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LII.N - Q4 2023 Lennox International Inc Earnings Call

EVENT DATE/TIME: JANUARY 31, 2024 / 2:30PM GMT

OVERVIEW:

Company Summary

CORPORATE PARTICIPANTS

Alok Maskara *Lennox International Inc. - President, CEO & Director*

Chelsey Pulcheon

Joseph William Reitmeier

Michael Quenzer *Lennox International Inc. - Executive VP & CFO*

CONFERENCE CALL PARTICIPANTS

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

Damian Karas *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate of Electric Equipment & Multi-Industry*

Deane Michael Dray *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

Gautam J. Khanna *TD Cowen, Research Division - MD & Senior Analyst*

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

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

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

Joseph John O'Dea *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

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

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

Noah Duke Kaye *Oppenheimer & Co. Inc., Research Division - Executive Director & Senior Analyst*

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

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

Timothy Ronald Wojs *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Welcome to the Lennox Fourth Quarter and Full Year 2023 Earnings Conference Call.

(Operator Instructions)

As a reminder, this call is being recorded. I would now like to turn the conference over to Chelsey Pulcheon from the Lennox Investor Relations team. Chelsey, please go ahead.

Chelsey Pulcheon

Thank you, Shelby. Good morning, everyone. Thank you for joining us this morning as we share yet another quarter of outstanding performance. With me today is CEO, Alok Maskara, our new CFO, Michael Quenzer; and our outgoing CFO, Joe Reitmeier. Alok, Michael and Joe will share their prepared remarks before we move to the Q&A session.

Turning to Slide 2, a reminder that during today's call, we will be making certain forward-looking statements, which are subject to numerous risks and uncertainties as outlined on this page. We may also refer to certain non-GAAP financial measures that management considers relevant indicators of underlying business performance. Please refer to our SEC filings available on our Investor Relations website for additional details, including a reconciliation of all GAAP to non-GAAP measures.

The earnings release, today's presentation and the webcast archive link for today's call are available on our Investor Relations website at investor.lennox.com.

Now please turn to Slide 3 as I turn the call over to our CEO, Alok Maskara.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Thank you, Chelsey. Good morning, and welcome. I'm proud to represent our 13,000 employees as we delivered another full year of record results. We are pleased with our 2023 growth, margin expansion and more important cash generation. Our strong results were noteworthy, given the unprecedented destocking faced by residential HVAC manufacturers last year. I'm deeply grateful for our employees and our customers whose hard work, loyalty and dedication drove the results that we will be discussing today. I would like to begin by highlighting 4 key messages on Slide 3.

First, we delivered $3.63 in adjusted EPS for Q4, an increase of 41% year-over-year. Adjusted EPS for the full year was $17.96, a 27% increase year-over-year. Our 2023 full year results were also notable for 6% core revenue growth, 300 basis point expansion in adjusted segment margin. In addition, our operating cash flow more than doubled compared to prior year.

Second, we continue to invest wisely in manufacturing capacity, distribution optimization, technology transitions and growth initiatives while maintaining our industry-leading ROIC of 44%. Third, while end market uncertainties linger, our transformation momentum sets a strong foundation and gives us confidence in our 2024 EPS guidance range of $18.50 to $20.

Fourth, given the robust progress on the self-help transformation plan, we are pleased to increase our previously announced 2026 financial goals. Now please turn to Slide 4 for more details at 2023 self-help accomplishments.

In 2023, Lennox experienced significant success during the first phase of our self-help transformation plan. Our strategic initiatives allowed us to effectively navigate the destocking challenges, which demonstrated our resilience and exceptional execution. This phase laid a solid foundation for future growth and positioned us to capitalize on further growth opportunities.

We accelerated growth by strengthening our distribution muscle to better serve our existing customers, attract new customers and increase our share of wallet from HVAC dealers. We are investing in our sales and stores teams to create greater alignment, accountability and autonomy for improving the customer experience.

To ensure resiliency we implemented pricing excellence initiatives to recover margins from previously depressed levels as many long-term key account contracts which were signed before the recent inflationary period came up for renewal. We also achieved higher factory output, enhanced productivity and optimize product mix. Together, these measures contributed to the overall margin expansion and strengthened our margin resiliency. Finally, to ensure consistent execution, we implemented a balanced scorecard based operating system, which we refer to as Lennox Unified Management System. This system was instrumental in driving accountability and ensuring alignment with our strategic goals to accelerate revenue growth and expand margins. We also simplified our portfolio with the sale of the European businesses and improved our total life cycle value proposition with the recent AES acquisition.

On the next slide, I will share more about how we fine-tuned our internal engine to ensure success of the transformation plan and accelerate growth throughout the journey. Slide 5 shows the 5 components that fueled Lennox's success in 2023 and are building momentum that will continue to power Lennox's bright future. At the heart of our transformation is our unwavering commitment to our vision and mission.

These set the true north direction for everything we do, aligning our efforts towards a shared goal. Moving outward, the strategy to great will deliver accelerated growth, resilient margins, execution consistency, advanced technology portfolio and talent and culture that help us win every day. Next is the commitment to our customer charters, emphasizing our dedication to always being a partner of choice by delivering exceptional customer experience and quality solutions.

Another crucial element to our outstanding performance was the implementation of our Lennox Unified Management Systems. We are utilizing balanced scorecard to drive accountability, integrating standard processes and best practices and aligning operating cadence for efficiency. This represents our commitment to a unified approach that enables Lennox to shift into a higher gear and outperform competition.

Lastly, our core values and guiding behaviors serve as a foundation of our high-performance growth culture with a passion for improving the customer experience. Last year, we rolled out 9 guiding behaviors that improved the team's focus on critical behaviors such as positive engagement and sustainability. These 5 components not only helped us build momentum on our self-help transformation this year, but also act as a spring boom to continue our long-term journey of growth and expansion.

Before we move into the detailed financial section, allow me a few moments to express my gratitude to our outgoing CFO, Joe Reitmeier. I am thankful for Joe's years of service to Lennox, and I'm especially grateful that stayed with us to train me, the new CEO, and to oversee a smooth transition to our new CFO, Michael Quenzer. Now for the last time on an earnings call, let me hand the call over to Joe.

