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LII - Q1 2019 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 1Q19 GAAP revenue of $790m, GAAP operating income of $95m and GAAP EPS from continuing operations of $1.73. Expects 2019 revenue growth to be 3-7% and EPS from continuing operations to be $12.65-13.25.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International First Quarter 2019 Earnings 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 first quarter of 2019. I'm here today with Chairman and CEO, Todd Bluedorn; and CFO, Joe Reitmeier. Todd will review key points for the quarter, and Joe will take you through the company's financial performance and outlook. (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 of today's conference call on our website at www.lennoxinternational.com. The webcast will be archived on the site for replay.

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I would like to remind everyone that in the course of this call, to give you a better understanding of our operations, we will be making certain forward-looking statements. These statements are subject to numerous risks and uncertainties that could cause actual results to differ materially from such statements.

For information concerning these risks and uncertainties, see Lennox International's publicly available filings with the SEC. The company disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise.

Now let me turn the call over to Chairman and CEO, Todd Bluedorn.

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

Thanks, Steve. Good morning, everyone, and thanks for joining us. Let me start with an overview on the first quarter and key points on each of our businesses and then discuss the accelerating recovery in our Residential business from the tornado impact as well as the insurance proceeds this year.

On a GAAP basis, company revenue was $790 million, down 5%, including 10% of negative impact from the tornado and divestitures. Foreign exchange had a negative 1% impact on revenue growth. On an adjusted basis, excluding divestitures, company revenue was a first quarter record $756 million, up 1%, including negative tornado impact of 5%. Foreign exchange had a negative 1% impact on revenue growth.

GAAP operating income rose 79% to a first quarter record $95 million. GAAP EPS from continuing operations was up 92% to a first quarter record of $1.73. On an adjusted basis, total segment profit rose 34% to a first quarter record of $99 million, and total segment margin expanded 330 basis points to a new first quarter high of 13.1%. Adjusted EPS from continuing operations rose 38% to a first quarter record of $1.68.

On our Residential business in the first quarter, revenues set a new first quarter high of $466 million, up 3%, including 8% of negative tornado impact. Revenue was up in both replacement and new construction business. Residential segment profit rose 69% to $87 million. Adjusted for a $22 million net profit resulting from a $40 million of insurance proceeds against $18 million of negative tornado impact, Residential segment profit was up 26% in the quarter. Residential segment margin expanded 730 basis points to 18.6%. Adjusted for the tornado impact and insurance recovery, segment margin expanded 160 basis points to 12.9%.

Turning to Commercial in the first quarter. Revenue was down 3%. Segment profit declined 31% and segment margin was down 360 basis points to 8.7%. Commercial revenue in the first quarter was driven by a mid-teens decline in new construction, well-known for being a lumpy business. In both 2017 and 2018, for example, we had 2 quarters of strong growth and 2 quarters of a decline in new construction revenue.

In replacement business, revenue was flat in the quarter with planned replacement down a couple of points with solid growth in emergency replacement, up mid-single digits. For both new construction and planned replacement, we saw some national account customers temporarily pause investment in the context of all the government and macroeconomic uncertainty in the market in the first quarter. Currently, however, we are seeing backlog up nicely heading into our seasonally largest quarters.

Operationally, we continue to focus on productivity improvements at our factory in Arkansas. We have been addressing labor shortages and inefficiencies in recent quarters. In the first half, we are continuing to focus on training for all the new employees brought on board full time and ramping up productivity further.

Our VRF business saw strong double-digit growth in the first quarter. And on the service side, Lennox National Account Services revenue was up mid-single digits. We continue to expect Commercial segment growth and margin expansion on a full year basis with revenue up the remainder of the year and margin expansion in the second half.

In Refrigeration for the first quarter, revenue was up 2% at constant currency. But we had 4% of negative foreign exchange impact in the quarter. Regionally, North America was down mid-single digits due to the same dynamics as I mentioned for Commercial. We saw some customers temporarily

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pause investment in the context of all the government and macroeconomic uncertainty in the market. As in Commercial, Refrigeration backlog is building and up nicely as we enter our strongest seasonal periods.

In Europe, revenue was up low double digits at constant currency with Refrigeration down slightly and Commercial HVAC up more than 20%. Both of these businesses can be lumpy on a quarter-to-quarter basis. Refrigeration segment profit was down 20% in the first quarter and segment margin was down 180 basis points to 8%. Lower mix was a factor with the fast growth in Europe and volume was down for the segment overall. We continue to expect Refrigeration segment growth and margin expansion on a full year basis with revenue up the remainder of the year and margin expansion in the second half.

For the company overall, the second quarter is off to a solid start. We are reiterating our revenue and adjusted EPS guidance as we look ahead to another year of strong growth and profitability. We are raising our guidance for stock repurchases this year from $350 million to $400 million.

Before I turn it over to Joe for more financial details on the quarter and our outlook, let me summarize where things stand on the tornado impact and insurance recovery this year. Big picture, for core and noncore related tornado, we now expect total insurance proceeds of approximately $358 million, about the same as the $356 million in previous guidance. We received $124 million of that of 2018 and expect approximately $234 million in 2019.

