24-Apr-2024

Lennox International, Inc. (LII)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Lennox First Quarter 2024 Earnings Conference Call. All lines are currently in a listen-only mode, and there will be a question-and-answer session at the end of the presentation. [Operator Instructions] As a reminder, this call is being recorded. And I would now like to turn the conference over to Chelsey Pulcheon from the Lennox Investor Relations team. Chelsey, please go ahead.

Chelsey Pulcheon

Director-Investor Relations, Lennox International, Inc.

Thank you, Savannah. Good morning, and thank you for joining us today. We are excited to share our 2024 First Quarter results. Joining me is CEO, Alok Maskara; and CFO, Michael Quenzer. Each will share their prepared remarks before we move into the Q&A session. Turning to slide 2, a reminder that during today's call, we will be making certain forward-looking statements, which are subject to numerous risks and uncertainties, as outlined on this page. We may also refer to certain non-GAAP financial measures that management considers relevant indicators of underlying business performance. Please refer to our SEC filings available on our Investor Relations website for additional details, including a reconciliation of all GAAP to non-GAAP measures. The earnings release, today's presentation, and the website archive link for today's call are available on our Investor Relations website at investor.lennox.com.

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

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thank you, Chelsey. Good morning. I want to begin by expressing my gratitude to our customers and employees whose loyalty to Lennox helped us deliver strong Q1 results marked by record profit margins. Specifically, I want to extend my appreciation to our dealers, distributors, and key account customers for trusting Lennox to deliver industry-leading HVACR products and solutions across North America.

The success of our transformational effort to strengthen our distribution network, elevate customer experience, advance innovative platforms, execute pricing excellence, and drive productivity can be entirely credited to the unwavering support from our employees and customers. This successful quarter further demonstrates our ability to maintain our growth momentum, navigate complex end markets, and effectively prepare for the upcoming low-GWP regulatory changes.

Now, let's dive into the details of this quarter on slide 3, where I would like to highlight four key messages. First, Lennox's core revenue grew 6% and our adjusted segment margin expanded 157 basis point to 15.9%, resulting in our adjusted earnings per share increasing 23% to $3.47. Our operating cash usage was $23 million, a significant improvement from $79 million usage in the prior year.

Second, Home Comfort Solutions delivered a slight revenue decline, alongside moderate EBIT growth. With the destocking effect on volume, counterbalanced by price and mix, we delivered 30-basis-point margin expansion, and we are all glad to see the destocking phase nearing its end.

Third, our Building Climate Solutions team delivered record Q1 margins, supported by both revenue and profit growth. We remain on track for the opening of our new Saltillo, Mexico factory in early Q3, which will enable us to fully satisfy customer demand and our grow presence in emergency replacement market segment.

Lastly, we are delighted to announce the updated fiscal guidance for this year, as the Q1 results give us greater confidence in our earnings per share range. Michael will provide a detailed review of the guidance later in the call. But for now, let's turn to slide 4 for more details on the upcoming low-GWP refrigerant transition.

We are fully prepared and on schedule for the upcoming refrigerant transition. Our product designs, manufacturing processes, and technology engineering have all been finalized. We are currently transitioning our raw material inventory to facilitate the product launches, and we plan to start shipping the new low-GWP refrigerant product later this year, in time to meet expected demand. We anticipate price increase of 10-plus percent for the new product line.

During this low-GWP transition, we will face manufacturing headwinds as we convert each production line in our factories. Our approach to reconfiguring our factories will effectively balance production flexibility with cost efficiency.

Looking ahead, we foresee 2024 as predominantly an R-410A refrigerant year. As we move into 2025, we expect the demand for the new low-GWP product to reach approximately half to two-thirds of the end market. This shift in demand will benefit our product mix and also position us favorably to capture market share. Ultimately, we are well prepared and confident in our ability to navigate this transition successfully.

Now, please turn to slide 5 for an overview of our initiative to become a better distributor of HVAC products. As you know, Lennox is a top-tier HVAC distributor in North America with substantial geographical coverage through over 250 outlets, supported by more than 25 regional distribution centers.

Nearly 45% of Lennox residential sales are now through our digital platform, LennoxPros.com, where our contractor partners also have access to a digital service dashboard for equipment prognosis, diagnosis and monitoring. We have the opportunity to grow our market share by expanding geographical coverage and improve our share of wallet through greater focus on parts and accessories.

We also have an opportunity to increase dealer loyalty with improved fill rate and an enhanced customer experience. The distribution network improvements and the three core changes highlighted on this page will accelerate our growth and increase our margin resiliency. First, we have established a decentralized and better aligned organization that is consistent with distribution best practices. As a result, local leaders who have better visibility into local market conditions will have increased autonomy for faster decision-making.

Furthermore, we have established five regional P&Ls, led by experienced leaders who are accountable for both regional sales and stores. In addition, we are building our capabilities in critical areas such as revenue operations, pricing excellence and distribution management. This is a long-term journey and we are pleased with the early progress we have seen thus far.

Second, to improve the quality of our customer service, we completed a physical distribution network analysis to ensure that we have sufficient growth capacity and optimal cost structure. We have streamlined and digitized our end-to-end demand and inventory deployment processes, and we are also implementing a modern warehouse management system throughout Lennox. It will take us a few years to fully realize the benefit of these changes, but thus far, we are pleased with the recent trend in our fulfillment rate.

Third, we have created customer charter for our businesses and have established Net Promoter Score practices across the company. This allows us to collect feedback and set numerical goals around our customer interactions. We are delighted with the improvements we are seeing in our Net Promoter Scores and know that this is a commitment that will continue to yield results over the long term.

To summarize, we are becoming a technology-enabled distributor, and we are investing in talent, and resources to support this growth opportunity. While there are early signs of promising results, this is a multi-year endeavor that will accelerate growth and promote margin resiliency.

Now, let me hand the call over to Michael who'll take us through the details of Q1 financial performance.

Michael Quenzer

Chief Financial Officer & Executive Vice President, Lennox International, Inc.

