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Lennox International, Inc. (LII)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Lennox Second Quarter 2024 Earnings Conference Call. All lines are currently in a listen-only mode, and there will be a question-and-answer session at the end of the presentation. [Operator Instructions] As a reminder, this call is being recorded.

I would now like to turn the conference over to Chelsey Pulcheon from Lennox Investor Relations team. Chelsey, please go ahead.

Chelsey Pulcheon

Director-Investor Relations, Lennox International, Inc.

Thank you, Maddison. Good morning, and thank you for joining us today. We are excited to share our 2024 second quarter results. Joining me is CEO, Alok Maskara; and CFO, Michael Quenzer. Each will share their prepared remarks before we move to the Q&A session.

Turning to slide 2, a reminder that during today's call, we will be making certain forward-looking statements which are subject to numerous risks and uncertainties as outlined on this page. We may also refer to certain non-GAAP financial measures that management considers relevant indicators of underlying business performance. Please refer to our SEC filings available on our Investor Relations website for additional details, including a reconciliation of all GAAP to non-GAAP measures. The earnings release, today's presentation, and the webcast archive link for today's call are available on our Investor Relations website at investor.lennox.com.

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

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thank you, Chelsey. Good morning. I'm pleased to share that Lennox delivered outstanding Q2 financial results and has also made significant progress on multiple strategic initiatives. I'm proud to highlight that we have now achieved six consecutive quarters of double-digit EPS growth. This demonstrates the power of our transformation plan and management's ability to consistently execute our growth acceleration initiatives.

Turning our attention to slide 3, let's review some of the achievements of this quarter. Lennox's core revenue grew 8% and our adjusted segment margin expanded 100 basis points to record 21.9%, resulting in an adjusted earnings per share increase of 11% to $6.83. We generated $184 million of operating cash flow, and our industry-leading ROIC grew to 44%.

Home Comfort Solutions delivered record segment margins of 23.3%, a 170-basis-point expansion over prior year, as we started experiencing the end of destocking in our two-step distribution business.

Our Building Climate Solutions segment continued its track record of profit growth. In addition, we manufactured our first units at our new commercial factory in Saltillo, Mexico. As we continue to ramp up this factory, we know that there will be second half inefficiencies, but we are excited about the addition of growth capacity to better meet customer demand by year end.

One of our key accomplishment this quarter was the establishment of a joint venture with Samsung. This joint venture will open up exciting opportunities for both companies by combining Samsung's global reach and brand strength with our direct-to-dealer distribution network. This collaboration is expected to significantly enhance our heat pump market share.

Strong first half give us the confidence to increase our full year EPS guidance, raising it to a range of $19.50 to $20.25. Our focus on executing our transformation plan continues to pay off. But before moving on, I want to express my gratitude to our dedicated employees and loyal customers who have made this success possible.

Now, please turn to slide 4 for more details on our recent joint venture with Samsung. I am excited to provide more insights on the Samsung Lennox HVAC North America joint venture. Our collaboration is all about accelerating heat pump growth, both for ducted and ductless products.

Let's start with what makes this partnership a winning combination. Lennox and Samsung are mutually exclusive ductless HVAC partners in North America, combining our strength to create a comprehensive and integrated portfolio that will benefit our customers. This integration allows us to leverage our direct channel strength with Samsung's global brand and technology, providing unparalleled value and service to our dealers.

Heat pumps currently make up about 30% of the market. And through our joint venture, we can extend our reach within this fast-growing category. Our joint offerings include attractive ductless solutions, and we are particularly excited about our colder climate heat pumps, which are designed to deliver better performance in the Northern US regions.

Another key advantage of our joint venture is the enhanced technology it will provide our customers. Samsung's SmartThing (sic) [SmartThings] controls and home automation platform are at the forefront of innovation, providing seamless integration and superior energy monitoring for homeowners. Both companies are committed to North American-specific new product development, ensuring our offerings meet the highest quality standard and deliver superior comfort to our consumers.

In the future, we expect to provide our dealers with combined ducted and ductless offerings in addition to more hybrid heat pump systems. This joint venture is set to accelerate heat pump growth for us through an industry-leading portfolio with advanced technology and strong brands. Ultimately, this partnership between Lennox, a North American champion; and Samsung, a global champion, is poised to be a winning combination. We are looking forward to driving growth and innovation together.

Now, let me hand the call to Michael, who will take us through the details of our Q2 financial performance.

Michael Quenzer

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

Thank you, Alok. Good morning, everyone. Please turn to slide 5. As Alok mentioned at the start of this call, we're pleased to report our sixth consecutive quarter of year-over-year double-digit earnings per share growth. In addition to delivering double-digit profit growth, we have achieved year-over-year ROS expansion in each of those quarters. The strong second quarter financial performance underscores the effectiveness of our strategies and the dedication of our team.

Now, I will share more details on the second quarter financial results.

Core revenue was $1.5 billion, up 8% driven by sales volumes improvements, continued pricing excellence, and benefits from the AES acquisition. Adjusted segment profit increased $38 million or 13%. This improvement is largely due to $44 million of price and mix benefits, and $19 million of organic and inorganic sales volume. These profit gains were partially offset by wage inflation, new factory ramp-up costs, and investments in both SG&A and distribution. Total adjusted segment margin was a record 21.9%, up approximately 100 basis points versus prior year. Our second quarter tax rate was 19.9%. And diluted shares outstanding were $35.8 million, compared to $35.6 million in the prior year quarter.

Let's turn to slide 6 and review the financial performance of our Home Comfort Solutions segment. The Home Comfort Solutions segment had an exceptional quarter, delivering 5% revenue growth, 13% segment profit growth, and an impressive 170-basis-point expansion at segment profit margin. The 5% sales growth was primarily driven by our continued pricing excellence, which delivered 4% price yield in the quarter. In the second quarter, we achieved a volume growth of 1%, driven by mid single-digit increases in our two-step distribution channel as industry destocking concluded midway through the quarter. Sales volumes through our direct-to-contractor business were flat to prior year.

