REFINITIV STREETEVENTS

EDITED TRANSCRIPT

LII.N - Q2 2020 Lennox International Inc Earnings Call

EVENT DATE/TIME: JULY 20, 2020 / 1:30PM GMT

OVERVIEW:

Co. reported 2Q20 GAAP revenue of $941m, GAAP EPS from continuing operations of $2.62. Expects 2020 revenue to be down 10-15% and GAAP EPS from continuing operations to be $7.31-8.11.

REFINITIV

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Breindy Elizabeth Goldring *Morgan Stanley, Research Division - Equity Analyst*

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

Christopher M. Dankert *Longbow Research LLC - Research Analyst*

Deepa Bhargavi Narasimhapuram Raghavan *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

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

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

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

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

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

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

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

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

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International second 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 second quarter of 2020. I'm here today with Chairman and CEO, Todd Bluedorn; and CFO, Joe Reitmeier. Todd will review the key points for the quarter and the outlook, and Joe will take you through the company's financial performance and guidance. (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 and available 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.

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. Let me start with a quick overview on the second quarter that was significantly impacted by the COVID-19 pandemic and then discuss the updated outlook for 2020, in which we are raising guidance for revenue and earnings for the year.

For the second quarter, company revenue was $941 million, down 14%. GAAP operating income was $136 million, down 36%, and GAAP EPS from continuing operations was $2.62, down 7%. The second quarter last year included an insurance benefit of $26 million and a pension settlement charge of $61 million. Total segment profit was $153 million, down 24% from the prior year quarter that included an $18 million insurance benefit.

From an operational perspective, excluding the insurance benefit, total segment profit was down 17%. Total segment margin for the second quarter was 16.3%, down 210 basis points as reported and down 50 basis points from an operational perspective. Adjusted EPS from continuing operations was $2.97, down 21% as reported and down 12% from an operational perspective.

In our Residential segment in the second quarter, revenue was down 6%. Revenue from replacement business was [down] high single digits, revenue from new construction was down low single digits. Residential segment profit was $127 million, down 17% as reported and down 6% on an operational basis, excluding the $18 million insurance benefit in the second quarter a year ago. Segment margin was 19.7% in the second quarter, down 260 basis points as reported and up 10 basis points on an operational basis.

Our Residential business improved each month through the quarter and was up 7% in June as the economy continued to reopen and weather heated up for the summer. Cooling degree days for the second quarter overall were up 4% from the prior year quarter. For the month of June, cooling degree days were up 12% from last year. The hot weather has continued month-to-date in July, and we're seeing strong residential growth on excellent operational execution by the team to capitalize on market opportunities.

Turning to our commercial-facing businesses. They are more heavily impacted from the pandemic as we expected. On the Commercial business segment, revenue was down 28%, segment profit was down 34% and segment margin contracted 170 basis points to 18.9%. National account revenue was down approximately 40% and regional and local revenue was down approximately 20%. Breaking down the revenue another way, replacement was down 35% and new construction was down nearly 20%.

On the service side, Lennox National Account Services revenue was down about 20%. VRF revenue was up low single digits. While overall Commercial Equipment was down 30% in the second quarter, we're seeing signs of relative improvement in the business with Commercial Equipment backlog currently down 20% year-over-year. Commercial continues to win new business and position for future growth. Commercial won 15 new national account customers in the first half, including 6 in the second quarter.

Turning to our Refrigeration business segment. Revenue was down broadly across our businesses in North America and Europe, declining 26% at constant currency. Segment profit was down 53% and segment margin contracted 460 basis points to 8.2%. North America revenue was down more than 20% and Europe revenue was down about 30%. As in our Commercial business, we are seeing signs of relative improvement in Refrigeration as well. Backlog is down approximately 20% year-over-year.

Overall for the company for the second half of the year, we continue to face highly uncertain market conditions. Our stock repurchase program remains on hold currently given the high uncertainty, but we continue to be encouraged by the performance of our Residential business and relative improvement in the Commercial and Refrigeration businesses. We continue to maintain a strong balance sheet and expect a strong year of cash flow generation. We continue to target $340 million of free cash flow for 2020.

The company has executed well on its $115 million of in-year SG&A savings for 2020. And we managed decremental EBIT margin of 20% on an operational basis in the second quarter. We are raising our financial guidance for 2020 and now expect adjusted revenue to be down 10% to 15% and adjusted EPS from continuing operations within the range of $7.90 to $8.70.