Thank you, Alok. Good morning, everyone. Please turn to slide 6. Expanding on Alok's earlier comments, I'm excited to share our Q1 results, which not only reflect a strong start to the year, but also highlight record first quarter margins, and an impressive 23% growth in adjusted earnings per share. Core revenue was $1 billion, up 6%, as price gains, and revenue from the AES acquisition were the main drivers of year-over-year improvement.

Adjusted segment profit increased $25 million, where most of the growth came from $40 million of price, and mix benefits. This was partially offset by continued inflation, and investment in SG&A, and distribution.

Total adjusted segment margin was 15.9%, up approximately 160 basis points versus prior year. Corporate expenses were $24 million, which includes $3 million of expenses previously considered non-core adjustments.

Beginning in 2024, we will include certain previously categorized non-core adjustments in our adjusted earnings. This approach aims to reduce recurring or immaterial adjustments, which improves our overall quality of earnings reported. Our adjusted earnings will continue to exclude the effects of business divestitures and significant non-recurring items, such as restructuring programs. Our first quarter tax rate was 19.4%, and diluted shares outstanding were 35.8 million compared to 35.6 million in the prior-year quarter.

Now, let's direct our attention to slide 7, where we can review the financial performance of our Home Comfort Solutions segment. Revenue declined 1% to $681 million in the first quarter. The volume in our two-step distribution channel continues to feel the effects of industry destocking and was down mid-teens. Our direct-to-contractor sales volumes were up low-single-digits with solid growth in the new construction channel as new home building starts have rebounded. Price yield was 3%, an improvement from the 2% price yield we earned in the second half of 2023, reflecting our successful execution of pricing initiatives in the quarter.

The Home Comfort Solutions segment profit increased $1 million to $112 million and segment margin also experienced approximately 30 basis points of growth to 16.6%. Although pricing initiatives are progressing well, results are still impacted by inflation, as well as the ongoing investments in distribution and sales.

Overall, given the challenging conditions in the end market, we are proud of our execution to increase profit margins even with volume and mix headwinds. We are prepared to launch the new low-GWP product in the coming months and ensure the new product pricing material maintains gross margins.

Turning to slide 8 in our Building Climate Solutions segment that delivered another strong quarter. The Building Climate Solutions revenue was up an impressive 21% this quarter, propelled by 7% volume growth and our best performance in many quarters. Combined price and mix were up 8%, and revenue from our AES acquisition contributed 6% revenue growth in the quarter.

Building Climate Solutions' profit grew by $28 million or 56%, and segment margin expanded 480 basis points to 21%. These results were primarily driven by price and sales volume gains. Our profit results also reflect a $2 million headwind for our new Saltillo, Mexico factory ramp-up expenses.

Despite ongoing production and supply chain challenges, unit production volume from the Stuttgart, Arkansas factory shows steady improvement. Additionally, we are excited for product output from the new Saltillo factory in early Q3, and will launch our new low-GWP product in early 2025. We continue to be impressed by the Building Climate Solutions team's strong efforts in executing initiatives that paved the way for achieving our long-term targets.

If you'll now turn to slide 9, I will review our cash flow performance and capital deployment strategies. Operating cash flow use in the quarter was $23 million compared to $79 million in the prior-year quarter. Capital expenditures were $30 million for the quarter, a decrease of $5 million compared to the prior year. Later in 2024, we anticipate temporary increases in working capital as we ramp up our new Saltillo, Mexico factory and prepare for the transition to the new low-GWP product.

Concurrently, the team is focused on improving processes, and generating efficiencies in both accounts payable, and accounts receivable. Both items are reflected in our full-year free cash flow guidance and long-term cash conversion targets.

Our commitment to high ROIC drives strategic and targeted investments that enhance our performance and competitiveness in the marketplace. As previously mentioned, the new Saltillo factory and the transition to the new refrigerant products is proceeding as planned and showing positive progress.

We also continue to look at bolt-on M&A opportunities that align closely with their overreaching company strategy.

Net debt-to-adjusted EBITDA was 1.4 times, down from 2.1 times in the prior year. Our approach to capital deployment remains consistent. We prioritize capital expenditure investments with strong returns, grow dividends with earnings, continue to explore M&A opportunities, and supplement with share repurchases when necessary. Additionally, we are committed to maintaining our investment-grade rating.

Turning to slide 10, let's review the 2024 full-year guidance. Our outlook on revenue provided during our last conference call remains unchanged, as first quarter trends performed as expected. As a reminder, I will reiterate a few revenue guidance points. The table on the left highlights full-year revenue growth factors.

Total company revenue is projected to increase by approximately 7%. We also expect stable sales volumes with a slight increase from Building Climate Solutions and flat for Home Comfort Solutions. Price and mix are expected to drive a mid-single-digit revenue growth, where price increases will ensure we remain price-cost positive. As a result of our strong first quarter profit performance, we are also revising our full-year earnings per share guidance to $19 to $20 from the previously guided range of $18.50 to $20. Our free cash flow guidance remains unchanged at $500 million to $600 million. Those product and other cost assumptions also remain unchanged.

Component cost inflation is anticipated to be up mid-single-digits, including large increases in our cost to acquire our R-410A refrigerant and recent inflation in commodity prices. We expect this cost inflation to be partially offset by material cost reduction programs. We anticipate ramp-up costs of approximately $10 million for the new

Saltillo, Mexico factory, along with approximately $5 million to $10 million associated with the refrigerant transition across our Home Comfort Solutions manufacturing facilities.

SG&A expenses are expected to increase in the year, the result of both inflationary pressures and investments. Our investments are focused on resources to improve customer service, information system advancements, and distribution growth initiatives. We will also be making investments in both sales and marketing to support our long-term growth targets. Capital expenditures remain unchanged at $175 million. Interest expense is still expected to be approximately $50 million, and our tax rate is expected to be approximately 20%.

