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LII.N - Q2 2022 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 2Q22 revenue of $1.37b, GAAP operating income of $227m, GAAP EPS of $4.96, and adjusted EPS of $5. Expects 2022 revenue growth to be 10-15% and GAAP and adjusted EPS to be $13.80-14.50.

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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 2022. I'm here today with CEO, Alok Maskara; and CFO, Joe Reitmeier. Alok will discuss the highlights from the quarter and key strategic developments, and Joe will take you through the company's financial performance and outlook for 2022. After that, Alok will provide closing comments and take us into Q&A. (Operator Instructions)

The earnings release with GAAP to non-GAAP reconciliations, today's presentation slides and the webcast link for today's conference 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, 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 CEO, Alok Maskara.

Alok Maskara - *Lennox International Inc. - CEO*

Good morning, and thank you for joining us today. I have enjoyed meeting with many of you since I started on May 9, and I look forward to more conversations so that I can continue to get insights and perspectives from all our key shareholders. I'm happy to kick off my first Lennox earnings call by reporting a record quarter with record revenue, record EBIT and record EPS driven by strong growth. .

Before I begin, I want to thank all our employees for their hard work towards improving service levels, given the global supply chain disruptions. It is their hard work and perseverance that has enabled us to deliver record revenues and profits.

Please turn to Slide 3, where I want to highlight 4 key messages: One, we had a record quarter driven by continued strong execution in our Residential and Refrigeration segments. Company revenue was a record at more than $1.3 billion, up 10%. Adjusted earnings per share was a record as well at $5 per share, up nearly 10%. Our turnaround efforts in our commercial factory in Stuttgart remains on track, and we are pleased with the sequential improvement in our quarterly results. However, supply chain disruptions continue to constrain production and our ability to meet strong demand.

Second, we continue our disciplined capital allocation strategy as we repurchased $100 million of stock and paid $33 million in dividends in the second quarter as we generated $97 million in cash from operations in the quarter. Third, the company continued to advance its strategic priorities with a focus on innovation and ESG. I will talk more about these in a moment, but we are the first company to complete the Department of Energy's Cold Climate Heat Pump Challenge, and we recently published our latest ESG report that includes the company's science-based targets.

Fourth, we are increasing our full year revenue guidance and are also raising the low end of our full year EPS guidance range. Now please turn to Slide 4 to discuss the company's recognition for being the first to achieve the objectives of the DOE Cold Climate Heat Pump Challenge. Homeowners in colder climates have traditionally relied on fossil fuel heating for their homes. The DOE challenge was created to accelerate cold climate heat pump advancements for colder climates and revolutionize the HVAC industry with a solution that offers comfortable cooling and heating while significantly lowering greenhouse gas emissions.

In June, I was honored to host the Secretary of Energy, Jennifer Granholm, who traveled to the Dallas area to recognize the Lennox team for their accomplishments and advancements in affordable, clean and efficient heating and cooling solutions. Lennox takes great pride in designing, manufacturing and delivering the most efficient climate control products on the market.

Even before the challenge, the Lennox advanced technology team was already working on the development of a cold climate heat pump to add to our extensive line of best-in-class heat pump products already on the market. The cold climate heat pump represents our dedication as a company to accelerating environmental sustainability through ongoing product innovations, advances in efficiency gains and greenhouse gas emission reduction targets.

Turning to Slide 5. Our 2021 ESG report has been published and is now available on our website. Beyond our leadership in heat pumps and dedication to decarbonization, our latest ESG report highlights that our emission reduction targets are now approved by the Science Based Targets initiative. This initiative is focused on climate action in line with the goals of the Paris Agreement to help prevent the worst impacts of climate change.

The ESG report covers how we are meeting or exceeding our improvement targets in environmental as well as the continued progress we are making in diversity and inclusion. And of course, strong governance is fundamental and the bedrock of Lennox. I encourage all our stakeholders to read the report and continue following our ESG progress.

Now I will hand the call over to Joe to discuss the second quarter financials on Slide 6.

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

Thank you, Alok, and good morning, everyone. Looking at the second quarter for Lennox International overall, the company posted record revenue of $1.37 billion, up 10% as reported and up 11% at constant currency. GAAP operating income was a record $227 million, up 5%. And in the chart, you see that total segment profit rose 4% to a new record $230 million.

Total segment margin was 16.8%, down 110 basis points, primarily due to inflationary pressures, global supply chain disruptions and factory inefficiencies. GAAP EPS was a record $4.96, up 10% and adjusted EPS was a record $5, up 9%. Moving to the business segments, starting on Slide 7.

You will see a record quarter for Residential in revenue and profit. Against the 30% prior year revenue growth comparison, Residential revenue came in at a record $978 million, up 17%. Price was up 13%, and volume was up 5%. Mix was down 1% as we still saw supply constraints on our high-end products in the second quarter, and we expect this to be the case through the second half of the year.

