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LII.N - Q1 2023 Lennox International Inc Earnings Call

EVENT DATE/TIME: APRIL 27, 2023 / 1:30PM GMT

OVERVIEW:

Co. reported 1Q23 core revenues, excluding European operations, of $990m, GAAP diluted EPS of $2.75 and adjusted diluted EPS of $2.83. Expects full-year 2023 core revenues to be flat to up 4% and EPS to be $14.25-15.25.

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PRESENTATION

Operator

Welcome to the Lennox First Quarter 2023 Earnings Conference Call. (Operator Instructions)

As a reminder, this call is being recorded.

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

Unidentified Company Representative

Thank you, Britney. Good morning, everyone, and thank you for joining us for Lennox's first quarter earnings results. I'm here today with CEO, Alok Maskara, CFO; Joe Reitmeier, and VP of Finance, Michael Quenzer.

Alok will discuss highlights for the quarter and Joe will take you through the company's quarterly financial performance and our view on 2023 fiscal guidance. After that, we will have a Q&A session with Alok, Joe and Michael.

Turning to Slide 2, a reminder that during today's call, we will be making certain forward-looking statements, which are subject to numerous risk and uncertainties as outlined on this page. Please refer to our SEC filings available on our website for additional details. All comparisons mentioned today are against the prior year period unless otherwise noted. Speakers may also refer to certain non-GAAP adjusted financial measures that management may consider to be relevant indicators of underlying business performance and trends.

A reconciliation of all GAAP to non-GAAP measures is included in today's earnings press release, SEC filings and in the appendix of this presentation. The earnings release, today's presentation slides and the webcast archived link for today's call are available on our website at www.lennoxinternational.com.

Now let me turn the call over to our CEO, Alok Maskara.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Thank you, Chelsea. Good morning, and welcome, everyone. Allow me to start by sharing my appreciation for all of our employees whose hard work has enabled us to deliver exceptional performance this quarter, including record quarterly earnings per share.

We take great pride in our team's effort to gain share, expand margin and seamlessly transition our product portfolio to meet the new minimum energy efficiency regulations. This successful quarter reflects our company's product leadership, strong direct customer relationships and advanced digital platforms. These factors will continue to fuel our share gain and margin expansion for the foreseeable future. I want to also take this opportunity to thank our dealers and customers for their loyalty to Lennox as we improve our service levels while delivering the best HVAC products and solutions in North America.

Now please turn to Slide 3, where I want to highlight 4 key messages. First, Lennox is proud to report another quarter with record financial results. First quarter 2023 core revenues grew 3%. Our margin expanded 210 basis points, resulting in our adjusted EPS, increasing 15% to $2.83. Our free cash usage this quarter was $114 million, which is typical given the seasonality of our business. Second, we are pleased with the pace of margin recovery in our commercial business segment.

Our profits more than doubled compared to last year as manufacturing operations stabilized and the benefit of price and mix outpaced inflationary cost increases. Third, we continue to help our dealers and customers succeed during the transition to the new minimum efficiency regulations that went into effect on January 1, 2023. Our superior design and successful track record of executing during regulatory changes, in conjunction with improved service inventory levels has put us in a strong position to gain share.

Fourth, given the strong quarterly results, we remain comfortable with our previously issued full year financial guidance. We continue to closely monitor end market sentiments, track movements in commodity pricing, and execute countermeasures, including additional price increases. We are also optimizing our inventory levels, given improved lead times and current sales outlook.

Now please turn to Slide 4 for our view on the current end market conditions. In the residential end market, we are experiencing destocking in our 2-step distribution channel just as we had expected. We anticipate the destocking to continue through the beginning of second half of this year.

Volume in our direct-to-dealer channel was flat in Q1. However, we are expecting softness later in the year, driven by fewer new housing starts in 2022. We are closely monitoring consumer confidence for any changes that may impact the replacement versus repair decisions, but we are also encouraged by the recent improvement in the new housing starts.

There is no change in our full year outlook for a mid-single-digit decline in residential unit volumes. In commercial, our backlog is strong, and our lead times have improved as the factory situation has stabilized. The industry lead time for commercial equipment remains extended due to the shortage of common components. We still believe that commercial sales will grow by high single digits this year.

On the price versus inflation balance, we are price cost positive, but we are monitoring recent inflation in commodities such as steel and copper to offset the higher material cost we have implemented a targeted residential price increase that will become effective on June 18 this year. Overall, we are well positioned to gain share with our success in seamlessly transitioning to the new minimum efficiency standards and given our improved service inventory levels.

In addition, we are strengthening our go-to-market organization by adding more field resources and offsetting those investments by driving back-office SG&A productivity. Now please turn to Slide 5. To accelerate our profitable growth and to expand margins, we are investing in pricing excellence at Lennox. Over the past few years, we have managed to offset inflation with price, but there remains a significant opportunity for us to refine our pricing strategy to drive greater benefits from both price and mix.

We are strengthening our pricing infrastructure by increasing price analytics, engaging outside experts and further developing our internal talent. Recently, we have revised our company-wide contract signing authority to ensure appropriate scrutiny over key account pricing, and have redirected new business development on higher-margin channels and applications. We also plan to expand our rebate auditing process and take all the necessary steps to increase price netting. Another priority of ours is to work with our larger key accounts to optimize our cost to serve so that we can establish win-win partnerships.

In summary, we know that pricing excellence is an important step towards Lennox regaining our competitive margin advantage. And thus, we are increasing our focus to meet or exceed our long-term margin goals. Later in the presentation, I will provide an update on our long-term goals.

