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LII - Q2 2018 Lennox International Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 GAAP revenue of $1.18b, GAAP operating income of $195m and GAAP EPS from continuing operations of $3.39. Expects 2018 GAAP revenue growth guidance to be 4-6%, adjusted revenue growth guidance to be 6-8%, GAAP EPS from continuing operations to be $9.43-9.83 and adjusted EPS from continuing operations to be $9.95-10.35.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Lennox International Second Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this call is being recorded. I would now like to turn the conference over to Steve Harrison, Vice President of Investor Relations. Please go ahead.

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

Good morning. Thank you for joining us for this review of Lennox International's financial performance for the second quarter of 2018. 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 unless otherwise noted. You can find a direct link to the webcast to today's conference call on our website at www.lennoxinternational.com. The webcast will also be archived on the site for replay.

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

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

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

Thanks, Steve. Good morning, everyone, and thank you all for joining us. Lennox International posted a record quarter in the second quarter of 2018 with new highs set for revenue, total segment margin and profit and adjusted EPS from continuing operations.

Revenue on a GAAP basis was a record $1.18 billion, up 7%. On an adjusted basis, excluding noncore Refrigeration businesses on Australia, Asia and South America that are being divested in 2018, revenue was up 9% to a record $1.16 billion. Foreign exchange was a 1% benefit to revenue.

On a GAAP basis, operating income was a record $195 million in the second quarter, up 11%. GAAP EPS from continuing operations was a record $3.39, up 25%. On an adjusted basis, total segment profit rose 13% to a record $206 million. Total segment margin expanded 50 basis points to a record 17.8% and adjusted EPS from continuing operations rose 30% to a record $3.67.

Turning to the key points on our business segments for the second quarter. Residential set new records for revenue and profit. At constant currency, revenue was up 9%. Revenue from replacement business was up 10% and new construction was up high single digits. Residential segment profit rose 9% and segment margin remained at the record level of 21.5% of a year ago.

Turning to Commercial. Revenue and profit also hit new highs in the second quarter. Commercial revenue was up 12% at constant currency. Segment profit was up 18% as margin expanded 70 basis points to 18%. In North America, at constant currency, Commercial Equipment revenue was up low double digits for the quarter, replacement revenue was up high single digits and new construction revenue was up high teens.

Looking at the equipment business another way, national account revenue was up low double digits, and regional and local revenue was up high teens.

On the service side, Lennox National Account Service revenue was up more than 25%. In Europe, Commercial HVAC revenue is down mid-teens at constant currency.

Turning to our core Refrigeration business. Revenue was up 1% at constant currency. In North America, constant currency revenue was down low single digits. In Europe, at constant currency revenue was up more than 20% on the strength in both food and nonfood Refrigeration business. Refrigeration profit was up 5% in the second quarter and segment margin expanded 40 basis points to 14.9%.

To update you on the sale of our noncore Refrigeration businesses, in the second quarter, we closed on the sale of our Australia and Asia business to Beijer Ref as expected. We also closed on the sale of the Sydney area real estate associated with our former operation on Australia. We booked a USD 24 million gain from the sale in the second quarter, which has now been included in our GAAP guidance with that transaction completed.

We're still on track to close on the sale of our South America business in the second half of the year with Elgin, a privately held Brazilian company, subject to Brazilian antitrust approval. With a total of approximately $115 million in net proceeds from these transactions, we've increased our stock repurchase guidance for the year from $350 million to $450 million.

Joe will talk about each point in our guidance in a moment. But high level, we are raising guidance for adjusted revenue and EPS from continuing operations with a strong first half performance and start to the third quarter.

Following a second round of price increases this year effective mid-June, we now expect a total price benefit of $75 million for 2018, up from the prior guidance of $50 million. The $75 million of price for the year offsets $50 million of headwind from steel, copper and aluminum, $20 million of headwind from freight and $5 million of headwind from the Section 301 tariffs that are currently effective and proposed. Beyond price, we're also attacking freight and tariff headwinds with sourcing strategies, as you would expect.

One last point related to developments late last week. As you may have seen on our press release on Friday, a residential factory in Marshalltown, Iowa was damaged by a tornado on Thursday, July 19. We are in the process of fully assessing the extent of the damage. Thankfully, there have been no reported injuries to our employees and that is our first priority.