As I turn it over to Joe, I will just mention that Lennox has a seasoned team with experience managing through economic downturns while continuing to invest and advance the company's position. All of us are focused on capitalizing on market opportunities and share gains. Now 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 second quarter, revenue from Residential Heating & Cooling was $645 million, down 6%. Volume was down 8% and price and mix combined was up 2%, and foreign exchange was neutral to revenue.

Residential profit was $127 million, down 17% as reported. Segment margin was 19.7%, down 260 basis points as reported. Segment profit was negatively impacted by the year-over-year difference in the insurance benefit, higher warranty expense and the COVID-19 pandemic that led to lower volume and factory inefficiencies. Partial offsets included favorable price and mix, lower material, freight and distribution costs and lower SG&A expense.

Turning to our Commercial Heating & Cooling business. Commercial revenue was $188 million, down 28%. Volume was down 27%, price and mix combined was down 1%, with price up and mix down. Foreign exchange was neutral to revenue. Commercial segment profit was $36 million, down 34%. Segment margin contracted 170 basis points to 18.9%. Segment profit was negatively impacted by unfavorable mix, higher warranty expense and the COVID-19 pandemic that led to lower volume. Partial offsets included lower material, freight and distribution costs and lower SG&A expense.

In Refrigeration, second quarter revenue was $108 million, down 27%. Volume was down 27%. Price and mix combined was up 1% and foreign exchange had a negative 1% impact on revenue. Refrigeration segment profit was $9 million, down 53%. Segment margin was 8.2%, down 460 basis points. Segment profit was impacted by higher warranty expense and the COVID-19 pandemic that led to lower volume and factory inefficiencies. Partial offsets included lower material, freight and distribution costs, lower SG&A expense and favorable foreign exchange.

Regarding special items in the second quarter, the company had net after-tax charges totaling $13.4 million. This included $7.9 million for the restructuring activities, $2.6 million for personal protective equipment and facility deep cleaning expense incurred due to the pandemic and net $2.9 million in charges for various other items. Corporate expenses were $19 million in the second quarter, down 22% from the prior year quarter.

Overall, SG&A was $130 million, down 15% from the prior year quarter. In the second quarter, the company generated $105 million of cash from operations compared to $30 million in the prior year quarter. Capital expenditures were $19 million compared to $16 million in the prior year quarter that also had approximately $6 million of proceeds from insurance.

Free cash flow was approximately $87 million in the quarter compared to $20 million in the prior year quarter. The company paid approximately $30 million in dividends in the quarter. Total debt was $1.39 billion at the end of the second quarter, and we ended the quarter with a debt-to-EBITDA ratio of 2.4. Cash, cash equivalents and short-term investments were $49 million at the end of June.

Now before I turn it over to Q&A, I'll review our current market assumptions and guidance points for 2020. For the industry overall, we expect North American Residential HVAC shipments to be down mid-teens. We expect both Commercial unitary shipments and Refrigeration shipments to be down 25% for the industry.

Looking at the company's performance in the first half of the year and the outlook for the second half, we are raising 2020 revenue guidance from a range of down 11% to 17% to a new range of down 10% to 15%. We are raising 2020 guidance for GAAP EPS from continuing operations from a range of $7.07 to $8.07 to a new range of $7.31 to $8.11 for the year. We are raising 2020 guidance for adjusted EPS from continuing operations from a range of $7.50 to $8.50 to a new range of $7.90 to $8.70 for the year. The various puts and takes in our financial guidance for 2020 remain unchanged.

We continue to expect a benefit of approximately $25 million in net price for the year. We still expect a $20 million benefit from sourcing and engineering-led cost reductions. Residential factory productivity is still expected to be a $10 million headwind. Residential mix is still expected to be flat and we still expect tariffs to be neutral. Commodities are expected to be a $20 million benefit this year, and we continue to expect freight to be a $10 million benefit.

Now a few other points to mention in our financial outlook. Corporate expenses are still targeted to be $75 million. And as we talked about last quarter, we have taken $115 million of SG&A cost reduction actions in total to benefit the second, third and fourth quarters of this year. Net interest expense and other expense guidance remains approximately $40 million, and we still expect an effective tax rate in the range of 21% to 22% on an adjusted basis for the full year.

