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LII.N - Q3 2022 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 3Q22 revenue of $1.24b, GAAP operating income of $186m, GAAP EPS of $3.99 and Adjusted EPS of $4.10. Expects 2022 revenue growth to be 12-15% and GAAP and adjusted EPS to be $13.80-14.20.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International Third Quarter Earnings 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. I'm here today with CEO, Alok Maskara; and CFO, Joe Reitmeier. Alok will discuss highlights for the quarter and Joe will take you through the company's quarterly financial performance and guidance for 2022. After that, Alok will discuss our current view on 2023 before Q&A. To give everyone time to ask questions during the Q&A, please limit yourself to 2 questions or follow-ups and requeue for any additional questions.

The earnings release with GAAP to non-GAAP reconciliations, today's presentation slides and the webcast link for today's call are available on our website at www.lennoxinternational.com. The webcast also will be archived on the site for replay. All comparisons mentioned today are against the prior year period unless otherwise noted.

Turning to Slide 2. I would like to remind everyone that in the course of this call, we will be making certain forward-looking statements, which are subject to numerous risks and uncertainties. For information concerning these risks and uncertainties, see Lennox International's publicly available filings with the SEC.

Before I turn the call over to Alok, let me remind everyone of our upcoming Annual Investor Day on Wednesday, December 14, when we will discuss specific guidance for 2023 and our 3-year outlook, as well as provide an update on our strategy.

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

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

Good morning, and welcome, everyone. I want to start by thanking all our employees who are working exceptionally hard given the ongoing supply chain disruptions to better serve our customers. As a result of their efforts, Lennox was able to deliver another record quarter, while improving our customer service level.

On Slide 3, I want to start by highlighting 4 key messages. First, our record third quarter financial results included double-digit revenue growth in all 3 of our business segments. Overall, company revenues were up 17% to a third quarter record of $1.24 billion. Adjusted earnings grew 21% to a third quarter record of $4.10.

Second, we are prepared for the upcoming minimum efficiency regulation to be effective on January 1, 2023. As part of the preparation, we are replenishing inventory levels, which will also help us increase supply chain resiliency. Given our inventory build, cash from operations was $171 million in the quarter, down $51 million from a year ago.

Third, the recovery in our commercial business segment is progressing well, and the daily output from our factory in Stuttgart is steadily increasing. Third quarter Commercial segment profit was up 72% sequentially and up 31% year-over-year.

Today, we are also announcing investment in a second Commercial factory to be built in Mexico. The total capital required for the new Commercial factory is expected to be in the range of $125 million to $150 million over the next 2 years. The new Commercial factory will provide us the much needed additional manufacturing capacity while enabling margin expansion.

Fourth, given persistent supply chain inefficiencies and the adverse mix impact driven by shortage of components for high-end Residential products, we are revising our full year EPS guidance range to the lower end of the prior range.

Now please turn to Slide 4 to discuss our preparedness for the minimum efficiency regulatory changes. In our Residential and Commercial end markets in the U.S. and Canada, the new required minimum cooling efficiency level for air conditioners, heat pumps and rooftop units is increasing on January 1, 2023. For air conditioners in the South and Southwest regions, the change is based on date of installation, while for air conditioners in the North region and for all heat pumps and rooftop products, the change is based on date of manufacture.

For the new 2023 compliant units, we expect a double-digit benefit of price and mix to more than offset the higher cost of the units.

For Residential products, our competitive design includes single-stage compression, more efficient aluminum coils and an optimized external footprint. This design approach achieves higher efficiency standards without having to change indoor units, making our solutions better for dealers and end users. Lennox historically has done very well competitively during this minimum efficiency transitions, and we believe we are well positioned to do so again.

Now please turn to Slide 5 for an update on our commercial profit recovery efforts. At our existing Arkansas manufacturing facility, we have met our targets for hiring and retaining talent, resulting in staffing levels reaching normalcy, which is up 30% since April. Since achieving normal staffing levels, we are systematically increasing our daily output, which is now up 15% since April. Higher output is improving service for our customers who have been mostly understanding of our challenges given industry-wide supply shortages.

We are grateful for our customers' loyalty and patience, and want to assure them that we are doing our utmost to increase capacity and reduce lead times. We are deploying additional talent and working closely with our suppliers to satisfy current demand levels and remain committed to delivering additional manufacturing output and productivity from the existing factory. However, in the fourth quarter, we are expecting sequentially lower manufacturing efficiency and output as we transition our product lines to build our newly launched Enlight and Xion products that meet or exceed the new minimum efficiency standards.

Similar to Residential, price positioning of the higher-efficiency Commercial products will enable us to more than offset the associated higher cost. Looking ahead, we have decided to invest in a second Commercial factory in Saltillo, Mexico near our existing Residential operations. The new factory will increase our capacity to support our customers' forecasted demand, and it will also position us to regain lost share, especially in the emergency replacement market.

We expect an 80% lower hourly labor cost at this new facility, although some of those savings will be offset by higher freight cost. Overall, as Commercial production continues to recover, we expect $100 million segment profit improvement within the next 3 years.

With that, I will hand the call over to Joe on Slide 6 to discuss full quarter financials and guidance for the full year.