Joseph William Reitmeier

Thank you, Luke, and greetings to everyone joining us this morning as we announce Lennox's record-setting performance and outlook. I've had the pleasure and privilege of serving as Lennox's Chief Financial Officer during a period of transformation and record-setting achievements. Portfolio changes enable a more intense focus on our key North American end markets, the team introduced new and innovative solutions. We delivered on initiatives that drove significant increases in profitability and that coupled with efficient capital allocation resulted in industry-leading returns on invested capital.

We fortified the balance sheet and most significantly, we generated exponential increases in returns for our shareholders. Now before I hand it off to Michael, I'd like to reflect briefly on 2023. It was another year of exceptional performance while strengthening the foundation for the future by investing in our people, sustaining industry-leading innovation and enhancing our capabilities to better serve our customers. Now while I'm extremely proud of my time with such a great organization that has accomplished so much. I take even greater pride knowing that I'm leaving an extremely talented and seasoned team that is very well positioned both strategically and financially for long-term success.

I'd like to wrap up my comments with a sincere thank you to all Lennox employees, our valued customers, the investment community and other stakeholders for your partnerships over the years. I'll now hand it over to Michael, who will take you through the details of Lennox's financial performance and outlook. Michael, take it away.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Thank you, Joe. Good morning to everyone.

Please turn to Slide 6. As Alok mentioned earlier, 2023 has been a record year in the fourth quarter with no exception. Core revenue, which excludes our revenue operations was $1.1 billion, up 7% as price and mix drove the year-over-year improvement. The adjustment segment profit increased $44 million at $69 million of price and mix benefits were partially offset by inflation and investment in SG&A and distribution. Total adjusted segment margin was 15.9%, up 320 basis points versus prior year. For the fourth quarter, corporate expenses were $30 million, a decrease of $3 million. Our fourth quarter tax rate was 20% and diluted shares outstanding were 35.8 million compared to 35.6 million in the prior year quarter. The fourth quarter achieved record levels of revenue, segment profit and adjusted earnings per share, which grew by 41% to $3.63.

Let's shift our focus to Slide 7 and review the financial results of our Home Comfort Solutions segment formerly referred to as a residential segment. The left graph shows revenue grew 1% to a record $709 million in the fourth quarter. The segment benefited from favorable mix of higher efficiency products and effective pricing execution. This was partially offset by volume declines.

Although unit sales volumes for the segment declined by 5%, our direct-to-contractor sales volumes remained stable, signaling a resilient consumer demand landscape. Unit sales volumes through independent distribution channels declined more than 20% driven by continued industry destocking. Home Comfort Solutions profit decreased approximately 4% to $115 million, and segment margin also experienced a decline of 70 basis points to 16.2%.

The decrease was attributed to a $9 million decrease in sales volumes and $25 million impact from inflation and investments in distribution and selling.

Moving on to Slide 8. We will now review the performance of our Building Climate Solutions segment, formerly referred to as the commercial segment. The segment continues to consistently deliver outsize performance each quarter, resulting in another quarter of record revenue and profit. Revenue was $390 million in the quarter, up 19%. Combined price and mix were up 11% and volume was up 5%. Building Climate Solutions profit was $91 million or up 98% and segment margin expanded 930 basis points to 23.2%. These results were primarily driven by price and sales volume gains. The team's execution on several self-help initiatives aided in the recovery of previously depressed profit margins.

These initiatives include price corrections, enhanced factory productivity and strengthened supply chain resiliency. The AES acquisition also played a role in the growth during the quarter. The integration is progressing smoothly with existing Lennox customers showing interest in the AES full life cycle value proposition. Ultimately, the fourth quarter continued the year's momentum and resulted in a strong finish to 2023.

If you will now turn to Slide 9, I will recap the full year Lennox results. For full year 2023, core revenue, excluding European operations, was $4.7 billion, up 6%. Adjusted segment profit increased $180 million as $348 million of price and mix benefits were partially offset by Home Comfort Solutions sales volume declines as well as inflation and investment in SG&A and distribution. Total adjusted segment margin was 17.9%, up 300 basis points versus prior year. Despite facing volume challenges in the residential end markets, inflationary pressures and ongoing investments, the Home Comfort Solutions segment achieved revenue and profit growth through successful execution of strategic pricing initiatives and the seamless transition to the new minimum SEER standard.

The Building Climate Solutions segment also achieved impressive results in 2023. Healing supply chains and factory productivity played a key role in growing volumes in the second half of the year, and pricing execution helped the segment recover previously depressed profit margins from years of higher supply chain and production costs. Exceptional execution by both segments resulted in adjusted earnings per share growing to $17.96, setting a new record and representing a 27% increase compared to the prior year.

Moving on to cash flow and capital deployment on Slide 10. Operating cash flow for the quarter was $306 million compared to $132 million in the prior year quarter. Capital expenditures were $125 million for the quarter, an increase of $91 million compared to the prior year. Net debt to adjusted EBITDA was 1.3x, down from 2x in prior year. Our approach to capital deployment remains consistent. We will prioritize organic growth investments with strong returns, grow dividends with earnings and continue to explore M&A opportunities and to supplement with share repurchases when necessary.

Lennox's industry-leading ROIC of 44% reflects our dedication to delivering value to our stakeholders through strategic and targeted investments. We not only aim to maintain our high ROIC, but also aimed to make necessary investments to elevate our performance and competitiveness in the marketplace. We anticipate the successful completion of our upcoming commercial HVAC factory and production is slated to begin midyear. While overhead and ramp-up expenses posed known challenges in the first half of 2024, we anticipate the factory will realize productivity benefits in 2025. This facility plays a pivotal role in our sustained growth, enhancing our commercial production capacity by 25% by the end of 2024.

It will allow us to better address consumer demand and recapture market share in emergency replacement market.

Now let's transition to Slide 11. Here, I will provide an overview of our full year financial guidance for 2024. We anticipating another year of profitable growth, the chart on the left provides key growth drivers with revenue expected to increase by approximately 7%. Alok will provide additional comments on end markets later in the presentation, but sales volumes are expected to remain relatively flat with a slight upward trend from Building Climate Solutions growth and stable Home Comfort solutions end markets. The combination of price and mix is anticipated to contribute to a mid-single-digit growth in revenue, price increases will sustain margins amid continued cost inflation and a slight favorable mix is expected due to the 2023 minimum efficiency regulatory change.

