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EDITED TRANSCRIPT

LII.N - Q3 2020 Lennox International Inc Earnings Call

EVENT DATE/TIME: OCTOBER 19, 2020 / 1:30PM GMT

OVERVIEW:

LII reported 3Q20 revenues of $1.06b and GAAP EPS from continuing operations of $3.42. Expects 2020 revenue to be down 5-9% and GAAP EPS from continuing operations to be $8.35-8.95.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International third quarter conference call. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to turn the conference over to Steve Harrison, Vice President of Investor Relations. Please go ahead.

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

Good morning. Thank you for joining us for this review of Lennox International's financial performance for the third quarter of 2020.

I'm here today with Chairman and CEO, Todd Bluedorn; and CFO, Joe Reitmeier. Todd will review key points for the quarter and the outlook, and Joe will take you through the company's financial performance and guidance. (Operator Instructions)

In the earnings release we issued this morning, we have included the necessary reconciliation of the non-GAAP financial measures that will be discussed to GAAP measures. All comparisons mentioned today are against the prior year period. You can find a direct link to the webcast to today's conference call on our website at www.lennoxinternational.com. The webcast will be archived on the site and available for replay.

I would like to remind everyone that in the course of this call, to give you a better understanding of our operations, we will be making certain forward-looking statements. These statements are subject to numerous risks and uncertainties that could cause actual results to differ materially from such statements. For information concerning these risks and uncertainties, see Lennox International's publicly available filings with the SEC. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Before I turn the call over to Todd, I would like to announce the date of our annual investment community meeting. The event will be held the morning of Wednesday, December 16. The format will be virtual this year. Please mark your calendars. Invitations and more details will follow. Now let me turn the call over to Chairman and CEO, Todd Bluedorn.

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

Thanks, Steve. Good morning, everyone, and thank you for joining us. Let me start with a quick overview on the third quarter that continues to be impacted by COVID-19 pandemic and then discuss our updated 2020 outlook.

For the year, we are raising guidance for revenue, earnings and free cash flow driven by the continued strength in our residential business. Overall for the company in the third quarter revenue was up 2% to $1.06 billion, a third quarter record. GAAP operating income was up 7%, a third quarter record $167 million. GAAP EPS from continuing operations was up 16% to a new high for any quarter of $3.42. The total adjusted segment profit was a third quarter record of $177 million, up 1% from the prior year quarter that included $16 million of insurance benefit.

From an operational perspective, excluding the insurance benefit, total adjusted segment profit was up 11%. Total adjusted segment margin for the third quarter was 16.7% compared to 17% in the prior year quarter. From an operational perspective, excluding the insurance benefit in the third quarter last year, total adjusted segment margin was up 130 basis points. Adjusted EPS in continuing operations was up 6% to $3.53, a third quarter record.

Our Residential segment in the third quarter, revenue was up 13% to a new high for any quarter of $722 million. Revenue from replacement business was up low double digits. Revenue from new construction was up mid-teens. Residential segment profit set a new record -- excuse me, set a new third quarter record at $153 million, up 21%. Segment margin expanded 140 basis points to a third quarter record of 21.2%.

On an operational basis, excluding the insurance benefit in the prior year quarter, segment profit rose 38%, and segment margin expanded 390 basis points. Our residential business benefited from continued strong market conditions and favorable hot weather in July and August. Consumers continue to replace units more than repair with equipment growth rate running multiples ahead of the parts growth rate. September turned significantly cooler, which continues -- which has continued to date in October as contractors look toward winter and furnace season. Strength in the residential market continues and the team is executing well, as it continues to take advantage of market opportunities and gain share.

Turning to our commercial facing businesses. They continue to be more heavily impacted from the pandemic than residential, as expected. In the commercial business segment, revenue and profit were down 18%. Segment margin expanded 10 basis points to 18.7%. National account equipment revenue was down nearly 30%, and regional and local revenue was down mid-teens.

Breaking down revenue another way, replacement was down high teens, and new construction was down high 20s. On the service side, Lennox National Account Service revenue was down low double digits. VRF revenue was down low double digits. While overall commercial equipment revenue was down 20% in the third quarter, we continue to see signs of relative improvement in the business, with commercial equipment backlog currently down mid-teens year-over-year and order rates reflecting gradual improvement as well.

