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LII.N - Q2 2023 Lennox International Inc Earnings Call

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OVERVIEW:

Company reported segment margin of 20.9%, adjusted earnings per share of $6.15, operating cash flow of $196 million, segment margin of 21.6%, segment margin of 25.3%, Total debt of $1.6 billion.

CORPORATE PARTICIPANTS

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

Chelsey Pulcheon

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

Michael Quenzer

CONFERENCE CALL PARTICIPANTS

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

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*

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

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

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

PRESENTATION

Operator

Welcome to the Lennox Second Quarter 2023 Earnings Conference Call.

(Operator Instructions)

As a reminder, this call is being recorded.

And I would now like to turn the conference over to Chelsey Pulcheon from Lennox Investor Relations team. Chelsey, please go ahead.

Chelsey Pulcheon

Thank you, Ashley. Good morning, everyone. We are excited to have you here with us this morning. Joining me today is CEO, Alok Maskara; CFO, Joe Reitmeier; and VP Finance, Michael Quenzer.

Alok will discuss quarter highlights and Joe will go into depth on the company's quarterly financial results and our updated guidance for fiscal 2023. After that, we will have a Q&A session with Alok, Joe and Michael.

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 to be relevant indicators of underlying business performance.

Please refer to our SEC filings available on our website for additional details, including a reconciliation of all GAAP and non-GAAP measures.

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

Now let me turn over the call to our CEO, Alok Maskara.

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

Thank you, Chelsey. Good morning, everyone. I am delighted to share our impressive results from the recent quarter ending on June 30, during which we delivered record revenues, record profit, record EPS, record margins and record cash flow. These results demonstrate the power of our focused growth strategy and the progress of our commercial turnaround plan.

I am grateful to our dealers and customers for their continued loyalty towards our products and services as we remain committed to further improving our service levels and enhancing their customer experience. I'm also thankful for the dedication and hard work of my 13,000 Lennox colleagues, whose relentless efforts have contributed to our outstanding performance this quarter.

This successful quarter demonstrates the power of our laser-focused strategy, which builds on our existing strong direct customer relationships, advanced products platform and our unique distribution network. These factors will continue to fuel our share gain and margin expansion for the foreseeable future.

Now I want to discuss some key highlights of the quarter on Slide 3. First, core revenues grew 3% and our adjusted segment margin expanded 320 basis points to 20.9%, resulting in our adjusted earnings per share, increasing 22% to $6.15. Additionally, our operating cash flow increased nearly 100% to $196 million.

Second, we are extremely proud of our commercial team's execution of our profitable growth strategy. Both revenue and profits for the Commercial segment hit a record this quarter, driven by favorable price/mix and improved production output from our Stuttgart manufacturing location.

Third, residential end markets were challenging, which resulted in our Residential segment, delivering lower revenue, margins and profits. Margins were also impacted by lower factory output and absorption as we normalize our own inventory levels, post the SEER transition.

We remain cautiously optimistic about the second half, as we believe that the industry's inventory rightsizing is decelerating. In addition, our recent price increase will enable us to deliver improved margin performance during the balance of the year.

Fourth and finally on this page, we are pleased to share the revised fiscal guidance for this year as we anticipate higher revenues, higher earnings per share and higher operating cash flow for the full year. Joe will review the revised guidance in greater depth later in the call.

Now, please turn to Slide 4 for our view on the current business conditions impacting the industry. For the residential end market, we experienced higher-than-expected distributor destocking and a cooler start to the summer selling season. We are now anticipating unit volumes for the full year to decline by high single digits versus prior expectation of a mid-single-digit decline.

Looking at the second half, we expect the impact of distributor destocking to diminish and we have started to see an uptick in our replacement sales, consistent with higher [summer] temperatures.

In Commercial, we now anticipate sales to be up low double digits for the full year versus prior expectations of high single digits to low double-digit sales increase. The order backlog remains strong, and although delivery lead times remain extended, they are 50% lower than last year and in line with the industry.

Regarding price versus inflation, we are pleased to report that the industry pricing remains disciplined and our own mid-year price increase has been broadly successful. Our outlook on both components and commodity cost inflation remains stable and unchanged, and we expect the second half of the year to deliver a positive price versus inflation spread.

Ultimately, our improved service levels and increased commercial production gives us confidence that we are well positioned to gain share in the second half of this year. We continue to invest SG&A dollars towards improving our go-to-market processes, while deploying incremental frontline resources to win over more dealers and more key accounts.

We believe that Lennox outperformed the industry in successfully launching the product portfolio to meet the new minimum efficiency standards, gaining further loyalty from customers and our dealers. During future regulatory transitions, including the upcoming low GWP refrigerant requirements on January 1, 2025, Lennox aims to deliver similar outperformance and capture additional share.

Please turn to Slide 5 for more details regarding ongoing Lennox activities related to the upcoming refrigerant transition. We are pleased to announce that Lennox will transition to R-454B from R-410A refrigerant to meet the EPA requirement effective January 1, 2025. The R-454B choice was driven by our commitment to provide the best option for our valued customers and the environment. Compared to the existing 410A refrigerant, R-454B reduces greenhouse gas emissions and is approximately 80% less global warming potential.

