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LII.N - Q1 2021 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 1Q21 revenue of $931m, GAAP operating income of $114m and GAAP EPS from continuing operations of $2.20. Expects 2021 revenue growth to be 7-11% and GAAP EPS from continuing operations to be $11.33-11.93.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International First Quarter 2021 Earnings Conference Call. (Operator Instructions) As a reminder, this call is being recorded. I would now like to turn the conference over to Steve Harrison, Vice President of Investor Relations. Please go ahead.

Steve L. Harrison - *Lennox International Inc. - VP of IR*

Good morning. Thank you for joining us for this review of Lennox International's financial performance for the first quarter of 2021. I'm here today with Chairman and CEO, Todd Bluedorn; and CFO, Joe Reitmeier. Todd will review key points for the quarter and Joe will take you through the company's financial performance and outlook for 2021. (Operator Instructions)

In the earnings release we issued this morning, we have included the necessary reconciliation of the non-GAAP financial measures that will be discussed to GAAP measures. All comparisons mentioned today are against the prior year period. You can find a direct link to the webcast of today's conference call on our website at www.lennoxinternational.com. The webcast will be archived on the site for replay.

I would like to remind everyone that in the course of this call, to give you a better understanding of our operations, we will be making certain forward-looking statements. These statements are subject to numerous risks and uncertainties that could cause actual results to differ materially from such statements.

For information concerning these risks and uncertainties, see Lennox International's publicly available filings with the SEC. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Now let me turn the call over to Chairman and CEO, Todd Bluedorn.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Thanks a lot, Steve. Good morning, everyone, and thank you for joining us. In the first quarter, we continued to see strong momentum in our Residential business, combined with strong improvement in Commercial and Refrigeration, as the overall company set new first quarter highs for revenue, profit and earnings per share.

Overall for the company, revenue was up 29% to a new first quarter record of $931 million. At constant currency, revenue was up 28%. GAAP operating income was a first quarter record $114 million, up 213%. GAAP EPS from continuing operations was a first quarter record $2.20, up 588%.

Total segment profit rose 208% to a first quarter record of $116 million. Total segment margin expanded 720 basis points to 12.4%, and adjusted EPS from continuing operations rose 305% to a first quarter record $2.27.

Looking at our business segments for the first quarter. We realized double-digit revenue growth and margin expansion in all 3 businesses. In Residential, we set new first quarter highs for revenue and profit. Residential revenue was up 37%.

Segment profit rose 197% and segment margin expanded 850 basis points to 15.9%. Replacement business was up more than 40% and new construction was up more than 25%. Breaking it down between our Lennox business and our Allied business, Lennox revenue was up about 25% and Allied was up about 70%, strong growth rates.

Let me take a moment to unpack the strength we saw in residential in the quarter. First, with strong operational execution, our Residential team is capitalizing on its ability to deliver to meet contractor and distributor demand and gain share. Post the 2018 tornado and the initial 2020 pandemic impact, we are back on offense with production, distribution and executing our playbook for market share gains.

Second, Residential benefited from the colder winter weather with heating degree days up 13% from the first quarter last year. You may recall, we had a soft first quarter in 2020.

Third, I'd like to note that we had 6 -- I would like to note that we had a 6% benefit to revenue for more days in the quarter this year than last year. That happens every 4 years as we reset the calendar. Conversely, the fourth quarter will have a 6% headwind from fewer days in the quarter this year. This applies to Residential as well as all our other businesses. Adjusting for the days, Residential grew 31% with Lennox growing nearly 20% and Allied growing about 65%.

In addition for Allied, we had approximately $25 million of pull-forward in the first quarter from different distributor loading patterns this year than last year. Adjusted for both days and this pull-forward, Allied was up approximately 35% in the quarter.

Working through all this math I gave, adjusting for days and the pull-forward in our Allied business which sells to independent distribution, overall Residential segment revenue was up about 25%. We believe this compares to mid-teens sell-through for the industry driven in part by the favorable cold weather that I talked about. Our performance that is above that is due to market share gains.

As I mentioned earlier, we are back on the offensive with production, distribution and executing our playbook for gaining share. The team has had strong operational execution to drive this outperformance, and we are well positioned for the summer season in our largest seasonal quarters.

In Commercial, revenue, segment profit and margin were all first quarter records. Revenue is up 12%. At constant currency, revenue was up 11%. Segment profit was up 47% and segment margin expanded 330 basis points to 13.8%. In the first quarter, we saw broad strength in Commercial as year-over-year growth turned positive across all of our businesses. At constant currency, Commercial Equipment revenue was up mid-teens in the quarter. Within this, replacement revenue was up mid-teens with planned replacement up mid-teens and emergency replacement up high teens. New construction revenue was up high single digits.

Breaking out revenue another way, regional local business revenue was up mid-teens. National account equipment revenue was also up mid-teens. Our team won 3 new national account equipment customers in the quarter. On the service side, Lennox National Accounts Services revenue was up mid-single digits. VRF revenue was up mid-30s percentage.

Some highlights to mention for commercial. Schools continue to be an area of focus for us. We have a dedicated sales force and product line that will drive a multiyear growth opportunity for us in this market. Today, K-12 schools are just a little under 10% of revenue for this -- equipment revenue for this segment. This business is up more than 20% for us in the first quarter. And given the recent stimulus package that benefits HVAC indoor air quality spending for schools, we expect K3 schools to be a growth vertical for us moving forward.