We also experienced a $90 million year-over-year increase in expenses driven by wage and general inflation, as well as critical investments in distribution and sales to further our goal of improving the customer experience.

Moving on to slide 7, the Business Climate Solutions segment also continues to deliver strong revenue growth, up 15% this quarter. 6% of this revenue growth is attributed to the AES acquisition, which was completed in the fourth quarter of last year. We are very pleased with the integration progress of this new business and the substantial synergies we have already realized.

In addition to inorganic growth, we achieved a notable 9% organic volume growth driven by gradual production improvements at our existing Stuttgart factory. While these improvements are positive, total production output still limits our ability to fully meet demand. We are encouraged by the progress of our new commercial factory, which remains on track, and we successfully built our first few units in early July.

Profit for the segment increased $11 million, although this was moderated by approximately $5 million in ramp-up costs for our new commercial factory in Saltillo, Mexico.

Please turn to slide 8, where I will review our cash flow performance and capital deployment strategies. Operating cash flow generated in the quarter was $184 million compared to $196 million in the prior year quarter. Capital expenditures were $33 million in the quarter, a decrease of $17 million compared to the prior year.

In the second half, we anticipate temporary increases in working capital as we ramp up our new commercial factory in Saltillo, Mexico, and prepare for the transition to the new low-GWP product. The team also remains focused on accounts payable and accounts receivable process improvement to drive efficiencies. These factors are all included in our full year free cash flow guidance and long term cash conversion targets.

Maintaining our industry-leading ROIC is an important part of our investment strategy. Additional factory capacity, enhancements to our distribution network, and smooth regulatory transitions enable us to consistently deliver results and improve our competitiveness in the market. In addition, we're continually evaluating M&A opportunities that fit our strategic objectives, positioning us for sustained growth and market leadership.

We have a very strong balance sheet with net debt-to adjusted EBITDA at 1.2 times, down from 1.8 times in the prior year. Our strategy for capital deployment remains focused on prioritizing high return capital expenditure investments, increasing dividends annually, and share repurchases dependent on M&A activity. We are also dedicated to maintaining our investment-grade rating.

If you will now turn to slide 9, I will review our revised 2024 full year guidance.

After the second quarter results and more visibility into the second half of the year, we have refined our full year revenue guidance for each segment. The table on the left summarizes our full-year revenue growth factors. Total company revenue is still projected to increase by approximately 7%. We now expect low single-digit improvement in sales volumes, which reflects increases for both segments. Price and mix expectations remained relatively unchanged within the range of mid single-digit revenue growth.

As a result of our strong first half profit performance, we are raising our full year earnings per share guidance to $19.50 to $20.25 from the previously guided $19 to $20. We're also maintaining our free cash flow guidance at $500 million to $600 million. Component cost inflation is now expected to be up low single digits compared to mid single digits in our previous guide. We still anticipate year-over-year increases in R-410A refrigerant and commodity inflation.

We anticipate ramp-up costs of approximately $10 million for the new Saltillo, Mexico factory, along with approximately $10 million associated with a refrigerant transition across both segments' manufacturing facilities. SG&A expenses are expected to increase in the year as the result of both inflationary pressures and investments. Our investments are focused on resources to improve customer experience and distribution growth initiatives. We will also be making investments in both sales and marketing to support our long term growth targets.

Capital expenditures are expected to remain unchanged at $175 million, interest expense is still expected to be approximately $50 million, and tax rate is expected to be approximately 20%.

Overall, our performance in the first half of the year, combined with increased clarity on market risks, has given us the confidence to raise and narrow our EPS guide range.

With that, please turn to slide 10, and I'll turn it back over to Alok for an overview of end markets.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thanks, Michael. Let me provide updates on our outlook and share opportunities for both our segments. Within our Home Comfort Solution segment, historically consumer health has been a significant driver of the repair versus replace decision. Therefore, we are diligently monitoring macroeconomic factors, but have only seen minor shifts toward repairs. Encouragingly, industry inventory levels have largely returned to normal, and recent updates on the EPA ruling have provided greater clarity on the upcoming refrigerant transition.

In the Home Comfort Solution segment, the greatest share opportunities will result from successfully executing the upcoming refrigerant transition, improving overall fulfillment rates, and enhancing go-to-market capabilities.

Within the Building Climate Solutions end market, we continue to watch for any indication of short-term disruptions due to the refrigerant transitions. However, order rates and backlog continue to be stable, and feedback from our customers suggest that there is a strong pent-up demand for rooftop replacements. While we have seen project delays in some verticals, we are encouraged by the customer interest in our new cradle-to-grave services enabled by the recent AES acquisition. We remain excited about the opportunity to gain share in the emergency replacement market, leveraging our upcoming production capacity at Saltillo.

The new production capacity at Saltillo will also free up capacity at our Stuttgart plant to target additional key accounts. Overall, our outlook for the year remains cautiously optimistic. Based on Lennox's history of successful regulatory transitions, we expect to benefit from new product mix and potential market share growth.

Now, please turn to slide 11. As we conclude today's earnings call, I want to reaffirm our confidence in our ability to consistently deliver growth results by focusing on the five elements of our strategic transformation plan.

First, we will continue to accelerate growth by improving our go-to-market effectiveness.

Second, we will expand resilient margins through pricing excellence, increased productivity, and by leveraging our direct-to-dealer network.

Third, by leveraging the Lennox Unified Management System, we will streamline processes, leverage best practices, and consistently execute our strategy.

Fourth, our continued technological advancement will enable Lennox to remain at the forefront of innovation for our customers.

Finally, our core values and guiding behaviors are the foundation of our winning culture supported by our pay-for-performance incentive structure. This comprehensive strategy not only supports our current performance, but also reinforces our commitment to delivering long-term goals.

I am immensely proud of our achievements, and I firmly believe that our greatest successes are still ahead of us.