Lennox has demonstrated a solid track record of successfully navigating regulatory changes and this will be no exception. We have completed most product redesign and are now in the testing phase for this transition. The redesign includes updated compressors and other components for refrigerant compatibility and high efficiency performance.

To address safety requirements for the new A2L refrigerate, we will have additional safeguards on all our products that use this refrigerant. These safeguards may include sensors, controls and algorithms which will mitigate any leaks if and when they occur.

Safety of all our products remains our highest priority, and our redesign will meet or exceed applicable safety standards. As you know, Lennox has a structural advantage of primarily selling direct to dealers. This enables our team to deliver advanced training to deliverers and equip them with accurate information to share with the end consumers. This helps us and our dealers to win during the regulatory transition, while addressing all the safety requirements for manufacturing, distribution and installation.

Throughout this transition, we do not expect a significant inventory prebuild as the transition to R-454B would likely happen faster compared to similar refrigerant transitions in the past. We intend to deliver a safe, seamless transition, supported by appropriate inventory levels. By maintaining strong relationships and timely communications with our suppliers, we will avoid supply chain disruptions.

While we are still reviewing this transition's financial impact, we expect it to be neutral or accretive to our margins. We are confident that the increase in the product cost will be offset by price. Overall, we anticipate that once again, we will outperform the industry and garner additional loyalty from our dealers and customers during this refrigerant transition.

Now let me hand the call over to Joe, who will take us through the details of our Q2 financial performance.

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

Thank you, Alok. Good morning, everyone. Please turn to Slide 6.

As Alok mentioned earlier, the company posted a strong revenue and earnings growth. Core revenue, which excludes our European operations was a record $1.34 billion, up 3% compared to prior year's price and mix benefits, more than offset Residential sales volume declines.

Total adjusted segment profit increased $50 million or 22% versus prior year. Price and mix increased profit by $106 million and were partially offset with $43 million from lower volume and $13 million from inflationary effects and investments in distribution and SG&A.

Total adjusted segment margin was 20.9%, up 320 basis points versus prior year. For the quarter, corporate expenses were $25 million, a decline of $2 million, as we continue to tightly control corporate spending.

The second quarter not only achieved record levels of revenue and segment profit, but also marked record earnings per share, with GAAP earnings per share rising 23% to $6.10, and adjusted earnings per share growing by 22% to $6.15. Our record -- our second quarter tax rate was 17.6%, and diluted shares outstanding were 35.6 million compared to 35.7 million in the prior year quarter.

Now turn to Slide 7. As we saw in the first quarter, industry-wide distributor destocking continued in the second quarter and the summer season began with cooler temperatures, resulting in a 12% volume decline. The volume decline was partially offset with 2% favorable price and 6% favorable mix.

Our direct-to-dealer sales, which are around 75% of our segment revenues, experienced a revenue increase in the low single digits. The remaining 25% of our revenue, which goes through distributors was down approximately 20%.

Residential segment profit fell 6% to $203 million, and segment margin dipped 50 basis points to 21.6%, driven primarily by lower volume, inflation effects and selling and distribution investments. The headwinds were partially offset with price increases and favorable mix, partially driven by the new minimum efficiency standards.

Turning to Slide 8, and our Commercial business that delivered another quarter of exceptional results. Revenue was $408 million in the quarter, up 24%. Combined price and mix were up 22% and volume was up 4%. Commercial segment profit was $103 million, up 150% and segment margin more than doubled to 25.3%.

Price and mix had an outsized impact in the quarter, delivering $66 million and the total $62 million -- of the total $62 million of the profit increase. Last year, we provided guidance on a multiyear profit opportunity of $100 million, and I'm delighted to share that our trailing 12-month segment profit has already surged by $120 million compared to the same period last year.

Our rooftop production output continues to increase, and we are maintaining a robust commercial backlog, while steadily improving delivery lead times, which now align with the industry.

Moving to cash flow performance and our debt to EBITDA starting on Slide 9. Operating cash flow for the quarter was $196 million compared to $97 million in the prior year quarter. Capital expenditures were $49 million for the quarter, an increase of $28 million compared to the prior year. Our capital deployment priorities remain consistent, supporting organic growth investments like our new commercial factory in Mexico, driving industry-leading innovation and exploring potential bolt-on acquisitions.

In the quarter, the company paid $38 million in dividends. Total debt was approximately $1.6 billion at the end of the quarter, and our debt-to-EBITDA ratio was 1.9x. Cash, cash equivalents and short-term investments were $58.6 million at the end of the quarter.

Turning to Slide 10. Let's review our 2023 full year guidance. As a result of our strong first half performance, we are increasing our full year outlook. We expect core revenue to be up between 2% and 4% for the year and earnings per share of $15.50 per share to $16 per share. We are increasing our free cash flow target to a range of $300 million to $350 million.

Our guidance for capital expenditures remains consistent with our prior guide at $250 million. As a reminder, that includes investment in a second commercial factory and investments related to the refrigerant transition to take effect in 2025.

Price benefit is now expected to be $250 million, and we now expect net material cost to be a $25 million headwind in 2023. The material cost headwind is driven by component cost inflation of $90 million, net of $30 million in savings from cost reduction initiatives, along with the $35 million commodity cost benefit.

Our new target for corporate expenses is $95 million attributable to higher incentive compensation expenses. We will continue to manage SG&A expenses tightly, while simultaneously making essential investments in the business to support growth initiatives, advance our innovative products and solutions and enhance productivity. And finally, we still expect the weighted average diluted share count for the full year to be between 35 million and 36 million shares.