Our commercial team continues to win new business and position for future growth. Commercial won 11 new national account customers in the third quarter, bringing the year-to-date total to 26. In addition, our commercial group has launched an initiative called Building Better Air that is focused on improving indoor air quality commercial spaces. This initiative combines our innovative product line and industry-leading building services to provide comprehensive IAQ solutions to commercial customers. We're helping business and building owners evaluate for HVAC systems, recommend a comprehensive indoor are quality solution tailored to the building and identify a maintenance plan to ensure ongoing indoor air quality effectiveness.

Turning to our Refrigeration business segment. Revenue was down 14% at constant currency. North America was down high teens, and Europe was down high single digits. Segment profit was down 34%, and segment margin contracted 350 basis points to 10.4%. Refrigeration profitability was impacted by negative mix, with Europe down less than the U.S. in the quarter as well as factoring inefficiencies due to COVID-19. As in the commercial business, we are seeing signs in refrigeration of relative year-over-year improvement from the third quarter with backlog up and order rates reflecting strong improvement.

A quick update on SG&A cost savings this year. Earlier this year, we enacted $115 million SG&A savings program. Due to the improved performance of our end markets and our strong operational performance, we have restored compensation and volume-related SG&A costs. Several examples of what I'm talking about are reinstituting pay from the temporary salary reduction, increased sales commissions and paying performance-based compensation. We're now planning for $65 million of SG&A savings this year with 45% coming from discretionary spending, 40% from headcount reduction, and the remaining 15% from paying incentives that returned in 2021.

To wrap up with our updated guidance on 2020, we are raising revenue, adjusted EPS and free cash flow. Revenue is now expected to be down 5% to 9% for the full year. Adjusted EPS from continuing operations is now expected to be $9.05 to $9.65, and free cash flow is expected to be approximately $425 million. We continue to face highly uncertain economic conditions in the fourth quarter and remain cautious on the potential impact from the pandemic heading into the winter season. But Lennox has a seasoned team, experienced in managing through downturns while continuing to invest and advance the company for the future. We look forward to closing 2020 strong with the momentum into 2021.

Now over to Joe.

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

Thank you, Todd, and good morning, everyone. I'll provide some additional comments and financial details on the business segments for the quarter, starting with residential heating and cooling.

In the third quarter, revenue from Residential Heating and Cooling was a record $722 million, up 13%. Volume was up 11% and price and mix combined was up 2%, and foreign exchange was neutral to revenue. Residential profit was a third quarter record $153 million, up 21% as reported over the prior year quarter that included $16 million of insurance benefit. Segment margin was a third quarter record of 21.2%, which was up 140 basis points as reported over the prior quarter with the insurance benefit.

Segment profit was primarily impacted by higher volume, favorable price, lower material and other product costs, higher factory productivity and lower distribution and freight costs. Partial offsets included the year-over-year difference in insurance benefit, higher selling and incentive expenses and tariffs.

Turning to our Commercial Heating and Cooling business. Commercial revenue was $208 million, down 18%. Volume was down 16%. Price and mix combined was down 2% and price flat and mix down. Foreign exchange was neutral to revenue. Commercial segment profit was $39 million, down 18%. Segment margin ticked up 10 basis points to 18.7%. Segment profit was primarily impacted by lower volume, driven by the COVID-19 pandemic and unfavorable mix. Partial offsets included lower material costs, higher factory productivity, lower distribution costs and lower SG&A expense.

In Refrigeration, third quarter revenue was $125 million, down 12%. Volume was down 16%, price and mix combined was up 2%, and foreign exchange had a favorable 2% impact on revenue. Refrigeration segment profit was $13 million, down 34%. Segment margin was 10.4%, down 350 basis points. Segment profit was primarily impacted by lower volume and lower factory efficiency due to the COVID-19 pandemic and unfavorable mix. Partial offsets included favorable price, lower material costs, lower SG&A expense and favorable foreign exchange.

Regarding special items in the third quarter, the company had net after-tax charges totaling $4.4 million that included a $3.6 million loss from natural disasters, net of insurance recoveries related to an August 2020 high wind damage at the company's manufacturing facility in Iowa. $2.2 million for personal protective equipment and facility deep cleaning expenses incurred due to the COVID-19 pandemic, a net charge of $1.4 million for various other items and a benefit of $2.8 million for excess tax benefits from share-based compensation.

Corporate expenses were $28 million in the third quarter compared to $18 million in the prior year quarter as the company's financial results in the third quarter triggered incentive compensation true-ups for performance year-to-date. Overall, SG&A was $152 million, up 6% from the prior year quarter. And for the first 9 months, SG&A is down 7%.

