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Lennox International, Inc. (LII)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Lennox Third Quarter 2024 Earnings Conference. 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, Margo. Good morning, everyone. Thank you for joining us today as we share a remarkable 2024 third 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 consider as 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 archived 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, everyone. Lennox delivered another record quarter, highlighted by double-digit revenue growth, operating margin exceeding 20% and strong free cash flow. We also made solid progress on multiple key initiatives as part of our ongoing transformation plan. I am grateful for a talented team and the growth mindset of our customers who enabled these exceptionally strong results. Let us turn to slide 3 for the highlights of this quarter. Core revenue grew 15%, and our adjusted segment margin expanded 90 basis points to a Q3 record of 20.2%, resulting in adjusted earnings per share increase of 24% to $6.68. We generated an impressive $452 million in operating cash flow this quarter, which is $139 million, or approximately 44%, increase over the same quarter last year. Our industry-leading ROIC also grew to 47%. Both our segments, HCS and BCS, achieved 15% revenue growth in the quarter, and both continue to deliver strong segment profit.

Investments in manufacturing capacity and front-end redesign has enabled us to gain share and meet customer demand for R-410A products. In addition, investments in digital processes and distribution technologies led to improved order fill rates within Home Comfort Solutions. The new commercial factory startup remains on track. And the Building Climate Solutions segment successfully integrated the AES acquisition ahead of schedule. These results reflect the dedication of our 14,000 employees and the continued support of our dealers and customers. Therefore, I am confident in raising our 2024 EPS guidance range to $20.75 to $21. Now, please turn to slide 4 for more details on our CLO transition. As announced earlier this morning, John Torres, Lennox's Chief Legal Officer, has elected to retire. I want to take a moment to acknowledge John's outstanding 16 years of leadership and his lasting impact on Lennox.

He led multiple acquisitions and divestitures to streamline our portfolio and ensure that we operate with the highest ethical standards by strengthening our ethics and compliance office. As a result of our thoughtful succession planning, we are excited for Monica Brown as she takes on the role of Chief Legal Officer, effective January 1, 2025. Monica has been with Lennox for 12 years with a proven track record across our businesses and legal functions. Before joining Lennox, she spent nearly 13 years with a leading outside law firm. Looking ahead, Monica is well-positioned to continue John's legacy of success, with a focus on advancing our digital capabilities and accelerating future growth.

Now, let me hand the call over to Michael to take us through the details of our Q3 financial performance.

Michael Quenzer

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

Thank you, Alok. Good morning, everyone. Please turn to slide 5. We're pleased to report our seventh consecutive quarter of double-digit year-over-year adjusted earnings per share growth. This quarter, we increased our adjusted segment margin by 90 basis points and achieved a remarkable 15% revenue growth, resulting in 24% adjusted EPS growth. Now, I will share more details on our third quarter financial results. Core revenue was approximately $1.5 billion, up nearly $200 million from last year, attributed mostly to volume gains in both segments. Adjusted segment profit increased by $52 million or 21% driven by $86 million in volume as well as price and mix benefits. This was partially offset by regulatory transition costs and expenses related to our new commercial factory ramp-up. Ongoing investments also impacted profits as we are committed to strategic initiatives in sales and distribution to support consistent, profitable growth.

The tax rate was 18.7% and diluted shares outstanding were 35.8 million compared to 35.7 million in the prior-year quarter. Let's now turn to slide 6 and review the third quarter financial performance of the Home Comfort Solutions segment. The Home Comfort Solutions segment had an exceptional quarter, delivering 15% revenue growth, 25% segment profit growth, and an impressive 170-basis point expansion in segment profit margin. Sales volumes increased by 11%, fueled by over 30% growth in our two-step distributor channel, primarily reflecting normal restocking after several quarters of industry-wide destocking. Our one-step contractor channel saw modest volume growth, supported by R-410A product availability compared to the broader market. Towards the end of the quarter, we saw early signs of R-410A pre-buy demand.

Pricing execution has been a key focus for the HCS segment over the past year, driving 4% revenue growth in the quarter. Having successfully met our 2024 price improvement targets, we are now concentrating on pricing for the new R-454B product, and these initiatives are progressing well. Finally, our quarterly profit was impacted by anticipated product cost challenges during our transition to our new R-454B product and for ongoing investments aimed at enhancing our distribution capabilities and improving the overall customer experience. Moving on to slide 7. The Building Climate Solutions segment also delivered an impressive 15% revenue growth in the third quarter, 6% of which can be attributed to inorganic growth from our AES acquisition. We are very pleased with this acquisition which was completed in the fourth quarter of last year. The integration was finished ahead of schedule and we have delivered better than expected AES profit margins driven by additional synergies.

From an organic growth perspective, sales volume was up 7% in the quarter, but was constrained by manufacturing challenges and new factory ramp-up inefficiencies that limited production output. Segment profit increased by $9 million, though profit margins declined due to anticipated manufacturing ramp-up costs. Production start-up at our new commercial factory in Saltillo, Mexico, remains on track. However, total manufacturing output for commercial HVAC continues to be below demand levels. For emergency replacement, we have started offering products in some pilot markets, and early results are encouraging. Please turn to slide 8 where I will review our cash flow performance and capital deployment strategy. Operating cash flow for the quarter totaled $452 million compared to $313 million in the same period last year. Capital expenditures were $40 million, representing $1 million increase year-over-year.