With that, let's turn to Slide 11, and I'll turn it back over to Alok.

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

Thanks, Joe. In addition to solid short-term results, we are also making significant progress towards transforming the company for longer-term shareholder value expansion. Last quarter, we shared the key initiatives that pave a clear path towards our 2026 financial targets.

Today, we would like to share 3 transformation phases that would clarify the execution time frame of those initiatives. Collectively, these initiatives will deliver on the 2026 targets and set up Lennox for even longer-term value creation.

We are currently in the self-help phase of the plan, which delivers execution consistency to our customers and shareholders. We have already demonstrated success in our commercial recovery and portfolio simplification initiatives. Our pricing excellence initiative will drive favorable margins through improved price setting, getting and netting. We are strengthening our core foundation by enhancing talent and reinforcing culture with an emphasis on accountability. This stronger foundation will serve as a springboard for accelerated growth in 2025 and beyond.

Looking into 2025, Lennox is prepared for growth acceleration in several areas. Our up-to-dated go-to-market sales strategy will increase our growth capacity and grow our core dealer base with a renewed focus on premium margin products. As we highlighted earlier, we anticipate accelerated share gain during the upcoming refrigerant change. Our technology advantage in cold climate heat pump will enable additional share gain during ongoing industry electrification.

While we remain committed to delivering our 2026 financial targets, we also recognize the opportunities to continue expanding shareholder value even beyond 2026. We will build upon our structural competitive advantage with an expanded distribution network to increase our North American coverage.

We will also capitalize on this expanded distribution network to expand our share of wallet through higher commercial service penetration, higher attachment rates for parts, supplies and adjacent products used by HVAC dealers.

In summary, we are committed to our 2026 fiscal targets and also have a clear line of sight to strategic imperatives that will continue creating differentiated shareholder value.

Now please turn to Slide 12, where I will like to recap why I believe that Lennox's structural competitive advantage is poised to deliver long-term differentiated shareholder value. Let me highlight the 5 pillars of our structural advantage.

First, our direct-to-dealer model uniquely positions us to deliver accelerated growth. To capture this, we will enhance our sales go-to-market effectiveness, consistently elevate the customer experience and make necessary investments in growth capacity to meet market demand.

Second, because we own our own primary distribution channel, we can deliver sustainable and resilient higher margins by leveraging scale and technology to reduce cost and increase the efficiency of our distribution network.

Third, our balanced scorecard-based operating system, dual sourced supply chain and lean digital processes, deliver execution consistency throughout our operations.

The fourth pillar is our advanced technology portfolio that is perfectly suited to serve the North American heating and cooling industry with environmentally sustainable innovative solutions.

Finally, we have high-performance talent and culture that is nurtured by our core values and recently launched guiding behaviors. We are continuously engaged in talent development and succession planning, while diligently ensuring that our compensation structure is closely aligned to shareholder value creation.

I would like to close by reaffirming my gratitude to our employees and our customers. We are proud of our accomplishments in the first half of this year and continue to believe that our best days are ahead of us.

Thank you. Joe, Michael and I will be happy to take your questions now. Ashley, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first question from Jeff Hammond with KeyBanc.

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

Just on commercial, I mean that the margins were just exceptional. So I just wanted to understand margin sustainability, any aberrations in the quarter? And then maybe just speak to the backlog and how much your lead times are improving versus peak and just the level of reduction that kind of contributed to the quarter?

Michael Quenzer

Yes. From a sustainability perspective, first, the backlog remains resilient. It's down a little bit, mostly because the lead times are improving. Margins within the backlog remains strong, reflective of the margins we saw in Q2. So pricing mix is solid in that business. And again, we continue to see output coming out of the factory, which is a good sign for volume growth to continue.

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

Yes. I think the one thing you'll see, Jeff, for the quarter, price and mix propped up the quarter. In back half of the year, you should see volume even more from the commercial segment. So we're excited about the future there. Once again, I think we've achieved getting this business back to the trajectory that it was once on and are excited about our ability to now demonstrate our trajectory of getting into our target margins by 2026.

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

Okay. Great. And then just in resi, anything more than really weather that's informing kind of the lower trajectory there? And just maybe speak to how your destocking is going for your company-owned stores.

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

Sure. This is Alok. Yes, listen, on resi, I don't want to talk just about weather, but we all know Q2 was softer. I think the distributor destocking was also more pronounced than we had expected. And at the end, we took our volume guide down and talking about high single digits. That's also to just reflect our learning in 6 months of the year. But as you see -- notice, we kept our revenue the same.

From my perspective, our own inventory destocking is going fine. I think it will take us another 6 to 9 months to bring it down to more normal levels. And that's because internally, we are just more cautious and don't want to lay off a lot of people just to turn around and try and hire them, which we know was a struggle in the past.

From what we hear from the distributors, they -- most of them expect destocking to be over by Q3. If there's a little bit that bleeds into Q4, that's likely to be seasonal products like furnaces and things that don't sell well in Q3. So that view hasn't changed for us.

So overall, in resi, it's slightly worse than we had talked about last time. But within the overall guide range, we think it's similar outlook to what we previously disclosed.