But for now, I'm going to hand the call over to Joe Reitmeier, who will go through our first quarter financial performance.

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

Thank you, Alok. Good morning, everyone. Please turn to Slide 6. Looking at the quarter for Lennox overall, the company posted strong revenue and profit growth, core revenue, which excludes our European operations was a record $990 million, up 3% compared to prior year.

Both our Residential and Commercial segments experienced sales volume declines, but price execution and favorable product mix more than offset the volume headwinds. Total adjusted segment profit increased $24 million or 20% versus prior year. Price and mix exceeded product cost inflation by $63 million with partial offsets of $17 million from lower volume and $22 million for inflationary effects and investments in distribution and SG&A expenses.

Total adjusted margin was 14.4%, up 210 basis points, with most of the margin expansion driven by performance in our Commercial segment. In the first quarter, corporate expenses increased $6 million to $19 million due to the timing of incentive compensation expenses.

Moving on to net income and cash flow performance, starting on Slide 7. The first quarter not only achieved record levels of revenue and segment profit but also marked record earnings per share with GAAP earnings per share rising 20% to $2.75, and adjusted EPS growing by 15% to $2.83. Our first quarter adjusted net income included a 21.4% tax rate, and diluted shares outstanding were 35.6 million compared to 36.4 million in the prior year quarter.

The company used $79 million of cash in operations compared to a use of $98 million in the prior year. Working capital optimization is a priority, and we remain on track to achieve our 2023 cash flow target. Capital expenditures were approximately $35 million for the quarter, an increase of $10 million compared to prior year.

Capital investments will be higher this year as we fund growth and increased capacity including a new factory for our commercial business. We used $114 million of free cash flow compared to a use of $123 million in the prior year quarter. In the quarter, the company paid approximately $38 million in dividends. Total debt was $1.67 billion at the end of the quarter, and our debt-to-EBITDA ratio was 2.1. Cash, cash equivalents and short-term investments were $48 million at the end of the quarter.

Moving to the business segments, starting on Slide 8, where our Residential segment delivered record fourth quarter revenue. Residential revenue was flat to prior year as sales volume declines of 8%, were offset with 4% favorable price, 5% favorable mix and 1% unfavorable foreign exchange. Total sales, which go direct to dealer represent about 70% of our segment revenue and were up mid-single digits. The remaining 30% of our revenue goes through distributors where total revenues were down low teens, the result of expected industry destocking.

Residential segment profit rose 3% to $111 million, a first quarter record. Segment margin expanded 50 basis points to 16.3% as continued pricing gains more than offset product cost inflation of our new minimum efficiency standard products drove favorable mix. Partially offsetting these gains were $12 million of lower volumes and $16 million from inflationary headwinds on distribution and selling and administrative expenses, where we've made investments to fuel growth.

Turning to Slide 9 in our commercial business. As announced in our last earnings call, beginning in the first quarter of 2023, the Commercial segment results will include our North American refrigeration operations. Our European operations will be reported in our Corporate and Other segment until we complete the divestiture of the European businesses. Revenue was $309 million in the quarter, up 10%, combined price and mix were up 16% and volume was down 6%. Commercial segment profit was up 110% and segment margin expanded 770 basis points to 16.2%.

We are pleased with the profit recovery in our commercial segment where price and favorable mix were the main contributors to profit growth early in the year. In the first quarter, we successfully transitioned our HVAC products to the new minimum efficiency standard, but industry-wide supply chain challenges constrained production output and continue to limit sales volumes. Demand from customers remains robust with a solid order backlog, while supply chain challenges persist, lead times to our commercial customers are shortening and are competitive with the industry.

Turning to Slide 10. Let's review our 2023 full year guidance. Our outlook provided on our last conference call remains unchanged. As a reminder, I will reiterate a few guidance points. We expect core revenue to be flat to up 4% for the full year and earnings per share of between a range of $14.25 per share to $15.25 per share. Free cash flow is targeted within a range of $250 million to $350 million.

We are planning capital expenditures of $250 million that includes investment in a second commercial factory and investments related to refrigerant transition to take effect in 2025. Price benefit, including price associated with the 2023 SEER transition is now expected to be $175 million. And we now expect net material cost to be a $45 million headwind in 2023. The material cost headwind is driven by component cost inflation of $100 million, net of $30 million in savings from cost reduction initiatives, along with $25 million from commodity cost benefits.

Corporate expenses are still targeted at $80 million. We will manage SG&A tightly while continuing to manage necessary investments in the businesses to support growth initiatives and drive productivity. And finally, we still expect the weighted average diluted share count for the full year to be between 35 million to 36 million shares, which incorporates our plans to repurchase $100 million to $200 million of stock this year.

With that, let's turn to Slide 11, and I'll turn it back to Alok.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Thanks, Joe. Please turn to Page 11 for an update on the key initiatives reviewed during last year's Investor Day to deliver on our long-term targets. As a recap, our 2026 target is to deliver an ROS of 18% to 20% with revenues over $5 billion. We believe that our laser-like focus on North America HVACR market, our direct-to-dealer business model and our superior technology portfolio will ensure long-term success.

We are executing 6 self-help strategic imperatives outlined on the right-hand side of this page to meet or exceed our 2026 goals. First, growth acceleration to drive share gain will be achieved by optimizing our go-to-market effectiveness by improving our brand customer experience and by increasing growth capacity. Second, we will increase resilient margins through commercial recovery, productivity and pricing excellence, which was highlighted earlier in the call today.