The noncore gain expected for the difference in book value and replacement value of assets is now approximately $91 million, down from the previous guidance of $109 million for 2019 due to lower estimated construction costs, approximately a $1.79 benefit to GAAP EPS versus a benefit of about $2.30 in previous guidance.

From a core perspective, our Residential business continues to make significant progress. We're seeing an acceleration in the recovery from the tornado. As I mentioned previously, we are back -- we were back to full production across all 3 of our Residential factories for cooling product by the end of the fourth quarter of 2018 and are there as well for heating products as of the end of first quarter 2019.

We are taking back business as the market as we resupply dealers and are focused on fully refilling our company-owned regional and local distribution network. The expected negative impact from the tornado is down from our prior guidance as the team continues to perform operationally and take back business for Lennox in the market.

From a core perspective in the first quarter, the negative tornado impact on revenue was $35 million versus guidance of around 40 -- of $42 million. The negative tornado impact on segment profit was $18 million in the first quarter versus guidance of around $21 million.

For revenue in 2019, we now expect $70 million of negative tornado impact, down from the prior guidance of $85 million. We estimate $40 million of negative segment profit impact, down from a prior estimate of $43 million. And the business interruption insurance recovery for lost profits is expected to be about $80 million for 2019 compared to $83 million in prior guidance. This results in a net segment profit impact of positive $40 million in 2019, the same as in prior guidance.

Of the remaining negative tornado impact for 2019, we expect a hit of approximately $21 million in revenue and $13 million in profit for the second quarter. For the third quarter, we expect a hit of approximately $14 million to revenue and $9 million to profit. For the remaining $40 million of insurance recovery in our core guidance, we expect that to flow evenly across the 3 remaining quarters.

A lot there. We've posted tornado financial update chart on our website with the details reflecting prior guidance and the current view.

Now I'll turn it over to Joe.

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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 & Cooling. In the first quarter, revenue from Residential Heating & Cooling was a first quarter record $466 million, which was up 3%. Volume was flat, price was up 2% and mix was up 1% and foreign exchange was neutral to revenue.

Residential profit of $87 million was up 69%. Segment margin was 18.6%, up 730 basis points. Segment profit was favorably impacted by a net $22 million of benefit from insurance proceeds relative to a negative tornado impact in the quarter as well as higher volume, favorable price and mix and sourcing and engineering-led cost reductions. Partial offsets included higher commodity, freight, tariffs and warranty cost, lower factory productivity, distribution investments and higher SG&A expenses.

Turning to our Commercial Heating & Cooling business. Commercial revenue was $173 million in the first quarter, down 3%. Volume was up 6%, price was up 2% and mix was up 1%. Foreign exchange was neutral to revenue. Commercial segment profit was $15 million, down 31%. Segment margin was 8.7%, down 360 basis points. Segment profit was impacted by lower volume and factory productivity, higher commodity, freight, tariffs, warranty and other product costs, distribution investments and higher SG&A expenses. Partial offsets included favorable price and mix and sourcing and engineering-led cost reductions.

In the Refrigeration segment, revenue was down 2% in the first quarter. Volume and mix were flat and price was up 2%. Foreign exchange had a negative 4% impact on revenue. Refrigeration segment profit was $9 million, down 20%. Segment margin was 8%, down 180 basis points. Segment profit was impacted by lower volume and factory productivity, unfavorable mix, higher commodity, tariffs and freight costs, distribution investments and higher SG&A expenses. Partial offsets included favorable price and sourcing and engineering-led cost reductions.

Regarding special items in the first quarter. The company had a net after-tax benefit totaling $2.2 million. That included a gain of $5.2 million from insurance recoveries net of losses incurred, a benefit of $4.4 million for excess tax benefits from share-based compensation, a loss on the sale of business of $5 million, $1 million for noncore business results and a net charge of $1.4 million for various other items.

Corporate expenses were $12 million in the first quarter. On a GAAP basis, overall SG&A was $146 million or 18.4% of revenue, down from $155 million or 18.6% in the prior year quarter.

Net cash used in operations in the first quarter was $141 million compared to a use of $84 million in the prior year quarter. Capital expenditures were $37 million compared to $23 million in the first quarter a year ago. We also had proceeds for tornado damage to property, plant and equipment that totaled $7 million.

In the first quarter, we used $171 million of free cash flow compared to a use of $106 million in the prior year quarter. The increase in use of cash for the quarter was a result of timing of payments tied to the reconstruction of Marshalltown and was in line with our expectations.

Given our business's seasonality, we used cash in the early part of the year and generate cash in the latter part of the year. The company paid $26 million in dividends in the first quarter and repurchased $100 million of stock. Total debt was $1.3 billion at the end of March and we ended the quarter with a debt-to-EBITDA ratio of 2.0. Cash and cash equivalents were $32 million ending the quarter.

Before I turn it over to Q&A, I'll review our outlook for 2019. Our underlying market assumptions for the year are unchanged. For the industry overall, we expect North America Residential HVAC shipments to be up mid-single digits. We expect North America Commercial unitary shipments to be up low single digits and we expect North America Refrigeration shipments to be relatively flat.

