Trane Technologies

2022 Q4 Earnings Conference Call
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10:00 a.m. ET

Operator: Good morning. Welcome to the Trane Technologies Q422 Earnings Conference Call. My name is Lisa, and I will be your operator for the call. The call will begin in a few moments with the speaker's remarks and the Q&A session. [Operator Instructions]. I will now turn the call over to Zac Nagle, Vice President of Investor Relations.

Zachary Nagle: Thanks Operator. Good morning and thank you for joining us for Trane Technologies Fourth Quarter 2022 Earnings Conference Call. This call is being webcast on our website at tranetechnologies.com, where you'll find the accompanying presentation. We are also recording and archiving this call on our website.

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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 our 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?

Dave Regnery: Thanks, Zac, and everyone, for joining us on today's call.

Let's turn to Slide #3.

Before we dive in, I'd like to spend a few minutes on our purpose-driven strategy, which drives our differentiated financial results and long-term shareholder value.

Our strategy is aligned to powerful megatrends like climate change – which has serious and far-reaching effects on the environment, the economy and human health. 2022 was again one of the warmest years on record, and we continue to see extreme weather events. Urgent action is needed to accelerate our transition to a low-carbon, green economy.

That's where Trane Technologies is uniquely positioned to lead. Our innovation is transforming the industry and accelerating decarbonization of commercial buildings, homes and transport. We're helping our customers advance their own sustainability goals, while contributing to our Gigaton Challenge – a pledge to reduce customers' emissions by one billion metric tons by 2030.

Our purpose-driven strategy, relentless innovation, and strong customer focus enables us to deliver a superior growth profile, strong margins and powerful free cash flow. The end result is strong value creation across the board…for our team, our customers, our shareholders and for the planet.

Moving to slide number four.

Our global team delivered strong performance in 2022. As we compare our results to peers and the broader industrials, we're confident our organic revenue and adjusted EPS growth will again rank in the top quartile for both the fourth quarter and for the full year.

Our global teams have demonstrated resiliency and tenacity, navigating persistent inflation, supply chain and a myriad of other macro-related challenges globally. They've executed our business operating system, which is designed for operational excellence, and delivered record results across virtually all key metrics.

Throughout 2022, and building on extraordinary strength in 2021, we are continuing to see our relentless year in and year out, rain or shine, reinvestments in innovation pay dividends … through unprecedented levels of customer demand. While this demand has been broad-based, we are seeing particular strength in our non-residential businesses, led by commercial HVAC. Global commercial HVAC organic bookings were up nearly 40% in 2022 on a 2-year stack. Americas commercial HVAC bookings were up **more** than 40% on a 2-year stack. The tremendous growth we've delivered over the past two years has driven absolute bookings to record levels. We continue to encourage investors to look at absolute bookings levels in addition to growth rates to gain a more complete understanding of the strength of our businesses and our backlog. As an example, our commercial HVAC organic revenues were up more than 20% in the fourth quarter while organic bookings were higher by about half that level, up 11%. Still, the book-to-bill was over 105%, further adding to already record backlog. Likewise, while enterprise organic revenues were up 16% in the quarter and organic bookings were flat, total book-to-bill was still 100%. Customer demand, absolute bookings and absolute backlog have never been higher. We disclose absolute bookings and revenues each quarter by segment in our earnings release.

2022 bookings of $17.5 billion exceeded 2022 revenues by $1.5 billion, for a book-to-bill of 109%. Backlog entering 2023 is $7 billion, well over 2 times historical norms. Further, we expect backlog to remain elevated throughout 2023 and anticipate entering 2024 with backlog in excess of $6 billion. At our guidance midpoint revenue growth rate of 7%, 2023 revenues would be approximately $17.2 billion. When compared to bookings of $17.5 billion in 2022, bookings would need to decline by over $1.1 billion in order for backlog to fall to the $6 billion number that referenced heading into 2024…that would equate to a decline of about $275 million per quarter. For backlog to return to more normal levels of approximately $3 billion, bookings would need to decline by over $4 billion, or more than $1 billion per quarter. While we recognize that we have difficult comps in 2023, we have a high degree of confidence that bookings will remain robust and that we will enter 2024 with backlog of $6 billion or more.

Turning to our guidance for 2023, we expect continued strong revenue growth, EPS growth and free cash flow. We have a proven strategy to outperform end markets and our business operating system enables us to deliver consistent strong execution despite challenging macroenvironments.

We have a multi-year track record of delivering differentiated financial performance for shareholders and are well positioned to deliver strong shareholder returns over the long term.

Please turn to slide #5.

As I discussed at the outset, I'm proud of our global teams for delivering strong performance in 2022, despite persistent macro challenges. We significantly exceeded our revenue and EPS growth targets while delivering solid leverage and free cash flow…and returning significant cash to shareholders through dividends and share repurchases. While free cash flow was strong at 91% of adjusted net earnings for the year, we fell short of our target of 100% free cash flow conversion. We drove an exceptional volume of shipments in the month of December in our commercial HVAC and Thermo King businesses to meet customer demand, which shifted the timing of

approximately $150 million in receivables into the first quarter of 2023. We also invested about $40 million in safety stock inventory in the fourth quarter to ensure continuity of supply in this dynamic environment. Net of these two areas, free cash flow would have been 100%.

Please turn to Slide #6.

One of the most important elements of our long-term strategy is fueling our high-performance flywheel through relentless investments in innovation to solve our customer's most complex problems. Leading customer innovation drives consistent and profitable market outgrowth which in turn drives more cash to reinvest back into the business to further accelerate growth. This "flywheel", as we refer to it, is one of the key differentiators between Trane Technologies and our competition. We are unwavering in our commitment to invest heavily in our business year after year, in good times and in bad. It's this ongoing focus that has enabled us to drive differentiated financial performance for shareholders over time. Over the past 5 years, including the pandemic in 2020, we've delivered a 7% revenue Compound Annual Growth Rate, 250 basis points of margin expansion, free cash flow conversion well in excess of 100% and since 2017 we've deployed more than $13 billion in capital, with $8.3 billion returned to shareholders in the form of dividends and share repurchases.