With that, please turn to slide 11, and I'll turn it back to Alok for an overview of end markets.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thank you, Michael. On slide 11, I will share our outlook on the end markets for both segments, which align with the full-year guidance that Michael just went through. Within our Home Comfort Solutions segment, we have started to see a rebound in residential new construction, signaling consumer health resiliency. Nevertheless, we continue to closely monitor the repair versus replace dynamic amidst macro uncertainties.

We are pleased to see distributor inventory return to near normal levels. However, the introduction of new low-GWP refrigerant product and pending EPA updates on component manufacturing cutoff dates does add inventory management ambiguity for dealers and distributors. With that said, we anticipate that most of this year's sales will still come from R-410A products, with limited adoption of the new R-454B product towards the end of this year.

Transitioning to the Building Climate Solutions segment, we expect deceleration in new construction accompanied by potential project delays. However, order rates and backlog remain strong, driven by pent-up replacement demand. Insights from our national account services team highlight a significant upcoming need for replacements, as well as increased interest in our new cradle to grave services.

Our market share prospects in the BCS segment will be driven by volume from the new Saltillo, Mexico factory and our expansion in the emergency replacement market. We are also securing additional wins in national accounts with our new integrated offerings made possible due to the AES acquisition. Overall, our outlook for this year remains cautiously optimistic. Given Lennox's track record of success during regulatory transitions, we anticipate benefit from new product pricing and potential market share gain. We acknowledge that the market remains uncertain, but we are confident in our proactive strategies aimed at driving growth, optimizing margins, and delivering exceptional value to our customers and shareholders. We do this by focusing on controllables and action items that we can drive.

Now, please turn to slide 12. As a recap, Lennox operates in growth end markets, has resilient margins, demonstrates execution consistency, and serves its customers through advanced technology and high-performance talent.

The five reasons we remain confident in Lennox be a great investment opportunity is, first, we will continue to make strategic growth investments to improve our go-to-market effectiveness and support customer demand. Second, margins remain a focus as we continue to evaluate our pricing strategy, implement innovative solutions to increase productivity, and optimize our direct-to-dealer network. Third, by leveraging the Lennox Unified Management System, our teams will be able to streamline processes, leverage best practices, and consistently execute our strategy. Fourth, our continued technological advancement will enable Lennox to remain at the forefront of innovation for our customers.

Finally, our team's focus on core values and guiding behaviors is the foundation of a high-performance culture. Our pay-for-performance incentive structure further aligns the talents of our team with the interest of our shareholders. Allow me to wrap up by saying thank you to each of our dedicated employees and valued customers. I'm proud of all that we have been able to accomplish, and I'm looking forward to the promising future that lies ahead of Lennox, as our best days are still ahead of us. Thank you. We'll be happy to take your questions now. Savannah, let's go to Q&A.

QUESTION AND ANSWER SECTION

Operator: Of course. [Operator Instructions] And our first question will come from Tommy Moll with Stephens. Please go ahead.

Tommy Moll
Analyst, Stephens, Inc.

Q

Good morning, and thank you for taking my questions.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Good morning.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Good morning, Tommy.

Tommy Moll
Analyst, Stephens, Inc.

Q

Alok, I wanted to start with a follow-up on the comments you made regarding strengthening the distribution network. You gave us a lot to think about. There are, I think, nine different points on the slide that you introduced. You clarified it's a multiyear effort. So, all very helpful context, and my question there is, if you were to focus our attention on this year and where we should look for early signs of progress, where would you focus us? And to what extent can you quantify or frame some of the investments, whether in personnel, technology or elsewhere behind those efforts. Thank you.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Thanks, Tommy. So, on the investment side, as you see, our Q1 SG&A is up year-over-year, and so large part of that investments that we're talking about are already in our numbers – are already in our guidance. Among the – and thereby, this is a classic McKinsey training, right, there are three buckets of three, hence you get to nine. But that I blame on my McKinsey background, not anything else.

The two things I would focus on would be both around our customers in terms of fulfillment rate and our Net Promoter Score, which are both, like, indicators of – early indicators of market share gain. And we are seeing solid progress in that.

Third thing we'll point out is pricing excellence, which is kind of embedded in there, but you see that in our numbers anyway. The first two we don't talk about publicly, but that's what I monitor internally in significant amount of detail, looking at where is our NPS and where is our fulfillment rate.

Tommy Moll
Analyst, Stephens, Inc.

Q

That's helpful. Thank you, Alok. For a follow-up, I wanted to ask – this one probably goes to Michael for a couple clarifications on the raised EPS guidance midpoint. Michael, can you just refresh us on the seasonality here. Is 50/50 still the right way to think about it for first half, second half? And then related point, you mentioned a convention regarding the corporate expense and what is versus isn't included there. Any additional detail you could provide, especially if you can just give us a bogey for what you're assuming for the year would be helpful. Thank you.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Sure, yes. So, on the seasonality, from the revenue perspective, we've already mentioned that we think from a revenue perspective, Q1 is about 20% of the year. First half's about 50%, second half is about 50%. That's from a revenue perspective. And then on the items that we've now included in corporate, previously, we had some items for asbestos litigation, environmental expense, unique litigations. So, these are kind of just small, immaterial noisy items that were somewhat recurring, and it was about $0.25 of items last year that we've now moved into our adjusted earnings this year.

Tommy Moll
Analyst, Stephens, Inc.

Q

So that would be a...

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

And, Tommy, if I can just piggyback on – sorry. Go ahead, Tommy.

Tommy Moll
Analyst, Stephens, Inc.

Q

Yes. I was going to say, Michael, that – so that would be a $0.25 unfavorable item from last year to this year? Am I hearing you correctly?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yeah. If those expenses are generally flat, which we think they are, yeah, it's about a $0.25 headwind.

Tommy Moll
Analyst, Stephens, Inc.

Q

Okay, got it. Sorry, Alok.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah, Tommy, I think we did that just to improve the quality of our earnings. I mean, these items are small. They became more recurring. And we think we should only exclude onetime items, extraordinary items. So, this was just a bit of a cleanup. As Michael came into the role, we thought this was a good opportunity to take these items, which had all become recurring for past many years.

Tommy Moll
Analyst, Stephens, Inc.

