business.

Question – Joshua C. Pokrzywinski: Is that something that from a capacity or supply chain perspective, you guys are able to move the needle on? Because on one hand no one can really get as much of anything as they want out the door. But if this is kind of that big shift in entire industry mix overnight, like can the manufacturing base handle that or is this stuff a little bit more fungible?

Answer – David S. Regnery: I don't. We're not concerned about the capacity of our heat pumps. So, I think we're okay there. We have added capacity in our Resi space, about a year and a half ago, because we had a weather event and we reconstructed the facility there and we've actually added about 30% capacity. So, that's not a concern of ours. And on the Commercial space, again, it's not – we're not concerned about capacity.

Question – Joshua C. Pokrzywinski: Got it. And then maybe just the sort of the next regulatory tailwind. It sounds like a good industry if I'm only talking about regulatory tailwinds, but...

Answer – David S. Regnery: I don't know how to explain this. So, to look forward, they were asking me about all the different policies that have come out over the last three or four years. And I was explaining, it's like, if you're in a hallway and you put a fan in the hallway, you start to feel the breeze. Well, if put two fans in, you feel more. Put three or four or five, you could see the stacking effect that's happening here with these policies. And these are tailwinds that are becoming very strong for our business. And if you think about what we have to do as a world to really bend the curve on global warming, these are all good events. Okay. And it's a tailwind to our business, a tailwind to the industry. But it's really good for the climate as well.

Question – Joshua C. Pokrzywinski: How should we think about the next catalyst on SEER change? It seems like the industry is signed up for this 10% to 15% type benefit. It seems like the last time we've gone through these things, the benefits were smaller, but every kind of iteration is a little different. And I think maybe regulators get a little smarter over time as to how to thread the needle on that. But what are you guys watching as we kind of approach that transition date that would give you maybe some more insight into what gap could look like?

Answer – David S. Regnery: Yeah, I think the SEER change that's happening in the Residential business. First off, we don't see a big pre-buy just because of the way it's being rolled out where you have heat pumps on a national level, you have AC manufactured date versus an installed date base. So it's a little bit different than has rolled out in the past. If you think about the industry today, about 70% of the industry is at the minimum SEER.

And if you think about the SEER change, it will add between 10% and 15% to the price of those products. Now, understand this would probably be margin neutral because it cost more. A wrong answer would be to take 70% of the cost of the Residential business and multiply by .10. This is affected

product. So in that 70% you have furnaces and peripherals, etcetera. So think about it as maybe 30% to 40% of the business would actually be impacted by the SEER change from a price standpoint.

Question – Joshua C. Pokrzywinski: Got it. And just with all the compounding price that's gone in between regulatory actions and capturing, recapturing inflation, is demand destruction something that you guys are watching or concerned about? I mean, clearly, the industry is very healthy now. But as someone who has purchased a couple of HVAC systems over the last few years, it has gotten less fun over time?

Answer – David S. Regnery: Could I ask the next question? Which brand? No, I won't ask...

Answer -- Joshua C. Pokrzywinski: You represent a few brands. I do have one Trane...

Answer – David S. Regnery: All right. We haven't seen any demand destruction at this point and you could see that with our order rates. I mean, second quarter, a two-year stack up 37%. Our Residential business had an exceptional second quarter. Revenue was up 30% in the second quarter. Incoming order rates were down slightly, but our book-to-bill was 101%. So we built backlog despite having revenue growth of 30%, we're not seeing any destruction.

Question – Joshua C. Pokrzywinski: Got it. And we're sort of heading into a part of the season where, not just in Resi HVAC but really across the board, folks are probably thinking about how much inventory do they want to carry into the offseason. I think free cash conversion has probably been low across anyone that is making products this year as there's more working capital than usual. Are we sort of in the point in time when folks are going to start to scrutinize that a little bit more and just think about how do I get more cash between now and year-end, or is this something where like there's not – there's not much they can do because serving their customers was required?

Answer – David S. Regnery: We watch inventory, obviously, in the dealer part of the business which is about half of our Residential business, and we have not seen any unordinary behavior occur. In fact, the inventory levels are where we would expect them to be right now.

