Q4 2019 Ingersoll-Rand PLC Earnings Call

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PRESENTATION

Operator

Good morning. Welcome to the Ingersoll Rand 2019 Q4 and Full Year Earnings Conference Call. My name is Lindsay, and I will be your operator for the call. The call will begin in a few moments with the speaker remarks and then a Q&A session. (Operator Instructions) I would now like to hand the call over to Zac Nagle, Vice President of Investor Relations.

Zachary A. Nagle, Ingersoll-Rand Plc - VP of IR

Thanks, operator. Good morning, and thank you for joining us for Ingersoll Rand's Fourth Quarter 2019 Earnings Conference Call. This call is being webcast on our website at ingersollrand.com, where you'll find the accompanying presentation. We are also recording and archiving this call on our website.

Please go to Slide 2. Statements made in today's call that are not historical facts are considered forward-looking statements and are made pursuant to the safe harbor provisions of federal securities law. Please see our SEC filings for a description of some of the factors that may cause 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 Mike Lamach, Chairman and CEO; and Sue Carter, Senior Vice President and CFO. Also joining today's call is Chris Kuehn, Vice President and Chief Accounting Officer, who we recently announced will be succeeding Sue Carter as Chief Financial Officer after her planned retirement post-closing of the Reverse Morris Trust transaction with Gardner Denver in early 2020. With that, please go to Slide 3 and I'll turn the call over to Mike.

Michael W. Lamach, Ingersoll-Rand Plc - Chairman & CEO

Thanks, Zac, and thanks, everyone, for joining us on the call today. Before we begin today, I'd like to take the opportunity to thank Sue for her many contributions to Ingersoll Rand over the past 6 years as CFO. She's been a terrific business partner and a leader of the finance organization. And while we'll miss her once she retires in the upcoming months, we certainly wish her well and a well-deserved retirement.

I'd also like to welcome Chris Kuehn to the call as the future CFO of Trane Technologies. Chris has been a strong business partner and leader at Ingersoll Rand since he joined the company 5 years ago. Execution of this succession plan is well underway in order to ensure a smooth transition and he is well positioned for the role. Sue will be with us through the close of the RMT transaction, and we're happy to have both Sue and Chris participate on the call today.

Turning to Slide 3, I'd like to start out today's call with a brief overview of our global business strategy that's enabling us to consistently deliver strong financial results for our shareholders. As we continue to progress towards the close of the RMT transaction and prepared to transition to a pure-play climate company, our strategy remains unchanged. At its core, our strategy is at the nexus of environmental sustainability and impact, which are strong secular tailwinds for our business.

The world is continuing to urbanize while becoming warmer and more resource-constrained as time passes. At our core, we are focused on and excel at reducing energy intensity in buildings, reducing greenhouse gas emissions, reducing waste of food and other perishable goods, and we excel in our ability to generate productivity for our customers, all enabled by technology. Unless you think the world is getting cooler, less populated and less resource-constrained as time passes, these strong secular tailwinds will continue to provide opportunity for shareholders and purpose for our vision. As I look back over the past several years, these secular tailwinds are only growing stronger and have a greater sense of urgency.

Moving to Slide 4. Fiscal 2019 was a great year for Ingersoll Rand with strong execution against all elements of our strategy. We delivered top quartile performance, with organic revenue growth of 6%, 70 basis points of adjusted operating margin expansion and free cash flow generation of $1.8 billion or 118% of adjusted net earnings. We established a leadership role in tackling the world's environmental and sustainability challenges by putting forth our aggressive 2030 sustainability commitments, and we issued this challenge to likeminded companies in order to amplify progress towards a more sustainable future.

We invested heavily in our core business, acquired Precision Flow Systems, entered into a game-changing RMT transaction with Gardner Denver, repurchased $750 million in shares and continue to pay a strong dividend to our shareholders, executing against all elements of our capital allocation strategy. The RMT transaction creates a leading industrial company. It also creates a world-class pure-play climate control business, which squarely focuses 100% of our portfolio on our sustainability strategy.

Finally, we maintained very high employee engagement despite a rapidly changing environment with additional economic and geopolitical challenges, ensuring Ingersoll Rand remains a great place to work for our people. I'm very proud of our teams for delivering these strong results for our customers and our shareholders.

In the fourth quarter, our global end markets largely continued to be healthy with solid revenue growth across North America, Europe and China. We've highlighted North America Commercial HVAC’s growth as a standout all year long and the fourth quarter was no exception. Year-over-year revenue growth was up high teens in the fourth quarter alone despite very tough comps in 2018. We've talked about the extraordinary Transport business bookings growth in 2018 and the normalization process that's been occurring in 2019, with steep rates of decline in Transport bookings in every quarter. This has been a drag on top line enterprise bookings all year, so we've been providing bookings growth numbers, excluding our TK business to help you understand the real underlying bookings of the enterprise to the Climate business. I hope this information has been helpful to the investment community.

In the fourth quarter, Enterprise bookings were extremely strong, excluding TK, up high single digits. Climate bookings, excluding TK, were even stronger, up low teens. Net, our underlying business remains very healthy. Our fourth quarter Enterprise and Climate leverage was lower than our guidance at the end of Q3. The lower leverage in the quarter was a result of 3 factors: first, revenue in our higher-margin Transport business declined high single digits in the quarter or roughly $50 million, deleveraging in line with gross margin rates. In addition, the combination of very strong Commercial HVAC growth coupled with Transport declines drove incremental negative portfolio mix.

The second impact is a good news, bad news story. On the positive side, we had exceptional free cash flow in the fourth quarter that well exceeded our forecast. So on the flip side, we needed to accrue a substantial increase to our full year incentive compensation plans as a result, which impacted operating leverage. And lastly, we had some unplanned inventory adjustments in the fourth quarter. We know from your pre-call questions that the Transport markets are on many people's minds, so we devoted a fair amount of discussion to this topic throughout the presentation and at a slide near the end.