Q

Got it. Thank you very much. I'll turn it back.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yes.

Operator: And our next question will come from Jeff Hammond with KeyBanc.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Good morning, guys.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Good morning, Jeff.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Good morning.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Maybe just talk to me about residential. You called out negative mix. So I want to understand what's going on there. What do you see on repair/replace? Because we noted in our checks kind of discernible change more recently. And just, as we go into the selling season, given kind of a weaker 4Q, 1Q, kind of what's the lean on kind of industry volumes for the year?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. If I could start on the mix for the first part, the mix that we are referring is just residential new construction, which was subdued last year is now coming back. And we – and that's lower margin to us compared to replacement. So that's kind of mix impact we were calling out that we've noticed.

On the repair versus replacement, I think the jury is still out. I mean, I've read your channel checks. We have talked to our dealers. Kind of depends on which part of the country and which dealer. We haven't noticed any significant change in part sales versus equipment sales, but we probably won't be the first one to notice that anyway. There'll be other distributors who would call that out. But our dealers remained pretty robustly optimistic on overall the life of the equipment where repair may not be the most economical way to move forward.

So, haven't noticed anything, but we've mentioned that as a callout because that's clearly a possibility as consumer health might get worse.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then just on the refrigerant transition pricing, and I think you called out in the presentation greater than 10%. I think you've been saying 10% to 15%. Has anything really changed there other than maybe timing of when you'd get that? And then just what are you seeing from R-410A refrigerant prices that might drive pricing changes this year?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. So if we – on the first one, the R-454B pricing, nothing has changed. Last year, we may not have been clear enough, but I think we talked few times that we had said that'll be about 15% over two years. So that increased pricing was for 2024 and 2025, and we had made that statement in 2023. Nothing has really changed, because the [ph] fourth (00:28:35) part of the price increase is already in process. We implemented price increases mid-Q1, and we're going to see that impact. So, the remaining is 10%. So, I just want to clarify that. Nothing has changed. It was just over two years, and now we're talking about one year.

On R-410A pricing, I think the picture is mixed. I think, to be fair, the actual R-410A pricing ramp-up is less than we expected, and it's almost flat. But we think that's still going to move; and from our perspective, that hasn't changed our price on the end product that we are selling this year.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Thanks.

Operator: And next, we have a question from Ryan Merkel with William Blair.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Hey, everyone. Congrats on the quarter.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Thanks, Ryan.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Thanks, Ryan.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Yeah, Alok, I wanted to also ask on the A2L, just the 50% to 60% in 2025 from A2L, just why is that the right number. And then can you clarify, is the price increase, the 10%, is that both resi and commercial, or is commercial potentially a little bit less?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

So first, I'll answer on the price increase. We think it's probably going to be both in that same ballpark of 10%, if not higher. Both products need significant investments in the factory and some of the sensors and the compression technology. And then, why we think it's 50% to 65%, I mean, what we're seeing is that you're going to have a bit of a carryover into next year from R-410A systems that are able to be sold next year, that were kind of built this year. Then you also have within the EPA guidance that you can sell components into next year. So, we think those two combined are going to be 35% to 40% of the market next year, and then the balance would be new adoption of the R-454B refrigerant product.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

Got it. Okay, that's helpful. And then, I also wanted to ask on resi and just trends. So, down 2% for volume in the first quarter, but I realized there's some destock, I think, March with the weather wasn't great. Are you just thinking resi volumes are up low-single digits? Is that the right cadence for the rest of the way?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yeah. If you kind of look at our applied guidance, the balance of the year would be kind of low-single digit. It's a little stronger on indirect than the sell-through side, but balance kind of flat to slightly up for the rest of the year.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

And that is mostly for indirect. The comps get much easier starting Q2, and we are seeing the end of destocking.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

Great. All right. Thanks.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Thanks.

Operator: Next, we will hear from Joe Ritchie with Goldman Sachs. Please go ahead.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC
Q

Hey. Good morning, guys.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Hi, Joe.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Hi, Joe.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

So, maybe I'll just kind of start on just the M&A appetite question, just given there are some assets out there that could be coming to market soon just based on what has been publicly disclosed. So, talk a little bit about your appetite currently and what you are looking for in potential M&A transactions going forward.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. I mean, we read the same articles that you guys read, I do follow JCI pretty closely, but that is mostly because my good friend Jim Lucas is now the Investor Relations leader there, and I like Jim a lot. But if you think from our perspective, nothing has really changed compared to when we talked about it in Q1. And just to kind of re-emphasize that, like we believe industry consolidation is good, especially as regulatory changes accelerate, you need more scale to be successful. From our perspective, we have been public in the past about the interest for this asset that is rumored to be on sale. And that hasn't changed either. What we are very focused on is making sure we execute appropriately. We have a very strong path ahead of us. Our three-year plan is going to create significant value. And we have kind of talked about our long-term targets. There's so much opportunity for us to become a better distributor, improve our commercial volume through the new factory, working through pricing excellence on an ongoing basis, and gain share as we successfully execute through the refrigerant changes. And we have a huge, big pipeline of bolt-on opportunities as well. So, while we can't talk about any specific process, we have sufficient scale to compete. And we feel we are in a very good position and evaluate opportunities as they come by.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

That's super helpful, Alok. Thank you. My follow-up question, maybe for Michael, just going back to that seasonality comment that you made. Just curious, as you kind of think of just the cadence for 2Q specifically, you guys – it seems like destocking is coming to an end. Shouldn't the seasonality be slightly better this year? Because you're kind of lapping destocking comps. So, if any commentary around that would be helpful.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes. I think there's still some uncertainty though in the end markets on the sell-through. I think we're trying to watch weather within Q2. It's cold here in Dallas. We'll see where it goes for the rest of the quarter. So, I think there's some concerns on where weather could go, but I think that 50% of the sales in the first half still seems appropriate.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. And we don't want to call out weather for revenue upside or downside. I'm new to the industry, and whenever I worry about weather, my business leaders who have been here for longer terms, say, hey, just wait till next week, and your concerns might go away. So, still early in the quarter, May and June make up a significantly bigger portion of our sales than April does.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC
Q

Makes sense. Thanks, guys.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yes.