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

Thank you, Alok, and good morning, everyone. Looking at the quarter for Lennox International overall, the company posted record third quarter revenue and profit. Revenue was $1.24 billion, up 17% as reported and up 18% at constant currency, primarily driven by volume growth and price.

GAAP operating income was a third quarter record $186 million, up 14%. And in the chart, you see the total segment profit rose 15% to a third quarter record $189 million. Total segment margin was 15.2%, down 30 basis points, primarily due to supply chain inefficiencies and lower mix, driven by manufacturing constraints on higher-end products.

GAAP EPS was up 17% to a third quarter record $3.99, and adjusted EPS rose 21% to a third quarter record $4.10.

Now moving to the business segments. Starting on Slide 7. You see a record third quarter for Residential in revenue and profit. Residential revenue grew 17% to $835 million, volume was up 7%, price was up 10% in the quarter. Residential replacement and new construction sales were both up high teens, with new construction growing faster.

Residential segment profit rose 7% to $154 million. Segment margin contracted 190 basis points to 18.4% due to lower mix as we were unable to increase output of high-end units due to the component shortages.

Regarding Lennox stores, we opened 4 new locations in the third quarter to bring our total store count to 239. We expect to end the year with approximately 245 stores.

Now turning to Slide 8 in our Commercial business. Revenue was $253 million in the quarter, up 20%, led by strong growth in National Account business. Commercial price was up 9% and mix was up 11%. Commercial segment profit was up 31% and segment margin expanded 100 basis points to 11.7%.

Commercial demand and backlog remained strong, and our Arkansas factory recovery continues to progress well. We have recruited and hired the number of employees we need for the factory, the daily output is increasing and we continue to make progress on improving processes and productivity.

Now turning to Slide 9 in our Refrigeration business. Revenue was $157 million for the third quarter, up 14% as reported, and up 21% at constant currency. Price was up 16%, volume was up 5%, foreign exchange had a negative 7% impact. Revenue growth was led by North America, up more than 20%. Europe revenue was up 2% as reported and up 20% at constant currency. Overall, for the Refrigeration segment, profit rose 54% to $22 million, and segment margin expanded 370 basis points to 14.3%. Refrigeration demand and backlog remains strong.

Turning to Slide 10. Let's review our 2022 full year guidance. We now expect revenue growth for the full year of 12% to 15% compared to the prior range of 10% to 15%. For the industry, we continue to assume low single-digit shipment growth in North American residential markets and mid-single-digit shipment growth in the North American Commercial unitary and Refrigeration markets.

We are updating our guidance for GAAP and adjusted EPS for the full year to a range of $13.80 to $14.20 compared to the prior range of $13.80 to $14.50.

Now looking at the puts and takes that are changing. Price is now expected to be a $425 million benefit for the year, a yield of 10%, which is up $25 million from our prior guide of $400 million. Residential mix is now expected to be a $45 million headwind for the full year compared to our prior guidance of a $25 million headwind. The mix headwind is attributable to the shortage of higher-end products as supply chain constraints continue to limit production of our Dave Lennox Signature Series.

Commodity cost inflation is now expected to be $120 million, down $10 million from our prior guidance of $130 million. However, we are still seeing inflationary pressures on components and other materials, and now expect $120 million headwind compared to prior guidance of a $100 million headwind. Supply-related factory disruptions are now expected to be a $25 million headwind compared to prior guidance of a $15 million headwind. Interest and pension expense guidance is now $40 million, up from our prior guidance of $35 million.

And as we invest more in inventory for supply chain resiliency, buying ahead of continued component price increases and the minimum efficiency regulatory transition, free cash flow is now expected to be approximately $300 million for the year compared to prior guidance of $400 million. And stock repurchase guidance is now $300 million for the year, which has been completed compared to our prior guidance of $400 million. The effective tax rate will be approximately 19% for the full year.

Now for the guidance points that are not changing. Freight costs are still expected to be a $20 million headwind. We still expect corporate expenses to be $95 million and we are still planning for $125 million of capital spending, and we still expect a weighted average diluted share count of approximately 36 million shares for the full year.

And with that, let's turn to Slide 11, and I'll turn it back over to Alok to talk to you about our thoughts on 2023 at this time.

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

Thank you, Joe. While we will be giving specific guidance on 2023 at our Investor Day in mid-December, I wanted to spend a few minutes today on the different headwinds and tailwinds that are guiding our 2023 outlook.

On the headwind side, we are prepared for a decline in residential unit shipments due to the downturn in single-family new housing starts, as well as possible impact on the replacement units from rising interest rate environment and broader economic slowdown.

On the cost headwind side, we expect the first half of 2023 to continue seeing component inflation, and we also expect some of the current supply chain disruptions to persist in the first half of 2023. For the 2023 tailwinds, we expect to see a price and mix benefit from minimum efficiency regulatory increase in both Residential and Commercial. We also see significant carryover and annual price increase benefit.

Our 2023 margins will also be favorably impacted by commercial manufacturing recovery and easing commodity cost. In addition, our material cost reduction pipeline will provide meaningful savings as we expect that most of the supply chain inefficiencies will be behind us by the middle of the year.