In addition to the profit drivers from revenue, we have listed key costs and investment assumptions on the right side of the slide. Component cost inflation is expected to be up mid-single digits, including large increases in our cost to acquire R-410A refrigerant. We expect this to be partially offset by material cost reduction programs. We anticipate ramp-up costs of approximately $10 million for the new commercial HVAC factory along with additional costs associated with the refrigerant transition across our Home Comfort solutions manufacturing facilities.

We will continue to invest in information system advancements, distribution growth initiatives and projects to improve customer service. Additionally, we expect to support growth initiatives by making investments in both sales and marketing. While we continue to focus on managing SG&A expenses, we do expect moderate inflation area pressure in 2024. Our guidance for capital expenditures is approximately $175 million. This includes final spending for the new commercial HVAC factory and the 2025 low GWP refrigerant transition. Interest expense is expected to be approximately $50 million and tax rate is estimated to be between 20% and 21%.

Incorporating all of these guidance items, we expect earnings per share to be within the range of $18.50 per share and $20 per share. Finally, we expect free cash flow to be within the range of $500 million to $600 million.

With that, please turn to Slide 12, and I'll turn it back over to Alok for an overview of 2024 business conditions.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Thanks, Michael. As we look forward to the coming year, it is important to recognize that while our transformation momentum has yielded positive results, we are still facing challenges in the end market. Within our Home Comfort Solutions segment, the health of the consumer will remain a significant driver of demand and greatly influence the repair versus replace dynamic.

We are mindful of consumer sentiment, especially in an election year, and we'll continue to track macro data for early indicators. It is important to point out, we have not yet noticed any meaningful shift from replace to repair. EPA rulings have also introduced an element of uncertainty regarding industry inventory levels. Ahead of the R454B transition, we do not anticipate a large pre-buy due to inventory fatigue in the channel and the increased cost of carrying inventories.

However, we do expect distributors to normalize inventory levels this year as the channel returns to its usual ordering patterns. We also expect ongoing benefits of the strategic pricing initiatives and potential share opportunity as Lennox historically win share during regulatory transitions. Turning our attention to building Climate Solutions, we predict solid demand in 2024. With the data we have from our National Account Services business, we know that rooftop units are aged past historical averages and will need to be replaced soon. 2024 demand may be impacted if key accounts delay installs pending new R454B product availability. End markets may also face challenges related to softening commercial new construction and project delays. Ultimately, our outlook on 2024 remains cautiously optimistic, though we acknowledge the complexities of the market conditions in the coming years.

We trust that our proactive strategies focused on driving top line growth, expanding our margins and consistently executing on initiatives will continue to propel Lennox towards enhancing customer experience and shareholder value.

On the next slide, I will go into more depth on each of the strategies as it relates to 2024. On Slide 13, I want to take a moment to revisit our self-help transformation plan, which has been steering our current success. As a reminder, this plan is structured around 3 phases over the next several years.

Now let's dive into the specifics of our actions for 2024, where we will transition from the initial phase to the growth acceleration phase. This year is pivotal as it sets the stage for the next wave of growth through strategic investments and focused actions. First, we are investing in our sales force to expand customer touch points, enhancing the overall customer experience through digital innovations and anticipating improved output from our new commercial HVAC factory. Additionally, we aim to increase the attachment rate for parts and accessories, ensuring the holistic experience for our customers.

Second, we are committed to driving resilient margins. This involves maintaining pricing excellence, leveraging greater productivity from volume recovery, realizing material cost reduction and reaping the mix benefits of transitioning to the new R454B product. These actions collectively fortify our financial position and solidify our sustainable competitive advantage.

Lastly, we will leverage the Lennox Unified Management System to streamline our operations and set clear priorities. Our focused strategy, investment in heat pump growth and enhancement to our distribution network further exemplify our commitment to consistent management execution. 2024 is a year of purposeful actions that will propel us into the growth acceleration phase and lay the groundwork for our journey into the expansion phase. I am confident that with our collective dedication and strategic approach, we are not just following a plan, we are shaping our future success.

Now please turn to Slide 14 for an update on our long-term financial goals. It has been just over a year since we introduced our 2026 goals and are confident that our execution is ahead of schedule, even though market uncertainties persist. We are pleased that Building Climate Solutions has achieved record margins and that Home Comfort solutions demonstrated margin resiliency, even while facing significant volume headwinds.

With this year's achievements, we recognize the need to adjust our long-term goals to better reflect our current positions. For 2026 we are now targeting revenue of $5.4 billion to $6 billion, with total company target margin range of 19% to 21%. Our free cash flow conversion target is approximately 90% as we complete the necessary investments to support our growth.

We are increasing the long-term target for Home Comfort solutions to a range of 20% to 22% ROS and building Climate Solutions to a range of 22% to 24% ROS.

Now for a wrap up, please turn to Slide 15 for the reasons I continue to believe that Lennox is a great investment opportunity. Lennox operates in growth end markets, has resilient margins, demonstrates execution consistency and serves its customers through advanced technology and high-performance talent. The 5 reasons we remain confident in our ability to deliver strong results are: first, we will continue to make strategic growth investments to improve our go-to-market effectiveness and support consumer demand; second, our margins remain a focus as we continue to evaluate our pricing strategy, implement innovative solutions to increase productivity and optimize our direct-to-dealer network. Third, while leveraging the Lennox Unified Management Systems, our teams will be able to streamline processes, leverage best practices and consistently deliver strong results.

The fourth aspect reflects our continued technology advancements that ensure Lennox will remain at the forefront of innovative solutions for our customers. Finally, the introduction of our guiding behavior enhance our team's focus on core values and fortified our high-performance culture. Our refreshed pay-for-performance incentive structure further aligns the talents of our team and the interest of our stakeholders.

Allow me to wrap up by saying thank you to each of our dedicated employees and valued customers. I am proud for what we were able to accomplish this past year, and I'm looking forward to the promising future that lies ahead of Lennox as our best days are still ahead of us. Thank you.