Looking forward, you can expect us to continue to consistently reinvest in our business and we'll talk later in the presentation about some of the ways in which we are accelerating investments in 2023, leveraging the strong outlook we see entering the year.

Overall, we are exceptionally well positioned to continue our strong track record of performance and capital deployment over the long term.

Please turn to slide #7.

As I discussed earlier in the presentation, customer demand for our innovative products and services is at record levels, with particular strength in our non-residential businesses, which comprise approximately 80% of our portfolio.

Americas commercial HVAC was again a standout, with low-teens bookings growth and mid-teens revenue growth, including another quarter of high-single digit services revenue growth. Bookings were up nearly 40% on a two-year stack, resulting in high absolute dollar bookings, and a book-to-bill ratio of over 110%. Backlog continued to grow from an already high base and is now at levels that are 3 times historical norms, further adding to our visibility and confidence in our guidance for 2023.

In residential, bookings continue to normalize and were down mid-twenties in the quarter. This decline was expected against a very high prior year comp, as two year stacked bookings were still up double-digits. Residential revenues were up low-single digits in the quarter and sell through was up mid-single digits, reflecting healthy end market demand.

We continue to have historically high backlog in our residential business and, in the fourth quarter we worked closely with our Independent Wholesale Distributers, or IWDs…to help them manage their inventory positions and mix as they entered 2023. Our goal was to mitigate the risk of "stranded" inventory across the channel. I'm pleased with the approach we took and the partnership with our channel. We believe our IWDs are in a good inventory position entering 2023 as a result.

Our Americas Thermo King business had another very strong quarter, with 30% revenue growth. This follows growth of more than 60% in Q3. We've included our traditional transport

refrigeration market overview slide near the back of the presentation which shows the strong share gains for our Thermo King businesses globally in 2021 and 2022. Bookings were down modestly, as expected, but still up more than 40% on a two-year stack. Backlog in this business remains at historically high levels, providing good visibility into future revenues.

Overall, Americas backlog is unprecedented, at 3 times historical levels.

Turning to EMEA, results in the quarter were also very strong. In our commercial HVAC business, we've highlighted acute supply chain challenges that have been impacting revenues and, more importantly, leverage, throughout 2022. We were able to overcome many of these challenges in the fourth quarter and delivered revenue growth in excess of 40%…with strong leverage. Services growth was once again robust, up double-digits.

Bookings were also robust, up low-teens, with two-year stack bookings up more than 20%. We're seeing tremendous demand for our thermal management systems, which are 3 to 4 times more efficient than conventional heating and cooling.

Our transport refrigeration business in EMEA also delivered strong performance with low-single digits organic revenue growth in the quarter in a market that was down double-digits. We discuss the transport refrigeration business in detail on slide 16 of the presentation.

Overall EMEA backlog remains elevated, 40% higher than historical norms.

Turning to Asia Pacific, the commercial HVAC team delivered another very strong quarter in Q4, with revenues up more than 20% and services up mid-teens. Asia bookings were down, as expected, related to tough prior year comps on large bookings in the high-tech sector outside of China. Two-year stack bookings were still up high-teens. China was resilient in the quarter with bookings up high-single digits and revenue up double-digits.

Overall, Asia backlog remains elevated, approximately 50% above historical norms.

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

Chris Kuehn: Thanks, Dave.

Please turn to Slide #8.

This slide does a nice job encompassing our overall performance in the quarter which was strong across the board. Organic revenues were up 16%, adjusted EBITDA margins were up 100 basis points and adjusted EPS was up 34% versus prior year.

We delivered strong organic enterprise growth in both equipment and services, up high-teens and low-teens, respectively. Services growth was consistently strong throughout 2022 and our services mix is approximately 32% of enterprise revenues. Strong services mix bolsters the company's resiliency in virtually all market conditions.

Please turn to Slide #9.

We've discussed the key revenue dynamics for the quarter, so I'll focus my comments on margins.

We delivered strong margin expansion in each of our business segments. The key margin drivers are the same for each of our businesses, so we've consolidated the highlights on the right side of the page.

Robust volume growth, positive price realization and modestly positive productivity more than offset persistent material and other inflation in the quarter. We also leveraged strong margin expansion across the businesses to accelerate investments in innovation across a number of key initiatives.

As mentioned previously, we are pleased with the significant progress we've made over the past two quarters mitigating acute supply chain challenges in our EMEA businesses, which led to strong volume growth coupled with significant margin expansion in the quarter.

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

Dave Regnery: Thanks, Chris.

Please go to Slide #10.

As we've discussed throughout the call, underlying demand for our innovative products and services has never been higher, with historically high levels of bookings and backlog across our businesses. Relentless innovation, leading brands with strong market positions, customer focus and operational excellence are hallmarks of our market outgrowth over time.

In the Americas, our commercial HVAC business is driving strong demand and share gains as demonstrated by our full year 2022 order growth that is more than 40% on a 2-year stack. And, we've exited the fourth quarter with elevated backlog that is 3 times historical norms, providing us significant visibility into future revenues.

The non-residential markets remain strong, and we are bullish on the outlook for commercial HVAC. Demand continues to be robust in data centers, education, health care, and the high-tech industrial verticals, where we have strong customer relationships and market positions. Our commercial HVAC business is underpinned by long term secular tailwinds of energy efficiency, decarbonization and indoor environmental quality, which are only growing stronger. We also see tailwinds from new and ongoing regulatory and policy related drivers such as the Inflation Reduction Act, education stimulus and the CHIPS and Science Act. Our commercial HVAC business is well positioned as the **premier** franchise to capitalize on the significant market opportunities that lie ahead.

