Trane Technologies

2023 Q1 Earnings Conference Call
May 3, 2023
10:00 a.m. ET

Operator: Good morning. Welcome to the Trane Technologies Q123 Earnings Conference Call. My name is Brent, 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?

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

I want to begin with a few thoughts on our purpose-driven strategy, which enables us to drive differentiated financial results and shareholder returns over the long-term.

Our strategy is aligned to powerful megatrends like climate change – which continues to have serious and far-reaching effects on the environment, the economy and human health. Urgent action is needed to limit global warming and preserve our planet next generations.

That's where Trane Technologies is uniquely positioned to lead. We just released our latest ESG report, which highlights how our innovation is helping our customers decarbonize their operations, save energy, and improve performance. We have reduced our customers' carbon emissions by 93 million metric tons since 2019, towards our goal of reducing emissions by one gigaton, or one billion metric tons, by 2030.

These bold ambitions drive our relentless focus on innovation – and our innovation creates tremendous demand for our sustainable solutions. This enables us to deliver a superior growth profile, strong margins and powerful free cash flow. The end result is long-term value creation across the board…for our team, our customers, our shareholders and for the planet.

Moving to slide number four.

Our global team continues to execute at a high level and delivered another quarter of strong performance, showcasing the power of our diverse, resilient portfolio. Organic revenue was up 9%, adjusted operating margins expanded 140 basis points, and adjusted EPS grew 26%.

Absolute bookings levels continue to be extremely strong, as evidenced by our book to bill ratio of 117% in the first quarter. We added $400 million to our backlog, driving record backlog of $6.9 billion at year end 2022 up to $7.3 billion at the end of the first quarter.

Demand continues to be particularly strong in our long cycle, commercial HVAC businesses, where global commercial HVAC bookings were up more than 35% on a two-year stack and Americas commercial HVAC bookings were up nearly 40% on a two-year stack.

We've been encouraging investors to look at absolute bookings levels and backlog, in addition to growth rates, to gain a more complete understanding of the strength of our business. Q1 is a good example of why that is important. Our enterprise book to bill of 117% was led by commercial HVAC in all regions and demonstrates ongoing, exceptional levels of demand for our innovative products and services… and continued backlog build.

These strong results position us well for continued profitable growth in 2023 and 2024 with improving visibility. Our backlog of $7.3 billion is more than 2.5 times historical norms. Further, we expect backlog to remain elevated throughout 2023, and anticipate entering 2024 with backlog in excess of $6.0 billion.

To be clear, $6 billion in backlog is a scenario we believe represents the floor. The intent is to accomplish two goals: First is to give investors a high degree of confidence we will meet or exceed the floor scenario. The second is to give investors a high degree of confidence that the floor scenario would put us in a very strong position entering 2024, with backlog as a percentage of forward revenues significantly higher than historical norms.

Our strong balance sheet, liquidity and financial position continue to provide us with excellent capital allocation optionality. Year to date, we've deployed $720 million to dividends, share repurchases and M&A, and we expect to deploy approximately $2.5 billion in 2023. On the M&A front we acquired a leading industrial process cooling technology company in EMEA and committed to acquire a precision temperature control cooling company in the life sciences vertical in the Americas.

Overall, the first quarter played out essentially as expected and gives us confidence in raising our full year guidance for revenue and EPS growth. We continue to expect free cash flow to be equal to or better than 100% of adjusted net earnings. Chris will discuss our guidance in more detail later in the presentation.

Please go to slide #5.

Demand for our innovative products and services continues to be broad based across our segments, highlighting the strength of our global portfolio. Our book to bill in the quarter was not only strong at the enterprise level, but exceeded 115% in each segment as well, contributing to elevated backlog across the portfolio.

Revenues were also robust in each segment, with particular strength across our commercial HVAC businesses.

In the Americas, our book to bill ratio exceeded 115%, led by commercial HVAC. The commercial HVAC team delivered standout results, with strong absolute bookings that exceeded mid-teens revenue growth.

Revenue growth was strong in both equipment and services, up hig- teens and low-teens, respectively.

Our Americas residential business performed largely in-line with our expectations at this early stage in the year. Bookings and revenue continue to normalize as we approach the cooling season and distributers manage their inventory positions. Still, our book to bill was roughly flat in the quarter. Sell through revenues across our channel and our IWDs were flat year over year.

Our Americas transport refrigeration business performed consistent with our expectations for the first quarter, with mid-single digit revenue growth. We expect this business to outperform the end markets, which are expected to be flat for the year. It's also worth noting that we expect quarterly bookings for both Americas and EMEA transport to be lumpy throughout the year given the timing of order books, customer order patterns and elevated backlog levels.

In our EMEA segment, our commercial HVAC business delivered another standout quarter. Bookings were robust and revenues were up more than 25%, with strength in both equipment and services, up nearly 40% and high- single digits, respectively. Our transport refrigeration business also had a very strong quarter with revenues up mid-single digits. We expect this business to outperform the EMEA transport refrigeration markets, which are expected to be down low-single-digits to mid-single-digits for the year.

In our Asia Pacific segment, the team also delivered strong results, with revenues up high-single digits, supported by broad based growth in China and across the region. Commercial HVAC was again a standout, with low teens revenue growth led by services, which was up nearly 25%.

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

Chris Kuehn: Thanks, Dave. P**lease turn to Slide #6.**

This slide does a nice job highlighting our overall performance in the quarter which was strong across the board. Organic revenues were up 9%, adjusted EBITDA margins were up 100 basis points and adjusted EPS was up 26%.

At an enterprise level, we delivered strong organic revenue growth in both equipment and services, up high-single digits and low-teens, respectively.

Our high-performance flywheel continues to pay dividends, with relentless investment in innovation driving strong top-line growth, margin expansion and EPS growth.

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

We delivered strong margin expansion in each of our business segments and have highlighted the key margin drivers on the right side of the page.