We will now be happy to take questions. Easy questions can go to Michael and I and the harder questions should go to Joe Reitmeier. Operator, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And we'll take our first question from Jeff Hammond with KeyBanc Capital Markets.

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

Joe, look forward to seeing you in Cleveland, look me up. Just on margins, I'm just trying to think about the puts and takes. You've got some profit incrementals on the left of Slide 11 and then you talk about a number of headwinds. I'm just wondering if you could put a finer point on just overall incrementals embedded in the guide and maybe how to think more fine point. Much of this refrigerant inflation, manufacturing efficiencies are going to cost similar to how you did for the factory ramp-up costs?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. So on the left-hand side, you can see our contribution margins. And on the right-hand side is the increase related to rate for costs as well as investments. So you have to join those two together see the full impact. But we do expect some margin improvement for the enterprise next year when you look at the combined. Our component costs are a big piece of our cost of goods sold are nearly 45% and then refrigerants also going to go up significantly. So most of that pricing should be there to maintain our current gross margins and then we'll get a bit of leverage on the volume and a little bit of leverage on the acquisition as well. But overall, we do expect margins to be up just not 300 basis points like we saw in 2023.

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

Okay. And then can you just talk about your inventory destock process with respect to your company-owned distribution? And just on the independent channel, where are you at? Or what are they telling you in terms of how much more to go on destock?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I'll take that, Jeff. On our own internal -- I mean I always think we can get more working capital improvements, but I think we are reaching a level, especially given the upcoming A2L transition, but I think the levels are going to be relatively flat. We might have to build up some towards the second half of 2024, and that's embedded in the guide just to ensure a smooth transition. On the independent channel, I mean, honestly, the destocking in Q4 was more than we expected. And we do think there's going to be some destocking happening in Q1, especially on product line (inaudible) whether that's impact of weather and all, we don't know. But I think from overall, we do expect some destocking bleeding into Q1, but remain confident that by second half or Q2, independent channel distribution destocking would be largely behind us, especially as the distributors get ready for a A2L transition and the EPA ruling allows them some sell-through in 2024 as well. So lots of moving pieces, but we've embedded all of that in the guide, Jeff.

Operator

And we'll take our next question from Nigel Coe with Wolfe Research.

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

Congratulations, Joe. Enjoy your retirement. So I'm not sure whether it's a tough question or not. But just on the -- I think maybe on the back of Jeff's kind of question about incrementals. You've got price mix as a 90% incremental margin. So just wondering how that plays into the mid-single-digit component inflation math. So maybe I'm just asking Jeff's question again, but if you just see mid-single-digit contribution from price mix with 90% incremental, you get to sort of a $3 to $4 EPS tailwind. Is that how you're thinking about it?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. I mean what we have to do is look, it's predominantly price, price drops through to 100%. There's a little bit of mix that we'll get from the carryover benefit from the minimus year transition. So that will kind of drop through at 30%. When you blend the 2 together, you kind of get to the 90%, but then that then covers some of the cost inflations we have on the right-hand side where we think our components are going to be up significantly, both from the normal inflation, mid-single digits as well as the refrigerant.

So that kind offsets a lot of that, which maintains your gross margins. And then thereafter, we start to make investments in distribution and SG&A. And we still see overall operating margins improving think, of it maybe a little less than 50 basis points within the guide.

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

Okay.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

And I think if I could add to that, Nigel, keep in mind, the factory inefficiency both for the start-up in Saltillo or the commercial factory and for the A2L conversion, but that's fairly massive transformation we have to do. Every line has to be redone. We'll have (inaudible) factory shutdown. So we bake in all of that. So I understand your question. It's just we got to -- we baked in all of those inefficiencies in our guide.

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

I get it. I understand that now. And then just on the component inflation of mid-single digits. We talked to some of the motor manufacturers, some heat exchange suppliers. And it doesn't feel like they're targeting mid-single-digit price increases in 2024. So just curious where you're seeing that mid-single-digit price inflation. And maybe just talk about the R-410A, what your expectations are in terms of that commodity inflation in 2024.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. First of all, you should give me the list of all those people that were telling you that. So we can go and negotiate use their work on that. I'd love to get that Nigel. But no, more seriously, some of it comes down to the starting point. In some cases, on components, we did have long-term contracts that are coming up for renewal. So we may have like escaped some of the inflation in the past. The other thing you've got to see in the 410A, I mean, the spot pricing, the contract pricing and where we are still a lot of moving pieces. But based on the production quota reduction from EPA, we fully expect and have baked in inflation on 410A. And overall, I mean inflation is lower than before, but it's not gone away, whether it's SG&A or NAV factors. So we've built all of that in as we looked at what's going to happen in 2024 for us. but we do continue to see inflation in components, especially if our long-term contracts come up for renewal.

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

Right. I'll e-mail those suppliers to you offline, okay?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Thanks, Nigel.

Operator

We'll take our next question from Tommy Moll with Stephens Inc.

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

I wanted to start on price mix and your outlook for the year, mid-single-digit contribution. Can you give us any sense of the phasing there? I presume it's going to contribute a little bit more to growth in the back half versus the second half? And then if you think about what's the art of the possible here over the next 2 years, Alok, I think in the past, you've said 15%, 15% plus is a good bogey to use for where we'll land by the end of 2025. But I wonder if you could just refresh us there? And are you any more or less confident on that outlook?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. So I'll first answer on the price, we see that mostly starting to build in through Q2, Q3 and Q4. As we announced in Q1, it will take a little bit of time to get that new price increase. But in Q1 is where you'll see the carryover benefit on the mix side from the minimum SEER product, we'll get the full year benefit of that.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I think, Tommy, on the overall, we stick to the 10% to 15% total pricing impact by 2025. A large part of that is going to happen in 2025 as like in R54 products start getting launched towards the tail end or second half of this year. So we will see a lot more of that benefit next year than they will see this year which is unfortunate because we'll see some of the manufacturing inefficiencies this year as we transition our line from 410 to 454B, a lot more of the benefit coming to as tail half of this year or like early next year is when we start seeing those benefits. But our view and outlook has not changed on that, and I was glad to see that others in the industry are also now catching up to that dynamic because there's extra cost of sensors, the extra cost of controls, there's extra cost that we're going to do as we look at the heat exchangers capacity, compressors. There's just a lot of extra cost that we must offset.