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 follow up with one more on the resi volume trends and outlook. Are you able to share the volume trends in the quarter for direct-to-dealer versus Allied? And then you've talked on several occasions about the distributor destocking, which I would think is more an Allied-driven comment, but is there anything on a sell-through basis other than, like you said, about the cooler weather in the second quarter that's changed in terms of your outlook?

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

Yes. So clearly, Allied and ADP, which makes up our indirect channel, they had significant decline. Our core Lennox business was kind of flattish, maybe slightly down in terms of units. So I mean that gives us a lot of confidence that the industry is holding quite well. And all the current softness is mostly driven by just the distributor destocking.

Now you've got to ignore things like weather because June was a little colder, July is going to be a little bit harder, but that just gets washes out for the full year, Tommy. But net-net, I think overall industry is holding up well, and the current impact is almost all driven by channel destocking.

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

That's helpful. I also wanted to follow up on a theme you highlighted earlier, Alok, just on the accountability and growth culture that you really want to drive. Can you just bring us in a little bit more on what that means and what some of the initiatives are?

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

Sure. So I mean, Lennox has a great culture, as always had a great culture. For the past 5 years, we just trained for Lennox. Starting with the Marshalltown tornado, which as you saw, we finally finished the rebuilding and we never want to use the T word again in any of our conversations.

Two, to COVID and many other pieces where supply chain, we got disproportionately negative impacted versus the industry because the supply chain was more reliant on China.

I think in the past 5 years, we just got beaten down and started using all of those as excuses. And I think going forward, we have launched -- relaunched our core values. We have 9 guiding behaviors. You may have seen some of those posters when you were here. Each and every employee is going through a training that's going to be over the next 12 months, complete.

And we really want to emphasize things such as customer experience, accountability, innovation, sustainability. And of course, that depends on where you are in the organization. But we are very pleased with the results. Employees are genuinely excited about the path forward, and everybody is ready to put the past 5 years behind us and truly embrace the next 5, 10 years.

Operator

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

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

Great numbers, guys. I wanted to ask about that refrigerant change next year. And when do you expect the mix to transition to that new refrigerants? And then what is the pricing implications of that change? When do you start to see the product transition into the channel? And is it -- do we get another lift like we did this year with this year transition in terms of average selling price and the like?

Michael Quenzer

Gautam, this is Michael. Yes. So the transition really won't happen until pretty much January, but you will start to see in January 2025, some of that price/mix dynamic where we'll lift up the price to more than offset the cost. But really, that will be more of a 2025 impact than 2024. We'll be preparing for that through inventory preparations and transitioning and preparing the dealer network, but really no financial impact in 2025 -- or 2024.

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

Okay. And just a quick follow-up on the Commercial side. Where are you with respect to the emergency replacement market? Have you kind of reentered it? Do you have the capacity to do that yet? And when do you expect to?

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

Yes, Gautam, the way I would characterize that right now, we're still focused on the planned replacement and national account segment of the business. We're early innings in reengaging in emergency replacement as our factory continues to increase output. By the end of the year, we'll be more fully engaged in that, but it's early innings right now, and that remains a significant upside opportunity for us going forward.

Operator

We'll take our next question from Nicole DeBlase with Deutsche Bank.

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

So just maybe on the revised full year guidance. So I think you're kind of implying that sub-50% of earnings going to come in the second half now. And typically, that's more like 55% in the second half. So just trying to understand like the dynamics between potential conservatism in the guidance or something that we should be factoring in from one half, as you have?

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

Yes. I think once again, Nicole, we've been accused of being conservative in the past. And I think even though we've had a strong first half, there still remains some uncertainty around the economy and certain Residential end markets, whether it's certainly cooperating now, it tempered second quarter results a little bit, and you saw that in our commentary about our Residential segment. But going forward, once again, I think we probably have upside in the number. But once again, we're going to be cautiously optimistic as we move forward.

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

Got it. That's clear. And then with respect to the Resi margins. So I guess, normally, margins are kind of flattish sequentially between 2Q and 3Q from a seasonal perspective. Do you guys see opportunity to improve Resi margins as we move into the third quarter because of some of those specific headwinds that you called out on the call related to 2Q?

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

Nicole, this is Alok. On the Resi margins, I was disappointed on where the margins turned out to be. So while we understand the seasonal trend, and I don't want to bake up a lot of upside in the model. From my perspective, Resi margins have a lot more room for the upside.

If you think about just the things we talked about, we need to get more manufactured margin and distributor margin to have margin performance that's much, much higher than where we are today. So I think there's a lot of room. Our pricing excellence initiative which only starts in Q3, from delivering results perspective, is going to have a benefit. Right now, the factories are building less than we are selling. So there's a clear negative absorption impact, which is going to last through the year. So we think margins are going up in the second half, and then I think same will continue in 2024 as well.

Operator

And we will 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 wanted to follow up on the Commercial margin. Joe, you said it was price/mix. I think that boosted the quarter. It seems like the second half, the guidance is more like EBIT margins in the 15, 16 range. So can you just help us bridge kind of 2Q to the second half and what's changing?

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

So obviously, we don't give really second half guidance, but implied in that, there is still some conservativeness. But what you really saw in the first half was a lot of carryover price benefit that we started to get in the second half last year. So you will see some more price benefit in commercial in the first half than the second half. But with that said, our backlog still has solid margins and they should reflect that way through the balance of the year.