Operator: Our next question will come from Damian Karas with UBS.

Damian Karas
Analyst, UBS Securities LLC
Q

Hi. Good morning, everyone. Thanks for all the details thus far. I just have to ask, Alok, so...

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Good morning.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Good morning, Damian.

Damian Karas
Analyst, UBS Securities LLC
Q

Hey. Morning. So, we've been hearing about the end of this destocking for a few quarters now. Let's drive your confidence that this is the last time we're going to hear about this as a headwind in a quarter.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Well, we've been wrong before, so we got to keep that in mind as I answer the question. We talked about earlier it ending by Q4, and then in Q4, we got a sense and we signaled that it's likely going to continue in Q1.

As we look at leading indicators, so things such as coils, we make universal coils and when we sell those, those are typically the canary in the coal mine in terms of first to go down and first to go up. So, when I look at those product lines that went down first in sales, we've seen them coming back up, and we had a pretty good March on those product lines. And in addition, conversations with our distributors, so those would be the two data points. But listen, this is – we were wrong before, so maybe we'd be wrong again, but I think this time, we have much more data that supports it.

Damian Karas
Analyst, UBS Securities LLC
Q

Got it, makes sense. Appreciate that. And then you guys have talked a little bit about stable, still solid orders in BCS. Could you maybe just give us a sense for what you're seeing, different end markets, maybe national accounts versus emergency replacement, how that's kind of unpacked? And how you're thinking about kind of book to bill going forward?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Sure. If you think about our presence, remember, we don't do things like office buildings and large multi-story apartment complexes. So, from that perspective, our exposure to those areas, which we see more slowing last year and continue to be slow, is limited. We are more in single-story building and in national accounts, whether it be large big boxes of any type and others. The replacement demand is what's kind of exciting and that's what we are seeing really good momentum on, as a lot of the supply constraints are behind us, lead times are normalizing across the industry and folks are more willing to put in the investments, especially given the energy and the carbon savings they're going to get out of the new equipment.

On emergency replacement, our share has dropped so low that the market trends really don't matter to us. I mean, it's all about share gain and we are making good progress in getting back into our traditional dealers, our traditional accounts, and we'll make a lot more progress in the second half of the year when our second factory gets up and running. So that's kind of behind what we talked about in terms of overall trend. Replacement, which is vast majority of our sales, continues to be strong and that's driving strong order rates.

Damian Karas
Analyst, UBS Securities LLC
Q

Thank you. I'll pass it along. Best of luck.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Thanks.

Operator: And our next question will come from Noah Kaye with Oppenheimer. Please go ahead.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.
Q

Good morning, and thanks for taking the questions. Just wanted to unpack a little bit more the price, mix outlook for the balance of the year across segments, I guess, mathematically implied more of a dollar benefit in the resi segments. It sounds like that is primarily just the price increases, less so than mix, but would appreciate color on that, as well as color on the commercial side, what drives price, mix for the balance of the year.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Sure. Yes. So, within the quarter, we had pretty good price yield at 3%, but that was only a partial yield for some of the price increases that we announced in February and into March, so we're going to see a little bit more carryover and pickup on the pricing side. Also, don't expect the new construction mix to continue like it did in Q1, so we think that that will moderate later in the year, and then we'll also start to see some of that carryover benefit from the minimum SEER efficiency products as we get to the second half of this year. Maybe late in the year, a very minor favorable mix for the R-454B products, not really much within the guide, but overall, it's just continued pricing within HCS.

On the BCS guide, it's a similar story where we're lapping some really big price increases that we did last year, so you can see a lot more of that in the first quarter that will then moderate in the later quarters this year as we get some of the price increases that we announced in that segment as well.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.
Q

Perfect. Thanks, Michael. And then, really appreciate you guys taking a view on what the mix will look like on the refrigerant side next year. Just, is it possible to quantify how much of a working capital headwind that is for this year? Because you're obviously going to have to build that inventory, certainly for the direct channel, before the cutoff date.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yes, there's two things that we're focused on at working capital this year. It's inventory builds. The first is some additional raw materials to help transition to the new Building Climate Solutions factory in Mexico. So, that's a piece of it. But then, the other side of it is going to be to do a pre-build for some R-410A systems on the residential side, depending on end market demand and how that's going to carry into next year. And then, also on the BCS segment is that we can continue to build R-410A unitary rooftops through the end of this year, and then we have three years to sell that through. So, we want to make sure we have sufficient R-410A demand to cover a few years of or continued volume for the next year or so on the BCS product. So, that all adds up to about $50 million of inventory that we're going to have to add this year.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.
Q

Okay, perfect. Thanks for the color. Great execution. See you guys in a couple of weeks.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Thanks.

Operator: Our next question comes from Brett Linzey with Mizuho.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Hi, good morning, all.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Good morning, Brett.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Hey, wanted to just come back to the Building segment and really thinking about a way to dimension the new commercial capacity coming online. How does that ramp up in terms of revenue or units produced? And how should the factory utilization levels phase through the second half and then into next year?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

From a units produced, we have internal targets, but we haven't shared that externally, so don't want to go there. I mean, over the long term, we did talk about that we got enough square footage to double the capacity. We think that happens over five years or more, so think of maybe perhaps like at max 20% capacity, slowly ramped up one line at a time, so I think that's kind of one way to think about it. But clearly, we'll be prudent. We'll look at market conditions, and in some cases, we can obviously move and balance production between the existing factory and the new factory. So that's going to be one way to look at it, but we haven't put in machines in the ground to double the full capacity. We've got enough space to do that, but we'll put those investments as the demand materializes.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Okay, got it. Makes sense. And then, just wanted to come back to the forecast on the composition of the new refrigerant products next year. I guess as the old refrigerant supply is reduced, is it reasonable to think the pricing on the legacy units also needs to step up again next year as you're dealing with less supply?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yes. As we always do, we'll come out with a new price increase next year on the R-410A systems, and depending where the cost of that gas goes up, which we expect to go up significantly, it could also have a pretty large increase similar to the R-454B product. But we're monitoring that, and there will be another price increase on that next year for that 35% of the demand.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

And also keep in mind there'll be manufacturing inefficiencies associated with manufacturing the older R-410A units, because the volume is going to go down, and the factory has got to be more complex.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

And then higher costs for the R-410A that we expect.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Got it. Appreciate the color. Great quarter.