Indoor air quality continues to be an important focus for us with our Building Better Air initiatives. Most interest and activity we are seeing are in this K-12 school segment, but conversations are taking place with many customers across many industry verticals.

We have launched our new Model L rooftop unit as we continue to lead the field and energy efficiency. The Model L features variable speed technology and an all-new advanced control system. We're seeing high customer interest in this industry-leading product for 2021 and beyond. Overall, for Commercial entering the second quarter, momentum continues with backlog up double digits and strong order rates.

In Refrigeration for the first quarter, revenue was up 21%. At constant currency, revenue is up 17%. In North America, revenue was up more than 25%. Europe Refrigeration revenue was up low single digits at constant currency, and Europe HVAC revenue was up mid-single digits at constant currency.

Refrigeration segment margin expanded 560 basis points to 6.3%. The segment profit rose to $8 million from $1 million in the prior year quarter. Like in Commercial, momentum continues for Refrigeration entering the second quarter with backlog up double digits and strong order flow led by North America.

The strong performance for the company overall in the first quarter and outlook for the second quarter and year, we are raising 2021 guidance. We now expect 7% to 11% revenue growth and adjusted EPS from continuing operations of $11.40 to $12. We are also raising free cash flow guidance to $375 million for the full year. We now assume about 55% of earnings in the first half of the year compared to the prior guidance of about 50%. This reflects the strong first quarter performance and second quarter outlook. We repurchased $200 million of stock in the first quarter and plan on another $200 million for a total of $400 million in our guidance for the year.

Now I'll turn it over to Joe.

Joseph William Reitmeier - *Lennox International Inc. - Executive VP & CFO*

Thank you, Todd, and good morning, everyone. I'll provide some additional comments and financial details on the business segments for the quarter, starting with Residential Heating & Cooling. In the quarter, revenue from Residential Heating & Cooling was a first quarter record $606 million, up 37%. Volume was up 32%. Price was up 1% and mix was up 4%. Foreign exchange was neutral to revenue.

Residential profit was a first quarter record $96 million, up 197%. Segment margin expanded 850 basis points to 15.9%. Segment profit was primarily impacted by higher volume, favorable price and mix, higher factory productivity, sourcing and engineering-led cost reductions, distribution and freight savings and favorable foreign exchange. Partial offsets included higher commodity, warranty and other product costs and higher SG&A.

Now turning to our Commercial Heating & Cooling business. In the first quarter, Commercial revenue was a first quarter record $199 million, up 12%. Volume was up 15%. Price was flat and mix was down 4%. Foreign exchange had a positive 1% impact to revenue growth. Commercial segment profit was a first quarter record $27 million, up 47%. Segment margin was a first quarter record 13.8%, which was up 330 basis points. Segment profit was primarily impacted by higher volume, lower material costs and lower SG&A. Partial offsets included unfavorable mix.

In Refrigeration, revenue was $125 million, up 21%. Volume was up 15%. Price was up 1% and mix was up 1%. Foreign exchange had a positive 4% impact to revenue growth. Refrigeration segment profit was $8 million in the first quarter compared to $1 million in the prior year quarter. Segment margin was 6.3%, up 560 basis points. Segment profit was primarily impacted by higher volume, favorable price and mix, lower material costs and higher factory productivity. Higher SG&A was a partial offset.

Regarding special items in the first quarter, the company had net after-tax charges of $2.7 million that included a $2 million net charge for other tax items, a $1.9 million net charge in total for various other items and a $1.2 million benefit for excess tax benefits from share-based compensation. Corporate expenses were $16 million in the first quarter compared to $14 million in the prior year quarter. Overall, SG&A was $145 million compared to $131 million in the prior year quarter. SG&A was down as a percent of revenue to 15.6% from 18.1% in the prior quarter.

In the first quarter, the company used $18 million in cash from operations compared to a usage of $99 million in the prior year quarter. Capital expenditures were approximately 25 -- $24 million in the first quarter and in the prior year quarter. Free cash flow was a negative $42 million in the first quarter compared to a negative $123 million in the prior quarter.

The company paid approximately $30 million in dividends in the quarter and repurchased $200 million of stock. Total debt was $1.17 billion at the end of the first quarter and we ended the quarter with a debt-to-EBITDA ratio of 1.8. Cash, cash equivalents and short-term investments were $40 million at the end of the first quarter.

Now before I turn it over to Q&A, I'll review current market assumptions and our updated guidance points for 2021. We now expect the industry to see high single-digit shipment growth in residential, commercial unitary and refrigeration markets in North America for the full year, up from our prior assumption of mid-single-digit growth in these end markets.

For the company, we are raising guidance for 2021 revenue growth from a 48% range to a new range of 7% to 11%, and we still expect foreign exchange to be neutral to revenue for the full year. We are raising guidance for 2021 GAAP EPS from continuing operations from a range of $10.55 to $11.15 to a new range of $11.33 to $11.93, and we are raising our 2021 adjusted EPS from continuing operations from $10.55 to $11.15 to a new range of $11.40 to $12.