Residential replacement sales were up mid-teens and new construction was up high teens. Residential segment profit rose 14% to a record $216 million, Segment margin contracted 50 basis points to 22.1%. Cooling degree days were favorable in the prior year quarter in the Southeast and South-Central regions in the U.S. but cooler elsewhere. We opened 2 new Lennox stores in the second quarter and are targeting 20 to 30 new stores this year weighted to the second half, and we now have 235 Lennox stores.

Now turning to Slide 8 in our Commercial business. Revenue was $220 million, down 13%. Volume was down 22%, price was up 4% and mix was up 5%. Commercial segment profit was down 62% to $17 million and segment margin contracted 1,010 basis points to 7.8%. Commercial end market replacement demand remains strong, and we have made significant progress in hiring factory direct labor at our factory in Arkansas to support that, but supply chain disruptions continue to significantly impact the equipment business.

Commercial improved sequentially in the second quarter, and we focused on prioritizing key national account customers and school business during the summer months. We announced a third Commercial price increase effective August 1 and continue to expect commercial improvement in the second half of the year.

Looking at our Refrigeration business on Slide 9. You see second quarter record revenue and profit. Refrigeration revenue was $169 million, up 14% as reported. Price was up 12%, volume was up 9% and mix was down 1%. Foreign exchange had a negative 6% impact, so revenue growth at constant currency was 20%, led by more than 30% growth in North America.

Order rates and backlog remained strong. And in Europe, Refrigeration revenue was up high single digits at constant currency. Europe Commercial HVAC was up mid-single digits at constant currency. The geopolitical environment is weighing on the market regionally, and supply chain disruptions continue to impact our European operations. Overall, for the Refrigeration segment, profit rose 73% to $23 million, and segment margin expanded 470 basis points to 13.8%.

Turning to Slide 10, let's review our 2022 full year guidance. We are raising revenue growth guidance to 10% to 15%, up from a prior range of 7% to 11%. For the industry, we continue to assume low single-digit shipment growth in North American residential -- in the North American residential market and mid-single-digit shipment growth in North American commercial unitary and refrigeration markets.

We are raising the low end of our guidance for GAAP and adjusted EPS to a range of $13.80 to $14.50 compared to the prior range of $13.50 to $14.50. Price is now expected to be a $400 million benefit for the year, which is a 9.5% yield, and this is up from our prior guidance of $335 million in price. Residential mix is expected to be a $25 million headwind for the full year compared to the prior year guidance of being neutral.

This is primarily due to continued supply disruptions that are impacting the high end of our product lines. Commodity cost inflation is now expected to be $130 million, down from the prior guidance of $140 million. However, we are still seeing inflationary pressures on components and other materials and now expect a $100 million headwind compared to prior guidance of a $70 million headwind for other components.

Factory inefficiencies are now expected to be a $15 million headwind compared to prior guidance of being neutral, and freight costs are now expected to be a headwind of $20 million, up from prior guidance of $15 million. Interest and pension expense guidance is $35 million, down from prior guidance of $40 million. Other guidance points are not changing. We still expect corporate expense to be $95 million.

The effective tax rate is still expected to be between 18% to 20%, and foreign exchange is still expected to be neutral for the full year. We are planning for $125 million of capital expenditures. And then regarding free cash flow for this year, the third quarter has a solid start with continued hot weather. And as we get into the other side of the summer season, we have more of a read on macroeconomic -- on the macroeconomic environment with rising interest rates as well as the supply chain and our progress in converting raw materials and WIP into finished goods and shipments, we will know more.

We are maintaining free cash flow guidance of approximately $400 million this time for the full year as well as $400 million of total stock repurchases for the year, with $300 million already completed. We still expect a weighted average diluted share count of approximately 36 million shares for the full year. Now with that, let's turn to Slide 11 and I'll turn it back over to Alok.

Alok Maskara - *Lennox International Inc. - CEO*

Thank you, Joe. Looking at the second half, we are mindful of a potential slowdown in the U.S. economy, and with interest rates rising, a potential decline in residential new construction. We are prepared and have contingency plans in place. But to be clear, that's not what we are seeing in our business today. Demand continues to run ahead of our ability to fully satisfy our customers as supply chain constraints persist.

Due to the supply chain challenges, factory inefficiencies continue to impact performance, especially at our Arkansas factory for Commercial. As we look ahead, we have a strong backlog and order rates across Residential, Commercial and Refrigeration. Commodity inflation is easing, and our ongoing productivity and material cost initiatives will positively impact the business and be evident as the supply chain normalizes.

Before we go to Q&A, let me close our prepared remarks on Slide 12 by summarizing why I believe Lennox is a great company and what excites me most about being the CEO of Lennox, a company with 127 years of history and a storied value-driven culture. We are the leader in energy-efficient climate control solutions, operating in high-growth end markets with strong replacement demand.