For the company in 2019, we are reiterating revenue growth of 3% to 7% with neutral foreign exchange. We are updating GAAP EPS from continuing operations from a range of $14.30 to $14.90 to a new range of $12.65 to $13.25. This incorporates the benefit from special items in the first quarter, lower estimated factory reconstruction cost and the associated gain of approximately $91 million, which was $109 million in the previous guidance for 2019. That results from the placement of value above book value and a noncash pension settlement charge of approximately $61 million pretax in the second quarter of 2019.

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The pension settlement charge relates to an agreement we entered into with Pacific Life Insurance Company in April to annuitize $106 million of our defined benefit pension obligation. As part of this transaction, we also transferred $100 million in pension assets to Pacific Life. This event required a remeasurement of the pension plan and will result in a $61 million noncash pretax settlement charge in the second quarter of 2019 to write off the related accumulated actuarial losses. For adjusted EPS from continuing operations in 2019, we are reiterating guidance for a range of $12 to $12.60.

And now let me run through our key points in our guidance assumptions and the puts and takes for 2019. We still expect to capture $80 million of additional price for the year. We are planning for a $25 million benefit from sourcing and engineering-led cost reductions and an $8 million benefit from Residential factory productivity. We still expect a $30 million headwind from commodities and that's $15 million from freight and $10 million from tariffs. We continue to expect headwinds of $15 million for distribution investments and $15 million from SG&A.

Net interest expense is still expected to be approximately $45 million. Corporate expenses are still targeted at $90 million for 2019 and we still expect an effective tax rate in the range of 22% to 23% on an adjusted basis for the full year.

Now a couple of updates. Capital expenditures are now expected to be $195 million, down from the $215 million in the previous guidance. The change is due to lower reconstruction cost to complete the Iowa manufacturing facility. We now expect this to be $95 million versus the prior guidance of $115 million and will be funded by insurance proceeds. And finally, we continue to expect the weighted average diluted share count for the full year to be between 39 million to 40 million shares, which incorporates our plans to repurchase $400 million of stock this year.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First, from the line of Julian Mitchell with Barclays.

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

Maybe just the first question around the Commercial margins. I know you talked on the last call about headwind in Q1 from labor inefficiencies and the factory productivity. Just wondered if the margin decline in Q1 that you saw was worse than you thought. And how do you think about the timetable of getting through those productivity issues over the balance of the year?

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

It's quite frankly a little worse than what we thought. And we now think it's going to be second half of the year before we see margin expansion. I mean there were a couple of things though in the quarter for Commercial above and beyond the factory. We've had lower volume as well as lower factory productivity as we discussed and the lower volume hurt us on absorption.

And as I talked about in the script, operationally, we continue to focus on productivity improvements at our factory in Arkansas. We've been addressing these labor shortages and we continue to focus on training and ramping everybody up.

Also in the second half of '19, we expect to have a larger positive gap between price and commodities, freight and tariffs. So on a full year basis, we're ahead as a corporation. In Commercial, on a full year basis, we're ahead. But in first quarter in Commercial, we were negative price/cost, the elements I just said, because it takes a little longer for Commercial to get priced in the marketplace from -- the price increases, they announce at the end of the year.

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So second half of the year will have a positive gap between those 2. As I mentioned on the script, margins are up nicely, which is up mid-single digits as we entered the quarter. And we -- as we enter a quarter on Commercial, about 50% of our revenue is already in backlog and 50%, we have to book and ship.

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

And then my second question on the Residential business. Any update on sort of broad end market conditions? How are you feeling about Q2? And also if the market share progress you're making is in line with what you'd hoped coming out of the tornado impact.

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

Short answer is -- or short and long answer is, we're actually slightly ahead of where we thought coming out or when we guided last time of winning back share and you saw that in a lower tornado impact to core earnings. So in other words, we sort of overdelivered on the revenue and EBIT side for Residential ex the tornado.

I'd look at our results, our first quarter revenue was up 3% at actual in Residential and then we said we had 8% of tornado impact, which applies we had been up 11%. Residential is going -- still going very strong and we're getting ready for the summer selling season. We continue to gain back the share that was borrowed from us. And we're confident, as we go through the year, we will do that.

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

And market conditions are as you thought as well?

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

Yes. I mean what -- it's always a little hard to tell as you go when you're this early in the second quarter. But we have events, we call them Lennox LIVE but they're really dealer meetings where we meet with thousands of our largest dealers in 4 or 5 locations around the country. The mood was extremely positive. People are excited, both loyal to us, at least that's what they tell us in the room when we bring them in, but they're showing that with their spending. But more importantly, people are confident going into the spending season.

I think you saw -- well, I don't think you saw -- you saw in our Commercial and Refrigeration numbers, which I think are more tied to sort of concerns that you get by watching cable news. And I think there was some softness that was attributable to our softness in Commercial and Refrigeration it was tied to sort of this macroeconomic overhang in North America or certainly in the U.S. I think that's now behind us and all 3 of our businesses, as we go into the summer selling season, feels pretty good.

Operator

Next, we'll go to Jeff Hammond with KeyBanc Capital Markets.

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

So just going back to the kind of share recapture. Are you finding -- just what are your experiences as you talk to dealers? And are you expecting some dealer attrition? Because it just seems like some of your competitors were suggesting that they'd be able to hold some of this share shift.