Now let me run through the key points in our guidance assumptions and the puts and takes for 2021. First, for the items that are changing. We have announced a second round of price increases and now expect a benefit of $90 million in price for the year, up from our prior guidance of $50 million. We now expect residential mix of $10 million, up from our prior guidance for neutral mix.

We expect a benefit of $15 million from sourcing and engineering-led cost reduction actions, down from our prior guidance of $25 million. And this change reflects inflationary pressures from suppliers. For commodities, we now expect a $55 million headwind, up from our prior guidance of $30 million. Corporate expenses are now expected to be approximately $95 million, up from prior guidance of $90 million primarily due to higher incentive compensation.

And now for the guidance items that remain the same. We still expect a $20 million benefit from factory productivity. With 30 new Lennox Stores planned for this year, we will be at a more normal run rate with distribution investments compared to last year. Freight is still expected to be a $5 million headwind and tariffs are also expected to be a $5 million headwind.

We are planning for SG&A to be up approximately 7% for the year or a headwind of about $45 million. Now within SG&A, we are making investments in R&D and IT for continued innovation and leadership in products, controls, e-commerce and factory automation and productivity.

A few other guidance points. We still expect neutral foreign exchange. We still expect interest and pension expense to be approximately $35 million. We continue to expect an effective tax rate of approximately 21% on an adjusted basis for the full year.

We are still planning capital expenditures to be approximately $135 million this year, about $30 million of which is for the third plant at our campus in Mexico. We expect construction to be completed at the end of 2021 and have the plant fully operational by mid-2022, and we expect nearly $10 million in annual savings from the third plant.

Free cash flow is now targeted to be approximately $375 million for the full year, up from prior guidance of approximately $325 million on the strong earnings performance in the first quarter and our current outlook. And finally, we still expect the weighted average diluted share count for the full year to be between 37 million to 38 million shares, which incorporates our plans to repurchase $400 million of stock this year.

And with that, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Jeff Hammond with KeyBanc Capital Markets.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Just on mix, it seems like kind of tale of 2 cities here with Res mix really good and Commercial negative. Just kind of explain what was going on there and how you see that persisting going forward. I know you raised the mix guidance.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

For Residential, it's just positive benefit from the premium product. We're seeing traction on the new furnace line that we launched, which is our premium product, now part of the Ultimate Comfort, and we're coming out with 26-year residential units. So we feel good about the mix, and we saw that in the quarter. I wouldn't read too much in the Commercial. That just has to do with the lumpiness of customers in the quarter. So we feel good about mix full year for Commercial.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay. And then it looks like the incrementals were a little bit better than kind of your run rate. Just maybe talk about what went right in the quarter and how you're thinking about -- as you look at the moving pieces of price/cost, how you think about incrementals into the selling season.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean the things we did well was we managed the factories in the face of lots of pressures on the supply chain and on labor because of COVID, managed the factories well. We executed on MCR. But I mean, there's some timing involved here, obviously, Jeff, as you know, and that's why you asked the question.

We're getting the benefit of the price increase and we're getting benefit of laps -- lapping the SG&A cuts that we did in April of last year, but we don't have the full inflationary pressures yet of commodities and components in the numbers yet. So the decrementals -- excuse me, the incrementals will soften as we go through the year but it'll -- they'll still be overall, for a full year basis, nice, but they won't be as strong as they are in first quarter balance of the year.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

And where do you think price/cost is the biggest challenge? Like timing-wise, does that kick in, in 2Q or...

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

It will be second half of the year, third, fourth quarter.

Operator

And our next question is from the line of Tommy Moll with Stephens.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

Todd, I wanted to start on the resi market. Specifically, on your comment back on offense, good to hear. So I wanted to ask what levers you've pulled in the business behind that strategy.

You mentioned a couple of points distribution among them. But what specific changes to the business or the strategy would you call out? And then as you look to the full year, just bridging from Lennox to the industry, it sounds like the outlook for units now went from mid- to high singles. Should we think about Lennox as in line there, maybe outperforming or too early to tell for the full year?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Well, we're certainly expecting to outperform the market. So I'll answer that question first. So we raised the market from mid to high for resi and for the other end markets. And our goal is always to gain share, and we certainly have been gaining share, and we expect to do that for the full year.

Now the point about being back on the offense is for -- it seems like forever. It's certainly been -- since mid-2018, we had a tornado, then we had the pandemic. And so we've sort of been stalled on driving new business. And we talked about coming out of the tornado in 2019, right before the pandemic hit, that we had won back to dealers. We were sort of gaining their business, and that's a multiyear effect. I mean you start to get the flywheel going on new business development. It really helps.

We had really -- we've had strong momentum in our Allied business where theirs is not signing up dealers. It's signing up distributors. And then it just continues to be the flywheel effect of investments we continue to make in digital, on our e-commerce initiatives and our ability to support our dealer contractors with our control systems.