Thank you for listening. We will be happy to take questions now. Maddison, let's go to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we will take our first question from Ryan Merkel with William Blair.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

Hey. Good morning. Thanks for taking the questions. I wanted to start on the price mix contribution at up 3% versus the mid single-digit guide. Are you expecting price mix to improve in the second half?

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

Hey, Ryan. This is Michael. No. Actually, what we're expecting is the second half of the year to be similar to the first half. So, I think we were kind of low single digits in the first half. I think we're applying slightly mid single digits in the second half. If you recall, in the first quarter, we had some unfavorable mix, mostly because of residential new construction in the HCS business. But overall, price mix should continue on, similar to what we saw in Q2.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

Got it. Okay. And then I had a question on the outlook. Just to clarify, residential, you lowered it to up 5%. I think it was up 6% last quarter. But you raised the volume to low single digits from flat. Can you just unpack that a little bit and talk about what you're expecting in the second half?

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

Yeah. That's just cleaning up some of the guide points based off the year-to-date mix that we've seen in both Q1 and Q2.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

Got it. Okay. So, nothing's really changed with the resi outlook. You mentioned minor shift to repair, but not a lot has changed?

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

Nope. Not a lot has changed. Just cleaned up the guide points.

Ryan Merkel
Analyst, William Blair & Co. LLC
Q

All right. Thanks. I'll pass it on.

Operator: Thank you. And we will take our next question from Damian Karas with UBS.

Damian Karas
Analyst, UBS Securities LLC

Q

Hey. Good morning, everyone.

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

A

Morning, Damian.

Damian Karas
Analyst, UBS Securities LLC

Q

Congrats on the JV. Alok, maybe just wanted to ask you about that. How are you thinking about the financial impact of the JV? You talked a little bit about it's really focused on heat pump and your opportunity to gain some market share. How much of an uplift to your organic growth profile for the residential Home Comfort business? Do you think that represents? And any other kind of margin or cash flow impacts of the JV we should be thinking about?

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

A

Sure. Yeah. Thanks. Let me start by saying it's going to impact both the Home Comfort Solution and also the Building Climate Solutions because obviously we bring mini splits for – mostly for HCS, and we bring VRF products mostly for BCS on both sides.

As we looked at our long-term goals, we have always talked about that heat pump penetration is a pending opportunity for Lennox. And this essentially closes the gap between our portfolio and what the market-leading portfolios were.

The cash flow margins, all that from a JV contribution, it's not going to be meaningful. What's going to be meaningful is the margins we make on selling the products, the share we gain by expanding our heat pump portfolio, and the increased benefit of having a strong partner like Samsung as we develop new technology, whether it's cold climate, heat pump technology, or just simply look at controls such as SmartThings and total integration for a home or building control.

But the JV itself, the way we look at it, is the financials are not going to be material to our bottom line numbers. But it's going to be the result of partnering and selling those products that we are super excited about.

We went through a long process. We've been exploring for this for about two years, spoke to several different potential partners. And we do believe Samsung is kind of the best partner for us, given that we have like consider ourselves as a North American champion. And they consider themselves – and are a global champion. So, putting that together, we are excited about the combination.

Damian Karas
Analyst, UBS Securities LLC

Q

Makes sense. Thanks for that. And I wanted to ask you about Home Comfort. I think investors were getting pretty bullish just experiencing some of the hot temperatures thus far this summer. Felt – feels like kind of your resi volumes are a little bit more stable. You did raise the expectations for the year to low single digits. Could you just maybe talk about kind of how your orders trends have been progressing through the second quarter and kind of how July has been playing out so far?

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

Sure. So, one of the things we, Michael and I, [ph] try (00:22:54) really, really hard is not to talk about weather in an earnings conference call. I think there's a – I've never seen any upside to talk about weather in an earnings conference call. But it does have an impact. But, listen, the year is progressing along as we expected is a simple way to look at it. Yeah. There was some price mix cleanup that we did based on results year-to-date. But overall, the volumes are as we expected.

Last year, we talked about destocking ending in the first half. It ended in Q2. We had wished it ended Q1. We think consumer demand is very stable, and that's reflected in our volume guide for the year and our first half performance. So, nothing really has changed.

What's exciting there is the upcoming R-454B refrigerant. That – the EPA rules and the clarification of EPA rules has just given us more confidence going forward on what it could be. But at the same time, there are quite a few uncertainties that remains in the second half. And those are around R-454B transitions, how competitions will do around that. Will there be a large pre-buy or not? Election years could be weird for consumer behavior, so we are watching out for all of that. So, we built all of that uncertainty into our second half guide and try to reflect that.

Damian Karas
Analyst, UBS Securities LLC
Q

Great. Thanks for your thoughts. Best of luck.

Operator: Thank you. And we will take our next question from Tommy Moll with Stephens, Inc.

Tommy Moll
Analyst, Stephens, Inc.
Q

Good morning, and thank you for taking my questions.

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

Morning.

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

Morning, Tommy.

Tommy Moll
Analyst, Stephens, Inc.
Q

First question for you on the Home Comfort Solutions volume. So, the outlook for the year went from flat to up low singles. Can you just tell us what your underlying assumptions are there for two-step versus direct? And then on the two-step side, any context you can provide as to how the destocking ended through Q2, even if just anecdotal would be of interest. Thank you.

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

Sure, Tommy. Yeah. In the full year guide, what we're expecting on the sell-through or the direct side is approximately flat for the full year. And on the two-step, up mid single digits. So, that kind of blends to a up low single-digit increase. As you recall, when we went into the year, we expected the direct side through our Lennox channel to be down low single digits. That's performing a little bit better. And then the destocking, as we mentioned, yeah, it definitely accelerated as we went through the quarter. And June was better than the beginning of the quarter, so I was pleased to see the destocking ending.