In the third quarter, the company generated $440 million of cash from operations compared to $236 million in the prior year quarter. Capital expenditures were $12 million compared to approximately $25 million in the prior year quarter, and free cash flow was $428 million in the quarter compared to $211 million in the prior year quarter. The company paid approximately $30 million in dividends in the quarter. Total debt was $1.01 billion at the end of the third quarter, and we ended the quarter with a debt-to-EBITDA ratio of 1.8. Cash, cash equivalents and short-term investments were $59 million at the end of September.

Now before I turn it over to Q&A, I'll review our current market assumptions and guidance points for 2020. For the industry overall, we now expect North American residential HVAC shipments to be roughly flat this year. We now expect both commercial unitary shipments and refrigeration shipments to be down approximately 20% for the industry this year.

Looking at the company's performance year-to-date and outlook for the fourth quarter, we are raising our 2020 revenue guidance from a decline of 10% to 15% to a decline of 5% to 9% for the year. We are raising our guidance for GAAP EPS from continuing operations from a range of $7.31 to $8.11 to a new range of $8.35 and to $8.95 for the year. We are raising our guidance for adjusted EPS from continuing operations from a range of $7.90 to $8.70 to a new range of $9.05, and to $9.65 for the year.

Looking at the various puts and takes in our financial guidance for 2020 that we are updating commodities are now expected to be a $25 million benefit for the year compared to prior guidance of a $20 million benefit. We now expect a $25 million benefit from sourcing and engineering-led cost reductions, compared to prior guidance of a $20 million benefit. Residential mix is expected to be a headwind of approximately $10 million for the full year as new construction has outperformed replacement business year-to-date. Earlier expectations were for new construction to slow and mix to be flat. We now expect corporate expense of approximately $90 million compared to prior guidance of $75 million, primarily due to higher compensation expense related to the company's performance.

We now expect interest and pension expense of approximately $35 million compared to prior guidance of $40 million. We now expect an effective tax rate for the full year on an adjusted basis of 19% to 20% compared to the prior range of 21% to 22% due to the timing of certain tax benefits this year. And for 2021, we expect the effective tax rate to be in the 21% to 22% range. Capital expenditures are now expected to be $100 million for this year from prior guidance of $120 million on the timing of some spending between 2020 and 2021.

And our guidance for free cash flow is now approximately $425 million from the prior guidance of $340 million for the year. For our guidance points that are remaining the same, price is still expected to be a $25 million benefit for the year. Residential factory productivity is still expected to be a $10 million headwind. We still expect tariffs to be neutral, and we continue to expect freight to be a $10 million benefit. The weighted average diluted share count for the full year is still expected to be between 38 million to 39 million shares, and our stock repurchase plans remain on hold after repurchasing $100 million of stock in the first quarter for the $400 million that was planned going into the year.

Now with that, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And first on the line of Julian Mitchell with Barclays.

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

Maybe just a first question on the top line. The guidance at the midpoint and even the high end implies sort of step down in Q4 sequentially that's much worse than normal. Is that just because of the uncertainty in the environment? Or is there anything sort of specific that you're calling out? And maybe related to that, just wondered on your latest assessments of the health of the resi market entering next year. I heard you say this year, you're looking at a flattish market now. Any thoughts on sort of fundamentals into next year?

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

Yes. On the first point, it's a combination of both of uncertainty in the fourth quarter but also we had just such a strong third quarter, if you're looking at it sequentially year-over-year, I mean, it's a record third quarter for us. Our residential revenue is up 13%, driven by hot weather, so that helped. And so I think that's part of it. In terms of looking into 2021 on markets, we continue to remain bullish on the residential markets. There's lots of moving pieces. But we called -- we're calling for the market to be flat this year. And I think that's an important perspective to remember. I understand that some folks are wondering the demand get pulled in to something from 2021 get pulled into the strong third quarter. 2 points I'd make. One is, overall, the market is going to be flat year-over-year in the middle of a pandemic. Second is just the behavior of a residential homeowner.

Even when there's not a pandemic, no one wants anyone enter their house to replace the unit unless they have to. And there's a catastrophic failure if they replace the unit. And especially in a pandemic, no one wants people coming into their houses and spending 2 or 3 days replacing the units. So these are being replaced when they break. And they're not being repaired like they were during the financial crisis, but there has to be approximate cost for them coming in. And that's not pulling forward demand. No one is sort of saying, let's replace it now rather than next summer. They're replacing it now when it breaks, and they have enough choice. And so we remain confident, as we've talked before, that we think there's another couple of years of this mid-single-digit growth and for it to be flat in the middle of the pandemic shows the resiliency of this market. And so we remain confident in the resi market for 2021.