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

Yes. I mean the short answer is yes. There are some dealers we lost that won't come back. But at the same time every year, we have met hundreds of dealers that we bring on, we lose some, we bring new ones on. So when it's all said and done, they can't hold all their dealers. They can't hold all their dealers plus the ones they took from us. So we're attacking on a broad front, both winning backlog dealers who they borrowed share from but also going after their existing dealers. So we're attacking on all fronts. We're real confident, at the end of the year, we're going to be in a good share position and we're seeing it in the numbers.

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

Okay. And then just on Refrigeration, just confidence that, that steps up given some of the, I guess, pause or concern as we move into the latter part of the year.

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

Yes. I mean as confident as you can be when you have 50% of backlog for the quarter and you still have to book and ship, but we're up double digits in Refrigeration backlog entering the quarter. And like Commercial, 50% of it, we still have to book and ship but 50% of it is in backlog. Like Commercial, it can be lumpy. Where we saw the softness was in North America, which was down mid-single digits. Our European business was actually up. And I think that ties to the theory of the case that I said earlier. And so again, we're confident going into the balance of the year. Like Commercial, there'll be a lag on price cost. And so margin expansion will be second half of the year, but we expect revenue to be up second quarter.

Operator

Our next question is from Ryan Merkel with William Blair.

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

So first question is on second quarter. You said it was off a solid start. I just want to confirm, is this true across all segments?

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

Yes. So I'll give you the math again. Commercial backlog, up mid-single digits. Refrigeration backlog, up double digits. And Residential, where backlog doesn't much matter, we're off to a solid/strong start, but again, with the reminder obviously that you know, Ryan, but I'll say to others, is April is about 20% of what we do, May is about 1/3 and June is half. So bottom of the first, we're doing well but we still have 8.5 [months] to go.

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

Got it. Okay. And secondly, Commercial margin expansion, the second half of '19. Maybe just give us some context on the second quarter though. Should we be lowering our expectations? Is that what we're sort of hearing?

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

Yes. What I'm trying to tell you is I think margins -- I would guide that margins will be flat to down in second quarter and they'll be up second half of the year and it's a combination of still ironing out some of the factory productivity issues we had. Roadmap's in place, we're executing, it's just a matter -- when you have 1,500 people in the factory and a lot of them are new, getting everyone trained up. And then second is price/cost was negative in Commercial. First quarter will be relatively flat and second quarter and then second half of the year, we have positive price/cost.

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

Got it. And then maybe just quickly, lastly, it's good to hear you're taking back share in the resi business. But are you having to do less discounting than you expected?

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

I think I'd answer it this way. We got 2% price in the quarter. We see it in the numbers and we're real confident we're going to get 2% price. So I won't necessarily get into what we expected. But we're holding -- we're getting the price increases that we had hoped for and what we guided to and we're sticking to price.

Operator

Next, we'll go to Nicole DeBlase with Deutsche Bank.

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

So with respect to the margin improvement that you guys expect to -- for Commercial and Refrigeration for the full year, is it possible to get a sense of the magnitude? Are we talking about 10, 20, 30 bps, just to give us some conviction around what's embedded in the second half?

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

Yes. This early in the year, I'm not going to guide to margins. I think I'm giving more than I normally do on segment guide. So we're guiding that both will be up year-over-year for the full year. We'll be up second half of the year and we'll be down first half. The way I frame it, I mean I'm not breathless about the margins, but we're confident they're going to be up.

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

Okay. Got it. And then on capital allocations, I know you guys raised the buyback guidance, makes a lot of sense, seems like it's deployment of Kysor proceeds. But does that -- what does that indicate with respect to the M&A pipeline, if you could talk about that a little bit?

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

I think it's -- there's no read through to the M&A pipeline. Our M&A pipeline, as we've talked about, will sort of most likely be -- we think we'd be interested in with the HVAC North America, that would be large and lumpy. And when that time comes, if that time comes, then we'll figure out how to finance it and take care of it in a shareholder-friendly way. But in lieu of that, we're not going to let the balance sheet grow and we'll give money back to shareholders.

Operator

Our next question is from Robert McCarthy with Stephens.

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Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

I guess maybe just to augment some of your comments around the homebuilding channel. I think you said positive growth there and what you're seeing there. And then not to beat a dead horse, but it sounds like you're really typifying this as a pause as opposed to something worse, particularly in the Commercial channel in North America. Obviously, you have a limited visibility. But maybe you could just reiterate what the strength of your argument is there?

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

Construction -- new construction in Residential was up low single digits for the quarter. And again, that's on -- that's with the tornado impact. We didn't break out the 8% tornado impact between new construction and replacement. Although I would tell you, the vast majority of that was replacement. So new construction was up sort of low to mid-single digits, roughly in line with what we expected for full year. And again, when we talk to the builders going into the summer building season, they remain confident.