Throughout the year, we've talked about the significant declines in order rates expected in 2019, balanced against the very strong backlog we carried into the year. We expected that the net of the 2 factors, combined with increasing cancellations in summer and fall, will lead to a mid-single-digit revenue growth for 2019 and year-end backlog that returned to more normal levels. We highlighted that Europe was soft throughout 2019 and that we were largely in agreement with the ACT data, which was showing a correction in 2020 in North America trailer and that November and December 2019 and early 2020 market conditions and order rates are going to be important to really understand how the end of 2019 and 2020 might play out.

We closed out 2019 with 3% revenue growth for Transport. Overall market demand in November and December did not pick up as much as we anticipated, and fourth quarter revenue was weaker-than-expected as a result. This knocked a couple of points off our full year Thermo King growth. We believe the fourth quarter marked the first quarter of what ACT and others believe will be a relatively short-lived down cycle as the booking anomalies of 2018 and 2019 reset, positioning the market for a flat or slightly positive growth profile for 2021.

Our Industrial businesses continued to execute very well in the fourth quarter. Our leaders remain focused on running the business and employee engagement remains strong, a testament to our culture and the strength of the businesses that will combine with Gardner Denver. In the fourth quarter, our Industrial business saw strong margin expansion

on a low single-digit revenue decline. Good growth in Small Electric Vehicles was offset by soft short-cycle demand and Compression Technologies and Industrial Products.

We're seeing excellent payback on the restructuring, operational and commercial investments we've made in the business over the past few years as evidenced by our strong margin expansion in the quarter. We believe the business is well positioned moving into 2020 and for the combination with Gardner Denver. We continued our balanced capital allocation strategy throughout 2019 and in the fourth quarter. The strong free cash flow we're generating continues to provide us with good capital allocation optionality moving forward.

Please go to Slide 5. We exceeded or delivered towards the high end of the range against all of our guidance commitments for 2019 and delivered top quartile performance. Again, I'm extremely proud of the entire Ingersoll Rand team for their hard work and perseverance, navigating through a very dynamic economic and geopolitical landscape in 2019.

Please turn to Slide 6. As we continue to move closer to the close of the RMT transaction with Gardner Denver, we're excited and well positioned to debut as Trane Technologies. 100% of our portfolio will be strategically focused on global megatrends and at the intersection of sustainability and advanced technology and innovation. All of our products and services are uniquely positioned to have a real and significant positive impact on reducing carbon emissions. We continue to compete in largely healthy end markets globally, and our strategy provides tailwinds to grow faster than GDP. While we expect the Transport market to move through a short-term correction period, we believe this is a great business to be in over the long term.

We expect the new Trane Technologies to continue to drive top quartile performance, and we expect to deliver approximately 25% leverage in 2020 despite headwinds from our Transport business. We're excited about the new Trane Technologies business and expect to host an Investor Day in the fall to lay out our long-term strategy and targets.

Please turn to Slide 7. This slide provides a visual depiction of organic bookings and revenue growth in the fourth quarter. The underlying Climate business remains very strong, with broad-based bookings and revenue growth in virtually all businesses and regions. Our Compression Technologies and Industrial Products businesses continue to be impacted by soft Industrial short-cycle spending, while our Small Electric Vehicle business has continued to deliver excellent growth.

The headline enterprise bookings decline of negative 6% does not accurately reflect the underlying strength of the business. Enterprise bookings were up high-single digits and Climate bookings were up low-teens, respectively, when you exclude Transport and the very large quarter four 2018 commercial HVAC order.

Please turn to Slide 8. This slide combines our quarter four growth performance with our preliminary view of our major end markets for 2020. I've covered the main points regarding fourth quarter growth on the prior slides so I'll focus my comments on our preliminary 2020 market outlook. Our global Commercial HVAC outlook continues to be positive. Leading economic indicators remain largely supportive of continued market growth in 2020, albeit slower growth than in 2019.

We're expecting to see low single-digit market growth for global HVAC with North American office, government, education and industrial markets all healthy. In the Residential HVAC market, which is a North American market for us, we're expecting to see low single-digit market growth led by continued growth in the replacement markets, which is approximately 80% of our business today. Economic indicators are also largely supporting continued growth.

As I discussed earlier, ACT, other data sources globally and our internal estimates point to Transport markets moving through a relatively short-term down cycle in 2020 and a more stable market in 2021. I'll cover this in more detail later in the presentation. Relative to the Industrial markets, we continue to see impacts of soft short-cycle CapEx spending in the fourth quarter, partially offset by solid growth in Small Electric Vehicles. We expect this to continue through the first quarter of 2020. Through focused execution of our business strategy, we expect our businesses to grow faster than each of the major market growth expectations just outlined. And now I'll turn it over to Sue to provide more details on the quarter. Sue?

Susan K. Carter, Ingersoll-Rand Co. Ltd. - CFO

Thank you, Mike. Please go to Slide #9. I'll begin with a summary of a few main points to take away from today's call. As Mike discussed, fourth quarter organic revenues were particularly strong in our Climate segment. With consistent focus on sustainability and energy efficiency for our customers, our Climate segment delivered organic revenue growth of 7%, compounding a 9% growth in 2018. Climate orders were also strong, up low-teens when excluding our Transport business that saw outsized order growth throughout 2018 and the approximately $200 million large Commercial HVAC order that we specifically called out in the fourth quarter of 2018.

In our Industrial segment, organic revenues were down 2% on a tough year-over-year comp of 6% in 2018. Small Electric Vehicles delivered continued revenue growth, which was offset by revenue declines in the soft Industrial short-

cycle markets we mentioned previously. Our team delivered exceptional free cash flow in 2019 of 118% of adjusted net earnings. We have delivered free cash flow in excess of adjusted net earnings consistently over time with a 5-year average of 107%.

