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LII.N - Q1 2022 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 1Q22 revenue of $1.01b, GAAP operating income of $112m and GAAP EPS of $2.29. Expects 2022 revenue growth to be 7-11% with neutral FX and GAAP and adjusted EPS to be $13.50-14.50.

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PRESENTATION

Operator

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

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

Thank you. And it sounds like we have some music. Okay. We're good. All right. Good morning, everyone. Thank you for joining us for this review of Lennox International's financial performance for the first quarter of 2022. I'm here today with Chairman and Interim CEO, Todd Teske; and CFO, Joe Reitmeier. Todd will review key points for the quarter, Joe will take you through the company's financial performance and outlook for 2022. To give everyone time to ask questions during the Q&A, please limit yourself to a couple of questions or follow-ups and requeue for any additional questions.

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

The webcast will be archived on the site for replay. We'd like to remind everyone that in the course of this call, to give you a better understanding of our operations, we will be making certain forward-looking statements. These statements are subject to numerous risks and uncertainties that could cause actual results to differ materially from such statements. For information concerning these risks and uncertainties, see Lennox International's publicly available filings with the SEC. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Now let me turn the call over to Todd Teske.

Todd J. Teske - *Lennox International Inc. - Chairman of the Board & Interim CEO*

Good morning, and thank you for joining us. It's great to be here on the earnings call today to review the quarter with Joe during the short interim period until Alok Maskara's start date as Lennox International's new CEO on May 9. Many of you already know Alok, over the course of his career from McKinsey to GE to Pentair and then as the CEO of Luxfer. In the coming weeks and months, you'll have an opportunity to reconnect with him or to make introductions.

We are excited to have Alok join us to lead the company as we continue to focus on driving growth and profitability to maximize shareholder value. Along with his impressive experience and proven track record of successfully operating businesses through various economic challenges over 25 years, we see Alok is a great fit with the performance culture of Lennox. With his background and experience, Alok was the candidate during the search process that rose to the top of an outstanding slate of candidates. Alok recognizes the firm foundation that's been built at Lennox. And I thank Todd Bluedorn for his 15 years leading the company, and we look forward to the next chapter in the company's history.

Turning to the near term. Let me start with some highlights on the first quarter of 2022, a record first quarter for revenue and earnings per share. Company revenue in the quarter was up 9% to a first quarter record of $1.01 billion. GAAP operating income was $112 million, down 2%, GAAP EPS was a first quarter record of $2.29, up 4%. Total segment profit for the first quarter was $115 million, down 1% and total segment margin was 11.3%, down 110 basis points.

Adjusted EPS was a first quarter record of $2.36, up 4%.

The record first quarter for Lennox International was driven by our Residential and Refrigeration businesses, which both set new first quarter highs for segment revenue and profit. In Residential, revenue was up 11% to a first quarter record of $682 million. Replacement and new construction were both up double digits. Residential segment profit was up 12% to a first quarter record $108 million. Segment margin was down 10 basis points to 15.8%.

In Refrigeration, revenue was $144 million, a first quarter record adjusted for historical divestitures. Revenue grew 15% as reported and 18% at constant currency led by more than 20% growth in North America. European Refrigeration revenue was up low single digits as reported and up low double digits at constant currency. And Europe HVAC revenue was up high single digits as reported and up mid-teens at constant currency. Refrigeration segment profit rose 78% to $14 million, a first quarter record adjusted for historical divestitures.

Segment margin expanded 350 basis points to 9.8%.

Turning to our Commercial business. Demand remains strong, but our commercial operations continued to be impacted in production by labor constraints and global supply chain disruptions. Commercial revenue was down 6%. Segment profit was down 77%, and segment margin contracted 1,040 basis points to 3.4%. More about this in a moment, but further breaking out revenue. Commercial equipment revenue was down low double digits. Within this, replacement revenue was up low single digits with planned replacement up more than 20% and emergency replacement down more than 35%. New construction revenue was down more than 30% in the quarter.

Breaking out revenue another way, regional and local business was down mid-teens. National account equipment revenue was down mid-single digits. On the service side, Lennox National Account Services revenue was up high single digits. A few points to make on the performance of our commercial business. Given the business mix to national account customers in a constrained environment, mix was up as was price, but price increases took longer to work through, given contractual obligations, causing inflation to run ahead of the price benefit in the commercial business currently.

We announced another price increase of up to 9% for our commercial business effective May 2, and we will continue to layer in additional price this year. We continue to see additional inflationary pressures in commodities, components and freight and the global supply chain disruptions continue to create factory inefficiencies along with lingering labor constraints.