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

Okay. Makes sense. And then I had a question on Resi, just the second half sales. It seems to imply maybe down 1. And it seems like what are the big drivers? Is it destock decelerating and a bit more price? Is there anything else?

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

I think those are the two right ones, Ryan, is destocking that caused most of the decline. And obviously, July weather has been a tailwind for us as we move forward. So I think those will be the 2 things I would call out.

Operator

We will take our next question from Josh Pokrzywinski with Morgan Stanley.

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

So I guess one thing I want to follow up on is, we talked about Commercial margins a little bit. Obviously, a big turn versus where we were a year ago. Alok, how much of what you're seeing today or what you're seeing this year is sort of a pull forward of maybe kind of the 3-year discussion that you originally laid out last year? Or you just had a plan by 12, 18 months? Is it more the price cost stuff, which maybe normalizes? Maybe walk us through that journey and how we should think about winning your progression from here?

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

Sure. Last year, about this time, they were at, I think, at Ryan's conference in Chicago, and we talked about $100 million. As Joe said, we have got $220 million. What happened is the price cost turned out to be better than rest as we expected. And that's because the team did a really good job kind of getting the cost benefits, getting the right kind of negotiations and repricing some of the backlog.

The upside continues from a lot of other factors, such as manufacturing. We are still below historical levels, which we talked about in terms of output. I think our factory still has a lot more room for productivity. I still feel there's a lot more opportunity for us, as Joe mentioned earlier, on getting into things like emergency replacement, which we are barely scratching the surface of.

And remember, we have a second factory that we're spending money on right now with no output. So net-net, it's not necessarily kind of pull forward, I would say. It's kind of things that just went better than we had communicated. Now clearly, when we promised 3 years, for $100 million on an external basis, our internal plan called for half of that, and now we are 6 months ahead of it. We're glad to put that $100 million behind us.

We would not be making a new commitment. But we talk about a long-term margin range of we've always said we want both segments to be in the 18% to 20% range on a sustainable basis. And that's what we're going to be focused on.

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

Okay. That's helpful. And then just transitioning to this refrigerant transitions you talked about kind of the new equipment coming out in '25. I know next year, there's a big step down in allocation for R-410A. Any sense for what you think that does to refrigerant prices or the replacement market, if folks are like, hey, this refrigerant is getting much more expensive?

Do I really want to replace something where availability is going to get tough? How do you think about that equipment transition being a couple of years away, but refrigerant gap up maybe being a little more near term, just open-ended question, anything on your mind.

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

Sure. A lot in there, and I'll tell you, we don't have a crystal ball looking into '24 yet. Each of the things that you mentioned is true, but we don't have final price on the R-410A for next year. There's always going to be an inventory draw down that we'll have to do to make sure we're not stuck with legacy R-410A beyond what we need.

And from a consumer perspective, I think this is going to be a small change. We have gone through changes before. Consumers really don't think about refrigerants. It's more going to be educating our dealers and a few consumers who are probably more well versed in this than others.

So still a lot of moving pieces. Net-net, I think there's a danger of overanalyzing this because the industry is used to these changes, we are very used to this change, our dealers are now getting used to this change. I think this is going to happen more seamlessly than we all expect with some pluses and minuses.

But as Michael said earlier, we think this helps our mix up towards in '25. But some of it might start happening in '24 if the R-410A pricing is higher, and we are like forced to increase our price in conjunction. So stay tuned, lots of moving pieces, but from a product design, dealer training and truly having confidence in the transition, I think we are way ahead.

Operator

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

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

So I guess, beating a dead horse here, but this R-454B transition. Investment spending, how does that sort of shake out through the next couple of years? I mean you talked about investment spend this year. How does that look into next year? Clearly, you don't know the mix impact that's going to be positive. But is -- from your understanding, is this an installation deadline? Or is it a production deadline? And do you think there's going to be any sort of channel impact as we transition to this new refrigerant.

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

Yes. I think this will be a situation where maybe a little bit different than the larger transitions we've had in the past, going back to the 10 to 13 SEER transition, which was traumatic for the industry. I don't think that's going to be anywhere near this as Alok mentioned, probably a little bit more seamless.

So we'll just play it out the way it is, once again, we're in great shape. We typically do very well during these transitions because we're on the leading edge of innovation. This requires a significant investment. $50 million this year, probably $50 million next year to prepare being able to factor and processes, et cetera, to make the appropriate investments. And we've made some of those investments already. And as Alok mentioned, are ahead of things.

This usually creates opportunities for us. There's typically 1 or 2 competitors that stumble, and they lease some share on the Street. So once again, we're well positioned for this transition. We're excited about what lies in front of us. And we typically win when these things come to fruition. So we're excited about what this brings forward to us.

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

And Nigel, just to add to that, it's a manufacturing date transition. But as Joe said, we don't expect significant inventory burn because the 410 is more expensive next year, the delta between a 2024 price and a 2025 price might be just like a normal price difference year-over-year. And I just don't think that's going to make a meaningful difference toward dealers' economic calculations.

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

I was just wondering, are contractors as excited as you are about using this flammable refrigerants. It seems like there was definitely some contractors out there that might be pushing the 410A next year to customers just on that basis alone.