Our cash flow performance has been solid this year, reflecting ongoing efforts to drive revenue growth, expand profit margins, and optimize working capital. Earlier this year, we implemented working capital initiatives with a focus on accounts payable, which has been a driver of the $183 million increase in year-to-date operating cash flow. In the coming years, we will unlock additional working capital by leveraging digital tools and efficient processes. Our return on invested capital, ROIC, stands at 47%, an industry-leading figure that remains resilient across business cycles due to high non-discretionary replacement demand. We continue to expand ROIC year-over-year while also making capital investments that are poised to deliver substantial benefits in the coming years. Finally, we maintain a healthy balance sheet with net debt to adjusted EBITDA at 0.8 times, down from 1.8 times in the prior year.

Our free cash flow deployment strategy remains focused on driving annual dividend growth and executing bolt-on acquisitions. We have re-initiated buybacks in the third quarter and will continue leveraging share repurchases to efficiently return excess cash to shareholders. If you will now turn to slide 9, I will review our revised 2024 financial guidance. After the third quarter results and more visibility into the last quarter of the year, we have raised our full-year revenue guidance. The table on the left summarizes our full-year revenue growth factors. Total company core revenue is now projected to increase by approximately 10%. We now expect mid-single-digit improvement in sales volumes, combined price and mix to be up low single digits, and our AES acquisition to contribute low single-digit growth. As a result of our strong third quarter profit performance, we are raising our full-year earnings per share guidance to $20.75 to $21 from the previously guided range of $19.50 to $20.25.

We are also raising our free cash flow guidance to $575 million to $650 million. As you can see, most of our other guide points have not changed, except for interest expense which is now estimated to be approximately $45 million. Overall, year-to-date performance, combined with increased clarity on industry demand, has given us the confidence to significantly raise our earnings per share guidance.

With that, please turn to slide 10 and I'll turn it back over to Alok for an overview of the low GWP refrigerant transition.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thanks, Michael. All necessary preparations for design, engineering and manufacturing of the low GWP products were completed earlier in the year, ensuring a successful launch in the third quarter. As part of this transition, we are also excited to introduce our new Lennox powered by Samsung mini-split and VRF heat pump systems. We have invested heavily in developing new low GWP products and minimizing disruptions during the transition. We anticipate continued manufacturing cost headwinds into the first quarter of next year as we continue to convert production lines in our factories. Our approach to reconfiguring our factories balances production flexibility with cost efficiency. In 2025, we expect a gradual shift in demand for the new low GWP refrigerant products. The first half of the year, specifically the first quarter, will see continued R-410A sales from manufacturers, distributors and dealers as everyone depletes their regular and pre-bought R-410A inventory.

We still estimate that, for the full year, approximately 65% of the end market demand will transition to low GWP product, which will favorably impact mix.

Looking further ahead, we anticipate existing R-410A refrigerant will face price increases as supply tightens and demand moves towards low GWP products. This will increase cost pressure on repairs, leading to higher demand for system replacements. This transition also opens more service opportunities for dealers and contractors, given additional safety features and components in the new R-454B products. We expect some of the low GWP price and mix benefits to extend into 2026 as the market fully transitions to the new low GWP product. With that, please turn to slide 11 for our early thinking on the outlook for 2025. We are pleased with the resilience of the North America HVAC industry growth. We remain cautiously optimistic for 2025, given our sustained competitive momentum from our ongoing transformation journey.

On the left hand side of the slide, you will see several factors that will likely impact revenue growth in 2025. Mix benefits from the low GWP transition with 10-plus-percent price increases will accelerate growth. Lennox has historically executed extremely well during these regulatory transitions, gaining share and confidence from our dealers and distributors. We plan to do the same thing next year. We anticipate higher manufacturing output from our commercial HVAC factories within our BCS segment. In conjunction with the investment we made in our sales team this year, we will be able to recapture some of the previously lost share in the emergency replacement market. Moreover, these improvements will instill greater confidence in our ability to serve national accounts with a full lifecycle value proposition. We are encouraged by the growth opportunities from partnering with Samsung for our ductless heat pump offering, strengthening brand recognition, and providing access to a broader customer base.

Increased incentives for energy efficient systems may lead to higher replacement demand as well as higher tier mix. While we are generally optimistic about 2025 revenue growth, it is important to recognize our outlook can be impacted by several end market factors. Uncertain consumer confidence continues to pose challenges alongside a trend towards more valued tier products, which may negatively impact mix. Higher costs for the new products may also create complexities in the ongoing repair versus replace dynamics. From an industry perspective, we expect destocking in the first half of 2025 as distributors sell through R-410A pre-buys this year. Additionally, competitors may gain some share as they overcome their current availability challenges. On the right-hand side of the slide, we have highlighted key drivers for margin expansion. We anticipate margin improvements from the low GWP product mix with 30% incrementals, supported by our continued focus on price/cost discipline.

We also foresee improvements in productivity from higher distribution fill rates as our focus on digital inventory planning and our investment in distribution technologies start to generate results. Greater factory efficiency will also contribute to a margin expansion, particularly in the second half of next year, as we begin to lap the ramp-up costs associated with the new commercial factory, and low GWP transition. However, these gains may be partially offset by several factors. Our investments in digital capabilities and distribution network improvements are essential for enhancing operational efficiency and improving customer experience. While these investments are crucial for long-term growth, they may create some near-term pressure on margins. Additionally, we anticipate inflationary pressures for both commodities and component costs. We also expect increases in healthcare and employee benefit costs.