Tommy Moll
Analyst, Stephens, Inc.
Q

Thanks, Michael. As a follow-up, I wanted to hit on the reference to product mix and inflation. Alok, this was on your 2024 slide. I'm just talking to the drivers of some of the end markets, and I'm just curious what was behind that comment. And maybe more importantly, Alok, do you continue to view 10-plus percent as a cumulative realization on the A2L product? Thanks.

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

Yeah. Let me start with the 10%. Yes. The answer is simple, and it's yes. We continue to expect 10-plus percentage pricing benefit on that. I think just any change in the product mix that we talked about, and Michael referenced earlier, were minor. It was more driven by the fact that we do see consumers continue to demand R-410A products, and we don't see the industry or ourself having a significant share of R-454B sales this year.

As we had talked about in Q1, but we're just kind of reconfirming that R-454B is going to be 10%-plus pricing increase. We think majority of this year's sales are going to continue to be R-410A, even more than we thought previously. And we remain very bullish about R-454B next year as a step change in the industry's profile around margin expectations and a step change in technology. And we are also very confident that we are in a strong, strong position to execute well and give our dealers exactly what they want, which is they want R-410A products as long as possible, and then they want to switch to R-454B as seamlessly as possible.

Tommy Moll
Analyst, Stephens, Inc.
Q

Thank you, Alok. I'll turn it back.

Operator: Thank you. And our next question comes from Jeff Sprague with Vertical Research Partners.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Hey. Thank you. Good morning, everyone. Hey. Speaking of election uncertainty, could you just level-set us on what your – how much of your sales contribution is coming out of your Mexico facilities at this point? I think we had it sort of in the mid-20s when we did this fire drill in 2018 and 2019. Any update there would be helpful. Thank you.

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

So, sure. On the BCS side, we're just starting the Mexico facility, so it's close to zero on that one right now. On the HCS side, our low-end products are mostly made in Mexico. Overall, I would say it's about half. Half of our products come from Mexico. And we have obviously all the standard protections around, making sure we have the [indiscernible] (00:28:28) structure and all that set up.

We'll see where the election goes. I mean, I think we are in a very strong position. We are taking steps to just like starting two years ago to reduce our reliance and sourcing more products locally, and we continue to do that. But we do have half our production coming from Mexico, which gives us substantial advantages even when we buy components and bring them from overseas into Mexico.

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

And I'll just add, our competition also manufactures in Mexico, very, very similar to us.

Jeffrey Todd Sprague — Q
Analyst, Vertical Research Partners LLC

Great. Understood. And then, Michael, just on free cash flow, it's kind of a modest week, right? But estimate net income's going up, free cash flow isn't. It already wasn't particularly strong free cash flow conversion year. Just kind of what's going on there? And maybe – we know CapEx is probably going down in 2025, which will help on the conversion. But maybe just a little bit of additional color on what to expect, how things play out the remainder of the year and into the first part of next year.

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

Yeah. Yeah. I think some of that's just around flexibility. We want to work with the markets and our customers as this R-410A transition occurs to the R-454B, and the ramp-up of the new factory. We make sure we have sufficient raw materials and inventory there. So, really, it's just more uncertainty in the second half of some of our inventory levels, but we're focused on, I think, driving that cash flow perspective.

But then, as we get into next year, we've set targets at near 90% cash flow conversion. That's what we're focused on right now.

Jeffrey Todd Sprague — Q
Analyst, Vertical Research Partners LLC

Great. Thanks. I'll leave it there.

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

Yes.

Operator: Thank you. And our next question comes from Nigel Coe with Wolfe Research.

Nigel Coe — Q
Analyst, Wolfe Research LLC

Thanks. Good morning. So, look, I've – no word of a lie, I've just installed a bunch of Samsung heat pumps, and they're great. So, congratulations on that JV. I'm not sure you got a slide for that, by the way. It might've been before the JV was formed, but it works really well.

So, just – talking about the sell-through down mid singles for your direct business, June had two fewer selling days. So, I know you don't like to talk about the weather, but maybe just address what impact those two fewer selling days might have had on the Home Comfort performance this quarter.

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

Sure. So, I think Home Comfort on the direct side, Q2 was flat to last year, and we are guiding the full year also to be flat. Our original guide was to say we would be down low single digits on our direct-to-dealer method. So, implied guide is higher for us in terms of on a direct side.

On the two-step, we expect second half to be pretty strong. But as you can imagine, the destocking went on a little longer than we all had expected. That's kind of the only change that has happened in our outlook for HCS, is midway through the year, as Michael said, we updated bunch of our guide points. But the reality, the only change has been that we destocking lasted a little longer. But now, we are confident it's over. Our direct is doing a little better than we expected, to be essentially flat compared to last year. And we think R-454B is going to be on track, and it's going to be launched and sold mostly in 2025.

But there's no really change to our outlook beyond that.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Yeah. The June impact, did that have an impact in the quarter?

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

Sorry, which impact?

Nigel Coe
Analyst, Wolfe Research LLC
Q

The selling days, the two fewer selling days, did that have an impact?

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

No. I think from a 2Q, we didn't see any specific impact of that. No.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Okay. Great. And then just digging into the commercial, the building control segments, price mix, I think, was pretty flat this quarter. That's obviously been very strong. And I know you got tougher comps as we sort of lapped that impact. But anything to call out there? I know you're sort of calling for a mid single-digit impact from price mix. So, just wondering if there's anything intra-quarter that we should think about.

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

Yeah. We have some normal transitory mix within that segment. As you recall, we have HVAC equipment, we have services, and we have refrigeration business. We did see a little bit of unfavorable mix mostly in the service and refrigeration business, but nothing to be concerned about. Just kind of transitory normal mix. We expect that to continue kind of mid single digits for the balance of the year in that segment.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thank you.

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

A

Yes.

Operator: Thank you. And our next question comes from Julian Mitchell with Barclays.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe just wanted to start with the BCS segment, so the top line outlook. You talked about sort of solid demand. And you mentioned, again, these project delays that you talked about last call. But obviously, you've taken up the volume guide for that segment for the year a little.