In terms of Commercial and also I'd extend it to Refrigeration, with an industry phenomena, there are 3 or 4 months where the industry was down. We were part of that. We saw industry data for February that started to recover. And as I said, we can see it on our order book and our backlog where our Commercial business is up mid-single digits. When we talk to the customers, they're confident. So we've seen last year, in '18, we had a couple quarters where we were down and a couple quarters that we were really strong. So it's not unusual for that to be the case with this business.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

Any comments you can make around the segments in terms of how we -- is there any change that we could see in terms of underlying incremental margin lift at Refrigeration and Commercial? Obviously, given the fact that you change margin targets for Refrigeration, that should be the case. But any kind of color how we should be thinking about incremental margins at the subsegment level for those 2 and then just in the context of resi?

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

No. I'm not going to give -- at least I don't have any guide points that I'm going to share right now for 2019. The 3-year targets, no. And I would -- the 3-year targets for resi are 19% to 21%; and for Commercial, 19% to 21%; and for Refrigeration, 15% to 17%. And I think about it roughly as a straight line between 17% and 21% to get there -- excuse me 18% and 21% to get there. But I think I've been pretty clear about, I said it 4 -- 3 or 4 times that Commercial and Refrigeration will be back half of the year this year.

Robert Paul McCarthy - *Stephens Inc., Research Division - MD & Analyst*

Congrats on a solid start.

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

Okay. Thanks.

Operator

Next, we'll go to Jeffrey Sprague with Vertical Research Partners.

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

Just back to the share recovery [pot], if we could. Could you still elaborate a little bit actually how you're calculating that at this point, right? I would imagine it's somewhat imprecise, but we're talking relatively precise numbers. I mean is the 8% unfilled orders? Or is it some other kind of mathematical construct?

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

I mean it's a couple of ways. I mean -- and we sort of triangulate, then it's quite frankly how we're talking to the insurance company also. I mean we understand what the market does and we understand what our share was going into the tornado. And so then we understand the delta between what "our revenue" would have been and what it was, so that's top-down. The other way we do it is we know literally by customer who took -- who left us, who we allowed to leave, how much business they took and then we can tell how much we're winning back as we get it back. So we have a pretty clear line of sight of what was lost, who it was lost with, how much was lost, quite frankly who took it, borrowed it from us. So when it comes, time as it is now to get it back, we know exactly whose door to knock on and how to get it back.

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

And to the extent that [of course], this is maybe a struggle for dealers as opposed to a struggle for volume within a dealer, are there nonprice price things going on in your business, kind of pledges to dealers, some givebacks, rebates things like that that show some point in the future? Or do the numbers fully reflect the competitive dynamic that's going on?

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

It fully reflect the dynamic that's going on. In other words, just from the accounting, I mean we made a promise on some kind of spiff or kickback then that's sort of reflected in the economics as we accrue the revenue against it. So that's all in there.

I mean we are doing the basic things. Quite frankly, we always do when we convert dealers. In this case, it's getting back share. But somebody switched over to competitor X and they have a handful of furnaces or air-conditioners, we'll buy them out. We'll take over the units from them. If they need some marketing support, we'll do that. There's lots of creative things we'll do and we reflect it in the P&L. But as I said earlier, we did better on revenue and getting back to share in the first quarter than we initially guided and we stuck to 2% price. And so I would be nervous if we weren't sticking price but we're sticking price.

Operator

Our next question is from Robert Barry with Buckingham Research.

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Maybe just to start with the weather. Anything notable to call out there as either a headwind or a tailwind in the quarter?

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

No. I mean it was a little bit cooler than it had been last year but sort of on the round the same number. So weather really didn't impact much.

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Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Got it. And then if I pull out that $22 million net benefit from the tornado in resi, which I think that you highlighted was kind of more than you expected. Kind of the underlying contribution margin there looks kind of mid-teens-ish maybe, I don't know if that's just seasonality or if there's anything mixed going on in the quarter that you'd want to call out?

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

Here's how I think about it. You're just talking resi overall, right, you're talking resi?

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Yes.

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

Yes. I mean I would subtract the $40 million of insurance proceeds, add back the $18 million of tornado impact and then add $35 million of revenue. And I think if you do that, it shows incrementals of 28%, 29%. So I'm not sure where you get 13%. I think it's 28%, 29% and I think it shows margins up 150, 160 basis points.

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Got it. Got it. Yes. No. I'll definitely revisit the math there. On the Commercial...

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

I think you were just testing my conviction, Robert. I don't think...

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Right. Well, I was also doing the math on the fly, so I'll check it. On the Commercial, just anything from a vertical perspective in terms of pressure, any particular verticals under pressure?

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

No. I mean it was across the board. I mean it -- we're half national accounts. So predominantly, the story, as you would expect, would be national accounts. But I wouldn't bleed that over to the broader concern that we all have longer term about what's going to happen to retail. This is more people just sort of pulling back in and deferring, as you know, in replacement, there -- for national accounts, the majority of the time it's planned or placement so they have discretion that they can make decisions on, and it was just a matter sort of pulling back a bit. And in new construction, same thing.

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Got it. Got it. Just lastly, and I'll apologize in advance for kind of a more esoteric accounting question. But just looking through the K for last year, I think there was a fairly significant headwind in this kind of other product cost category, which I think a lot of that was LIFO adjustments?

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

Correct.

Robert Douglas Barry - *The Buckingham Research Group Incorporated - Research Analyst*

Curious if there is any visibility there on -- like is that just kind of expected to be neutral this year or first or just any thought on how that might play in the P&L.