Ultimately, our focus in 2025 remains on superior execution to drive differentiated growth and expand margins. We will provide further financial guidance when we report our Q4 earnings early next year. Now, please turn to slide 12. As we wrap up today's call. I want to emphasize, our confidence in driving sustainable growth guided by five key elements of our strategic transformation plan. Our first focus is on accelerating growth by adding new customers, as well as capturing a greater share of wallet from existing customers. Second, we will expand our margins from price/cost productivity and leveraging the strength of our direct-to-dealer network. Third, the Lennox Unified Management System remains key to our success, helping us streamline operations, share best practices, and execute our strategy. Next, our ongoing investments in digital and heat pump technology keep us at the forefront of innovation to deliver cutting edge solutions for our customers.

And finally, our strong culture, rooted in core values and reinforced by our pay-for-performance model drives our success. Our differentiated strategy continues to create sustained competitive advantages and will enable us to achieve our long-term goals. I'm incredibly proud of what we have accomplished so far, and I have no doubt that our best days are still ahead of us.

Thank you. We will be happy to take your questions now. Margo, let's go to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] We'll take our first question from Tommy Moll from Stephens. Please go ahead.

Tommy Moll
Analyst, Stephens, Inc.

Q

Good morning, and thank you for taking my questions.

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

A

Good morning, Tommy.

Tommy Moll
Analyst, Stephens, Inc.

Q

Alok, I want to start on the A2L commentary that you've provided. I hear you talk about the 10% plus pricing tailwind versus the R-410A product, and then also about some early success with initiatives in recent weeks or months, I guess. So, if we pull all this together, am I correct in saying that, number one, the magnitude of the pricing mix tailwind is unchanged versus prior expectations? And then number two, that your conviction in successfully realizing that is higher now that you've introduced some product into the market, albeit at low volumes?

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

A

I would say both are true, Tommy. The third thing I would add to is, the competitive share gain that we get normally during any regulatory transition, the confidence in achieving that in this transition is also higher.

Tommy Moll
Analyst, Stephens, Inc.

Q

Thank you. Looking at the 2025 early thinking slide you provided, Alok, I wanted to unpack what you're referencing here in terms of a trend for the value tier, and then the repair versus replace. What have you seen to date on those points? And then, what do you want to make sure to communicate about how that might evolve into next year? Thank you.

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

A

Yeah. What we have seen so far is not a meaningful shift between repair and replace, and – but we continue to be cautious about it, especially given that the price of new equipment will rise. So, we continue to monitor that, and that's why I want to call it out. On the value tier shift, as we went from sort of 13 SEER to 14 SEER, and as we look at the overall state of the economy, we have seen a shift towards more people buying the minimum SEER. It already used to be, what, 60%, 65% of the industry. So, now it might be 65% to 70% of the industry. So, that's what we are calling out in the value tier. No surprises, no changes from any of our previous conversations. Just wanted to lay out the positives, and the potential watch out for 2025, but really no change in Q3 that we are calling out.

Tommy Moll
Analyst, Stephens, Inc.

Q

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

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

A

Thanks, Tommy.

Operator: Thank you. We'll next go to Ryan Merkel with William Blair. Please go ahead.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Hey, everyone. Thanks for taking the question. My first one is just on the 65% next year, that'll be A2L. Can you just talk about some of the assumptions you're making there? And then, would you say the risk is to the upside there or to the downside? I know that's kind of a hard question, but...

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

A

It is a hard question but, Ryan, we are here to answer your hard questions. Listen, I think the risk right now is fairly balanced around the number 65%. If you remember earlier in the year, we were talking about 50% to 65%, but right now, we feel more confident around the 65% number. I think if it's a little lower, it could be because there is more buy in R-410A, which we will see in Q4. And if it's higher, it'll be because a lot of the competitors already out of R-410A inventory right now. So, as we're selling R-410A, it could be used this quarter versus being left over for next year. So, those are kind of the two dynamics on the R-410A that we are selling today, does that will end up becoming pre-buy which I think is – we've got some chances or is just because competitors are short on that product. So, those will be the pluses and minuses on that, Ryan.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Got it. Okay. And then, just on the pre-buy, clearly that helped the quarter. As we think about the first half of 2025, can you quantify the magnitude, just so we can set our models correctly?

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

A

Sure. So, on the pre-buy, I'm not sure how much it helped Q3. I mean, if you think about Q3, what helped us was three different factors. First of all, the end of destocking and beginning of restocking, I mean, that was probably the largest contributor. As you saw, our two-step business was up over 30% – or around 30%. So, I think that's the biggest factor for what helped in Q3. Second, I would call out is just share gains. We've been gaining share just because of better execution, and there was some impact of competitors running out of inventory. I think share gains were the second factor. Third, which may have happened a little bit towards the tail end of the quarter, is pre-buy, but remember most of our business goes to dealers and, unless they go start renting out big barns, they're not going to be able to do a lot of pre-buy, and distributor inventory levels are still pretty close to normal.

So, I just want to emphasize the point on the pre-buy on how we expect. What we would expect, as I said, is in Q1 next year, there clearly would be some depletion or destocking of pre-buy, maybe some carryover in Q2, but that gives us confidence in the 65% number saying majority of the sales next year will be R-454B.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Got it. Thanks.

Operator: Thank you. And we'll next go to Joe O'Dea with Wells Fargo. Go ahead.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Thanks for taking my question. I wanted to start on the market share comments that you've made. I think that going back to 2018 time period and tornado and a period of time of maybe two or three years of some share headwinds, it seems like over the past couple of years those have reversed and you've been on a share gain trajectory. But can you just level-set in terms of, through these periods of time, how much you may have given up, how much you recaptured? Net-net, where do you stand today and how you're thinking about those share gain opportunities moving forward?