Third, to maintain execution consistency, we have introduced a balanced score card operating system. We are transitioning to a dual-source supply chain, and we are implementing lean digital processes like sales and inventory planning. Fourth, we are reconfirming our commitment to 90% to 100% cash conversion and a healthy balance sheet while building a bolt-on M&A pipeline focused on North American HVACR.

Fifth, we will enhance our technology leadership through the frequent regulatory transitions by winning in core climate heat pump and investing in digital AI/ML adoption across all our business functions. Fixed and finally, we are reinforcing our high-performance talent and culture by rolling out guiding behaviors to support our core values.

In addition, we are undertaking succession planning and ensuring that our compensation scheme remains aligned with value creation.

Once again, I would like to thank our employees who are working hard to successfully implement this self-help transformation plan. To close our prepared remarks, I would like to summarize on Page 12, the reasons why I believe LII is an attractive investment opportunity.

Lennox is a narrowly focused North American leader in the attractive industry of energy-efficient, environmentally friendly HVACR solutions. We operate in high-growth end markets with strong replacement demand that provides us with resiliency even during periods of economic uncertainty. The company has a unique direct-to-dealer network, which creates a sustainable competitive advantage. And we have a history of robust execution with disciplined capital allocation. As I complete my first year at Lennox, I'm even more excited about Lennox's future and continue to believe that our best days are ahead of us. Thank you. Joe, Michael and I will be happy to take your questions now. Britney, let's go to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll take our first question from Joe O'Dea with Wells Fargo.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Just to start on the commercial margins, certainly some encouraging progress there. Anything that you can talk about that you would consider sort of non-repeat in the quarter versus just some of the progress that you were expecting maybe coming through a little bit faster, kind of weave that into how you're thinking about sort of the go forward from here is supply chain continuing to improve? And those margins continuing to improve sequentially?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. So Joe, on the commercial, we are pleased with the progress. We had talked about earlier that we think there's a reset coming in the first quarter of this year, given that many of our key accounts had to be repriced with the sea change and the new product addition. And you saw that loudly reflected in our P&L. So that's consistent with what we expected. We had also talked about almost a little over under a year ago, $100 million in EBIT improvement. And over the past few quarters, we have already delivered $60 of that $100 million. So yes, we are a little ahead of where we expected, and that's a good thing. We remain on that journey. I think we are going to get to that $100 million faster than what we had originally talked about, just given we are more than halfway through with that.

And with supply chains improving, demand remaining strong, we still expect high single-digit growth this year, and we still expect margins to hold. And no, there was nothing unusual in we would expect the performance trajectory to continue going forward.

Joseph John O'Dea - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Great. And then on the resi side, can you talk a little bit about your sort of expectations for the year on the sort of direct-to-dealer versus to distributor kind of outlined. And you gave some color on the first quarter, but curious sort of how you think about that, if you're able to talk at all about sort of your framework for the second quarter, thinking about that? And then just generally, for the full year, how we should think about those varying trends?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. So I think let me start with the end consumer, right, because that's how we look at it. I mean the end consumer demand seems to be holding pretty well. From our perspective, as you know, this was not a great season from a heating perspective. It was unseasonably warm in quite a few parts of the country.

Despite that, we talk about that in our direct-to-dealer business, we had flat drive units coming through. And on our 2-step motor, we had declines, and that was largely destocking driven. So from our perspective, the end consumer demand remains healthy. There's obviously a slowdown in growth but we don't see any declines coming up because the replacement business is holding pretty steady. For the rest of the year, Joe, I will expect a decline in direct mostly because of residential new construction. That slowed last year, and that's going to impact our demand now. On 2 step, I think the declines get better. So I think in Q2, we'll see less destocking that we saw in Q1 and Q3, we'll probably see a little to no destocking as that gets behind us. We're only in April, May, June are bigger months for us than in April. But overall, we remain confident in the full year outlook of mid-single-digit unit decline with 0% to 4% revenue growth for us as we look at all these factors combined together.

Operator

We will take our next question from Nicole DeBlase with Deutsche Bank.

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

Maybe just going back to the commercial margins, obviously really strong this quarter. And with respect to Joe's question, I mean, I think you usually see a step-up in margins seasonally in commercial from 1Q to 2Q and then a smaller step-up in the third quarter. Would you say that it's possible that we could see a seasonal increase? It's just kind of hard to gauge since 1Q was so strong?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. I mean, commercial, listen, overall, for the long term, we expect that business to be a 20% ROS business. And Q1 was good, but we were only at a 16%. So I think there's still room for improvement for us. I don't want to accurately try and predict Q3, Q4 or Q2. I mean we don't have that level of precision. But I would see no reason why our typical seasonality trend won't hold this quarter. Because remember, this quarter, we also had some inefficiencies related to the CEO transition as we completed those. So stay tuned. I mean, I think we're starting at a good spot and we expect, you know, to end in a few years at closer to 20%.

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

That's really, really clear. And then second question, just on price/cost. Obviously, a benefit to margins in the quarter. How does that phase through the year, especially given the new price actions that you talked about today? .

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. So the new price actions that we talked about are on the residential side. On commercial, we had a reset going into this year. So I think the price cost benefit that you saw, we will see the levels to remain the same, but obviously, we start going through more difficult comps because we had done significant price increases. So the year-over-year comps get difficult, but I think the levels on a as this basis remains where we have to do more pricing effort is on the residential side, and that's where we are putting a lot of our emphasis and focus, and that's where the new price increase that we talked about goes into effect in June 18.

