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LII.N - Q3 2021 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 3Q21 revenue of $1.06b, GAAP EPS from continuing operations of $3.41, and adjusted EPS from continuing operations of $3.40. Co. expects 2021 revenue growth to be 13-15% and GAAP EPS from continuing operations to be $11.97-12.17, and adjusted EPS from continuing operations to be $12.10-12.30.

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PRESENTATION

Operator

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

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

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

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

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

Before I turn the call over to Todd, I would like to announce the date of our annual investment community meeting. The event will be held the morning of Wednesday, December 15. The format will be virtual again this year. Please mark your calendars. Invitations and more details will follow. Now let me turn the call over to Chairman and CEO, Todd Bluedorn.

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

Thanks, Steve. Good morning, everyone, and thank you for joining us. Strong demand continued in the third quarter across all our businesses, but global supply chain and COVID-19 disruptions to production and labor availability negatively impacted our financial results, approximately a $75 million impact to revenue and $75 million (sic) [$25 million] to operating profit in the quarter. Company revenue was up slightly to a third quarter record of $1.06 billion, with the benefit of strong price in the shipment-constrained environment.

GAAP operating income was down 3%. GAAP EPS from continuing operations was relatively flat at $3.41 compared to $3.42 in the prior year quarter. Total segment profit was down 7% and total segment margin was down 120 basis points to 15.5%. Adjusted EPS from continuing operations is down 4% to $3.40, including approximately $0.55 of negative impact from the global supply chain and COVID-19 disruptions.

Looking at business segment highlights for the third quarter. Residential revenue was down 2% and segment profit was down 6%. Segment margin was down 90 basis points to 20.3%. Residential revenue from replacement business is down mid-single digits. Revenue from new construction was up low double digits. Lennox brand revenue was down low single digits and revenue from Allied and our other brands were up low single digits. Market demand remains high entering the fourth quarter, and we remain bullish on the residential market as we look ahead to 2022 in the coming years.

More people continue to work from home and run our HVAC systems than before the pandemic. With global warming, the hotter weather we are seeing has an exponential impact on reducing the life of cooling systems. And there are more complete HVAC system sales taking place with old R-22 refrigerant systems and replacement window. This is driven by the EPA ban on the sale and distribution of equipment using R-22 refrigerant effective January 1, 2010, and the ban of the production or import of R-22 refrigerant effective January 1, 2020.

While R-22 refrigerant is still available in the market, it's significantly more expensive than 410A. In many cases, it's cheaper to replace with a new 410A system, which is also more efficient and comes with a new warranty, than to repair the old R-22 system. From 2005 to 2010, 60% of air conditioners and heat pumps sold were R-22. The need to replace these has a meaningful benefit to residential growth. We expect these dynamics to lead to strong residential market conditions for the years ahead. In addition, Lennox and Allied will be running their proven playbook for market share gains.

Moving to our Commercial business. Third quarter revenue was up 2%. Commercial profit was down 42%. The segment margin declined 800 basis points to 10.7%. On top of supply chain shortages and bottlenecks disrupting production, our Arkansas factory was hit the hardest by COVID-19 in the quarter, and labor availability was a significant issue. At constant currency, commercial equipment revenue was down low single digits in the quarter. Within this, replacement revenue was up low single digits with planned replacement up more than 20% and emergency replacement down more than 30%. New construction revenue was down mid-single digits.

Breaking out revenue another way, regional and local business revenue was down high single digits. National account equipment revenue was up high single digits. The team won two national account equipment customers in the third quarter to total 11 year-to-date. On the service side, Lennox National Account Service revenue was up mid-teens. [ERF] revenue was up more than 30%. In Refrigeration for the third quarter, revenue was up 10%. North America revenue was up more than 20%. Europe Refrigeration revenue was relatively flat, and Europe HVAC revenue was down mid-single digits. Refrigeration segment profit was up 12% as margin expanded 20 basis points to 10.6%.

Looking ahead for both our Refrigeration and Commercial businesses, demand remains strong. Backlog is up approximately 60% for Refrigeration and 90% for Commercial and order rates continue to be strong. Demand is clearly not an issue. But as we look at the fourth quarter, we continue to expect a material impact to production from supply chain shortages and bottlenecks. We currently expect a similar negative financial impact to our business as we saw in the third quarter, approximately $75 million of revenue and $25 million of operating profit.

We continue to see broad inflationary pressures, including for commodities and components, but we have enacted 3 rounds of price increases this year. The latest one was just on September 1 with a focus on staying ahead of inflation. The company yielded 4% price overall in the third quarter, including 5% in Residential. In addition to the carryover benefit next year from our June and September price increases, we're announcing additional price increases heading into 2022.

Our Refrigeration business has announced a price increase of 8% in North America effective for December 1. Likewise, our European business has recently announced another round of increases generally from 5% to 10% to drive price in 2022. Our Commercial business has announced a price increase of up to 13% effective January 1, and our Residential business will be announcing another round of price increases in November to be effective heading into 2022.