Second is our commitment to serving our customers. An advantage of owning our own distribution network across North America is that we have supply of more than 40 days of equipment and more than 235 distribution centers and stores ready to support our customers in the field. Beyond that, more than 75% of our North America residential equipment units are manufactured at our facilities in Mexico and South Carolina, and those teams are stepping up as Marshalltown recovers. We are enacting recovery and operational contingency plans and have great teams in place to address the challenges. We will keep you updated on our status and progress.

Now let me turn it over to Joe to talk in more detail about second quarter performance and the full year outlook.

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

Thank you, Todd. 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 second quarter, revenue from Residential Heating & Cooling was a record $716 million, up 10%. Volume was up 8%, price was up 2% and mix was down 1%. Foreign exchange had a positive 1% impact on revenue. Residential profit was a record $154 million, up 9%.

Segment margin remained at a record 21.5% level. Segment profit was positively impacted by higher volume, higher price, sourcing and engineering-led cost reductions, lower SG&A expenses and favorable foreign exchange.

Offsets included unfavorable mix, higher commodity and freight costs, distribution investments and higher other product costs. Residential also had a smaller favorable annual warranty adjustment this quarter than in the prior quarter -- prior year quarter, which resulted in a $2 million headwind year-over-year.

Now turning to our Commercial Heating & Cooling business. Commercial revenue was a record $292 million, up 13%. Volume was up 10%, price was up 2% and mix was flat. Foreign exchange had a positive 1% impact on revenue. North America Commercial HVAC equipment revenue was up mid-teens. National Account Services revenue was up more than 25%. Europe Commercial HVAC revenue was down mid-single digits.

Commercial segment profit was a record $53 million, up 18%. Segment margin was 18%, up 70 basis points. Segment profit was positively impacted by higher volume, higher price, sourcing and engineering-led cost reductions and favorable warranty adjustment. Partial offsets included unfavorable mix, higher commodity and freight costs and higher other product costs.

In our Refrigeration segment, which excludes the noncore businesses in Australia, Asia and South America being divested in 2018, revenue in the second quarter was $150 million, up 2%. Volume was up 1%, price was up 1% and mix was down 1%, with foreign exchange having a positive 1% impact on revenue.

By region, on a reported basis at actual currency, North America was down mid-single digits and Europe was up more than 30%. Refrigeration segment profit was $22 million, up 5%. Segment margin was 14.9%, up 40 basis points. Segment profit was impacted by higher volume, higher price, engineering-led cost reductions and sourcing benefits, including selling refrigerant allocations in Europe and favorable foreign exchange. Partial offsets included unfavorable mix and higher commodity freight and other product costs.

Overall for the company on an adjusted basis, the second quarter had net after-tax charges of $11.3 million. This included a $31.4 million asset write-down related to the Refrigeration divestitures, a net gain of $18 million from the sale of Australia and Asia businesses and Sydney area real estate and a net gain of $2.1 million for various other items.

Corporate expenses were $23 million in the second quarter, down from $24 million in the prior year quarter. Overall, SG&A on a GAAP basis was $161 million in the second quarter or 13.7% of revenue, down from 15.3% in the prior year quarter.

On an adjusted basis, SG&A as a percent of revenue was 13.5% in the second quarter, down from 14.7% in the prior year quarter. Net cash from operations in the second quarter was $49 million compared to $59 million in the second quarter a year ago. Capital expenditures were $21 million compared to $19 million in the prior year quarter. Free cash flow was $28 million compared to approximately $41 million in the second quarter a year ago.

Total debt was $1.35 billion at the end of the second quarter and we added -- and we ended June with a debt-to-EBITDA ratio of 2.2. Cash and cash equivalents were $39 million at the end of June. The company paid $21 million in dividends and $200 million for stock repurchases in the second quarter.

Now before I turn it over to Q&A, I'll review our outlook for 2018. Our market assumptions for 2018 are unchanged. For the overall -- 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 up low single digits.

Looking at revenue guidance on a GAAP basis. We now expect 4% to 6% growth, factoring in the timing of the Refrigeration divestitures and neutral foreign exchange. On an adjusted basis, given our underlying market assumptions, our targets for market share gains and the company's first half performance, we are raising our range from 4% to 8% with a positive 1% benefit from foreign exchange to 6% to 8% with neutral foreign exchange.