Question – Joshua C. Pokrzywinski: Got it. That's helpful. Maybe just switching over to Commercial HVAC and the broader market, I mean, for folks

who have covered this industry long enough, and I remember when the census non-Resi data or ABI really moved people's opinions around and moved the fundamentals around as well.

And now, it seems like we've gotten to this point where enough of the industry is either secular or has regulatory tailwinds where new construction doesn't matter anymore. I mean, if you had to think about what sort of tipped the scales there, was it we hit some sort of threshold on regulatory support? We hit some sort of technology threshold where the paybacks got much shorter. You sort of offered that you were running the Commercial business and parts of that before becoming CEO. How do you think this evolved in the marketplace?

Answer – David S. Regnery: Well, I do think that new construction is still an important part of the business, okay? And ABI is still a great macro, longer-term macro number to look at. And by the way, ABI has been positive above 50 now for I think it's 19 months in a row and that's a six to nine-month tail. So assume that that's going to continue to be a strong business into the future.

It's a great question on the – obviously, the retrofit market is always going to be larger than the new construction just because of the installed base. But yeah, there's been dramatic changes over the last 7 to 10 years in the industry. There has been refrigerant changes. There has been efficiency changes. There has been ways to upgrade your product now with drives and controls that have all added to the economics to make the paybacks so much less than they were in the past.

And people also realize that we need to take action to start having more efficient buildings. And I think all that together has added to the growth in the built environment. But we still pay a lot of attention to the new construction and what's happening there and right now both are very strong.

Question – Joshua C. Pokrzywinski: On the retrofit side, is there a way to sort of quantify the – that improvement and paybacks over time?

Answer – David S. Regnery: It's difficult just because you have so many paybacks that have occurred. I would tell you that you could get paybacks if you were to switch out a system now and go from a conventional system that would have a separate boiler and a separate chiller and use a thermal management system which would combine that, depending on where you are in the world, you could have paybacks that are less than three years and in some cases, less than two years, so that's a very compelling proposition.

Question – Joshua C. Pokrzywinski: And a useful life for this stuff is like 40 years, right?

Answer – David S. Regnery: Yeah, 30 to 40 years. I mean, these are very sophisticated systems, but it's very compelling, especially when you could eliminate the need for the fossil fuel. And if you think about what's happening in Europe we talked about, but this is a global phenomenon where people understand that there's a more efficient way to do heating and cooling today than there was 7 to 10 years ago.

Question – Joshua C. Pokrzywinski: So the way to think about how do you price for that or how do you go to market for that? I mean, people talk about a lot what about price cost and that ends up becoming like more of a substitute for a steel and copper discussion. But I'm thinking more about like pricing for value. I mean, on one hand, I think the applied equipment market is sort of on the lower end of the margin profile in the business. But on the other hand, like the technology seems pretty high and you have that rich aftermarket that comes down the road.

Answer – David S. Regnery: That's right.

Question – Joshua C. Pokrzywinski: How do you think about pricing given that the value proposition is improving...

Answer – David S. Regnery: We're going to price for value, right? So if we're adding innovation, that's adding value, we're always going to price for that. I think you're – if you think about our Commercial HVAC business, we use the Americas as an example, 50% of that business is services; 50% of that business is equipment. And if you think about the equipment, you'd say 50% of that is unitary; 50% is applied. All right. So you think about 25% of your business is driving this other 50% over here, which is your service business, which has very nice margins.

The applied structural margins are a bit lower than the unitary. But the tail, as you said Josh, these things, these products can last, you know, 20 to 30 years, in some cases. And the service required on those is there's a long tail. So it's a great business. It's a business that feeds itself because you're constantly with your – with our direct sales force and our direct technicians in facilities every day. We're always helping our customers look for opportunities as to how they can improve their operations.

Answer – Christopher J. Kuehn: The global service business has grown high single digit over the last five years Josh and that includes 2020 when it was flat in a pandemic year when you couldn't get technicians into a building, right? Just given concerns around passing on COVID and otherwise. So think about that high single digits compound annual growth rate over the last five years.

Question – Joshua C. Pokrzywinski: So how do you staff that? So it's so important to the business and clearly we're in broad labor shortages. But these aren't fast food workers. Like, these guys are educated and not just turning a wrench either. Is that a limiting factor for growth? I mean, I think you've seen some of your competitors get caught up a little bit in some of their field exposure. And you guys seem to have kind of managed through that. Is there – what about Trane's business or the way that you kind of staff that so it allows you to move around it better?