For 2021, we are nearing our revenue and EPS guidance for the year. We are nearing 2021 guidance for revenue from 12% to 16% to a new range of 13% to 15%. Foreign exchange is still expected to be a 1% favorable to revenue. We are narrowing 2021 guidance for adjusted EPS from continuing operations from $12.10 to $12.70 to a new range of $12.10 to $12.30. Our free cash flow guidance remains $400 million for the year. As the company continues to battle through the disruptions to production from the global supply chain in COVID-19, we are also positioning the company for the future.

It's too early to set guidance for [2020], but as we think about next year, we expect strong pricing power to continue. The company yielded 4% in the third quarter, which had just one month of benefit from the third price increase this year. For 2022, we'll carry over price benefit from our June and September 2021 price increase. We have announced additional price increases in our next year with a strong price benefit to offset commodity headwind next year. Looking at market drivers and our strong backlog position in order HVAC Residential, Commercial unit [turn] Refrigeration up in 2022, as we get more and more of the supply disruptions behind us, we expect to return to strong growth and profitability as we capitalize on market opportunities. Now let me turn it over to Joe.

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

Thank you, Todd, and good morning, everyone. I'll provide some additional comments and financial details on the business segments for the quarter, starting with Residential Heating & Cooling.

In the third quarter, revenue from Residential Heating & Cooling was $711 million, down 2%. Volume was down 6%, price was up 5% and mix was down 1%, with foreign exchange neutral to revenue. Residential segment profit was $144 million, down 6%. Segment margin was 20.3%, down 90 basis points. Residential profit was primarily impacted by lower volume due to global supply chain and COVID-19 disruptions to production, factory inefficiencies, unfavorable mix, higher material, freight, distribution, tariffs and other product costs, with partial offsets included favorable price and lower SG&A expenses.

Now turning to our Commercial Heating & Cooling business. In the third quarter, Commercial revenue was $212 million, up 2%. Volume was down 6%, price was up 1% and mix was up 6%. Foreign exchange had a positive 1% impact to revenue. Commercial segment profit was $23 million, down 42%. Segment margin was 10.7%, down 800 basis points. Segment profit was primarily impacted by lower volume due to global supply chain and COVID-19 disruptions to production, factory inefficiencies, higher material, freight, distribution, tariffs and other product costs, with partial offsets included favorable price and mix.

In Refrigeration, revenue was $137 million, up 10%. Volume was up 9%, price was up 2% and mix was down 1%. Foreign exchange was neutral to revenue. Refrigeration segment profit was $15 million, up 12%. Segment margin was 10.6%, which was up 20 basis points. Global supply chain and COVID-19 disruptions to production constrained revenue and profit growth. Segment profit was negatively impacted by factory inefficiencies and higher material, freight and SG&A costs. Results were positively impacted by higher volume and favorable price.

Regarding special items in the quarter, the company had net after-tax benefit of $0.5 million that included a benefit of $2.7 million for excess tax benefits from share-based compensation and a net charge of $2.4 million in total for various items excluded from segment profit, including personal protective equipment and facility deep cleaning expenses incurred due to the COVID-19 pandemic and a net benefit of $0.2 million for other items. Corporate expense was $16 million in the third quarter, down from $28 million in the prior year quarter, primarily due to lower incentive compensation.

Overall, SG&A was $134 million compared to $152 million in the prior year quarter. SG&A was down as a percent of revenue to 12.7% from 14.4% in the prior year quarter. In the third quarter, cash from operations was $222 million compared to $440 million in the prior year quarter. Capital expenditures were $23 million in the third quarter compared to approximately $12 million in the prior quarter. Free cash flow was $199 million in the third quarter compared to $428 million in the prior year quarter. The company paid $34 million in dividends and repurchased $200 million of stock in the quarter. Total debt was $1.28 billion at the end of the third quarter, and we ended the quarter with a debt-to-EBITDA ratio of 1.8. Cash, cash equivalents and short-term investments were $44 million at the end of the third quarter.

Now before I turn it over to Q&A, I'll review current market assumptions and our guidance points for 2021. For Residential and Commercial unitary HVAC and Refrigeration markets in North America for the full year, we continue to expect low double-digit shipment growth for the industry. For the company, we are now narrowing guidance for 2021 revenue growth from 12% to 16% to a new range of 13% to 15%, and we still expect a 1% benefit to revenue from foreign exchange.

We are narrowing guidance for 2021 GAAP EPS from continuing operations from $11.97 to $12.57 to a new range of $11.97 to $12.17. And we are narrowing 2021 guidance for adjusted EPS from continuing operations from $12.10 to $12.70 to a new range of $12.10 to $12.30. And as previously mentioned, the fourth quarter of 2021 will have a headwind of 6% from fewer days than the prior year quarter. The first quarter of 2021 had a 6% benefit from more days than the prior year quarter. For 2022, there are no days differences, I'd like just to highlight.