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

There might be, and we have 10,000 dealers plus more in U.S. and we can't control. But I think overall, I think the flammability concerns a little overblown. I mean if you take a candle and blow the refrigerant on it, the candle extinguishes versus catch on fire. So this is not as flammable as like some people might fear. We have done lots of internal testing and the safety mechanisms are solid. So I think from that perspective, I believe majority of the contractors will come along with us to say, hey, this is a safe product. This is a good product, and we'll follow the rules and make the transition seamless.

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

Okay. I appreciate that, Alok. And so a quick one, just to clarify the distribution network expansion. Is that primarily Lennox store expansions? Or are you looking at -- or do you think it's been more on the independent channels?

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

It's both. I think the way we look at it is we are underpenetrated in both. On our stores, our recent focus is more around increasing output through the current stores and putting more products through that, but we are still geographically underpenetrated in North America. And on independent distributors, of course, we have a very low share. So both of those, I think we have significant expansion opportunities.

Once we get through our self-help, once we get through our growth acceleration and put the right amount of feet on the street and the process behind that. We're super excited about the expansion phase.

Operator

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

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

So just on the commercial side, so the -- I know there's like differences in comps and things like that, but Carrier reported very, very strong volume. You guys, I think, were up like 3%. You mentioned you still have yet to reenter emergency replacement. But where do you think the differences between your growth rate and theirs and anything vertical specific to talk about?

Michael Quenzer

Steve, this is Michael. Yes. So we saw total volumes up 4%. But if you look at the rooftop production out of our Stuttgart factory. That was up significantly more. So we're pleased to see that side of it. We had some obviously offsets in different products, but definitely some growth more than the 4% coming out of our Stuttgart factory. A lot of that growth that we saw on the rooftops was on the national accounts, and it was really broad-based across retail and restaurants and distributions that really saw that broad-based growth.

From an emergency replacement, although it's small, we did see a little bit of growth in the quarter, but still very small. So it's a good start to that journey as we move back into that space.

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

And I think I would start -- also say that, hey, congratulations to the Carrier team. I haven't digested the earnings, but great growth for them, and we are excited that the industry growth trend continues, and the industry overall is in good shape. I think that bodes well for us and for them.

We still remain production-constrained where we are producing less than we confirmed. So excited about continued output increase in Stuttgart and our new factory in Mexico.

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

And then just on this, since you're kind of delving into the technology here, you talked about it not being that big of a change, I think, in December, you said you now have -- I mean, you just chose your refrigerant, I guess, is what you're saying. What's the source of confidence that your technology is so much better than the other guys?

And also, why do you think you're entitled to share gains? In the last couple of years, it's been very choppy, obviously, with what's happened. A little bit of a different approach on initiatives relative to what the former CEO did over a 10-year period, a little bit different of a market like what -- where do you think your product is so differentiated versus the other guys?

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

Sure. A couple of things, right? First of all, for the past 5 years, as I said, Lennox was in a very difficult spot because our supply chain was more constrained versus others because we are more reliant on China than others. The tornadoes severely crimped our manufacturing ability, especially for the premium products. And I think the transition on leadership and CEO that obviously, while it doesn't have a direct impact, had lots of indirect impacts.

So -- but that's not important right now. What's more important is your question of why are we confident. I think our direct-to-dealer network is something that we have under leveraged, but have done a great job building up. So I think that's -- the investment that still needs to continue delivering results for a while.

Technology-wise, I mean, even in the current SEER transition, there was a lot of noise about compatibility of indoor units versus the outdoor units. A lot of new homebuilders they put indoor units first and then they put outdoor units. During the year transition, they have to go rip out indoor units if the indoor units were the older SEER compatible and outdoor units were new SEER. Ours' didn't have to make that difference because our indoor units were compatible both with the new SEER and the old SEER.

So the connection to the dealer we have, that helps us make those kind of choices and decisions. At the end, I can't tell you that our compressor is better than our competitive compressor because you buy it from the same place usually. But what we can tell you is our product design, our actual package and the choices we made for our dealers, that's what helps us gain share. The results would be probably more convincing than any of my answers. So let's wait a year or 2 and then we'll answer this question with numbers.

Operator

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

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

Look, you probably accused us of overanalyzing stuff, but that is what we do. So I appreciate Joe's comments on reiterating kind of the investment for the transition. It sounds like you clearly know what you need to do. So I think Mike kind of left Gautam's question somewhat unanswered in terms of what's your best guess on the increase in cost or selling price to customers in 2025 on the transition?

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

I think the -- well, fair enough, I'll try and give more detail of it. Part of it is we don't know exact numbers. I can give you ranges. So there's 2 things to think about. The price increase from current prices, like 2023 to 2025, and then price increase from potential 2024 price to 2025. The reason we are hesitant to answer that question is not that we are trying to be evasive, but we don't know the 2024 pricing, which could get significantly impacted by R-410 production curtailment that's going on.

I don't think it's going to be 20%. I just give you some ranges. I don't think it's 0% either. It's likely to be between 0% and 10%, putting everything together. And that's just going to help us all preserve our margins and pass on the cost through.

Going back to the over analyzing, it was actually one of the research report, which says the HVAC industry has become like analyzing storms in a teacup. So I'm not -- I actually enjoyed reading all of this, and I think I've learned a lot in my one year. And I think what we have learned is that Lennox is going to win because of our direct-to-dealer network, because we need to leverage that better, because we are really focused on one thing and only one thing, and because we are able to design our products.