Our commercial business continues to be challenged by supply chain disruptions that has adversely impacted production more than our other businesses. There are unique components in the commercial equipment primarily electronics and controls to name just a few, that distinguish it from our other businesses where we are experiencing abnormal delays even for these times. For all of our businesses, lead times in the supply chain continue to lengthen. However, they have been especially disruptive in commercial's configure-to-order environment. We do not know all the components required for units production until you get all of the specifications of the products configuration from the customer.

Our sourcing, engineering and manufacturing teams continue to collectively address supply chain disruptions by working closely with our suppliers and assisting them in addressing their delays, increasing safety stock, rapidly qualifying new suppliers, and expanding the supply base along with in-sourcing and substitution where feasible. Even with the actions we continue to take, there are still unavoidable extended lead times for our commercial configure-to-order products due to delays in the supply chain for certain components.

With respect to labor constraints in Stuttgart, Arkansas and surrounding areas where we draw from -- for direct labor, Unemployment is at historical lows, 3% or less. We have been experiencing unprecedented employee turnover in our commercial factory. Part of the turnover stemmed from late last year and early this year as we navigated the COVID-related disruptions affecting our commercial facility, many COVID-exposed employees elected not to return to work at the factory. In addition, our utilization of overtime to overcome production disruptions also impacted employee retention.

To ease labor constraints at our Arkansas factory, we have raised wages to attract a broader pool of talent in a very tight market and make Lennox the employer of choice in that area. In addition to raising wages, we have instituted static scheduling in the factory that will ease demands for significant overtime on direct labor and create a better work-life balance for our factory employees. We expect the actions we've taken in the factory of increasing wages and stabilizing the work schedules for our factory employees to significantly reduce absenteeism and improve employee retention easing the labor constraint, that along with supply chain disruptions is resulting in commercial manufacturing delays.

Our commercial team continues to work diligently to overcome these disruptions with the primary focus of taking care of our customers. For the company overall, price is pacing ahead of commodity component and freight pressures, and we expect that to continue through the year. In the first quarter, the company captured $85 million of price for a 9% yield compared to $58 million of material and freight headwind in the quarter. Joe will talk more about it in the 2022 guidance, but we now plan to capture approximately $335 million of price this year compared to prior guidance of $235 million with a focus on staying ahead of inflationary pressures.

For the company overall, in 2022, we are raising revenue growth guidance from 5% to 10% to a new range of 7% to 11% and we are reiterating EPS guidance of $13.50 to $14.50 for the full year. We are reiterating plans for $400 million of stock repurchases in 2022 as we drive toward another record year led by the strength in our residential and refrigeration businesses.

Now I'll turn it over to Joe for more detail on the first quarter and our outlook.

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

Thank you, Todd, and good morning, everyone. I'll provide some additional comments and financial details on the business segments for the quarter, starting with Residential Heating & Cooling. In the first quarter, revenue from Residential Heating & Cooling was a first quarter record $682 million, up 13%. Volume was flat, price was up 11% and mix was up 2%. Foreign exchange was neutral to revenue.

Residential profit was a first quarter record $108 million, up 12%. Segment margin was 15.8%, down 10 basis points. Segment profit was primarily impacted by favorable price and mix. Partial offsets included higher material, freight and warranty costs, global supply chain disruptions and factoring inefficiencies, lower joint venture income, distribution investments and higher SG&A.

Now turning to our Commercial Heating & Cooling business. In the first quarter, commercial revenue was $188 million, down 6%. Volume was down 16%, price was up 3% and mix was up 7%. Foreign exchange was neutral to revenue. Commercial segment profit was $6 million, down 77% and segment margin was 3.4%, down 1,040 basis points. Segment profit was primarily impacted by lower volume and factory inefficiencies due to labor constraints and global supply chain disruptions, higher material, freight, distribution and other product costs and higher SG&A. Partial offsets included favorable price and mix.

In Refrigeration, revenue was up 15% to $144 million, a first quarter record adjusted for historical divestitures. Volume was up 11% and price was up 8%. Mix was down 1%. Foreign exchange had a negative 3% impact on revenue. Refrigeration segment profit rose 78% to $14 million also a first quarter record adjusted for historical divestitures. Segment margin expanded 350 basis points to 9.8%. Segment profit was positively impacted by higher volume and favorable price than a year ago. Partial offsets included unfavorable mix, global supply chain disruptions and higher material, freight and SG&A costs.

Corporate expenses were $13 million in the first quarter compared to $16 million in the prior year quarter. Overall, SG&A was $155 million in the first quarter or 15.3% of revenue down from 15.6% of revenue in the prior year quarter.