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

A

Sure. I'll start by re-affirming what you said is that, yes, we have reversed those share losses and we are back on a positive trajectory. Because we do both one-step and two-step, share is a little difficult as we look at AHRI or any of those data. But today, where we stand because of all the moving pieces, we are confident that we have gained share and we continue to gain share. What we have to do next year is make sure that we can retain most of the captured share because as competitors have inventory, which many of them don't right now on R-410A product, then there would be like a lot of our effort going towards making sure our share gains are more permanent. On the commercial side where also the share gain comment comes up, we have not been able to recover the share so far as part of our plan for 2025 on getting share back on the emergency replacement because we are still constrained by manufacturing capacity, not demand in that segment. So, I want to separate the share comments into commercial and residential.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Got it. And then, just wanted to circle back on the R-454B pricing commentary, and you've noted that the initiatives are progressing well. Any color that you can provide on what that means in terms of or with respect to the 10%-plus price? And I think there's still debate out there on how to think about that price in list versus realized. So, any clarification there when you talk about 10% price and if that's a realized number?

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

A

I think as we finish Q4, when we have greater clarity on market movement and acceptance, we can talk about that in early Q1. Right now, the 10% is what we are looking to gain out of price. But realized will apply to only 65% of sales and only the products that are R-454B, and we will also be raising price on R-410A next year, so the 10% has to be taken in conjunction with R-410A pricing today. So, there are a lot of moving pieces and we can provide greater clarity, but the overall where we are seeing in the marketplace is the higher-cost products that we're introducing, R-454B, is being supported by our and competitive moves on 10%-plus price increase into 2025.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Got it. Thank you.

Operator: Thank you. And next, we're going to go to Jeff Hammond with KeyBanc. Please go ahead.

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

Q

Hey. Good morning, guys.

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

A

Hey, Jeff.

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

Q

Hey. Just I appreciate all the color on the 2025 moving pieces. If we just kind of looked at the market today, what do you think res unit and commercial unit kind of market growth looks like as you snap a line into 2025? I know there's a number of moving pieces, some noise with the pre-buy. But just kind of underlying unit demand in each of the businesses?

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

A

If you think about res, and we talked about this earlier in the year that we expected for a dealer, the volume to be flat to down, then halfway through the year we upgrade it to be flat, and now we're going to say flat to maybe slightly up is where we are on the res side. And I'm talking about installed units away from stocking, destocking, but think of flat as a conservative flat to slightly up as maybe a little bit more like aggressive numbers to look at. But it's hard to come to that in a firm number, as you know, with the different moving pieces.

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

A

Yeah, I think what we need to do is see the Q4 pre-buy play out and see kind of how that impacts the end market demand as well as share gain initiatives. As we talked about, normally, we've executed better than others during the transition, so those are two unknowns that we needed to see how they play out over the next quarter.

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

A

So, we'll wait for AHRI, but I think flat to slightly up would be a good way to look at end market on residential. On commercial, since we remain supply-constrained, we just go with the industry figures where I think the market has been growing slightly. It's still not fully recovered from the COVID decline that had happened because our market – remember that we don't have offices, we don't have as much multi-story housing. What we call commercial is typically retail single-story buildings, so from that perspective we do see that market continuing to do grow low single digits at the end market. And on resi, I'm more optimistic about lower interest rates, better, like, market performance going into next year.

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

Q

Okay. And then, just in commercial, maybe remind us your mix in education. And there's been a lot of funding, ESSER funding around K through 12, and I know that's been a hot market. If you're seeing any signs that as that sunsets, that market might see a move back?

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

A

We are not seeing any signs of that market going back. Our exposure in education is probably less than some of our competitors given – like, historically, we have been so focused on retail, but we look at that as a good growth opportunity. But currently, we don't see any of that slowing down as we see also schools issuing bonds and other pieces because these are very necessary maintenance and many of these units remain way past their useful life.

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

Q

Okay. Thanks so much.

Operator: Thank you. Next, we'll go to Jeff Sprague with Vertical Research. Please go ahead.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Hey. Thank you. Good morning, everyone. Alok, I just want to come back to kind of the share gain dynamics, and we got to hop over and see what else Watsco is saying this morning. But you're kind of pointing to share gain largely being a function of some competitors running out of R-410A, where they sound like maybe there's actually some bigger problem with somebody. I'm not expecting you to kind of name names on competitors, but are you actually seeing somebody also struggle with the transition or are there some other kind of systematic problem with someone in the channel other than just kind of running out of R-410A?

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

A

Obviously, we don't know what's happening inside the hood with any of those competitors. What we know is our availability right now on R-410A products is better than many of the other players, and that's giving us an advantage. We also know that a lot of the investments we made last year in improving our sales team, being a better distributor, making sure we have higher fill rates and ensuring that we have a decentralized model that gets more aggressive and focused on our typical AOR dealer, all that's paying off as well. So, I [ph] do (00:34:12) want to break out the share gains into two comments, right? One is totally consistent with everything we have been trying to do. And second, maybe some current advantage because of competitive stumbles. It's part of the transition. We made a bet that throughout this year R-410A demand would be higher and the shift to R-454B would only happen next year.

I believe some of the competitors may have made a different bet, and they may have run out of products.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

And then, thinking about the aftereffects of whatever pre-buy we have in the next year, right? I mean the 35% of the market that's not R-454B almost by definition, right, has to be sitting in distribution by the end of the year, right? If manufacturers are running low on it now. So, I mean, that – I mean, that feels like really a potentially bigger air pocket early in the year than, I don't know, maybe people – maybe just to kind of comment on that, like the how you see the state of distribution at the end of the year, and how this kind of giveback on the pre-buy might play out?