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

And then my second question, just on the margin outlook. Perhaps clarify exactly how much of that $65 million in the savings could reverse or come back into the P&L next year. And what are you thinking for sort of residential operating leverage as you look out now that the revenue line has returned to growth again?

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

I think the way I think about it is our new guide on the SG&A take up $65 million. And then when you look at that $65 million, only 15% of it now is paying incentives because so much came back into the P&L this year. So the 15% that's paying incentives, that will bounce back next year. So that's whatever the math is $7 million, $7.5 million. The balance of it, the 45% that's discretionary and the 40% that's headcount. We control those. And it depends on how the market is performing and the investments that we want to make in the business. But our sort of goal of having 30% incremental margins is plus or minus what our target will be for next year. So previously, our guide was $115 million with a lot more tied to paying incentives. I think that risk is now off the table for next year in terms of it bouncing back on us in a meaningful way.

Operator

Our next question is from Ryan Merkel with William Blair.

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

First off, can you just dive into some of the commercial end market performance to give us a little more detail?

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

I think we called it up somewhat out on the call. We've seen national accounts down more than our local and regional business. And that national we would have expected. Just the way the market behaves, that the planned replacement gets deferred as people sort through things. And so our planned replacement was down mid-20s versus a year ago. But in Q2, it was down over 40%. So the trend line on plan replacement is going in the right direction. And when we look at our order and backlog, the planned replacement as many companies are getting more comfortable in the current environment and some of our large customers are people like Home Depot, Lowe's, Best Buy are doing pretty well, are getting more comfortable spending.

Emergency replacement was down 10%-ish in the quarter after being down 35% in the second quarter. So again, heading in the right direction. And then new construction is the one that goes the other way because new construction things that were in flight, continue to be built, but that new business starts to go down, and we saw that down near 30% in third quarter after only being down mid-teens in the second quarter. And then as we mentioned on the call, the order -- excuse me, the backlog is down mid-teens. And so the backlogs heading in the right direction. But when we think about the full year, we still think the market is going to be down 20%.

The one still realigning and all that as the comp gets a lot easier next year. So when we think about 2021, sort of at least the way the world looks now, we would expect that the commercial market -- commercial unitary market would be up after such a hard hit 2020. And when you look back on history of the commercial unitary market, whether it's the 9/11 downturn or financial crisis downturn goes down hard, comes back quickly.

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

Okay. That's helpful. And then secondly, you mentioned commercial IAQ initiatives. Can you just talk about how big that business is today? And then what is your outlook for the coming quarters?

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

Yes. I mean we tend not to quantify the market. And again, I think you heard in the way I talked about it, we think about it as a facilitator to win the equipment business. And our Build Better Air initiative is leveraging off our historic capabilities in indoor air quality and our relationships with the end building owner. And we're an industry leader in indoor air quality in both residential and commercial markets. As we talk about indoor air quality is air purification like filters and UV lights, ventilation and circulation and humidity control. Our residential pure air equipment is the best in the industry as noted by consumer reports. And then we talked about building better air and our advantages and our opportunities there.

Operator

Our next questions are from the line of Jeff Hammond with KeyBanc Capital Markets.

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

Jeff, I just want to point out before you ask your question that so many things changed in 2020, I personally take great comfort that Pittsburgh-Cleveland remains consistent over the decades.

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

I knew that was coming.

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

Okay. Go ahead.

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

Can you just talk about your distribution based business versus direct sales in the quarter? And then just talk about how you think inventories are in your channel and at independent? And maybe speak to how the channel is thinking about furnace distribution build versus maybe how they managed the cooling side?

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

The performance of the businesses were relatively consistent. They were both up plus or minus the 13%. So there wasn't one that outperformed the other. And I read your note, and I thought you raised valid questions around the AHRI numbers versus the HARDI numbers, one being sell-out, one being sell-in. And we take great comfort that our Lennox business performed very similar to our allied business, i.e., the sell-through or the sellout of our Lennox business directly to dealers was up 13% to 14%, whatever the exact number was that -- and so that's a good sign for our Lennox business. Our Allied business also did well.

I think the direct question -- answer to your question is inventories are low right now, which is normal coming out of such a hot summer. And then what happens is there's a recency bias with short memories or however you want to phrase it of dealers. And so they had trouble getting cooling product in the summer, which many didn't because our competitors had trouble delivering. Then they want to make sure their bars are full with furnaces. And so we see that right now as people are loading up on furnaces.

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

Okay. And then just on refrigeration, I think you said backlog was up, maybe what's differentiating the order trend there? And then I think you've mentioned COVID disruption there. What's unique about the facilities there versus the other businesses?