GAAP EPS guidance from continuing operations for 2018 moves from a range of $8.79 to $9.39 to a new range of $9.43 to $9.83 after second quarter results and incorporating the gain from the Sydney real estate into our guidance with the completion of that transaction. We are raising adjusted EPS from continuing operations guidance for this year from $9.75 to $10.35 to a new range of $9.95 to $10.35.

Now let me run through some of the key points in our guidance assumptions and the puts and takes for 2018. First, the guidance points that are changing. As Todd highlighted earlier, we are raising our guidance for the year from $50 million to $75 million. We are raising our price guidance for the year from $50 million to $75 million, which will offset the headwind you see from commodities, freight and tariffs. And of course, we are attacking all those headwinds with sourcing strategies as well.

Foreign exchange is now expected to be neutral for the year versus prior guidance of a $5 million benefit. We are raising our stock repurchase guidance for this year following $150 million of purchases in the first quarter and $200 million in the second quarter. We now plan to repurchase $450 million of shares in total for the year, up from prior year guidance of $350 million. Accordingly, our weighted average diluted share count for the year moves from a range of 41 million to 42 million shares to approximately 41 million shares.

Now for the guidance points that are unchanged. We continue to expect $35 million in savings from our sourcing and engineering-led cost reduction programs. We still see $7 million in savings from our residential factories as we focus on automation at our U.S. plants and other productivity initiatives. Investments in distribution will still be a $10 million headwind this year, and we still expect SG&A to be a $10 million headwind as well.

A few other guidance points. Corporate expenses are still targeted at $85 million this year. Net interest expense is still expected to be approximately $35 million for the full year. Tax rate guidance remains 22% to 24% on an adjusted basis for the full year. Capital expenditures are still planned to be approximately $100 million in 2018, and $395 million in free cash flow is targeted for the full year.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Jeff Hammond with KeyBanc Capital Markets.

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

Just couple questions on Residential. One, did you see any prebuy in your Allied brands? And two, can you just speak to the negative mix dynamic?

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

On the prebuy, it's always hard to know. But our guess is 0 to $10 million of prebuy across all the brands. On the Residential margins, as we said on the call, it was 21.5% at record levels. Our first price increase that we put in at the end of last year was to offset the headwind from commodities and we did that in the quarter.

But in Q2, Residential also had $4 million of headwind from freight rate increases. The mid-June price increase will offset the headwind from both commodities and freight, and we'll be better positioned for margin expansion in the second half of the year with Residential.

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

Okay. And then can you just -- the -- so it seems like the incremental costs are really freight and then this tariff dynamic. Can you speak -- what are you seeing on the tariff specifically, is that sourcing motors, et cetera?

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

Yes. Short answer is yes. It's the 301, the one that came out that's already been implemented plus the -- our best understanding of the $200 billion -- excuse me, $36 billion or $34 billion that's already been implemented and then the $200 billion that's going to be implemented. Our sort of best understanding of the future one plus our current understanding of the one that's already implemented, for this year, about $5 million headwind. And yes, it's primarily motors and electronics and to a lesser degree, some of our controls from China.

Operator

Our next question come from the line of Tim Wojs with Baird.

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

Nice job. So just on mix in Residential, it looked like the new construction and R&R markets grew kind of similar rates. So just kind of curious what you're seeing in terms of mix. Are you seeing any sort of trade down kind of within R&R around the price increases?

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

No, no. I mean, we continue to see within each of the segments sort of the natural mix up and that continues to be the case. And so no, we haven't -- the -- sort of the opposite when people know there are price increases happening, they'll do the preload plans that we put in place, and those tend to be a richer mix. So no, I mean, we haven't seen any pushback on the price.

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

Okay. And then just on raw materials. I know you're mostly hedged for this year. But any flexibility to hedge more now that copper and aluminum have moved lower just as you look into '19?

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

We have -- I think the right word will be thoughtful hedge strategy where we have a band and we can either be in the middle of the band, the high end or the low end of the band, then we have rules in place that we react to it. So we're not commodity speculators. But we try and react to drops in the market.

Operator

Our next question comes from the line of Ryan Merkel with William Blair.