Answer – David S. Regnery: Yeah, I mean, we want to be a destination location for our employees. We want our employees to come work for Trane. A lot of that has to do with the culture that we have at Trane Technologies. So, in our service business specifically, we're always looking for great technicians. But I would tell you, we have done a lot of work on building apprenticeship programs and really helping our service technicians advance. And the training that we provide them, these are all company employees. We don't outsource our service. We train them and we also train them on the innovative products that we're putting in the marketplace. So they could be intelligent in front of their customers. I mean, it's a system of things that makes us a great company, our service is part of it but within our service. Again, the standard work that occurs there in our operating systems allows us to be a great service company.

Question – Joshua C. Pokrzywinski: Is there within that, I guess a requirement that you guys kind of draw the line somewhere in terms of what you're willing to do in the Commercial HVAC environment? Like are there, yeah, do you not do new installs or types of service that you just say that's too low-end?

Answer – David S. Regnery: We tend to – our service businesses is really built around our applied systems, and we'll still service unitary, especially if it's a – for a customer that has dual equipment on them. But we tend to lead with the applied systems.

Question – Joshua C. Pokrzywinski: Got it. Switching over to the other side of pricing and going to steel and copper. You guys have done pretty well on price cost throughout, including when inflation was a little bit more demanding late last year. How should we think about sort of the pockets of deflation that could show up in the business over the next kind of a few quarters just based on where we're at for spot today?

Answer – Christopher J. Kuehn: Yeah. I mean 2022 was much more inflationary than 2021. But we got out in front of that inflation, to your point, Josh, really with the first quarter of 2021 so we've had six quarters straight of price cost positive on a dollar basis. This year, we're certainly seeing the negative impacts on a margin basis but it's one of the most resilient part of our business operating system. And what I would maybe describe is one of our most improved parts of the business operating system.

If you go back five years and you think about the last inflationary cycle around commodities, we were behind on price cost for about five quarters. So for us to get out in front of it from the very beginning has been great. We're seeing those curves too and ultimately where things may be – we hope we're trending here some deflationary battles. We continue to hedge our commodities, so think about copper and aluminum being 70% to 75% hedged one quarter out. 60%, 50%, 40% hedged as you go to second, third and fourth quarter out. So we continue on that process. So we smooth on the upside. And we’re going to smooth on the downside of deflation.

Steel is about a six-month lag from where we buy to when we see that come through the P&L But I would say that's probably more of an opportunity if commodities retreat, probably more of an opportunity in 2023 than 2022 right now, given that hedging strategy and where we're locked in the second half of the year.

Answer – David S. Regnery: I would just add that there's still a lot of inflation out there. I know we talk about the commodity side, but there's still a lot of inflation. And I think all of us saw that yesterday with the latest news. But labor is going to be a lot – under a lot of pressure next year.

Question – Joshua C. Pokrzywinski: Is that something that's going to require you to go out with more price even as you see, say something like metals come in?

Answer – Christopher J. Kuehn: Well, we'll roll out our 2023 plan in the next couple of months. So far this year we've had across our businesses on

average two price increases. We had three plus price increases a year ago. So I don't think the rate of price increases will be hopefully the same as what we've seen the last 18 months. But we're going to factor that in, right? As we think about our service technicians in a fully burdened way, we're going to factor all of that in as we think about pricing for next year.

Answer – David S. Regnery: And that's really the power of our operating system with our product management teams. They know the inputs. They're able to look around the next corner and they really are able to dial in when we need to take a price increase.

Question – Joshua C. Pokrzywinski: Shifting gears just a bit to something I know is kind of a big focus for your predecessor. I think we talked about it on this very stage several years ago, the retrofit opportunity in China on Commercial. Property markets there, kind of taking a little bit of a hit or not as strong. How have you guys been able to sort of position around that? I mean, clearly not as focused on like new property but any kind of slowdown, I would imagine, is a knock-on effect. How is that kind of laid in for Trane?

Answer – David S. Regnery: Well, I mean, we have a very strong second quarter. We've been strong in China for a number of years. I think it's – there's a couple of things that are playing in our favor. One is the verticals that we play in remain strong in China. If you think about electronics, data centers, healthcare, we're very strong.