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

Yes. The -- we got hit both in our European business and in our Tifton, Georgia business. If you look at Tifton, Georgia on a map, it's in one of the hardest hit areas for COVID in the country and so that had some impact on our businesses. And so absenteeism and then actually having had the factory shut down for a bit in both locations impacted our productivity. When you look at the backlog of commercial, as you know, we're more exposed to retail there than we are in refrigeration, and that's been a softer spot. And then also in refrigeration, cold stores is one of our largest verticals, and that's been relatively strong given that people are building up the cold chain to support different consumer buying habits and buying food at home and also maybe a bit of preparing for the vaccine. And so we've seen strength in cold storage, and that's helped us.

Operator

And next go to the line of Joe Ritchie with Goldman Sachs.

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

Todd, maybe just commenting a little bit on the resi HVAC monthly trends. Obviously, you guys had told us what July was up. I'm just curious how the rest of the quarter went. And then as you're switching over to furnace, I'm just curious whether you think there are any issues that may occur just given how strong HVAC has been just from a manufacturing perspective. I'm just wondering if there's any kind of like pig in the pipeline type problem as you try to deliver on furnace sales.

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

The trend line during the months, July and August were mid-teens, as I talked about on the second quarter earnings call, at least on July. And then September was up significantly, but more low double digits, high single digits as you sort of got away from hot summer selling season. We're positioned as well or better than anyone in the industry to meet both cooling demand and furnace demand. So we think we're in good shape. I think some of our competitors may have issues. And again, I think it gets -- gets more pronounced as if you have independent distributors trying to get large orders from you all at once. And maybe our competitors are seeing some of that. But we think we're in a good position as well or better than anyone in the industry to meet the upcoming furnaces.

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

Okay. Great. And then my just -- my one follow-on. As you think about 2021, and I know it's probably a little too early, but I'm just trying to think about how to think about the price cost dynamics in resi, you saw copper is up a lot, but you mentioned getting good price/mix this quarter on the resi HVAC side. Any comments on just the dynamics heading into 2021 just given the increase we've seen in commodity costs?

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

Yes, I'll broaden the question just sort of talk a little bit about 2021 more broadly. Obviously, lots of moving pieces. There's always uncertainty in October when you think about the following year, but maybe as much now as ever. And I talked a little bit about the end markets earlier, I repeat that we walk out or almost out of 2020 with a clear understanding of the resiliency of the residential market. And again, it's demand that's being caused by the home failing. And when we model all that, we think there's another couple of years of that. So we think mid-single digits next year for residential and new construction remains strong.

For commercial and refrigeration, as I talked earlier, more uncertainty there. But after being down 25 -- 20% this year, we'd expect some rebound in 2021. Directly to your question is we do expect some commodity headwind for next year. But I would also just mention, we've always historically said commodities that matter most to us are steel, copper and aluminum in that order. With all the work we've done on moving to aluminum in our heat exchangers across our business. It's now steel, aluminum and copper that's most important to us. And so while copper still matters, it matters significantly less than it did 4 or 5 years ago. And aluminum, I think has behaved more nicely, if you will, now sounding like a president with that terminology, but has behaved better. And so we expect some commodity headwind.

We expect some freight headwind at the current point in time, although that still has to be shaken out. And then as we talk about, we expect a little bit of compensation bounce back given the pickup of reduction this year. But as always, we're going to be announcing a price increase here shortly, and we expect to get price next year, just like we do every year. We're going to benefit from sourcing and engineering. We're on cost reductions. We talked about raising that number from $20 million to $25 million this year. And so that's order of magnitude that we've done for the last decade, $20 million to $30 million depending on the year.

Factory productivity, after not really having much of any factory productivity this year because of all the disruptions because of COVID, we'll get back on track there. And then as always, our target of 0.5 point in market share gain. So I know I haven't quantified a lot of those, but it's to send a signal that we think the setup for next year will be not dissimilar to the setup of prior years where we have market share gain price to offset commodities and then continued productivity and material costs and factory productivity.

Operator

Our next question is from the line of John Walsh with Crédit Suisse.

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

Maybe just a finer question on that commodity discussion we just had there. You took commodities and the sourcings combined up $10 million relative to where we were in Q3. Just how much of that falls through in Q4 versus how much has been realized kind of the year-to-date?