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

Yeah, sure. First of all, we will get greater clarity next year, because Q4 is still just starting and we got to work through that. Our 35% number was based on that. Even manufacturers will have some R-410A inventory, like we will have R-410A inventory at the end of the year that we will be selling. So, like, as we look at our own distribution, and I think other manufacturers will likely also have R-410A inventory at the end of the year. So, it's not just inventory at distributors, it's inventory at manufacturers and distributors. Q1 is where we will see the most impact. I think the effect starts waning away in Q2. And that's why the 65/35. But, Jeff, I wish there was an exact science behind this or if we had full visibility and complete transparency. So, this is just like, us looking at what we know and coming up with an educated guess. We are going to be wrong. We just don't know whether it's going to be wrong on the upside or the downside.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Understood. No, thanks for the color. I appreciate it. Thanks, guys.

Operator: Thank you. Next, we're going to go to Stephen Volkmann with Jefferies. Please go ahead.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Thank you very much. Actually, I'm just going to build right off of that, Alok. Wouldn't you rather be wrong by having more R-410A, so that you are price competitive further into 2025?

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

For the whole industry, which is what we care about deeply as well, I would hope that everybody runs out of R-410A by the end of the year. So, we get the better mix and the transition is more seamless for our dealers. For a dealer dealing with two different product lines and training their crews and all that, it's just very difficult. So, we want to support our dealers and I hope the entire industry runs out, which is quite likely, given that some competitors already running out of R-410A. But from our perspective, yes, we would like our manufacturing transition to be clean and for us to move to R-454B. At the same time, we don't want to be price disadvantaged in the first quarter when others may have R-410A. So that's a daily balance we got to drive, Jeff (sic) [Steve] (00:37:39).

Stephen Volkmann
Analyst, Jefferies LLC
Q

Okay. And maybe just switching to commercial. Any words of wisdom as we think about how the new facility kind of ramps up through 2025? And we sort of try to model that and when the startup costs kind of go away?

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

Yeah, the startup costs will go away definitely by Q2, a large part will go away in Q1. Right now, where we are is, we are on track from the timeline perspective. I would say the startup inefficiency maybe a shade higher than what we thought originally. Just because we are putting extra focus on quality, and sometimes we are paying more for freights to move products back and forth, and we want to make sure it's a really good quality product and we take care of our customers through the transition. So, I would say you should expect by mid next year us to be kind of running up to as we thought the capacity of the factory would be.

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

Yeah.

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

So, think of another three quarters worth of ramp-up associated with inefficiencies fading away in Q1. Michael?

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

Yeah, I'll just say, a lot of these costs we're experiencing right now, we believe, are temporary. Obviously, we're trying to launch a factory. So, in the second half of next year, when that factory is fully operational, these temporary transition costs should abate.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Great. And then, just finally on that, you mentioned earlier that demand is outstripping supply on commercial. When this thing is up mid-year to normal run rates, is that then in better balance?

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

We know we'll be better balanced. We may still be below capacity because remember, we are only getting 20% of the potential capacity installed [ph] till you're (00:39:20) up and running. And if demand continues to outstrip supply, we will put up another 20%. I mean, the factory is large enough for us to be able to double our current capacity, but we are doing it 20% at a time. But yes, we'll definitely better balance and better be able to serve our customers. And currently, our customer satisfaction [indiscernible] (00:39:40) is very low because we just can't meet the amount of demand and orders we have.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Helpful. Thank you, guys. Good luck.

Operator: Thank you. Next, we're going to go to Joe Ritchie with Goldman Sachs. Please go ahead.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Thanks. Good morning, guys. So, Alok, I know that you clearly – you don't have a crystal ball here. But I just square those comments on your own inventory levels exiting the year, is the way we should think about it that you expect to carry inventory levels of R-410A products at least meet demand for the first quarter, and that's really kind of like the balance that you're trying to make sure you get right?

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

A

Approximately. The reason I say is like, I mean, remember, we are also a distributor, and 70% of our sales act just like a distributor sale. And [ph] turn (00:40:33) inventory five times a year, which I know we do around that much, I will have R-410A inventory just from phase-in, phase-out perspective that we will sell through in Q1. So, I think some of it just practical constraints of transition, and other is, of course, we do want to remain competitive. So, while it's not a goal, I think that just largely how it will play out, because we will continue manufacturing till the time we can.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Fair enough. And then just maybe just sticking on pricing for R-410A, given that the products are going to be discontinued going into next year, does that change the pricing dynamics that you're able to put through in the early part of next year, as you typically put your annual price increases through? Or how should we kind of think about that R-410A pricing, even for the portion of the year that it sells in through the network in early 2025?

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

A

First of all, we want to take care of our customers and be fair. But second, from a demand and supply perspective, if R-410A is short in supply, which is what we are experiencing right now, I mean, we fully expect to capture the incremental pricing in 2025 for any R-410A products sold in 2025. When we do annual price increases, I mean, cost of benefits are going up. Cost of a lot of the commodities continue to be around inflation in wages. So, yeah, we fully expect to have R-410A sold in 2025 to be at higher price than R-410A sold in 2024.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great to hear. Thank you.