Operator: Our next question will come from Julian Mitchell with Barclays.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Hi, good morning, and thanks for the effort to improve earnings quality. I think most companies are hell-bent on going in the other direction, so thanks for that. Maybe my first question would be the commentary around the sort of second quarter and the first half and so forth. So, you've got about $1.5 billion sales, I suppose, or thereabouts, dialed in for Q2 based on that 50%-50% first half split. When we're thinking about the sort of margin profile, classically, you've had sort of 35%, 40% sequential operating leverage in the second quarter, just with the fixed cost absorption and so forth. I just wondered if that figure would be any different this year, whether because of the Mexico plant ramp-up or the phasing of, say, those A2L headwinds of $5 million to $10 million that you call out.

Maybe just any sort of color around how those items play out from here and the sort of second quarter sequential leverage.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yeah, there will be some additional investments we're going to start to make in the second quarter that weren't fully impacted in the first quarter, predominantly around launching the new commercial factory, as well as starting the transition to the new R-454B product in HCS. Additionally, we had a bit of a onetime benefit within Q1 for margins for warranty adjustments, so that will also kind of not repeat in the next year or in the next quarter. But, overall, yes, there will be some cost increases coming into the second and third quarters that weren't within the first quarter.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Got it. Okay. So, still sort of decent leverage, but maybe with some offsets this year, specifically.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Correct. Yes, some ramp-up costs that we're going to need to transition to get the product ready.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thanks. And then my second question, circling back to the BCS division, certainly the tone, I think, from Alok seems a little bit more cautious on that new construction aspect and project delays, and we see that more broadly in things like the ABI readings. Maybe sort of, if you could put a finer point, Alok, the project delays aspect, is that just an expectation of what could happen later in the year? Maybe any updated thoughts on the education vertical as the tailwind sort of starts to expire? And I guess the thrust of the question is really you had 21% revenue growth in that BCS segment in the first quarter, the year's up 10%. Is an implied decline at some point just pure conservatism, or is there anything we're really seeing on those project delays or education vertical or something like that?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Sure. I guess, Julian, the two biggest factors on that is we like to be conservative; and second, we had fairly easy comps in Q1 compared to where we were last year. On the demand side, I'll start by saying, we remain manufacturing or production capacity constrained, not demand constrained. So, keep that in mind as I answer all the other different points in here.

The new construction and the project push to the right [ph] isn't (00:47:10) actually happening right now. Now, that only impacts 15% to 20% of our sales as about 75%, 80% of that is – our sales are all replacement. So – but we needed to call that out just because it does impact portion of our sales. But today, it's not an issue because, again, being supply constraint versus demand constraint continues to hold for us.

Education vertical, yeah, it had some benefits last year. We may have less this year, but it's really not a material mover for us, nor was it last year. So, it really doesn't impact us.

The biggest driver of optimism there is the age of units. The units on the rooftop, whether it's a big box and others, they are way beyond their useful life. Many of them are like 18 years, but their useful life is closer to 14 to 16. That's what drives our optimism about order rates and things going forward. But the delta that you officially asked for at the beginning is easier comps and some conservatism built in, because no factory start-up goes perfectly, Julian. As you know, factory start-ups always have some issues here or there. So, we just didn't want to get ahead of ourselves.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That makes sense. Thank you.

Operator: Our next question will come from Joe O'Dea with Wells Fargo. Please go ahead.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Thanks for taking my questions. First question is just related to pricing strategy. And I think both on HCS and BCS, you had sort of engaged with consultants and have implemented pricing changes as a result. But the question is just related to what inning you're in in that, the degree to which that's complete, the degree to which we see it in the P&L? And as a result, was it a matter of you were pricing below market on a net pricing side of things and maybe you're above market, just overall kind of the outcome of those efforts, sort of where you are pricing relative to what you see pricing in the market being?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

If it was cricket, I would tell you in the first inning, but since it's baseball, I have to say, we are probably in the third or fourth inning of that right now. So, where we are is, yes, we were below market price in many of our key accounts where we had signed contracts after the tornado and pre-COVID and we did not have inflation clauses in that. So, there was definitely a large portion of our sales where we were, and in some cases still, below market. And that's a multistep process to get up to the market level. So, I think there's a big part of that.

There is second part of that, which is around giving the local leaders autonomy to an extent to get pricing adjusted. We used to do national pricing and then we realized there is no such thing as national pricing. Pricing in South is very different than pricing in the North. So, we will be able to capture greater pricing excellence just by having more localized pricing. And there's going to be upside on that, working through that.

The third aspect of pricing is simply around us continue to capture pricing ahead of inflation, because people think inflation has gone away, and it's not. So, as we do price increases and the fact that we lost margin points during the COVID transition and during the tornado, we need to just work with all our channel partners and customer and make sure we get price ahead of inflation, not behind inflation, because inflation continues to, like, impact us, whether it's SG&A or materials or labor, all of that impacts SG&A.

So, those are the three aspects. I would say, we are less than halfway complete, but pleased with progress so far and, like, especially pleased with some of the price actions we took on key accounts and got them closer to market, but still below market in some cases.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Got it. And then, also just wanted to ask on leverage and when you think about the M&A opportunity set out there. You talked about a long-term target leverage range in the 1 times to 1.5 times, but if the right opportunity were to present itself, how high are you comfortable taking leverage to pursue that type of opportunity?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yeah. If the right opportunity materialized, we'd go up kind of 3 times, maybe a little over 3 times near term, and then quickly want to get back to that 1 times to 1.5 times after that initial increase to above 3 times. But the key is maintaining investment-grade ratings. That's the key.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Got it. Thanks very much.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes.