Regarding special items, the company had net after-tax charges of $2.5 million in the quarter. Net cash used in operations in the first quarter was $98 million compared to $18 million in the prior year quarter as working capital increased primarily due to sales growth, increasing accounts receivable as well as inventory increasing due to mitigation strategies to combat supply chain disruptions, along with inflationary effects year-over-year on product costs.

Capital expenditures were approximately $25 million in the first quarter compared to $24 million in the prior year quarter. Free cash flow was a use of $123 million for the quarter compared to a use of $42 million in the prior year quarter. And seasonally, we tend to use cash in the first half of the year and generate cash in the second half. The company paid approximately $34 million in dividends and repurchased $200 million of company stock in the first quarter. Total debt was $1.61 billion at the end of the first quarter, and we ended the quarter with a debt-to-EBITDA ratio of 2.4. Cash, cash equivalents and short-term investments were $40 million at the end of the quarter.

Before I turn it over to Q&A, I'll review our outlook for 2022. Our underlying market assumptions for the year remain the same. We expect the industry to see low single-digit shipment growth in residential and mid-single-digit shipment growth in commercial unitary and refrigeration markets in North America. We are raising 2022 revenue guidance from 5% to 10% to a new range of 7% to 11% with neutral foreign exchange. And we are reiterating our guidance for GAAP and adjusted EPS of $13.50 to $14.50.

Let me now run through some of the other key points in our guidance assumptions and the puts and takes for 2022. First, for the items that are changing. With the second round of price increases announced for 2022, we now expect price to be a benefit of $335 million for the year, an 8% yield and this is up from our prior guidance of $235 million. Some headwinds that have increased in our guidance, we now expect approximately $140 million headwind from commodities, which is up from $110 million previously. We now expect a net headwind of approximately $70 million from components, up from a net headwind of $30 million previously.

And guidance for factory productivity is slipping from a benefit of $20 million to flat for 2022. And freight is now expected to be a $15 million headwind for the full year, up from a $5 million headwind previously. Tariffs are now expected to be a $5 million headwind compared to prior guidance to be neutral, and we expect the weighted average diluted share count for the full year to be at the low end of our prior guidance at approximately 36 million shares, which incorporates our plans to repurchase a total of $400 million of stock this year.

Now for the guidance items that are remaining the same. We are guiding for residential mix to be neutral and we will assume neutral foreign exchange. We will be a more normal run rate with distribution investments this year with 30 new Lennox stores planned and SG&A is still expected to be up $45 million this year, including our investments in R&D and IT.

Now for a few final guidance points. Corporate expenses are still targeted at $95 million. We still plan for capital expenditures to be approximately $125 million this year. And finally, free cash flow is still expected to be approximately $400 million.

And with that, we'll go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we move first to the line on Nicole DeBlase with Deutsche Bank.

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

So maybe just starting with the challenges that you faced in commercial HVAC during the quarter. I guess you provided some color around what you've done to fix the margin. But how quickly can we start to see that come through with a very like rapid snapback in margin performance starting in 2Q? Or do you think it will take time to kind of execute and return to prior margin levels like throughout the year?

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

Yes, I think it's going to be a couple. It's probably going to take a little bit more time, Nicole, but we're battling things on 2 fronts. One is the supply chain, which obviously everyone is challenged across the industry and we'll continue to do what we need to do there to make sure that we're taking appropriate steps and minimizing the disruptions in the factory.

The second is more in our control, and that's the recruiting necessary to get our direct labor headcount to a level where we can continue to increase production. And quite frankly, in the first quarter, that was a limitation on the commercial business, which was getting product out of the commercial factory.

We have more product come out of the fact that we'll be able to fix it. What we would expect to see would probably be improvement by the end of the second quarter because it will take a little while to get those folks in the factory, train and productive on the factory floor. So once we're on the other side of that, it will lend itself to hopefully, what we're expecting is improved profitability in the second half of the year and back on the trajectory of achieving their 3-year long-term target margins.

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

Okay. Got it. That's helpful. And then I guess, the resi strength that you guys saw in the quarter, obviously getting a lot of questions from investors about the sustainability of that. Is there anything you can share with respect to order activity later in the quarter and into 2Q to give some confidence that this isn't just a pull forward of channel inventory restock?

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

Yes, Nicole, I think the overarching comment that I would make about Residential's continued strength. Early in the quarter, we were challenged even in our Residential business, with component shortages. Now that improved as we got through the quarter. And March was an exceptionally strong quarter for us. We do expect that momentum to continue. What we see in our order rates and our backlog, to the extent that you can have a backlog in Residential is order demand very strong.

And we're also coming off of a very tough comp last year where we were up 37% in that business. So overall, a record start to the quarter. It's seasonally our lightest quarter. We're over the hill, but we have them out in front of us, but we still expect to see strength in Residential and quite frankly, also Refrigeration for the balance of the year.