Just recently, we got the design awards, and we won more awards than others. So I think that's what I've learned more is that everything else matters, but we all do it about the same. What differentiates Lennox is what was in the last page of my presentation.

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

Yes. That 0% to 10% is from '23 to '25 though, just to put that finer point on it? Or is it...

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

If you're not going to hold me to it, yes.

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

Yes. And then just a separate question. I know Joe likes to kind of link and not and yet we're conservative. But I mean, realistically, guys, like you're going to be at your 2026 guide this year, right? You're going to be at the midpoint of it, roughly. So clearly, you're signaling you think there's upside to that. But also, are you in fact signaling that maybe there's heavier investment to drive growth and therefore, we shouldn't kind of extrapolate too aggressively on margins from here. Maybe just give us a little bit more context on how you're thinking about that.

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

Sure. I think the reason I talked about the third phase of the transformation, which is beyond '26, is yes, there is a high chance that we will get to the '26 targets sooner. I won't commit to this year or next year because, I mean, our actions remain the same. So I think that's one.

On the conservatism side, listen, there are so many things that could go wrong. And historically, it has gone wrong for us in the past. So we just want to make sure that if we are wrong, we are going to be wrong on the conservative side versus being wrong on the aggressive side.

On the investment questions, no, I think, I mean our current investment rate is kind of what we expect going forward. I mean CapEx will go down going forward for sure, as the second factory is the heavy lift this year. And a lot of those refrigerant change investment is happening this year and some will happen next year. So no. And some of this is also we are lapping ourselves on incentives, on much lower incentive payouts last year.

Last year, our incentives were below target. This year, at least current math shows it will be above target. So that's where the corporate cost delta you see. But net-net, we are optimistic, and we hope to get to the 2026 targets sooner, but we know we'll get there to 2026, by sure.

Operator

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

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

Maybe just to better understand the revised price/mix, EBIT outlook of $250 million benefit. You've already done $182 million, right, year-to-date. So maybe if you can help us understand the dynamics for the rest of the year. It seems like maybe a little bit less benefit in commercial because the carryover is easing, but I mean Resi is clipping along at kind of this $40 million per quarter run rate, you just implemented PI. So just help us understand that revised guide?

Michael Quenzer

Noah, it's Michael. Yes. One of the big drivers is, as you mentioned, the carryover benefit of Commercial. So that's the odd sized difference between first half and second half. But with that said, we do have a little bit of conservativeness, as Alok said some of that would be in the price/mix category. But really, what we're focused on is the pricing excellence in Residential is new price increase that was just announced that will start to happen in the second half. And again, margins look good in the Commercial backlog. So everything looks positive for the second half on price/mix still, but guide may be a little conservative.

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

Yes. Just to double click on that, I mean how do we think about the incremental benefit of that price increase in Resi side?

Michael Quenzer

Yes. So in the last quarter, we raised our price/mix guide from $150 million to $175 million, the $25 million reflected that additional residential price increase. We already had in the previous $175 million guide.

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

Okay.

Michael Quenzer

So that's progressing well.

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

And then on the Saltillo expansion, just can you give us an update on how the timetable there looks. And then just sort of remind us or dimension for us how much that increases Commercial's revenue capacity.

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

Sure. Yes, just before the -- 15 minutes before the call, I was with the Commercial team, congratulating them on an excellent quarter, and I saw latest video feed and pictures of the Saltillo factory construction. The ground is all prepared. We have roof going up in portions of the business. We are hiring talent, some are being redeployed from our residential factory in Saltillo. Clearly, we are well on the way of ordering equipment given some of the extended lead time.

So all indications are green and solid that we will be starting production end of next year. Nameplate capacity wise, over years, it could more than double our capacity. But at the same time, we're not going to put all the equipment immediately, right? We're going to get enough land and roof space to put more, but we're going to put equipment on a judicial basis.

And the last thing we want is the industry to have overcapacity on this as well. So we're going to watch out. And as Joe mentioned earlier, this would be focused around standard products shipped by the truckload, getting into the emergency replacement, where our revenue is below what it used to be and our share is just dismally low. And we have a huge opportunity to use our distribution network to increase that number. So we are very excited and all systems go there.

Operator

And we'll go next to Joe Ritchie with Goldman Sachs.

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

So maybe just along the lines of Jeff's question earlier and just trying to think about these commercial margins. I know that it was only just a few months ago that you gave us that 19% to 21% long-term target. But first half of the year, you guys are already there and actually slightly above it. I'm just curious, like how do you kind of think about the trajectory of the margins then from here after that business, maybe even beyond 2023.

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

I think our next Investor Day is going to be 2024, and we love to update you on our long-term targets. There's a lot going well, but I keep in mind that a lot could go wrong as well. I think one quarter doesn't make a trend. I mean it's a great sign of our progress. I think the team has done an excellent job, but we need to leave some room for things could slide different ways.

Net-net, listen, we are not doubting anything you're saying. I think we need to be cautious and not get ahead of ourselves in where we are in the journey.