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

I mean I'll give the layman's answer and then I got Joe here sitting in front of me. I mean LIFO is just an accounting attempt to true up at the end of the year what should -- or could have flown through the P&L during the year. And it has to do with the timing of when the cost of inventory flows through the P&L. We've had perfect information obviously and sort of set it up so there was no LIFO adjustment. The negative LIFO that you saw -- we saw last year was really more of we had really good or significantly good news in '17. We had less good news in '18. So it showed the change to the change was negative. When we think about LIFO during the year, we never guide to it. So we just sort of expect that it's going to be neutral during the year, and that's how I'd encourage you to think about it.

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

Yes. What we expect it to be. And quite frankly, the way that we planned it and we're guiding is no impact in 2019 at this point. If that changes in future periods, we will give you some -- some heads up.

Operator

Our next question is from John Walsh with Crédit Suisse.

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

So talking to some dealers, we heard that there's some new fan efficiency rating requirements that are going to be coming online this summer. I believe it's more related to the heating side instead of the AC side. But just wanted to maybe understand that dynamic a little bit and if you're seeing anything outside of kind of the normal share recapture that would distort the way to think about this cooling season?

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

Why don't I talk about the regulatory change and talk about how it will impact us, and then I'll make sure I capture the share impact at the end because the answer to that is, yes, there are some things that will take place with those other independent distribution. So on July 3 of this year, there's a furnace fan efficiency rating, FER furnace -- or excuse me, fan efficiency rating, FER regulation that's scheduled to go in effect.

This requires some move from standard efficiency what are called [PSE] mode or still higher efficiency what are called constant torque of variable speed motors. It's probably more technology than anyone called once but waited -- from a business point of view, the regulatory change is going to add about $25 to $50 to the cost of a furnace.

This regulation is based on manufacturing stop date for the standard efficiency units and companies continue to sell them after that date, i.e., you can build up inventory at independent distribution or company distribution to sell later. And like we've done on other regulatory transitions, we're going to have a prebuild of the standard units as well our -- as are our competitors, and we'll continue to sell them past July 3.

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And the goal, and we're pretty confident we're going to do it, will be the same thing that happened on the 13 to 14 SEER transition that you sell -- you feather in the new units that are higher cost over time, and so there isn't a step function change in pricing, better stated, there isn't this erosion of pricing on the older units and so you sort of feather it in over time. And so we're confident we're going to be able to protect margin and price when we go through this transition.

I think the impact that you'll see in share will be -- and you'll be able to pick it up on the AHRI data, that the -- April, May, June aren't big furnace seasons compared to wintertime. But some of our competitors who are selling to independent distributors, you'll see a big spike in furnace share or furnace volume for them during that time period. That's them stocking independent distributors with these standard units that they can't build after July 3. You won't see that in our numbers because we'll carry the inventory ourselves and we'll sell through the dealers during the furnace selling season that will come later in 2019. Was that clear enough, John?

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

Yes. No. That was a great detailed answer. Appreciate that. And then maybe just a quick follow-up here. I mean given the move in copper, wouldn't necessarily expect any impact to '19 given your hedges. But how do you think about that move? And maybe further -- or around pricing potential.

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

We continue to remain confident we can get price to offset commodities. And so I prefer that all the commodities go down rather than up. But if they go up, we'll price in the out years to do it. As of April, we're 73% hedged on copper for 2019. So we're pretty locked in. And again, as copper moves, we'll adjust.

Operator

Next, we'll go to Steve Tusa with JPMorgan.

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

So what was price in the first quarter for Residential, price realized?

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

Turning this on to make sure we got the right number.

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

It was a little more than 2% for the quarter.

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

Yes. So it was 2% for the quarter. I know that. I don't know the exact number, but 2% for the quarter.

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

Okay. And to just kind of like better understand the -- how you're calculating the tornado impact, I mean your revenue was...

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

I turned to somebody, it's $11 million.

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

Okay. Your revenue was up 3% or whatever. But you're just kind of like looking at the -- just stripping out the impact of the insurance proceeds, which you could consider to be like totally nonoperational if you will, your profits were down. So I guess if we're not adjusting -- I guess the point is like you have extra cost that's just running through from all these things that kind of skews that kind of profit performance. It's not just kind of an incremental margin on the lost volume. Is that the correct way to kind of think about it?

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

No. I mean I'll tell you how I think about it. I mean we've been clear from the beginning that the drop-through on the lost revenue was going to be a rich drop-through. So the guide for the quarter -- or the actual for the quarter, which is better than our guide, was $35 million -- the tornado was $35 million -- someone in the background is yelling and agreeing with me. It was $35 million of revenue impact and $18 million of EBIT impact from the tornado. And that's because it's our highest margin product that's really rich mix coming out of Marshalltown.

So if you take what our reported results were and subtract $40 million from the insurance proceeds and add back $35 million of revenue and $18 million of EBIT, what you'll see is that our earnings were up 25% in resi and that our margins expanded 150, 160 basis points and we had a 28%, 29% incremental. So that's how I do the math and it's the story, just what I thought it would be. I think your math isn't taking into consideration $35 million of revenue yield at $18 million of EBIT and that's because it's such a rich mix of product.