We have an ESG mindset and are narrowly focused on HVACR. The company has innovative products with a unique direct-to-dealer network, and we have a history of robust execution and disciplined capital deployment.

Thank you for listening. 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're going to start question-and-answer with the line of Julian Mitchell with Barclays.

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

Welcome, Alok. I hope it's been a smooth start so far. I suppose -- maybe just a first question around that Commercial business and how you're thinking about the pace of margin improvement there as you go through the third and fourth quarters. It does sound like you're becoming more satisfied or less dissatisfied with the sort of plant efficiency there. So what kind of maybe margin exit rate could we see entering into 2023, for example, in the Commercial segment?

Alok Maskara - *Lennox International Inc. - CEO*

Julian, great question. I would hate to give you a number now. We are still in the midst of a turnaround. And I was pleased to see sequential improvement and our long-term goal of getting that business to an 18% to 20% range in margin still remains valid. But given the shortage of components that not just Lennox, the whole industry is facing right now, and the disruption in supply, I think it's a little early for us to give a specific number for Q3 and Q4.

Our focus on Commercial remains serving our customers, protecting our key accounts, serving our school base. And personally, I will be expecting small but steady sequential improvements in the business going forward. But it's going to be slower than I like, slower than our shareholders would like, but we are making good steady progress, Julian.

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

That's good to hear. And then maybe my second question, just around the sort of any sense of the weighting of earnings between Q3 and Q4. Anything unusual this year because of price cost and in terms of how that plays out? And I guess to sort of put a finer point on it, if we're looking at, say, Slide 10, you've got a very good summary on the right-hand side that you ran through. If we're thinking about the price of $400 million and the commodity cost of minus $130 million, how do we think about those in the second half versus the first half, those 2 numbers?

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

Yes. I think, Julian, I think you can almost mirror the price where we've got $400 million of price out there. $225 million, we've already captured first half, $175 million second half. I would split the cost almost accordingly with respect to that. And then the cadence or seasonality of earnings, I think we're getting more and more close to what I would characterize as more routine or normal seasonality within our business.

Last year, it was a little bit disrupted, given the strong first half we have where we were up significantly, first half, and then things seemed to slow down in second half. I think it's going to be just the opposite this year, where we had a little bit slower start to the first half, largely because of the tough comps, but that momentum continues in the second half. And I think once again, we'll get back to more normal earnings seasonality if you were to look back to 2017, 2018 time frame.

Alok Maskara - *Lennox International Inc. - CEO*

And Julian, I would just add to that to remind that the second half pricing is going to appear to be lower just because we start lapping ourselves on price increases that we did last year. So it doesn't mean we are giving back price or anything, like we are clearly going to hold price.

Operator

Next question comes from the line of Jeff Hammond with KeyBanc.

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

So just back on Commercial, how are you thinking about kind of the balance between the headwinds being supply chain and the headwinds being labor? And just kind of update us on progress on recapturing the labor in Stuttgart. And any thoughts around kind of diversifying production within Commercial long term?

Alok Maskara - *Lennox International Inc. - CEO*

Sure. So I think Commercial turnaround remains a huge focus of ours. On the labor situation, the actions we took earlier in the year are bearing fruit, and we are now meeting our hiring goals and our retention goals. So I think while you don't declare a victory on that, I think labor situation is now under control.

And our biggest bottleneck at this stage remains availability of components and improving factory processes to get the right quality output. I guess from a going-forward perspective, as I look at supply chain, clearly, we've got to diversify our supply chain, get more than 1 supplier, but there are some industry-wide part shortages that we are dealing with and that remains our focus.

On your longer-term question, Jeff, yes. I mean, listen, this is a growth industry. We have previously talked about our desire to have a second factory, and we remain committed to that thought process. We're going to go a little slower than what we may have thought simply because if we take a factory with poor processes and replicate it, I will have 2 factories with poor processes. So I think we're going to take our time to make the right decision, find the right location and improve the processes.

But be on the lookout. When we have the Investor Day in December, we'll give you more color on it, Jeff, but we remain committed to expanding capacity and winning back the share that we might have lost through this disruption.

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

Okay, great. That's good color, Alok. Just on some of the early feedback on this SEER and some of the regulatory changes in the price or the cost price component into 2023 around that has been coming in higher. And I'm just -- maybe just speak to, one, your readiness for the change in kind of the redesigns you're doing and what you think the inflation around the regulatory changes into '23 look like.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. So the answer is we are 100% ready. This is a smaller change than what us and the industry have dealt in the past. We went from 10 to 13 in the past. I mean, we are going from 13 to 14, not 14 to 15. So I think we're 100% ready. And I believe overall, the whole industry is going to be ready.