The residential market outlook remains dynamic. Near term, we see the market continuing to normalize across bookings and revenue and this process is well underway, as we saw in the third and fourth quarters. For 2023, we believe this normalization process results in market units likely down in the mid-single digit range. With tailwinds from elevated backlog, pricing, supportive regulatory and policy initiatives and share gains, we believe our revenues will be relatively flat. Our guidance encompasses scenarios for residential in the plus or minus low-single digits range.

We don't see a cliff scenario, and residential is about 20% of our business, so a 10% decline would present a 2% headwind to the Enterprise. Longer term, we continue to see residential as a GDP plus business for us.

Turning to Americas Transport refrigeration, our diversified portfolio of products and aftermarket significantly outperformed the end markets in 2021 and 2022. ACT is calling for low-single digit

growth in Trailer in 2023 and for weighted average transport refrigeration growth to be flattish. Consistent with our strong track record, we expect to outperform the end markets in 2023.

Longer term we continue to see transport refrigeration as a GDP plus, plus business. We'll talk more about the transport refrigeration outlook in our topics of interest section.

Turning to EMEA commercial HVAC, the market growth picture remains muted, with macroeconomic and geopolitical challenges weighing. Given our innovative and leading sustainability solutions, we've been able to significantly outgrow the EMEA HVAC markets over a long period of time. We see continued opportunities for market outgrowth going forward aided by our thermal management systems which are 3-4 times more efficient than traditional heating and cooling solutions and are gaining momentum in the market.

Turning to EMEA transport refrigeration, the removal of the Russian market was a key driver of the market decline in 2022. Thermo King EMEA outgrew the end markets, up high-single digits for the year. As we turn to 2023, we expect the market to be down low-single digits to mid-single digits, mainly related to economic uncertainty in the region. Our innovative products and solutions continue to provide us with a strong platform to outgrow our end markets, which we expect to do again in 2023.

Turning to Asia, the environment remains dynamic and Covid continues to add complexity and unpredictability to the market forecasts. We see continued strength in data center, electronics, pharmaceutical and healthcare verticals, and if these markets continue to perform well, we could continue to see relatively stable growth in 2023. Asia continues to be one of the more dynamic markets so we're cautiously optimistic on this segment, which represents about 10% of our portfolio.

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

Chris Kuehn: Thanks, Dave.

Please turn to Slide #11.

Dave provided a good framework for how we're looking at our key end markets for 2023 and our guidance reflects these views. Embedded in our guidance is our philosophy around our value creation flywheel, which builds in high levels of business reinvestment in innovation, outgrowth across our end markets, and strong leverage.

We're guiding 2023 to 6%-8% organic revenue growth and $8.20 to $8.50 in adjusted earnings per share, or approximately 11% to 15% EPS growth.

Through the back half of last year, we talked about ending 2022 with $6 billion or more in backlog and we're sitting at a record level of $7 billion as of the beginning of 2023. This gives us good visibility into 2023 revenues.

We have approximately 1% of growth from M&A in 2023 from bolt-on acquisitions completed in 2022, and we expect FX to be neutral on a full year basis.

We're targeting organic leverage of 25% plus for the year. There are a few key factors that play into our organic leverage target, so I'll spend a couple minutes covering these factors to help frame the guidance. First, we're expecting modest incremental price and solid volumes to offset material and other inflation and drive strong incremental margins. Second, while we're expecting

slow and steady improvement in the supply chain as we've seen throughout 2022, we're not expecting it to be fully normalized until well into 2023 at the earliest. This will continue to put pressure on the realization of strong productivity which is where our business operating system really thrives.

Third, the environment around prices for Tier 1 metals remains dynamic. In the third quarter and early part of the fourth quarter last year, we saw a deflationary trend for base metal prices, however pricing has increased over the last two months on copper, aluminium, and steel, negating much of the potential deflationary benefit in 2023. To update you on a question from our earnings call last quarter, our Tier 1 spend on these metals is approximately $750 million, split roughly one-third each for copper, aluminium, and steel. We are seeing modest deflation in freight and logistics costs, but we are also seeing inflation from Tier II suppliers as they incur higher than normal wage increases and energy costs. Net, we're not baking in significant inflation or deflation into our guidance at this early stage in the year.

Fourth, we're using the favorable environment we see in 2023 as an opportunity to double down on key investments across the business in advanced manufacturing and automation, digital and electrification platforms, among other key programs. We're targeting 20-30 basis points of incremental spend across these areas which will be embedded in the segment P&Ls. This is above and beyond our average incremental spend of approximately 40 basis points per year, so we're targeting 60-70 basis points of incremental spend in total. We've highlighted that business reinvestment is how we win over the long term and we're confident we can make these investments in 2023 while hitting our guidance range. We have additional investments earmarked in our corporate and capex guidance as well.

Lastly, while our M&A transactions I referenced earlier will have a strong payout over the next several years, they will add about 1% to our revenue at approximately 3% leverage in the first year, inclusive of integration costs. The net effect cuts about two percentage points off of our enterprise reported leverage versus our organic leverage that excludes M&A. It's not a huge amount but it's something we wanted to highlight as a factor to consider in our guidance as organic leverage will be stronger than reported leverage, simply on the math related to M&A. We'll highlight organic leverage each quarter to provide transparency.

Turning to cash, we expect 2023 to be a strong cash collection year. We have about $150 million in receivables that shifted from December into early Q1 and, barring persistent supply chain issues all year, which we do not anticipate, we expect to bring working capital levels down, specifically around inventory. Net, free cash flow conversion should be 100% or better.

Please go to slide #12.

We remain on track to deliver $300 million of run rate savings from business transformation, including an incremental $60 million in 2023. We continue to invest these cost savings into high ROI projects to further fuel innovation and other investments across the portfolio and I discussed a number of targeted investments for 2023.