Adjusted earnings per share was up 6% versus the year-ago period, building on 29% growth in 2018. EPS growth was driven by operational performance in both our Climate and Industrial segments. Importantly, we remain focused on deploying excess capital on our best ROI investments for our shareholders. After reinvesting in our core business through expense and capital in 2019, we deployed $510 million in dividends, $750 million in share repurchases and entered into or completed 4 acquisitions totaling more than $1.5 billion, including Precision Flow Systems and the pending RMT transaction with Gardner Denver. Moving into 2020 and beyond, we expect to continue to generate powerful free cash flow and execute on our balanced capital allocation strategy, deploying 100% of excess cash over time.

Please go to Slide 10. Stepping back from the details for a moment, Q4 was another strong quarter, capping off a year of top quartile performance. In the quarter, we delivered organic revenue growth of 5%, adjusted operating margin improvement of 10 basis points and adjusted earnings per share growth of 6%.

Please go to Slide #11. As mentioned previously, our Industrial segment delivered strong margin expansion through productivity, operational improvements and restructuring savings. When coupled with the strong revenue growth in our Climate segment, we delivered another quarter of strong operating income and EPS growth in the quarter. Fourth quarter corporate costs were higher than prior year, primarily due to 2 impacts: first, the timing of functional spend was higher in Q4 2019 than in 2018; second, we achieved stronger-than-expected free cash flow performance in Q4, which increased our 2019 free cash flow conversion beyond our already strong forecast of 105% of net earnings to our actual results of 118%.

Free cash flow conversion is one of our most important long-term financial metrics for a healthy company, and it plays a central role in our incentive compensation design. Net, the strong performance is great to see and is testament to the hard work by our employees globally. On the flip side, it costs us a little more in incentive compensation, and there was a full year true-up taken as a lump sum in the fourth quarter. Lastly, our effective tax rate in the quarter of 20% was in line with third quarter guidance but up versus the low 16.5% in the fourth quarter of 2018.

Please go to Slide #12. Before discussing the elements of our margin bridge today, I'd like to highlight that we made one modification to what you have seen previously. We've separated volume from mix and combined mix with price, material inflation and tariffs. We believe this is a clear way to visualize the margin bridge. As this is a bit different than you may be accustomed to, I'd like to take a couple of minutes walking you through the modification and why combining mix, price and material inflation and tariffs is a positive adjustment. Since late 2016, we've seen tremendous amounts of material inflation and tariffs that have been fast-moving and volatile. To offset the massive material inflation and tariffs, we have realized price increases in the neighborhood of 5x historical levels. At the same time, our business has been growing at very high rates, and we have a large percentage of business that is not driven off of a price list. The line between mix and price and inflation is thin already, and it has become more difficult to break mix and price apart at the level we've been providing on these bridges.

For example, when we create a configured system for a high-rise in New York, that system is unique to that building. Since we have detailed tracking of input costs to calculate inflation, when gross margins on the project are better than the project down the street, the question we must answer is whether the margin improvement is because we've priced the project better or if it's better mix because we utilized higher-margin components in the system.

To be clear, we are confident we delivered strong price cost in the quarter, completing our seventh consecutive quarter of positive price cost. We also delivered strong margin expansion from volume growth in the quarter. Negative product mix more than offset price cost as we continue to deliver outsized growth from our Commercial HVAC equipment as compared to revenue declines in higher-margin products like Transport and short-cycle Compressors and Industrial Products.

Productivity versus other inflation was flat in the quarter. Our segments delivered solid productivity from operational excellence and restructuring savings. The savings were offset by the previously mentioned incentive compensation increases and Climate segment year-end inventory adjustments following an ERP implementation and footprint optimization projects. We continue to invest heavily in growth and operating expense reduction projects with high returns on investment.

Please go to Slide 13. Our Climate segment delivered another quarter of solid organic revenue growth. Consistent with our expectations, we delivered strong volume growth, price realization and productivity. As previously mentioned, operating leverage was below expectations, primarily due to the deleverage on Transport revenue declines and the year-end true-ups we mentioned on the previous slide.

Please go to Slide 14. In our Industrial segment, organic revenues were down 2% on a tough year-over-year comp of 6% in 2018. Strong revenue growth in Small Electric Vehicles was offset by revenue declines in the soft Industrial

short-cycle markets we mentioned previously. Over the past several years, we've built a stronger, more resilient Industrial business. Despite organic revenue declines in the quarter, our Industrial segment expanded adjusted operating margins by 240 basis points through productivity programs, operational improvements and restructuring savings. The combination of our operating margin improvement efforts with our PFS acquisition expanded EBITDA margins 350 basis points in the quarter.

Please go to Slide 15. We remain committed to a balanced capital allocation strategy that consistently deploys excess cash to the opportunities with the highest returns for shareholders. We maintain a healthy level of business investments in high ROI technology, innovation and operational excellence projects, which are vital to our continued growth, product leadership and margin expansion. We continue to make strategic investments and acquisitions that further improve long-term shareholder returns. We remain committed to maintaining a strong balance sheet that provides us with continued optionality as our markets evolve. We have a long-standing commitment to a reliable, strong and growing dividend that increases at or above the rate of earnings growth over time.

With the proposed transaction with Gardner Denver growing closer, I remind you that we expect to maintain our annualized dividend of $2.12 per share post-closing and through 2020. This will deliver an attractive dividend yield for Trane Technologies. For 2021 and beyond, we will evaluate dividend increases in line with earnings growth and consistent with our long-standing capital deployment priorities. As we look forward to 2020, we remain committed to a balanced capital allocation strategy. We remain enthusiastic about the future opportunities to deploy excess capital to the best ROI investments, whether that be reinvestment in the business, a strong dividend, making value-accretive strategic acquisitions or repurchasing shares.

Please go to Slide 17. Anticipating the Reverse Morris Trust transaction will close early this year, I'll spend a few minutes walking you through a high level 2020 outlook for Trane Technologies. After the proposed transaction closes, we anticipate the newly combined Industrial business to provide guidance, including our Industrial segment. Given the market backdrop Mike outlined earlier, we expect total reported and organic revenues to be up 3% to 5% in 2020 and broadly healthy HVAC end markets.