In each of our regions, strong price realization, volume growth, and productivity combined to more than offset continued supply chain challenges and persistent inflation in the quarter. As we've highlighted previously, the supply chain is slowly improving, and we expect this trend to continue throughout 2023.

As an enterprise, we delivered about 6 and a half points of price and about 2 and a half points of volume in the quarter, which was largely in line with our expectations. We delivered strong volume growth in our commercial HVAC businesses in each region, accompanied by strong leverage, which was partially offset by lower volumes in our residential business, as those markets continue to normalize.

As we've discussed previously, we've earmarked approximately 30 basis points for incremental business reinvestment to accelerate the timing of key projects. This is above our average run-rate of approximately 40 basis points annually…for a total of approximately 70 basis points in 2023.

While investment spending was less than 70 basis points in the first quarter, it was in line with our expectations based on the timing of projects. We expect to ramp up to 70 basis points in the second quarter and there is no change to our full year guidance of approximately 70 basis points.

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

Dave Regnery: Thanks, Chris. **Please turn to Slide #8.**

We presented this slide on our fourth quarter earnings call to help provide color on our key markets.

Overall, we had a very strong first quarter as expected, and our positive outlook for our segments and our end markets is largely unchanged.

We see strong core demand for our sustainability focused solutions continuing. We see the stacking effect of supportive policy and regulatory changes that play to our unique strengths as a leading climate innovator, as tailwinds that are either early-to-mid innings, or future multi-year opportunities. We see the effects of a tight supply chain slowly, but steadily improving. And we see strong execution of our business operating system and unprecedented backlog supporting resiliency and improving visibility into 2023 and 2024.

In our Americas segment, our overall outlook is relatively balanced between commercial and residential. We see our residential business continuing to normalize through Q2. Our bias on our prior revenue estimates of the business being plus or minus low single digits for the year, is now towards the lower end of that range, or flat to down low-single digits. While this may present a modest headwind to the second quarter, we see strength in our commercial HVAC business more than offsetting this on the full year.

Our transport refrigeration business performed as planned in the first quarter, and we continue to expect to outperform the market for the year.

In our EMEA segment, the first quarter was strong, and in-line with our expectations for both businesses, and our outlook for the year is unchanged.

Likewise for our Asia Pacific segment, Q1 performance was strong and our outlook for the full year is unchanged.

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

Chris Kuehn: Thanks, Dave. **Please turn to Slide #9.**

We're off to a strong start to the year and we continue to see slow but steady improvement in our supply chain. Additionally, bookings and backlog continue at high levels providing us with improving visibility into future revenues.

All in, we're confident in raising the low end of our full year revenue and EPS guidance for 2023. We are raising our full year organic revenue growth guidance to between 7% and 8%, up from our prior guidance of 6 to 8%, reflecting strong results in the first quarter and improving visibility on the year. We're raising our adjusted EPS guidance range to $8.30 to $8.50, up from $8.20 to $8.50.

We're also expecting to deliver free cash flow equal to or greater than net earnings.

Other elements of our guidance remain largely unchanged, with a few modest exceptions, mainly one additional point of M&A and associated impacts, higher interest expense related to debt refinancing in the first quarter and expected pension expense in 2023.

Please see page 18 of the presentation for additional details related to guidance to assist you with your models.

As we've highlighted before, we pay close attention to our investment peer group and target top quartile revenue growth, EPS growth and free cash flow conversion as part of our annual planning process and we monitor our progress throughout the year. We believe our full year guidance places us in the top quartile of the peer group on these metrics for 2023.

In addition to our full year guidance, we believe it may be useful to provide a high-level construct regarding how to think about Q2 and the cadence of earnings. For the second quarter, we expect revenue growth in the high single digit range, which reflects a step down in pricing sequentially, given very high levels of pricing realized in 2022. It also reflects continued normalization and inventory optimization across our residential distribution channels, as Dave referenced earlier. Adjusted EPS is expected to be between $2.50 and $2.55, which includes approximately 30 basis points of incremental investment spend in the second quarter versus the first quarter, as I discussed earlier. This EPS range is also consistent with our 3-year average for second quarter earnings as a percentage of full year earnings, which is approximately 30% at our full year EPS guidance midpoint of $8.40.

Please go to Slide #10.

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

Our continuous improvement mindset is an integral part of our business operating system and it's designed to drive gross productivity each year to offset other inflation. While it's been extremely difficult to realize meaningful levels of productivity in recent years given the supply chain and other macro challenges, productivity has been improving as supply chains slowly recover and is contributing to our 25% plus organic leverage target in 2023.

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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 #12, and I'll provide an update on our capital deployment for 2023.

Year-to-date through May, we've deployed $720 million in cash, with $170 million to dividends, $250 million to M&A and $300 million to share repurchases. We have significant dry powder, with $2.9 billion remaining under the current share repurchase authorization and our shares remain attractive, trading below our calculated intrinsic value.

Our M&A pipeline remains active and we have committed or deployed approximately $500 million year-to-date to bolt on, leading technology acquisitions and equity investments, two of which Dave mentioned earlier, including a leading industrial process cooling technology business which closed on May 2nd and will complement our portfolio in our EMEA commercial HVAC business.

All in, we're on track to deploy approximately $2.5 billion in cash in 2023. Our strong free cash flow, liquidity and balance sheet continue to give us excellent capital allocation optionality moving forward.

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

Dave Regnery: Thanks, Chris. **Please turn to Slide #14.**

The key takeaway for our Thermo King business is that the transport refrigeration market forecasts for both North America and EMEA remain unchanged, and we expect to outperform each market in 2023. Our performance through the first quarter is on track to meet these expectations.

The slide shows key data points on the markets, and on Thermo King specifically, to provide additional transparency and reference information.

Please turn to Slide #15.

ACT has updated their long term forecast for refrigerated trailers and they are projecting strong demand through 2028. The data supports the view we've been highlighting for some time now that this is a strong, mid-40-thousand-unit market, plus or minus a few percentage points.