And then it continues to be investments in product. I mean our residential dealers are excited by our new Ultimate Home Comfort System. They're excited by our new heat pump products. And we have a full product lineup, and we're making significant investments to even make it better and we're seeing the benefits of that.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

That's all helpful. One quick follow-up on the stores. It sounds like 30% is still the number for this year. Rough timing, you could give us on when think you'll execute through that plan? And just given the strength of the market at least through 1 quarter, any potential that number might go higher?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I don't know if the number will go higher just in terms of the lead time to find the real estate to put it in place. And the majority of the stores are second half of the year. We're -- we put a handful in first quarter. We'll put some in second quarter, but it's really third and fourth quarter, especially once we get to the summer selling season that we really start to stack up the stores.

Operator

Our next question is from the line of Stephen Volkmann with Jefferies.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

Todd, can I just ask you to give us a little more on the sort of the shift a little bit toward the first half from the second half to 55% and the first half now used to be 50%. Is that all kind of Allied or distributor channel? Is there anything in Commercial that might be moving that at all?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

No, it's not Commercial. I mean a large part of it's the Allied reshuffling, and that's sort of best expectations.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then you talked about the K-12 opportunity. It seems like that's taking off. What are you actually seeing those guys doing? Are they upsizing systems? Are they putting in just more IAQ? Or what exactly is driving that growth?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

It's replacement. So it's -- I would -- I think about it as replacement rather than new systems. But yes, they have older systems. They're now comfortable that they're going to have financing and available capital to upgrade it, so they're doing that.

They're talking a lot about indoor air quality because that really doesn't -- isn't what moves the needle. What moves the needle is replacing the entire system, and then that has better efficiency, better ventilation, which leads to better indoor air quality.

Operator

Next, we'll go to Julian Mitchell with Barclays.

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

Maybe just wanted to circle back on the earnings sort of seasonality. So I think your guidance implies at the high end around $5.40 for the second half in EPS. Last year's second half was around $1 higher.

So just wondered if you could help us understand year-on-year how that dollar decline breaks out. How much is just kind of resi volume versus a bigger price cost headwind firm-wide? Any other -- there's a day sales impact that you mentioned. Any other factors that I didn't capture there?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean if I had to put them in order, I think it would be inflationary pressure on commodities. It would be the days impact, and then it would be -- I understand there's lots of questions about, and rightfully so, about what we're doing on full year guidance.

As you know, Julian, I've been doing this for 14 years. I don't think I've ever raised guidance after the first quarter. And so we raised guidance by $0.85 for the full year after first quarter. I said I never ever do that. We did it.

Let's get through second quarter, and then we'll see -- we'll have a better, clearer view of what we should do for the full year guidance. Obviously, our guidance is our guidance right now. But let's get through second quarter, and I think we'll have a better -- clearer view of the second half of the year.

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

Fair enough. And maybe just to switch to Commercial a second. You mentioned the replacement activity in the education vertical just now, but it was interesting to see the high single-digit revenue growth in new construction and commercial in Q1. I think that's surprising for people, given all the macro data on the U.S. non-resi market starts and so forth. So maybe help us understand what drove that new construction growth in the quarter and how you see that new construction growth in commercial over the balance of the year.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Again, not to get too hung up on the math of things, I mean you make the adjustment for days. It's low single digits. It's a good number. It's not quite as impressive as high single digits. And then it was multiple verticals. I mean it certainly was in K-12. It was some of our retail customers. But maybe the largest driver was the distribution customers, people like Amazon building new distribution.

Operator

Next, we'll go to the line of Jeff Sprague with Vertical Research.

Jeffrey Todd Sprague - *Vertical Research Partners, LLC - Founder & Managing Partner*

Todd, I missed a little bit of the open, but did you also comment on kind of the margin impact of kind of the revenue pull-forward and if there's any kind of distortive effects on the margins in resi in particular.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I did. The short answer, there really isn't -- the revenue would have dropped through on the normal margin line. So when I think about the margin expansion in Residential, I would hang my hat on the pull-forward. I, quite frankly, would hang my hat on factory productivity, the SG&A cuts that we took at the end of last year, the ability to get price and the fact that commodities and inflationary pressures haven't worked their way into the numbers yet.

Jeffrey Todd Sprague - *Vertical Research Partners, LLC - Founder & Managing Partner*

And just thinking about the price given the inflationary pressure, it sounds like there's talk of kind of round 2 actions this year and some of those are out in the market, I think, already. But what do you see the kind of the likelihood of kind of a second bite at the apple on price? And any kind of pushback in the channel on that?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean I think the second bite has already taken place, Jeff, right? So we announced the price increase -- a second price increase effective June 1. Trane's announced a second price increase. Daiken's announced a second price increase. Rheem's announced a second price increase, Goodman's announced a second price increase. Carrier businesses have announced a second price increase. So we've all announced second price increases.

And we feel -- as you know, we get price to offset commodities as recently as in 2019, 2018, we got 2% on price, and we're signing up for a little bit more this year, but inflationary pressures are greater this year. So we feel pretty good about the price increases.

Operator

And our next question is from the line of Nicole DeBlase with Deutsche Bank.

Nicole Sheree DeBlase - *Deutsche Bank AG, Research Division - Director & Lead Analyst*

So Todd, you kind of alluded to some challenges on the supply chain side. Could you just provide a little bit more (inaudible) and what the bottlenecks are and I guess, the level of concern as we (inaudible)

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I mean I think the highest level message I would give is you can see from our performance in Q1, we're delivering a lot of product, and we're set up to deliver a lot of product in second quarter. We think we're as good or better shaped than anyone else in the industry is what we hear from our customers.