We continue to expect the weighted average diluted share count for the full year to be between 38 million to 39 million shares. We repurchased $100 million of stock in the first quarter and the $400 million plan going into this year. Our stock repurchase plans currently remain on hold. We continue to target capital expenditures of $120 million this year, and our guidance for free cash flow remains approximately $340 million for the year. And with that, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And first, we have the line of Julian Mitchell with Barclays.

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

Maybe just the first question on the revenue outlook. So it looks like your guidance on revenue implies the second half is down mid-teens year-on-year, so similar to the Q2 decline, but you seem to have better momentum in Residential, and you even talked about stabilization in the other 2 divisions. So maybe just help us understand that second half revenue outlook.

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

I'll be very clear, so I won't dance around the question. If the market environment remains like it is today, we're going to do better than the midpoint of our guide. The concern that we have is that there's a lot of moving pieces, both medically with the pandemic and the impact that, that has on end markets. And so we baked that into our guide.

But if you've then asked the question, I'll answer your question, in July, our Residential business is up mid-teens so we have strength in July. And if things stay the way it is, we're going to do better than the guide. But the concern is a changing world and a changing marketplace, and that's reflected in the guide.

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

And then just secondly, on the profit margins. Maybe clarify if you can how much of that $115 million of SG&A cost out is still left to be booked in the P&L in the second half. And also, clarify the decremental margin. I realize there's different categories of it, but I think if you take the adjusted number of 20% in Q2, are we right in thinking that the second half, you're assuming that's around a mid-teens number at the midpoint of guidance?

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

I'll answer the last part first, Jeff. You're right to assume that second half of the year, it's -- mid to high teens is the adjusted number of the decrementals at the current guide. On the first part of the question, out of the 100 -- we think about the $115 million this way. We implemented May 1, the vast or -- all the cost reductions were implemented by May 1. And the salary reductions were implemented effective May 1. And so I would think about

May and June were sort of full run rate savings for the $115 million. And then third and fourth quarter will be -- all 3 months will be full run rate of the [same].

Operator

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

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

So just -- we -- in our checks, we picked up a lot about supply chain. I know some facilities, not yours, were shut down in Mexico. And I think your inventories on your balance sheet are low. Can you just speak to -- it seems like certainly, Residential coming in better and just your ability to kind of manage inventory, manage demand, get the right product to your dealers.

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

We did a really good job in the second quarter. And there's a continual triage going on, I think, across corporate America, certainly within our industry and certainly within our company. Almost a whack-a-mole is another analogy. But our team and suppliers have done a great job through this. Our supply chain is slowing and our manufacturing plants are all up and running, and we are focused on meeting the demand in the market. I think we're as good or better positioned than anyone in the industry as we flow through the balance of the year.

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

Okay. And then just on commercial, I think you said some signs of stabilization. What's getting better? Is that just work stoppages abating? Or are you seeing kind of better -- where are you seeing better trends ultimately?

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

Let me go a little bit into detail on the question, Jeff. When we think about the Commercial unitary business in North America, really think about it in 3 parts. About 40% of the market is planned replacement, that's primarily for national accounts. We expected a quick decline in that, and we saw that in April and May, orders were down 40%, 50%. But they've picked up and are stronger in June, so the decline's maybe half of that at this point. 20% of the market is new construction and commercial new construction didn't drop as quickly as what we saw in the planned replacement because planned replacement is discretionary. People can make the decision right away.

New construction projects are ongoing, so we didn't see that drop early, but we're now starting to see that drop. And 40% is emergency replacement or flow business, sort of like the residential business. It slowed down, but not at all like national accounts, that's been more in the down 15%, 20%, during the process.

So that's a lot of words, but I think the answer to your question is where we've seen improvement has been planned replacement, national accounts, where we have an outsized position. As I mentioned in the script, while revenue was down 30% in Q2, our backlog is down about 20%.

Operator

Our next question is from Gautam Khanna with Cowen.

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

A couple of questions. First, I was wondering, any discernible trend on mix in resi? Are you seeing a mix down? Or has mix held up pretty well in July and...

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

Yes. No. I mean the mix in the Residential business was up slightly in the second quarter. We're still guiding for it to be flat year-over-year. There's lots of moving pieces on mix in any given quarter. But I think one strength is our Lennox-branded product performed better than our Allied-branded product. And at the gross margin level, it has higher margins.

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

Okay. So you're not seeing it. And then secondly, just competitively, have you seen any change in behavior from your principal competitors in the U.S. on the resi side?