One key takeaway is that ACT has increased their 2024 forecast to 42K units up from 40K units, which represents a 7% decline vs an 11% decline. In 2025 ACT forecasts the market to increase 7% and return to 45K units, and to continue growing low single digits through 2028.

Both our Americas and EMEA Thermo King businesses are poised to continue to outperform their end markets through leading innovation and strong execution. We believe this is a GDP plus, plus, business for us over the long term.

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In summary, we are positioned to outperform over the long term.

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

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

Our strong first quarter performance, diverse and resilient portfolio, and unprecedented backlog give us confidence in raising our full year revenue and EPS guidance and reaffirming our full year free cash flow conversion guidance.

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

Operator: [Operator Instructions]. Our first question comes from Scott Davis with Melius.

Scott Davis: You guys always give a lot of great detail and answer a lot of questions, which is helpful. But I haven't really heard you talk about mega projects specifically. And when I think about kind of these giant semi fabs and the EV facilities and everything that is on the list that folks are talking about, is this stuff starting to move into your backlogs? Are people starting to spec out the HVAC needs in those facilities?

And if so, I'm just kind of guessing these are super complicated. I have to imagine a semi fab requires some pretty incredible engineering to get the cooling right, and perhaps you guys have an advantage in that regard. So, I'll just open it up to that.

David Regnery: Yes. Great question, Scott. And the short answer is, look, we're -- this high-tech industrial vertical, as we call it, we have a lot of strength in that vertical, and we have for a number of years. Yes, we are starting to see early stages of some big orders coming in, specifically on the fab plant side of things. But again, I think the CHIPS and Science Act is really in front of us. And once that really starts to happen, you're going to see even greater closing of some of these big projects.

So, I think a lot of it's in front of us. We are seeing some -- we're also seeing some of it on the EV battery plants. And that's certainly been a nice -- again, we classify this all as a high-tech industrial vertical, but it's certainly been a strength to us. And you're right, these are sophisticated operations that require kind of detail engineering. Not everyone is as cookie-cutter as you might think, so there's always unique things. And our expertise in this vertical really allows us to have a lot of strength, and we'll continue to execute in the future.

Scott Davis: That's helpful, Dave. And this is a little pie in the sky, but AI, the cooling of the chips, when you start talking about, I think it's something like 5-kilowatt going to 100-kilowatt and there's a lot of heat there. And I'm told there's a lot of white space because, frankly, the cooling of those chips is still -- whether we go all liquid or whether there's other kind of hybrid solutions. But are you guys involved at all or perhaps working on technologies to be involved at all in some of that chip level cooling?

David Regnery: Yes, absolutely. You're talking about immersion cooling, and that's certainly on the cutting edge. And yes, we're very active there. In fact, we made an equity investment in a company called Liquid Stack, which is really -- that's their expertise. We're partnering with them. And yes, we're certainly on the leading edge of that technology.

Operator — Your next question comes from the line of Andy Kaplowitz with Citigroup.

Andy Kaplowitz — Dave, commercial HVAC bookings growth has remained really strong, low teens growth in EME despite maybe a little bit slowing against tough comps as you talked about in the Americas. Have you seen any slowing in any of your main commercial HVAC verticals in the Americas?

Or is it really just tough comps? And then would you say the main difference in EAME is the strength of your thermal management system out there? And if it is, where are you in that buildout? And where are you in terms of bringing it into the U.S.

Dave Regnery — Well, Andy, I think it's -- commercial HVAC has been strong globally for us. And I think the mega trends around decarbonization, they continue to intensify. We had a very strong start to the year here in the Americas. Order rates were up low single digits, but the backlog grew, and that's a great thing. If you go to EMEA, I mean, yes, I mean, the team there is just performing at a very high level.

And you hit it, right? Thermal management systems is -- we have a differentiated technology and we're winning with our customers. If you think about the commercial HVAC EMEA business in 2022 was up 20%. In the first quarter, we were up 25%. Our equipment orders for commercial HVAC, I mean, we're up close to 40%. So, I mean, this is great. The team is executing well.

The other thing, too, I'd point out is that margins were very, very strong in Europe as well. If you remember a year ago, we were talking about more acute supply chain problems in Europe and a higher cost to serve our customers and we are -- with spot buys and expedited freight.

You see that pulling through now with productivity that the team has been able to deliver. So very strong in EMEA, very strong in the Americas and Asia Pacific also performed quite well. Order rates were up low teens and really broad-based too, both in China and outside of China. So off to a great start here in 2023. And commercial HVAC business is certainly -- we're seeing a lot of demand for our products.

Andy Kaplowitz — That's helpful, Dave. And I want to follow up on your comments on sort of the EME margin. Maybe for Chris, you talk about price versus cost benefit in Q1 for the year. I think you mentioned previously the 2% to 2.5% carryover price embedded in 2023. Has that gone up a bit? And as Dave mentioned, is it really you're comping against sort of an easier, you know supply chains are better in EME and Asia, and that's sort of the big reasons why the margins were much stronger in those regions than versus the Americas? Or are you investing maybe more in the Americas versus those other regions?

Chris Kuehn — Andy, it's a great question. If I go to EMEA margins first, I mean, if I go back a year ago, we saw very acute supply chain issues impacting that region and really unfortunately holding back revenue growth and lowering volumes. It also came with the product we get out the door, a lot of additional cost to serve our customers. And a year ago, it was very difficult to get leverage in that region.

What you're seeing coming through here in the first quarter, and you guys will see this in the 10-Q that gets filed, you'll see 9 points of price in EMEA and about 6.5 points of volume. And with that volume came strong leverage, and we're starting to see some productivity come through within a slowly but improving supply chain.

So I think about the margins around productivity improvements on a year-over-year basis, stronger volume with good incrementals and pricing continues to remain strong in the region as well. So really nice start to that team.

I think you mentioned a question on maybe price overall for the company. Enterprise-wide on the full year, we're probably still in that 200 to 300 basis points on a full year price. And I would bias our full year revenue growth more to the volume side than to the price side on the full year.