Our Commercial and Refrigeration businesses have strong demand and backlog into 2023, and all our businesses have share gain opportunities ahead of us. Bottom line, even if residential units are down on new construction and macroeconomic softness, we still expect revenue, margin and EPS growth for LII in 2023.

Please turn to Slide 12 for some final thoughts before Q&A. I would like to close our prepared remarks by summarizing why I joined Lennox and why I believe LII is an attractive investment opportunity. Lennox is narrowly focused leader in energy-efficient, environmentally friendly, climate controlled solutions. Our innovative products continually reduce global warming potential. We operate in high-growth end markets with strong replacement demand that provides us resiliency even during economic uncertainties.

The company has a unique direct-to-dealer network, providing a strong, sustainable competitive advantage. And we have a history of robust execution with disciplined capital deployment. In summary, I believe LII is a compelling investment opportunity as we look at 2023 and beyond, and that our best days are ahead.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will take our first question from Gautam Khanna.

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

A couple of questions. First, I was wondering on the Commercial side, as you think about supply chain and get to root cause of what's happening there, is there any evidence of a) is it getting better, and likewise on the high-end residential products? And b) are you seeing anything where maybe you guys aren't getting as strong an allocation from certain suppliers relative to some of your competitors? Is there any evidence of that? And then lastly, if you could just talk about the CapEx required to build the new Commercial facility and the time line.

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

Sure. So on the supply chain side, both for Residential and Commercial, yes, it is getting better. But I've said this a few times and then something hits like COVID hit once and the Ukraine crisis hits once. But so far, everything that we are seeing, things are getting better. Maybe not fast enough, but they are.

Second, no, we have no concerns or have no evidence to show that the allocation issues impacting our supply chain performance. We have long, lengthy relationship with our core suppliers. And we believe that a lot of the challenges we are facing are exactly the same as other industry players. So we are not concerned about any of the allocations.

On the capital spend, we highlighted for the new factory, it's about $125 million to $150 million. We (inaudible) now planning purposes, assume that to be evenly split between the 2 years. But we can give you more guidance on that when we are together for the Investor Day on December 14.

Operator

Our next question will come from Jeff Hammond with KeyBanc.

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

Just back on the Residential supply chain, like you kind of commented that it's getting better, but it feels like it's getting worse. And I'm just wondering if there's anything with how you use your supply chain and a little bit more sourcing from Asia is creating a little bit of a lag. I just want to understand, because it just seems like across the board, people are saying things are getting better, and this seems kind of same to worse.

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

I think I would separate the supply chain situation with the Q3 residential margins. Because if you look purely at the margins year-over-year, you could reach a conclusion that it's getting worse. But frankly, there were a few decisions we made in Q3 to expedite materials and spot buy to make sure that we could serve our customers well. And I wouldn't look at our Q3 margins as an indicator especially the year-over-year change in Q3 margin as an indicator on supply chain.

Our inventory levels are getting healthier. Our lead times are improving. There are pockets of challenges remaining, especially on the high-end products, which are more dependent on microelectronics and semiconductors. But overall, things are getting better. And I think our guide implies that our Q4 margins on a year-over-year basis would be down significantly less than what we saw in Q3. So I look at Q3 as a onetime impact of multiple different factors.

So I would come back and reiterate, Jeff, that no our supply chains are getting better. Unless another shoe drops that we aren't aware of, we would expect most of the supply chain inefficiencies to be behind us no later than kind of mid next year.

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

Okay. Helpful. And then we've started to hear kind of about the pricing changes associated with the regulatory change. Can you just speak to what you're seeing there? And then just as we look at headwinds and tailwinds into next year, it just seems like the tailwinds are much more meaningful than the kind of lingering headwinds. Maybe just give us a better frame for if that's the right way to look at it.

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

Sure. So on the pricing for the new minimum efficiency products, I mean we talked about a double-digit benefit. And clearly, we're going to do our best to make sure that we get the appropriate price benefits. Currently, we remain very confident that we'll more than recover the additional costs associated with that.

Clearly, there are nuances, which I won't get into on the call on which products, CDs and what. But we remain confident that it's going to be a double-digit increase, and that's consistent with the higher cost and what we are hearing like an acceptable levels from our customers and channel partners.

On the second side, yes, I mean, that's a good takeaway. I thought if I put 3 bullets on the headwind and 8 bullets on the tailwind, I would naturally drive everybody to that conclusion that there are more tailwinds than headwinds. The biggest unknown there, Jeff, which we have talked about in the past is how well is the replacement demand going to hold. We think it's going to hold well. We think the replacement versus repair equation is going to tilt more towards replacement given the various dynamics, including higher labor cost for repair and including the Inflation Reduction Act and other pieces that naturally drive people towards replacement.

But, yes, we'll give you more details in December, but I think that's a fair way to interpret what we said.

Operator

We will take our next question from Nicole DeBlase from Deutsche Bank.

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

Maybe we could start with pricing question. So maybe putting a finer point on like attempting to loosely quantify the pricing tailwind in 2023. Alok, can you talk about like when you combine the impact of the double-digit improvement due to our SEER standard change and then think about just the price carryover from the actions that you guys took throughout 2022 that bleed into 2023 as that is annualized. Is there a sense of how much of a pricing benefit that can be in percentage terms for next year?