To be clear, our continuous improvement mindset is an integral part of our business operating system and continues well beyond the transformation program that we started in 2020 when we launched Trane Technologies. Our business operating system is designed to drive gross productivity each year to offset other inflation. While it's been impossible to realize that level of gross productivity over the past three years given the tumultuous macroeconomic backdrop, productivity has been improving as supply chains slowly recover and is contributing to our 25% plus organic leverage target in 2023.

Please go to Slide #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 #14, and I'll provide an update on our capital deployment in 2022 and our outlook for 2023.

In 2022, we executed strong and balanced capital allocation of $2.1 billion, including approximately $1.2 billion to share repurchases, $620 million to dividends and approximately $250 million to M&A.

We're targeting $2.5 billion in capital deployment in 2023 and expect to deploy 100% of excess cash over time. Our M&A pipeline remains active, and we continue to exercise discipline in our approach. Our shares remain attractive, trading below our calculated intrinsic value and we have approximately $3.2 billion remaining under current share repurchase authorizations.

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?

Dave Regnery: Thanks, Chris. **Please go to Slide #16.**

Our Thermo King businesses have significantly outperformed their end markets in both 2021 and 2022, as illustrated in the table on the right-hand side of the page.

In 2022, the North America transport refrigeration markets were up 12%, while Thermo King Americas was up more than 20%. The EMEA transport refrigeration markets were down 9% in 2022, while Thermo King EMEA was up high-single digits. We’re very pleased with the share gains we’ve achieved over the past two years.

In 2023, we expect the markets to be flat to modestly down, and for Thermo King to once again, outperform, consistent with our strong track record.

We also added additional information to the slide this quarter to help investors and analysts gain a better understanding of the size of the businesses. We’ve included a footnote that Global Thermo King is approximately 15% of our enterprise revenues and that the split between the Thermo King segments is roughly 60% Americas, 35% EMEA and 5% Asia.

Please turn to Slide #17.

ACT has updated their long-term forecast for refrigerated trailers through 2027. The data supports the view we’ve been highlighting for some time now that this is a mid-40-thousand-unit market, plus or minus about 10%.

The chart plots the actual and forecast, but the key takeaway is that the market is expected to be flat at 45,000 units in 2023, dip to 40,000 units in 2024, rebound back to 45,000 units in 2025 and to continue growing low-single digits from that point forward to 2027.

Additionally, our transport refrigeration business is a diversified portfolio with a healthy aftermarket business. We have strong positions in large and small trucks, APUs, bus, air and rail and a proven track record to outperform the transport refrigeration markets. We believe this is a GDP plus, plus, business for us over the long term.

Please go to Slide #18.

In summary, we are positioned to outperform. Consistently.

Energy efficiency, decarbonization and sustainability megatrends continue to intensify, driving increased demand for our innovative products and services.

We are delivering leading technologies and innovation to address these trends and accelerate the world's progress, underpinned by our engaging, uplifting culture.

The strength of our business operating system, the power of our global team, unprecedented backlog and continued high levels of customer demand give us confidence in our full year revenue and EPS guidance.

We believe we have the right strategy, the best team and a solid foundation in place to deliver strong performance in 2023 and differentiated, shareholder returns over the long-term.

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

Operator: [Operator Instructions]. Our first question comes from Julian Mitchell with Barclays.

Julian Mitchell: Morning, maybe just the first question around any thoughts on sort of the cadence of the organic sales trend, the 7% through the year. Any sort of particular weighting early versus late in the year? And also that 25% plus core leverage goal for the year? Again, is that -- is there anything in kind of price cost or the investment spend weighting that skews that first half versus second half at all?

Chris Kuehn: Good morning, Julian, this is Chris. I'll start and then Dave may jump in. But as we think about the cadence throughout 2023, let me start with the first quarter. Q1 is typically around 11% to 12% of our full year earnings. Right now, we would project Q1 to be a bit stronger than that than our historical average. It's probably in the 15% to 16% range of full year earnings, and we see that around really between $1.30 and $1.35 on adjusted EPS. I think the revenue growth in terms of the first quarter, it's roughly in line with how we see kind of the full year at this point. And we see leverage being really 25% plus really throughout the year. So, it's roughly balanced.

The investment spend, it really is going to be ratable throughout the year. We started -- we've been many years, of course, with investments in leading in innovation. But I see that spend really being roughly equal throughout the year. Dave, anything you want to add?

Dave Regnery: No, Julian, Hi, how are you doing? First of all, Chris talked a little bit about our leverage of 25 plus. Could there be a quarter where that's higher? Sure, absolutely, based on where we see opportunities. But I would tell you, from my vantage point, we love to reinvest in our business.

We love to find opportunities to drive differentiated revenue growth on the top line. The flywheel that I referred to in my opening comments, it's something that has a proven track record for us. And as an innovation leader in the industry, we plan on that continuing well into the future.

Julian Mitchell: That's very helpful, thank you. And, if we're looking at the sort of markets of residential and then transport on a global basis, are we assuming that the resi weakness is more sort of first half and the transport weakness more pronounced in the second half? Is that the right way to think about those two pieces?

Dave Regnery: Well, I mean, let's start with residential. I think we are pretty clear in our comments there. We think residential for the full year will be down in the mid-single-digit range. We think that based on some of the tailwinds that we have in our own business being a strong backlog, strong price, we'll see some tailwinds probably later in the year with some regulatory changes, specifically around IRA.

We see that as -- we'll be plus or minus 1% in residential. On Thermo King, if you look at the Americas and you look at ACT specific data, right now, they have that as a stronger first half or second half. But that assumes. Julian, that the trailer OEMs will actually be able to hit the production rates. We haven't seen them demonstrate that. So, my belief is that some of that volume will actually push towards the second half from the first half, but we'll see how the year plays out.

As far as in Europe Thermo King, we think the market will be down. A lot of that's the economic conditions there. But, in both cases, whether the Americas or in Europe, we plan on outperforming

Julian Mitchell: That's very helpful, thank you.