Operator: Your next question is from the line of Julian Mitchell with Barclays.

Julian Mitchell: Maybe just wanted to start with the sort of the backlog outlook and orders. And I guess one approach is just not report the orders when they're down in quarter. But if we look at over the balance of the year, how are you thinking about the sort of the book-to-bill ratio, let's say? Just trying to understand a little bit better, Dave, your commentary around that $6 billion backlog at year-end perhaps being a floor number. Any color as you're thinking about book-to-bill by region or the market in terms of commercial versus transport?

Dave Regnery: Yes. Look, our order rates for the first quarter were actually flattish, okay, but our backlog increased by $400 million. So ,we thought we had a real high backlog at the end of 2022 at $6.9 billion, it's now $7.3 billion. We will enter 2024 with a very inflated backlog. And we're kind of using $6 billion just as -- just to demonstrate the strength. If you think about any year we go into, the backlog typically represents about 20% of the forward revenue. We'll be far in excess of that going into 2024.

So the book-to-bill, if you just do the simple math while we're -- looking at our midpoint on revenue, yes, it would come down a bit from what we're seeing right now. But I would tell you, the first quarter was exceptional and it was a little bit stronger than even we thought, especially on our commercial HVAC standpoint.

Our commercial HVAC business on a two-year stack in the first quarter, is up 35% for orders. So, I mean it's very, very strong right now and we're seeing a lot of demand. And you heard Scott talk about some of the tailwinds that are to come, some of the mega projects out there with the CHIPS and Science Act and IRA. As it starts to kick in here in the -- hopefully, the fourth quarter, that will be an additional tailwind that we're going to see into 2024 and beyond.

Julian Mitchell: That's helpful. Then my second question would just be on the Americas operating margin for the year. So I suppose, one, I think some investors may have thought maybe you'd have higher operating leverage in the first half and the sort of mid-20s number because of price cost, tailwinds to margins and the last sort of bout of transformation, savings as well as the good volume growth.

So I understand the sort of investment reference that Chris had made. Anything else going on in that Americas margin? And also, when we're thinking about second half operating leverage in the Americas, does that stay at that mid-20s rate that you've got in the first half? Anything sort of moving around there?

Chris Kuehn: Julian, this is Chris. I'll jump in. Yes, the Americas saw a nice margin expansion in the first quarter, 90 basis points op margin expansion, about 50 basis points EBITDA margin expansion really led by our commercial HVAC business. We saw declines in residential in the quarter and Thermo King was right in line with our expectations, plus or minus. So I think it's really just the combination of the mix in the quarter, where residential volumes were down but we saw very strong growth in commercial HVAC.

I think on the guide, as we've guided Q2 and then raised the low end of the guide on both revenue and earnings on the full year, would suggest maybe some leverage, it's a little lower second half versus first half. But I'll tell you, we're very confident in our full year guide. I think the performance in the first quarter was very strong. And at the same time, we've got a strong backlog entering into the second quarter. And as Dave talked out, the guide for the backlog going into 2024, we expect to be very high as well. So we have a lot of confidence in the full year guide.

The first quarter, it's really our smallest quarter of the year. It's about 17% of our earnings on a full year basis. And let's get into the cooling season and we'll update you in a couple of months. But we're really happy with where we started.

Operator: Your next question is from the line of Gautam Khanna with TD Cowen.

Gautam Khanna: I just wanted to ask if you're seeing any evidence of price elasticity in the residential channel given the volumes are a little bit lower across the industry, just -- or any sort of competitive price movements downward.

Chris Kuehn: Gautam, it's Chris. I'll start. Look, I think pricing continues to be strong and as we expected in the quarter for residential. We're ready for the cooling season with the inventory we have on hand, but we're not seeing anything from a price elasticity perspective that you're referring to. Things remain to be very disciplined as we see today, and we're ready for the cooling season.

Gautam Khanna: And just a quick follow-up on the M&A pipeline, if you could talk about what kinds of things you're looking at. And is it more of what we've seen before with technology add-ons? Anything sizable in the pipeline that might be attractive?

Dave Regnery: Yes. Gautam, I'll start on that. At the end of the day, we're going to get an opportunity to see everything as a major global HVAC player. In the second quarter -- or in the first quarter here, we announced MTA. Chris talked about that and we've actually announced that yesterday. A great example of what we do really well.

This is a technology in industrial process cooling, it's in EMEA, great technology at an enterprise level, the revenue is less than 1% for the enterprise. Margins are nice, they fit nicely into the business with our strong scale -- with our strong channel, we're able to scale these acquisitions quite quickly. So we'll look at everything. We'll be disciplined, and we're going to continue to execute the strategy that we've been executing to, and we've had a lot of success with it.

Operator: Your next question is from the line of Josh Pokrzywinski with Morgan Stanley.

Joshua Pokrzywinski: So look, we talked a lot about the backlog. Clearly, the trends there are impressive in terms of what that means for the revenue story. I guess I'd like to talk a little bit about how backlog margins have trended.

And I guess where I'm coming from is some of what the answers have already touched on is these opposing forces where supply chain and price cost, it seemed like they should probably be improving in the backlog. But you also have some of these larger projects, where I would imagine in commercial HVAC, maybe a lower margin upfront and you get paid more on that longer tail of things like service. How would you carve that for us as you're thinking about the margin in backlog today and maybe where that trends?

Chris Kuehn: Josh, it's Chris. I'll start. We see the backlog is still over 90% non-residential. So that would be primarily commercial HVAC plus our transport businesses globally. But price/cost, we like the margins in backlog. But remember that price scenario, that's going to be a tougher comp as we work throughout the balance of the year. Just to remind investors, we really led with price in 2022. And so we're going to have a tough comp as we work throughout the year on incremental price.