Operator

And next, we go to Julian Mitchell with Barclays.

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

Thanks, Todd, for the interim update. In terms of, I suppose, just a question around kind of the cadence of earnings through the year. The operating margins, I think, for the year as a whole are guided to grow slightly, and they were down 110 bps in the first quarter year-on-year.

So just trying to understand operating margins, do we assume they're down again year-on-year Q2 and then you get sort of 30% plus leverage in the second half to get the operating revenues up for the year overall. And when you're thinking about earnings kind of seasonality or EPS seasonality, are we thinking of sort of a 50-50 type first half, second half split?

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

Yes. As you know, Julian, it's been a while since we've had a normal year going back to the tornado and then right into the pandemic and here we are today. So I think you nailed it. I think when you look at our earnings seasonality, what we expect this year, it's going to be closer to 50-50. We had an extremely strong start last year in the first half, where we were up more than 30% in our Residential business, for instance. Margins continue to grow, and then things became more challenging in the second half. So comps in the second half of the year should ease a bit, but we would expect margins to be up for the full year.

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

And then just a follow-up maybe on that point around the resi market overall. And yes, depending on which macro data you look at, some of it suggests there is a lot of inventory out there, not necessarily in Lennox's channels, but perhaps more broadly in the market, your own inventory and the cash flow statement had a big outflow in Q1.

I suppose because of the anticipation of further good volume demand in Q2, but just wondered your assessment of that the aggregate sort of selling sell-through dynamics kind of in the marketplace, your own channels may look quite lean, but are you worried about the broader kind of inventory pressures out there?

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

Yes. When I talk to the folks in our Residential business, what we are hearing is that distributors are hoarding a little bit of inventory for fear that they will not be able to meet end market demand and eventually be able to sell that product regardless. And then dealers quite frankly, aren't hoarding as much inventory. Typically, they'll let distribution carry more of that inventory load. And we think that they're adequately supplied at this point.

Our inventories still remain lean. As you know, as we entered this year, we were pretty well depleted of finished goods inventory in our Residential business because of strong demand. So high-quality problem. We're addressing that as well. So looking forward, I think inventory in the channel depending on which channel you look in, once again with 2-step distribution, distributors continue to take on additional inventory and dealers are more at, what I would characterize as a normal level of inventory for what they need.

Operator

And we go to the line Jeff Hammond with KeyBanc.

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

So on the -- just back on the commercial business. I guess anything you're thinking about doing different structurally for this business? It just seems like, yes, the labor issues have kind of ebbed and flowed for multiple years now. And I'm just wondering if makes sense to diversify beyond Stuttgart or how to think about that business differently long term.

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

Yes, great question, Jeff. We routinely evaluate our business strategies, and that includes our manufacturing print, specifically in our commercial business, where we have 1 physical manufacturing location. We believe that a multilocation manufacturing strategy could be beneficial to add capacity, to support growth, provide manufacturing flexibility, as you mentioned, and with cost in line, quite frankly, add to profitability going forward. So given the current challenges in our Stuttgart facility and expected growth of the commercial end markets, our commercial manufacturing strategy is definitely on the table. So I would just encourage you to stay tuned on that front.

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

Okay. Great. And then you guys always give the market color and I think the trend has been you guys are kind of been outperformers, but I know you've taken a pause on kind of new store growth until this year and some of the issues around commercial. But maybe just relative to low single-digits units in resi and the mid-single-digit growth in commercial, just level set us on maybe how you think you perform in line or underperform those kind of market metrics.

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

When I talk to the folks once again in our Residential business and look at the industry data that we have to date, it looks like we're relatively flat on share. So I wouldn't read into the first quarter dynamics too much other than the fact that we're able to give price. We continue to combat the supply chain challenges, but we're more effective in that in our residential side of the business. And as far as end market growth, as I mentioned previously, it remains strong. When you look at the order rates that we're continuing to see, both in our direct-to-dealer business, along with our 2-step business.

Both were up. Quite frankly, Lennox was up revenue-wise, low teens, as I mentioned, but our Allied business was up high teens. Once again, getting back to the comments that I made about the differences of inventory levels in each of those channels. But overall, for the commercial business, we continue to see steady demand. We're not seeing any of the indications of end market challenges like you might see if the market was ready to turn, meaning a mix down in our equipment business or product and supplies that outpace equipment growth. So all the indicators of continued strength in residential remain intact. And once again, we're excited about a record-setting first quarter start and what lies ahead for us in the balance of the year in our Residential business.

Operator

And we can go to Gautam Khanna with Cowen.