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

Good to hear. I wanted to follow up with a question on M&A. There's another participant in the market that's talked about potentially turning loose of some assets. Begs the question just about your appetite for M&A at this point or any insight you might share there?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I expected that to be one of the first question. I'm surprised it was a third question on the call today. So but (inaudible). Listen, I'll start by saying a few things, right? First of all, in the past, even before my time, Lennox has been very clear that if there is an industry consolidation opportunity, Lennox will like to participate. And we have specifically named out companies that we would like to participate if that came up.

So let me just confirm that, that view has not changed. We still believe that if there's an opportunity that Lennox would be a participant in that. Overall, when I look at it industry consolidation, it's good for quite a few reasons. As we look at increased regulations, as we look at dealer consolidation. I think we'll better serve our customers. We'll better look at technology to come to the consumer. I think it gives us the right kind of investments that we can make to succeed.

So I think it's going to be good. We would like to participate as and when things become clear and available. I don't want to comment specifically on any specific company and the news. But all I can tell you is that we don't have to do this. I mean, we are very confident in our own stand-alone strategy as well. We have sufficient scale to compete. We are gaining share in respective segments. We have like a very good technology team and a great path forward. So I think that's kind of the balanced outlook on that is if there's an opportunity, we would like to participate, but we're also very confident on where we are positioned ourselves.

Operator

And we'll take our next question from Julian Mitchell with Barclays.

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

Thanks, Joe, for all the help. Maybe just a first question on the sort of cadence of earnings through the year, is it can be kind of tricky looking at -- does pre-COVID seasonality apply or has something changed and we have the nuance of the Mexican plant and the refrigerant change? So are we assuming it's a kind of sort of 50-50 split first half versus second half earnings and then Q1 and always seasonally low and maybe you're starting out the year with weak home comfort volume.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes, I think I'd look at the revenue seasonality in kind of 50-50. Q2 and Q3 should be pretty similar kind of 30% of the year each then you have kind of 20-ish in Q1 and Q4 on the revenue guide. That's similar to what we saw in 2023.

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

And then if we're thinking about the split within Home Comfort solutions for the year as a whole in terms of volumes. How wide a bifurcation should there be in the direct-to-contractor versus independent distribution? Just trying to understand kind of how quickly that delta narrows after being very significant in the fourth quarter.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I think overall, we expect that to get even by 2025. I mean, in the independent channels or the distribution channel, we fully expect, because of comps and because of inventory get to appropriate level, increase in sales versus last year. We're not sure of the timing on when that stops, given all the comps and everything else. But we do think inventory levels and order patterns normalize and we will see a bounce back in our sales to the channel, irrespective of what happens from the channel to the dealer.

On the dealer side, we were pleased with the resiliency that we saw, although volumes were down, they were better than most of us expected. And that resiliency gives us comfort going into 2024, and we expect and have baked in sort of flat to down numbers on that going into 2024. Just because of all the chatter around repair, replace, interest rate, election year, which so far has not turned out to be true, but we want to kind of make sure we put all of that and let (inaudible) decide. Like here are assumptions that you can decide how you look at it. We focused on what we control, and we know we are going to win share through the transition, and we are recovering our service levels nicely.

Operator

And we'll take our next question from Noah Kaye with Oppenheimer.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director & Senior Analyst*

Here's a potentially easy one. What drove the rebranding of the segments? Any functional difference to be aware of?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

No, no functional differences to be aware of. We simplified it from 3 to 2. We had some internal confusion going on between business unit name and segment name so we embarked on a new branding, which I guess was the positive message. Overall, at Lennox, we have not focused on building a brand with dealers and consumers, and there were just different confusion going on. We simplified our websites. We have huge investments in improving our customers' experience, introducing new technology, updating even our e-mail addresses and our lennonx.com.

It was part of a big rebranding exercise. It was just about time to differentiate residential segment from business unit, but I wouldn't read anything more to it besides just simplifying our internal nomenclature and better reflecting what we do, right? Because what was called commercial also had a tiny bit of refrigeration in there. So I do think the new names better reflect what we do and are more consistent with our new branding guidelines.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director & Senior Analyst*

Alok, as you talked about in your prepared remarks, a significant effort over the past year around the culture. You mentioned implementing more pay for performance. Can you highlight what some of those major changes were functionally in terms of pay for performance, what types of metrics you're trying to incent people towards, the timing of when you did those and how you might expect that to impact behavior and performance as we get into '24.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. Let's start with me and the highest level on the executive staff. So last year was the first year where our short-term incentives had a growth component or a revenue component to end. So 20% of our short -- STI now comes from growth. And that just changed the mindset. Just to give you an example, but let's take it down to a few levels on where it really matters. So if you think about sales incentives and compensation, it used to be the other way around because only on revenue are not enough on profits and margins. So as we talked about accountability, autonomy and in deploying all of that in the sales force, we are now measuring our sales team more on profits, more like a distributor would measure them versus purely on revenue.

So that's kind of the 2 switch on the more senior level, more focused on growth and on the street level, more focused on profitability and profit margins. And that's a long journey because you can't change these things overnight, especially if they have been seeped into the culture for many, many years. But we are pleased with the early results and fully prepared for the long-term journey as we add technology and finance scorecards and metrics-driven behavior versus the storytelling behavior, sometimes pleased to get there.

Operator

And we'll take our next question from Joe Ritchie with Goldman Sachs.

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

Thank you, Joe, for everything. Have a great retirement. It's well deserved. So my question is for Alok and Michael. It sounds like the implied 1Q guide is above where consensus is today and consensus is towards the high end of your full year guidance for the year. So, I'm just trying to understand kind of like the conservatism that might be baked in to the low versus the high end. So any color you want to provide there would be helpful.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure, I'll start, and then Michael will jump in. Because we really did not consider consensus was giving guidance, and we don't give guidance by quarter. But here's what we did, right? We laid out the volume assumptions on Page 11, so you can look through that. And that kind of brackets are low end and the high end, all on the volume assumptions. As we look at it, Q1 is going to be a little weird because we get more mix benefits, as Michael said earlier, because last year, we still had old SEER and new SEER products. Some of the price increases go into effect in February for us, as you saw along with the other competition. So you get only half a quarter benefit on that.