Operator: Thank you. Next, we'll go to Julian Mitchell with Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks very much. Alok, maybe first off, there's some sort of interesting bits and pieces on the margins, I suppose, on slide 11, maybe trying to wrap it together. So, I think your margins – your operating margin this year is guided up about a point for the year as a whole, just total Lennox. So, it's sort of 30-ish percent incremental margin. When we look at the bits and pieces on slide 11, is the main takeaway that it's a similar incremental next year, or is there something I'm missing on some of the moving parts on slide 11?

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

A

I think overall, we expect our margins expanded both next year, predominantly led by the mix benefits that we'll see. Then, offsetting some of that will be some of the investments we're making. We're going to have at least a 30% incremental on the mix, and then we'll get some more volume tailwinds and share, which is also 30% incremental. We'll have to go through all the puts and takes and some of the investments we're making. But 25% to 30% incremental sound in the range. But we've got to go through all the details still.

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

A

Yeah. And, Julian, remember our long-term targets for Lennox margins that we have published – I mean we are still not there. So, we obviously want to keep making progress towards that over the next year, year and a half to get there. So, I don't want to give you exact number because Q4 still has to play out depending on how that goes. But we do expect margin expansion next year for sure.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's helpful. Thank you. And then, just my follow-up, revisiting, sadly, the pre-buy stuff again. So, I guess it sounds like, if we're trying to quantify it, we should not be too concerned, if that's right, for a couple of reasons about the extent of the destock. I think one is if I look at your residential volume guide for this year, it's gone up about 3 points, I think, for the year versus what you said in July. But a lot of that is share gain. So, you've got maybe, I don't know, a point of effect from pre-buy this year. And then also, if the effect is mostly in Q1 of next year, Q1 is typically a very small seasonal quarter anyway for you and particularly so for cooling product, which presumably is what the refrigerant change affects rather than hot product. So maybe just clarify for me, if I'm misunderstanding anything with those points, please.

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

A

First of all, you're not misunderstanding, Julian. This is the – your classic quote. If I can quote back to you like, analyzing storm in a teacup, right? I mean, our industry is overanalyzed sometimes. I think companies that execute well have a strong strategy to do better. But yes, your math is about correct. I mean, we – 70% of our sales are kind of immune to this whole pre-buy discussion, and that's going to work as planned. The other 30%, we believe majority of the effect right now is talking destocking, not pre-buy. Having said all of that, Q4 is still out there. I mean if Q4 is a very heavy quarter, and a lot of that's driven by pre-buy, then all our answers could change. And we will have to talk about that in Q1. But I mean, so far, we are assuming there will be some pre-buy but not a heavy pre-buy that impacts us this year.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

Operator: Thank you. Next, we're going to go to Noah Kaye with Oppenheimer. Please go ahead.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks for taking the questions. Really great quarter for cash generation. And as we look towards 2025 and lapping some of the investments you've made in the CapEx side. And I think in the past you talked about getting back to 100% free cash flow generation or free cash flow conversion. How do we think about share repurchases? I mean, that picking up here in 4Q levels for 2025, it had been a couple of years. But going back, you used to be pretty active on the repo front.

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

A

I'll start by just saying that our new CFO is really helping to drive the free cash. He's bringing a new level of discipline, a new level of accountability, and a new level of focus on working capital management. With that, I will hand it over to Michael to actually answer the question.

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

A

And I'll just add on that. That's one of the initiatives I've started, is trying to align the organization on working capital management, especially as we look to get 90% or even close to 100% of free cash to net income. So, it's something we're focused on over the next couple years but, yeah, we are generating a lot of cash. And our deployment strategy is going to be basically consistent where every year we're going to increase our dividend. We're going to look at our dividend yield compared to growth companies in the S&P 500, so we'll do that. And then, we're also evaluating bolt-on acquisitions that have to have the right fit with the right returns on it, so we're being very disciplined in that but we're definitely focused there. And then, thereafter, it's going to be about share repurchases. We started getting back into share repurchases this quarter. We'll continue to do those, but it will be a kind of a tool to efficiently deploy that capital if we don't do acquisitions.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay. And can you talk a little bit about that acquisition pipeline and what your needs might be at this moment?

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

A

Yeah, I think what we've looked at is different technologies, kind of bolt-on technologies in the commercial space that just give us a better product offering with our commercial customers. We've looked at distribution opportunities that have a full assortment of products that we can sell through our residential distribution network; those are two big ones. And then, there's different technologies to make our products smarter, either on the thermostats, IAQ. So, it's a host of things that we're looking at. But again, they got to have the right fit and the right price.

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

A

And I would add to that, remember, I mean, we're also trying to be more of a distributor versus just a manufacturer, and there's a big opportunity for products that our dealers buy or our key accounts buy that we don't sell today. So, if we could look at appropriate products and technologies as Michael said and bring them into our network, that would be significantly value-enhancing to our shareholders. So, we are very disciplined in capital allocation and, as Michael said, we will look at all those opportunities and balance those appropriately. But it starts with strong cash flow which I think Michael and the team are doing a great job at.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Great. I'll have some follow-ups offline. Thanks very much.

Operator: Thank you. Next, we're going to go to Deane Dray with RBC Capital Markets. Please go ahead.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

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

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. I saw that the plan to build share in emergency replacement is highlighted on the outlook for 2025; you talked about this before. Can you just share some color on what it means to refocus on that business? My understanding is you will need to boost inventory in the field because you need 24-hour turnaround and the customers have to know this, and it's either you're ready for that order or you miss it entirely. So, what kind of working capital burden increase are you looking at to fill emergency replacement? And can you size that? Thanks.