Operator

We will take our next question from Tommy Moll with Stephens, Inc.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Equity Research Analyst*

We appreciated the insight you provided on the pricing excellence strategy, and I wanted to drill down on a couple of the items in there, specifically around the optimizing local versus central decision-making. Can you bring us in on what that involves? And to what extent was that related to the midyear price increase that you just announced on resi to us today? Or was there some other factor driving that decision?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I think as we went through the tornado many years ago as we went through COVID and significant inflation, we went into more of a command and control more because we had to. Those were crisis that we're managing. Historically, we have really good territory managers. We have really good branch leaders. We have really good folks. We have good field intelligence. And we need to act accordingly, just like a distributor does because although we had a manufacturer, our 250 outlets act more as a distributor. So as we are looking at S, we want to give more input, more say to local pricing decisions versus looking at things doing more centrally. And so obviously, you want to set our strategy centrally, but our local field force have a lot more market intelligence and look at every region behaving a little differently.

So that was the comment was we're going to optimize it, and that's a pretty typical thing for us to do because pricing in South Florida may be very different than pricing in North Dakota. And we need to make sure that we appropriately account for those differences.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Equity Research Analyst*

I appreciate the context there. As a follow-up, I wanted to look at the residential profit contribution versus the commercial side, which was quite robust this quarter. But if we think about the full year trajectory there, your guidance does imply some growth in profitability year-over-year, given the residential volume headwinds that you've articulated, should we assume that all or substantially all of the profit growth this year should come on the commercial side? Or is that not the right way to think about it?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

No, I think it will be a balance between residential and commercial. Listen, Commercial had a good start. I think residential has lots of room for improvement, with the price, with the mixing with the inventory level coming down. So I'm optimistic on residential, and we are driving that hard. Commercial did have easy comps to compared to where we started in Q1 last year, Tommy, so look at that.

I think the overall profit increase for this year would be balanced between those 2 as residential. The benefit of sea change also is going to happen a little slower than commercial because commercial, we didn't have as much finished good inventory sitting around. And in residential, we sold quite a bit of a lower SEER products in Q1 as we are finishing that inventory. So I think putting it all together, we are equally optimistic about residential improving for the rest of the year.

Operator

We'll take our next question from Jeff Hammond with KeyBanc.

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

I just want to come back on price. I guess, first, what's informing another price increase kind of on this June 18. And then just as you talk to the contractors and get feedback, any start -- you're starting to see -- are you starting to see any pushback from contractors or fatigue from the consumer on kind of these multiple increases?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. I mean listen, costs keep going up. I mean you saw steel has been up significantly. Copper started to go back up. And what we also did is just like you would expect good companies, too, we did a pricing benchmark on where we stand. So I think the price increase in June is a targeted price increase. We targeted areas where we think we have greater opportunities. And that's because for the past couple of years, we were sort of doing brute-force price increases versus what I would call sophisticated price increases. So a lot of that is working with our own analytics and our teams to go through that, and fully offset the inflation and make sure we remain competitive in the market and capture the adequate balance.

So it's a lot of details and analytics behind it, Jeff, but we remain confident the right thing to do and support the industry pricing level. On the second part of your question, I mean remember the equipment price is only a small portion, less than half of what the consumer pays or sees in there. And we have seen no pullback because the repair versus replacement dynamics, in fact, still favors replacement, given that repairs are more expensive, our 22 units are very hard to repair or the cost of our 20 is going up. And cost of spare parts and labor has gone up more than the cost of equipment. So we haven't seen any changes, and I think they are consistent with the industry. Well, obviously, we remain closely aligned with 10,000 dealers, and we keep getting their feedback, and we'll adjust if anything changes.

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

Okay. Great. And then just as we look at it, it seems like you still have a lot of confidence in the resiliency , seems like commercial is running ahead. What kind of precluded you from kind of moving the guide at this point?

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

Yes, Jeff, I think, once again, first and fourth quarters were seasonally or lites, we've got a lot of the year still in front of us and just didn't really want to -- once again, we approach it with conservative. Cautious optimism, I think, is the right way to characterize it. We remain confident and are gauging the underlying markets. But just wanted to get into the peak season before we made a call on the full year.

Operator

We'll take our next question from Julian Mitchell with Barclays.

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

Maybe I'll leave commercial margins in pace for the time being. Maybe just on the commercial kind of top line. I fully understand the excitement around the good margin performance. But on the top line, maybe remind us of some of those main sort of end market exposures for the commercial piece in terms of kind of end market verticals obviously, a lot of concern from people out there on things like office and retail and so forth in recent months. So have you seen any kind of shift in customer behaviors? Any color you could provide on sort of bookings or orders at all on the commercial side? And again, any sort of flavor you could give on how the end market breakout for the business?

Michael Quenzer

Julian, this is Michael. Yes, on the commercial side, the backlog still is healthy. We're seeing good demand across most of our verticals. New construction is kind of 15%, 20% of that business. We're not seeing any credit issues yet, but the backlog is definitely still healthy going -- reaching into Q3. So we're really not seeing a pullback on the demand yet. Backlogs are extended a little bit because of some of the lead times in the factory. But from a demand perspective, it still looks healthy.

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

And Michael, any color you could give on sort of vertical splits, I don't know, education versus more commercial applications, anything like that?

Michael Quenzer

Yes. We're seeing some good demand on the education. So that's predominantly a summer season, though when the schools are out of season, and we can get in and do the replacement work. So schools are more of a Q2 kind of Q3 dynamic more than Q1. Right now, it's still just executing our backlog that we've had for quite a while, and we're seeing good demand across most of the channels.