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

No change in behaviors. That's a specific question about Trane and Carrier that's often asked. I mean I don't think it's a secret -- certainly not a secret in the industry, Goodman's had some production issues, and that's opened up some opportunities for us and others in the industry to sort of pick up some of the business that Goodman hasn't been able to meet.

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

And lastly, just pricing. I mean, obviously, you're getting a little bit of price, mix hasn't been worse. So any potential to actually raise prices in this environment? Or is it not supportive of that type of dynamic?

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

Yes. Pricing is more as you go into the season and you put a price in place. And we have the price in place. And again, we have long-standing relationships with these customers, with these dealers. And sort of a hot summer to raise prices, you really don't want to do that. So I think we're going to get the price that we committed to. And the markets help support that with the demand.

Operator

Our next question is from the line of Deepa Raghavan with Wells Fargo Securities.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

New construction, pretty, I mean, strong just given results, especially in Residential. Curious how you're thinking about new construction trends for the rest of the year? This is a Residential question. And would that be -- would that pace better than replacement?

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

Our best guess is it won't stay better than replacement. I think new construction, although it's been very resilient and low interest rates are helping, our best guess is second half of the year, that tails off in add-on or replacement, which was increasing -- sequentially stronger April, May and June; continues to hang in there. And so we expect new construction to tail off.

But another thing that I just want to weave into the conversation around some of our confidence about add-on and replacement is, as you remember, Deepa and others on the call, during the great financial crisis, the canary in the coal mine in our industry was parts sales started to grow very quickly, and that was an indicator that people were repairing rather than replacing. We haven't seen that yet.

So what we saw in the second quarter was that, for our Lennox business, our Residential replacement was down low single digits, while parts were down high single digits. And just for the month of June in our Lennox business, our Residential replacement was up mid-teens and parts and supplies were only up 1%. So we're not seeing anything like we saw during the financial crisis. And to me, that's an indication that add-on and replacements are hanging in there. And I would expect new construction to slow down.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Got it. My follow-up is on cost actions. I think the last time we spoke about cost actions, some of them are temporary, mostly in the salary front. Just given how residential trends have outpaced expectations in Q2 and how July is trending strong -- I understand the uncertainty ahead, but how are you thinking about the time line of rolling back some of those temporary measures? And does your guide range assume any rollback, at least at the better end of it?

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

Our guide range assumes our perspective on how the balance of the year is going to play out. And I understand that sounds like a political answer. So yes, it encompasses our best guess of things coming back. In terms of the $115 million coming back, about 40% of the $115 million were what we call pay -- temporary salary reductions, STI or short-term incentive, that sort of thing. And if we do better in 2020, especially second half of the year, I can imagine some of that would come back, but that's all encompassed by our guide. So there won't be bad news that we give you later because we decide to pull some of it back.

Operator

And next, we'll go to the line of Joe Ritchie with Goldman Sachs.

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

Todd, just my first question, there's a lot -- there's been a lot of commentary around the length of the resi replacement cycle and how far we are into that specific cycle. Do you think the kind of changes, this working from home dynamics, potentially taxing HVAC systems actually changes the trajectory of that cycle? Just would love any color around that.

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

I think it could. I don't -- the honest answer is, I don't know. But when you think about it, I think about people working at home, it becomes their island, it becomes their life raft, if you will, and the desire to sort of invest in it and protect it. Now I think that's in a world where unemployment doesn't go back up to 20% and that people have money to spend. But certainly, the repair versus replace dynamic that I talked about earlier supports that answer that things have changed.

And I also think, as we've said for a while, it's an inexact science and some -- not you, Joe. Any work Goldman does is spot on. But other sell-side models have attempted to sort of guess how this is going to work, there's some false precision. I'm not sure anyone would have guessed that with degree cooling days up 4% that we would see this kind of performance in the face of COVID -- including us. And so I think the market is pretty resilient.

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

Okay. Good to hear. And I guess just the second question, just thinking about the commercial business. I appreciated the breakdown that you guys gave us. So when you kind of think about this opportunity for like the potential service tail to come back quicker, and I know that we're in a bit of a difficult time right now with the surging continuing in the U.S., but how are you thinking about the -- just like the service tail to that business specifically for you guys and your ability to get on-site access to do repairs and service on your commercial equipment?