And seasonality will be similar to what we have seen unless there are any unusual weather patterns. So honestly, we didn't spend tons of time looking at quarter-over-quarter. We were just thinking of the longer term where we are focused and drive that. Michael, what would you add to that?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. I would just add, we obviously don't give quarterly guidance. But generally, when you look at the seasonality that you plot as we just talked about, maybe a little bit more destocking as Alok talked about through the distributor business in Q1 and then starting to revert back up thereafter. And then a little better production out of the commercial factory, maybe a little better volumes in Q1 from commercial as well.

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

Got it. Okay. That's helpful. And I guess, look, just a follow-up question to M&A. Maybe just remind everybody what your criteria for M&A would be? And if you're looking for potential deals in the space. What is your kind of appetite to go broader internationally versus the footprint that you have today, which is predominantly U.S.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I mean I think from our perspective, we like where we are positioned. So let's start that like we think we are positioned in an attractive market. That happens to be North America, but it could be somewhere else. I mean what we look for is attractive end markets, where we can win, where we can succeed, where we can generate the appropriate returns. I don't think we exited Europe because of Europe. We exited because the margin profile was weak, and we did think we were positioned to win there.

So I don't want to make any specific comments and rule anything in or out at this stage. But we will look at those things is how does it benefit our shareholders? Are we positioned to win? Does it create attractive opportunities for us, versus share buyback? I mean, end of the day, we have done very well, and we'll continue to do well based on share buyback. But I mean we're going to look for markets where we are positioned to win.

Operator

I will take our next question from Damian Karas with UBS.

Damian Karas - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate of Electric Equipment & Multi-Industry*

I wanted to ask you about your commercial outlook for this year. You spoke to a lot of the pent-up demand and the older installed base. You're guiding the building come for volumes to up low singles. Could you maybe just kind of parse that out, how you're thinking about planned replacement versus emergency and new construction?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. So I'll tell you, it's maybe a [tale] of 2 halves that is quite a few moving pieces, but let's talk positives, right? I mean our order rate remains strong. Our backlog although doesn't matter, but in the short term backlog remains solid. Our sales team is pretty excited and we see no impact of any of the things that we read about, whether it's KBI index and all that, we do see some projects moving to the right. So we are a bit cautious as we go into it. We also -- as we talk to our key accounts find a lot of enthusiasm around the R454B product and are somewhat concerned that maybe towards mid- to late this year, they might say, "well, I'll just wait for the 454B versus take the existing product."

So that's kind of baked into us, we looked at the guide for different competing factors, just to go back to it, pleased with the current order rate, please with the current backlog, pleased with our production output, excited about this Saltillo factory even adding more to our output because we remain supply constrained versus demand constraint. And they just want to reflect some of the noise [slash] what we see in the future is slow in construction and any weird air pocket that could come in if you look at 454B transition.

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

I guess just thinking about the overall industry outlook, I know you said you think consolidation could be a good thing for the market, but you're expecting to kind of gain share. I guess one of my observations coming out of the AHRI show, it does feel like there's a bigger push in the U.S. by some of these overseas players. I'm wondering if you're perhaps seeing any increased competition or expect to maybe see some over time.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

We saw that too -- and I'm sorry, I missed you at the AHRI show, but like I went to all the booths and it was impressive on some of the overseas players and the amount of money spent on the booth. I'll tell you the amount of money they spend in the booth was uncorrelated to the market share in U.S., it probably more reflects their aspirations for the future. I think what these players have done very well, it comes to mini splits and VRF, but if it comes to traditional unitary products, I think very few -- if any of them had any success, and that's where the core U.S. market remains very, very different and you know mini splits and all are still in single-digit market share overall and had a tough year in '23.

But listen, we are -- on the only -- we are the only unaffiliated player in U.S. So we look at the international players, both as a threat and as an opportunity to be able to work with them to drive our joint market share in some areas. But we also look at it as a threat. So that's the way we look at it, but we were pleased with the interest we are getting on our own new products like at AHRI, we were pleased with people excited about new production capacity we're adding, the emergency replacement products that we displayed and just general energy from our sales team on how robust the activity was.

It was the highest attendance AHRI show has had, which kind of makes me more optimistic on the economy than what I read in the newspapers.

Operator

(Operator Instructions)

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

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

Maybe if you could just expand on the comment, a lot of discussion on the new refrigerant. And Alok, I think you said you're not expecting a prebuy. And I think you added the term, there might be some -- was it inventory fatigue. Just it's an interesting concept. Maybe you can expand on that, please, if I heard that correctly.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I mean, historically, these transitions had a lot of prebuy from the independent channel. But because of the confusing EPA rulings that came out in sort of November, December, I think the channel is -- just a little concern about landing up with obsolete products. And since they see the manufacturers being pretty prepared, they may not feel the need higher interest rate works in that environment as well. And the overall given how much inventory people were holding because of the CEO transition just 2 years ago, because of the COVID disruption a year ago. Some of the distributors are just working with us and saying, why don't you manage that for us?

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Make sure your lead times are low, and I can get it quickly. I may not want to spend a warehousing space and the cash to build up. Now but listen, if you're wrong, we will have upside in '24 and downside in '25. I mean over a 2-year period, it normalizes anyway. So we will be prepared if people decide to have a prebuy, but based on as we were looking at it, we just said, let's not take any of that in.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

And then second question, just on the longer-term targets, the free cash flow at 90% seems like you are underpromising there because this is not a capital-intensive business. You should be by -- from our perspective, closer to 100%. And I know you've had a big CapEx push over the near term, but are you baking in more capacity expansion in that free cash flow conversion, but it just seems light versus what your potential is.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

That slide went through so many changes over the past 48 hours. We tried to give a range. We tried to -- but listen, if you're starting the year and you got $175 million of CapEx, you're not going to reach 100% in a 3-year period, right? I mean, just where we are. But in the long term, I think we'll get to 100% to have some investments.