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

From a percentage terms, we could probably give you a lot more color in December as we finish launching all the higher SEER product change. But I mean, we do expect that number to be meaningful. In the first half of the year, we obviously will have a significant carryover benefit on pricing that comes through.

And for the full year, there will be annual price increases, and they will be the mix and price benefits from regulatory changes. But at this point in the call, I would say I think it's best for us to wait until December before we can give you like a range of price number. But what we're indicating is that it will be more than any volume decline that we're expecting at this stage in the residential side.

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

I'll also add to that, Nicole. We expect to be more price cost positive than we were here in 2022.

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

Okay. Got it. That's really helpful. And then maybe just anything you guys are seeing with respect to channel inventory dynamics. Obviously, there's a lot of questions about this from investors. And I think that it's especially tough to understand the level of inventory in the channel right now with what's going on with the SEER standard change. So how do you guys feel about where inventory is in your own distribution as well as Allied?

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

Sure. So in our own distribution, which is where a majority of our sales come from. I think the inventory level is getting healthier, but we are still short on some of the higher-end products. And if we could, we would actually maintain more inventory to ensure that we have all the products that our customers need as they go into the SEER change, which does make it messy.

On the independent distribution, which majority of the industry users, we think inventory levels are getting healthier. In those areas, I do worry about an air pocket sometime in the near future, driven by lead time improvements and driven by sort of the post-minimum efficiency change. People may try and resize the inventory. But I think that's not something we're experiencing now, and that air pocket is probably going to be early next year as most people are being cautious and will want to keep inventory -- sufficient inventory for the SEER change.

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

And just to make one more point. The air pocket is more attributable to those that go through 2-step distribution versus our direct-to-dealer model.

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

So we think that impacts us very little.

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Operator

We will take our next question from Julian Mitchell from Barclays.

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

I just wanted to start off with sort of a question about fourth quarter. So just wanted to understand, is the sort of assumption at the midpoint that you've got mid-high teens sales growth in Q4, not too different total or across the segments than what you saw in Q3. And then it's kind of a flattish margin year-on-year in the fourth quarter. So a little bit better year-on-year, and that's because of resi. Is that the right way to think about it and kind of still single-digit growth in resi volumes in Q4?

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

Yes. When I sort of step away and look at things year-over-year, particularly in the fourth quarter, I think what we're going to see is more of an impact on the Commercial business and fourth quarter margins. We had better margins last year in the fourth quarter. And because of the challenge that we have in that business, that's going to be the biggest drag in the fourth quarter on margins. The challenge is in the Residential business. We intentionally made some investments to procure inventory to make sure we can serve our customers, and that simply came at a higher cost, which we don't expect to repeat in the fourth quarter at the same degree.

And then our Refrigeration business continues to do very well. Net-net, we expect margins for the fourth quarter, even though we typically don't give guidance. I'll give you a little bit of insight here, flattish to up slightly in the fourth quarter.

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

And then maybe my follow-up would be around kind of cash flow and cash uses. So I think, yes, this year, you're running at about 60% free cash flow conversion from adjusted net, and understood it's because of the supply chain constraints. And then you have the sort of the CapEx for the new plant the next couple of years. So are we thinking it's cash flow conversion headline-wise probably doesn't get back to 100% for 2 or 3 years. Just wanted to check if that that's the right way to think about it. And also, any context as to the reduction in the buyback guide.

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

Yes, I'll start with the reduction in the buyback. What we did in the -- over the last few months is continue to evaluate what we need production-wise to meet end market demand and continue to look for opportunities to create slack in our supply chain and also fend off component price increases that will stick come January 1. So we made additional investments in inventory and lose share repurchases to make sure that we had adequate supply to support our customers going into a critically important time in 2023. So that's the trade-off there. And we'll continue to do things with the share repurchases to target our desired leverage points of between 1 and 2. We've talked historically about targeting between 1.5 and 2. I think we want to be closer to the midpoint as we embark on 2023.

And with respect to free cash flow conversion going forward, the way that I would do it, Julian, is start with the assumption that we're going to deliver free cash flow that approximates net income, and then take the incremental spend of the new manufacturing facility for commercial and adjust cash flow accordingly for that. And that should give you a pretty good proxy what the next year's cash flow looks like.

Operator

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

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

Look, maybe first on the new Commercial plant. Can you give us some sense of the increase in productive capacity that comes with this plant in terms of whether it's square footage or potential revenue output, something to kind of frame the size of this increase relative to the current base?

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

Yes. I think, listen, we are working through all the details. And what we did is work backwards from our customers' forecast and look at how much capacity we would need 5 years from now, 10 years from now and work backwards through that. So the plant may start out with lower capacity, but it will be very much matched to the customers' demand.

Other thing remember, in Stuttgart, we are running much lower than nameplate capacity given the local challenges and the labor availability. So at this stage, I don't want to give a number, but I mean, it's sufficient to say this plant will give us capacity at least for the next 5 to 10 years to keep serving our customers with their forecast they need.