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

So first, on incremental margins, I think you put up 23% this quarter adjusted. I think we were talking about 30% for the year. But are we -- is that still in the cards and why or why not?

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

I think if you take the midpoint of our guide, we are a little bit below 30%. And I think the thing that we've seen is first half of the year, we were chasing freight and chasing the tariffs, and we've now put in place a price increase. I think second half of the year, we'll probably be closer to 30% on a full year basis. We'll probably be a little bit below it.

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

Okay. And then secondly, on price cost, it sounds like the second half, you expect the spread to be a little bit better, but just clarify that for me, if you would.

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

I think what we are saying again, to repeat, is -- and what we saw in second quarter was if you added freight of $6 million to the commodity increase year-over-year, it was greater than what we got with price because the first price increase was really focused on just offsetting commodities. Second price increase will help us offset the freight.

And so for the balance of the year, what we're guiding -- or on a full year basis, we're guiding $75 million of price headwind of $50 million from commodities, $20 million from freight and $5 million from tariffs. So on a full year basis, we'll offset everything. First half of the year, we weren't able to offset freight, so second half of the year it should be positive.

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

Got it. And then just lastly, you mentioned July is off to a good start. Can we just get a few more details in terms of the growth rate and any segment color?

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

Yes, I'm not going to give the exact growth rate. It just -- I mean, you all can read a weather map and when it says hot, it helps us quite a bit. So it's early, but July is off to a nice start. We also had a nice backlog in our Commercial businesses, both Commercial HVAC and Refrigeration in North America.

For the quarter, for the third quarter, July and August, there are about 30% of the shipments in each and then September is just under 40%. So we still have a lot of work still in front of us.

Operator

Our next question comes from the line of Gautam Khanna with Cowen & Company.

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

I wanted to follow up. I thought I heard this right, that National Account Services was up 25% plus?

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

Yes.

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

And that was on, if I recall, a big comp from last year, right? So what's going on there? Can you...

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

We have a really good team there. And it's -- we -- when things start to kick in on a business model, you get a really positive flywheel effect. And so all the work that we've done on our national account equipment business tied into our service business and then increasingly, what we're trying to do with our controls business with our ICON controls, we've put together a nice package.

We think we're -- we have the right cost structure to go after these large national accounts who want service from us. And so it's a reflection of a multiyear strategy. We've been showing charts for 4 to 5 years saying that this is a good business for us. We want to grow it and second quarter was a nice quarter for us.

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

And so presumably, the momentum should continue into Q3 despite the tough comps and...

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

I think it continues. I'm not sure we grow 25% a year or 25% each quarter. But we said we're going to grow double digits, mid-teens in this business. And that's what we've done the last 4 or 5 years, and that's what we expect to continue to do.

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

Okay. I wanted to also know if you could calibrate us on Q3 given last year had some weather, just the hurricane disruptions. Just how should we think about the incremental margins in Q3 given the price that you mentioned, the price actions plus? I don't know if you ever had a chance to quantify what the negative drag last year was in Q3 from the hurricane disruptions.

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

Yes, I think we've been reasonably balanced around that. I don't think we bitched too much about it in third quarter and then we haven't promised too much coming out of it. So I mean, it had some impact in Houston and Florida, but I don't think it had a major impact.

I -- what we've said for the second half of the year is that we have priced to offset commodities and freight and we should expect a better drop through second half of the year than we saw first half of the year.

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

Okay. Last one for me, if you will. You upped the buyback a little bit now with the proceeds from the divestitures. Could you talk a little bit about the M&A pipeline, if there's been any change there?

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

No. I mean, M&A pipeline, we've been -- we've had the luxury of growing organically, both within markets that are growing and gaining share. We've been pretty clear that we'd want to consolidate the North America HVAC, unitary HVAC market. But others would have to decide, they wanted to exit.

We've said that the right acquisition in Europe might make sense. But that's not a priority for us. And so I guess, that's consistent with what we've said in the past and that's still true today.

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

Great results. Congratulations.

Operator

Our next question comes from the line of Nigel Coe with Wolfe Research.

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

Just a couple of quick questions, we covered a lot of ground here. You mentioned the Marshalltown facility. And first of all, apologies to all affected. What (inaudible) -- you mentioned very clearly in your PR that you've got countermeasures in place.

