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IR - Q3 2016 Ingersoll-Rand PLC Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2016 / 2:00PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Ingersoll-Rand third quarter 2016 earnings conference call. At this time all participant are in a listen-only mode. Later we will conduct a question and answer session and instructions will be given at that time. As a reminder, this call is being recorded. I would now like to turn the call over to Zac Nagle, Vice President of Investor Relations.

Zac Nagle - *Ingersoll-Rand PLC - VP of IR*

Thanks, operator. Good morning and thank you for joining us for Ingersoll Rand's third quarter 2016 earnings conference call. We released earnings this morning. You can find our news release, our earnings presentation and our webcast to this event on our website at IngersollRand.com. We are also archiving this call on our website.

Please go to slide 2. Statements made in today's call that are not historical facts are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities law. Please see our SEC filings for a description of some of the factors that may cause our actual results to differ materially from our anticipated results.

This presentation also includes non-GAAP measures, which are explained in the financial tables attached to our news release. The participants on this morning's call are Mike Lamach, Chairman and CEO, and Sue Carter, Senior Vice President and CFO. With that, please go to slide 3 and I'll turn the call over to Mike.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Thanks, Zac, and thanks everyone for joining us today. I'm going to begin by discussing our strategy and how as a foundation our business operating system drives top tier financial performance for shareholders. Sue will provide more details about the quarter financials and guidance then I'll close with a few comments before we answer your questions.

As a matter of strategy, more than 90% of our product portfolio directly addresses demands for greater productivity and energy efficiency with lower greenhouse gas emissions in buildings, homes, industrial and transport markets around the world. The strength and resiliency of our portfolio comes from our leadership in growing markets that are durable because these markets are central to addressing the global strategic imperative to dramatically reduce greenhouse gas emissions and to conserve resources.

Our business operating system is a systematic way our people work within the Company to deliver against our strategy globally. It is a holistic approach that establishes strong baseline execution expectations, then builds on those expectations through continuous development of people and improvement of processes and standards. Respecting and engaging our people in the development and maturation of our business operating system makes it sustainable. It is a core element of what it takes to win over the long-term. Rigorous execution of our business operating system has enabled us to deliver consistent top tier financial performance across key metrics including organic growth, incremental margins, EPS growth and cash flow conversion over many years.

The third quarter demonstrated our consistent progress against these key metrics. We delivered strong organic growth of 3% across our diversified portfolio. We had record operating margins of 14.1% and drove leverage through the P&L resulting in adjusted EPS growth of 17%.

Year-to-date free cash flow is more than 100% adjusted net income, demonstrating our ability to convert earnings into real cash -- a fundamental driver of valuation. Record margins in the quarter were primarily driven by continued strength in our climate business where adjusted operating margins expanded 90 basis points to 16.7% with particular strength in our commercial and residential HVAC businesses.

We are also pleased to report that our industrial business turned in a positive direction in Q3 moving adjusted operating margins higher by 180 basis points sequentially to 11.6%. Adjusting for the capitalized costs that we discussed last quarter of 1.1 percentage points, the business improved 70 basis points sequentially from 10.9% to 11.6%.

The actions we've been taking to improve the business are taking hold and we believe we saw margins bottom in the second quarter. Improved profitability was driven by operational excellence in our continued focus on delivering innovation centered on energy efficiency, sustainability, system reliability as well as disruptive game changing technological advancements in areas like controls and digital connectivity.

In Q3 our overall growth was led by our commercial and residential HVAC businesses in North America where we continue to see strong double-digit growth and market share gains. Our performance in 2016 is a direct result of the continuous long-term investment program prioritized around a clear set of opportunities and managed from inception to launch by focused and committed product growth teams.

The net result is that our product growth teams averaged a growth rate about four times higher than our overall average growth rate in quarter three. Continuously delivering innovation through our product growth teams is one way we produce strong financial results and stay ahead competitively.

Another key driver is our commitment to being the leader in energy efficient and sustainable products. About 10 days ago the 28th meeting of the parties to the Montreal protocol was held. At that meeting about 200 countries agreed to an amendment that phases out hydrofluorocarbons beginning in 2019 and aims for an 80% production in their use by 2045. For several years now we have been planning for the phase out of hydrofluorocarbons and over that time we have been a leader in developing several commercialized, next-generation, low global warming potential products that meet and exceed the transition requirements to help customers achieve their sustainability goals.