We are in the most inflationary time that we have ever seen in our careers, at least a few of us. So clearly, I think this is a great opportunity for us and the industry to make sure that we capture the full value of the SEER change in pricing. We intend to do so. So I think if you are seeing indication in the industry that the price is going to be better, I think that's good discipline.

And that helps us to invest more in products that are environmentally-friendlier and the newer technology. So we're 100% ready. The value will be captured in price. And if anything, I think the industry margin should expand because of the change. And I don't expect any huge stock-up or prebuy just because at least we still remain in a supply-constrained environment, not a demand-constrained environment.

Operator

Next question comes from the line of Gautam Khanna with Cowen.

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

Congrats on the new role. I had a couple of questions. First, I was curious if you could speak to the long-term framework that the company has provided in the past for financial guidance. It's been somewhere around mid-single digit sales growth of 30% incrementals. Do you largely buy into that framework?

Alok Maskara - *Lennox International Inc. - CEO*

I do. And the reason we didn't talk about long-term guidance this quarter because there is no change to it, so there is no update. And I think we have previously said that I wouldn't expect any updates just because there's a new CEO. I mean, if you need to change things because of macroeconomic conditions or something else. But yes, I mean, I rest the incremental at 35% and I'm looking at Joe and smiling as I say that. But no, there is no change or update to that, Gautam.

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

Okay. And we've seen a dip in copper, aluminum and steel costs. Could you update us on how quickly those could -- the spot rates that we've seen in the last quarter can flow through the P&L? And what -- you mentioned component costs are still rising. And so just maybe if you could square the percentage of COGS that comes from raws versus components and how it all kind of could net benefit next year, if at all?

Alok Maskara - *Lennox International Inc. - CEO*

Sure. So I mean, at this stage, as commodity costs ease, I mean, Joe already mentioned that we have reduced some of our guidance range from (inaudible) by $10 million. If the cost ease more, we might see slightly more benefits. But frankly, most of the benefit of any commodity easing is likely to be in 2023 because given the inventory we hold and the prebuys we all have done for locking in commodity pricing, the impact is going to be in the Q4 or 2023 time frame.

I'll let Joe talk about some of the walk between the different pieces, but keep in mind that beyond the commodity and the component cost, we have many other inflationary pressures such as labor costs, such as health care costs, such as real estate cost. But Joe, please feel free to add any more color to that.

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

Yes, I think that's correct. We did take the commodity guide down $10 million, and that's for the benefit of what we see in the second half of the year, net of our hedge positions. And if commodity costs remain where they're at today, what we'll see is we'll see a lift in the second half of 2023, once again largely come of where prices were in the first half and then also where we have prices locked in with our hedge positions.

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

Okay. And just the last 1. Have you seen any -- if you could talk about the supply chain, where things still are -- what your visibility is to things improving? Where are pinch points getting worse, where they've been stable? Where are they getting better? Just if you could talk to that.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. So I'll say for things such as freight and availability of freight, things are getting better. So I think that's an industry-wide phenomena. We like that. If you look at availability of sort of components, it's a mixed bag. I think there are quite a few components which is getting better. But in some commercial components, we seem to be facing industry-wide shortages, right? So I think that's something that we have to continue watching out for.

The whole issue around semiconductor microchips, I mean, that remains our biggest pinch point right now. And despite redesigns, despite adding vendors, we still expect to see significant improvement only in early 2023 at this stage. But net-net, the positive here is that things are no longer getting worse.

I mean, for the longest time, as we looked at it, we kept finding new things as we played whack-a-mole. So we're still playing a bit of whack-a-mole but it's an existing thing, and we don't see anything specifically getting worse.

But every time I say something positive, I turn out to be wrong here so let's be cautious as we go forward. The team is working extremely hard. We have a very talented team that continuously watches and monitors the performance of our supplier base.

Operator

Our next question comes from the line of Jeff Sprague with Vertical Research.

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

A lot of ground covered already. I'd be interested in a little bit more context from kind of an overall portfolio thought process, Alok. You expressed a lot of comfort in the fact that you like that the company is basically a pure play company. So it doesn't sound like you have big strategic moves on your mind.

But as you've settled in there a little bit and looked at the portfolio, do you see opportunities for bolt-ons in various areas? Also a lot of discussion about Commercial, but I just wonder about Refrigeration and what work you might need to do there to get the margins on even better trajectory.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. So Jeff, I think the view hasn't changed. We like being focused. We like being HVACR and we will continue doing so. So yes, if your big strategic thing means if I'm going to go buy a smoke alarm company, then probably not. I mean, we're not going to be doing that. So I think from that perspective, that's good.

But being a smaller player in a larger industry, we have another lower market share among the top 4 companies. We see tons of opportunities for bolt-on's, tons of opportunities for product expansion, ton's of opportunities for geographic expansions within U.S. and outside U.S. So yes, I do see significant opportunity there.