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

A

Deane, that's a very good question. Thanks. So, I agree with you that going back to emergency replacement requires a lot of effort. It starts with us having more manufacturing capacity. Then, it goes into making sure we have appropriate inventory within 24 hours and in some cases, [ph] urban market (00:50:12), the same day. And then finally, it also comes down to having the right feet on the street and getting all the contractors who may have gone to something else or someone else to come back and look at that [indiscernible] (00:50:25), and we're doing all of that. Most of the working capital impact will be in 2025, and we'll be happy to come back and look at it. But I can also tell you it won't be as material because today, we have excess working capital but it's on the raw product side. As we are starting factories and transitioning factories, I will look to redeploy a lot of that working capital from raw materials more into finished goods and closer to the customer.

So, it's a pretty heavy move. But from a financial perspective, I would expect a lot of that come from the additional raw inventory we are carrying as part of startup.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's really helpful. Thanks. And then, second question for Michael. On ROIC, Lennox is so far ahead of anyone else in industrials. I think from our coverage, you're probably – you're nearly two times bigger versus the next closest competitor, so just kind of talk us through. As you make decisions, investment decisions, CapEx decisions, are you looking at the ROIC impact? Do you hesitate at all in investments? I know it's a rhetorical question. You're going to insist no, but just the idea that you will at times pressure ROIC. So, is this more of an outcome or a target, the way you think about it in the company?

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

A

Yeah. What I'll say is that our industry-leading ROIC is mostly driven by our organic disciplined approach to investments, so we've not done a lot of inorganic acquisitions. Obviously, when you do those, they will be dilutive. But when we look at acquisitions like we did with AES, it was a good ROIC, well above 20% but still below the 47% that we're tracking. So, we'll continue to look at bolt-on acquisitions that are above our cost of capital. And then, from a capital expenditure perspective, we do the same thing. So, we're not necessarily targeted on growing above 47%, but we want to stay 40% and have good ROI projects on these CapEx. And so, we're looking at both on the organic capital expenditures and the inorganic acquisitions to have healthy ROIC above our cost of capital.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's really helpful. Thank you.

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

A

Yeah.

Operator: Thank you. Next, we're going to go to Brett Linzey with Mizuho. Please go ahead.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Hi. Good morning. Congrats on the quarter.

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

A

Thanks.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Hey. Yeah, wanted to come back to the early thinking on 2025 and the 30% incremental comment on low GWP. Is that a volume incremental comment? And then price/mix should drop-through at something above that similar to this year? Just hoping you could maybe parse those pieces out.

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

A

Yeah, yeah. What we're expecting, it's more of a kind of a price/cost that'll come through. We'll have mix up for the pricing that we just talked about. And then the drop-through on that mix will be at least 30% to maintain our gross margins and reflect the additional costs that we're having to put into the product and investments that we're making. Our volume incrementals are also similar to 30%, so we have both kind of dropping-through at 30% of the mix next year and our normal volume gains.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Got it. And then just thinking about new versus replacement in residential, obviously new housing has been a drag. How much was that down so far this year? And then, you noted some of the value to your growth for next year. Thinking about a better housing environment and some of the investment, should you maybe pick up some share in new housing next year or grow in line with the market? Any thoughts there?

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

A

Yeah, I think we are starting to see some green shoots in new housing, so we are like either bouncing along the bottom or we are coming off from the drought from new housing. So that's positive. And remember, we are kind of six months behind the new housing starts number that you might see. Our share position in there remains very strong. And on the replacement side again, if you believe even the recent Wall Street Journal article about homeowners starting to do more repairs and renovations, we think higher demand there will probably result from lower interest rates and consumer confidence.

But all that said, there's just a lot of uncertainty. On the value tier, our comment was driven by because of the SEER changes, because of the pricing levels and because of the higher interest rates that are prevailing versus a few years ago. So, we just want to watch out for that going forward. So, a lot more for us to analyze and evaluate before we come to you in 2025, and give you more firm guidance on those things.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Thanks. Appreciate the insight.

Operator: Thank you. Next, we're going to go to Steve Tusa with JPMorgan. Please go ahead.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey. Good morning.

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

A

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

What do you think is driving distributors to stock up in, like, the last couple months of the summer, when the demand is effectively like maybe flat to up a little bit, and you have this transition coming? What's kind of the – what's the driver there?

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

A

Yeah. And I think, Steve, it depends on which type of distributors. I mean, we can talk about our distributors. We haven't seen our distributors stocking up. We are seeing our distributors going away from destocking. So, they're going back to normal inventory levels that existed pre-COVID. And we haven't seen them taking extraordinary measures to stock up. Now, I think in Q4, they might do some 410 pre-buy to get some price advantage versus R-454B. But I have not seen any, at least from our distributors that we work with, any big push to stock up.

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

A

And I'll just add on top of that, the comps, if you go back to Q3 last year, that channel was down 20% due to destocking. So, definitely favorable comps year-over-year as they restock, as Alok mentioned.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Got it. And then, when it comes to the pricing for next year, so you're saying 10% plus on 70% of your revenue, I think 65% penetration. So that kind of gets you into – firmly into the mid-single digit plus range for price for next year, kind of, capture for the segment. Is that like the right math that you're talking about?

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

A

Yeah. We'll get you greater clarity in 2025, because I do – we'll have more clarity both on 65/35, R-454B, but I think that's roughly the right math, and the way you looked at it right now.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay. And then, lastly...

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

A

Most of us are going to look at mix – most of us are going to look at mix versus price, right, because these are brand-new products.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Right. So, this is mix versus like just pure price. But that is the right math right now, it's around 5%, 6%?