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

Okay. Got it. So -- but I guess if we just look at it in kind of on a real-world basis, that would suggest that your profits would have been down on kind of these lower mix units -- on growth in those lower mix units?

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

Yes, exactly. So -- and for instance, the tornado impact, we lost a cream off the milk, right? So yes, we had lower margins.

Operator

Our next question is from Joe Ritchie with Goldman Sachs.

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

So Todd, your comments earlier on resupplying your dealers, I'm just curious, when you think about sell-in versus sell-through in the resi channel, how far along are you on the sell-in process?

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

We're 75%, 80% owned distribution. So we only have -- we don't sell in, sell out, we just sell out. So we don't recognize it until we sell the product. On our Allied business, there's some inventory loading with selling in. But the sell-in, sell-out is really for people who are dominated or have large independent distribution, that's not us. Our numbers are 80% sell-through. That's all we report.

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

And so maybe asking that a little bit differently, in terms of getting your inventory levels back to where they need to be, do you feel like you're there at this point? Or is there still some room to go?

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

There's still some room to go. I mean we turned on full production at the end of the first quarter. It's now April. And so we're still sort of running our Residential factories hard to get ready for the summer selling season.

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

Okay. And then maybe one follow-on as I kind of think about some of the cost headwinds that you guys outlined for the year, whether that's commodities, freight, tariffs. I guess how should we be thinking about the cadence? Was there any like -- was there potentially a disproportionate impact in 1Q? Or how are you guys thinking about it as the year progresses?

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

We're thinking about it as -- that about 1/3 of the benefit of -- we said that price will be $80 million and commodities, freight and tariffs will be $55 million, so we're going to be 20 -- plus $25 million. When we think order of magnitude, 1/3 of that will be first half of the year and 2/3 of it will be second half of the year, and so it's going to be back end loaded.

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

Okay. And do you guys have a number for 1Q at your fingertips for the cost impact?

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

1Q, we were slightly negative.

Operator

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

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

Can you comment on your Residential momentum in the quarter? I know backlogs don't matter. You spoke pretty extensively about Residential. But just curious, how was the progression from March to April? March was a big month. And also, like some other distributors called out, was Easter a benefit in the quarter and therefore, probably a pull forward from Q2. Or just curious, any other puts and takes from a year-on-year perspective or a seasonality perspective as we think about Q2.

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

Yes. I don't think Easter much matters. I mean I understand Good Friday is a selling day. But -- so I wouldn't -- I don't think Easter -- it's not like Christmas where it's a week of activity gets delayed or deferred. It's like a day of activity and not for [lapsed] Christians. I think in terms of the timing and the momentum of the business, I think the end markets remain strong and solid. But it's more about our performance. I mean the factories are roaring. We're producing all the product lines. We're sort of out there gaining back share. And so the momentum in the Residential business is strong as we go into second quarter.

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

Got it. Can you -- this is probably just a forward-looking question. Can you comment on if you would be impacted by any Mexico border closure, if that happens at all? And what could some of the steps be that you should be taking to work around such an event?

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

Yes. We would be impacted by a Mexico border shutdown, and parenthetically so would most of corporate America. And so obviously, we produce a lot of production in Saltillo, and as a percentage of our business, even more than it was a year ago. And we source components from Mexico, for our North America factory. So a shutdown would impact us. And so we're doing the things you might expect to do, looking at different options about buffering inventory in and different ways to get it across the border. But short answer is, if the border gets shut down, we're all going to be impacted and we'll all scramble.

Operator

And next, go to Tim Wojs with Baird.

Timothy Ronald Wojs - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Just 2 quick ones for me. So first, just on the CapEx reduction, is there any reason why that $20 million shouldn't flow down into free cash flow for the year? And then secondly, just what's the right quarterly D&A number once Iowa was kind of fully in the -- the reconstruction of Iowa plant fully in the P&L?

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

Tim, I'll take the capital spend comment. That's really tied to the reconstruction of Marshalltown. So there will be a direct reduction in insurance proceeds as well for the capital expenditures there.

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

And then D&A [timing]?

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

Yes. Depreciation and amortization, we have $80 million for the full year. That will impact us more as we get into 2020 but not so much in 2019.

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Operator

Next question is from Gautam Khanna with Cowen and Company.

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

Follow-up question on the Commercial productivity comment you made in the warranty expense. Just -- is there any amplifying color you can give on what's at the root of the problem there? If it's behind us or...

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

Yes. I don't remember anything -- saying anything about warranty. But I mean the issue has to do with productivity and it has to do with -- we're a seasonal business. We bring in a significant amount of temp workers every year into the factory. And when unemployment is at a record, not record lows, but lows that none of us have seen in our business lifetime, it's much harder to get workers. And so it has to do with attrition and absenteeism and training the workers we've had.

We've made some adjustments. Quite frankly, we've raised the wage rates, we changed the way we're operating with direct labor in the factory. And I'll be frank, I thought at the end of the first quarter, it would be behind us. It's lingered longer than what we had hoped. But I'm confident we're doing the right things and we'll get it better.

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

Okay. Now the warranty reference was in the release, higher warranty year-over-year, and other product costs, but okay...