Now let me run you through the key points of our guidance assumptions and puts and takes for 2021. First, for the items that are changing. We now expect a benefit of $130 million from price for the year, up from prior guidance of $110 million benefit. We continued -- with continued inflation and components, we are reducing our net savings from sourcing and engineering-led cost reduction to neutral, down from prior guidance, to be a $5 million benefit. We now expect LIFO accounting adjustments to be approximately $20 million this year, up from our prior guidance of $15 million due to higher material costs from inflationary pressures. About 40% of that was in the third quarter and about 40% is expected in the fourth quarter.

Factory productivity is now expected to be a $10 million headwind, down from prior guidance, to be a $10 million benefit. Residential mix is swinging from a $10 million headwind -- excuse me, swinging to a $10 million headwind from a $10 million benefit, and corporate expense is now expected to be $95 million, down from prior guidance of $100 million on lower incentive compensation. Overall, SG&A is now expected to be approximately a $40 million headwind, down from prior guidance of $45 million. Within SG&A, we continue to make investments in research and development and IT for continued innovation and leadership in products, controls, e-commerce, factory automation and productivity. For headwinds that are unchanged from our prior guidance, commodities are still expected to be a headwind of $80 million and freight is still expected to be a $5 million headwind with tariffs still expected to be a $5 million headwind as well.

Other guidance items that remain the same: foreign exchange is still expected to be a $10 million benefit; we still expect a net interest and pension expense to be approximately $35 million; the effective tax rate guidance remains approximately 20% on an adjusted basis for the full year; and we still expect capital expenditures to be approximately $135 million this year, about $30 million of which is for the third plant at our campus in Saltillo, Mexico. This is still on track to be completed by the end of 2021.

Pilot runs of the initial products took place in mid-October. We now plan to start initial production before the end of 2021 and ramp up to full production in mid-2022, and we expect nearly a $10 million in annual savings from that third plant. Free cash flow is targeted to be approximately $400 million for the full year. In the third quarter, we repurchased $200 million of stock to complete our target of $600 million for the full year, and then guidance for our weighted average diluted share count for the full year remains between 37 million to 38 million shares. And with that, operator, let's now go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First from the line of Julian Mitchell with Barclays.

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

Maybe just wanted to understand from you, how you're thinking about sort of the pace of the catch-up here from some of these issues, the $0.55 headwind in Q3, similar in Q4. How quickly can Lennox sort of come back from these headwinds when you're thinking about aspects like market share recapture, getting those plant inefficiencies down into 2022?

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

Yes. Let me unpack it and sort of swing away at that question because that's obviously the topic of the day. When we get AHRI data, we look through August year to date, we're sort of flat on shares. So I think others are having issues too. I know Watsco reported a larger number. But again, their carrier's primary or top distributor. If you looked at top 80% dealers and distributors, they're up also, it's the 20% or 30% that we're shutting off that are down so much.

So I think share wise, I think we're sort of doing -- our sense is, different people or different OEMs at different times have had their turn in the penalty box. We think we're middle of the pack, maybe even slightly above middle of the pack. But let's see how the others report and sort of see where they're at. In terms of the timing of getting things behind us, we're making very good progress, both on the COVID impact, which I'll talk more about in a second and about the supply chain impact. Things are getting better.

Although financially, fourth quarter look similar to third quarter, that's just the way it works because the costs get hung up on the balance sheet. You don't see it until you sell it. So sort of the absorption impact and the overtime impact and our problems are being seen. And then on the revenue side, it's because we're entering -- we ended the quarter with lower inventory than what we need. But on the production line rates, we're seeing nice improvements.

So let me unpack it a little bit. 65%, 70% or so of the issues are driven by supply chain to balance from COVID. Let me talk about COVID first. We saw unplanned absenteeism in our Southern factory, South Carolina, Arkansas, Georgia, Mississippi, double due to COVID. The good news is the Delta variant has really sort of run its course in our factories, and we're confident, at least as we stand today, that the worst is behind us.

On the supply chain side, I mean, it's the things we all know. It's integrated circuits, which are in motors, which are in compressors. It's things as mundane as corrugated cardboard and pallets. We've aggressively worked to sort of address that. We're taking inventory in parts and buying a year's worth of inventory in things like integrated circuits to protect ourselves. We're requalifying different parts with suppliers, and we have tiger teams literally in key factories making sure -- and supplier factories getting what we need.

So it's not the best news, obviously. But from a competitive viewpoint, at least today, we've seen so far, we don't think we're losing much. We think others are in similar situations, although we haven't seen all the OEM numbers published, but what we see in share data from AHRI. And we think COVID is behind us to a large degree in supply chain, while we're still battling, it's better now than it was a month ago and significantly better than 2 months ago, although we'll still see the tail of the financial impact in Q4.

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

That's really helpful, Todd. And maybe just one follow-up on residential market demand. You emphasized your bullishness on the market trend there as you look at 2022. The volumes in Lennox Residential, I think, were down about 6% year-on-year, Joe had said, in Q3.