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

Joe, you made a comment with respect to potential changes over time in the commercial manufacturing footprint. But I was wondering maybe just more broadly, if you guys could talk to any changes you expect under the new leadership and whether it's portfolio, whether it's strategy or anything else. I mean, it's a well-run company. It's okay to say that you're not expecting much. But I'd love your opinion on that.

And then the second thing, just on the transition of CEO where Todd left before Alok could join. Was that the plan all along? And is there any risk that we should be thinking about? Because that's a question we've gotten from investors that there hasn't been much -- there is no overlap. So yes, just wondering how we should think about that.

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

Sure. I appreciate that question. Let me take the second half of your question first, and then we'll go back to the first. So essentially, we did not -- we did plan to have some overlap. However, the way that timing all worked out with the search and ultimately, with Todd, he had another opportunity that I think some of you may have seen now, got announced several weeks ago. And that's really what drove the situation with me being interim and then not having a lot of overlap with Alok.

However, I would tell you that even though Todd is now somewhere else. The fact is I have his phone number, and I'll give his phone number to Alok, and he made it abundantly clear that he is happy to take any questions or help in any way he can with the transition of Alok coming in. So ultimately, we hadn't planned it that way, but given timing and personal commitments, that's ultimately the way it shook out. I think at the end of the day, it's -- everything is working out well. The team here is exceptionally strong. And so I think I know Alok is rolling into a very solid situation, a team that is high performing. And as you point out, has really executed well over time.

With regards to the first part of your question and should you expect any changes. As we went through the whole search process, the one thing we made sure -- we want to make sure of is a couple of things. One is culture. The culture here is a really high-performing culture, and we did not want to lose that at all. And so one of the things that was really important to us as we review candidates, interviewed candidates was how will they fit with the culture. And Alok clearly rose to the top as it relates to that. We also wanted to make sure that there was experience at scale.

And Luxfer is a smaller company, but certainly Alok's experience at Pentair running over a $2 billion business, provided experience at scale. And so those 2 things, along with now what we've asked them to do when it gets here on May 9 is take the first 100 days and learn. This company is operating very well. Obviously, we've got some challenges in commercial, but the team is well aware and is executing on those challenges to alleviate those challenges. And so ultimately, we want to make sure that we're taking a fresh look at the various opportunities that might be out there without losing the foundation of what we've built. And so ultimately, it will be up to Alok to come in, do a review of the business, come back to the Board and give his observations, recommendations. And then ultimately figure out what the next chapter for Lennox is going to be.

And so we're really excited. I'm very excited about Alok coming in and joining the company and ultimately look forward to what the next chapter is. Is there anything imminent that's a significant shift? Of course not because Alok has to come in and ultimately learn the business even better than he has already. He's done a lot of homework already and come back and give us his observations and his recommendations.

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

I appreciate that. And Joe, just to follow up on an earlier comment you made. You haven't seen any erosion in mix despite the price hikes and all that. Has there been any improvement in the mix? I know you mentioned in the past quarters, the electronic components are more sophisticated on the higher SEER units as the bottlenecks in that part of the portfolio subsided a bit. Did you actually see a better mix in Q1?

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

Yes. Residential mix was up modestly. Roughly 1%, but we're not seeing the erosion. One of the things, as you mentioned, Gautam, we're limited because of production on the high end. The more sophisticated electrical components are more difficult to get, and that's limiting availability for instance of 28 SEER, and obviously, our commercial products. So that's where we're seeing some of the constraints, but mix overall was slightly up when you look at it year-over-year.

Operator

And in line with Tim Wojs with Baird.

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

Maybe just on price. I guess as you think about the pricing contribution between the different segments, how would you kind of distribute I guess, both the incremental price and just maybe kind of the pricing contribution by segment for the entire year?

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

Yes. I think as you would expect, it's more heavily tilted towards the residential segment. I would expect their yield to be slightly higher than the company average. Company average will be closer to 8. I would expect Residential to be north of that 9. I expect Refrigeration to be on par with that. And then commercial, given some of the challenges we're experiencing there and the typical time delays of acquiring price versus cost actions. I expect that to be slightly below the company average.

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

Okay. Okay. And then what would the carryover impact for next year be? Do you have that number?

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

I'm trying to get through the first quarter -- or excuse me, the second quarter now, Tim, to be honest with you. So we haven't really figured that out. But similar to what we experienced this year, there certainly will be some carryover pricing. The price increase that we just announced will be effective early May.

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

Okay. Okay. Good. And then just as you think about the transition with the SEER regulations in 2023, I mean, what are some of the kind of internal activities that Lennox is doing just make sure you're kind of ready for that transition when it snaps the line at the end of the year?