On Refrigeration, it's a good business. We have pockets that are better than others and that's a review that's ongoing for us as we look through it. Of course, our short-term focus is to improve the performance of the business. I believe every business unit within the Refrigeration segment has an opportunity to do better, and that's what I want the team to focus on.

As we look through the overall situation and come back and present to you in December on how we will take each of our business segments to a higher margin level. So still remain very excited about the portfolio, still continue to evaluate lots of bolt-on and partnership opportunities. And yes, we would not be going into far adjacencies in any big bold strategic move because I think that's not who Lennox is.

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

Great. And could you elaborate a little bit on how you're thinking about share gain or share recapture? I would assume it's maybe a kind of a dealer-oriented strategy, but I'll let you answer. Any color there would be appreciated.

Alok Maskara - *Lennox International Inc. - CEO*

Sure, Jeff. I think the first thing for us is to be able to restore our supply and manufacturing capability. We had a history of share gain or maintaining share. And ever since the Marshalltown tornado, we have struggled to recapture share or gain share. So our first focus is going to be restoring our manufacturing capability. So salespeople, instead of apologizing to dealers for not having products, are going to spend more time getting new dealers on board. So I think that's our #1 piece, right?

Second for us is relying on our innovative new products, and we have quite a few. But again, given supply conditions, we have not been able to fully market and launch those to gain share. Let's take heat pumps as an example that we talked about. Third 1 is just proven strategy, opening new stores. When we didn't have enough products, we didn't open new stores because those stores would be half empty. But as we get inventory to be in a better spot, we're going to go back to opening new stores.

And yes, if I package it all together, of course, we need to add more dealers. Of course, we've got to get back into the Commercial, the curbside replacement business, which we have sort of walked away from. And of course, we've got to expand our geographical footprint. There are pockets of U.S. where our market share is much lower just because of our historical footprint and no other reason.

So I'm very excited about the opportunity to gain share. We believe we have strong value propositions, and our dealers love our value proposition that we are direct-to-market and don't have to go through a distributor all the time. So I think there's lots of opportunities and we'll tell you more in December, Jeff.

Operator

Our next question comes from the line of Ryan Merkel with William Blair.

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

I wanted to go back to the question about the SEER change impact for '23. How much are you raising prices on (inaudible) for '23 because of the SEER change?

Alok Maskara - *Lennox International Inc. - CEO*

Ryan, we haven't declared the price for our '23 lineup yet. But at minimum, if you think we are going from 13 to 14 or 14 to 15, you should think of that being baked into the price, right? This percentage SEER change baked into percentage price. But clearly, there are many more complicating factors, and it depends also on where we are on the inflationary cycle. But yes, we do expect to capture that on price. But we haven't announced a price level for our '23 line card yet, Ryan.

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

Got it. And what percent of sales would this change impact?

Alok Maskara - *Lennox International Inc. - CEO*

As you know, the lowest or sort of the base led typically accounts to 50% to 60% of the industry sales, and we expect the new SEER would be about the same. Now we hope to use the opportunity to upsell the consumers on a higher SEER product because we still make the highest SEER products in the industry. But I think a 50% to 60% number, Ryan, which has historically been true, will remain for the short term.

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

Okay, makes sense. And then a follow-up on Commercial. There's a view that Commercial could buffer potentially slower resi demand in '23. So how is quoting and booking trends looking? And do you have enough backlog that extends into '23 such that there could be a buffer?

Alok Maskara - *Lennox International Inc. - CEO*

If resi slows, which as we mentioned earlier, we haven't seen signs in our order book but it could be masked because of the weather patterns we're having. Yes, I do think Commercial should be a buffer, A, based on volume; B, for us also based on the margin opportunity because remember our Commercial margin opportunity is probably larger than others, given that our current state is challenging.

The whole industry and not just us. At this point, we are sold out for 2022. So yes, we do have backlog for '23 as well. But some of those backlogs are still tentative as we work through pricing, availability and design. In the short term, we are extremely busy just so in the 2022 order. But as Residential slows, I agree with you, Ryan. I think Commercial should give us buffering both from volume and from a margin perspective.

Operator

The next question comes from the line of Josh Pokrzywinski with Morgan Stanley.

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

And Alok, welcome to the call. I just want to follow up on an earlier comment, Joe, that I think you made in terms of recognizing commodity deflation really more in the second half of '23 based on the hedges. I guess, that sounds like, I don't know, a couple of quarters later than history.

And I guess as it pertains to steel, I was kind of unaware that mills would let you lock out that far. So just wondering if there's something kind of unusual about this environment in terms of that duration kind of driving that later-than-expected realization there.