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

We have access. We have access today. Our North American -- NAS, our North America service business, we're up and running. We never shut down. We're an essential business. On the product that we sell through our distributor, through our dealers, they are essential businesses that are on site. They're working. And so the service revenue, while down in second quarter, we expect it to be flat, maybe even up second half of the year.

And then on -- I talked a little bit about planned replacement that it goes down steep and then it comes back steep too. So when it comes back, it comes back quickly. I think you have to have a bit more of a green light than what we have now, although, as I mentioned, it's gone -- the order rate has gone from being down 40%, 50% in April, May time to half of that now. So it's not healthy, but it's certainly better than it was a couple of months ago.

Operator

Our next question is from John Walsh with Crédit Suisse.

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

I guess just a question about the strength of the exit rates you're seeing and trying to understand if any of that or if you can quantify how much of that is kind of contractors maybe not getting into a house as we were kind of more at the peak of COVID in those kind of April and May months. Is some of this a catch-up of that? Or do you think we're at -- these exit rates are something we can kind of roll forward?

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

You broke up a little bit on the beginning of the question, so can you restate it for me, John?

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

Oh, sorry. Was just thinking about if some of the strength in the exit rates you're seeing is kind of a catch-up from when contractors couldn't get into people's homes to do kind of replacement and regular maintenance?

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

No, no, no. I don't think so. I don't -- I think when we talk to our customers -- when we talk to our contractors, I mean, they've had access the entire time. I think it has to do with the hot June. And so degree cooling days [going up 4%] for the quarter were up. I'm looking at my notes to make sure I have the right...

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

12%.

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

We're up 12%.

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

For June.

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

In June. So that warm weather helped us in June. I think the other thing that we're going to have to see is we think we gained share in the second quarter. In fact, I know we gained share in the second quarter because I've seen the industry data. And we had mentioned exiting 2019 that we had regained business with 80% of our contractors that have -- or dealers that have been impacted by the tornado. We're now seeing that flow through in our volumes.

We also -- as I mentioned in the first quarter call and the last fourth quarter call that we focused on new business, and we had a significant backlog of additional new business coming into the year, and we're seeing the benefits from that and then, as I mentioned earlier, some of the issues that our competitor or competitors producing products.

So I think it's a combination of repair versus -- replace versus repair staying in place, some hot weather. But actually, I think share gain is one of the largest reasons we had such a strong June and quite frankly, have a very strong July.

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

Great. And then just curious if you're seeing your customers on the Resi or the Commercial side do more add-ons around indoor air quality. I don't know if that rolls into the mix piece, but just trying to see if they might not go higher on this [sphere], but they're doing other add-ons that you might be able to benefit on as you capture that?

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

Indoor air quality is a scenario that we focused on for years, both in residential and commercial. And when you think about sort of a bit of a baseline, for folks on the line, John, when we think about indoor -- well, I think when the industry thinks about indoor air quality, it's about air purification, which is filters, HEPA filters and UV lights, [about] ventilation and circulation. And then third is about humidity control. And it's always about balancing, bringing in outside air and that's part of ventilation and then humidity control and also the capacity of the units as you bring out the outside air that's untreated.

We're definitely seeing increased interest in IAQ, indoor air quality, in both Residential and Commercial. Our Residential PureAir equipment is the best in the industry. And that's just not us saying that, that's consumer reports. In Commercial, similar to Residential, we work with our customers to address their solutions.

So I think it's important. And I think it's about you have to have the capability to win the customer and serve the customer. But it's not a big enough dollar item, even if people add it to the mix of the equipment, to sort of have an outsized impact on sales and margin. I think it's about a binary item that you have to have this capability to be able to talk to your customers, end customers and your dealer contractor customers to win business, and we're well positioned to do that.

Operator

Next, we go to the line of Nicole DeBlase with Deutsche Bank.

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

Just maybe starting with the free cash flow guidance. Just curious why that's not also moving higher as EPS is higher. And maybe same topic, any thoughts around working capital potentially flipping to an inflow in the second half of the year?

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

I think we'll still continue to generate cash from working capital second half of the year. Given the caution that I identified around EPS, even a greater caution around cash flow, just historically, our ability to forecast it, so I mean, $340 million is our best guess right now. But similar to what I said on earnings, if the world stays the way it is, we'll do better than $340 million.