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

A

Mid-single digit is a good range.

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

A

And I'll just add that the stick rate we normally see in regulatory transitions is high, because we're making a lot of cost investments. We need to stick it.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Got it. And then, just lastly, I guess with the combination of the pre-buy for the industry at least, maybe perhaps more – some of the things you talked about is being uncertain as far as consumer confidence, repair versus replace, all that. Do you expect, like, industry volumes next year at this stage to be down, industry volumes? You've talked about your share gains. But, is industry volume down next year do you think?

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

Listen, from my perspective, I would say the industry volume – and this is installed in the ground. So away from any, like, distributors stock in or stock out and all that, I would think it's going to be flat to slightly up next year. And a lot of that's just driven by like an ongoing trends, age of units and the cost of repair versus replace. But I wish I could predict that more accurately, Steve. Everybody is going to have a different view on this.

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

And interest rates are going to have a heavy influence in that as well.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Right. And then, sorry, one more question.

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

Remember, new home construction is picking up, so, right.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah, yeah. Sorry. One more question from maybe the guy that overanalyzes, as you said, whatever the comment was. The share gains this year, with your competitors that are, that have been like out of the market, why are those sustainable? Why isn't that like a tough comp into next year? Are they – is this kind of structural share gain you think you've taken because of that?

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

Whenever somebody stumbles, some of that becomes permanent. Like when we stumbled with the tornado, it took us years, like six years to get that share back. So, I mean, I look at our past tumbles and some dealers will switch back, some won't. So, I mean, I that's what our comment is. Our goal is to make them as permanent as possible. But that's where execution comes down and see what works.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Got it. Okay. Thanks a lot.

Operator: Thank you. Next, we'll go to Nigel Coe with Wolfe Research. Please go ahead.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Thanks. Good morning. We covered a lot of ground, and let's not overanalyze this situation, but what is the feedback from your end customers, the contractors, the dealers on A2L? I mean, have they come to terms with the technology, the trend requirements, et cetera? Do they actually want to have A2L or do they want to take as much 410As they can? And I'm just wondering this dynamic of 4Q versus 1Q, if you're going to increase prices effective 2025, is there an incentive for them to stock up in 4Q versus 1Q?

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

Yeah. So, talking about end contractors, I mean the good news is we are belly to belly with 10,000 of them. And I can tell you all 10,000 have 10,000, like, individual views. So, depending on whom you ask you will get that view. In general, I would say most contractors would prefer to continue doing what they are doing. They are change resistant, but they also realize that they don't have a choice and they have to move to R-454B. It only comes down to some of them, especially the high end one, will want to move sooner versus later because they're selling a high-end product and they're not at the bottom end of the range. Others who are more chuck in a truck and at the bottom end of the range, they will want to keep doing R-410A as long as possible.

On the positive side, it's been well accepted. People have gone through training, people understand how to install it. We are spending a lot of time doing training. Other distributors are doing a lot of time doing training. So that'll happen. Is there a risk that some of them will stock up more on R-410A at the end of the quarter because they do have garages and barns, they may not have warehouses? Yeah, I think there is a risk to that. I mean, that's the risk we deal with every year.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Yeah. Okay. I'm just got this vision of barns being used to stock up HVAC units. We have to do some barn visits and then just...

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

I was at a barn in Wisconsin, and actually saw that, so...

Nigel Coe
Analyst, Wolfe Research LLC
Q

Yeah, side by side with the cheese. Then just thinking then about, just conceptually, the repair versus replace dynamic. If we're in a R-454B world and you've got a R-410A system or 20 system, you're going to have to replace the whole system as opposed – if you're going to replace in terms instead of just a component replacement, et cetera. So why wouldn't there be more kind of compressor replacements or motor replacements or whatever in a world where we're putting through another 10% price? I'm just trying to figure out here whether we will see kind of more of a repair mix, as we transition through this A2L.

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

I think fundamentally...

Nigel Coe
Analyst, Wolfe Research LLC
Q

Does it make sense?

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

A

It does, absolutely. I still think it comes down to the age of the unit. So, if the unit is five-year-old and it's got a compressor broken, the dealers likely to come and change the compressor. If it's a 12 to 15-year-old unit where the compressors broken and the motor is making noises, they're likely to replace the whole system. In the 12- to 15-year-old unit, because the extra cost of R-410A, once it spikes and it has not spiked yet, becomes an additional factor that comes into play. So, I don't think it's just like the R22 to R-410A pieces. At the beginning years, it didn't change the repair to replace, but in the future years, it did move it more towards replacement versus repair. I think the same thing is going to happen. Probably no impact in 2025 for repair versus replace, but in future years, it will.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. And then just a quick one. I'm probably the last questioner here. Have you sized the dollar TAM for the emergency replacement market for commercial? What sort of share do you think you can get off that TAM?

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

A

We haven't sized or broadcast that yet, but we know what we used to have. And we also know that the industry broadly has a healthy mix between emergency replacement and key account, and we are essentially almost all key accounts. So, the industry is 60/40. We are probably 90/10 in that, in terms of 90% key account and 10% emergency replacement. So, we do know we have a significant opportunity for us to take that forward. You can take that and multiply it by AHRI industry data. But the industry is a lot more weighted towards the emergency replacement than we are. Maybe next year, we will come back and give you some sizing on that.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. That's great. Thanks.

Operator: Thank you for joining us today. Since there are no further questions, this will conclude Lennox 2024 Third Quarter Conference Call. You may disconnect your lines at this time.