Operator: We'll take our next question from Gautam Khanna with Cowen.

Gautam Khanna: Good morning, thanks guys. I wanted to ask you about any -- are you seeing any evidence of weakness in the forward project pipeline on the commercial HVAC in that domain?

Dave Regnery: No, actually, if you look at our commercial HVAC businesses on a global basis, right, lots of strength in the Americas really across many verticals, okay, which is always a good sign. We don't see that slowing down. In fact, we see some tailwinds towards the back half of the year with regulatory changes as far as IRA as well as with the Chips Act, okay? That's all in front of us. So those would be nice tailwinds. With a book-to-bill of 110%, we have a lot of backlog in our commercial HVAC Americas business.

In Europe, just to be really blunt about it, we're winning in Europe with our innovations. And just a really strong fourth quarter. We had been faced with some supply chain issues there throughout 2022. A lot of those challenges improved dramatically in the fourth quarter. You see that with our revenue growth. I mean the revenue growth in the fourth quarter was up -- it was over 40%. And our bookings continue to be strong as they were up in the high teens. So, a lot of strength there.

And then in Asia, I mean, Asia was a surprise. I mean, our revenue growth was 20%. About 5 points of that was kind of a hangover from the COVID problems we had in the second quarter, but still 15%, very strong. And order rates remain strong. In China, specifically, our order rates were up close to double-digits. Revenue was up double-digits. So, we're cautiously optimistic on Asia as it reopens, China, that is.

Gautam Khanna: Thanks for the thorough answer. And then, just lastly, could you quantify how much price you have embedded in the sales guidance this year?

Chris Kuehn: Hey Gautam, this is Chris. Yes, I think we have modest price carryover going into 2023. Certainly, we're going to be comping against tough comps in 2022 with record levels of pricing. You think about the full year '22, we had close to 10 points of price. It's actually 9.5 points of price on the full year. Right now, we're not planning on multiple price increases in 2023, but we do remain nimble to react to how we see input costs playing out during the year.

It's a strength in our business operating system. We remained price cost positive these last 2 years of highly inflationary environment. So, we're going to remain nimble. Could it be in the 2% to 2.5% range? That's probably the range that it's in for carryover.

Operator: Our next question comes from Josh Pokrzywinski with Morgan Stanley.

Joshua Pokrzywinski: Hi, Good Morning, I guess just wondering if you can give us any detail on how you're thinking about some of the stimulus items? I think you mentioned that probably more of a second half phenomenon. So maybe more of a 24 story. But what do you think that could be worth in terms of growth? Is 23 really just a bookings year? And when you think about, Dave, that sensitivity you gave on the backlog conversion versus maybe the cushion you have on the orders front, would IRA be a potential, kind of further source of cushion that you think about in that?

Dave Regnery: Okay. Nice question, Josh. I think that, first, I'll start with what we're seeing right now in stimulus. We're seeing a lot of demand, obviously, within the education vertical. If you look at our education vertical in the Americas, the equipment business, in 2022, it's up close to 40%, okay? And that's going to continue for some time now.

I believe the change in that was if an order is booked in, I think, in September 2024, you actually have until 2026 to have it installed. So, we see that continuing to happen and, you see that in our very, very strong absolute booking dollars that we're able to generate.

IRA, obviously, that's still being worked through. The funds are going to flow from the Fed to the states and then the states will operate in a framework, and we'll work with the different states to make sure that we're very clear on how that's going to happen. We see that as -- that's certainly in the back half of the year both in the commercial space as well as in the residential space. The key to being successful really with IRA is how do you take something that's pretty complex right now and make it really simple for the customer.

And that's exactly what we did with the education funding that was available, and we'll do the same, we're really good at that, with the IRA. As far as the Chips Act go, yes, that's going to be back half. I mean we -- that's all in front of us. And it's certainly going to be an opportunity. We have a lot of strength in that vertical. We have great customer relationships. But some of that bookings could happen in 2023, but that's really all in front of us. I think the applications are just being opened up here in the first quarter so that they start applying for these funds. So that's really all in front of us given the duration time it takes to actually get a fab plan from planning up to operations.

Joshua Pokrzywinski: Perfect, that’s helpful. I’ll leave it there.

Operator: We'll take our next question from Chris Snyder with UBS.

Chris Snyder: Thank you. I just wanted to start by following up on the prior commentary around some of the IRA benefits potentially coming through in the back half of the year. I mean, how do you feel about capacity and available supply to meet the expected pickup in heat pump demand into the back half?

Dave Regnery: Yes, it's a great question. I think that -- I'll start with the supply chain. I think the supply chain continues to improve gradually. The fourth quarter was better than the third quarter. I'm sure the first quarter will be better than the fourth quarter.

What we see that as several quarters before the supply chain gets back to what I would call normal. As far as capacity is concerned, we don't have capacity concerns. As a company that embeds lean thinking in our operating system, we're constantly looking for ways to expand our capacity with our own four walls. So, we're very comfortable we'll be able to meet the demand that will happen. And, hopefully, it starts to happen in the fourth quarter.

Chris Snyder: Appreciate that. And for the follow-up, I wanted to ask on transport bookings, specifically in the Americas, which seemed to drive a good chunk of the sequential slowdown. As we look forward, should we expect bookings there to pick up as the back half 2023 order book is opened up? Thank you.

Chris Kuehn: Hi Chris. This is Chris. I'll start with that answer. We've been selective with opening up the backlog in our Thermo King businesses now for the last couple of years. And what it means is we haven't opened up the second half of 2023 orders at this time. We are talking with customers. We are getting strong insights from them on what units they need. We're just not pricing that at this point at the end of the fourth quarter. And therefore, it's not making its way into bookings and/or into backlog.