The areas that we're wrestling with, and I think everyone in our industry, if not corporate America is wrestling with, is integrated circuits, both on our own control systems but -- integrated circuits that go and components that we buy from others. Steel and resin and sort of other raw commodities are under some pressure to make sure we get them.

And then since the pandemic started over a year ago, there's sort of a hopscotch around the globe of wherever the hotspot is, then you have pressure on a supply chain that comes from there. And right now, we think that's largely behind us because we don't source much from India, but that sort of has been the issue that we've wrestled with when Mexico was not going well. We had issues in one of -- the U.S. was having some problems. We're having some issues.

And then I think the final piece, and we've talked about this over the years, it went away last year, it's now back, it's just shortage of direct labor, that -- in our factories -- in our suppliers' factories, making sure we have enough workers to build. This high demand is something we continue to work through, and unemployment has snapped back or employment has snapped back nicely. And I'm all for the President's policies on the Democrat. But I would observe, when you pay people to stay at home, they're less likely to come to work, and we continue to wrestle with that.

Nicole Sheree DeBlase - *Deutsche Bank AG, Research Division - Director & Lead Analyst*

Got it. That's really helpful. And I guess just one follow-up. (inaudible) a little bit about channel inventory and how you're positioned as we move into the summer selling season, maybe how that compares to last year.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I mean we think we're in a really good position, as you know, but I'll say it for others on the phone call, we -- 80% of our business is Lennox Residential. And there, that's when the homeowner decides to buy a product, the dealer replenishes the stock. And so we sort of have direct sell-through almost to the end customer.

So dealers aren't carrying inventory. I saw one sell-side analyst note that -- suggested maybe because of price increases, homeowners were deciding to preemptively replace their systems. Ain't no way that's happening. People aren't going to do that because of a 2% price increase.

For the portion of the market that we sell to independent distribution, we talked about the $25 million pull-forward. And we got that number, broadly speaking, by talking to our distributors, understanding their inventory levels. And so one way of thinking about it is our inventory levels are $25 million higher than last year at this point in time as a pull-forward inventory.

Operator

And next, we'll go to the line of Joe Ritchie with Goldman Sachs.

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

So Todd, maybe my first question, just starting on just the growth outlook for the rest of the year. If I think about the second quarter, if we normalize resi for Q1, you still come up against your easiest comp in 2Q, and it sounds like the backlog trends are really good. So I mean is there any reason why like the second quarter growth number can't be as good as you put up in Q1, again, kind of normalizing for resi days and the inventory pull-forward?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

We're set up to have a strong second quarter. So I mean I hate the hypotheticals or any reason not. Yes, I mean, I come out with the reasons not, but we're set up for a strong second quarter, and we obviously just need to execute.

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

Got it. And then just like talking through the comments you made earlier, I think to Julian's question around the guidance. It's just too early for you guys to take up the back half guide at this point. But as you see today, things seem really good. And the 7% to 11% looks like a beatable number at this point, looks conservative.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Let's try nuances. I mean the guide is the guide, number one. So the guide is the guide. But as I said earlier, we never raised -- after first quarter, we raised $0.85. I've learned anything's -- since the tornado and the pandemic, is things can change quickly.

If we stay on the trend line we are in North America because we're a North America business -- that we've looked the pandemic and we're back to normal economy, with all the government investments and the economy, have a nice run for a couple of years in all 3 of our businesses, and we're prepared for that. So we feel good about 2021. Quite frankly, I feel good about 2022 and -- but the guide is the guide is, I guess, the short answer.

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

Yes. I don't mean to back you in, but that makes a lot of sense. I guess one last one and just thinking through the -- you mentioned the pull-forward on the Allied side of the business this quarter. Do you think that there's any dynamics with the pricing that's going into effect in June, where you continue to see kind of stronger demand ahead of the June pricing increases?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I think there may be some effect. There may be some effect. But I think it's distributors right now want to make sure they have enough to get through the summer selling season. And they're willing -- they're going to pay what they need to do to make that happen. So I think there'll be some pull-forward.

But again, at sort of the demand levels we're at, we may not have all the product when they want the product to load the barns early. They may just have the product when they need the product. And so we'll continue to work through what will happen. There may be some pull forward. But again, that's 20% of our business. So I don't think it will be a material impact to us.

Operator

(Operator Instructions) And next, we'll go to John Walsh with Crédit Suisse.

John Fred Walsh - *Crédit Suisse AG, Research Division - Director*

Was just -- you mentioned heat pumps earlier. Just wanted to get kind of your temperature on where your capacity is for this product and if you might be spending any CapEx to increase production of heat pumps in particular.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean we're -- we can always continue to manage the capacity versus demand and we make them on the same line. So when we talk about adding a third factory in Saltillo, that's adding overall capacity to heat pumps and every other product line that we do.

So heat pump continues to be a growing market for us. We came out with a high -- excuse me, cold weather heat pump that allows us to play north of the Mason-Dixon line, be very competitive in northern climates, and we think that's a growing market. And I would have said 5 years ago, we lagged the competitors in our heat pump offering. I'd say now we're on par with the big boys, Carrier, Trane and further ahead of our other competitors. And so we like that market, and we're well positioned to compete there.