But what does this do to factory loading in 3Q in Mexico and South Carolina? And what -- the -- I'm assuming there will be some freight costs (inaudible) as you rebalance the manufacturing. Would you exclude those costs in 3Q?

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

The -- to just be clear about it, we're still fully assessing the extent of the damage. The manufacturing facility in Marshalltown sustained damage to sections of the roofs and the walls and portions of the manufacturing floor. Our distribution center that's located there wasn't damaged at all. So a lot of the finished good products, ready to ship.

As we said in the call, we're enacting recovery and operational contingency plans very early. And so I understand your questions. But the honest answer is we're not sure internally exactly how we're going to handle this and what we're going to do except for the point that we made in the press release that we're committed to taking care of customers.

And one of the luxuries of owning your own distribution is we have a lot of product in the field, more than 40 days. And for some of the product we produce in Marshalltown, significantly more than 40 days is out in the distribution network. And so we're going to work through it and we'll keep investors updated as we finalize the status and progress of how we are going to respond.

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

And then just quickly, a quick one on Europe. I know you're not -- Europe's not a big market for you. But we saw strong trends in refrigeration. We saw weak trends in commercial HVAC. There's a little bit of noise around European trends. But just, from your perspective, from your perch, what are you seeing in Europe? Would you expect that market to weaken over the balance of the year?

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

Our HVAC business was down just because of lumpiness of a couple major customers. So significant piece of business that we did last year didn't repeat this year. Our Refrigeration business was up nicely. We think Western Europe is where we play predominantly. France, Spain, Germany, we think it's going to be up low single digits and we think that will remain for the balance of the year.

But again, I always use the phrase that we just have a small PO on this market. We serve portions of it and -- but the portions we're serving, we're cautiously optimistic for the balance of the year.

Operator

Our next question will come from the line of Julian Mitchell with Barclays.

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

Maybe just a question, Todd, to you, sort of drawing on your long experience in this industry. Looking out beyond the sort of price cost gyrations week to week this year, when you're thinking about the typical period after you've had a lot of input cost inflation and price reaction by the HVAC manufacturers, how much of a carryover does there tend to be in terms of a tailwind for HVAC margins in the subsequent period once that cost inflation dies down?

If you think back sort of historic cycles and any reasons why, say, next year might be different versus history?

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

Well, if I understand the question right, I'd answer it this way, is -- once we get price, we don't give it back. And so we get price to offset commodities. And then if commodities go down, then margins go up, and we had several years where that was the case.

And so I would think about it as the price increases that we are getting in June will have -- rounding half a year impact this year and then there will be carryover into next year. And if commodities continue to rise, then we'll pass on additional price. So I think that's how I think about it. When you get price, you never give it back. Commodities go up and down.

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

And the competitive dynamic is pretty similar now. Have you seen any changes there in recent months or quarters?

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

We've seen all our competitors announce similar price increases. Our best sense in the field is that they're implementing them. And I think you can see by our results that we're certainly not losing share. My guess is we're gaining share through the first half of the year, both in res and in commercial.

So we're not giving up any market share position by implementing prices. And I think our competitors are doing the same thing. Not gaining share, but I think our competitors are passing on price.

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

And then lastly, the gross margins were down in Q2, having been up in the first quarter. Do you think we should see them coming back in Q3 or it's more towards the end of the year, you'll get the gross margins up again?

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

I think I'll take it on the round and say we think gross margins will be up second half of the year. And so what we saw in second quarter was for the corporation, we had about a $6 million headwind from freight that wasn't offset by price. With the June price increase, we now will be able to cover that plus commodities. So we think second half of the year gross margins will start to grow again.

Operator

Our next question will come from the line of Rich Kwas with Wells Fargo Securities.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Just on the freight thing. So with regards -- I mean it doesn't seem like that's going to slow down anytime soon. So as we think about '19, will you have to put an incremental price increase to cover what could happen as we think about '19?

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

There's a couple, sort of, what-if scenario. I think I just directly answered it. We'll keep our eyes on commodity, freight and tariffs. And just like we've priced -- with second half of the year to offset those. As we go into '19, we'll price to offset them too.