Unidentified Company Representative

The other main driver is as we grow revenue, you're going to have net working capital growth with that revenue. CapEx to be closer to depreciation by 2025 and 2026. So it's mostly related to just growing working capital with the revenue growth.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

What's the working capital -- working capital sales target associated with that 90%?

Unidentified Company Representative

Upper teens.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes, 15% to 20%, like it's higher on our direct model, lower on the indirect side, probably in the range of...

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

Upper teens is fine.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes, it below 20 overall. But listen, one thing is our cash flow, we don't do any adjustments, right? I mean this is our -- the checkbook balances.

Operator

And we'll take our next question from Ryan Merkel with William Blair.

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

I had 2 questions. First, on the fourth quarter, in terms of weather, how big of an impact was the mild winter? And did you see any lift with the cold snap in January? And then my second question is just on the cadence of commercial margins. It sounds like it might be up slightly year-over-year. Is the first half sort of down a little and the second half is up a little bit? Just any help.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I'll let Michael answer the second one, and then I'll come back to the first one. So Michael, why don't you go ahead.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. So on the commercial margins, yes, we'll see a little bit of a headwind, though, on the factory ramp up in the first half, but we'll get the benefit of the mix and a little bit of volume. That should kind of neutralize each other. So overall, margins should be up in commercial, but I think they'll be kind of flattish throughout the year with those 2 elements adjusting against each other.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

And I think to the first question on weather. I learned early in my career, Ryan, that never ever talk about weather when you have a challenging number set to be delivered. But based on like where we are, yes, Q4, we had some of the kind of the warmest winter, and that did negatively impact our daily order rates and we track the same things you guys would track on average heating days and cooling days. And yes, Q1 with the cold streak, we have had a good start based on, as you would expect on the weather, but we don't know what tomorrow looks like or February looks like, but both your statements are correct, Ryan.

Operator

And we'll take our next question from Tim Wojs with Baird.

Timothy Ronald Wojs - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Thanks for the entry here. Joe, congratulations and it's been good working with you. Just 2 quick ones for me. First, as you look at '25, just given the transition kind of changing from -- I can't remember, just EPA or DOA and -- or DOE, allowing the sell-through. Would you expect to still sell through a fair amount of R-410A product next year through your own distribution?

And then just a second question on the kind of longer-term mix benefits from A2L, I think, Alok, you said 10% to 15%. Is that a change from what you said before? Or is it just kind of some rounding?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

No. I think the second one for us, it's just kind of rounding because we give longer numbers, we'll get some benefit this year as well. So I'll try to portray what 2025 looks like, right? So that's just rounding. Maybe I should just stop giving ranges and pick a center line like 15% here.

Tim, on the first one, there's still some uncertainties and EPA is not coming up with the final rule, they have indicated to rules. Listen, our preference would be not to make 410A products. But based on currently the way it's written, we'll probably be forced to make some 410A products next year. And that would be then impacting the 10% to 15% number because there will be some 410A products, they're going through the factories as people can repair outdoor units using new 410A products. I know it's a weird dynamic there. So still waiting for some clarity on that. We would prefer not to make 454 -- not to be 410A for manufacturing efficiency and other reasons, but we are just at a stage that we've got to see how the final rules plays out and how each of the state adopts it, too.

Operator

We'll take our next question from Jeff Sprague with Vertical Research.

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

Two quick ones from me. Just back to kind of M&A, maybe just a little bit of color on where your comfort zone is on leverage. I think you talked about kind of normal leverage targets before. But like where is the flex target for something bigger that you'd be comfortable to work down from?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I think when the time is right, we'll have that discussion with the board and put it all together. I mean, from our perspective, that have to be an opportunistic discussion on something that's attractive to the company. But yes, if it's attractive to our shareholders and we need to lever up. The key question would be is, would we get back to our preferred leverage range within a year or 2. I mean that's what our focus is going to be. So you can do the math backwards, right? I mean as long as we think there's real cash, and then we can use that cash to get back to our long-term leverage goals within a couple of years. I think we could make that work.

But investment grade rating is important to us, right? I mean we are not in (inaudible) shop or anything else like that. We'll maintain investment grade.

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

Understood. And then just on CapEx. Has the amount of CapEx expected for the total program, the new plans and otherwise changed. I think you were talking about $150 million in CapEx for 2024 previously. Now we're at $175 million. I was just kind of getting through it faster. Maybe you could just provide a little additional color there.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

The total program is still the same. We just have some additional CapEx that we have in 2024 to prepare for the new refrigerant products and investments with (inaudible) and new refrigerant lines within the factory that also come in this year.

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

And normal CapEx when we're all through this is $75 million to $100 million a year?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes,e-with inflation, probably not closer to $100 million like...

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes, I think it'd be closer to $100 million, $110 million, not $75 million to $100 million. Just growth and maintenance built into that, right? Maintenance might be $75 million, $80 million, but to support our growth, we probably will add more. So I would say it's north of $100 million.

Operator

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

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

Yes, I missed you at AHRI. I'd say attendance of investors was also at a record which may be inversely correlated to multiples someday, but we'll see.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I saw you from far in a different company booth, but you were holding a good audience, I didn't interrupt.

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

Yes, yes, yes. Lots of great details of that show, for sure. Just on the price capture dynamics. I think you guys had talked about doing some midyear price increases this year, your capture was in the fourth quarter around 2%. Can you maybe just talk about how -- what types of things you were doing at midyear and what your kind of net realization was and how that waterfall works?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I'll start. So I think the overall, as we talked about price increases, we talked about doing residential new construction price increase in the middle of 2023. That did go ahead as expected and as we looked at the overall drop-through that is about what we expected, maybe a share worse than we expected, to be honest. And I think that just came down to the mix between residential new construction and the seasonality baked in there. Not a whole lot of R&C gets shipped towards in the Q4 time frame. So from that perspective, that went as we expected.

We have key account price increases going into effect this year, mostly early this year, and we know we announced a price increase, broader one and that goes into effect in February. So all the pricing actions that we talked about is gone as we had expected. We remain comfortable on where we are. And it's been good to see that the whole industry moving in that direction as well.