Operator: And our next question will come from Deane Dray with RBC Capital Markets. Please go ahead.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hi. And I appreciate, Alok, that you're not going to use any cricket analogies, because I would have no idea what you're talking about.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

[indiscernible] (00:52:19)

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Yes. On the manufacturing line conversion, just give us a sense, is this the – clarify, is that the $5 million to $10 million that is in the assumption? And is this in the Mexico facility? And just give us a sense of how disruptive is this to the actual line to change over to the new refrigerants? Are you adding some new components? Is there new testing? Is it a higher pressurization? Just, what – from a technology standpoint, logistics standpoint, how disruptive might that be?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Sure. So, the two inefficiencies we called out, one is the Saltillo, Mexico start-up inefficiencies. And then we called out $5 million to $10 million of additional inefficiencies on residential for transitioning from R-410A to R-454B. The change is pretty big. We have to make sure that we are handling appropriately the new refrigerant, which is mildly flammable. So, it has a different classification when it comes to DOT regulations, so requires different piping, different storage, different testing, different test chambers.

A lot of the compressors are new, the size of the product might change in some cases, so it's a fairly big change. But we are pretty used to it, we are very ready. This is not starting now. A lot of these changes started last year. So, for example, the new refrigerant line already been installed and the new storage tank's already in the facility. We're already doing test runs. If we needed to make products today, we would. So, the inefficiency call that we called out would simply be lines shutting down for a few weeks, while we make all the changes, test the product, and then restart it. That's kind of the core source of inefficiencies. Most of the investments are already kind of on the floor now.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

That's real helpful. Thank you. And then, the follow-up question from Michael, and I'll also add my shout-out for the quality of earnings. I mean, we had to spend some time this morning to double-check that we weren't missing something, there were no eliminations. And that was the conclusion, I said, oh my gosh, this [ph] is – has closed the gap as (00:54:40) any company we follow. So thank you.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Chelsey and I were listening to you, Deane, when you told us that at your conference, and we took that as a challenge. So, it did start at your conference when you mentioned that to Chelsey and I. So...

Deane Dray
Analyst, RBC Capital Markets LLC
Q

All right, I appreciate that. So – and then – so that's – with all this buildup, I've got more of a mundane question on free cash flow. It just – we know first quarter is typically a use, but it's – was less of a use. Just, what are the dynamics there? And you said you've got some additional inventory build coming. Where does buffer inventory – as we distance ourselves from all the supply chain issues, have you rid yourself of buffer inventory entirely? Is it still winding down? But some color there would be helpful. Thanks.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.
A

Yes. On the raw material side, yes, our inventories are still higher than we'd like. They are drifting down better. Supply chains are healing, so they are coming down. But we're going to have to grow them a bit for this Building Climate Solutions transition to ramp up that new factory. But, overall, raw inventory is getting better. But, yes, we're going to start to grow inventory later this year for the new R-410A product. We're going to start to pre-build and grow some of that in the second half of this year. And then another element that we have within the free cash flow guide is that the CapEx is also going to be a little bit higher in the second half of this year than our normal guide. Normally, we have about $110 million of CapEx. It's about $175 million. You can see that there's going to be more in the second half to complete the ramp-up of the factory and get our transition to the new R-454B product ready to go.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's all helpful. Thank you.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes.

Operator: Our next question will come from Nicole DeBlase with Deutsche Bank. Please go ahead.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yes thanks. Good morning, guys.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yes, thanks for taking my question. I guess the first thing is just on the commercial margins, obviously really, really strong again this quarter. Thinking through all the puts and takes through the rest of the year and how the comp gets a lot harder through from 2Q to 4Q, I guess how much conviction do you guys have that you can continue to expand margins year-on-year through the rest of the year?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes. So, we continue to do pricing excellence. So, we've announced up to 8% price increase in Q1, so we're going to continue to drive price increase, even though it's going to lapse some of the comps, which are going to be a little more challenging. Right now, our guide is volumes kind of flattish to up low-single-digits on the balance of the year. That normally comes with 30% incrementals, so that should help drive our return on sales, operating profit margins up higher. But then working against that is a little bit of the headwinds that we have to ramp that new factory up. So, absent of the factory ramp, we still see margins modestly moving up.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Okay, got it. That's helpful. And then we've seen copper and aluminum costs rising recently. Can you just refresh us on when that could potentially impact your P&L? Would that be more of like a 2025 concern at this point or something to focus on? Thank you.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes. So, we see steel increases that are also starting to come up. That's more immediate. That kind of is on a quarterly lag. The copper and aluminum goes through a hedging process. It's kind of an 18-month blended hedging process. So, we'll start to see some of that this year, but it will come into next year as well. We'll continue to monitor that. If it stays elevated, we'll have to see what type of pricing actions later this year we need to do. But definitely, that would be reflective in the new R-454B product, if it continues, on pricing and the R-410A pricing into next year.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thank you. I'll pass it on.

Operator: And our next question will come from Steve Tusa with JPMorgan.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hi, good morning.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Hi, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Can you just help me reconcile some of the price and mix dynamics? I mean, you guys had put through, I believe, Allied was in Jan 1 and then the rest of the business maybe in early February. I think there were upwards of like 10% price increases. Price was up 3% in the quarter. So, maybe just help me reconcile that. And then, what basically gets that to accelerate through the rest of the year? I mean, your price/mix was basically 1% for the quarter with negative mix. So, maybe just help me reconcile those data points with kind of the mid-single-digit guidance?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Yes. I'll specifically speak to the pricing. So, within the quarter, we only had a partial quarter on the price increase. We announced on the Lennox brand, started in February, so that didn't even fully get all the way through February, [ph] say (00:59:36), about a month on the Lennox side. So that should continue to increase as we go throughout the year on just the normal flow activity on Lennox. And then we also had price increases on some of our large PE and builder contracts that also was – some of those were also a partial quarter. You'll start to see that also expand later in the year.