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

Not really. It may be earlier, Josh. Once again, it's pretty volatile at this time. Once again, it's the year-over-year comps that I was referring to. It does take a little bit of time for those components because we prebuild inventory earlier in the year to work their way through inventory and into cost of sales or on the P&L. And that's really the dynamic that I was counting on.

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

Got it. And then just second question...

Alok Maskara - *Lennox International Inc. - CEO*

Josh, just so you know, you and I both would be happier if it falls through sooner, right? So I think what Joe is saying no later than second half. So let's see where volatility takes us.

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

Yes.

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

Okay, fair enough. Yes, I guess the last 6 months have probably humbled a lot of people trying to forecast input prices. On the SEER change and kind of price impact of that in the marketplace, look, if I look back to 2015 and the regional SEER that took over that year, I think price mix for a lot of the industry was like low single digits at best and probably no different than a normal year.

I'm just wondering what's kind of unique about this point in time where you would think that'd be higher, especially with some of the deflation coming in and a couple of folks having ceded share with supply chain interruptions.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. I mean, I could start by saying I wasn't here in 2015 so maybe we didn't raise price as much. I think in all seriousness, we are in an extremely inflationary environment globally on every product. And I think the disciplined set of computation that we have, everybody is going to look at this opportunity to make sure we capture the full value of it.

I mean, a consumer has to keep in mind that the equipment costs are less than half of the total cost that they are paying for and the strong replacement component and there's an energy efficiency benefit. So I can't answer the question of 2015, but in today's supply-constrained environment, where labor, material, all the inflation has been high, I would expect the SEER change to drive incremental price benefits for us and for the industry.

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

And I would also add there, Josh, it's also going to come with a bit of a mix benefit as well. Remember, I believe the last SEER change only covered half the country. So this one's the whole country, so I think that will present a little bit different dynamic. And then once again, it will be a combination of both price and mix benefit in 2023 from the SEER conversion.

Operator

Our next question comes from the line of Nigel Coe with Wolfe Research.

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

By the way, I love the slides. That's a nice innovation, I guess. Just on the price...

Alok Maskara - *Lennox International Inc. - CEO*

We did promised last conference that we would have slide, Nigel. So I'm glad you noticed.

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

There you go. I notice these things, it's good. But first of all, Alok, nice to see you on board. So the 9.5% price for the full year, I mean, how does that look by business? And the spirit of the question is, obviously, Commercial with 4% prices lagging behind, so just wondering if we're going to see some catch-up on price in the back half of the year. And maybe that could be a force for improving margins for commercial in the back half.

But on the Commercial business, I'm just wondering how we view normal margins for that business. And again, just thinking about the labor increases, the labor cost increases we've seen at the facility, does that, in any way, pinch longer-term margins for Commercial?

Alok Maskara - *Lennox International Inc. - CEO*

Yes. Lots of good questions in there. So let me start by talking about sort of pricing. So I think your observation is correct. Commercial is lagging behind on pricing, but they are doing better than what they did in Q1 so we are pleased with the sequential improvement. That's a business, as you know, is heavily dependent on key accounts. So as the key accounts negotiations continue, we are moving forward and we're getting more.

And we just mentioned in the script that we have announced another price increase that goes into effect August 1. So I would expect Commercial to catch up on pricing. Additional thing to keep in mind is that the SEER change that's coming in 2023 would require a new set of products, which means there's an opportunity to establish new price levels, so the current contracts do not describe price levels for the new product, which are necessary and mandated by 2023. So I do expect a step change in price for Commercial as we approach 2023.

The labor cost is a unique thing. So as we go through the math, to your question, first of all, hourly labor is not a huge portion of our labor cost. So that's one, right? Second, I think we are taking the opportunity to upskill our workforce and offset some of those increases based on higher quality, lower scrap and also in the long term, looking at a second location, which is likely going to be in a lower labor location, lower labor cost location versus where we are now.

So in the short term, for a quarter or so, is it a headwind? Yes. Is it material in the big scheme of things? No. I think there are other things such as just our scrap and overtime, that all kills us more than the higher hourly wages. So I don't -- lots of detail probably more than you wanted. But yes, Commercial needs to catch up on price, and we are confident that we'll do better in the second half and we're even more confident that we'll do better in 2023.

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

Okay. No, no. We like detail so don't worry about that. But again, come back to price for the full year. I mean, maybe just what are we baking in for Residential in that number? And maybe you could just clarify, does the SEER change, is that baked in at all to that number? I think that's more of a mix than the price, but that's splitting hairs, but I just want to make sure that's not in the numbers.

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

Yes, we've got it all broken. We've not given price by segment, but it's probably not much different if you were to do the math on what you see in the first half of the year by each segment. Once again, we just instituted another price increase in Commercial that will give us more of a lift in the back half of the year and going into 2023. But once again, I'm not going to break down price by business. But once again, we remain confident that we're going to deliver $400-plus million at a minimum.

Operator

Our next question comes from Steve Tusa with JPMorgan.