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

I'm not sure, to be honest with you, John. Maybe we can sort of guide that. I think that the commodities, I think people are scrambling diligently to sort of find. I think the commodities can tamper down as we go through the year, where the material cost reduction starts -- continues to increase as we go through the year. So if I had to guess, I would say commodities are around $20 million, $22 million year-to-date. And then MCR, I think the raise is just confidence that we'll continue to execute for the balance of the year.

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

Great. And then just, I guess, maybe you talked a little bit about 2021, just kind of 2 questions on my mind. I mean you just talked about your normal kind of market share gains. But as I understand it, one of your competitors, right, had a factory disruption. And so they might have not been able to fulfill orders and that arguably comes back online next year. So does that make it harder to get that kind of normal market share gain that Lennox has been getting?

And then maybe just on this replacement pull forward question. I guess it depends on how you think we look from a work from home benefit next year, but wouldn't -- because we were sheltering, we'd see more breakage this summer that needed replacement arguably that pulled from '21 into '22? Or is that just not the right way to think about it? I would just like to get your perspective there.

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

I'll answer the second question first, not just you, John. I've heard others talk about that. I don't think that's how it works, right? And what I mean by that is I don't think people set their thermostats to 85 when they go to work and then when they come home, they set it to 68. In fact, I think the majority of people don't even set their thermostats on a time or just sort of remains constant over time. And then I think people raise it maybe the 78 to 80 when they're gone and then 75 when they get back. So I don't -- in terms of usage, that doesn't drive a spike up where units all of a sudden have huge acceleration of use and breakage.

So I just step back and say the market is flat year-over-year in 2020. That doesn't show pull forward to me. It's flat in a hot summer. So the market is flat in hot summer, that doesn't show pull forward to me. That shows people were hesitant to spend money on us they had to, but when the unit breaks, they replace the unit rather than repaired it. I don't think there's I don't think anything was pulled forward because people were at home. Remind me what the first question was?

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

Oh, just on the ability to kind of get your normal market share gains? I mean I think in April, right, yes.

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

Yes. One, give me personal privilege to just sort of observe that when we lost because of tornado everyone assumed we'd never get it back. And now that we've taken it from others, there's an assumption that maybe we won't be able to hang on to it. I think a couple of things. I think having been on the other end of it, we were cognizant in a constrained supply environment to supply the dealers who we thought we had the best chance of keeping business to. So we weren't selling arms to anybody. We were selling arms for units of those dealers who we thought we were already sort of in conversations with and converting over and those the ones we sold to. So we may -- we're not hanging on to all that we've gained, but we're going to hang on to a lot of it, a whole lot of it. And then we're also on the attack to gain more share. So I remain confident that we'll gain -- we're gaining significant share this year and I am confident we will gain some next year.

Operator

And next, we'll go to the line of Deepa Raghavan with Wells Fargo Securities.

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

Todd, can you provide your thoughts on when you think you can resume share buyback? It looks like you're starting to loosen up on some of the variable costs and getting comfortable, given your strong cash outlook. So will it be normal for us to assume buybacks return in 2021?

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

Yes. I'll be more direct, put it in your model. We're not going to start it up here in the fourth quarter given some of the uncertainty. But when we give the December guide for 2021, we'll be back to a more normal stock repurchase program for 2021.

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

Great. Can you -- how do we think about normal volume-driven leverage in 2021? I mean you have -- you're going to have all these costs in and out, rollbacks, more things like more headwinds. I don't know if price gets that much more incrementally better. So should I think about your volume-driven leverage to be slightly below trend? Or should all those dynamics not impact just given that you probably should be able to price for them or take costs elsewhere?

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

Our variable gross margin is around 40%. So volume drops through at sort of a normal 40% either direction. And then obviously, in a year where we're spending SG&A and doing other things then the incrementals goes down. And so that's how we end up at the 30% incremental that we're making investments in the business, building out distribution, driving productivity, but sort of normal volume leverage is about 40%.

Operator

And next, we'll go to Gautam Khanna with Cowen.

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

Great results. I had a couple of questions. First, I was wondering if you could maybe frame the magnitude of the pricing opportunity for resi. You mentioned you're going to announce some price increases. Just should '21 be a better net realization year than normal? Any framework for that?

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

Yes. I mean I'm going to withhold -- what we'll announce will be what we always announced publicly 4 to 6, whatever the final number is going to be. So we'll announce price. But yes, I do think there's when we expect the market to be up after having been constrained year before, that sort of leads you to believe you can get price in the marketplace. As we spoke about when we're having challenged meaning demand as we did and the whole industry did in 2020, wasn't really the right time to raise price dynamically in the middle of the season.