So for the Americas business, we're seeing the transport markets being slightly favorable. The trailer market being 1 to 2 points up on a year-over-year basis, so very solid. Dave commented about the cadence throughout the year that may shift a little bit more into the second half, depending on how the OEMs get through their fleets and get their output up. But I would tell you that it’s a really strong business. We have a lot of innovation in that business is a diversified business as well. And so, while we've been able to outgrow the markets the last several years, we have those plans to do it again in 2023.

Dave Regnery: Chris, the other thing I would add is if you look at the Thermo King Americas business on a 2-year stack, order rates are up over 40%. We have a very large backlog going into 2023. So, it's a business that has performed extremely well in 2022, and will continue to outperform the markets in 2023.

Chris Snyder: Thank you.

Operator: We'll take our next question from Joe Ritchie with Goldman Sachs.

Joe Ritchie: Thanks, Good Morning, guys. Dave, I really like the way you teed up the backlog discussion earlier today. I mean there's been a lot of focus on order rates decelerating and it seems like the trends in your business, particularly on the commercial HVAC side remain really strong. I know it's probably too early, but as you kind of think about what's occurring today from a stimulus perspective, nonres construction, supply chain is still a bit of an issue. I mean should your backlog exit the year well above normal levels as you kind of think about the growth rate even just beyond 2023?

Dave Regnery: Yes. I think you're spot on, Joe. I think that a normal backlog for our business at the end of any year is probably in the $3 billion range. And we'll end 2023 and enter 2024 with a backlog that could be $6 billion or greater. And we do. We believe our backlog will be elevated for a long period of time, which gives us a lot of visibility which gives us a lot of visibility not only to future revenues, but also allows us to help our suppliers and to make sure they have plenty of visibility as to what our requirements are going to be.

Joe Ritchie: That's great to hear. And I guess maybe my one follow-up is really just on commercial HVAC and EMEA. That was really strong this quarter, much stronger than we anticipated. Can you maybe just provide a little bit more color what you're seeing there specifically? Is that heat pump demand? Like what drove that -- the growth rate this quarter?

Dave Regnery: Joe, it's a great question. And I'll tell you, I'm so proud of our team in commercial HVAC, EMEA. Yes, we had 40% plus revenue growth in the quarter. We had some supply chain issues earlier in the year that we highlighted, okay? A lot of those -- many of those got rectified in the fourth quarter. So that helped us get the volume out. But I look at the order rates as well. And the order rates are up mid-teens, 2-year stack up 20%.

We are seeing tremendous demand for our thermal management systems. So, our growth rates in Europe are really a function of our innovation that we've been able to deliver to the marketplace. And we are winning share in Europe, and we are winning with our customers. So, it's a really great story with our business in EMEA. I've been with that business for a long time, and I was in the days when it was not such a great business, but it is very, very strong today. We have such a great leadership team there that's constantly pushing the envelope on innovation. So, expect more in the future.

Joe Ritchie: Great, thank you.

Operator: We'll take our next question from Steve Tusa with JPMorgan.

Steve Tusa: Hey, Good Morning. Can you just provide a little bit of color on the difference in the Americas between unitary and applied just on the revenue side and then maybe orders as well?

Dave Regnery: Sure. Let me put my glasses on here, so I can see. We were strong really. On an equipment basis, the Americas was strong really in both. I mean, our unitary revenue was up -- it was north of 30%, Steve. And our -- the applied business in the Americas was mid-teens. So, both very, very strong.

Steve Tusa: Yes. And then -- sorry, go ahead, bookings. Sorry about that.

Dave Regnery: Yes, bookings were high-single digits in unitary and around 30% for the applied, very strong, very strong results.

Steve Tusa: And then how do you kind of see just the high-level profile of these businesses? You said the revenue growth is going to be pretty consistent in the -- throughout the quarters from a cadence perspective. How do you see the businesses -- each of those businesses performing just at the high level commercial HVAC, TK and resi relative to the annual guidance?

Chris Kuehn: Steve, as we think about commercial businesses, I'll speak for Americas and EMEA. Really just our plans right now up high-single digits in terms of revenue on the full year. The significant backlog just gives us really strong visibility to the revenue profile. And then Dave talked about the stacking effect from a bookings perspective.

Could we see 10% growth in some of these businesses and pockets? Possibly. It really depends on the maturity of the supply chain, which we've seen gradually get better over the last several quarters. And we've got embedded in the guide, a gradual improvement in 2023.

But if it got stronger, could that output be stronger on the top line? Yes, it could be. But let's see how the year kind of plays out. I think for Asia, we're calling it dynamic. We're calling right now for stable growth as we work throughout the year. But it's a dynamic market, and we're watching it closely, but very strong backlog entering into the year.

Steve Tusa: Sorry. I meant for first quarter, I don't know if that's what you're talking about just the first quarter high level on the three businesses.

Chris Kuehn: Yes. I would say first quarter, overall, starting with the enterprise that I mentioned earlier, I see the revenue growth in Q1 in line with how we see the full year, that 6% to 8% kind of range. Commercial HVAC, I would expect to be stronger as we work throughout the year, just given the profile. TK, we've got some backlog, but certainly carrying into the first quarter. We'll open up the bookings here for the second half shortly. But I would expect that to be at the enterprise level in that 6% to 8% range, and we'll see how it plays out.

Steve Tusa: Okay, great thanks.

Operator: We'll take our next question from Andy Kaplowitz with Citi.

Andy Kaplowitz: Hey, Good Morning guys. So, Dave and Chris I know you mentioned not too much carryover pricing in '23 and that you might not get as much deflationary benefit as you first thought, given the rise in -- recent rise in commodity prices. But I think, just in the last couple of weeks, you've raise prices, commercial HVAC, call it, mid- to high single digits and up to 10% on resi HVAC. So are the recent price increases really because commodities such as copper have been rising here lately? Or should we read into the fact that demand is still quite good for Trane and so the ability to raise price is still there in '23?