Our customers and us both remain pretty optimistic about Commercial replacement demand especially as the new regulations come in and the ESG benefits that the customers receive. But given a lot of sensitivities around construction time lines and the impact on our existing facilities, I would rather not give exact details. But rest assured, we have a fairly detailed plan that we'll execute on within the next 2 years to make sure we can ramp and start production by the end of 2024 at the new facility.

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

Understood. And then just thinking about the SEER change again and kind of the mix impacts. As you exit '22, what percent of the business was at minimum SEER levels across the country in 2022, and therefore, subject to the mandatory step-up?

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

We've always talked about is more than 50%. I mean, the industry number typically hovers about 60%, 65%, and we are in a similar range. That number is probably a little higher in '22 just because the higher-end products use more microelectronics and they remain in somewhat short supply. But I would use a number of around 60%, which is the industry average, and that will apply to us as well.

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

Great. And then maybe just one last one. Just the comment about higher end componentry and the like. Is that causing any friction on the new SEER units or you're talking more 18, 20 SEER kind of up and there where you're having kind of component supply issues?

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

20, 24 or 28, I mean, remember, we make the highest year units and are very well known for those, they typically go as part of our Signature Series products. That's where we are seeing shortages, which unfortunately forces a dealer not to be able to upsell. I mean our dealers are really good at upselling and getting customers more energy-efficient products. And we have just been constrained on that. But we do see that easing as well as we get into 2023.

Operator

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

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

First off, you mentioned being prepared for the SEER change. How does your equipment lineup look competitively with the other brands?

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

Ryan, as the CEO, I always believe we are the best in this, right? So listen, a lot of the changes are still being unveiled. We believe that our design which, a), keeps the box size the same, so the footprint remains optimized. We believe as we have put single-stage technology that gives us competitive advantage. We believe our aluminum exchangers are better. But I think the most important difference is that for our products, a dealer does not have to change the indoor unit and just by changing the outdoor unit, they can meet the higher efficiency standard. For many of our competitors, they're going to change the indoor unit and the outdoor unit.

So listen, I'm biased. But I think we've got a great solution. I think our dealers and end users are going to be well positioned. And we are looking forward to gaining some share through the transition.

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

Got it. And then nice job on commercial. I'm curious what inning are we in for increasing production? And then did you say that in mid-'23 you'd be at full production for commercial?

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

Well, if you follow cricket, there we are in the first inning. If you follow baseball, we are probably in the second or third inning on that one. Listen, we had early innings, labor was a big challenge, we got that, but we are still no way close to meeting our customers' full demand or their natural lead time. At minimum, like our production should go up another 15%, 20% in the near future, and improving our manufacturing processes is a big deal. I mean, this is not acceptable level of productivity.

And finally, now our suppliers have to ramp up with us. And these are often smaller suppliers that we have let down in the past few years. So we are working through that. But early innings, probably in the second or third inning on a baseball terminology.

Operator

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

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

The 2023 early peak was helpful. I wanted to follow up on one of the comments that you made around resi replacement for next year. Specifically, where you talked about the potential for some volume pressure there in the context of an economic slowdown. How much of that in your mind is just a repair versus replace dynamic? Or are you also hinting at some discretion with respect to the timing of when a homeowner decides to spend, like, for example, in the context of an existing home sale?

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

No, I think pretty much all of it is a balance between repair and replacement. We continue to believe that this is a nondiscretionary spend. Now, would there be a small percentage that people will choose to live with a broken air conditioner? That's always there. But I think that's negligible. I mean, we think it's purely a repair versus replacement. We are still working through the analysis. We have looked at other recessions and economic uncertain environments in the past. And we think this time around, if there is a softness, the repair versus replacement will still turn more favorably towards replacement.

So I think we continue to believe it's all nondiscretionary. And the answer that nobody knows and we just have scenarios around it is how much of repairs versus replacement trade-off is going to change in the time of economic uncertainty. And we'll go back to driving more towards replacement.

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

I think there's also some other variables in play that will point things toward -- more towards a replacement versus repair scenario. One is the R-22 dynamic, where there's still a significant number of R-22 units installed, where it's going to be difficult, if not punitive to find that refrigerant should that be a necessary repair.

Secondly, is the minimum efficiency change. So I think that will help us a little bit. And then also incentives for heat pumps, electrification and all that with government incentives. So I think all of that points towards maybe a lower price tag for a replacement scenario compared to escalating costs in a repair situation. So, I think those dynamics are more closely aligned than they were in previously economic tough times.

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

And as one of your analysts with an R-22 system, I'm keenly aware of these dynamics. So I appreciate all the context there.

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

We can pick there.

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

We can point you the next dealer in your area.

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

We'll circle back after the call there for sure. Joe, I did want to ask about interest expense for next year. I know some of your debt is floating rate. Is there any way that you could frame based on the information have now or maybe the rate curve? What the headwind in terms of interest expense might look like next year?

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

I'm going to wait until December to clarify that for you, if you don't mind. We still have a lot of work to do on our plan, et cetera, and all of that. So there's lots of moving pieces, various scenarios that we're whittling down at this time. So I don't think it will be significantly different than wanting to stay will be higher, but it won't be significantly higher than where it is today.