During 2019, our Climate segment delivered 40 basis points of margin expansion. In 2020 on an apples-to-apples basis, we expect to further expand segment margins between 30 and 70 basis points. In the first quarter, we anticipate solid revenue growth in our HVAC business, offset by steep declines in our Transport business, creating continued mix headwinds. Mike will outline our Transport outlook in more detail later in the presentation.

Apples-to-apples unallocated corporate expenses are expected to be approximately $260 million, including stranded costs previously allocated to our Industrial segment. I'll explain more about our stranded cost outlook later in the presentation. For modeling purposes, we also offer the following items. Depreciation and amortization is expected to be approximately $300 million. We estimate interest expense to be approximately $240 million, reflecting debt retirement of $600 million in the May time frame. We're targeting free cash flow to be greater than 100% of net earnings with capital expenditures approximating 1% to 2% of revenues. And we've modeled $500 million in share repurchases.

And now I'd like to cover 2 topics of interest with you. Please go to Slide 19. We often get questions about the status of the proposed Industrial segment Reverse Morris Trust transaction. We've covered most of the slides throughout the presentation so I'll cover a few points here. Entering 2020, we anticipate onetime separation and transaction costs to be at the high end of our previously communicated range of $150 million to $200 million. During 2019, we spent approximately $95 million and we expect to spend the rest in the next few months.

We continue to execute our detailed project plans to carry out all of the separation, integration planning and transformation work. Given that we and Gardner Denver continue to operate as 2 separate companies and compete in the marketplace until the close of the transaction, much of the integration and transformation work ramps after the deal closes. Last month, we announced that our pure-play sustainability-focused Climate company will be named Trane Technologies, pending shareholder approval. We expect Trane Technologies to trade on the New York Stock Exchange as TT, and we plan to host our first Trane Technologies Investor Day in the fall of this year.

In contemplating the timing of our Investor Day, we recognize that 2020 is the third year of the 3-year financial targets we set at our Investor Day in mid-2017. Today, we're giving guidance for the final year, which will complete that 3-year plan. Additionally, between now and the time of the Investor Day, we will close the transaction, begin operating as 2 separate companies, file the appropriate historical financial statements and give you a chance to analyze a couple of quarters of reporting under our new segment structure. With those tasks complete and 2020 performance well underway, we will be in a position to give long-term financial targets and further outline Trane Technologies' continued strategy at Investor Day.

Please go to Slide 20. We also get questions about the stranded costs associated with the RMT transaction and how to model the savings for our new Trane Technologies. With that in mind, I'll walk you through the math illustrated in the chart at the bottom of the slide. Starting from the left, our 2020 unallocated corporate cost guide was $250 million at the time of the agreement. At the time, we also estimated approximately $50 million of allocated corporate costs

were being absorbed by our Industrial segment that were not specific to Industrial. In addition, we are targeting $50 million of cost reduction for a total of $100 million of stranded costs.

To make the math simple, we've shown a re-baseline totaling $300 million that includes both the unallocated costs and the costs currently allocated to the Industrial segment. Our guidance for 2020 unallocated corporate cost of $260 million reflects a $40 million reduction in stranded costs netted against the $300 million re-baselined corporate costs. To be clear, these cost reductions may come from corporate or from the Climate businesses. We are presenting guidance in this way to give you easily comparable Climate margin and corporate cost targets for modeling our 2020 outlook.

As we move to 2021, we plan to remove an additional $60 million from either corporate or the Climate businesses to achieve our full $100 million stranded cost reduction target. To realize these stranded cost reductions, we expect to spend approximately $100 million to $150 million. We'll provide quarterly updates on our stranded cost reduction progress. And with that, I'll turn the call back over to Mike.

Michael W. Lamach, Ingersoll-Rand Plc - Chairman & CEO

Thanks, Sue. Please go to Slide 21. The last topic of interest is related to Transport Refrigeration. While this is a preliminary view based on available forecasts and our internal estimates, I'll cover both what we are currently anticipating for the major end markets for the Transport business and what we expect to see for our Thermo King business specifically.

Given the complexity of this topic, we've significantly expanded the level of disclosure on our TK business, for the purpose of this discussion. We hope this will be useful in better understanding our outlook for the market and for our TK business. We expect the Transport markets to move through a short-term correction period in 2020. We're expecting to see steep declines in North American Trailer and APU and mid-single-digit declines in Truck. These businesses account for approximately 40% of our TK business. We currently expect the decline to be most significant in the first quarter, where the market faces tougher comparisons to solid growth in the first quarter of 2019 but remain challenging throughout 2020.

We're also expecting to see a high single-digit decline in our European, Middle East and Africa trailer business, with a steep decline in the first half of the year and recovery in the second half. The truck business in EMEA is expected to be lumpy but flat for the overall year. What's shown as the “all other” market for TK reflects aftermarket parts, marine, bus, rail, air and a few of the relatively smaller regional markets where market forecasts are not as robust as in North America or Europe. However, for these markets, we're currently expecting modest growth of low single-digit to mid-single-digit growth in 2020.

We believe we have the opportunity to outperform the overall markets in 2020, in part by leveraging the 40% of our business that is in markets where modest growth is expected. We believe we have opportunities to significantly outperform in areas such as aftermarket parts, where consumption increases in a down cycle and in APU, where we continued our successful strategy to improve our bolt-on rate beyond current levels. We also anticipate outperforming the overall trailer and truck markets in both North America and EMEA through innovation and new product launches and where we see opportunities for share growth.

The situation is obviously fluid in Transport Refrigeration, and we're closely tracking order rates of the market indicators to improve our line of sight into 2020 moving forward. At the present time, however, we're guiding for quarter one TK revenues to be down somewhere in the 20% range, and for 2020, TK revenues to be down in the 5% to 10% range.