So, maybe just sort of update us, are these project delays kind of more or less than you'd thought a few months ago in BCS? And any kind of updated thoughts about how we should look at the education vertical within BCS, just as that as your funding starts to sort of wind down over the next couple of years, any sort of broad brush thoughts on that? And maybe too early to throw in Mexico plant impact, but anything you could give us on the top line.

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

A

Sure. On the first part, on the project delays, I think it's getting better, not worse. So, I think to answer your question, when we called it out in Q1, there was a lot more noise. Part of it's everybody reads some news articles and we try and interpret our own results. But our backlog remains [ph] strong (00:34:28), order rates remain strong, and we are still heavily supply-constrained or demand-constrained.

On the education vertical, it's kind of fairly steady. And I know this was some IRA funding, but we ran out. But education has been a good growth engine for us. Our share had been low. We are gaining share in that vertical. And we also feel really good about all the other verticals that have not picked up yet, especially around some of the foodservice and retail that went through the COVID lows and now they're kind of coming back up.

So, from our perspective, we don't think that makes a meaningful impact either way for us going forward because we continue to be, at the end, supply-constrained, not demand-constrained in our BCS business.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks a lot. And then just my follow-up would be, I suppose I know that you and Michael, for very good reasons, don't like to get too in the weeds on sort of quarterly color and all the rest of it. But just as we're halfway through the year, I don't know if there's any sort of pointers you could give us for the balance of the year. I think often, for example, the third quarter, we get that seasonal double-digit earnings decline sequentially.

I just wonder if this year might be different because of something going on with the refrigerants change coming up or the Mexican plant just starting pilot production. And just on that Mexican plant sort of related, just any sort of pointers on revenue effects over the next 12 months?

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

A

Sure. So, I'd say on the – let me start at the Mexican plant, and then I'll come back to the other part of your question. On the Mexican plant, we had inefficiencies in Q2, and we called it out. Imagine we are, like, 300 to 400 people fully on our payroll building under construction, but zero sales. So, from that perspective. Something similar will happen in Q3 as well. So, I think that's sort of embedded and built in into our numbers and guide.

From a revenue perspective, we expect the bulk of the revenue to start coming through only 2025. We want to make sure these products are really good, highest quality. We are going to test them fully. We are going to field try them before we sort of mass market launch them. And, of course, there will be revenue in Q4 as well, but I think a meaningful revenue from Mexico would be 2025.

Not much has changed in terms of seasonality. So, I think the historical seasonality, Q2 and Q3 used to be similar. We may have had some situations back and forth, but I think that'll be similar. What we have to watch out for honestly is to think about, is there going to be a significant amount of pre-buy of R-410A product? And if there is demand, does the manufacturers have the capacity and ability to make additional R-410A product? That's sort of the uncertainty that concerns us right now. But we sort of embedded that within the range of the guidance point we gave out. But I would expect nothing unusual besides the Mexican plant inefficiency that we mentioned.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Got it. So, third quarter, sort of similar to Q2, and then we have that Mexican caveat this year to watch?

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

A

Yeah, essentially, with the normal seasonality baked in, just like last year.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks so much.

Operator: Thank you. And our next question comes from Noah Kaye with Oppenheimer.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks so much for taking the questions. On the Samsung JV, Alok, can you kind of walk us through the game plan for how this gets operationalized when the Samsung products start to become available to the dealers and in distribution and the strategy around how you're marketing that?

And then, Michael, I believe it was already said that it's not expected to be a material contribution this year. But presumably, there's going to be good growth and equity income at some point from this. You're not consolidating it, correct me if I'm wrong, so this should show up as an equity income contribution. Where will that actually show up in the financials? Will that be in corporate? Will be split among the segments? Because presumably, it's going to be margin-accretive once it starts coming on.

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

Sure. Let me start on the availability. So, to minimize any dealer disruptions, we are going to launch the Samsung products in the A2L range. So, we will run out with our current products and keep running through that through the R-410A transition, and that Samsung powering the Lennox product would be launched as the new R32 product. And so you could expect it towards the end of the year. So, until then, for our dealers and all, it's status quo.

Obviously, in the background, we are doing everything from making sure we have sufficient inventory in hand, getting the branding right, doing test marketing with the dealers, going through the technology specs. But essentially, revenue 2025, launch this year.

On the second aspect of it in the JV, the equity income, again, is not going to be meaningful. The whole point of this JV is going to be around technology development and the margins we make on selling the product through our channels. Samsung will make manufacturing margin. We would make distribution margin. And it's a great way for us to test and demonstrate how we are going to be a better distributor.

Now, we already do this with a different vendor. So, it's not new, and you're not going to see a step change anywhere. If I were to model anything, I would just model greater heat pump market share for Lennox based on this JV because we think this gives us a very strong offering, great brand name. And it gives us dealers a great choice to fight against other market-leading companies who are currently dominating this space.

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

And, Noah, and I'll just add, just specific to where it's going to land in the P&L, we already have equity income on our P&L, so it'll be on top of that. But as Alok mentioned, it's going to be minimal. The biggest gain is going to be within the segments for sales and margins.

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

Yes. Very helpful. That plays into the second question around distribution. You called out some increased investments. You've been very clear that you have a strategy to become a best-in-class distributor. Maybe unpack some of the use of those investments you're making here and through the back half of the year, help us understand how the strategy is progressing.

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

Sure. The strategy is progressing real well. We are pleased with what we are seeing. Some leading indicators such as fill rate have improved substantially. So, like, at the end, all of this investment is worth nothing if we don't deliver the appropriate impact to the customer and if it doesn't reflect in our share. So, all of those things are running positive for us. Fill rate, customer share, customer satisfaction, all of that's doing well.

The investment is around – a lot of just around warehousing, logistics, a lot is around IT systems and making sure we have the appropriate systems to keep track of our products, do the appropriate [indiscernible] (00:41:58), and then finally talent.