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

Yes. And a few more things, Julian. Where we've put a concerted effort was preserving our national account customers. Once again, that strategy, I think, is paying off for us. as once again, the order rates and backlog remain strong there.

And then as we continue to reengage in the emergency replacement segment of the market, that should provide us additional upside more in the second half than first half. But regardless of how the underlying vertical is performing, we still think, given where our business is positioned today, we still have tremendous runway, particularly in the second half of the year.

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

That's helpful. And then just my quick follow-up on going back to sort of residential volumes. So I understand that maybe Q1 is a bit noisy with the CEO transition just sort of happening and so forth. And you had that and maybe some weather constraints. So you've got the down volumes in resi in the quarter just behind you. As we think about how that plays out through the year and what you've seen in April, albeit it's a very small month for the quarter, but do we assume sort of second quarter is down about the same amount, sort of volumes down high single digit in the second quarter. And then by the fourth quarter, you're probably growing volumes again. Is that the way to think about the year for resi volume?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I mean, it's hard to say in April, I mean April doesn't really give a trend. I mean if you think about the key drivers of the volume decline in Q1, almost all of it was destocking right? So I mean, if I take that destocking part, and I would say Q2 we'll see some de some more destocking. I don't know if it be as extensive as Q1, probably not because Q1 was the most pullback as people completed so transitions and knew that they were comfortable stock, and that's what we expected. I think Q2, there'll be a little less destocking. Q3 will be minimal to 0 and then Q4, we should be done with destocking.

So I think that's the way to think about it. And the user demand seems to be holding just fine. I mean, there's no growth that we saw rapid growth that we saw during COVID in other places, but that demand seems to be holding just fine. And RNC, residential new construction, we can predict very well. because the housing starts is what drive it. So I think the volume declines moderate. It won't be 8% in Q2, Q3. But in Q4, to your specific portion, I'm not sure if it returned to growth because that will depend on the residential new construction. It's looking better. We started the year thinking it will be down -- right now, it looks like it's closer to 10% from a housing start perspective, we just need to watch and monitor that Julian.

Operator

We'll take our next question from Jeff Sprague with Vertical Research Partners.

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

I want to come back to kind of the -- maybe it's on Slide 5, kind of the pricing slide. Alok, can you dig a little deeper into maybe the opportunities, I guess, I'll call them nonprice price actions, right? -- rebates, leakage, things like that. Is this an area where the firm once had discipline and lost it or this is a new area of focus? And maybe you could give some color or insight on like how significant driving some of these "netting" actions might be?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. I guess having done pricing back in my consulting days, I strongly believe that all 3 levers are important, setting, getting and netting. So I think it's important. In some of these cases, yes, we had strong discipline. And during Covid and other cases, as we pulled back on noncritical activities, some of these just had to give that we had to focus on other things such as recovery on COVID, looking at supporting the volume constraint. So I think we have that muscle. We've got to kind of make sure we retrain it. We make sure we find it and deploy it.

A lot of this is also around -- we have structural advantages when it comes to serving some of the large accounts, whether it's we call it national accounts or key accounts and it's going to be for us to work jointly with our customers to find the lowest cost way to serve them and create win-win situations there because we are direct, right? We can optimize a lot of freight, distribution and make it win-win for us and these large growing often like a sponsor-owned dealer network. So we think that's a big opportunity. where it's less about what the list price is, but it's more about what's margin on both sides, and we have an opportunity to optimize that.

So we used to do it very well. We lost some ground just because we had to focus on other areas. We are bringing that back, and we are excited about the structural advantage we have in going after larger accounts where the cost to serve would be lower on both sides.

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

And then just on inventories, you spoke to the channel destocking and the like. I just wonder if you could address your own inventories I guess we're up 30% year-over-year and 20% sequentially. It's not crazy given the inflation that's out there. But maybe just address where your inventories are vis-a-vis where you think they should be any particular absorption or other issues embedded in the guide as you work through that or anything else to be aware of there?

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

I think what you saw is our inventories definitely grew in Q1, but that's normal with our seasonal nature of our business. We always grow inventory in the first quarter. And then we'll burn that off in Q2 and Q3 built into the guide that burn off of the inventory. We're going to look to potentially do a little bit more. We think there may be some upside to exceed the free cash guide. But it's normal to build inventory as we did in Q1.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

And if I can just jump on that. I mean, if you go back again a few years ago, when we were turning inventory at 5 to 6x a year and we still have room for improvement there. I mean, right now, we are taking it at 3 to 4x. So I think over the 3-year planning period, you can expect us to go back to turning inventory at the historical levels. driven by finished goods optimization that Michael mentioned, but also raw material supply chains became extended, we bulked up on raw material, and we don't want to do anything crazy here, but over the next 2 to 3 years in a very disciplined manner, working with our suppliers and our customers, we are going to drive our inventory turns to be better.

Operator

We will take our next question from Josh Pokrzywinski from Morgan Stanley.

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

Look, I want to follow up on, I guess, adjacent to price, but really about share gain. If you think about where you see the biggest opportunity today, is it more on kind of the larger dealers, bigger national accounts like homebuilders? Is it in the smaller guys? Maybe talk about where this kind of newer field autonomy is really designed to try to meet the market between different customer types.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. I mean, Josh, I think the simple answer is all of them. I mean we have an opportunity with smaller dealers because we underserve them post the tornado. I mean we were known for our endo Signature Series products. We had really good partnerships -- and because we didn't have enough inventory or service levels, many of them were forced to look somewhere else.