About six or seven years ago, we invested in a direct sales force and that continues to pay dividends, right? We're able to talk to architects, engineers and be able to explain to them the value of the Trane system. And that continues to pay benefits today. On the Resi space, we don't really – we don't play at all in China, very, very little. So that's not a market and that's the market that's really been down quite significantly.

Question – Joshua C. Pokrzywinski: Are there areas that you don't play in that have gotten more attractive? Now, I don't mean to say like, do you want to get into China Resi, but like the market has moved fast. You guys are pretty holistic already. But are there product gaps that that could use filling in?

Answer – David S. Regnery: We like our portfolio and it makes us a great company with the broadest – you could argue the broadest portfolio in the industry. If you take that with a great channel and a great service organization, you end up with a great company. And that's what we have at Trane Technologies.

Question – Joshua C. Pokrzywinski: So another part of that breadth that's maybe not quite as much as HVAC, but Thermo King, where I think cyclicality of that business probably gets more attention than is really necessary. But what's your view on that today? And is there a kind of fresh regulatory tailwind with some of this push toward electrification in that market as well?

Answer – David S. Regnery: It's a great business, Thermo King. I had the opportunity early in my career to run it so I could speak from the heart. But it's a fantastic business. The need to transport perishables continues to increase. The amount of food waste that we see in the world is a bad story. I mean, think about it, 10% of greenhouse gas comes from food waste. And why do we have food waste? Because of the way it's being transported, the majority of it. So there's a big opportunity there.

As far as innovations in that space, electrification is happening. Okay, it's starting small but it's getting big. We have – we're obviously working to electrify the entire portfolio. You'll need some infrastructure to help be a tailwind there, especially if you get into the long haul space. So, these would be trucks that are traveling across the country. But there are – we have products today that we've already introduced into the marketplace that are serving some of those niches.

Question – Joshua C. Pokrzywinski: Do you expect to still kind of throttle back the order book and open up that kind of piecemeal just based on things like inflations watching?

Answer – David S. Regnery: We want to make sure we get it right, the pricing. So, as we said on our second call, we'll open up the order book in the third quarter for the beginning of 2023.

Answer – Christopher J. Kuehn: And think of it as those dialogs are happening with customers all the time. We're getting good insight on the slots that they ultimately want to place the order with. It's just that we have to combine it with the price. And what we said is for 2023, we'll start opening up that order book here selectively really in the third quarter.

Question – Joshua C. Pokrzywinski: Got it. And so, if – just kind of the to summarize some of what you said, Dave, like you have, just kind of multifaceted long-term tailwind across multiple businesses. Like what do you do with the cash then?

Answer – Christopher J. Kuehn: Yeah. I mean, do you want me to start? That's actually one of the most fun parts of the job, right? It's a good problem to have. So, we've committed to deploy all the excess cash over the long term. We had $1.1 billion cash at the end of the end of June. So, we continue to deploy the cash. Guidance for the year is around $2.5 billion dollars of deployment, $600 million of that to dividends and the balance of $1.9 billion to M&A and share repurchase. So, we completed one acquisition earlier in the year in the Americas and the channel space, a Commercial HVAC channel acquisition, we got a few of those for the last few years, we just announced in Europe a small immaterial acquisition in the air handling space and we'll continue to really throttle between M&A and share repurchase.

But number one, we're investing in the business. That's what's been driving our market outgrowth and the result of the order bookings we're seeing today and over the last 18 months, two years is really from the innovation we've been driving the investment over that time, grow the dividend is second priority. And then after that, let's follow between M&A and share repurchase.

We have a lot of firepower in terms of our repurchase program, almost $4 billion under the program that we can buyback. And it's a fun problem to have in terms of what we're going to do with the cash. So, we have a lot of options.

Answer – Joshua C. Pokrzywinski: Excellent.

Answer – David S. Regnery: And we're going to be disciplined with the M&A activity, right. We have a great portfolio of products. We really don’t need to do anything. We have a great service business. We have a great controls business. We have a great channels to market business on a global basis. So, we're going to be disciplined as to which technologies we invest in.

Excellent. I see we're coming up on time. So I appreciate you guys making the time and joining us in person. Back at it again. Thanks for coming. Thanks everyone.