Please go to Slide 22. 2019 was another year of top quartile financial performance with strong revenue growth, EPS growth and free cash flow. Looking forward, we believe the company is extremely well positioned to deliver strong shareholder returns over the next several years. Fundamentally, we excel where global megatrends and sustainability intersect with our innovation and capabilities. Today, 15% of the world's carbon emissions come from heating and cooling buildings, and another 8% comes from global food loss and these numbers are growing.

We are continually innovating to bend the curve on global warming. By 2030, we will reduce our customers' carbon emissions by one gigaton by changing the way the world heats and cools buildings and moves refrigerated food, medicines and other perishables. We've been heavily investing for years to build franchise brands and to advance our leadership market positions to enable consistent profitable growth. We have an experienced management team and a high-performing culture that instills operational excellence into everything we do.

We remain committed to dynamic and balanced deployment of capital, and we have a strong track record of deploying excess cash to deliver top-tier shareholder returns over the years. And lastly, we're extremely excited about the pending RMT transaction and the strategic combination of our Industrial segment with Gardner Denver. Combining two of the premier complementary industrial businesses offers the opportunity to drive significant innovation and growth with meaningful revenue and cost synergies, supported by secular growth trends and diverse end market exposures.

And personally, I couldn't be more excited about creating the premier pure-play HVAC and Transport Refrigeration company as Trane Technologies. Our Climate businesses have clearly differentiated performance, and we see significant opportunity as a pure-play to build on this performance for our people, customers and shareholders. And with that, we'll be happy to take your questions. Operator?

QUESTIONS AND ANSWERS

Answer – Operator: (Operator Instructions)

Our first question comes from Steve Tusa with JPMorgan.

Answer – Charles Stephen Tusa: Just a question on the kind of timing of everything that's happening here. I think you might have touched on an update. But when would you expect to kind of have a little bit of a deeper dive on the new TT business from an Investor Day perspective?

Answer – Susan K. Carter: So Steve, it’s Sue and Chris can join in with that. The first thing we're going to do is finish off the very detailed work that's going on right now on the separation of the Industrial businesses and then start building off of the base that we've got. We'll have to go through and issue some historical financial statements and then transition into that. But Chris, your thoughts?

Answer – Christopher J. Kuehn: Sure. Hi Steve, good to meet you here virtually over the phone. To Sue's point, I think there is a fair amount of effort still left to get done. We're on track from the RMT closure to be completed here in early 2020. But right after we do complete separation, we've got some requirements to restate some prior year financial statements. And I would expect around that time, we'd provide some more information around the historical view of Trane Technologies at that point.

I think from an Investor Day perspective, we are targeting kind of that September time frame with respect to giving us a chance of having a couple of quarters of closes under the new Trane Technologies structure and then be ready to walk out a little bit more details here in the fall.

Answer – Michael W. Lamach: Steve, Mike here. One second, Steve. I would say that just from an internal planning perspective, once we've filed all that we need to file around the restated financials, targeting something like a 5 to 10 day period after that, after you've digested it, to come back and provide more guidance. And so we'll likely structure a call, put a presentation together and lay out the 2020 guidance. And then we'll reserve until the Investor Day, report back on the last 3 years and then restate kind of going forward, likely another 3-year view for Trane Technologies through 2023.

Answer – Charles Stephen Tusa: Okay. And then thanks for the color on all the TK moving parts. When would you expect kind of the orders comp to get easier? Is that kind of a -- just remind us when you would think these orders should bottom out.

Answer – Michael W. Lamach: Yes. Steve, the way our revenue bottoms out first, I would say that you probably are just going to see the bottom in both Europe and North America in the first quarter and then it's going to still be negative, obviously, as you can see from the graphs we've got on Slide 21 in the deck for the balance of the year. But from a bookings perspective, you recover obviously a little bit quicker than that. Although there is a fair amount of book in turn, I think that will happen in the business. And so the comps get easy third and particularly fourth quarter. So second, third, fourth quarter, you get to see bookings, I think, improving. Revenue progressively improves throughout the year in both regions.

Answer – Operator: Our next question comes from Julian Mitchell at Barclays.

Analyst: Julian C.H. Mitchell, Barclays Bank PLC, Research Division - Research Analyst

Question – Julian C.H. Mitchell: Thanks, Sue, for all the help. Maybe just a question around the Climate revenue growth. Just wondered within that low single-digit Commercial HVAC market assumption for 2020, what are you assuming for Asia, given orders were down through most of 2019? And how much of a jump in the U.S. do you think you'll have this year after such a good 2019?

Answer – Michael W. Lamach: Yes, Julian, I want to be careful not to mix market expectations versus our internal businesses. So the market, I think that North America remains very healthy. We'll see growth across the board, equipment, parts, and services. I think that we feel good about what will happen in institutional, particularly education and health care. We expect Industrial and Commercial also remain healthy. And then if I translate to our internal view in North America, as an example, we end the year at the 17%, high-teens, kind of backlog over the prior year. So the setup for us and the setup for the market look pretty good.

In Europe, where you've got the sort of flattish expectation in 2020 and still some lingering Brexit execution uncertainties, we'll continue to outgrow the market as we have been, really based on the whole sort of sustainability focus on the go-to-market strategies that we've had there. So we expect to grow -- sort of outgrow the market at least a multiple of 2x or 3x there, I would assume, off a very slow kind of growth in the underlying market in Europe.

Middle East, Africa HVAC, it's going to be positive but the patterns are always lumpy because, particularly in the Middle East, these orders tend to be large district cooling plants and so they're very large orders when they come, and so you get a little bit of an anomaly there. And then actually, healthy growth in China and for the AP region in general. And again here, the backlog that we've got in China, fourth quarter versus prior year fourth quarter is up low double digits. So a good setup for us kind of coming into 2020, so I feel pretty good about what's happening in the commercial HVAC space.