Our product management teams have done an outstanding job staying ahead of inflation over the last couple of years, and we were price cost positive in the first quarter on a dollar basis and a margin basis. So I think that's an opportunity. But again, that headline price number is going to be a tougher comp as we work throughout the year. We have a lot of confidence in the 25% or better operating leverage on the full year, and that's going to come from multiple parts of the bridge, right?

We're confident that 20 to 30 basis points of price over cost. The first quarter start gives us confidence on that on a full year basis. But we expect to see good incrementals on volume, some productivity return as supply chain normalizes and really leverage all parts of the P&L to go drive the performance for the year.

Josh Pokrzywinski: Got it. And then I guess just sticking with the same kind of follow-up on some of the questions around some of these bigger projects. How do you think about the crowding out between more of the policy-led stuff and stimulus versus private? Obviously, a lot of focus on the higher interest rates and maybe tougher liquidity situation coming from the regional banks.

And I don't know how relevant that's going to be for like HVAC retrofit. But I guess, the wrench can only turn so fast and we still have labor bottlenecks. Is there a crowding out that you guys think happens on kind of the IRA stuff maybe versus more private demand here over the next year or two?

Dave Regnery: Yes. Well, we haven't seen that to date, Josh. It's a good question. But at the end of the day, we think they are all opportunities really in front of us. And we are -- as far as labor shortages, we have so many programs in place now to really train all of our employees at grassroots level. So that's starting to get a lot better for us, and we're not concerned about any crowding out as far as being able to meet the demand. And our account managers, our sales team, they're all over this, right?

And they're well trained and they're able to go to the most attractive verticals and really drive demand. And that's what we're seeing right now. And you see it in our results. I mean, our order rates are just tremendous right now. And I look at our team and what they've been able to do in EMEA right now and all those opportunities there that are -- we talk about IRA, but there's other policy that are happening in Europe right now that are really helping drive demand, and we're able to capitalize upon it.

Operator: Your next question is from the line of Chris Snyder with UBS.

Chris Snyder: I wanted to ask on commercial HVAC demand. Obviously, orders can reflect a bunch of things, comps, lead times. But when you were speaking with customers, do you sense any easing of demand, whether it's the result of macro uncertainty or just higher cost of financing?

Dave Regnery: Chris, good question. Look, we haven't seen that yet. And in fact, we continue to see very strong demand. And I think the whole megatrends around decarbonization continue. And the world is getting warmer and we need to take action and more of our customers realize that, and we have some solutions out there right now that can have a dramatic impact on how we decarbonize the built environment. So we have not seen anything slowing down right now. And that really is on a global basis for our commercial HVAC business.

If you look at the Americas, we play across all verticals. I think there's like 14 different verticals that we track. Maybe there's a little bit of softness in office, but there's a lot of strength in high tech that we talked about earlier. Education continues to be strong. Europe, we've been strong really across many verticals with our solutions there. In Asia Pacific, again, very strong start to the year. So we haven't seen any slowing yet, Chris, but it's a great start to the year for Trane Technologies, and it gives us a lot of confidence in our full year guide.

Chris Snyder: Appreciate that. And then following up on price cost. The company had been running ahead or kind of staying price cost positive. When we see the year-to-date reflation in metal, does that change how you're thinking about incremental price later in '23 as you try to kind of maintain that staying ahead on price cost into '24?

Chris Kuehn: Yes. Let me jump in, Chris. So it's a dynamic market around Tier 1 metals, and we started the year three, six months ago, thinking we could be in a really deflationary environment and that really hasn't proven through.

As I said earlier, our product management team members have done an outstanding job thinking about cost inputs, value to the customer and staying ahead on price. We remain confident that we're going to be price/cost positive on the year. The start in the first quarter gives us a lot of confidence on the 20 to 30 basis points price/cost spread that we have in the full year guide. We know that pricing gets to be a tougher comp as we work throughout the year.

But we remain nimble. If there's further movement of inflationary commodities or we continue to see some inflation certainly in Tier 2 around wage and energy, which we have baked into the guide. But if things were to become more inflationary. We have the nimbleness in the company, and I think the proven track record that we've priced effectively. So we have a lot of confidence on where we're going to be on the full year and ultimately just staying very nimble to what happens in the marketplace.

Operator: Your next question is from the line of Joe Ritchie with Goldman Sachs.

Joe Ritchie: So Dave, just maybe I'll start on resi HVAC. So interesting to see it flat, but your organic growth this quarter was down mid-single digits. I'm assuming pricing had to be up. So first, did I get my math right? It seems like volumes were probably down double digits, direct volumes were down double digits in the Americas. So my question is, is that right? And then secondly, what kind of line of sight do you have to that improving and what's embedded in the guide?

Dave Regnery: Yes. Yes, your math is about right. So you think about it on a revenue basis we were down mid-single digits, on a unit basis we were down in the mid-teens. Pricing was positive in the business. There's a little bit less than the company average, which is the first time that's happened in a while. But again, we have some very strong comps here in the resi business. The sell-through, which is really how we're looking at this business right now was flat, right?

So, we don't see it falling off a cliff. If you look at inventory levels in our IWDs, our independent wholesale distributors, maybe they're a bit high but that will normalize through Q2, nothing alarming.

This is a business that we have a lot of innovation coming through. We have some great brands, some great products, great distributors and a great management team. So it's early in the year. It's the first quarter. So we'll wait to see how the cooling season starts. But we don't see this business falling off a cliff. And we have this guide -- in our guide, okay? So it gives us confidence in our guide with what we have projected right now.

Joe Ritchie: Okay. Great. That's helpful. And then going back to the margins in EMEA, I mean, just -- I know that you had an easier comp because of some of the issues that occurred last year. But still a 17% margin in the business, the start of the year is pretty darn good. I guess my question is, is that kind of like the jumping off point now for the rest of the year? Because I'm assuming revenue/volumes are going to be higher through the remaining three quarters. And so it just kind of like the floor for margins in EMEA for the year?