On the mix side, we don't think that the new construction mix is going to continue, so that should help going forward. But we're watching it to see if it does. But, right now, we're assuming that that mix basically slows down the – on the RNC side.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

So that mix number that you put in there, the mix for sales, is a mix driven by type of business, like new construction versus like replace? That's what that negative 2% mix reflects?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Within the quarter, correct. Yes.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

I didn't – have you guys always accounted for it that way? I thought that was more about the – like the SEER level of the product as opposed to the type of customer you're selling to?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Well, if you think within that customer, it is the SEER level of the product. They normally do entry-level type products, so it's kind of a mix of both.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Steve, we have always done it the same way. Last year, we called out the SEER1 because that was the largest driver as we're going from older SEER standards to the newer one. But for us, mix has always been product types, and RNC products are part of that mix change.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Right. I guess – but that's not really going to change, I guess, over the next several quarters, right? Mix should remain relatively new construction-focused, or does that mix change over the next several quarters?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Well, as new housing starts had gone down, I think Q1 last year was abnormally low. So, I think that both start impacting, right? We're comping ourselves out of the dip that we had last year.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Got it. And then just one last one on commercial. What do you think the market did this quarter? I mean, the AHRI data, which is obviously a little more narrow than what some people define as a light commercial market, that looked pretty strong. You guys had volume that was up, I think, mid to high-single-digits. What do you think the market did? And did you guys – I guess, how do you perform relative to that in your estimation?

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Our AHRI reported rooftop units were up more than that 7%. We had some declines in our refrigeration volume within the quarter that were taking down some of the gains. But we think we grew faster than the AHRI on rooftops within the quarter, winning back some share.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yeah.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. And you can't take our entire segment and compare it to. Michael's saying only a portion of our segment gets compared to that. So, we did equal or better than the AHRI data.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yes. Okay. Great. Thanks a lot.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Thanks.

Operator: Our next question comes from Gautam Khanna with TD Cowen. Please go ahead.

Gautam Khanna
Analyst, TD Cowen

Q

Yes. Thanks. Good morning, guys. I had a couple of questions.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Good morning, Gautam.

Gautam Khanna
Analyst, TD Cowen

Q

First, I was wondering, in April – you talked about destocking in the third-party channel coming to an end. Can you talk about maybe April order trends in that channel and how that might inform your conviction?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yes. Given that we are having a call on – towards the end of April, our conviction is already reflective of what we are seeing in April. So, we remain convinced that the destocking is coming to an end.

Gautam Khanna
Analyst, TD Cowen

Q

Do you anticipate that channel to be down in the second quarter still in terms of unit volumes [ph] down (01:03:25)?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

No. I would expect that channel to be up in unit volume in Q2.

Gautam Khanna
Analyst, TD Cowen

Q

Okay. And that's irrespective – I mean, assuming weather is not a big variable year-to-year?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yes. I was going to call out weather, but listen, I don't want to get nervous just because I had to wear a sweatshirt in Texas in April.

Gautam Khanna
Analyst, TD Cowen

Q

Got you. Okay. I was wondering if you could talk about the demand you think you'll have as the new Mexican capacity comes online. So, maybe if you could talk about customers or business that you may not have been able to accommodate on the commercial side, so just because – obviously, we're a little – people get concerned about commercial unitary demand starting to soften after a big ramp-up of COVID. What gives you conviction that you'll be able to fulfill that capacity over time?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yes. So, listen, great question. While there are no certainties, here's what we know and we look at, right. I mean, our order rates continue to be higher than what we can manufacture and we are still turning away businesses that we would rather not. So that's just internal way we are looking at and that's been going on for two to three years now. So, could it turn suddenly tomorrow? It might, but that's one.

Second, we have made significant investments in preparing our sales team to go out and start adding, in some cases, adding back contractors whom we had lost and working towards emergency replacement. And that's part of some of the investments that we talked about is leveraging our core contractors or Lennox dealers to be able to push that emergency replacement market. And finally, it's the key accounts and the conversations that we are having with them, especially when it comes to R-454B products, because some of them had delayed replacement and want to do replacement with R-454B products because they know that that refrigerant will be around longer and will be lower global warming potential rated. So, they get some carbon credits for that as well.

So, it's multiple factors in there, goes down to our current rates, investments we have made in drumming up extra demand, and lots and lots of conversations with our key accounts to pull that forward. But at the same time, our current factory is running kind of overcapacity. So, in case the demand fully doesn't come through, we've got lots of flexibility in where we produce and what we produce. And that flexibility is also super exciting to us and baked into our numbers going forward.

Gautam Khanna
Analyst, TD Cowen

Q

That's helpful. And last one for me, on the JCI assets for sale, you guys have expressed an interest in the York resi unitary stuff. If it were – if there were other assets embedded in whatever they're selling, is that something you guys would entertain or is that too much complexity for what you ultimately want and therefore not worth pursuing? I'm just curious how that – because we hear that they may sell more of it all at once and then you'd have to divest it or whatever.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yes, sure. No, that's fair. Again, I don't want to comment on other company, but I'll tell you, we are going to be focused on HVAC. I mean, we are an HVAC, our company, and that's what we do and we focused on that, and I don't think that's going to change just because opportunistically something else becomes available. And our strategy is working. We have the scale, we see a strong pathway ahead for us, just doing like execution on our current business set. But no, we'll remain very focused.

Gautam Khanna
Analyst, TD Cowen

Q

And that's North American HVAC, just to be clear, correct?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

No, I would say we are looking at North American HVAC as being the primary market. We do a lot of exports as well, and the heat pump technology that we use, we do get from overseas, as you know. We already have hundreds of millions on sales in that, so...

Gautam Khanna
Analyst, TD Cowen

Q

Okay. Thank you. Appreciate it, guys.

Michael Quenzer
Chief Financial Officer & Executive Vice President, Lennox International, Inc.

A

Thanks.

Operator: And thank you for joining us today. With no further questions, this will conclude the Lennox 2024 first quarter conference call. You may disconnect your lines at this time.