Two years ago we made a public climate commitment to a 50% reduction of refrigerant greenhouse gases in the footprint of our products by 2020 and the transition out of curb refrigerants before 2030. We did this to help customers plan for the transition period based upon their business needs and system requirements. We are on track to complete our commitment goals and to date have avoided approximately 2 million metric tons of CO2 equivalent globally.

Another example is our equalized product portfolio. Typically when an eco-friendly refrigerant is used in a system, it reduces efficiency and can sometimes compromise safety. For example, the gas might be flammable or more toxic. With the introduction of our equalized product portfolio, we've had only developed a low global warming potential refrigerant product.

We've also designed it so the product or system is more energy efficient. A prime example of this is our new line of centrifugal chillers that have near zero global warming potential, do not concede safety and deliver 13.5% better efficiency than chillers using hydrofluorocarbons. So now a customer is not choosing between being green or being efficient, through equalized they're able to do both.

Growth with these products has been excellent. In Europe, for example, the equalized portfolio growth has nearly doubled over the last year and we see a healthy pipeline of high profile jobs coming in like the Chunnel Tunnel between France and the UK. After considering retrofit of their equipment, our expert technical team worked with Chunnel operators to install units from our equalized portfolio this year.

With near zero global warming potential, the units will allow a savings of around 40% of the electrical energy use in the Chunnel's cooling system. And to give you some perspective, the energy savings for this project is about as much energy than the island of Aruba generates annually as a savings of 53% compared to the customer's former units that we replaced from one of our competitors.

Vertical integration is another way that we drive growth and leverage technical know how across our climate and industrial segments. Our vertical integration and compressor technology is one area of real competitive advantage because we engineer and manufacture our screw centrifugal and the majority of our scroll compressors. We own the intellectual property and accelerated our time-to-market with these products.

Through our energy efficiency strategy, the next generation R-Series air compressor that we introduced in Q3 incorporates the latest advancements in variable speed drive technology to increase air flow output up to 15%, reduce energy costs up to 35% with an increase in system reliability. Customers are finding the product offering compelling and we are outpacing the market growth rate as a result.

These are just a few examples of how we're making investments in long-term innovation, energy efficiency and productivity to stay ahead of the competition and in front of an increasing regulatory environment. We are also tieing in services, controls and wireless to our products so they are leading edge as technology continues to move quickly.

We continue to see double-digit increases in our commercial HVAC controls business and high single-digit growth in services. In compression technologies we also realized mid-single-digit growth in our after-market business. Our multi-year trend in after-market growth is consistent with our strategy to drive service penetration across our segments and create a more resilient portfolio.

Turning to cash and capital allocation, Q3 was another quarter of steady and strong cash flow. Year-to-date free cash flow is nearly $1 billion. Over the past five years, our cash flow ROIC has averaged 18% per annum.

A top priority is to increase shareholder returns through high ROIC investments in our business that build a platform for consistent cash generation and investment and growth in innovation. Our long standing commitment to organic, long term strategic investments is what has enabled us to perform well in both up and down climate or industrial cycles over the years. As an example, in 2016 we've invested heavily in channel investments that will improve growth by penetrating key markets over the next several years.

In addition to fully investing in the business, we've spent $250 million in 2016 on share buybacks. We've raised our dividend twice, 10% in February and an additional 25% in October and we continue to have an increasing pipeline of interesting M&A opportunities.

Our consistency end performance and a result in strong cash flow and a healthy balance sheet puts us in an excellent position to maintain significant optionality to move quickly across any or all capital allocation fronts as opportunities arise in this uncertain and often volatile global economy.

Before I hand things over to Sue I want to hit on three key areas that we know are important for you to understand based on our conversations with many investors.

Turning to slide 4, I'm pleased with the progress of our industrial segment in the third quarter and we believe we remain on track to achieve our guidance for 2016 margins of 10% to 11%. The continuing actions we've taken and are taking to deliver improvement are taking hold. We continue to focus on operational excellence initiatives, restructuring and reducing costs, increased focus on parts and service and here we're already seeing growth in the service business but we believe we can step on the gas even further in this area.