Like, we are now getting to world-class talent level. A lot from outside, some from inside, putting it all together. And we remain committed to putting those. In some cases, we were just behind. We started this as company-owned factory outlets, and we're now becoming a distributor, and we have raised the bar on ourselves. But we are real pleased with the progress as we see all the leading indicators, which bodes well for us from continued market share gain going forward in the future as well.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks very much, as always, for the color. Looking forward to seeing the progress.

Operator: Thank you. And our next question comes from Joe Ritchie with Goldman Sachs.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys. Good morning.

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

A

Morning.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

So, I think I'm going to start with the – in the Home Comfort Solutions business. You guys called out that $19 million drag for margins. I know that you'll give a lot more color in the Q. But maybe if you could just give us some of the kind of moving pieces, whether it's SG&A, freight, and then also component costs because you have seen probably a pretty material decline in your material costs, and so curious how you're thinking about that through the rest of the year as well.

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

A

Yes. Yeah. So, the component costs are actually in that product cost bucket. So, we are seeing a little bit better on the component costs, mostly material cost reduction programs. The $19 million of other, think of it about half of that related to freight and distribution, and a good portion of that being investments and distribution, the other half being SG&A inflation and some of the IT and investments and head count that Alok mentioned.

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

A

Yeah. And just as a reminder of that, if I could jump in, I mean, we have broadcast very loudly that we're investing in additional sales resources. Our Lennox residential HVAC business has 20% additional sales resources. We are redoing our incentive comp. So, this has all been under works for a while. And, like, by the end of the year, we'll start lapping ourself on this, but these are all necessary and appropriate investments with very attractive payback.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC
Q

Yeah. That makes sense. And I guess maybe just a longer-term question, Alok. Given the Bosch announcement on the JCI assets, whenever there is any kind of changing of the hands, there's sometimes some investor angst as to what that means for the kind of discipline of the industry. I'd be curious to hear if you have any just initial thoughts on whether you think this kind of changes industry dynamics or your ability to continue to kind of gain share, particularly in the residential sector.

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

Sure. Well, on that one, I'll first start congratulating the management team at Bosch and the management team at JCI on the transaction. I'm sure it was hours and hours of hard work, lost sleep of multiple weekends. Not that I'm speaking for experience on the same transaction or anything, but I just want to congratulate them and glad that it's finally sealed and signed.

From our perspective, listen, I think Bosch is a very reputable company. I think they focus on technology. They have done wonderful things by investing in R&D. And as you know, they plow a lot of money back into charitable and social causes. I mean, we are looking forward to Bosch joining the list of very disciplined industry players and becoming another one of them. I mean, they are much better than some of the other feared owners of the JCI assets. And I'm super excited that the industry will remain disciplined going forward and will compete on technology, will compete on differentiation, will compete on better service and quality. So, I'm super excited about where we are.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC
Q

Great. Thanks, Alok.

Operator: Thank you. And our next question comes from Jeff Hammond with KeyBanc Capital Markets.

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

Hey. Good morning.

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

Morning.

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

Hi, Jeff.

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

Just – yeah, on the refrigerant change, I'm just wondering if you guys introduced your new products and pricing into the market and gotten any feedback. And then we've heard from a couple other competitors that they've kind of put out a last call for R-410A, which might start to indicate what level of pre-buy you might get. Just any color on those two fronts.

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

A

Sure. It seem – Jeff, it seem like every competition has launched these products on social media, if you look at the nice pretty picture that we all put out. But I think from practice, you can't buy a R-454B unit from anybody yet. So, I think that's – we are a similar situation. Are we ready to launch it? Yes. Have we made a few trial units? Yes. Just like everybody else. We are on track to launch it as customer demand picks up, especially as we get into 2025.

From overall last call perspective, we haven't made a last call, but we are working with our distribution partners and dealers to truly understand what their demand requirements are and tailor our manufacturing according to that. We have a very focused operation, as you know, and we want to remain flexible to give our dealers and distributors what they want. So, for us right now, all production is R-410A, and we'll continue producing it till the time the dealers want it, and till the time the law allows us to do it.

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

Q

So, I guess the comment on trade-down is that as you're getting feedback from your distributors and dealers, they're wanting more of that R-410A. But anything else within kind of the trade-down dynamic, where consumers are trading down, whether in SEER [ph] or feature (00:48:01)?

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

A

Yeah. The trade-down, which is a mixed comment Michael was saying, first of all, any reference is mostly just rounding and small. But, yeah, the – we are expecting to sell more R-410A versus more R-454B. But even beginning of the year, we were expecting to sell mostly R-410A throughout the year.

No major dynamics on the consumer. As we went from 13 to 14 SEER, obviously there's some compression in the product line, right? Like, people who are buying 16 SEERs, and I'm often happy with the 14. So, it's a bit of a natural thing as we can sell lower SEER products, but we don't see any meaningful trade-down. If I think of our sales of Merit products, Elite products, and Signature, kind of good, better, best, those ratios are relatively the same. So, I don't see major trade-down on that.

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

Q

Okay. Thanks.

Operator: Thank you. And our next question comes from Brett Linzey with Mizuho.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Hi. Good morning, all.

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

Hey, Brett.

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

I want to come back to BCS. So, the factor ramp costs, unchanged at $10 million for the year. What was the total impact year-to-date? And I guess as the production ramps into next year, should we think of that capacity getting absorbed and the $10 million becomes a tailwind? Or do you – is there still some under-absorption you're going to feel there?

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

Yeah. So, year-to-date, it was $7 million. So, $5 million in Q2, $2 million in the first quarter. And that's exactly right. So, as we fully ramp-up that factory to full efficiency second half of next year, we'll start to see the efficiencies – those inefficiencies go away.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Okay. Great. And then just on the pilot units in early July, so you're making the necessary factory investments. Where do you stand from a boots-on-the-ground, front-end selling standpoint as you look to reenter that emergency replacement market next year? Have you made the investments? Or is there more to go?