So we need to win them back. And I think that's where a lot of the local autonomy, the improved service levels and all of that goes into, right? Second part of that is just geographic based on legacy and driven, I mean, our market share in South Florida is much lower than our market share in Marshalltown, Iowa, and that's been for years. I mean that's where a lot of the efforts we have done, including increasing our reach, investing in our distribution footprint, getting more heat pump coverage, all of that has, I think second factor is geographic.

Third, to come back to the national dealers or the larger dealers, that's where we have a structural advantage, and it's a different, more sophisticated approach of working with them on trying to make sure that we create a win-win partnership. So Josh, we have opportunities in all 3 areas. And don't forget at the same time our indirect business, which is also doing very well. So when I talked about that direct on the indirect side, where we are targeting through Allied, our independent distribution network and giving them a stronger, better value proposition. That works well. So I think all 4 are important, right?

Smaller dealers that we lost unfortunately during and after the tornado. The -- truly looking at regional expansion, going into key accounts and getting to make sure we have a win-win value proposition and finally, continuing to expand our 2-step model as well because we believe we have a unique value proposition. So those are kind of our 4 levers of levers for market share gain.

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

Understood. And then just shifting over to the product side and the transition coming up. I know you really in guidance today, but it does look like you have a little bit of padding the start the year, so good performance in commercial. Anything that you're able to pull forward on R&D, CapEx, anything else on getting set for '25?

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

Yes. It's a situation where I think we're doing all that we can. Once again, our priorities are elevating our service levels with our customers, making sure we've got the right mix of product to meet end market demand and then continuing to pull forward, and we've done that to some extent, Josh, on is our capital expenditures are $250 million. $50 million of that is associated with staying ahead of the 2025 transition. So we're making those investments pulling ahead those activities that we can to deliver that value to our customers. And once again, much like we did with the minimum efficiency transition this year, seamlessly attack what's ahead of us in 2025.

Operator

We will take our next question from Noah Kaye with Oppenheimer.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director & Senior Analyst*

I guess to start with, interested in the commentary around this year benefit to mix. Look, I think you said absolutely, it was a fairly small amount of SEER product sold through the resi channel in 1Q. Is it possible to quantify the SEER benefit to mix in the quarter, how you would think about that into the seasonal uptick and what's embedded for Sears specifically in the full year guide?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. Michael will answer that question, but let me just clarify. Maybe in what I was saying is that not all our sales in Q1 were the new SEER products, about 1/3 of our sales in Q1 for still the older Ser products as you're going. But no, majority of the sale in Q1 did shift to new year but Michael can actually break down the mix benefit for you.

Michael Quenzer

Right. Yes. In residential, we did see favorable mix. It's predominantly for the SEER transition. As we've talked about previously, it acts more as volume than price. So it dropped through to about a 30% drop-through that we saw in residential. We should start to see that for the rest of the year a similar 30% drop-through on the benefit for the mix shift and a little bit higher margins on the drop through on the commercial as we are able to get some additional pricing on top of that. but should be about a 30% drop-through that we see in residential.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director & Senior Analyst*

Okay. Great. And then what did you see from the e-commerce channel this quarter? I think to the question around share gains overall, just how did that channel factor in?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. We don't break out e-commerce sales by quarter. But needless to say, as we talked in the Investor Day, it's a very important channel for us. We look at over 1/3 of our sales as we mentioned at the Investor Day, go through e-commerce, we find that all of those are very sticky customers, and that continues to grow. So I think the numbers we disclosed in December still hold or better but we don't break that out quarterly. Not do we think it's relevant to break it out quarterly, but it's an important part of our growth strategy. And what we're even more excited about is to be able to leverage those data and the relationship and using artificial intelligence and machine learning to make critical decisions, everything from inventory planning to pricing, also looking at making it easier for our dealers from predictive maintenance perspective and others.

It's a huge investment for us, very important for us, but the quarterly breakdown of that is not something we think is relevant.

Operator

We will take our next question from Ryan Merkel with William Blair.

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

Just a couple of cleanups for me. Just going back to commercial alone, can you put a finer point on why you're so far ahead on the margin recovery? Because I think before, you thought it was a 3-year sort of linear progression and now it looks like you might be there at the end of this year.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Well, first of all, I'd say really pleased to have a conservative CFO. So I think that will be the first start point on that, Ryan.

Listen, it definitely helps. And when we said 3 years, we really looked at that being like our external commitment. Internally, obviously, we were driving it to a faster pace. I think the SEER transition worked well for us. I mean, as we looked at the factory converting over, the labor stabilizing, getting the new products which I give full credit to the team as we were also able to rationalize our SKUs. So we have like 40% less SKU in the factories working through and simplifying. So a lot of just core discipline was restored. We make a step forward with SKU rationalization. We were able to work with our key accounts because these new SKUs were not covered by some of the legacy contracts.

So all of those -- so I think we if there was like an optimistic scenario and a conservative scenario, we were probably guiding you guys to the midpoint of that. And right now, we are fighting on cylinders to hit closer to the optimistic. But it's within the range of what we thought, Ryan.

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

That's helpful. And then just on resi. Any differences in the quarter by geography? We obviously had some weather out west. Just curious there.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Not substantial. I mean there is weather related, right? Because the winter was mild in certain cases, Northeast did not do well, but I think that's an industry-wide factor, not Southern states did well, but I think it could also be because some of our competitors stumbled during this year transition, and we had inventory. So I think some of the southern states, we saw particular strength. But nothing that I could call out or give you a Bob's answer on Ryan.