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

Okay. Got it. And then second question just around the potential for dealer inventory restocking. I know that was something that hadn't really happened obviously because of COVID as it normally does seasonally. Are you starting to see dealers restock inventory? And if not, is that -- and does that create potential for more uplift in 3Q if that does start to happen?

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

We've seen dealers restock in second quarter. And hopefully, if the weather continues to be hot and it's a strong July and August, we'll see some more sort of loading. On the distributor level, which is our Allied business, our -- which does 20% or so of what we do, it's more of an impact of when distributors decide to reload and they put off, in a broad degree, April and May. We started to see them reload and sort of do some buying in June, significant buying in June. And so I think that's where there's more momentum in sort of replenishing the channel. For us, it's on our Allied channel. On the Lennox side, dealers started buying in May, June.

Operator

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

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

Todd, on the surface, the comps start looking tougher in the back half. I'm just wondering if you could give us a little color as we try to think about Q3 and this really strong result here in July, how the comps for the remainder of the quarter kind of play out? And was July particularly easy this year?

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

No, I'm doing a little bit from memory. I'll be honest with you, Jeff, I didn't [spill up] on that exact question. I don't -- July wasn't necessarily easy last year. As I recollect, we had [a cruel] beginning to the summer last year. And so I think May and June maybe -- might have been easier, but we saw that in degree cooling days. And then I think July was sort of a normal July for us.

And then as I remember, fourth quarter, we [pitched] about warm weather and the impact that it had on our furnace stations. So I don't -- I think -- I don't think the comps are that dramatically harder. I think that when you look at the reported numbers, the tornado impact was much more pronounced during the first half of the year than [it was] in second half during the year. But when you sort of adjust for the tornado impact, the comps weren't that much different.

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

And on the factory and efficiency side, can you give us some sense of what we're talking about? Is that just the $10 million that Joe mentioned? Or there's just kind of other -- perhaps harder to measure kind of noise, inefficiencies going on in the factories?

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

The inefficiencies are driven by both traditional absorption, right, which is we don't have the volume, so the fixed costs don't get absorbed. And then there's -- absenteeism is up a bit. As you could expect, our factories that are in places like Georgia and Iowa and South Carolina where there has -- big COVID, and that has impact.

I broadly think about it as we entered the year saying we were going to get $10 million of factory productivity, and now we're saying we're going to have $10 million of inefficiencies. And so a $20 million swing is what I would think about, driven both by volume and by the absenteeism, right?

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

And then finally, what do you need to see to restart the share repurchase? Everything you said here today sounds pretty constructive. Obviously, the future is cloudy. But anything in particular you need to see -- just another quarter under your belt? How are you thinking about that?

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

I think we need -- I think the world is still changing quickly. So I think we certainly need another quarter under our belt. We'll see how third quarter goes. And I think I've been -- I don't know if I said this on an earnings call, but I certainly have said publicly before, I think the other issue that we have to continue to ensure of is we've asked for shared sacrifice from our employees around pay cuts and 0 bonuses. I think we have to start making some of that whole before we aggressively make investment in share buyback. I think we've got to sort of balance how the benefits flow out.

Operator

Our next question is from Nigel Coe with Wolfe Research.

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

We've covered a lot of ground already, Todd. So thinking about -- just take a step back and going back to 2Q and I'm looking at the kind of the cadence month on month. I'm not looking for a blow-by-blow account here. But the plus 7 in June, do we need to do any adjustments on sales -- selling days because I think a lot of companies had to [upsell in days] in June? Any distortions there? Or is that plus 7 a good exit rate for 3Q in your view?

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

I think the plus 7 is good exit.

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

Okay. Great. And then on the inventory side, obviously, your inventory is...

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

And on the other line, I'd say the up mid-teens in July, I know that for a fact is day for day.

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

Right. Exactly, yes. And then inventory down 10% from 4Q, which is obviously very unusual, these are unusual times. What needs to happen given -- it seems Residential continues with this mid-teens cadence through 3Q. Do you actually need to raise production levels to kind of restock?

I mean -- and any color you have on where that inventory, how that looks by business would be helpful. I'm just wondering, your free cash flow guidance, I wonder how much of that embeds some level of inventory kind of rebuild for you? And then any color on income taxes in 3Q. We are seeing some deferrals of income tax payments as well.