And Residential, similar view, 80% of the market for us is replacement. Underlying markets still look good. Consumer confidence still remains relatively high. U.S. economy remains relatively healthy. Unemployment's low, GDP is stable so pricing remains healthy. I think the market there appears to be pretty solid going into 2020.

Question – Julian C.H. Mitchell: And then just my second question around Climate margins. Just looking at your margin guide for the segment for 2020, backing out what you're seeing for Thermo King or Transport, it implies the non-Transport piece margins are up maybe 80 basis points or so in 2020. Just wanted to check that was roughly in line with what you were thinking and to what degree you think that number is back-end loaded, again, excluding Transport.

Answer – Michael W. Lamach: Yes. I mean, at starting point, I'll let Sue and Chris chime in, but you really end up with a pretty low quarter four comp that we just completed when you think about most of those impacts really were center hit on the Commercial HVAC markets. And so the road map we've got here is still a strong pricing environment, probably a moderating materials environment. Our productivity pipeline looks robust, should cover all of inflation. Volume should drop through at gross margins. We don't see anything happening there. And we don't see any repeat issues that would have been in the fourth quarter. I mean, obviously, we talked about the silver lining perhaps in the cash conversion. But some of the inventory adjustments were partially a result of just an immense amount of factory consolidations that were done starting in '18 and through '19 and those don't repeat. That smooths it out as well. So I feel like we're in great shape on Commercial. I think Residential continues to hum along, a good conversion there. I don't see any changes there. And even in a market like Latin America, we had great success in '19. It appears to be recovering, particularly Brazil, I would highlight. Margins there are good for us and I think that can help contribute as well.

Answer – Operator: Our next question comes from John Walsh with Crédit Suisse.

Answer – John Fred Walsh: And I'll echo the sentiment, a thank you to Sue for all the help.

Answer – Susan K. Carter: Thank you, John.

Answer – John Fred Walsh: Sure. Wanted to maybe get a mark-to-market on where we stand with kind of the controls and the connected buildings platform. I know last time, I think we got an update on that revenue base. It was north of $1 billion, and you guys used to throw out some metrics around the number of connected buildings or the portfolios of buildings that you were monitoring. Can you kind of mark-to-market us on that?

Answer – Michael W. Lamach: Yes, John, I would start with a caveat that if a company can actually tell you the revenue generation from their digital business, they probably don't have a digital strategy because the whole strategy really hits every bit of the value stream from the way that you design and develop systems to not fail all the way through to the way you monetize offerings in the service business through to the way that you utilize fixed service contracts, fixed service agreements to deliver service and more creative and better ways for the customer.

So you put that all together and it's in everything that we're doing. So it continues to be the norm. I would say 100% of what we're shipping out in the Applied space today is absolutely communicating, if not inside the customer's firewall, it's coming across to us with important data. We're acting on it. At last count, I think we monetized in our Commercial space alone about 20 different offerings that we put together in that space that use digital to monetize.

Same thing would hold true to TK. Interesting with TK, I'm just going to kind of skip to this as a little bit of a story here. When you look at ACT's 2020 forecast of 37,500 units, we look at the replacement of units on the road today in North America and we get to a number of about 35,000 units. I mean, you can think about more than 90% of the market ACT is representing could be accommodated just through replacing units. Well, part of the reason that we know where these units are and whether or not they're a candidate for replacement would be through things like the telematics that would tell us how systems are operating. And so that's a great example of if how the game really changes when you've got a complete digital strategy across these businesses.

Answer – John Fred Walsh: Got you. And then just looking at the investment and other line, obviously, you covered a little bit in the prepared remarks, but that -- it's been a long time since we've seen that flat. You have the comment

saying gross investment spending remains at high levels. As we think about 2020 and beyond, does that flip back to be a headwind? Or are you kind of plateauing right now on how you're thinking about your investment spending?

Answer – Michael W. Lamach: Well, we're coming through some really major platform investments and been a multiyear investment for Thermo King, let's just say, in particular. That's going to tend to kind of flatten out there but likely not in the Trane business, particularly with some of the regulatory changes that will happen between now and 2023. So it's at a very high rate, a good estimate for 2020, as is probably as low as 20 bps of incremental and maybe as high as 50 bps of incremental that will go into the Trane Technologies portfolio for 2020.

Answer – Susan K. Carter: And John, I would also add that as you think about as you think about those investments, that's such a huge part of the capital allocation strategy and what we do with the business that we are a great generator of cash. We have processes throughout the company with investment review boards looking at various and sundry things. We want our businesses to bring us great ROI projects that continue our growth and continue the great capital allocation strategy that we've got. So as you think about Trane Technologies forward, I see that great cash generation as an opportunity and a way to really do great capital allocation with investing in the businesses, and I think that should continue and I think you'd want that to continue.

Answer – Christopher J. Kuehn: I'll just affirm here, Sue, this is Chris, that it will continue that way, knowing that we have a strong free cash flow generator in Trane Technologies, and we'll be following those similar priorities for capital deployment.

Answer – Operator: Our next question comes from Jeff Sprague with Vertical Research.

Answer – Jeffrey Todd Sprague: Thanks, and good luck, Sue.

Answer – Susan K. Carter: Thank you.

Answer – Jeffrey Todd Sprague: Appreciate all the help. 2 questions on TK. First, just aftermarket in general, has it been your experience historically that when you get into OE equipment downdrafts, that aftermarket actually does grow? Certainly, we've seen in some machinery and equipment markets that aftermarket doesn't turn out to be quite as countercyclical as people would have hoped. So I would imagine it would typically decline less. But the question is, does it actually tend to grow in those down cycles?

Answer – Michael W. Lamach: Yes, Jeff, there's a number of things that I think that we can count on and, in some ways, drive and control, even with the trailer decline forecast for 2020 and that's one of them. So if the standard aftermarket growth rates would be something kind of in the normalized 3% to 5% range, as an example, if all 35,000 North American units that are probably up for replacement wouldn't be replaced, which would be an extreme view, you'd likely see something in the high-single digits. Our experience has been something maybe 8% to 10% if that were to be the case. So that tends to always pan its way out.