Operator

And we will take our next question from Nigel Coe with Wolfe Research.

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

Just a last point. So obviously, we saw a pretty significant share shift during the fourth quarter with the transition. It sounds like that continued perhaps not as a stream, but that did continue in the first quarter. Is that fair? Hello?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes, that's fair. And I think these things typically, given the abrupt nature of the regulations, but the difference between North and South, I think we all have got -- I mean, all industry players have got sophisticated on starting to make them in Q4 and continue selling them through end of kind of Q2 to make sure the inventory doesn't become E&O time excess and obsolete. So I think we have all done a good job with that.

Michael Quenzer

And I think our direct-to-dealer strategy benefits us due to the destocking in the 2-step channels. So once again, I think we were probably unjustly criticized for losing share as the 2-step channel stocked up, once again, as it destocks, we'll see some of that benefit in the form of additional share.

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

Yes. That's very fair. Going back to commercial margins. I know this has been well vetted. But if you think about the Arkinstall facility, where is labor and material productivity trending today relative to normal, and I'll leave you to define normal, but where are you sort of target on that curve?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I'm glad you're going to leave us to define normal. I'm going to leave it to somebody else. So it's hard to decide normal. But here's the thing, right? I mean, wages are not going back. So let's put it in that perspective. But our factories are still fairly inefficient lot of the inefficiencies that trapped in, including expedited rate, including over time, including line rates running below normal, those still persist. And Q1 was actually a little bit worse on that because we had to go through see our change.

So imagine retooling all your lines and getting to new products, which were completely new design for us. Remember, there are 3 new models that we introduced at the beginning of the year. So I think there's still room for productivity improvement for us going forward. Our priority is still output them, right? I mean, I think the more we can produce, the more we can find. We are still limited by our board but getting the output up, getting manufacturing productivity and working on the second factory, remember, all of this is still based on the existing factory. Once we have 2 factories and can truly look at one being focused on made to stock going after emergency replacement, making standard products at very high velocity, very high efficiency and the other being on mid-to order for key accounts specific. I mean, that's out of our vision that hasn't changed, we just got to the 1 factory improvement sooner.

Operator

We will take our next question from Joe Ritchie with Goldman Sachs.

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

Can you touch on just your visibility into the independent distribution channels. It looks like your Allied business was probably down. I'm guessing volumes are down like high teens this quarter. Just what kind of visibility do you actually have to destocking being pretty much behind you in 2Q?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. And when we say 2 steps, we mean ADP and Allied. So combined together, and you're right. I mean the volume was down in the range you mentioned. We have a very good relationship with this channel, and we have good visibility, that's the reason we are kind of hinting at, we would expect destocking to continue in Q2 and the beginning of Q3 or beginning of second half, we think that will be behind us. It's hard to quantify because every distributor is different, right? I mean nobody has the same exact operating return as somebody else in a different state. But the amount of excess inventory that the distributors are holding is -- should be compete with destocking by beginning of Q3.

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

Got it. That's super helpful. And I guess maybe just a follow-on on commercial. I know we've talked about it, and congrats on being way ahead of plan on getting that $100 million back is probably unfair for me to even ask this question, but how are you thinking about what -- where the margin improvement is going to come post achieving the $100 million, which seems like it's going to come a lot faster than you originally anticipated.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. I mean, I'll point out to a few different things, right? First of all, remember, the $100 million we had set does not include the second factory benefit. So I think we are still holding to that. So the second factory -- we have started construction. Things are moving along well. We expect to be under roof by the end of the year. We would expect production sometime next year. So that will give a significant benefit as we have 2 factories, very focused operating to serve our customers really well. So that's going to be 1 part.

Second on that is, I think there's significant opportunity for us to continue looking at our service growth service is a very attractive business for us, and we were not fully focused on that, given all the disruptions happening here. So getting service and increasing our service focus, which is good margin, it's repeatable, it's predictable, and gives us great insight for equipment sales. I think the service would really help us well. And finally, going back to the manufacturing inefficiencies. I don't want to rule that out. I mean we are in the early stages of working through manufacturing inefficiencies and getting all of those out of the system. So long term, we are committed to 20-plus percent ROS across both the segments. And we are excited about all the steps. And those are sort of the things I mentioned in the last page, when I talked about the 6 key self-help initiatives we are working on, they kind of equally apply to both residential and commercial. -- makes sense.

Operator

We will take our next question from Brett Landy with Mizuho.

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

I just wanted to come back to commercial briefly. So you noted the backlog remains strong and order rates are solid. What degree of visibility on those orders converting do you have for this year? And is there anything specific of mix, whether it's national account versus other verticals that we should be aware of over the next 2, 3 quarters?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

I'll take the second question first. So on the mix side, no, I mean we don't have large projects that funnel through the pipeline or anything, right? I mean these are all projects and these are products that we price accordingly. So no, the margin in our backlog is no different than the margin we are expecting in Q1, if that's your question, right? We have good visibility into that margin, and it's all good. Nothing to worry about there. On the overall demand visibility, it's everything from some key accounts who want to plan 2025 volume right now post the low GWP to people on emergency replacement who wants product tomorrow. But our backlog is healthy. I mean the industry lead times remain stretched. I mean, today, if somebody places an order, whether it's our sort of competition, chances of getting a product this year is low.