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

On the inventory build, we started -- I don't know if it's 6 weeks ago, 7 weeks ago, 8 weeks ago -- as soon as we started to see the markets and how they were behaving, we ramped up production. So we've already ramped up production to stay ahead of the demand curve. And as I said earlier, we're all -- in the summer when it's hot, you have to work through both the supply chain and inventory levels -- lay on top of that COVID. So our teams are working hard, but we feel we're in a great position and certainly as good as anyone in the industry to meet demand. And I'm not sure I understood the question on taxes.

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

Yes. With the CARES Act, I think there was a bump down in cash tax payments into July from...

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

Yes. It's a bit of a cash bump for us on the timing of the cash. But honestly, it's de minimis for us.

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

Yes, it's a modest -- the benefit for a quarter, or 2, but once again, it's a timing issue.

Operator

And our next question is from Josh Pokrzywinski with Morgan Stanley.

Breindy Elizabeth Goldring - *Morgan Stanley, Research Division - Equity Analyst*

This is Breindy on for Josh. I wanted to ask about how the tornado customer reacquisition was going in this current environment? And in terms of the incentives and rebate that -- how that was trending versus the $10 million range that was given -- implied in December?

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

It's tracking as we had hoped and expected and guided that it would, as I mentioned earlier. We think -- in fact, I know we gained share in the second quarter because I've seen the numbers. And a big piece of that is, as we talked about, that we had 80% or so of the tornado impact we had gained back with our customers, we'd see it flow through in 2020 and we're seeing that. And in terms of incentives and benefits that we gave to dealers, that lines up what we committed to do, we're following through. Even with a strong market, we're not going to be back off those incentives. We're committed to doing that. And so that's all in line also.

Operator

And our next question is from Steve Tusa with JPMorgan.

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

Todd, that shot at the sell-side really hurts -- just a little sensitive these days. So I thought I was on the Watsco call there for a second.

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

I thought I complimented Jeff Hammond.

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

Yes, you did. But talking about how our -- there's some false precision in our models, which is factually correct. But I guess there was also some false precision in your models as well because things are playing out better than you had kind of expected when we talked in April, and you did say that if consumer confidence rolls down, you would -- you were concerned about what it would do to the consumer, and obviously, unprecedented situation that is very hard to call for, I think, everybody.

What factor do you think is driving this? Obviously, this is very different than '08, '09, when there were negative savings rates and housing was imploding. Is it the fact that people are saving a lot more? Is it the fact that the people are running their systems harder because they're just sitting at home? And so if you have a little bit of savings from stimulus checks or whatever it may be -- I mean, what is kind of the feedback you're getting on why unemployment and why consumer confidence is not rolling through these numbers to a more significant degree?

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

I think it's several factors. And I'll be humble in that we're in the throes of this. So it's good news. We're not 100% sure what's driving it, but we're damn happy that it is. And that's the -- boil it to a point, it's about -- we're not seeing repair versus replace. Replace is hanging in there. I think it's a combination, I think, Steve.

I think it's -- one, just psychologically, people are in their homes, they're working in their homes. And it's -- so all of a sudden, it's more important for them to invest in their nest. And that -- where people can defer things and put it off because they're not at home, I think when you're there all the time, you want it dealt with.

I don't think it's because people are running the units that much harder. Because when we do studies and have done research, even -- it's always shocking what percentage of people don't have programmable thermostats and even those who have programmable thermostats never set them. So units tend to sort of run steady state to a large degree, plus or minus a few degrees. So I don't think it's that.

I also think it's -- we're not all on agreement with this. I continue to yell that this is the reason and our team says they're not sure this is the reason. But I continue to believe that people will not invest in depreciating assets. And so at the height of the financial crisis, when all you read was that your home's worth 30%, 40%, 50% less, the thought of putting in a new unit in something that was -- worth that much less, it was hard to swallow. I think and believe -- so far, that's been -- that hasn't been the case. In fact, it's sort of in the opposite that homes continue to appreciate, new construction continues to be strong, demand is high for homes. I think people are willing to invest.

So I think those are sort of the things that are happening. I also think there's maybe a psychological viewpoint that with COVID, people can tend to see a finish line of when this may end, where the financial crisis, having lived through it, I thought it was more nebulous about -- even what the causes were, as a lay man, and when it would all sort its way out. Well here, we can understand it and can see a finish line. We can debate when that finish line is.