Similar to commodities, our competitors will see freight just like we will and our competitors import the same motors and controls and electronics from China that we do. And so short answer is we'll price to offset the inflationary headwinds that we see.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

And the current price increase that you just put through midyear, does that cover the incremental $5 million on the tariff for next year?

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

Yes.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

All right.

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

Sorry, the price increase we put in effect this year offsets the $5 million we're going to see in 2018 for the tariffs. That's the guide I gave.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

All right. But -- so then there would have to get an incremental price increase at year-end to get in -- to cover the [slap-over] impact?

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

I think you could take a look of us guiding that -- from $50 million to $75 million in price and additional $25 million coming from the midyear price increase. I think you can sort of do the math that there's going to be, I don't know, significant -- but carryover of that price increase that I think will offset some of the commodity increases that you're talking about, some of the tariff increases you're talking about.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right. But on the freight standpoint, it sounds like you're -- the likelihood of you being caught again, as we go into '19, is less. You're watching it more closely or...

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

We're certainly watching it more closely. I think it's similar to what commodities did to us last year, 2017, as they start spiking up during the middle of the year. I mean, we're going to keep our eye on it and see what happens. Unfortunately, I think tariffs and freight will move in opposite directions, right? So if tariffs goes up, maybe there won't be quite as many freight requirements.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right. And then 2 other quick ones. On the guide for the incremental for the second half, that does not include any potential negative impact from Marshalltown?

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

Yes. I think it's trending. Short answer is yes. But we're going to sort of work through and try and minimize all that.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right, right, right, understood. And then just -- it seems like in the field, your -- one of your value-oriented competitors is still struggling on a fulfillment standpoint. So with the mix this quarter, with 13 SEER -- 13/14 SEER, a bigger percentage of the mix, were you able to pick up some share here this quarter? Was that clear or is that -- what you could be seeing out there?

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

No, I tell you, I think the mix was about the same this year as it was a year ago. And again, I think it reflects we're trying to gain share in multiple places. I think overall, we gained share. And we are competing at the low end, but we're also -- we're ready to mix up. And as I talked about, when you have these price increases and you're sort of moving product out, you have a tendency to mix up.

Operator

And our final question will come from the line of Walter Liptak with Seaport Global.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

I wanted to ask about the tariffs and just wanted to clarify that in your view, all the discussion about tariff is more of a cost issue and not a supply issue. And I guess, what I'm trying to get at is, do you start to look at North American suppliers, especially U.S. more favorably, with what's going on with kind of trade war with China?

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

I think right now, it's just a cost issue. And the ground keeps moving. So we're constantly assessing what's going on, where we are at and what's the right play. So depending on what happens, maybe we change our supply chain.

But right now, it's $5 million of headwind. We have good suppliers in China. And we're talking to our suppliers, as Joe mentioned and I mentioned in the script, about are there other options on where they can produce some of our components other than China that will be cost advantage to us -- or cost advantageous to us, and we continue to work through those strategies.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. And then just a last one. I don't think you talked too much about cold storage. But there's some discussion that tariffs are having an impact on meat inventories. And I wonder if that is -- it's too soon to start thinking about more cold storage going into the U.S.?

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

I don't -- I'm not sure we've seen that phenomenon sort of play out the tariff impact. More broadly, we had a little bit of slowdown in the first half of the year in our cold storage business. And you saw it a little bit in the revenue numbers in this quarter in North America where we were down in our Refrigeration business.

But we have strong backlog going in the second half of the year. Cold storage has been a growth segment for us over the last 2 or 3 years. And after slowing down a little bit in first half, we're pretty optimistic second half.

I don't think that has anything to do with tariff. I think that's just longer-term macro trends around people wanting prepared food and fresh food either delivered to their homes or supported in their grocery stores. And we think we're in a good position to handle that market.

Operator

And with that, speakers, I'd like to turn it back over to you for any closing comments.

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

Thanks a lot, operator. To wrap up, with record performance in the first half and a strong start to the third quarter, we are raising our guidance for 2018 and look forward to continued strong growth and profitability in the second half of the year. Thank you all for joining us today.

Operator

Thank you. And ladies and gentlemen, that does conclude your conference call for today. Thank you for your participation and for using AT&T Executive TeleConference Service. You may now disconnect.