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

Yes, that's really more the absence of good news versus bad news in the year, and that's what it is about. Yes, good catch.

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

Okay. No. No, that's helpful. I appreciate it. And then just -- if you could just comment on the competitive environment across the 3 segments, if there's been any change more -- obviously, we understand the resi dynamic of temporarily donating some share. But if you could just talk about it, have you seen any incremental price pressure? Is the industry still quite disciplined in terms of kind of raising price to offset commodity and holding it? Anything you've seen that would signal any sort of change relative to a quarter or 2 ago?

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

No. I mean price realization is always the acid test of an industry dynamic, and we continue to get price in the market price across all 3 of our segments and we're confident that we'll do it. I mean Residential is sort of now fun again. I mean I think about the analogy, I'll mix 2 or 3 metaphors here. But if you think about a fighter with an arm tied behind his back and that's what our sales force felt like and now their arm's released. And there are wild dogs chasing after raw meat in the marketplace after being held back. And so we're excited going into the second quarter.

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

And last one for me, just now that Marshalltown is back online, any change to how you guys -- the production system, if you will, and how you're going to source more or less for Marshalltown relative to South Carolina and Mexico? Anything you can comment about how that might change relative to pre-tornado?

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

No. I think it's what I said earlier about this that we've built capability at our other 2 factories, and do premium product, and we're glad we now have that capability there and we don't plan on sort of eliminating that capability. But man, we're really glad we had the Marshalltown team. They've done a heroic job, and having all that experience allowed us to come back. And so we are excited about the Marshalltown team. But obviously, we're excited about continuing to grow our Mexico facility and our South Carolina facility also.

Operator

Next, we have the line of Josh Pokrzywinski with Morgan Stanley.

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

Todd, can you just talk a little bit about the 2Q, 3Q, I guess both changes and just how you're thinking about the lost profits there? It seems like with heating and cooling now being both at full strength, I get that there's some temporary share shift that comes back and forth. But just any reason why those numbers couldn't be lower still? I think just case in point, in the -- in your table, you had it actually going up in 2Q in terms of lost profit. So anything you want to kind of monologue about there would be helpful.

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

I mean the guide is the guide. So I mean it could be better, it could be worse, that's the nature of the guide. I mean we're attacking or winning it back. But I mean it takes time. And it also takes time and I think you understand this is -- and our competitors have -- we're smart when they went in and did this. They had rebates tied to sort of buying so much product or they tried to get dealers to buy cooling product early in first quarter before we had the full capacity to meet people's needs. And so the -- so it's going to take us some time to win back. But if we do better like in second and third quarter than like we did in the first quarter, that's obviously very good news.

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

Got it. And then I guess just related to that, I think Joe said that mix was up in resi in the first quarter. I guess a little surprising just given that some of the higher mix products what was most impacted. Is that something that was more of an anomaly? Or how should we think about mix over the balance of the year? Because I think both pricing and mix, if you didn't know that the high-margin stuff was the one that was offline, it would read like any other quarter the past few years.

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

Yes. Mix was up just slightly. The majority of it was price. But we did have a slight favorable mix within the quarter.

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

And we would expect -- and again, it was negatively impacted from the lost revenue of $35 million because that was skewed to the highest profitable. So I think the point is we would have had significantly better mix if we hadn't have had the tornado impact.

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

Yes.

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

So mix should accelerate over the balance of the year, I guess, is one -- one other way to interpret that?

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

I think I'd interpret it we'll have a strong mix year in 2020.

Operator

Our final question will be from the line of Nigel Coe with Wolfe Research.

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

So just want to just go back to inventories. Quite a buildup year-over-year. And obviously, these are unusual -- fairly backdrop with the rebuilds at Marshalltown. But maybe just speak to that, Todd, and how you see inventory playing out, especially given this furnace switchover that's happening in July.

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

Well, I think part of what's in that -- I think our inventory was up 7%. And the order of magnitude, last first quarter versus the prior year quarter, we were up 18%. So when your revenue is growing, you tend to build inventory. You also lay in the cost impacts that we've had on commodities. That's also part of what's building into our inventory number and the prebuild of the furnaces. So we're still ramping up our factories, still driving production and inventory will continue to build until we get to the other side of the summer selling season.

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

Okay. Okay, that's great. And then just quickly on new construction. We've seen housing starts down double digits through the first quarter. March was in February, February was in January. Does that suggest that your new builder channel will get worse before it gets better? I understand you said low to mid-single digits growth for the full year. But does it get worse before it gets better?

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

We were up low to mid-single digits, and I think it's low single digits in the first quarter for us. So we had a solid first quarter and we think it's going to be up low single digits for the balance of the year. Again, we'll see what happens.

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

And where is that mix right now [tugged] between new builds and replacement for resi?

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

We're probably 15%, 20% new construction to balance out on replacement.

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Operator

I'll turn it back to the company for any closing comments.

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

Thanks, operator. To wrap up, our recovery from tornado impact continues to accelerate as we enter our largest seasonal quarters. Overall for the company, the second quarter is off to a solid start. We're reiterating our 2019 revenue and adjusted EPS guidance. We look forward to another year of strong growth and profitability. I want to thank you all for joining us today.

Operator

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

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