Chris Kuehn: Yes. Joe, it's Chris. Look, our expectation for the region would be that they'll deliver 25% or better leverage on the full year -- organic leverage on the full year. Q1 is off to a nice start. But as you said and as we commented before, it's really an easier comp versus some real challenges we had in the business a year ago. Supply chain got better as we got to the end part of 2022. The fourth quarter, we saw a strong revenue growth in EMEA from our commercial HVAC business, and they were really hurt first and hard with the supply chain challenges.

So we have a lot of confidence that team can deliver this year and the backlog continues to grow with their innovative products. So let's see how it kind of plays out. But we're confident we're going to deliver strong margin improvement on a full year basis for the region. And keep in mind, TK EMEA, markets there are expected to be down low to mid-single digits. We expect to outperform. But all in, we expect to have a strong year in the EMEA segment this year.

Dave Regnery: Joe, you're right Joe, again just a quick -- a great start to Europe. It really is. I'm so proud of what that team has been able to deliver. So fantastic.

Operator: Your next question is from the line of Steve Tusa with JPMorgan.

Steve Tusa: Congrats on the execution on the quarter.

Dave Regnery: Appreciate it.

Chris Kuehn: Thanks.

Steve Tusa: So you had 9% price in EMEA, I know we can wait for the Q, but what was it in the other two segments?

Chris Kuehn: Yes, Steve, it's Chris. So it was a little over 6 points in Americas. So think of that as 6 points of price in the Americas, pretty much in line with the enterprise. EMEA, we said 8.9 points of price, and Asia was around 4 points of price in the quarter.

Steve Tusa: Okay. And then just in the back half here, there's like kind of strange comps from last year. You had the China dynamics. Europe had a pretty good second half as well on volume. How do we -- I know you don't like to kind of guide by quarter. But like you guided to high singles.

You're running in the first half at high singles so far. Are there any comps in the back half that are volatile? Or is it pretty smooth? Maybe just help us out with the non-U.S. businesses and how you expect organic growth year-over-year to play out in 3Q and 4Q.

Chris Kuehn: Yes. I think as we get to the fourth quarter -- well, let me start with Asia, right, given the lockdowns in the second quarter of 2022. We saw muted growth in Q2 a year ago. The business was able to recover very nicely in the third and fourth quarter last year.

So Asia may have a little bit of tougher comps in the second half just given the cadence of how earnings played out and the lockdowns from COVID played out in China a year ago. I mentioned just earlier in EMEA, for commercial HVAC, the business really through the third quarter of last year had some very acute supply chain challenges.

We're not out of the woods yet, but that continued to get better in the fourth quarter, and we saw that getting better here in the first quarter as well. So I think we're -- fingers crossed, that continues to be a nice tailwind for the business on a year-over-year. But as you get later in the year, I think you'll see a little bit of a headwinds as we get to the fourth quarter there.

But TK, if I go to the Americas side of the house, the back half of the year for TK Americas, that will be a bit of a tough comp, very strong growth we saw in the third and fourth quarter in the Americas last year. So yes, there was a little bit of tough comps coming in the second half in a few of the businesses but we have such strength in the commercial HVAC businesses as well that we're really confident in the full year guide.

Steve Tusa: Okay. And then just on -- I just want to clarify some of these resi numbers. So you said revs down mid-singles. The sell-through comment being flat, is that revenue or is that units?

Dave Regnery: That will be revenue, Steve. That would be revenue.

Steve Tusa: Yes, revenue. Okay. That makes more sense. So basically, like through your independents, your volume was down probably more like, I don't know, like 20% or something like that, just through the independents?

Dave Regnery: They certainly normalized their inventory in the first quarter. We've been seeing that happen. Like I said earlier, inventory may be a bit high, but it really depends on how the cooling season kicks off. It's the first quarter. right? And as you know, this is the smallest quarter. We'll wait until the cooling season starts, and hopefully, it starts real soon.

Steve Tusa: How's April so far?

Dave Regnery: I think it's -- the cooling season hasn't started. So we're still in that shoulder part of the year. But we'll see. It's forecasted to get real warm here in May. So we'll see how it goes.

Operator: Your next question comes from Jeff Sprague with Vertical Research.

Jeff Sprague: Just one follow-up on resi and then just a different topic on the M&A from you. Just the price in resi below the 6.5% range, little surprised to hear that given the SEER change and the mix effect associated with that. Maybe you're not including mix when you say price, or perhaps you're still selling a lot of older units in the quarter. Could you just maybe clarify a little bit what's going on there?

Chris Kuehn: Jeff, you're right. We're not including the price benefit from the SEER change in that price number. We consider that as part of volume. So this would be more pure on a year-over-year basis.

Dave Regnery: Put that as mix, Jeff.

Jeff Sprague: Alright. We'll call it mix. And then just on the deals, a 2% revenue impact right on the $16 billion revenue base last year, That's $320 million of sales you're guiding for the partial year on deals, right, on $500 million expended. That sounds like a pretty good chunk of revenue for that amount of dollar spent. So maybe just a little color on the margin rates in these businesses. Do I have that math right? What percentage of the year do you expect what you just announced to actually be in the year? When does this stuff close?

Chris Kuehn: Yes, Jeff, it really is the contribution of three acquisitions that's leading to that roughly two points of revenue growth from M&A in 2023. One relates to the AL-KO acquisition we closed in October of last year. So you've got about nine months of that revenue coming through in 2023 that we're calling out as inorganic. Fourth quarter would be a comp would just be part of our organic results.

Dave just mentioned, we closed on MTA just yesterday. It is an industrial process cooling business in EMEA. So we'll start picking up the revenues from that business, also a partial year. Think about it as eight months of revenue this year. And then the pending acquisition that we've announced in the life sciences vertical in the Americas, that's not closed yet. We expect that to close sometime in the second quarter. We made an estimate of that here in the full year.

So all in, it's the combination of those three businesses that's getting us to roughly two points of revenue growth. And look, the contribution margin in year one, it's low just given the integration costs.