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

Yes. No, that's fair. And look, it's a good position to be in -- to be able to already -- be ready to update those targets. So congrats on the progress there. I guess maybe my quick follow-on question. The piece of your business, the quarter of your business that goes through independent distribution. I think you guys said it was down 20%. How much were volumes down versus the pricing that came through in that business?

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

Well, volume on that one is a little messy because remember, we sell a lot of coils in that business. So I think that kind of often skews the volume number for us in a negative way. But in general, I would say they were more -- they were slightly better than what you would look at on the AHRI data. I mean you guys all look at the AHRI data. So I think we did better than what you saw in the AHRI data, but slightly better.

Operator

And we will take our next question from Joe O'Dea with Wells Fargo.

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

I wanted to just start on the Commercial manufacturing, you've sort of noted that there are still further manufacturing improvements to make in the back half of the year. Any details around that, that you could outline for us any major sort of goalposts there? And what's the time line for when you expect factory output to hit targeted levels?

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

Sure. You did a very good question on that. Listen, when we started the year, we hardly had any production in January because we were taking some drastic improvement actions. We rationalized 65% of our SKUs. We looked at different lines and reconfigure the line to make the products that give us the best way to serve our customers. So starting from almost 0 in January until the end of the first half, we have reached progressively higher numbers and are starting to hit daily rates that are kind of consistent with what the factory used to do in the past.

I think of first half as kind of in a linear progression from 0 to getting to the rate and second half, I think that we've got to obviously maintain rate and continue driving the improvements going forward. The team is doing well there. I mean, our labor challenges are behind us. We are no longer struggling to track labor. I would say, supplier challenges are kind of 75%, 80% behind us.

We still feel like we are playing whac-a-mole sometime, but we have done a good job at getting dual source supplier or working with our suppliers to better communicate and build the appropriate buffer and transportation. So things are going well. It could go better the way I look at it.

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

Got it. That's helpful. And then just circling back to the 25.3% commercial margin, how does that compare to kind of internal expectations for the quarter? And then when we think about seasonality going forward, I mean, any sort of variances to be mindful of versus typical seasonality in the back half?

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

Yes, I could tell you my answer, but I'll hand it over to Michael to answer the rest. Yes, listen, my expectations are always higher than the team delivers. So put that aside, like I think Michael can give you a better answer on that.

Michael Quenzer

Obviously, the speed of the recovery is a little faster than expected and a lot of this on the price/mix benefits that we're pleased to see that side of it. But it was a little better than what we had expected, mostly just because of the price/mix speed of recovery that we saw.

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

And then on the seasonality that you inquired about, there's always a natural choppiness in the commercial business because of a lot of its project nature. It doesn't really have the perfect seasonality that we sometimes see in our residential demand patterns. So I'll just leave that out there. Sometimes the second quarter can be a little bit more of a leading quarter for us than the third quarter, but it all depends on projects.

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

But nothing non-repeat really in the quarter to be mindful of in terms of sort of comp into the back half?

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

No.

Operator

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

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

For anyone overly sensitive, definitely, the tea cup comments were not meant to denigrate diligent work. In terms of, I suppose, sort of diving in on the...

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

Julian, I sort of enjoyed that comment, and I used that offense. I thought it was a great way to look at bigger picture, while continuing to analyze the storm in a tea cup.

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

Yes, we'll see how the Resi cliff plays out, I suppose. But the -- in the very, very short term, are we sort of -- kind of it was in 2025. But are we trying to think about Resi HVAC volumes in your guide, you're assuming sort of down low double-digit third quarter and then down sort of low singles in the fourth quarter. Is that the way to think about it year-on-year?

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

On the indirect side, maybe, but no, not on the overall basis, our volumes are not down that much. And I know if you look at the current bridge and we showed 12% on the Resi side, Julian. And you got to keep in mind, that's probably the worst that you would see during the year. As we go toward Q3, we think the number just gets better from there on.

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

Okay. So even with the destocking in Q3, it's still a narrower year-on-year decline then?

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

Exactly, exactly. So I think some destocking start happening in Q3, very little. And we do think destocking is decelerating, as we mentioned in the comment. So I would look at that number being much lower in Q3 and then Q4.

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

That's perfect. And then I just wanted to put a finer point on the core sales guide of sort of up 3% total company for the year. Did you clarify the price/mix tailwind within that? I see the price/mix EBIT guided benefit, but just wondered if you clarified any revenue benefit from price/mix in that sales guide?

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

We did not. I think a lot of that is -- there are so many different types of mix in there. I mean we look at channel mix, we look at products like equipment versus parts versus coil. We look at, obviously, mix based on the SEER. We did say that about half of the mix benefit in residential was because of SEER and the other half was all the other factors in there. So still a lot of uncertainty out there, but we are pleased with where we are in July.

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

That's helpful. And one last quick one. Commercial backlog, how do you see that moving from here? I understand that lead times should normalize. Does that put much pressure on the backlog or the end markets are sort of strong enough it should stay stable?

Michael Quenzer

Julian, this is Michael. Yes. So we saw our lead times improved 50%, and obviously, our backlog didn't decline that much. So order rates continue to remain strong. Everything we see on plan, replacement for national accounts still remains strong. So really no indication yet of a backlog decline except for just because of lead times are shortening.

Operator

Thank you for joining us today. Since there are no further questions, this will conclude Lennox's Second Quarter Conference Call. You may disconnect your lines at this time, and have a wonderful day.