Operator

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

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

I wanted to start on the cost side. And if I heard you correctly, I think part of inventory investment might have been sort of in anticipation of seeing component costs go up, but maybe you can clarify that. And then related to that, when you think about sort of the -- within COGS, the raw materials versus the sort of sourced components exposure that you have, kind of the balance of that. So I mean, likely seeing, I guess, raw materials come down. But what is your anticipation in terms of some of the sourced components? Do you think you see price coming down there? Or would you expect that to sort of be flat or even moving higher as we move forward?

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

Sure. So let me start with the inventory piece. Listen, I mean, as we go forward, I mean, we will probably shift that mix a little bit, so we'll have more fixed, more final finished goods and less raw material. Right now, we have higher raw material given the supply chain lead times, our own supply chain lead times. So I think that's going to shift a little bit.

But overall, we are reaching fairly normal inventory levels. So I think majority of the buildup that we have was returning back to normal finished goods level. And in future, we would see that trending in the same way. And in my factories, we always challenge them to say, hey, we have less raw material and our warehouses need more finished goods to serve our customers better. But I don't think we'll break it out historically, and we won't do that right now.

Second one, on the component cost side, we are expecting inflation, and we will continue expecting inflation for a few months. They always lag commodities. And our supply team, in some cases, has negotiated some excellent contracts, which means that pricing for next year may be indexed to commodity pricing this year. I mean, that always creates a 6 to 12 months lag. And I think based on that, we would expect components to continue being inflationary.

But if you take components, commodities, our material cost reduction initiative, put it all together, next year that will be a positive versus a negative this year. So this year that was a net negative in terms of headwind to us. Next year, putting the whole package together, will be a tailwind to us, and we'll break that out for you in December.

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

That's all really helpful. And then I wanted to circle back on minimum efficiency pricing and just so that we kind of do the right math in terms of how much of the portfolio that applies to. And so you talked about what percentage of the air conditioning and heat pumps would be at the minimum efficiency level. But if we think about sort of total resi, I don't know that the right math is to just say 60% is going up 10% to 15%. So maybe just kind of help us step through that a little bit.

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

Yes. It's a little more complicated than that given the way the transition is, particularly in Residential, where you can still sell 13 SEER in the north. It's just going to be manufactured by December 31st of this year. So I think that's something that we'll scale that number back a bit. I'm not going to give you the math only because I'm not certain of it, so I'm not going to lay out on the table. But I just want to put those dynamics back to you because once again, it is a very difficult thing to get our hands out. We're roughly 50% of the revenue, 60% of the units are minimum efficiency. So you start there. And then like I said, you need to consider the timing of the transition and the way that it's laid out north versus south, particularly on the residential side to come up with a tighter number around that. We may give you more color around that in December, but I'm not prepared to do that at this time.

Operator

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

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

Alok, on the Commercial start-up here with (inaudible) and you mentioned you kind of hit a few milestones in Stuttgart, what should we think about as sort of the increments along the way to restoring that $100 million of profitability you talked about? Because I think on one hand, the reasons that you guys have cited for what drove the reduction, it sounds like they've been remedied. So I'm sort of wondering like what's the next thing to watch and are there any sort of buckets of profit restoration that you would think about as correlating with that?

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

Yes. Right before the call, I've met Joe Nassab, our President and CEO of Commercial. And he said, "We got to strike a balance" so I'm going to use his words "on making sure we are demonstrating and celebrating progress, but acknowledging that we have lots and lots of hard work still ahead of us. " The improvements on $100 million is still going to be spread over the next 2 to 3 years. A lot of that is going to come with higher output because our output is still way below nameplate capacity at Stuttgart. A lot of that is going to come from just manufacturing efficiency. I mean, just our number shows that we have increased staffing by 30%, but output only by 15%. So we should be able to make 15% more products without adding any labor. Just simple math on that.

And then there's a lot more benefit that comes from improving our manufacturing processes. I mean, you don't get to the state we got in April with robust manufacturing processes. So we need to establish those processes. And then finally, as we take the step forward towards your change, the price/mix benefit that we talked about in Residential also applies to Commercial, where some of our national account contract had artificially constrained us on a pricing level.

Put it all together, I mean, we are confident of the $100 million. We think it's going to be in 3 years or less. I hope to deliver it in 2, but we commit to delivering it in at least 3.

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

Got it. That's helpful. And then I apologize if you covered this earlier, I cut out a couple of times during the prepared remarks. But on IRA and some of the heat pump points to watch, I think you guys probably lean a little bit more towards furnace than some of your peers out there, I would imagine that comes at the expense of heat pump. On the other hand, though, heat pumps, I think in terms of the incremental technology benefit, might help you a little bit more in the North than what they would have historically. I guess, how do you think about both product and channel positioning to maybe kind of execute on that opportunity here?

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

Sure. So you are correct that our heat pump exposure is less than some of our peers, mostly because we serve or have a higher share in the North versus the South. I look at it as a huge opportunity for us to increase heat pump penetration. We had strong growth this quarter, just like previous few quarters in heat pumps. Our new core climate heat pump technology gives us an edge over our competition as heat pump penetration goes from South to North.