The other thing that is interesting, when you look at the auxiliary power unit bolt-on rate, I think into 2016, we're talking about something in the 10% to 11% kind of bolt-on rate there, and we said, look, we think we can move this thing. And for every 2.4 units of APUs we sell, it equates to 1 trailer unit, that was a strategy to help us through 2016 and '17. And we actually have increased that bolt-on rate by 10 points so we ended the year kind of in the low 20s. The remarkable thing about that is that's what the denominator, right, increasing dramatically in terms of what was built in terms of OEM tractors put out into the marketplace.

Other interesting thing there is the replacement factor that we see out there for APUs going into 2020 is roughly 102,000 units that are available. That's compared to a 99,000-unit market so here, you've got a replacement rate opportunity that's actually bigger than a new complete. So by taking the same experience we've had around bolt-on rates moving 3, 4 points a year with even a more aged APU fleet out there, that's an opportunity for us.

The NPD launches I talked to the new platforms should be good, and we've worked 3 years to get these things ready for the market. As I said in my remarks, truck, bus, rail, those will all grow too, small truck, in particular, bus, rail all grow too. So those are sort of factors that we can count on, I think, in 2020.

Answer – Jeffrey Todd Sprague: Great. And then just to follow up on Slide 21. I appreciate you trying to help us here and that you're kind of noting the scale isn't exact. But the position of the plus 20 and the minus 40 looks pretty proportional to where the 0 is, right? And so everything on that chart, with the exception of APUs, looks like it's down less than 20% with all other actually positive. So just a little unclear how or why you'd be guiding Q1 down 20% in aggregate.

Answer – Michael W. Lamach: I can't speak to the scale, maybe Zac or Shane who drew the scale could talk to that.

Answer – Zachary A. Nagle: But -- yes. I mean, Jeff, the market will be down close to 30% for trailers in the first quarter, North America trailers. Europe trailers, a similar number. APUs will be down in the 35% to 40% range. So

that's really how you get there. The balance of the market being the other 40%. So it's really the decline in the areas that really outgrew in the last -- in the fourth quarter of 2018, which were trailer and APUs and those are down the most.

Answer – Operator: Our next question comes from Andrew Kaplowitz with Citi.

Answer – Andrew Alec Kaplowitz: Sue, thanks for all your help.

Answer – Susan K. Carter: Thanks, Andy.

Answer – Andrew Alec Kaplowitz: Mike, you've been talking about your focus on sustainability and improving efficiency for a long time now. Given the continued strong bookings, especially in North America and Commercial HVAC, are you just seeing more awareness and acceptance of your HVAC systems capability, even especially in markets like office and education to help meet your customer sustainability goals as they look to replace their equipment? And is that allowing the business to increasingly look better than the macro data that we see like construction starts?

Answer – Michael W. Lamach: Yes. I mean, first of all, it's a passion inside the company. What I'm telling you around company purpose is something that gets deeply ingrained and even how investments and projects get evaluated because that's how we think we're going to win the marketplace. And so it's very tied out in terms of how we deploy goals and how we look at products going forward. So that, for sure, I think, is critically -- a critical factor in all of this.

When you look at some of the Dodge data as an example and the put in place, which people look to, it's interesting and I'm just going to talk obviously about North America here, which is where the Dodge data is more relevant. You take our Commercial business and you split it right down the middle of 50-50 between equipment and services. And of the 50% that's equipment, you get 60% to 70% of that which is replacement, which generally is not ever going to be reported on Dodge put in place because we're negotiating energy service agreements, service contracts, retrofits. So that really only has the Dodge put in place data addressing about 15% to 20% of the business. And so as folks try to read through that to our Commercial business on Dodge data or ABI data, you're probably only predicting 15% to 20% of what that looks like.

Answer – Andrew Alec Kaplowitz: And then just following up on some of the comments you made on China commercial HVAC. If I look at the bookings, they look like they turned down a little in Q4, but you mentioned backlog is up low double digits. So was it just kind of timing and can you give more color on China? I assume you continue to grow service penetration. What particular end markets are helping you in China?

Answer – Michael W. Lamach: Well, first of all, when we talk about Asia in particular, we have to remember that China is sort of half of the business and the rest is the rest of the region. China was actually relatively strong. The bookings were -- looked okay. Backlog, as I mentioned, is up double-digit year-over-year, and so a lot of the weakness was outside of China. And I think some ways we see those markets recovering. You can think about electronics in South Korea. You can think about those sorts of markets which were pretty tough. But we expect healthy growth in China and for the region in 2020, strength in health care and we think a rebound in some of the technology segments, which where we've been a big player historically.

Answer – Operator: Our next question comes from Joe Ritchie with Goldman Sachs.

Analyst: Joseph Alfred Ritchie, Goldman Sachs Group Inc., Research Division - VP & Lead Multi-Industry Analyst

Question – Joseph Alfred Ritchie: Congratulations to both Sue and Chris. Sue, you'll be missed for sure.

Answer – Susan K. Carter: Thank you, Joe.

Answer – Christopher J. Kuehn: Thank you.

Question – Joseph Alfred Ritchie: So maybe just my first question, just following up on that China question, Mike. Clearly, you guys have done a great job growing into Tier 3, Tier 4 cities and attachment rates. Obviously, a lot of concern right now given the virus outbreak. I'm just curious as you look forward and you think about like previous times, whether it's SARS impacting your business, have you seen any impact at all at this juncture from the virus? And how has this kind of played out for you guys historically?

Answer – Michael W. Lamach: Well, I mean, first of all, we've had no impact yet to employees, which is important. And I think we've sent 650,000 masks is what I saw to China so we're trying to do our part there on that. I will tell you that what we believe we know today is that best case would be China essentially going back to work on February 10th. This is sort of the market in general and sort of our business as well. So if that's the case, I mean, you're talking about really a week of production and that's just going to get pushed. I mean, that demand is there, it will get pushed out.