Are you sort of thinking that, yes, there's some noise in there from sort of inventory absorption and supply chain, and so that sort of flat to down slightly is a good sort of placeholder year-on-year for the next couple of quarters? And then as you go through 2022, momentum sort of year-on-year on volumes reaccelerates?

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

I think high level, just -- let me put it in my own words, which I think will be constructive to your question. If you adjust for the volume miss that we have because of production, our Lennox Residential revenue's up 2%, 3%, 4%. And I think compared against the very tough third quarter comp that we had from last year that people were really intimidated by, including us, quite frankly, I think, would have been a very nice performance.

And then I lay on top of that all the things you've heard me talk about around the units running longer, that R-22 systems 60% from 2005 to 2010 and the system sales kick in, and the fact that it just continues to be warmer summer. So I still feel, as we've talked about, bullish about the market.

Operator

Our next question is from Jeff Hammond with KeyBanc Capital Markets.

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

Todd, maybe you can jump into this mix shift. I think you swung at $20 million on the guide. Is that what people are buying? Or is that tied to the supply chain and COVID issues?

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

It's tied to COVID issues. I mean we talked about the resi business. The new construction was up and replacement was down. And there's a couple -- one supply -- the other issues we protect that are big builders, for obvious reasons. And so that drove it. And then on the supply side is our Mexico facility has -- Saltillo has been the most resilient facility around both COVID and out supply chain for a myriad of reasons. And it's a lower mix of product category that comes from there. So we would have been able to have a more rich mix if we had produced more out of Iowa, not in South Carolina, not in Mississippi.

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

Okay. And then just on the -- I mean, it sounds like the COVID dynamic is getting better, and who knows what happens with resurgence. But the supply chain dynamic, is your thought that, that carries well into '22? Or I mean I know you mentioned it getting better, but when do you think you get back to normal there?

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

I'm not sure it's the honest answer. I think what I know on a micro level when we look -- when I sit out with the businesses and supply chain reviews is it's better -- like I said, it's better than a month ago. It's better than 2 months ago, significantly better than 3 months ago. And we're sort of putting things to bed around integrated circuits because when we find them, we buy them, and we have significant inventory to buffer us. But I think we're close enough to 2022 that I think clearly supply chain issues in corporate America or industrial America aren't done.

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

Okay. And then just on price, if we snap the line on all the increases you've announced or planning to announce, like is a 4% kind of favorable price a good starting point to think about for 2022?

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

Yes. I mean we're going to get significant price. I mean math that I'll give you is what we said on the call, which was in the script, we got 4% in Q3, resi was up 5% and we guided at $130 million for the full year. If you do the math, which you will when you have time, through Q3, we're up about $70 million. And so that implies we're going to get over 6% prices at corporation in the fourth quarter. Now that's going to be the best run rate quarter. But we still -- you think about second, third and the fourth quarter price increases this year, we're going to have lots of Carrier we're going into next year.

Operator

Next, we'll go to Jeff Sprague with Vertical Research Partners.

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

Todd, can you just pick up on price a little bit more? So it sounds like we should expect a normal kind of December-ish, January-ish bump of some reasonable magnitude also.

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

Yes. I mean we -- what we tried to convey in the call or on the script was we've already announced Commercial up to 13% effective, I think, January 1. And the resi guys are just sort of putting the final wraps on things to probably [aggravate] me because they want to communicate it probably on their own, but we're going to announce something similar for resi effective January 1. And then Refrigeration already went out both in Europe and the U.S. in December with pricing -- for pricing increases effective December. So yes, there's another way that's effective in essence at the end of the year.

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

And I wonder if you could actually update us on the succession process, where that's at. Any other kind of update on expected timing or anything?

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

Yes. I think it's as is. I mean the search is ongoing, Board's fully into it. And when we have something to say, we'll announce it, I think, is the long and short of it.

Operator

And we'll go to Ryan Merkel with William Blair.

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

So first off, when do you expect to shift the $150 million of pushed res? And was the majority in commercial? Or what's the rough split?

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

I'll answer the second part of the question. I'm not sure of the first part of the question, but the second part of the question is, in third quarter, it was more resident -- excuse me, more Commercial than Residential. And then the fourth quarter will be more Residential than Commercial. And sort of the split is like 60-40. So third quarter is 60% Commercial, 40% resi. In the next quarter, it's the flip. And then what's the first part of the question, when we're going to ship it?

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

Yes, when you are going to introduce it and ship the push -- yes.

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

Yes. I think it's sort of just -- I think what's happening -- short answer is in fourth quarter, right? So there's sort of a bubble that moves through the system. And some of the things we couldn't ship in fourth -- third quarter, we ship in fourth quarter. I think we will see an AHRI data when it comes out that third and fourth quarter will sort of be muted quarters industry-wide in units, i.e., it will be flat to down. And I think what that will mean is we've all had trouble producing, as I suggested. And we're sort of at the end of the season.