And I believe Inflation Reduction Act is going to make a meaningful difference for us to increase heat pump penetration. And often, use the Inflation Reduction Act to go with dual fuel system, where you have a heat pump and a furnace in areas where heat pump may not work in the coldest few months, but work very well for the remaining 9 to 10 months. So there are a lot more opportunities ahead for us. Love to talk and show more of some of these points during the Investor Day. But pretty exciting opportunity for us and the rest of the industry, it gives us more favorable benefit given our low penetration and our cold climate heat pump technology.

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

Do you think you'll be able to quantify IRA? Or are we going to sort of ring-fence the opportunity at Investor Day?

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

It's potentially going to still remain very hard. Part of it is, it needs to flow down to states, and each of the states come up with their own local regulation. We know it's positive. I don't know if any of us, us or our peers, can give you actual quantification. We can probably point to themes, and I'm looking at Joe, and he's kind of nodding his head saying, I think it's going to be hard to quantify the exact impact just because it hasn't flown down to states and utilities and how it's actually going to be implemented.

Operator

We will take our next question from Steve Tusa with JPMorgan.

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

So first of all, what was the independent channel? How did that perform for you in the quarter? I know it was up pretty big last quarter in resi.

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

As you know, we serve mostly through the direct on the Lennox, and then with Allied and Heatcraft, we do go through the independent channel. I would say the growth was similar across the board. We historically don't break it out, but right now, the growth was similar across the board.

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

I think you just break it out in your 10-Q, no? Or is that no, you're not going to disclose that anymore?

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

Yes, we did break it out in the 10-Q. What Alok was talking about is in our formal presentation and prepared remarks, that's what he's referring to. So yes. And to Alok's point, I think both channels performed almost on par with each other this quarter.

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

They're not meaningful enough for us to point it out here.

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

Great. And then just one follow-up question. So I guess what everybody in the industry is now saying is that there's basically zero elasticity in the residential HVAC market. I mean, prices are up 30% to 35% relative to a couple of years ago, you're going to get another kind of artificial price increase with basically zero return for the consumer in spending that much money, and everybody is generally replacing today versus repairing. So you're just saying this market is kind of like fundamentally bullet proof from elasticity perspective. Is that kind of what I'm hearing, on residential.

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

No, I don't think we said that the pricing elastic. I think what we have to do as an industry players is make sure that we serve our customers best with the right solution. The repair versus replacements dynamic, I'm not saying there will be no shift. In fact earlier in the call, we did talk about that there maybe a potential shift and what we're doing is preparing for that. I don't any market ever is 100% price inelastic, but the current dynamics do favor more replacement versus repair, giving some of the factors we talked about. I don't think the SEER change pricing is artificial. I mean, I think that's real. There's real costs associated with it. There's real benefits associated with it. It's driven by regulation that impacts the whole industry. But there are a lot of unknowns. Our job as leaders is to be prepared for those unknowns and react in the best interest of our shareholders as those different factors play out, Steve.

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

Yes. I guess what I was just saying was that the consumer doesn't really care about regulation or any of that. So for them, that's just another 10% price increase. And they're not worried about your increase in costs and there's really not a payback associated with it.

So just one more question for you. What is the -- what -- in kind of the new efficiency systems, what is the average cost of install to replace one of these things now in your view in the channel, kind of your average as you look across your full year? If I'm a consumer, I'm replacing, what is that average now, cost?

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

So first of all, thanks for bringing up the cost of install, because to a consumer, the cost of equipment is often less than the cost of install. But that obviously depends on whether you're in Topeka, Kansas or whether you're in New York City. I mean, that obviously varies substantially based on the cost of labor. But the cost of equipment, on average, is less than half of the total cost to the consumer, given the cost of installing and supplies and labor and other pieces that are put out of that.

We don't have a number because it does vary so much to give you in terms of what's the average cost of install. And the industry data that you can, I'm sure, well aware of. But in our view, that has gone up substantially as well over the past few years.

And last thing I would say, there is a benefit to the consumer with higher SEER changes as lower electricity cost. Most consumers may not see that on their daily bills or may not be fully aware of it. But there is a benefit to the consumer in terms of lower energy consumption. That is meaningful when energy prices are at a record high sometimes.

Operator

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

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

So look, I think that you raised the point about the R-22 pricing as a driver of replace and repair. I think this is a really important debate because there's something that we hear a lot of debate about in the field. There are drop in refrigerants, like R407, R438, et cetera, that can replace R-22 at much lower prices and have performance very similar. Are we not seeing that happening? I mean, you haven't got to pay R-22 prices at this point. So just wondering what the view is on that.

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

Specifically to the R-22 units, you have to consider the cost of refrigerant along with many other factors, such as the age of the equipment, the potential life left in the compressors and the motors. So you're right. I mean, it's not just that. I mean, we look at that as a significant installed base that's upcoming due for replacement anyway, and the fact that the refrigerant cost is much higher gives our dealers an opportunity to talk to the homeowner about how it can be replaced with a more efficient unit, more environmentally friendly refrigerant with warranty, with potential benefits from the Inflation Reduction Act in terms of rebates.