I mean you would likely get into Q4 next year. So I think there's some flexibility here and there, but that's kind of the demand visibility we have. It's pretty solid going forward, both from actual revenue, sales and also margin perspective.

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

Okay. Great. And just to follow up on the news this week with one of your peers making a portfolio move into European heat pumps. -- you maybe just speak to your appetite to compete internationally, be it organically, inorganically? And then maybe just how much investment do you think is required to maybe reinvigorate that part of your portfolio?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

As you know, our -- we made a decision last year to make a portfolio move, which includes divestment of our European operation. We like being laser-like focused on North America HVAC business. It's a very large industry. We have low share. I think our focus is going to help us win. So I think we are currently 100% committed to remaining an North America HVACR player. We still have lots of bolt-on opportunities here, whether it's about service or expanding our line card, so our stores can be more efficient and looking at other opportunities. So I think for us, Never say never, but currently, we like our laser focus, and I think that will help us win share that will help us through the transition.

Everybody at Lennox gets up every morning and is focused on winning in North America HVAC, and all our 11,000 employees focus in that direction, we are confident that's a winning formula for us. And if you guys want to diversify for other international, you can always buy shares in other international companies.

Operator

We will take our next question from Steve Tusa with JPMorgan.

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

I don't quite -- I'm not sure I heard this before, been a lot of calls this morning, but could you guys comment at all on how April is looking relative in resi to what you guys posted for the first quarter.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

We didn't comment specifically on April, but I'll tell you, it's consistent with what we expected. And April is a hard month given that most of the summer sales stops in kind of May and June, but there's nothing in April that would have caused us to change our full year outlook.

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

Okay. And then I think you mentioned there were some production inefficiencies in the fourth quarter on new products coming up to speed. It was my understanding that you guys didn't really do like a major clean sheet kind of redesign for the year go around? I thought you were maybe taking a legacy product, and you were talking about how you had the outdoor unit kind of advantage there. Can you maybe just explain how your product strategy kind of progressed through that?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. So let's start with the 2 segments separately, right? So on the commercial, we did redesign our product, and that's what we were referring to earlier. So we launched 3 new models and replaced most of our legacy that included significant SKU rationalization, more modular design and more modern. So commercial, we did redesign our product line. On residential, we had to redesign our outdoor units just because vendor conditioning in PM, but that's what regulation does.

We did not relaunch an indoor unit because our indoor units are still very new. They were launched just a year or so ago. And they're already very high efficiency and they're compatible. So we believe that gives us competitive advantage in the marketplace is that our new higher sea air conditioning and heat pump units, are backwards compatible with our existing furnaces and air handlers indoor. So that's the piece, I think, of the product strategy we had mentioned earlier.

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

Got it. Okay. And then one last one. On this price increase, how much in total is the price increase? And then can you just remind us of how that works with your distribution channel? I mean are you selling. Does that price increase go independent versus your captive like -- is there a difference between what the contractor is seeing and what your independent distributor is seeing?

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. We call it a targeted price increase, Steve. And I think a lot of the discussions or the customers are starting now. So I would rather not go into terms of details in that one. But the answer is we believe that this is the right step for us to be more competitively priced in the marketplace. From a consumer perspective, this is a small portion of the overall cost. And all we are doing is making sure we can offset inflation. You'll notice in a full year guide. We now talk about $175 million in pricing benefits earlier, we'd given a range with the high end at 175, and we took our commodity inflation up by offsetting $10 million. So that's kind of where we are on the numbers.

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

Got it. So it's embedded in that $175 million now, your realization, whatever you expect to get in June.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Yes. We just to remove the range and stuck with the high number.

Operator

And we will take our next question from Chirag Patel with Jefferies.

Chirag M. Patel - *Jefferies LLC, Research Division - Equity Associate*

I just wanted to cover the Allied piece. Just 1 more kind of a blush here. One, I was just kind of looking at what the opportunity kind of seems like for you guys over time? I know in the past, we've talked about the idea of share gains of $300 million or so to get to target. How much of that is Allied? What do you kind of see the growth? Is there an acceleration opportunity in that. Is there an opportunity to partner with additional distribution channels to kind of expand that product? Just trying to get a little bit more sense for what you see as that particular piece of the business growing versus the core Lennox brand.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

Sure. So first of all, we're very proud of Allied. I mean they have done great over the past many years, I mean the business has grown up 4x. I mean the margins have expanded beautifully. And I think Jon Asaband the team have done a fabulous job taking that. At the same time, we don't think we're anywhere close to being done we have significant room for improvement. I can easily see that business doubling again over the next 5 years as we continue to add distributors to have a very focused product portfolio that wins a lot of awards and we truly focus on best serving these independent distributors. So excited about Allied. We think there's a lot of growth potential ahead. At the same time, I don't want to break down $300 million in opportunity between business A and B. ideally, both of them will get it, right? I mean, ideally, we would both get the $30 million target and we deliver more to the shareholders.

The super excited about Allied, I think we have share gain opportunities on direct and in indirect and we will keep driving both of them.

Chirag M. Patel - *Jefferies LLC, Research Division - Equity Associate*

I appreciate that. Would there be a mix shift if that were to grow a little bit faster or slower on the margin side, I just mean.

Alok Maskara - *Lennox International Inc. - President, CEO & Director*

No. And we don't break out margins. I just -- we remain committed to 20% margin on residential overall. And it's hard to kind of break down margin artificially because remember, we share the same infrastructure for manufacturing, product development and all of that. So that just becomes allocation game, right?

Operator

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