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

Right. Is outside of kind of the hole in April and May -- I mean if we look out to kind of next year in a more normalized environment, but one where maybe unemployment is sustainably higher, what -- do we kind of look to next year and say -- or this wasn't kind of the reset of the cycle, perhaps we were expecting, that this is kind of back to more kind of normalized fundamentals as people kind of go on living their lives?

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

I don't know, Steve. I mean again, that's sort of the humble nature of my answer. I think we're going to have to see how this plays out. For example, I mean, if everyone goes back to traveling and work 100% and everything is exactly as it was back at the end of '19, then some of the factors that I talked about are no longer in play. I can imagine a world that might be different. You [work some more] and so I'm not exactly sure how do we set for 2021. I think we're happy. And I wasn't taking a shot at your model, I was just making a point that we and you and others maybe had thought the cycle had ended and it indicates maybe it has.

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

No, I'm not taking it personally. I speak for all the sell-siders with false precision in our models. The -- just the second question, just remind us on the $115 million. Any update as to how -- just remind us of what's temporary and what's structural kind of as we look to next year?

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

About 20% of the $115 million comes from salaried headcount reductions. About 40% comes from discretionary spending like travel, marketing, incentive trips, those sort of things. And about 40% comes from pay actions, including executive incentives and salary reductions for -- 6% for the salaried employees, 12% for executives and then 50% for me. The way I think about it is the pay actions bounce back. The other 60% will depend on what's happening in the end market and how we want to respond.

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

Right. A little more kind of variable with what's going on with the volumes?

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

Correct.

Operator

Our next question is from Chris Dankert with Longbow Research.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

I guess first off, any color or additional details as far as kind of how labor markets are impacting growth, whether it's in terms of the actual construction market or just are we seeing good access to customer sites? What are you hearing from contractors on the ground in terms of both labor and then being able to access customer sites today?

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

Almost no barrier that I'm aware of, customer sites, both Commercial and Residential. We're an essential industry [and maybe us], and we're going in. Personally, I just had my air conditioner repaired. I had an issue with it. A technician arrived, masked up, booted up, it's plugged up and my wife and kids [hid] in the bedrooms and the guys did a [magnificent] work and left. And I think we're seeing that across the industry in the off-site.

In terms of labor availability, I think it's strong, better than it was a year ago. I think the only issue that we're seeing is when you're running a factory service business, if you have COVID strike, then you have to deal with it in the appropriate way and quarantine people and so that causes absenteeism. And so we and our channel partners work through those issues, but I think we're all focused on safety and taking all the right measures and are working through all the issues.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

Got it. Got it. That's helpful. And then my apologies, I fully appreciate the difficulty of trying to be precise at the moment as we've kind of gone through. But I just have to ask, again, thinking about the cadence of just volumes in a typical year for things to kind of fall apart as maybe the guidance assumes, things would have to really tick down in August. Otherwise, we're kind of through the bulk of the selling season now. Is there any visibility as to why things might slow in August? Or is it just conservatism and just taking a cautious view?

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

Well, I mean, August is the end of the selling season for AC, but obviously, in the fourth quarter, it's still, whatever -- I'm doing the math, 20%, 25% of our volume's in the fourth quarter, so it's the furnace season for us and look and see (inaudible) [on that math.] So fourth quarter still matters to us.

And so yes, it's tied to earn about -- like frankly, about COVID, what happened? Things -- it's been surprising to me, humbling to me to use that word again about how quickly things went down, how quickly they bounced up. I think Steve was right to sort of call me on it.

On my bell-shaped distribution curve, I had no bell shape distribution that said 3 weeks into July, in Residential, we'd be up mid-teens. So we've been pleasantly surprised. We never would have guessed it. But I'm humble enough to know that it could go back the other way. And so we're going to play this a quarter at a time.

Christopher M. Dankert - *Longbow Research LLC - Research Analyst*

Yes. Yes, absolutely. I appreciate that. And just as I was thinking about it -- or maybe again, you can deal with some sweating, but I think when it's cold outside, it's 32 degrees, you're going to replace that furnace, right? So I just think it's a matter of flexibility there. But thank you very much for the color. I appreciate it.

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

Let me wrap up. Market conditions remain highly uncertain, as we've just sort of talked about here, but we're executing well, very well on market opportunities and share gains. Third quarter is off to a strong start for Residential and our Commercial and Refrigeration businesses continue to see relative improvement. We have raised our guidance for 2020 and look forward to the remainder of the summer and second half of the year. Thank you, everyone, for joining us. Have a good day.

Operator

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