And while some of the demand is being picked up by Watsco, and people have some things, but I think broadly, what's happening is the lead times from local dealers to install HVAC or air conditioners is long enough that people are deferring the replacement until the summer season in many parts of the country. Not in Phoenix, not in Miami, but in many parts of the country, I think people are deferring because I think there'll be a bow wave when we enter -- when we get into 2022 when production picks up and we start to enter the summer selling season next year.

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

Yes. That makes sense. Okay. And then for my follow-up, you hit on this a little, Todd, but can you talk about the newer strategies you're implementing to offset the supply issues in COVID? And is there a time line you can share for when the company is going to see improvements from initiatives?

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

I think the answer is the time line was a month ago. So we're already seeing significant improvements from the initiatives. Just like I said, it just takes a while for it all to flow through the P&L. So I would have said the peak of disruption in our business was August, early September, and we're now past that peak. And the things that we're doing is we have, I want to say, tens of millions of dollars, maybe it's a little less than that. It just feels like that of inventory of integrated circuits. We're buying 18 months a year of an integrated circuit inventory.

We're sort of taking our MCR engineering team and focused them on qualifying new suppliers, and we're spending lots of times with key suppliers. So I think the major ones are behind us. But again, this thing is a bit of a bumpy ride, and we're trying to work through it, and things are getting better. But if our motor suppliers call us on the phone and say they have an issue, we got to work through it quickly.

And we've had those phone calls. We had compressors. I never thought I'd live in a world where pallets would be short, but they are and we've worked through that also. So I think the answer is the financial news is -- I'm repeating myself for the fifth time, I know, but the financial news is still bad in Q4 around this issue, but operationally, we're much better. It just takes a while for the cost caught up in inventory to work its way through the system.

Operator

Our next question is from Josh Pokrzywinski with Morgan Stanley.

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

Todd, just to kind of pick up that last comment on some of the good work's already been done, and it's just a matter of time. I mean, I guess maybe specifically in commercial, not to get ahead of ourselves on '22 guidance, but can margins start to kind of flatten out or go up on a year-over-year basis in the first half next year? Or do we need to kind of fully lap annually some of these dynamics before stuff gets better?

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

I'll be honest with you, Josh, I'm not trying to be coy. I don't have that -- I can't see that math in my head. But I think the answer -- I'll just make a third quarter comment, the fact we're down 800 basis points in the quarter, that's a one-off and we'll be back. What I do know is on a full year basis, we expect margins to increase in commercial next year from this year.

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

Got it. That's helpful. And then on the refrigerant dynamic that you talked about in resi, I think you're one of the only OEMs out there that sort of pointing to that as a specific driver, Watsco included, hasn't really noticed that per se. But anything that you can sort of put around that number-wise that's kind of driving that delta to the consumer? And maybe as kind of a side point, I remember like 10 years ago, recycling was supposed to be a big thing. Like why hasn't that kind of stepped in to fill in some of the supply or shortages there?

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

Well, I think Watsco's talking about it, too. I think everyone close to the business understands it. But I'll give you an example. Say, your house, Josh, you're getting a big unit. So you're getting a 5-ton unit for that 8,000 square foot you have in your house. And sort of the difference between a 5-ton air conditioner right now, the refrigerant charge, if you buy R-22 and assume there's 3 pounds of charge per ton, it costs you about $2,300 for the refrigerant. It's about $153 per ton. And for a 410A unit, it's about $1,100 because it's about $70 per ton of refrigerant. So that's about a $1,000 difference for a 5-ton unit of buying -- of recharging with refrigerant.

So I have a unit that leaks, I have a bad coil, and someone comes out and says, "Okay, it's $2,200 for me to put the refrigerant back in, plus there's some labor with that, or I can sell you a whole new system for $5,000. And by the way, that's only $1,000 refrigerant charge that's baked into that, and you get a 10-year warranty, and you get more efficiency." Those are the conversations that are taking place. And dealers know this. They're very, very good at this. And there's recycling that takes place, but it's the -- it's just supply and demand and the R-22 spiked up and it will continue to spike up.

Operator

Our Next question is from Patrick Baumann with JPMorgan.

Patrick Michael Baumann - *JPMorgan Chase & Co, Research Division - Analyst*

First one, just looking at the fourth quarter and the guidance for organic sales. It looks flattish in terms of the year-over-year, and I think you said price is about 6% and then you have a days sales impact, which pulls down the revenue by [6%]. I guess I'm coming at it and looking at it, I guess you're assuming flattish on volume.

And my question -- on a selling days adjusted basis, that is. And my question is really what's your visibility to kind of improving that volume growth rate in the fourth quarter versus what it looked like was kind of low to mid-single-digit decline on volume in the third quarter. It just seems like from your comments, you're not really embedding improvement from like the disruptions from COVID and supply chain. So maybe it's availability related to furnaces versus AC or something like that. I'm just kind of curious if you could give some color on that.