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

We have made most of the investments. So, at Q2 exit, the run rate would reflect most of the investments made in there. We were hiring starting kind of Q4 last year. And over the past three quarters of Q4, Q1, Q2, we have made the necessary investment, and it is reflected in our Q2 exit rate.

It's gone very well. I mean, we're excited about the increase in our boots-on-the-ground. We're excited about the process discipline that we are bringing along with that. We're also super excited about sort of putting our customers and dealers in a position to win again and getting them the confidence around our own availability, our lead time. And now we are in the process of setting up distribution points around the country to make sure that we can satisfy emergency replacement demand the same day in most cases and next day at the worst because that's sort of the critical portion of how you win this. So, we're now – we are in that portion, and that's somewhat the distribution investment that we mentioned earlier.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Appreciate the insight. Best of luck.

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

Thanks.

Operator: Thank you. And our next question comes from Steve Volkmann with Jefferies.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Hi. Good morning, guys. Most of my questions have been answered, but just a couple follow-ups. What is – how should we think about your heat pump share now in terms of trying to think about what the upside could be under the JV?

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

A

Yeah. I think we mentioned that heat pumps in US are around 30% of sales. We are closer to 20%-25% of sales. So, if you think about that, like, there's a significant delta between our sales and where the industry is. Share depends on obviously different players. I don't want to comment on shares. But think of that 5- to 10-point difference between us and the industry as an opportunity for us to win that amount and accelerate our growth.

It's going to come from two things, right? One is the Samsung piece. Second is also launching on a unitary side or the ducted side, combined products or just more products on the heat pump that meet the cold climate requirement, and that's all going to happen in the first half of next year. Currently, all our innovation teams are focused on A2L. And once we take a breather out of it, we have a new lineup of heat pump ready to go on the unitary side as well.

So, super excited about what this brings to us, and our ability to claw back and get into the industry average for heat pump share. So, we are quite behind.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Perfect. Okay. Thanks. And then are you at all concerned that a change in administration might have some impact on the A2L transition, either in terms of timing or amount or anything like that?

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

A

No. We are not. This is kind of baked into law at this stage, and some of these changes happened when the administration was under a different political party. So, I think at this stage, there's absolutely no chance of that happening.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Great. Thank you.

Operator: Thank you. And our next question comes from Joe O'Dea with Wells Fargo.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Can you just give the cadence of the refrigerant conversion cost, that $10 million you called out, how we see that kind of filtering over the course of the year?

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

Yes. It's all going to be second half. So, we haven't experienced any of that yet, and it'll be kind of equal Q3 and Q4.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC
Q

Okay. And then, Alok, can you just expand a little on how you think about the ROI attached to the 20% increase in sales resources? What – and is that primarily focused on kind of emergency replacement and with the new facility coming on line? So, overall, kind of what your timeline is, how you're thinking about that ROI, and the markets that you're going after?

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

Sure. From an ROI perspective, I think Michael talks about this, right? I think our internal investments have the best ROI. And adding these resources has a better ROI than putting in new machineries in our factories. So, it's a pretty quick ROI. Most of these are two years or less payback. And most of the payback is around hiring process, getting people trained and ramp up, and they're not really very efficient for the first six to nine months. They get pretty efficient after that. So, it's good ROI.

And the 20% comment, remember, it applies both in our BCS and HCS. On HCS, it was about being a better distributor, supporting our dealers better. And in BCS, yes, it was about focusing on emergency replacement and getting our districts fully staffed up to do that while maintaining our key accounts and investing in our key accounts from process and digital and separating those out in an appropriate way. So, quick payback, super excited about it. What we need is production capacity, and finally glad to see the Saltillo factory with a roof on and with some units rolling through the conveyor belts.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC
Q

Got it. Thank you.

Operator: Thank you. And our next question comes from Nicole DeBlase with Deutsche Bank.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.
Q

Yeah. Thanks. Good morning, guys.

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

Morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.
Q

So, most of my list has been answered. I guess maybe I'll ask one two-part question. So, BCS margins, I guess is the expectation for continued year-on-year contraction in the second half as the plant ramps up? And I think you guys had expected kind of modest expansion for the full year, so I assume that's still the outlook. And then ditto on the resi HVAC side, I think you were also looking for modest expansion margins in that segment for the full year. Just wondering if there's been any shifts in that. Thank you.

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

A

No. That's generally what's implied in our guide. Overall, if you look at our total guide, we're projecting about a 50-basis-point margin expansion for the enterprise. And, yeah, there'll be some contraction in the second half, mostly because of the ramp-up costs, both to transition to the new refrigerant and the second factor at BCS. But those are the kind of headwinds we see in the second half that have a little bit of a margin decline. But overall, full year margins up.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks, Michael. I'll pass it on.

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

A

Yeah.

Operator: Thank you. And our next question comes from Deane Dray with RBC Capital Markets.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone. Just had a...

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

A

Hi, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

...quick first question on the emergency replacement share opportunity. Just make sure I understand, what – where does it stand today? What has been lacking? What are you intending to do better to capture that opportunity?

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

A

Sure. Thanks, Deane. I mean, that's a important portion of our future, like, growth opportunity, both from revenue and margin. So, thanks for bringing it up. So, pre-disruptions in Stuttgart, so think of like pre-2021-2022, we had a small share in emergency replacement. That went to essentially zero during the Stuttgart disruptions. We have started selling into emergency replacement now, but we are still selling dribs and drabs, not in any sustained flow basis. We look at that as significant opportunity for us.

For the full industry, emergency replacement is up to half of the revenue, depending on which player you talk about. So, think of us so far being focused only on the other half and having very little or no share on the emergency replacement piece.