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

Yes. And I guess just on a unit basis, what was the actual revenue for the captive business in fourth quarter? And what was the -- putting parts aside, what was the unit volume for that business, the captive resi business?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. So total revenue through distributors was down high to mid-teens and then the direct was up high single digits for Q4.

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

So your unit volume in Q4 for that business was actually up.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Correct. Low single digits.

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

Okay. And one last one, just on the new A2L product. When is first call for you guys? And what's your -- when will you be able to actually ship that product? When will the distributors like see the specs and a physical product, like what's kind of the schedule of that rollout just on the ground physically?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. So I think with the key distributor, they're already seeing the spec. We're already going through the training and all that. First physical product probably comes out in the second half of this year. And we will start with sort of the high-end products, I think the consumer's appetite for going to R54B is going to be more and faster. And then we will slowly transition towards the lower SEER and the lower-end products. So we'll start with the higher end towards the middle of the year. And we are on track or ahead of schedule on each of those things. We don't expect any R454B for meaningful sales, can we put on a showcase on a display booths in first half of this year, yes. But for somebody to actually place a PO and buy, would be in the second half of this year.

Operator

We'll take our next question from Joe O'Dea with Wells Fargo.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

On the kind of commercial mix, can you just talk to how -- what percentage of the mix was emergency replacement in 2023 and how you're thinking about that stepping up in 2024. I think normalized as maybe something like 30%, but I think still on sort of a migration toward normal.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. So listen, we were close to 0%. I think we hit double digit in '23 in terms of trying to get to emergency replacement. Barely, I would say, high single digit, double digits in 2023, and that includes both our direct and going some through our distribution partners. And we still think there's a lot of room ahead. We probably won't move that needle until Saltillo comes in production in the second half of this year. So expect us to hover in high single digits, low double digits until Saltillo comes online.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Got it. And then what are your thoughts on when we think about the residential side and the direct demand sounds like trended better than anticipated in '23 indirect sort of worse. And so how do you align those 2 things? Is your assessment that channel inventory is just thinner than historical averages? And why would direct trend better and indirect destock headwinds trend worse?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Listen, as we talk to our distribution partners, and we're very close to them. It's not the channel inventory had more stock than we thought. And yes, with the EPA ruling and then everything, the channel essentially flows in Q4, especially they're worried that for a while remember the fear was that you would not be able to sell 410A products, unless it was replacement starting December 2024. So I think that ruling created just a freeze mentality in our channel, which I'm glad EPA issued some clarification and coming up with final ruling. But the direct business holding out better than we thought was actually a positive. I mean, which means the consumer is being resilient, and we were pleased with that resiliency.

Now being the CEO of Lennox, I also think we gained share, so that's something we will watch out for as numbers normalize. It's hard to figure out share dynamics right now given things are unclear on how much of it is us winning share and how much is the fact that we are going direct, but I mean, from numbers that we see, I mean, we gain lots of shares. We just need to figure out how much of that is transitionary versus rail.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

And I'll just add on the direct side, we executed very well on the minimum SEER transition.

Operator

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

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

I wanted to ask about the IRA and how well defined it is in the states in terms of the tax rebate.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

IRA has become such a topic for the past 12 months with very little to show for that we've kind of stopped banking on it. And one aspect of IRA, which was through the [C] tax credits that's kind of flowing through in some cases, some states are renewing it on their own. I don't think any of us saw the big impact we were expecting from IRA, but we're starting to see drips and dribblers. If the government really gets their act together and figure out this whole income qualification criteria to get the IRA piece, which there's no practical way to do it for a dealer right now, then I do think there's upside left, but we're not counting on it right now, especially given the election year, I don't know if the government will put this as a priority to figure it out with the state governments and dealers on how to make that work. But the rest of it is kind of slowly dripping in.

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

Got you. And then given the confusion, I guess, the phase-in of the new refrigerant resi systems in '25, what are your updated expectations for pricing over the next 2 years, average pricing in the past, we've talked about something like 15% off of the '23 levels. Do you think that's still valid or do you think it's lower now?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes, that's a valid. No, it's still valid. I think that's still just working through the entire process, and that was the comment earlier as well maybe getting some of that this year, especially with the 410A numbers that we talked about this year. But at that number over 2 years still totally valid.

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

Okay. And given the potential slowdown in unitary that you mentioned and what we're seeing in resi. Have you seen any evidence anywhere in the industry of intensified price competition? Or is everyone still just getting -- pushing through price and getting that?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

It's more the latter on an overall basis. But listen, if I speak to 1 salesperson in 1 corner, they will convince me that there's an intense price competition in their own territory, and that's why they're not meeting their numbers. But if you ignore those individual data points and you look at a broader trend, right now, the price seems to be sticking across the board. And it's no accident. I mean, the costs are going up too. I mean if you look at the overall margins, margins expanding nowhere close to what the pricing number we talk about. So some of it is just recovering the cost that we went through and are continuing to have to burden as we look at higher SEER products, new A2L refrigerants, better efficiency compressors and the labor and material inflation. So I don't see that going backwards because manufacturers have to offset the extra costs we are incurring.

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

And one last one for Michael. I just -- maybe could you further quantify the new facility costs in Q1 and Q2? And just -- like what are you specifically -- unabsorbed cost, if you will? What are you implying in the guide?

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes. Just thinking about it. We have a factory that we're going to start to staff with people. We're going to get them trained. We're not going to have very high productivity as we build units. And really, we won't even start to get any absorption until kind of mid- to late Q2. You have all of those ramp-up costs there. And then even in the second half, a portion of the $10 million will be lower efficiency, we will start to get some units out, but it won't be highly efficient. We won't be running at full efficiency until mid-2025. So it's probably going to be more to the front half, and it gets better as you get into the second half of that $10 million.

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

Got it. But in aggregate for the year, it's $10 million.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Correct.

Gautam J. Khanna - *TD Cowen, Research Division - MD & Senior Analyst*

With the front end. Okay. I appreciate it.

Michael Quenzer - *Lennox International Inc. - Executive VP & CFO*

Yes.

Operator

Thank you for joining us today. Since there are no further questions, this will conclude Lennox's fourth quarter conference call. You may disconnect your lines at this time.