But we go into next year, we'll be looking to raise price and -- for a couple of reasons. When we talk about commodities, COVID has added cost to our cost structure. We talked a little bit about what happened in our refrigeration margins because of it. But quite frankly, it's impacting the entire business, both on the SG&A side, everything we have to do to manage suppliers and manage our own business, absenteeism in our factories. And then we think freight is going to be up. So those are all reasons on why we're going to need to pass price on. And I think our -- in fact, I know our competitors see the same forces.

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

That makes sense. And also, could you just expound upon the IAQ opportunity, level of engagement with customers? Does it drive like a much bigger revenue cycle, anything you can add to that?

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

Yes. I mean I may be -- I don't know what the right phrase is maybe more clear eye on IAQ. I don't think it's just billions and billions and billions of dollars of opportunity, at least in unitary where we play in residential. I think if you're selling a $5,000 residential unit, your indoor air quality component is $400 or $500, on commercial, it's maybe even less of a percentage. So I don't think it drives the overall ticket. I think what happens is you have to have knowledge and expertise in it for those customers who want it. And you want to steer customers who want it to be able to handle their questions. And so commercial customers have build better air. Sit down with them, talk about what we have and we have everything. And then put it in place and then use our NAS or National Account Service to measure and monitor the compliance. In our residential business with our Pure Air S which has both passive filters and active UV lights that allows us to clean air and then also it is digitized. So as part of our iComfort controller, you can measure and monitor what's going on. And so I think it's being an expert in the area that allows you to win the jobs and convert dealers, and that's where we're focused on.

Operator

And next well on to Nicole DeBlase with Deutsche Bank.

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

We've covered a lot of ground here. But I guess, on the free cash flow guidance, it doesn't really embed a whole lot of free cash flow in the fourth quarter. I'm getting to something a little bit more than $30 million. So just thoughts on -- I'm guessing that working capital is kind of the biggest swing factor there. So any thoughts that you have about what we should expect for 4Q?

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

That's the answer. The sequence of the quarters are different this year. By the way, they're going to be different next year. We'll talk about that in December. But we're typically at this point in time, driving down production levels and burning off inventory. But given the hot summer selling season and given that we expected the markets to be down, while we saw the summer selling season was a burn-off of inventory, burn-off of receivables, payables. And then what we see in Q4 is on a year-over-year basis, reinflation of inventory and working capital. And so that's why -- so we typically have the big cash quarter in fourth quarter, this year we had the big cash quarter in third quarter.

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

Okay. Totally makes sense. Got it. And then just one more on refrigeration. So I think you characterized or you quantified a bit of what's going on with order and backlog within commercial. Could you just provide some detail around what you're seeing in refrigeration, Todd?

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

Yes. I mean our backlog is up year-over-year right now where we stand in the order rates on a 3-, 6-, 9-week basis, are all up in refrigeration. So the trend lines are good. I think it's both -- in our North America business, there's distribution business where we sell to about half of its distribution business, we sell-through large refrigeration wholesalers, and that has bounced back from being down significantly in second quarter. And then the other business is project business, a lot of cold storage. And that, as I mentioned earlier, has been relatively strong. Our Europe business has been strong, but we're a little -- obviously, a little -- we're concerned about COVID and lockdowns in France and Spain and what the trend line is there. But again, on a -- over the last 3 or 4 months our business in Europe the order rates are also trending in the right direction.

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

And have you actually seen any slowdown in Europe? Or is that just reading the headlines and being concerned about what could materialize?

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

We're starting to see things slow down.

Operator

And we'll go to Nigel Coe with Wolfe Research.

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

On obviously, the residential margins were exceptionally strong ex the prior insurance benefits. I'm just curious, can you -- do you think as volumes remain sort of high single digit, low double digits into 4Q and maybe even '21, you can maintain above 20% kind of margins? And then within your commentary on the margins, I think you mentioned sourcing from commodity is actually now more of a benefit than you expected last quarter. Is that mainly volume-related? And then I'm a bit surprised that freight isn't turning into more of a headwind. Can you just maybe just address what you're seeing on the presentation.

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

Freight remains a tailwind this year, and part of that's we were aggressive on -- we're managing freight like we've -- over the last year or 2, we've invested in freight management like we did in MCR 15 years ago. So we have a pretty sophisticated team. We now have the tools to measure it. And so I think part of it is just productivity on our side regardless of what's happening with the overall rate, and we expect it to be a tailwind this year and a bit of a headwind next year. In terms of residential margins, I think you sort of see it peak out in the current environment where we had volume, we had done aggressive SG&A cost reduction, and we had invested in stores because of the tornado. I think on an ongoing basis, since residential is 60% of our business, we talk about 30% incremental. So I think that's plus or minus what you should think about residential. I don't think it remains 40% because we're investing in SG&A. We're investing in stores, and we'll start that back up in 2021. And so we'll have the investment headwind, if you will, that beats the engine on an ongoing basis. And then was there another question, did I miss anything?