So I think it's a whole package you got to look together. Yes, there is a huge debate, and we are part of that debate in terms of repair versus replacement. And I think you and I have talked about before. Nobody knows the answer. They're all different models. And our goal as a team to drive it towards replacement, that's beneficial to the consumer, but we are prepared towards any possibilities. If the consumer chooses repair, we want to make sure we provide them with the repair parts. And then we'll talk to -- if we see shift in that dynamic, we'll come and talk to you all about the other shift we are seeing.

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

Right, right. And then just a quick one, I know we beat this one to death. But you alluded a lot this is -- don't hold your breath. This is government thing, the cogs turn slowly. Are we thinking here this is more of a 2024? I mean, certainly, if you look at the disbursements and the budget, CBO projections, it's much more '24 than '23. But when do you think your contractors and dealers can go out and actually start selling customers on these benefits?

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

I think it starts in some states next year. I mean, some of the states which are faster to roll this out. And I do expect, like that along the coast, you might see it sooner. Some of it will be in 2024. I mean, it is a good piece for our dealers to be able to start talking about it now. I mean, if you see from press releases from us and all our competition, it's already being used and there are already some rebates available with utilities and states that are not tied to IRA, but this gives our dealer an opportunity to go talk to a consumer about a rebate that may already be existing. But the actual impact of IRA, I think it starts in '23 and goes into '24. And it's just hard to quantify without knowing the full details of the rollout yet.

Operator

Our next question will come from Joe Ritchie with Goldman Sachs.

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

So, I might have missed this earlier, but just can you parse out the Commercial growth this quarter? How much pricing came through this quarter versus volumes? And then also if there's any commentary on commercial orders, that would be helpful.

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

Yes. I think we mentioned in the script that the pricing for Commercial was 9%. The total growth was 20%. So you think of it as 11% from core unit volume and 9% from pricing. We don't typically break out order information, but, I mean, orders remain healthy and currently are at or above our sales rate. So our backlog continues to build.

And in addition to the backlog on our book, there's also anticipated demand as many of the key customers are working with us on planned replacements here as they need to meet their ESG criteria. And at least here, there's a very sophisticated decision about repair versus replacement because through our national account service, we have huge insights into potential breakdown and replacements coming up. So it's all positive in terms of -- I think pricing is picking up, volumes holding strong and we have good insights into orders on the book and future orders beyond what's in the book.

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

Got it. That's helpful. And then it was nice to see Alok the margin expansion this quarter, both sequentially and on a year-over-year basis in Commercial. I know that there's some seasonality in the business, so 4Q and 1Q tend to be seasonally lower quarters. I'm just curious, as you're kind of thinking through the margin progression from here, are these margins -- are margins that can hold? Or do you expect the margins to kind of take a step back, at least from an absolute level sequentially because of the seasonality in the business?

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

So a couple of things, right? Overall for Lennox, our margins are going to go up in the future. So I think the current margins level are lower than what I expect a year from now, 2 years from now or 3 years from now. And we'll talk more about that on the Investor Day. Q4 specifically, you are right. Margins are seasonally low. And quite a few our manufacturing lines are going to go through a transition as we shift to minimum efficiency products, especially on the Commercial side. Hence, we hinted that in Q4, the Commercial margins may take a step back. But that's planned changeover where our factories lines need to be just rework and shut down to support the new products.

But overall, on margins, listen, we were disappointed with the resi margins this quarter. But we understand some of the onetime factors and the mix impact. We are cautiously guarded for Q4. But we're optimistic about margins in the future, like as we look at 2023 and beyond.

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

Got it. One more quick one. Just on the commercial facility that's coming online that you expect to be fully operational by, I think, you said 2024. Right now, Commercial end markets, to your point, the orders are strong. Who knows where we're going to be in 2024. I guess, the question I had for you is, you're adding capacity in that facility, how much leeway are you going to have to basically adjust to maybe changes in the market dynamics if we're in a much different place on nonresidential construction or commercial HVAC in 2024? What will you be able to do to kind of adjust your capacity to ensure that you're not taking significantly high decremental margins if the market were to turn?

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

Yes, that was part of the concern and the equation we went through. I mean, there may be a short-term softness 2 years from now, which none of us would know. First of all, I think the new facility gives us a lot of flexibility. I mentioned in my script that the hourly labor cost of the new facility would be 80% lower than our hourly labor cost at our current facility. Also, the new facility is close to our Residential facility, which gives us flexibility in moving labor around if we need to between and optimizing it collectively as Lennox International.

So yes, I think we will have significant flexibility to react as we have done in the past in terms of ensuring that margin degradation is minimal as we go through any volume decline based on external factors. But having 2 facilities will give us a lot more flexibility than if we only had one when things like went south economically.

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

And just that I'll also remind you, I think everyone knows this, our variable -- our costs are roughly 85% variable when it comes to product costs. So it's not a high capital intensive business where it would be catastrophic to decremental margins should volume decline.

Operator

We have reached our allotted time for Q&A. That was our last question. That concludes today's presentation. Thank you for your participation, and you may now disconnect.