John Fred Walsh - *Crédit Suisse AG, Research Division - Director*

Great. And then just maybe a second question here on capital allocation, taking up the free cash flow, taking up your share repo. Should we think that the majority of the excess cash goes to buy back stock? Or might there be anything in terms of M&A, bolt-on or otherwise, we should be thinking about?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes, I'm not breaking any news. I mean I would think about it, and I'll say for others, I know you know this is -- we'll -- we don't want to delever. So we'll do something with the cash, and we'll have dividends grow with earnings. And we will invest in the business. And we'll do type of M&As we've spoken about, but we've done one deal of any size that's up in here, and then the balance will get back -- share buyback.

Operator

Our next question is from the line of Nigel Coe with Wolfe Research.

Nigel Edward Coe - *Wolfe Research, LLC - MD & Senior Research Analyst*

So I think I've got the numbers. The underlying numbers for Allied is plus 35% ex the days and ex the $25 million. Just to be clear, the $25 million, is that the full extent of the inventory restock dynamic? Or is there some inventory restock within the plus 35% as well?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

The $25 million is our best guess of the extent of the inventory. The $35 million is ex any prebuy.

Nigel Edward Coe - *Wolfe Research, LLC - MD & Senior Research Analyst*

Okay. So the plus 35% is kind of an apples-for-apples. This is basically dealer market share gain, not inventory stock dynamics going on there.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Well, it is. The 35% versus, say, the 15% or -- that I said was sell-through, the difference is we're winning new distributors. And when you win new distributors and you have a big sort of wash-up volume that flows through your business. So it's not necessarily winning at the dealer level, it's winning at the distributor level. We're converting dealers from our competitors. And when we convert them, we get a slug of new volume.

Nigel Edward Coe - *Wolfe Research, LLC - MD & Senior Research Analyst*

Okay. That's clear. And then your inventory level, I think $502 million at the end of the quarter, definitely a lot lower than what you normally have. And you answered Nicole's question very well in terms of supply chain. But I'm just curious, all things being equal, is that low-level inventory?

Was that caused by just a surge in demand and then, therefore, depletion of -- and equipment? Or was there some surprising restraints that meant you weren't able to replenish your inventory? Just curious in terms of what caused that level of industry to be so low and your confidence in sort of rebuilding that -- those levels.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

It's primarily the demand. I mean, look, I knew we were not first quarter, I don't think resi is going to be up 37% 6 months ago. And so I think that's a primary issue. And then once you see the white of their eyes, if you will, and you see the demand rising, then you try and ramp up production to catch up with it.

And then when you start to ramp up production and you run into some of the issues that I talked about, which is if you're going to try and raise production 50%, 60% to get ahead of everything, then you run into integrated circuits and you're run into labor, then you run into other things.

So look, I've said we're doing as well or better than anyone in the industry. But everyone, when you have this kind of demand levels, you're sort of not grinding gears, but you're running hot and we're running hot.

Operator

Next question is from the line of Ryan Merkel with William Blair.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

So first off, you mentioned K-12 and the good outlook there. If everything goes well with the stimulus money, what kind of growth rates could you see from K-12 the next couple of years?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I understand the question. We -- I'll be honest with you, we haven't really modeled it in any great detail. I've seen some of the sell-side notes, including yours, sort of take cracks at it.

We think it could be a material opportunity for us. And I know people are modeling it externally. I just want to give a number that's about 10% of our segment revenue. And so whatever growth rate others are modeling, looking at the stimulus number, 10% of our business will be -- will grow that same speed.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

Okay. That's helpful. And then just talk about the resi new construction outlook, any signs of moderation or just full steam ahead there?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I think it's full steam ahead. I think the only moderation is trades, the employment issues I spoke about and -- impacts builders also and then inflationary pressures. But I don't think inflationary pressures will slow things down right now. I think people need homes. And there's not much inventory on used or existing homes right now, and so builders are trying to build. So we feel pretty good about new construction for the balance of the year.

Operator

And next, we go to the line of Josh Pokrzywinski with Morgan Stanley.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Todd, just on the mix front, I guess that number stood out to me on Residential that it was plus 4% even with all that strong growth in Allied. I would imagine you have some sort of long-term model of like how much the industry should mix up or homeowners kind of buy up on features or SEER in a given year. Did we just jump like several years forward? Like what's going on there? And how much ahead of where you would have been in recent years are we today on that mix dynamic?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I wouldn't read too much long-term macro into it. I'd tell you what I might read into it is our highest margin business is furnace. We had a warm winter last year. We had a cold winter this year. Guess what? Furnace sales grew probably fast. I don't have the exact numbers in front of me, but furnace sales grew strongly in the quarter, and that helped the mix of business.

So I think that's the biggest driver of that combined with -- we've launched some new product that's helped us. But saying that we're going to be up full year $10 million of mix, that's sort of a normal guide. I think the bigger question was why were we guiding flat in mix for a full year in resi.

And the reason we were guiding flat was because we had an uncertainty of what was happening with the pandemic and whether people are just going to buy entry-level product because they were concerned economically. That's now behind us, and we feel confident for the full year.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. And then I guess just kind of thinking about entering the selling season here. First quarter, I don't know if it's really indicative of much of all, but we're kind of through April at this point.