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

I think you covered that one. I just wanted to touch up on the buyback comments. You mentioned '21 would be obviously, a more normal year on buybacks. I think normal you told would be $350 million to $400 million would be sort of the run rate. Is there any catch-up from the 20-year pocket on buybacks? Or are we back to that $350 million, $400 million?

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

I think the way to think about it is -- and you're going to run the model on your own, right, is we don't want debt-to-EBITDA to go above 2. That's sort of our peg point. And so we will invest in the business with Capex, we'll do acquisitions or we don't. And then what's left, we'll pay dividends and share buyback. And so I think you model all that, and I think we start to peg what we do. I don't think there's a year where we do $600 million or $700 million, if that's a direct question. But there may be, if we do a little bit more, but it's all going to come down to that formula as I said.

Operator

Our final question will be from the line of Steve Tusa with JPMorgan.

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

On tax rate, what's kind of the go-forward you guys -- is this kind of 19% to 20% the right number? And have you guys kind of evaluated does that kind of revert if there's any like politics, if that -- if there's a blue wave or a Biden win, does that revert to a certain level, maybe not back to where it was, but what's kind of the long-term beyond the tax rate and...

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

As Joe mentioned in the script, we -- for '21, we think tax rate is going to be 20% to 21%. So it goes back to a more normal rate as we got it this year. We had some discrete items this year that allowed us to take it down, but 20% to 21% is what we're saying next year and that -- who knows, but we'll react to whatever's done, and we'll adjust accordingly.

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

Just going back to this kind of resi cycle discussion. So are you saying this year was kind of ended up being a normal year despite the pandemic, so there wasn't really a push or a pull in and out of this year? And I know you guys had, had that housing echo boom chart out there. We're kind of a couple of years into that chart. So are we still thinking that, that's the swing factor in this cycle? I mean housing peaked in 5, 16-year useful life. I mean is that still the way to think about it that '21 from an echo boom perspective is kind of a peak year? Or is there something that happened this year that kind of changes that profile?

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

I think I'd answer 2020 this year is we had a warm summer, and we also had a pandemic. And I think, broadly, they offset each other, and we had a flat market. So I think if we did have a pandemic, the market would have been up. And I think if we hadn't had a hot summer, the market would have been down. And I think we think the right call now is when you look at AHRI numbers, I'm doing this from memory, but through August, it's down about 3%. We think on a year-to-date basis, that's going to be close to flat when it all shakes out. And so that's our call. In terms of the market going forward, yes, I think we've been pretty consistent. I know we disagreed so I know that. But when we model it and look at it, we still think we have another couple of years of mid-single-digit growth, everything else being more. And if it's a hot summer, maybe better, if it's a cold summer, we'll do worse.

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

Is that echo boom analysis still in play? Or is there something else driving it?

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

No, it's still in play.

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

Okay. And then one last one is on...

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

I don't think the pandemic pulled anything forward. If people are sort of saying, there's another couple of years, but it all got pulled in this year, I'd say no way because it's a flat market and a hot summer. It doesn't make any sense.

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

Right. Absolutely. And then just one last one on free cash flow. You bounced around a bit here in the last couple of years. What is kind of the normalized conversion rate for you guys? And again, just to reaffirm, that's on a GAAP basis when you talk about conversion, right?

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

It is. And I read your note, it said 90%. I think if you look at a longer horizon, it's closer to 100%. And that's our number, 100%. And this year, we're having strong cash flow, and that's obviously because one, we performed EBIT wise, but obviously, if you deflate working capital you generate cash, and that's what we did. And so in the years where we're inflating working capital, we have more headwind in years for building Mexico. We have headwind in tornadoes. And so lots of moving pieces. But over a longer perspective, it's a business that will generate 100% of net income.

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

Yes. I think our note was talking about adjusted to be clear. So that would be more close to 100%, if it's on a GAAP basis. So just to be clear on that one.

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

To wrap up, the residential market remains strong entering the fourth quarter in commercial and refrigeration markets continue to improve. The Lennox team is executing well and taking advantage of market opportunities and share gains. We look forward to closing 2020 strong with momentum into 2021. And again, thank everyone for joining us today.

Operator

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