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

Congrats on the post here. And echo -- I agree with Nigel. Great to see the slides and a little bit easier to absorb in a busy morning. Just on the free cash flow, how do we expect that to play out for 3Q and 4Q? Is that -- I mean, I know 3Q is obviously seasonally heavier. So should we expect more of it to come in 3Q or more of a flush in Q4?

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

I think it will be more of a flush in Q4, to be honest with you, Steve. Another thing that we're going to continue to keep our eye on is availability of raw materials. And if we have the opportunity to carry more raw materials than normal to prevent some of the disruptions we see in the supply chain, we may do that later in the year.

They may have implications on free cash flow but don't think it will be material. But we'll have to just keep our eye on that as well. But those are sort of the things that I would expect, once again, probably getting back to what I would characterize as a more normal seasonality of our cash flow, once again, pre-tornado.

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

And then as far as the seasonality of your earnings in the second half, should that be pretty normal? Just remind us of what that split would be just roughly.

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

Yes. I think if you were to invert the second and third -- second and first quarter this year and the third and fourth quarter of this year, I think you'll come up pretty close.

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

Okay, great. And then 1 last 1. Where are you in terms of your independent channel and loading it for the new SEER products?

Alok Maskara - *Lennox International Inc. - CEO*

Sure. As you know, in Residential, most of our -- majority of our sale or a vast majority of our sales go direct to dealer, so there's clearly no loading going on. Some of these guys may buy a garage load or so but they're not doing that. On the Allied, on the distribution channel, we remain in a supply-constrained world.

So we're not currently have any plans to preload on a higher SEER basis. But that might change if demand slows and we get into Q4 and have more of an opportunity to do that. But we will be fully prepared.

And as you know, if needed, we'll move units from South to based on manufacturer date versus all the other wonderful things that the industry is already used to doing. So we're not concerned and living in a supply-constrained world, like we'll continue evolving. But we don't expect a significant amount of prebuild or presale like in the previous SEER change.

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

But I guess for the South, they have to have the product to start selling it on Jan 1. So I would assume that, that kind of mix in has to happen there, maybe not a prebuy but like certainly a gradual transition in the channel. Am I right about that or not? Because that's an installed base.

Alok Maskara - *Lennox International Inc. - CEO*

You're absolutely right. And that was my comment around Q4. So by the time Q4 comes in because most of our dealers and distributor. We are turning inventory at least 4 times a year, right? So by Q4 time, we will start shipping those.

Operator

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Operator Instructions)

Our next question comes from Joe Ritchie with Goldman Sachs.

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

Welcome, Alok. Congratulations. So I wanted -- sorry if I missed this in your prepared comments, but I'm curious, so the 17 points of growth you saw in resi this quarter, how much of that was volume?

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

5%.

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

Okay, 5% volume. And then did that 5% volume, is that pretty equally distributed between Allied and Lennox or did one grow quicker than the other?

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

Yes, we don't -- and we've not broken that out. Once again, what I'll say is we continue to see strong demand on both channels or in both channels.

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

Okay. And then maybe just going back to the Commercial margin. So clearly, like, obviously, it's been a difficult last few quarters, and you guys seemingly -- it sounds like things are getting a little bit better. I'm just curious like, if you kind of think about the margin improvement in that business for the second half of the year, like how should we be thinking about kind of like the right margin for that business, either sequentially or for the rest of the year?

Alok Maskara - *Lennox International Inc. - CEO*

Yes. I think it's really hard when you've a turnaround situation to give exact numbers. But I would say we were pleased that Q2 was better than Q1, even if it's modestly better. I would expect a similar pattern in Q3, Q4. But even if we have to take a hit for a quarter here and there, I mean, our long-term goal remains to protect our customers, serve the schools, make sure we work through the share dynamic.

Our long-term goal is to get that business up to 18%, 20% margin, and that might take us 2 years. I wish it's less than that but that's where we focus on. But I think a small sequential improvement is what we would plan for the rest of the year. But given the situation and still quite volatile, I wouldn't want to tie it down to any specific numbers yet.

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

No, that makes a lot of sense, Alok and I know -- maybe my last question. I know you're not seeing it in your business today but I'm sure you guys have done some sensitivity analysis around what a resi downturn could look like. Maybe just help us with any type of framework that you guys would approach a potential downturn if we start to see it in resi.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. Every time I read Wall Street Journal, I come to the office and say, "Oh, we are going to face a downturn." And then I look at our order rates and it turns out to be wrong. So that's been going on ever since I started. The broader question that you asked is clearly, a very seasoned team. We have run scenarios and all different aspects.

On the residential new construction, just based on slower housing starts, we can model that pretty effectively, and we know how many months after a home starts, HVAC goes in. So that part is easy for us to model and we are doing that. We're clearly going to offset that with new programs to gain share. And also remind everybody that 20% of our business, not 80%.