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

Yes, those things have already been executed, and we're ready to roll, quite frankly. And it's the 23 -- yes, the 23 regulatory change that affect both commercial and residential. I think one of the unique dynamics we have this year is with the challenges with the supply chain. I think most OEMs are going to shift towards the new minimum efficiency product and probably make minimal investments in those units that are being phased out. And it's different depending on where you're at. For instance, on Residential, in the north, it's on the manufacturer date. In the south, it's on the installed date. And then with commercial, it's on the manufacturing date as well. So we do have some flexibility there, but I think there's some limiting things that will affect the way that OEMs behave, given the supply chain challenges.

Operator

And next, we can go to Brett Linzey with Mizuho Americas.

Brett Logan Linzey - *Mizuho Securities USA LLC, Research Division - Executive Director*

Just wanted to come back to the commercial business. And just trying to reconcile some of the pieces there underpinning the activity in the quarter. And specifically, the new construction, down 30%. And I would think the system configuration is similar in terms of procuring parts. So I'm just curious what's driving the weakness there? Are you seeing any share shift, projects moving around? Any color on that new construction pocket?

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

Yes. I think it's a conscious effort to focus on our national account customers and their planned replacement activities and also the verticals that we're serving. So it's a situation where we've concentrated our efforts in production on making sure that we're preserving the core of the business and protecting the share that is most sticky. And quite frankly, I think that's lending itself to the commercial new construction numbers being down as significantly as it was. So I don't know if it's necessarily a market dynamic more than it is a conscious effort on our part to preserve the core of our commercial business.

Brett Logan Linzey - *Mizuho Securities USA LLC, Research Division - Executive Director*

Okay. Understood. And I appreciate the moving pieces on the cost inputs. But at the segment level on a full year basis, what are the incremental margins you're assuming for residential and refrigeration?

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

Yes, we don't give specific business unit guidance, so I'm not going to go down that path.

Operator

And next, we can go to Nigel Coe with Wolfe Research.

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

So on the share losses in emergency replacement and commercial, and it feels like some of the component shortages are getting into some of the share in residential as well. How confident are you that once you get beyond these constraints that you can regain that share?

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

Once again, I think our strategy has been to protect the core of the business where the share is most sticky, and that's with our National Account customer base. We feel, provided the success factors in emergency replacement are having the right product at the right place at the right price.

And once we are able to get through these challenges of direct labor in the factory and then hopefully, improvement in the supply chain, we think we can retain that share pretty quickly. So that will be it. We'll aggressively attack share once we've navigated some of the challenges that we have in the factory and we get more product out of that factory.

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

Okay. Great. And then the inventory buildup. I know we've touched on this in the Q&A already, but I'm sure that was by design, you've been running a little bit lower inventory through 2021. Was that build up really in -- mainly in components, so work in progress, finished goods? I mean, any sense, any color on that?

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

Yes, it was really across the board with to varying degrees. And what I mean by that is when you look at our raw materials, there's 2 things in that number. One is slightly more volume, but also the value or inflationary effects have impacted that as well. And then with some of the challenges that we've had in our commercial business, we have a higher work in process category than normal where we've got goods that have been semifinished and we're waiting for final components to come in so we can finish that. And that's driving some of the build that you see in the inventory numbers, specifically in the commercial business.

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

Right. Right. And then just housekeeping. The labor inflation that you talked about, is that in the productivity bucket in your guidance bridge? Would that be elsewhere?

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

No, it's in the productivity. Yes.

Operator

Next, we go to the line of John Walsh with Credit Suisse.

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

I appreciate you taking the questions. Maybe the first question, we've talked a little bit about the manufacturing strategy at commercial. I'm just curious, you've obviously done some automation in your residential factories, I think, particularly down in some of your Mexico facilities. But can you just talk about, is there a difference between resi and commercial and how much you can actually automate versus actually requiring a higher labor component to build the unit?

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

Yes. I think when you look at our conversion costs, it's typically 15% or less of cost of good manufacturing and the labor component is roughly half of that number. It's fairly consistent when you look at Residential and Commercial, might be a little bit more Commercial given the configure-to-order nature of the product versus the homogeneous products that we manufacture in Residential.

But there's opportunity for us to do more with automation really across the entire portfolio. It's just a matter of us selecting and prioritizing those investments. And we've done things along the lines of auto brazing, so certain high impact manufacturing activities, we've tried to make investments in to improve quality and throughput. And we'll continue to look for opportunities to do that along with examining our geographic footprint.