But we have a great track record of taking bolt-on acquisitions and bringing them into our channels, selling through with our robust sales forces and ultimately really driving very strong returns in subsequent years. So in the year, it's about $0.03 positive on an EPS basis with that leverage. And ultimately, we'll see what kind of plays out for the year, but it's still positive and slightly accretive by the year.

Operator: Your next question is from the line of Nigel Coe with Wolfe Research.

Nigel Coe: Dave, I don't know but about your neighborhood but still pretty cold up here. So make sure you pack something warm next week.

Dave Regnery: It's warming up, Nigel. It's warming up.

Nigel Coe: Okay. it's coming, it's coming. So obviously, one of your competitors is making a pretty big splash in European residential markets. How do you characterize the importance of Trane being a player in European residential heating specifically? I'm not saying a multi-billion-dollar deal, but do you see opportunities to be a player there in a smaller scale, perhaps?

Dave Regnery: Yes, great question. I mean, we really like our portfolio in Europe. You think about it in the commercial HVAC space where we play, we're having a lot of success. We have differentiated offerings that we're able to provide to our customers. And you see the results. I mean, our thermal management systems there, we've eliminated or significantly reduced the need for fossil fuel for heating in all geographic climates. And you could see the team's results. And like I said earlier, our revenue in 2022, up 20%; first quarter, 25%; equipment revenue, 40%. So we're going to continue to execute on our strategy in Europe.

We're having a lot of success. The team is high-powered and performing extremely well. And we have so much innovation that's coming through the pipeline that I get excited just talking about it. And as I said earlier, we get the opportunity to look at a lot of M&A deals being a global HVACR player, and we'll continue to do that and we'll continue to be disciplined. And we'll make sure we make the right investments for Trane Technologies and our shareholders.

Nigel Coe — Okay. And then maybe for Chris. We're coming up to the end of the $300 million program transformation savings. Is this it? This is the end of the kind of the big part of your move? Or do you see the potential for like another way perhaps of initiatives?

Chris Kuehn — Nigel, thanks for the question. Look, we're on a really good track to realize the incremental $60 million in savings this year, we continue to deploy that back into the business through reinvestment, and innovation in the portfolio also gives us confidence on delivering 25% or better operating leverage on the full year. But look, the company has always prided itself on lean thinking. And I would tell you that as we move forward, there's always going to be opportunities for us to lean on operations and drive cost improvements.

I think another area of opportunity for the company is the ability to claw back on some of the productivity that's been very challenged over the last few years, to deliver on supply chain challenges, higher cost to serve customers. Dave talked in past calls about spot buys and being exposed to those markets and higher costs. Those are really great opportunities for the company to get back to basics, get back to productivity offsetting other inflation.

And we're seeing a little bit of that come through in the first quarter with our commercial EMEA business. And we'll see how that kind of plays out for the year. But I would tell you that -- we'll update you more as we work throughout the year, but I'm really excited on the productivity side and I'm excited we still have a lot more opportunities to take cost out in the business.

Operator — Your next question is from the line of Deane Dray with RBC Capital Markets.

Deane Dray — Question about indoor air quality. Has the whole urgency around that theme faded? And understandably, you've showcased all the decarbonization benefits and climate change, and that makes perfect sense. But has the driver of indoor air quality, is that faded at all? Because originally, you were talking about a 200-basis point lift for quite a period of time.

Dave Regnery — Deane, it's a good question. I mean we've embedded indoor air quality into our applied systems. And I would tell you that -- I've been in this industry a long time, 10 years ago, we used to just have the conversation about indoor air quality in the health care vertical. We have that now in all verticals. So you might not read about it, but I would tell you it's still prevalent, and we talk about it with our customers.

And they talk about it with us. I mean, I think everyone's been educated on the importance of indoor air quality, the importance of fresh air exchange, the importance of being able to balance that with energy consumption. And we've done a great job of helping our customers work through that. So no, it's certainly part of our business. It's certainly part of our offering and it's top of mind of many of our customers.

Deane Dray — Yes. And I see that with the education stimulus spending that it's usually one of the top priorities.

Dave Regnery — Absolutely, absolutely.

Deane Dray — All right. And then second question on the incremental 70 basis points of spending reinvestment. Can you give us some examples of where that's going and a sense of the returns?

Dave Regnery — Yes. We really like the digital space. We really like the electrification of our portfolio. We really like optimizing our operations with automation, just to name a few. But our innovation pipeline is very robust. It's very full. Three times a year, I actually get to -- we have a deep dive on our innovation pipeline.

It's the best four hours I spend sometimes in the quarter because it's just so exciting to talk to our engineers and to see what they've invented and the impact that it could have on not only decarbonizing the built environment but really helping our customers save on energy costs and improve indoor air quality. So it's very robust right now. We love to invest in our business. It's -- we have a proven track record here, and we're going to continue to do that more in the future as well.

Chris Kuehn: Deane, I'd add on the investment side, we had a normal level of investments in the first quarter. Wanted to highlight that into the second quarter, we do expect that level of investments to ramp up to 70 basis points. We still see that being around 70 basis points for the full year, but that will be a ramp-up into Q2 as we just continue to see very strong projects, as Dave outlined. And let me come back to just a comment on EMEA as well.

We get a lot of questions around EMEA margins, maybe just to highlight, in the first quarter, we saw growth both in commercial HVAC and in the Thermo King business. Important to know that the Thermo King markets in Europe are expected to be down low to mid-single. So we're probably not expecting to see that outgrowth in Thermo King each and every quarter of the year. That's going to be an area we'll see how the year plays out. But nice to see both businesses deliver in Q1. But that will be a little lumpy and choppy as we think about Thermo King for the balance of the year.

Operator: Your next question comes from the line of Andrew Obin with Bank of America.

Andrew Obin: Just a follow-up on institutional spending. Can you just chat again -- clearly a key market, schools you've talked about. But can you talk about what's happening with the hospital spending? Because I know there was a pullback during COVID because of the budgetary issues. Are we sort of seeing cumulative catch-up or are hospitals still in trouble? If you could just talk about that key end market.