Chris Kuehn: Yeah, Andy, I'd say it's really a mix of all the above. We are trying to get with any luck just one price increase as we start the year. That's been our cadence prior to the last 2 years of this highly inflationary environment. So, we're trying to set the stage for where we see pricing for the year, inclusive of how we see these commodity costs playing out over the last couple of months. And the goal is, we don't have 3 rounds of price increases as we work through 2023. So right now, it's really baking in all of that information today with that price increase entering 2023.

Dave Regnery: Andy, just to add to that, obviously, we are seeing an ease off of raw materials, but labor is certainly inflationary as is energy cost. So if you look at all the cost inputs, which our product growth teams look at in a lot of detail, it allows them to have visibility as to what to see in the future.

Andy Kaplowitz: That's helpful, guys. And then you talked about Thermo King's increasing ability to outperform its end markets. It seems like, as you talked about, you're suggesting Thermo King can grow again in '23 despite the primary markets being flat to down. But did the secular challenge that we all know about, such as the electrification that's going on in Thermo King, raise the probability that it just becomes a lot less cyclical. So, as you go into a year like '24, where ACT is talking about its forecast is down a little bit that you could still not be that cyclical or even go up in '24.

Dave Regnery: Yes. I'm not -- I mean, the cyclicality we could arm wrestle over, okay? If you look at the trailer market in the Americas, it's been in that 40,000-unit range for a long time, plus or minus 10%. It's a very strong market. As far as the electrification, we'll wait and see on that.

I would tell you that we are -- that's one of the investments that we're really doubling down on is how do we expedite what we're doing there on electrification. We are seeing demand from our customers, especially in the shorter distances, I think of the truck aspect there. So our team is

doing a great job meeting their expectations, but more to come and I'm very excited about the innovation pipeline, specifically in our Thermo King business.

Andy Kaplowitz: Appreciate it guys.

Operator: We'll take our next question from Nigel Coe with Wolfe Research.

Nigel Coe: Thanks, good morning, everyone. So, I think I came on a little bit late, but I think you mentioned backlog moving down from $7 billion to $6 billion, still very healthy levels. I'm guessing most of that would be in commercial HVAC, but I'm just wondering how much TK would come into that backlog conversion as well.

Real question here is what is the key gating factor to an even stronger backlog conversion? I'm thinking your supply chain, construction labor, skilled labor in the field versus maybe customers don't want the equipment today, I guess, they do, but what is the gating factor to get an even more backlog converted?

Dave Regnery: I think you got the answer there, Nigel, there's a couple of things, right? First of all, the backlog of $6 billion, I was kind of using that as an example. I think we're going to end 2023 with a backlog of $6 billion or more, okay? So there's -- for us to burn $1 billion in backlog will be a lot.

As far as why can't you burn it faster? A couple of reasons you hit on, right? One is supply chain. It's improving. It will continue to improve in the future. Our teams are doing just a fantastic job working with our suppliers, giving them visibility and everything we can to make sure that we improve their performance, and that's happening. The second is, is that lead times, especially in our commercial HVAC businesses and the applied side of it, for sure, have extended. And that's not unique to Trane Technologies. That's really across the industry. In fact, we're very competitive with our lead times -- but -- so that means that customers don't want an order early, right? You're not going to ship an order, especially on the applied side to a customer before their job site is ready. And so that's elongating the backlog as well.

Nigel Coe: Okay. I was kind of hoping you might delineate between Okay, labor is a real problem, supply chain is getting better, but it's okay. And then on the 25% or better incremental margins for this year. I mean, that's pretty impressive when you think about commercial HVAC outgrowing residential and TK -- and we've all been trained to believe that resi TK better margin commercial HVAC business is low margin. Is that the wrong thesis? Or are you absorbing mixed headwinds within that 25% plus?

Chris Kuehn: Nigel, it's Chris. So, we're aware of that thesis. And I think with our focus on our business operating system, we're ensuring all of our businesses are growing margins. I would say in the commercial HVAC business, it has really been impacted the last couple of years with the supply chain challenges, lots of inefficiencies, the inability to drive productivity, lots of increased costs to serve customers, expediting freight, buying components on the spot markets.

We've incurred a lot of costs in the business just to get the revenue out. And that's presenting a nice opportunity as the supply chain normalizes as we can drive productivity in the plants and ultimately get our team members focused on both productivity and solving the supply chain issues, which they've done an outstanding job solving the supply chain issues throughout the last 2 years. But I see all of our segments next year having very strong leverage. And I think there's some really nice opportunities there for us to go drive and when we eliminate some of those inefficiencies.

We are also baking in incremental investments. So, I think we can do both next year. We can drive 25% or better organic leverage, with also incrementally another 20 to 30 basis points of investments, allows us to do both and really drive for market outgrowth.

Dave Regnery: And Nigel, just to follow up on the labor concern. That's not a concern for Trane Technologies. We've done a great job being able to track the right labor. We're doing a great job. Our human resource department is doing just a fantastic job of training, creating career ladders for our hourly associates. So, we really want to be that destination location, not only for our salaried employees, but also our hourly employees, and we're doing a great job there.

Chris Kuehn: Maybe I'll add one more thing because just our Asia business, right, as a majority, call it, 90-plus percent commercial HVAC and it's driving high-teens EBITDA margin. So, I think it shows that we can really drive there for our businesses globally.

Nigel Coe: Good point, thanks guys.

Operator: We'll take our next question from Deane Dray with RBC Capital Markets.

Deane Dray: Thank you, good morning, everyone. Just a lot of discussion on backlog here. Just struck me is, what happens on past due? Like you have to set realistic expectations with the customers on when they'll actually get deliveries?

Dave Regnery: Yes. That is exactly why there's elongated lead times right now. You do not want to disappoint a customer with delivery. You know, think about it, I mean, some of our products will use air handling as an example. If you're constructing a building, okay, you could end up holding up an entire job if you're late. And trust me, you don't want to be on the other end of a phone call, that has the whole building being slowed up because of your product. So, we're making sure that we're providing realistic lead times to our customers. It doesn't mean we don't have past dues. We do. We track that very intensely our plant managers drive that on a daily basis. But, for the most part, you really have to give real dates as to when a customer can expect the products and you need to hit it. And that's one of the key operational metrics that we look at, at a high level, and I would tell you it happens at a very detailed level within our business.