On the 80%, which is replacement, we feel very good that very little of that will move from replacement to repair, especially given the parts shortage, the historical refrigerant changes, the SEER changes. But then again, we have modeled that on different aspects. What if 10% changes from replacement to repairs? And then, of course, our goal is to get value out of those repairs as well.

So that's the kind of scenarios we have dealt with. No 2 downturns are the same. And whatever comes through, our goal is to be prepared and deliver the best value for our shareholders. But we have run at least 3, 4 different scenarios and we know what costs we need to take out. We know where we focus to gain share, and we know that like none of these downturns last very long in our industry.

Operator

Our next question is Brett Linzey with Mizuho.

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

Welcome to Alok. I just want to come back to the Commercial business. I appreciate some of the color on backlog. You noted you were sold out there. Just curious what you're seeing on the new order front and how that's been tracking. And really specifically around the national account business and how those conversations are going, given some of the lower consumer reads coming out of those customers.

Alok Maskara - *Lennox International Inc. - CEO*

Sure. I mean, good question. We are not seeing any changes in the demand there. We could sell whatever we make right now. So I think it's possible that there is an underlying weakness, and none of us are seeing it because every manufacturer has extended lead time there. I think 1 thing that gives us some comfort on these national accounts is that the higher efficiency units have a very quick payback that's apparent and these are sophisticated buyers.

So despite a consumer slowdown, as retailer, we'll get significant energy benefits by replacing the HVAC units and a quicker payback. So I think that's the piece that gives us some comfort in the commercial cycle is that there is apparent value and a willingness to pay for these upgrades. But we haven't seen any change. We'll keep watching it closely. But we don't expect larger customers to make any significant deviation from their current policy, which is like replacement every few years and get the value of energy efficiency.

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

Okay, great. And just on the contingency plans, I think you made a comment on that in the opening remarks. But just curious how you would handle a more shallow downturn. Would you just ride down the decrementals and try to preserve the integrity of the organization? Would you get at cost pretty quickly? Just kind of high level, how would you think about tackling that?

Alok Maskara - *Lennox International Inc. - CEO*

Every time we hit a downturn, if I knew it's going to last exactly for 8 weeks, then yes, we would try and preserve the organization. But in reality, we never know. I mean, having lived through many downturns, no. I mean, I think our goal would be to minimize the decrementals, take tough actions, take the opportunity.

I mean, never waste a crisis. I mean, remember that. We will always look at this as an opportunity to strengthen the organization, even if it's a smaller organization, and take some of the tougher actions. So no, we would try our best to minimize the decrementals. And they can offset it by G&A reduction, offset it by deferred investments just because we don't know how long the downturn will last.

Operator

And our last question comes from the line of John Walsh with Credit Suisse.

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

Welcome Alok and appreciate the slides this quarter.

Alok Maskara - *Lennox International Inc. - CEO*

Thanks for the compliment. We'll try and keep the slides going.

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

Yes. It's hard to take them away. You won't get the praise next quarter if they're gone. You'll get complaints.

Alok Maskara - *Lennox International Inc. - CEO*

Being an ex-consultant, John, as you can imagine. I think better with PowerPoint in front of me so we do like the small set of 12 slides.

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

Yes, yes. Just looking at the first half margin performance, I think last quarter, you had said that you could grow margins at the total company level. Just curious, when you think about your midpoint that's in the guidance range you have out there, I mean, what are total company margins doing?

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

Other down slightly. Once again, it's just the pressures that we're continuing to feel in the back half of the year. While we have commodities easing, we're still combating inflation on the components and other input side. So it's sort of the net-net there. All in, I think margins for the full year would be down roughly 40 basis points.

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

Got you. And then maybe just 1 follow-up. The Refrigeration incrementals have been pretty strong thus far in the first half, about 40%. Do you think you guys can maintain this zip code? Or how are you thinking about just Refrigeration incrementals broadly? I know you don't give spot guidance.

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

Yes. I think we're benefiting from a bit of a tailwind where we're catching up on price as well there, and that's lifting it something north of what we would typically target would be 30%, which is what we do for the balance of the company as well.

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

Great. Well, I appreciate taking the calls at the end here.

Alok Maskara - *Lennox International Inc. - CEO*

Okay. Thanks for all the questions. To wrap up, I just want to emphasize that the demand remains strong. We are raising guidance based on the strength of our Residential and Refrigeration business and expectations of continued improvements in Commercial.

Coming off a record second quarter, we look forward to the second half, and we'll remain focused on enhancing shareholder value irrespective of the macroeconomic uncertainties. Thank you for joining us today. This concludes our Lennox's second quarter earnings call. Thank you.

Operator

That does conclude your conference for today. Thank you for your participation and using AT&T teleconference. You may now disconnect.