Dave Regnery: Yes. I mean, we've been strong in the health care vertical forever. I think. As I said, we track all 14 different verticals, but health care is certainly one that we have a lot of strength in. And it really -- the reason why we have the strength there, And, it's a complex sale.

And hospitals, they have varying degrees of requirements, especially around fresh air exchange. So you're going to have a different application in a surgical suite versus you're going to have in a hospital room. So we're still seeing strength in health care. But to be fair, we've always seen strength in health care because our solutions are really built around those kind of more complex situations that we're able to capitalize on.

Andrew Obin: Yes. Just a follow-up. Headlines on pricing I think Daiken introduced a lower-priced product in the U.S. on the resi side. I think we've heard yesterday at the meeting that [Aon], it's the first sort of price -- they rescinded a price increase actually on the commercial side. As supply chains are getting looser, do you feel that people can get more competitive? Or you think there's still enough demand there to support steady pricing?

Chris Kuehn: Andrew, I'd say, look, demand remains strong, and we -- it's an industry that typically retains price and is disciplined on price. I won't necessarily talk about potential pricing actions we may do throughout the year.

As I mentioned before, our product management teams, our business units have done an outstanding job taking all the inputs in to lead on price the last two years, and a good strong performance here in the first quarter as well. So I do think we'll remain proactive and be prudent. And I think our track record hopefully speaks for itself that we can really have a lot of confidence on the 20 to 30 basis points of price over cost in the year.

Operator: Your next question is from the line of Nicole DeBlase with Deutsche Bank.

Nicole DeBlase: So just -- there's been a lot of focus on the EMEA margins on this call, but the Asia Pac margins and the operating leverage was also really, really strong. So can we just talk about how you guys are seeing that progressing through the rest of the year?

Chris Kuehn: Yes, Nicole, it's Chris. I would say, certainly the second quarter, but even in the first quarter last year we saw some parts of the China economy in these COVID lockdowns. And so as we entered into lockdown, it certainly cost a lot more money to keep customers happy and trying to get products out where you could in limited situations.

And now we're comping against a little bit easier comps as we think about the first half of 2023. So first off, the demand in Asia remains very strong. We continue to expect very strong performance from the team, and they had a great first quarter.

Comps probably get a little bit better in the second half given the partial reopening we saw in the second half of 2022. But look, very strong growth, not only on the revenue side, but bookings were up high teens for commercial HVAC in Asia. Services were up nearly 25% in the quarter. So I think our innovation and then the verticals that we play in, in Asia really played through very well in the year. And great job by our team there.

Dave Regnery: Yes. Thanks for noticing Nicole. I mean, Asia, sometimes we don't talk enough about it, but what a great leadership team we have there. And they really have been leaders for Trane Technologies with innovation. And the team just executed extremely well in the first quarter, a great start to the year. And to be fair, all of our segments really executed very strongly in the quarter. And it just speaks to the resiliency of our portfolio and it just gives us lots of confidence in our full year guide. So I certainly appreciate the question.

Nicole DeBlase: Great. And then on the TK order book, are you guys now fully booked out to 2023? And I guess what's the status of the order book? Is it actually open to accept new orders?

Chris Kuehn: Yes. Nicole, so we opened up the second half of the year order book mid-to late March. So orders started to come in a little bit in the first quarter, but we would expect that to really get filled up in the second quarter. And we have a lot of confidence that from what we can see with the backlog entering Q2 and the forward look that our guide in the full year, we're going to outperform the markets both in the Americas and in EMEA for the full year.

Operator: Your next question is from the line of Noah Kaye with Oppenheimer.

Noah Kaye: Would love to dig into the services trend a little bit more. I mean, that 25% year-over-year in China, maybe to the extent that reopening played into that and you can comment, but just the overall trends in services and how you expect that to trend over the course of the year.

Dave Regnery: Yes. I mean, services is a great part of Trane Technologies. It represents about 1/3 of our total business. And if you look at it over a five-year period, we've had a compound annual growth rate globally in our service business in high single digits. In the first quarter, we were double digits.

So I mean, it's a really strong business. It really differentiates us with our customers. And in China, yes, really strong start to the year. Some of that was obviously, the comps year-over-year just because they had a lot of restrictions still specifically in China at this time last year. But I would tell you, our service business is a very strong business.

We invest heavily in our service business. And it's just a -- it's a great business. And it's very, very resilient as well even during 2020 COVID where we didn't have access to many buildings, our service business was flat. And these products are more and more sophisticated today, and they require OEM service and we're able to provide that for our customers. So thanks for the question. I mean, service is a big part of who we are as Trane Technologies.

Noah Kaye: Yes. And that actually ties into the next question. I think in talking about the incremental spend, you called out the digital investments and maybe pulling forward some of that. Just would love an understanding of the road map to the extent you can share with us and how that plays into the services strategy. Are we looking at some meaningful refreshes or additions to the digital suite over the course of the year?

Dave Regnery: No. Look. Being connected to our assets is nothing new to Trane Technologies. We're connected to over, what the number is it now, well over 30,000 buildings and millions of different assets. So we love being connected to our assets. And now think about the next is how do you even get smarter with all the data that you have and think about how you could actually have buildings operate more efficiently.

And so when I talk about digital, those are the things that we're working on. It's no longer the service tech gets deployed when something is not operating properly. It's not operating properly because it's using too much energy. And that's the space that we're into here. And we really like the digital space and service and it really is a tailwind to our service business.

Operator: At this time, I would like to turn the call back to Mr. Zac Nagle for closing remarks.

Zachary Nagle: Thank you. I'd like to thank everyone for joining us on today's call. And as always, we'll be around to answer any questions that you have over the next -- well, today and the next coming days and weeks. And we'll also be on the road at a couple of conferences. So we'll be looking forward to seeing folks on the road or in person through a variety of events soon. Thanks. And have a great day.

Operator: Ladies and gentlemen, this concludes today's conference call. You may now disconnect.