At what point does the industry, whether it's dealers or your independent distributors, even though there's not -- it's not the bulk of the business. At what point do they just say, "Okay, now we're ready"? Are they still positioning inventory, thinking about what price levels they want to be loaded at right now? Or are they sort of saying we're ready to go for the season?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean -- and again, you know this, Josh, I'll say for others I mean 80% of our business, we're selling to dealers. They don't think that way. I mean they're not stocking up inventory. They're not getting ready. They see demand, they sell demand, they buy some more. And some of them may have a week to really -- well-capitalized dealers may have a couple of weeks, but that's not how that works.

For the independent distribution, the order rates remain strong. They still want inventory, and they're still selling product right now and demand is still high at the deal -- excuse me, at the homeowner level. And so they're coming out of a very good first quarter, and they want more inventory and we're selling it to them.

Joshua Charles Pokrzywinski - *Morgan Stanley, Research Division - Equity Analyst*

Got it. That's helpful. I apologize. I'm just going to try to squeeze in one more. The Allied color that you said where a lot of that growth is new distributors, any sense on kind of same-store growth within Allied versus the contribution from new customers there?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I don't have that math in front of me because I tend not to think about same stores. I know our internal people do within those businesses. I don't have that number in front of me. We're also focused on existing distributors getting them to grow. My guess would be the existing distributors who were selling to dealers, they were buying at 15%, 20% also, if that's where the end markets were growing.

Operator

Our next question is from the line of Gautam Khanna with Cowen.

Gautam J. Khanna - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

I have 2 questions. First, on the Commercial side, I was wondering, Todd, if you could maybe give us some perspective on how quickly the deferred replacement from last year -- with the commercial market down nearly 20%, how quickly that catches up and how much of it catches up?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I mean our experience here after financial crisis, and in my experience, I was at Carrier after 9/11, is [marble] rolls off the table and planned replacement goes down dramatically. And sort of at the trough last year, we were down 50%, 60% year-over-year on planned replacement, and then it comes back strongly. And my experience is it's 18 to 24 months that it all comes back.

And so over the next 18 to 24 months, assuming the environment remains benign, as I suggested it might, I would expect all the demand that we missed during that time period, the pent-up demand, if you will, to come back plus the normal planned replacement that was scheduled during the same time period. And so that's why we're pretty optimistic on the commercial end markets for the next 18 to 24 months.

Gautam J. Khanna - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

Got it. In fact, that math would suggest the guidance might be a little low. I mean I'm recognizing nobody knows. Okay.

And then just secondly, on resi, I was curious, did any competitors have any issues, production issues, what -- COVID outbreaks, whatever, that may have benefited Lennox' results that might be nonrecurring? We saw the Tyler roof collapse with Trane. Goodman had issues last year. Just wondering if anything stood out to you one way or the other.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I mean our competitors -- I mean, better stated, I -- Steve always gets worried when I bash competitors too much. So I actually have in my notes to say you can ask them. But I won't listen to Steve. I'll give a little bit more color. Look, our competitors had issues. I mean when we talk to our customers, we hear about JCI having issues, We hear about Goodman still having issues. And again, I don't think about that as a one-off thing.

I think it's -- when they aren't able to provide support, we step in and we win it either by signing up new distributors who convert over to us in our Allied business or we win with our own dealers in the marketplace. So the competitors' dealers can't sell product. Our dealers can, we win the share, we win. And that's not a onetime thing. We sort of get it and we keep it and we keep moving.

Operator

We have a question from the line of Chris Dankert with Longbow Research.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

Todd, just thinking about R&D priorities, I guess, where is the investment focus at the moment? I mean is it still controls and user experience? Is it efficiency? Is it footprint and noise reduction? I guess when you think about where you want to see the team is prioritizing investment, kind of any rank order there, any thoughts on the targeting of that spend?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. I think you said some of them. I think number one is digitization of the business. I mean we continue to make significant investments, both in product, on controls, but also significant investments in the e-commerce, in the back end of the business and so significant investments. And we continue to make those investments, and that's driving the productivity in part that you see in our numbers.

We continue to make investments in what I would call environmental sustainable product. And so having industry-leading energy efficiency, as we go through a refrigerant change that we're going to see over the next few years to lead the industry there and do it in the most effective and cost-effective manner to lower our greenhouse gas emissions is important. I think those are probably the 2 big areas, right? It's about digitization of the business and environmental sustainability of our product line. Those are the areas.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

Got it. And again, second question, forgive me if you commented on this in the past, but thinking about the Mexico facility, will there be kind of a flexible construction to it in terms of -- will you have the ability to build everything from entry level on up to the Dave Series there? Or is it a little bit more focused?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

We don't quite build everything there. There are certain products that we only build in Marshalltown and some products that we only build in Orangeburg or in our Mississippi -- Grenada, Mississippi factory. But we continue to build our capabilities in Mexico, started as cooling, then went to furnace, then it was just entry level. Now it continues to be almost the full product line. So we continue to develop our capabilities in our Mexico facility.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

Got it. It makes sense. Yes, just thinking about how having that ability to deflect the need was really brought to the floor now I mean I'm just a couple of years ago.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Yes. And quite frankly, brought to the floor right now. I mean I think one of the ways that we're able to battle against some of these issues around labor and/or absenteeism because COVID is we have multiple factories that can -- that have significant overlap on what they produce, and we're able to sort of meet demands.