Deane Dray: That's really helpful. And then as a follow-up, I was really interested in your comments just saying you're trying to avoid situations with stranded inventory. How does that happen? And any comment on the whole new SEER rollout?

Dave Regnery: Yes. It really -- it was associated -- the comment was associated with the SEER roll out. And I think that there's a little bit more complexity this time where depending on where you're located in the country, it's an installed date versus a manufacturing date.

So we really worked with our independent wholesale distributors in the South, okay, because that's really where the -- for non-heat pump product where that was an installed date by. So,we don't want them to get stranded. So, we helped manage that situation. And we're pretty good at this. I mean, we implement so many new products that phase in, phase out as we refer to it, is second nature to us. So,we just really helped our IWDs work through that process.

Deane Dray: Thank you.

Operator: We'll take our next question from Brett Linzey with Mizuho.

Brett Linzey: Hi, Good morning, all. I just want to come back to the transport business. You guys have been outperforming there for quite some time. It looks like '23, you've got a lot of innovative solutions, new products coming to the market. I was hoping you could just put a finer point on the outgrowth expectation there. And then, specifically on some of these new product launches, are you simply cannibalizing older equipment technology? Or are you actually increasing the total addressable market with some of these electrification offerings?

Dave Regnery: A bit of both on that. I think that you obviously are going to cannibalize any combustion engine that's out there with the electric solution. But there's also opportunities as you think about, I guess, the best example that would probably be, think of home delivery, right? That's -- I mean, it's a relatively new market, okay? It's expanding quite quickly. I think with some of our new electrified product at higher capacity, you're going to be able to create different market opportunities. And I won't be more specific than that, but we're pretty excited about what we see there. And your other question was…?

Brett Linzey: Just on the total outgrowth expectation for the year.

Dave Regnery: Yes. I won't get too specific on that, but I think you could see that we've obviously taken share for the last couple of years, and we anticipate taking more share in the future, right? I mean our team just does a great job there with working with our dealers, creating value propositions for our customers that are very compelling.

I mean I'll use Europe as an example. I mean if you have a product that's able to get 30% better efficiency than the best in the market. I mean you're going to have a very compelling opportunity to talk to every customer about the value proposition that we bring.

And that's what we do, and we see these innovations in Thermo King, these innovations in residential, these innovations in commercial, really hitting the mark with our customers and it really allows us to create that differentiated revenue growth that we're seeing on the top line. It's that flywheel that I referred to, and we're going to continue to make sure that we save plenty of dollars to reinvest in our business to keep that flywheel very vibrant.

Brett Linzey: Yes, makes sense. And just one follow-up regarding the incremental investment. Could you just spend a little more time on those priorities? I think you said factory automation, anything on paybacks or what you think the structural benefits might be there?

Chris Kuehn: Yes, I'll start, Brent. So generally, what I'd look at is: focus on our factory of the future and automation. We're spending time and cost around digital and also around electrification that Dave spoke to, specifically in not only the Thermo King portfolio, but also in our commercial HVAC portfolio as you think about electrification and heating. So, they're great investments to make. Some of them are driving revenues and backlogs immediately.

On the automation side, the factory side, this is the opportunity for us as we see the productivity coming back into the business and allows the features for us to go drive more of that productivity when we can drive some more automation, get more volume through the factories, and it's been an investment we've been working on for several years, and it also going to be a little bit of an increased investment in 2023. But, very strong paybacks. And look, I think it helps contribute over the long term to that target we have on incremental, is it 25% or better.

Brett Linzey: Got it. I appreciate the insight, best of luck.

Operator: And we'll take our next question from Andrew Obin with Bank of America.

Andrew Obin: Hey guys, thanks a lot for fitting me in. Just a question, very interesting discussion about the fact that the industry is changing. So, do you think that these extended lead times and much more visibility in the cycle is becoming more of a permanent feature of the industry? Because it seems you and the others are training the customers to live with the lead times and maybe give them some flexibility in terms of deliveries, but it seems that perhaps it's the future of the industry that's here to stay. I was wondering if we could push that discussion further. Thank you.

Dave Regnery: Yes. I mean it's a provocative question, Andrew. I don't see it that way. I think that as the supply chain improves, you'll see lead times contract. Does it go back to what it was post pandemic? Maybe not. Maybe it's a little bit longer. I think that everyone sees the value in the visibility. And we've done a lot of work with our customers setting up some of those more visibility in that space.

So that will stay. So, could they extend a bit? Sure. I don't expect -- I expect them to improve from where they are today. And if I went back a year, I would tell you, they've dramatically improved from a year ago. So, we'll see how it plays out, but it's a very provocative question.

Andrew Obin: Thank you, and just a follow-up. Can you address the safety stock investment? What specific area is that related to?

Dave Regnery: Yes. I mean I'll be very specific. I was very nervous about what's coming out of Asia. And so we want to put additional safety stock for anything that's coming out of Asia. And we think it's very prudent. It's about the $40 million range and the reopening there of China specifically, although we're cautiously optimistic, we just want to make sure that we were reading the tea leaves correctly and that we did not get caught short of supply.

Operator: And that concludes the question-and-answer session. I would like to turn the call back over to Zac Nagle for any additional or closing remarks.

Zachary Nagle: Thanks, Operator. I'd like to thank everyone for joining on today's call. And as always, Pat and I will be available along with Susan to take any questions that you may have in the coming days and weeks. We look forward to speaking with you then. And, also, we're going to be on the road quite a bit here at conferences in February and into March. We look forward to seeing you on the road soon. Thanks and Be safe.

Operator: That concludes today's presentation. Thank you for your participation. You may now disconnect.