So, over the multiyear horizon, we think it's a huge opportunity. Next year, we'll start making significant dent on it. And overall, our market share will still remain very low from – compared to the other large players. Remember, we are, like, third or fourth largest player in the industry. So, from that perspective, I'm not worried about disrupting the market because the whole industry is still running short of capacity.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Will that be a data point you'll be providing on a go-forward basis or just provide color?

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

A

We'll just provide color. I don't want to get, like, too much into quarter-by-quarter emergency replacement share or trends versus share because it could be lumpy. Not on the emergency replacement side, on the key account side, where we have often big projects. And some of it becomes giving away our competitive dynamics as well, so...

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. And then just a quick question on the colder climate heat pump technology. Is that something proprietary to Lennox? Just give us some color there on what that edge is and what the efficiency is in terms of how it works in colder climates.

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

A

Sure. As you know, all colder climate comes up using the vapor injection technology with, like, appropriate compressors in there. So, that part itself is not proprietary because the entire industry uses the exact same technology. What's proprietary around that is the valves, the controls, the algorithm behind those controls, and those are all proprietary to us. And obviously on the mini-split VRF, those would be proprietary to Samsung. So, I want to separate out the controls technology, which is proprietary, versus the compressor and the vapor injection technology, which is fairly industry standard used by all of us. As you know, everybody buys compressors from the same two or three vendors. So, that's kind of where we stand.

It impacts us the most because our market share in the Northern US is higher than our market share in the Southern US. Some of the leading industry players have higher market share in the South, e.g., warm regions, and lower in the North. So, for us, it just becomes a more meaningful change in, like, penetration of heat pumps that impacts us more than others.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Understood. Thank you.

Operator: Thank you. And our next question comes from Steve Tusa with JPMorgan.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Hey. Good morning.

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

Morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Thanks for fitting me in. Just on the – first of all, just on the EPS, as a follow-up to Julian's question, I think the normal seasonality is maybe down in EPS, but you said effectively flat in line with normal seasonality. Is there something that's influencing that? Or maybe on – maybe seasonality is tough to nail down over the last several years. But just wanted to get a little more precision on, that seems a little better than normal seasonality, flat sequentially.

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

Yeah. So, I was – when we're talking about flat, we were referring to inefficiencies and other things such as the ramp-up cost and other pieces. Those are flat. But, no, we do expect normal seasonality, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

So, down.

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

The flat was referenced to...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Down sequentially.

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

...inefficiencies and other pieces.

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

[indiscernible] (01:01:15) normal revenue seasonality.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Okay. So, EPS, flat, up, down, 3Q?

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

You're just going to have the headwinds of the ramp-up investments that we talked about that are going to be similar in Q3 and Q4.

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

Yeah. And we...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah.

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

As you know, Steve, we don't give quarterly guidance on EPS. We don't want to be kind of caught in trying to give one.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Okay. All right. All right. I – you could have just said that before. I would've – I wouldn't have pushed. So, I...

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

[indiscernible] (01:01:42).

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah. I probably would have pushed anyway. So, the – moving along. Moving along. The commercial business, so what is the revenue breakout of that today from an end market perspective?

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

Yeah. It's about 50% HVAC, 30% refrigeration, 20% service.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

But then, like, end market wise is what I meant.

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

Oh, end market?

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

We don't give out end market...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah, for the equipment. For commercial equipment.

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

Yeah. Within commercial equipment, we talked about majority key account, little bit of emergency replacement. We don't break it out by vertical. If you're looking for, like, what's education, what's retail, what's foodservice, we don't give that out.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Okay. Got it. All right. Thanks a lot.

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

Thanks.

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

Thanks.

Operator: Thank you. And our next question comes from Gautam Khanna with TD Cowen.

Gautam Khanna
Analyst, TD Cowen
Q

Hey. Good morning, guys.

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

Hi, Gautam.

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

Morning.

Gautam Khanna
Analyst, TD Cowen
Q

Wanted to ask about the state program to utilize some of the IRA incentives. It looks like a handful of states have been approved, and I'm wondering if you're actually seeing it and how you guys are going to market, how your dealers are going to market. Is it actually stimulating sales at this point?

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

First of all, I think it went better than I expected, Gautam. Last time you and I chatted, I thought we'll never see that money. But the fact that bunch of the states have actually applied and making progress, so that is better than we expected.

Second I would say is, we are very well-positioned, given our direct-to-dealer and our LennoxPROs and our engines which calculate all the rebates and incentives, all of that put together the right proposal for a dealer. I think we are better positioned than most.

Thirdly, would like to really answer your question is, no, we haven't seen a meaningful impact of that yet. If the current trend continues and states keep getting the approval and put that through, it still would be end of the year/early next year where we'll start seeing some of those come through. There are still some technical hurdles to be managed through that, but the progress honestly, better than the skeptical side of me, I thought it would be six months ago.

Gautam Khanna
Analyst, TD Cowen
Q

That's helpful. And then just to follow up on the third-party channel, I'm just curious, given the higher rate environment, we're done with destocking. Do you think there will be any meaningful restocking? Or will they be reticent to carry much inventory, given the carrying costs were higher?

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

Still a bit unknown there. I mean, honestly, I would – because a lot of those folks think more in terms of dollars versus units, and dollars might still be up given the inflation impact over the past two years.

I think folks are going to be more disciplined than, let's say, the R22 transition in other places. But I still think there could be a meaningful amount of people building up inventory just because of uncertainty and the history of some of the manufacturers who don't always get this transition right. So, I think it'd be less than that. But higher rate environment means we didn't bake in a lot around pre-buy and anything else in our forecast because of exactly what you said, Gautam, about the interest rate environment. But if industry starts not meeting demand or there's some disruption that's coming in there, distributors are typically risk-averse, and they will start building up inventory. Capital is still available, it just costs a little more. So...

Gautam Khanna
Analyst, TD Cowen
Q

Thank you.

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

Thanks.

Operator: Thank you for joining us today. Since there are no further questions, this will conclude Lennox's 2024 second quarter conference call. You may disconnect your lines at this time.