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

No. I think it's tied to what I said, that I mean we entered -- we're already almost a month through the quarter and we entered low on inventory. And so my comments were around our product -- our production capabilities. And so they're materially better than what they were a month ago and even more better than they were 2 or 3 months ago. So I mean the guide's to guide, but our production capabilities -- we're getting these issues behind us.

Patrick Michael Baumann - *JPMorgan Chase & Co, Research Division - Analyst*

Okay. Got it. The issues are behind, but the impact from the disruptions are unchanged.

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

I said the issues are getting behind us, right? So I didn't say it's fixed, I said getting behind us. And then I said that the cost hangs up on the balance sheet and then you have to enter the quarter with the inventory to be able to sell, and you sort of catch up as you go along. And so that's the issue that we face.

Patrick Michael Baumann - *JPMorgan Chase & Co, Research Division - Analyst*

Okay. And then my follow-up is on Commercial HVAC, and I wrote this down quickly, so I just want to obviously confirm these numbers. But I think you said emergency replacement down 30% and planned replacement up 20%. And I'm just wondering if you could talk about the drivers behind that. And since it was emergency replacement that was down a lot, doesn't that -- isn't that by definition just hard to kind of recapture?

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

Yes. I didn't say we were going to recapture emergency replacement. So I didn't say that, but I don't disagree with that. But what it reflects is we're protecting our national accounts, which is, by the way, a higher margin business for us. So we've captured -- we're going after it. And yes, it's hard to replace emergency replacement. But what I said earlier I think others are having similar issues. So we'll sort of see what the market share shake out as.

Operator

Next question is from Tommy Moll with Stephens.

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

Todd, it sounds like the pricing environment is still rather constructive. So I'm just curious. Is there any sign of that momentum diminishing? Is there any lack of discipline among the players in the industry? And what's your confidence level that you can keep price cost neutral into 2022?

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

Yes. It still remains constructive. I think that's Southern understatement, Tommy. I mean our price I said it's going to be up over 6% before. That's more than constructive. So the answer is we're aggressively getting priced. We're offsetting it this year even when we're sort of on our -- flatfooted going into it. But this year, we're going to get $130 million of price commodities is $80 million; LIFO, which [doesn't] affects cost, $15 million; freight,

$5 million; tariffs are $5 million, that all adds up to $105 million. And so we're more than offsetting those inflationary pressures this year and we'll even have a better performance next year.

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

Perhaps there was a little understatement there.

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

It's a tough quarter, Tommy. You've got to be helping me here. You can't get be (inaudible).

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

I wanted to ask a follow-up on the SG&A line. Just anything you would do to level set us on any comparisons next year versus this year that may be squarely, whether they be favorable or unfavorable? Or should we think about next year as best you know today, any way where that line should deliver a typical type of incremental as we've been accustomed to expect?

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

I think broadly, I would say that I think sort of high level things I think about is as salary increases maybe up a hair more than normal, given sort of inflationary pressures that we're all seeing and labor issues that we see, I think that's probably true. Even though we've taken a step down second half of the year on -- we had a really, really strong first half of the year.

So on a full year basis, incentive comp is up above target this year. And so we'll get a benefit next year when we re-base line it. And we'll continue to make the investments in products and distribution and in IT like we always do. So I think that's a long-winded way of saying there's some puts and takes, but I would end up where you started with this as I would sort of look at a model over the last couple of years of SG&A increases and we're sort of going up less than revenue, and that's what I would bake in.

Operator

Next, we'll go to Joe Ritchie with Goldman Sachs.

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

So maybe just parsing out those price cost comments just a little further, Todd. So you mentioned the 6 points in the fourth quarter. I mean, should we be thinking about that as kind of like a run rate then into the next maybe the first half of 2022? And obviously, like those cost curves are starting to come down. So at what point do you think you start to get the benefit of that spread widening into next year?

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

I think the cost curves are coming down much lower than I thought. So steel, still pretty high. Copper is down a little bit, but steel's -- aluminum is down out a little bit, but steel's where we're most exposed at this point as we move away from two large degree copper coils. So I think it starts to take a while to unwind.

I think over -- given the carryforward and the timing of things this year, commodities will still be up -- at least we're planning for commodities and our cost structure, given that we hedge and buy steel based on different formats to include prior quarter CRU pricing, we still expect commodities on a year-over-year basis next year to be up significantly. And we're pricing -- that's why we passed on a significant price increase at the end of the year.

And so we're going to have headwinds again next year. We're really confident we're going to offset them with price though. And I think to answer your question, the price increases of last year were beginning of the year, second quarter, third quarter and fourth quarter of this year. So yes, we'll have some nice tailwind the first half of the year.

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

Okay. No, that's helpful. I guess my one follow-on. And so you kind of referred to resi replacement being down mid single digits. It sounds like supply chain certainly impacted that to some degree. And this conversation just around kind of R-22 and the potential replacement. I guess any other color that you can provide in terms of just what's left to replace? I don't know if you guys have dug into that any further and how to think about kind of like this resi replacement market as we head into 2022.