Todd J. Teske - *Lennox International Inc. - Chairman of the Board & Interim CEO*

And John, the only thing I would add also is that what the company has been very good at is balancing off capital versus labor. Obviously, capital is fixed. Labor is not necessarily fixed. And so one of the things that becomes important at -- and we've got some really great manufacturing engineers in this company that as labor inflation continues, wage inflation continues, obviously, the robotics side of things, and the automation side of things, the trade-off may become more balanced to automation and robotics and things like that.

Again, not assuming that the inflation doesn't continue to ramp up in that area as well. And so the team is always looking for opportunities to deploy the right amount of capital and maintain the right amount of fixed versus variable in the business so that we don't become imbalanced.

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

The punchline is, John, yes, we'll continue to look for those opportunities and there are additional opportunities for automation among other things in our manufacturing strategy.

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

Great. And then maybe just a housekeeping here. Can you talk about the furnace sales and if that helped the mix in Residential? And then lastly, just heat pumps. As those roll through, does that impact your mix? Or does that impact your price when you give the...

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

Yes, it could affect both because we've raised prices on it, so there will be a price element. And then furnaces are some of our higher-margin products. So yes, it will affect mix favorably as well.

Operator

Next, we go to Steve Tusa with JPMorgan.

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

Yes. I guess I'll save the spirited debate on the cycle for the new CEO. I'll spare you, Joe. So just on the pricing on resi, any major difference between the independent and the captive on the realized price side?

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

No, we are able to capture price almost at the same level in both of those channels.

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

Okay. That's helpful. On the commercial new construction, what do you think the market actually was there in the quarter? You guys were down 30. I don't think the market was down. Was the market actually up in the quarter on commercial?

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

No. Once again, I think commercial new construction may have been flat to slightly down, I think, for the quarter. Once again, Steve, this is for the verticals that we serve. So that's what we saw was flat to slightly down. We were down more significantly once again due to the conscious effort to focus in other areas of the business.

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

Right. I just wanted to make sure I had a kind of magnitude there. And then just on the labor inflation side, what is it actually like taking to get people into the factories. Like what kind of cost increases are you having to -- and then benefits you're having to kind of like provide to kind of get people to come to work? I'm curious from more of a not necessarily a Lennox perspective, maybe just more macro. What is that actually taking to get people to come?

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

Yes. And it's a bit of a unique situation in the area of Arkansas, where we do business because it's a geography with a declining population and unemployment of 3% or less. So it's a situation where you've got a very tight labor market to begin with. Our wages historically have been at market. But as you can imagine, working in a manufacturing facility and the demands of overtime have resulted in us having more volatile employee schedules than I think our employees have a tolerance for.

And then the demographics of the folks that we were hiring more recently have been those that had less than 5 years' work experience, and most of them were unemployed. So we had to raise wages above market. We went as high in certain areas as high as 25% above where we were previously with the expectation that, that would open up a broader pool of candidates for our Arkansas facility.

And early reads are when you look at the demographics of the folks that are now applying for jobs in that facility, those folks have more than 5 years' work experience and a lot of them are currently employed. So it's doing exactly what we wanted it to do was to broaden the pool of talent that we can pull from and hire folks with a little bit more experience and probably a little bit more career-minded folks in our manufacturing facility there. So those are the steps we've taken. They came with the -- once again with a price, but we think over time, we'll cover that with productivity initiatives in the factory along with incremental price increases over time.

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

And Joe, you're talking specific to Arkansas. The broader question, Steve, basically, we're not at those kind of levels in the rest of the organization. So what we're seeing is typically what others are seeing in the market. And we are at market in the rest of our operations. And so we're not seeing anywhere near what we had to do down in Arkansas. That was really specific to that Arkansas plant.

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

Got it. That's too bad for Joe and Steve. On -- one last one for you, Todd. I think this is kind of a fair question to ask, given you're on the Board here and obviously, overseeing strategy. Does the new CEO have -- I think he took a pretty big swing in his prior employer early on strategically kind of with the portfolio. I mean, does he have kind of a green light to do something major strategic? Or is Lennox still going to be really just a core HVAC business and putting Refrigeration aside. Is there kind of a green light strategically here to do something material?

Todd J. Teske - *Lennox International Inc. - Chairman of the Board & Interim CEO*

So let me go to the premise of your question, Steve. And I'm not totally familiar with everything that happened at Luxfer but explaining someone else's business is always fun. The -- when you go back to Luxfer when Alok took over, he needed to take a big swing. The company needed a lot of work. It was really a transformation and there was restructuring and everything else from what I understand that needed to be done. That's very different from where we are here at Lennox.

So the fact that he took a big swing shows that he's got the courage to do what needs to be done. At the same time, I would tell you that as he comes in and learns and really immerses himself and assimilates himself into the industry, the company and obviously our team, we want his unvarnished observations and his recommendations.