Operator

And our next question is from Steve Tusa with JPMorgan.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

I was just checking all the inventory in my garage. I have a bunch of different HVAC systems in my garage sitting there. I'm going to sell them for a higher price.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

And my guess is they're probably Trane and Carrier.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

Definitely not. JCI, JCI. So you mentioned that the Carrier businesses have gone out with price increases. Have you seen that across all their brands?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

What I have in front of me is we've seen it in the ICP brands.

Steve L. Harrison - *Lennox International Inc. - VP of IR*

Carrier announced also, Todd.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Carrier announced also? Yes. So Steve's helping me. He's in a different room for security reasons. But yes, so we've seen it in the Carrier brand also, so we've seen it on all our major competitors.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

Okay. Got you. And then how do you kind of expect the kind of -- I know this is not a typical question. But obviously, with what happened last year, how do you kind of expect the monthlies to play out in the second quarter?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I think as you'd expect, right? So May was the nadir last year for the businesses. And so April will be up, May will be up and I think June will be up. And again, it depends on the business, quite frankly. Residential didn't go as deep and came back relatively quickly. The Commercial and Refrigeration business was deep and stayed deep and didn't really start to come back until fourth quarter.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

Right. And I guess for sales in the second quarter, you mentioned the 55% EPS seasonality. Can you just maybe update us on what you expect kind of from a sales seasonality perspective on that front, whether it's resi or the total company?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

No, I mean -- I quite frankly don't have it in front of me. I mean I'm not going to give the revenue guide. We just want to give the EPS guide.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

Okay. And then just one last one. How much -- I guess, 2.5% of price for the total company. How much in resi should we assume a tick above that in resi, something in kind of the 3.5% range?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

No. I think if I was modeling, because we don't give segment price guide, I would assume 2.5% across the board. Resi is 2/3 of our business. So we give a guide and we don't delineate it then. I just assume resi are gotten.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

I don't think you guys have -- that's kind of like a record price number year-over-year, at least the data I have looking back 10 years, right? I mean, that's a pretty decent sized number looking back historically, right?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I mean we did $70 million -- $71 million in 2019. We did $72 million in 2018. Steve didn't have the number that went back. I think in 2011, 2012 as a percentage because we were a lot smaller back then, I think we did close to 2.5%. But yes, I mean, we've done 2% as recent -- twice, 2 years in a row.

I would tell you the inflationary pressure people see and the headlines that they have on it, and all our competitors are feeling is unlike anything I've seen because it's just not in commodities. It's sort of across the board and better stated, it's just not raw copper, steel and aluminum. It's across the board because everyone sort of has a, what I would call, a COVID surcharge of inefficiencies that are trying to pass on. So I feel very confident we'll pass it on.

And again, the homeowner, it's opaque to them. They get a new unit once every 15 years, and half the price is labor and half is equipment. And so whether it's 2 or 2.5 doesn't matter. The question is, are competitors doing the same thing, and it looks like they are.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

And you're sure that there's no -- you haven't heard any anecdotes from -- about contractors not necessarily saying, "Hey, your price is going to go up 2% if you don't replace it today." But that they're saying last year, there were real availability concerns. The industry is extremely tight. There's a new regulation coming in a couple of years from now. I mean you don't think any of those conversations are going on at the kitchen table?

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

I think those conversations always take place at the kitchen table. So the way it works is there's a catastrophic failure. Compressor breaks, $3,000 to replace the compressor. The homeowner says I'm not going to spend $6,000 for a new system. I'll just replace the compressor. You don't want to do that, and here's the 7 reasons why you don't want to do that.

Those are always conversations that take place. My point is, there isn't a bad -- there isn't a thermostat software issue that you go to the home and fix that and the system is working fine. You say, "You should get a new system because there's a 2.5% price increase." That ain't never happened.

What happens is if there's a catastrophic failure, there's a conversation. And I don't -- there's price increases every year. There's refrigerant changes. There's a minimum efficiency changes. All of that takes place year after year after year. And whether it's a 2% price increase or a 2.5% price increase doesn't change that conversation. So in '18 and '19, we had a 2% price increase. Now we have 2.5%. That doesn't tip people over to replacement units in a wholesale way than they did before. No, so the answer is no.

Charles Stephen Tusa - *JPMorgan Chase & Co, Research Division - MD*

Yes. I don't think it's a price. I mean I would say availability is a bit more of a buzzword and a hot button issue these days than it's been in the past, but fair point.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Our dealers have product. So they have it.

Operator

And with no further questions, Mr. Bluedorn, I'll turn it back to you for any closing comments.

Todd M. Bluedorn - *Lennox International Inc. - Chairman & CEO*

Thanks. To wrap up, 2021 is off to a strong start and momentum continues in the second quarter. The company is executing well to capitalize on market growth and share gain opportunities and we look forward to a year of strong growth and profitability. Thanks again, everyone, for joining us today.

Operator

Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation. You may now disconnect.