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

I understand the question. I mean, we haven't done the math on the 2005 to 2010, that's 60% R-22. But I would -- when you think about 2009, 2010, even 2008, there's a lot of those units still out there. I mean they don't -- they're under warranty up until last year or the year before, depending on the time slice so people just get it fixed. So those units are out there and systems are out there. And so I think it's a major driver of demand -- significant driver of demand.

Operator

Next question from Gautam Khanna with Cowen.

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

Nobody asked about IAQ, so I figure I might as well. Can you comment on what you're seeing in terms of inquiries? How big it is maybe in the Commercial business?

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

Yes. I mean it still remains important, but I'll be honest with you. I mean, it sort of gets pushed a little bit to the side, given the other issues that we have and how we're taking care of customers and how we're prioritizing customers. So the biggest market for us is probably schools and low-rise office buildings, and inquiries are still strong and resi is still an important part. But as you know, I've been a little less bullish than others. So when I think about our opportunities going into 2022, I mean we'll drive and we're focused on it, but some of these other issues are obviously much more important.

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

Can you remind us what the incremental ticket size is if you do sell a system with IAQ add-ons? What is the portion...

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

Yes, if you do it on a resi system, it can be 20% or so. On a Commercial system, probably less than that, 10% to 20%. You sort of get the full package, if you get everything. If you just do MERV filters -- if you just upgrade filters, it's probably 3% or 4%, 5%. That's UV lights. That's sort of the whole thing.

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

Helpful. And Todd, just to be clear, on the Q3 and Q4 impacts from COVID, is that almost entirely a Commercial issue? Or did it also impact the resi facility in South Carolina or Iowa? You mentioned Saltillo was a little more resilient, but...

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

The factories that had impacted the most in order to the business was Arkansas. Our Arkansas factory, which is Commercial but our Mississippi Residential factory and our Orangeburg, South Carolina Residential factory. So really sort of two resi factories and then the Commercial factory.

And again, we think about lots of criteria where we put our factories. I know I will offend people when I say this, but I'm going to say it anyhow. I mean we never had a criteria where people believe in science, right? And in the Southern factories, our vaccine rates are much, much lower than they are in other parts of the country, as you would expect, because society reflects that. And so we've had around some of these factories with 20%, 30% vaccine rates.

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

And last question for me. You mentioned the mix dynamics. Is it also true that the higher-end SEER systems have more electronic components? And therefore, are more kind of at risk pinchpoints from the supply chain relative to the entry-level SEER products? Or is that not true? Does that also have an impact on the mix, just the supply constraint?

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

That's probably fair. I mean, I simplified it as thinking about it as production site that Mexico did better than Marshalltown, Iowa, and we had lower mix there. But I think you're probably right, both around variable speed and around control systems. So my guess is you're probably right, if I dug in, that would probably be part of the answer.

Operator

Next, we'll go to Nigel Coe with Wolfe Research.

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

So when we talk about the improving conditions in supply chain sort of real time, are we talking primarily about labor availability and productivity in the factory? Or is it labor and supply of compressive motors? And then just a sort of subtext to that would be the Commercial impacts on replacement. Was that partly VRF imports from your -- from Midea? Or is that something separate?

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

I'll answer it maybe in reverse order. VRF was up in the quarter, so we weren't really impacted much there. But the emergency replacement was clearly impacted by availability because we were protecting our large national accounts. I mean we had to protect our existing customers before we went after new contractor business (inaudible) replacement. What was the first part of the question, Nigel?

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

Yes, it's really -- is it mainly labor that's gotten better for you? Or is it...

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

Yes. What's behind us? Yes. The COVID impact sort of unplanned absenteeism, that's sort of behind us at this point. And again, you should see it in the Southern states COVID case charts. So if you look at New York Times, look at Arkansas, look at South Carolina, look in Mississippi, they're down dramatically, and we've seen that in our factories.

So supply chain, we still have challenges that we're facing, but it's much better than it was 2 or 3 months ago. And I think that's an order inventory positions that we've taken on critical components, investments we've made in qualified new suppliers. And I -- and then the third piece is, I think the supply chain itself is healing even if we hadn't taken actions on our own.

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

And then the auto companies are talking about some of these rare metals as constraints, magnesium and other metals that I can't even pronounce. But aluminum alloys are coming up as an issue. I know you're a consumer of aluminum, but any sort of what (inaudible) there?

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

No, not that's on my radar screen yet. I mean that may pop up in the future. But I think the issue around different metals has impacted the integrated circuit market in some ways. But I mean we buy straightforward aluminum and straightforward cold-rolled steel. So we're not buying anything exotic, but that doesn't mean there might not be issues in the future. But right now, that's not an issue with us. And the auto guys slowing down has helped us with aluminum and steel, as you might imagine. And so that has actually helped.