And so over time, the company has talked, and I know we've -- there's been a lot of discussion at conferences and whatnot with regards to industry consolidation and those sorts of things. We're open to it. But first and foremost, it has to create shareholder value. And as it relates to anything outside of industry consolidation, we're open to it as a Board, as long as it creates shareholder value.

And so ultimately, we are not going to put any constraints on Alok from the standpoint that he can't look at this or that or has to look only in these areas. We want him to take a very broad view of things. And so that's what we're looking forward to. And that's ultimately where we are going to get to after he's had a chance to digest and move forward.

Operator

Next, we can go to the line of Joe Ritchie with Goldman Sachs.

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

Maybe just following up on Steve's question. So in resi, so if pricing was comparable in Lennox versus Allied. What is volume -- what did volumes spike this quarter? Was volume down in the Lennox business?

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

Volume was flat in the Lennox business is the way I would characterize it, and it was up probably mid-single digits, maybe slightly more when you layer in the price on the Allied or 2-step business.

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

Okay. All right. Great. Maybe touching base on price. The $335 million you've described and know that the pricing increases are coming in May. Does that -- so the $335 million, is that -- once you put these pricing increases in May, where that should account for all $335 million? Or does that contemplate future increases? I'm just trying to understand that a little bit better.

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

No, that would incorporate just all announced price increases, and then we'll continue to do what we always do. And if inflation continues to run at the pace it does and we need more price work, we'll go out with more price.

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

Okay. That makes sense. And then just another real quick one on the commercial side of the business. We've talked about, obviously, since some of the pressure that you felt this quarter, it seems like some of the labor-oriented costs are structural in nature, just trying to understand from the margin degradation you saw this quarter, was there anything that was kind of like onetime and shouldn't really repeat going forward? Any quantification of that would be helpful.

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

Yes. I think -- and I'm not going to quantify it, but I'll characterize it. It's a situation where if you can imagine, with labor constraints and then compounded by disruption in the supply chain, which results you -- results in you having to reschedule production frequently. Just all of the inefficiencies that, that creates is going to be onetime in nature as we continue to address -- aggressively address these issues.

And once we get on the other side of it, the absence of that bad news will be a tailwind and then we'll further drive productivity with initiatives. It may be automation, as we discussed earlier. But once again, as we employ more people and they become more productive and engaged, we expect a lot of that bad news to go away just by virtue of that. But once again, we'll follow up on more of that with productivity initiatives like we always do.

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

And Joe, that's why we're not changing the long-term target for that business. And so we think that, as Joe points out, the labor gets fixed and the supply chain disruptions gets at the other side of all that, this business has a lot of room to run.

Operator

And next we can go to Jeff Sprague with Vertical Research Partners.

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

I did want to just touch on cycle a little bit. And Joe, you mentioned some of the key things you look at haven't played out. But also, we are in sort of a unique environment. And I just wonder, as you look at the market, right, and we're entering a period here where plus or minus, we could say there's little or no volume growth and everybody's revenue growth is on price. Does that, in and of itself, potentially portend peak of cycle? Have you guys thought about that? And what kind of context would you put around that question?

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

Yes, we have. Once again, I wouldn't read too much into the first quarter, our seasonally lightest quarter, once again, coming off comps where we were up last year, 32% in volume, 37% in revenue in our residential business. So once again, I think it's more of a tough comp. And as you pointed out, just some challenging times, but the things that we look at are the overall health of the homeowner and the consumer, we don't see those things.

Obviously, they're being challenged but not eroded to the degree where we're seeing a mix down, which would be an indicator that, once again, there's more financial stress on the homeowner, along with parts and supply sales. So all the things that we continue to keep our finger on the pulse of point in the direction of continued multiple GDP growth in our Residential business, and that's what we continue to see even when we look at order rates and like I said, what I would characterize as a backlog for residential, there's strong order and orders building in the pipeline.

Operator

I want to give the call back to our speakers here.

Todd J. Teske - *Lennox International Inc. - Chairman of the Board & Interim CEO*

Great. Thank you. So to wrap up, demand remains strong, and we expect another record year for Lennox International, led by our Residential and Refrigeration businesses. We're focused on the current challenges in the commercial business. We've taken aggressive actions and expect operational improvement as the year progresses. Looking ahead overall, the future of Lennox is very bright, and I could not be more excited. Under Alok's leadership, with a strong management team, dedicated employees and a great foundation on which to grow, we look forward to the future and continued success. Thank you for joining us today.

Operator

Thank you. Ladies and gentlemen, that does conclude the conference for today. Thanks for your participation and for using AT&T Teleconference. You may now disconnect.