Maybe it will get absorbed in the quarter, if it's possible to do. If not, it will get pushed in the second quarter. So it's fluid. We're watching it closely.

We're looking at the supply chain as well. We generally have strong supply chains. We generally tend to work in region-for-region. But to the extent we've got any Chinese components being imported, say, into the U.S. or Europe, we'll generally keep, in those cases, 8 to 10 weeks of inventory on hand. So again, a 1-week or 2-week issue is not going to be a problem for us with regard to that. But Joe, it's fluid and I'm hoping that this thing is contained and best case looks to be people are back to work February 10.

Question – Joseph Alfred Ritchie: Got it. Okay, that's helpful color, Mike. And then maybe just my follow-up here. Slide 21, super helpful, so nice job Zac and Shane, just curious as you kind of think about the climate business ex Transport. Is there anything we need to be aware of from either growth or margin standpoint as you think about cadence for 2020?

Answer – Michael W. Lamach: None that I can think of. Guys, anybody have any color on that?

Answer – Susan K. Carter: No. What I was thinking about, Joe, was as you think about the markets, when you think about HVAC with Commercial and Residential, it's going to follow the same cadence that it has historically followed, with Q2 and Q3 being our stronger quarters. So I think that stays in line with what we're doing. We do think that Q1 is going to be a quarter where the volume is tough and building. So I think that one is an area where you can think about Q1 maybe not quite being at historical levels of contribution.

The other thing that I would say, and I sound like I just think about cash, but I think as you think about Climate and Trane Technologies, we talked about this at the time of the stand-up, we believe that we're still going to generate 100% or greater than net income over time in the Climate business. It does tend to be a little more back half loaded than what we've seen, although I'm sort of laughing because we did have such a huge fourth quarter for cash flow this year. But I think that's one of the impacts that you might see. So revenues sort of following normal patterns other than the TK guide that we've already talked about out and cash flow more back-end loaded.

Answer – Michael W. Lamach: What I'll say, Joe, is that I go back to Commercial North America, which has been just incredibly strong. And it's strong across the board, meaning that the -- even the Unitary and Services growth have been double – Unitary has been in the teens, but the Applied growth has been extraordinary. The win rates there, the pull-through of systems has been excellent. Now that does initially book and ship at generally lower margins than the Unitary business. But of course, you get the long service tail in the Applied business. So in the long run, it's a great business to win.

That does put a little bit of probably mix pressure within Trane Commercial, and that again is one of those mix pressures we saw in quarter four as well. And so historically, I usually get the question and I didn't get it so far but I'll talk about it. We end up historically something in the 15% range of Q1 EPS to the total year. And the last 3 years has been that, 6 years have been a little bit lower than that. I would tell you, sort of a safer guide here would be something between 14% and 15%, just a result of that strong mix differential between Applied and Unitary and between TK and Trane.

Question – Joseph Alfred Ritchie: Yes. Tusa must have been caught off guard.

Answer – Zachary A. Nagle: So Joe, just to add to that. We're actually, just since we're guiding OI at this point, I'd say the average for OI, the Climate as a percentage of the year has been in the 15% range. It will probably be in the 14% to 15% range this year, so a little lighter in the first quarter.

Answer – Michael W. Lamach: Thanks, Zac. I'm so used to EPS after all this time that forgot we're going talk about OI.

Answer – Operator: Our next question comes from the line of Andrew Obin with Bank of America.

Answer – Andrew Burris Obin: Sue, it was such a pleasure working with you, I think, actually with multiple companies so congrats and good luck.

Answer – Susan K. Carter: Thank you, Andrew.

Answer – Andrew Burris Obin: Just a question. Residential construction, can you just walk us through your framework? How much visibility do you think on resi construction cycle over the next several years and what gives you confidence that it will continue sort of to be positive?

Answer – Michael W. Lamach: Yes, Andy, it's such a small part of kind of what drives your business that to us, we would be far from be the experts on giving you a forecast there. I mean, if you think about the Res equipment business being probably 10% of the company going forward and you think about 80% of our business there being replacement. New construction doesn't move the needle one way or the other for us really in our Residential market. So I'd probably defer to some of the better forecasts that are out there on that one and tell you that we've got a good read on that.

Answer – Andrew Burris Obin: Yes, I was just asking more as a lead indicator for non-res. Another question I have for you, how should we think about Trane's market share over the next couple of years? You've done a fantastic job. So how sustainable it is and what are the headwinds?

Answer – Michael W. Lamach: Well, I mean, when we guide, we're generally guiding on we think the market is going to be, pricing, some sense of volume, some sense of mix. We always target our teams with market share and margin expansion, so the goals there are always higher than what you see and I think that's a healthy thing for us to do. I feel really good about what's coming into the marketplace, feel good about a lot of the training and development we've had around the company, in terms of systems sales and some of the more sophisticated offerings that we do around services. So I feel like there's a lot of ways to win.

It's not always on the product technology, although we're a leader there, and that's a heavy part of the investment, but it's also in the way that you go to market in a way that the expertise gets played out in the channel. And as you think about what I've always said in the Commercial space, these are always going to be people that are 100% dedicated on behalf of the company. This is not something that you see sort of distributors doing for us. That's such an important thing when you're trying to drive an overall system strategy and trying to sell total cost of ownership over the long run. It's a sophisticated sale generally done by very technical people. They've been doing it for a long time, and that's something that's very difficult to replicate and something we always invest in, that capability. That's a big part of the secret sauce, I guess, of the business.

Answer – Operator: And that's all the time we have for questions today. I'll turn the call back over to Zac Nagle for closing comments.

Answer – Zachary A. Nagle: I'd like to thank everyone for joining on today's call and to remind everyone that we'll be available for questions, as always, today and in the coming days. And then we look forward to connecting with you soon on the road, in upcoming conferences and roadshows. Thank you very much.

Answer – Operator: That concludes today's conference call. You may now disconnect.