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

Okay. Great. And then Todd, can we just address once again the CEO search. I mean you're not -- you're committed to the company until mid-2022. So would you describe the search right now as intense? Or is there a time -- still time on your hands? I mean are we talking about weeks, months? Any color there would be helpful.

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

Yes. It's intense. I think we all understand that once you announce something like this, the sooner you move on, the better. And I got my wheels -- I've got my hands on the wheel and I'm driving as hard as I can and fighting every day. But as soon as they get somebody then the transition will take place. And so it's intense. We're trying to get it done as quick as we can, or to better say it, the Board is trying to get it done as quick as they can.

Operator

Our next question is from John Walsh with Credit Suisse.

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

Just wanted to come at the cost side of price cost a little differently here. Obviously, this year, demand has been, I think, better for the market than folks expected. So we've heard there might have been a little bit more spot buying of some of the commodities. Just curious if you would characterize this year as unusual on how much you buy in the spot market. I'm just thinking about next year, what you might have on hedged in terms of commodities versus what you had on hedged this year in terms of commodities?

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

I think I understand the question. I'm going to ramble around it and maybe directly touch on it and touch other areas. I think the inflationary pressures have hit us, to your point, of buying on spot in different ways, but I think broadly -- not broadly, I communicated that commodities are still going to be up significantly next year. This is the way we see it going forward.

I think the other way that inflationary pressures has hurt us in a way that we typically don't talk about is material cost reduction is usually $20 million to $30 million a year, where net costs were taking out. This year, it's closer to breakeven. And the delta isn't that we aren't doing cost reduction, we are. The delta is that people are passing on price increases to us.

So we're also seeing pricing pressure from suppliers who are passing on things that have steel in it, that have aluminum in it, and they're passing that on to us. And so when we go into next year, we'll have -- we'll also not have our normal material cost reduction here. But again, we're able to offset that aggressively with price, and that's why we're seeing the new price at the end of this year.

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

And then maybe just one on heat pumps. Are they meaningful -- are they a big enough part of the mix yet that they would have a mix impact, if there is actually one, from heat pumps? I don't know if they're actually accretive or dilutive to the overall margin for Lennox.

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

I think they're roughly in line with the margin. If we sell heat pump system with an outdoor heat pump and an indoor air handler, it's not dissimilar to the margins that we get if we sell an AC outdoor and a furnace indoor. And it's a meaningful part. It's, from memory, 1/3 or so industry-wide and with us of our total cooling capacity are heat pumps. So it's a meaningful part of our business.

And we've made significant investments, as I've spoken about, we are coming out with a cold weather or cold region heat pump that allows you to buy them as far north as Canada and still have them to be energy efficient and appropriate. And so we've made significant investments. I would have said 5 years ago, we lagged the industry. I'd say now we've caught up and maybe even ahead of people maybe not sort of a Carrier who has made significant investments, but almost everybody else we're ahead of.

Operator

Our final question will be from Joe O'Dea with Wells Fargo.

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

First, I just want to understand on Mexico. Is it strictly just you've had fewer COVID issues for disruptions there? Or is there anything else about Mexico and supply chain that has made that a more favorable place to be kind of manufacturing through what we've seen in the supply chain environment so far? And does that continue to pay dividends as you increase your capacity when that factory comes online?

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

I think one is COVID, that we were less hit there than we were certainly in our other factories in south of the Mason-Dixon line in the U.S. I think Gautam was probably on to something that I hadn't articulated, that I think the more entry-level product has less integrated circuits, so it's less at risk. And then the third is just some sort of basic areas like steel supply, pallet supply, the suppliers that we use for Mexico were more robust -- happen to be more robust. I don't think it's structurally in the answer that says Mexico is a better place to be for that reason. But the way it worked out, they, in fact, were.

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

Okay. And then a question on emergency replace. I just wonder as you get kind of more connected equipment and more data and maybe more preventive maintenance. Does that just become less of an opportunity in the marketplace for share shift over time? Are you seeing that where you can better protect share because you're not losing it out if there's an emergency replace and someone tries to swoop in and get that?

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

I don't think so because in a sense, emergency replacement tends to be entry-level product, electromechanical controls. They're not monitoring it. We're not monitoring it. It's -- they turn it on when it's hot, and they turn it off when it's cold and then it breaks and they call us. So I don't think we're going to remote monitor that in any meaningful way that will impact demand if people aren't booked -- if any -- if customers are sort of thinking about remote monitoring, then we're usually able to trade them up to a better unit.

Operator

Mr. Bluedorn, I'll turn it back to you for any closing comments.

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

Thanks a lot. To wrap up, we're battling through supply chain disruptions today but also positioning the company for the future. We carry strong pricing power into 2022 to offset inflationary pressure. Looking at market drivers and our strong backlog position and order rates, we see residential, commercial unitary and refrigeration markets up in 2022. To get more and more of the supply chain disruptions behind us, we expect to return to strong growth and profitability as we capitalize on market opportunities. I want to thank everyone for joining us today.

Operator

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