Segmentation and focus on growing markets like food and beverage, pharma and electronics and continuing multi-year product, channel and machining investments to achieve strong leverage when the markets recover. It's important to note, based on the actions we've taken and what we're seeing in the business, that we believe Q2 mark to [trough] in operating margins for the business and we're expecting improved performance going forward in 2017, though the results may not be a straight line up quarter-to-quarter.

If you turn to slide 5 the main takeaway here is that the Thermo King business is resilient. We saw this in the third quarter where revenues were down but margins moved higher. For 2016 we continue to see the business being consistent with the expectations we set out in July. The team deserves a lot of execution credit there for improving margins on declining revenue and for building a more resilient and valuable franchise over time.

Quarter three is a great example. The transport business grew margins on a 12% lower revenue base. We do expect about a 20% decline in trailers next year. But we believe we should be able to mitigate some of the downside by growing the business and other regions and in other TK products.

Moving to slide 6. Another topic on the minds of investors is how the dodge data for non-residential put in place translates to Ingersoll Rand. Here I think it's important to lay out where our business comes from and what drives the market. I think the market overestimates our exposure.

As the chart shows, the North American commercial HVAC segment is about $4 billion. It's split about 50/50 between services and equipment. Of the equipment, about 65% is replacement business, so not new put in place. The result is that our dodge put in place data just covers about 18% of our business.

Additionally, when you drill down further into the 18%, about 50% is commercial and 50% is institutional. Institutional is expected to show good growth in 2016 and even better growth in 2017. Our data says North American commercial HVAC will be mid-single-digits in 2016 and a similar number in 2017. So we continue to see a healthy market going into next year. And with that I'll turn things over to Sue.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Thank you, Mike. Lets go to slide 7. I'd like to begin with a summary of main points for you to take away from today's call. As Mike discussed, we continue to execute the core tenants for our business operating system in Q3, building upon our strong 2016 performance across the three pillars of growth, profitability and cash flow. Adjusted earnings per share was up 17% on 3% organic revenue growth. Cash flow was 180% of net income for the quarter. Our performance was highlighted by record results in our North America commercial and residential HVAC businesses where we captured additional market share while at the same time expanding margins year-over-year.

In our industrial business we drove 180 basis points of improved operating margin performance sequentially. We continued to take further actions on operational excellence initiatives, increased our commercial focus on after-market parts and service and added cost reduction activities to improve operating results going forward. The margin improvement was 70 basis points after adjusting Q2 margins for capitalized new product engineering and development [costs] that we highlighted in last quarter's earnings material.

We believe we are largely maintaining or growing market share across the portfolio despite continued soft industrial end markets. During the quarter we also extended our strong free cash flow performance by $644 million bringing our year-to-date total to $992 million, up $527 million from the prior year.

Given our long-term expectations for strong earnings and cash conversion, we also increased our dividend by 25% in October to $0.40 per share, or $1.60 annualized, making our dividend highly competitive, not only in our peer group but across the border market. Additionally, we now believe our free cash flow for 2016 will approximate $1.3 billion, up more than $200 million from our previous guidance of $1 billion to $1.1 billion.

We've also increased our earnings per share guidance for the year given our year-to-date performance and outlook. Our revised guidance of between $4.17 and $4.22 is higher by $0.14 at the midpoint reflecting the flow-through of our Q3 over performance versus our Q3 guidance midpoint and an $0.88 to $0.93 fourth quarter. The fourth quarter of $0.90 to $0.91 at the midpoint is consistent with our prior guidance.

On the next several slides I will highlight the key messages for this earnings call. Please go to slide 8. Our strong enterprise performance on organic growth, earnings per share growth and cash flow conversion was highlighted by our North America HVAC businesses and by sequential operating margin improvement in our industrial segment versus the prior quarter. Organic revenue was up 3% as adjusted margins improved 30 basis points year-on-year with 30% operating leverage. Our business operating system, again, guided us through good execution in our factories and in our cost centers. Our focus was on good operating results in a low-growth environment and we delivered against that objective.

Please go to slide 9. Organic orders continue to be solid through the third quarter of 2016 led by our climate business and partially offset by soft industrial markets. Climate orders were up 4% organically. Organic global commercial HVAC bookings were up mid-single-digits led by low teens growth in North America unitary. We also continue to drive excellent growth in service, controls and contracting with low teens growth in the quarter. Residential bookings were solid, up mid single-digits.

Organic transport orders were down low single-digits with order growth in Europe and Asia offset by declines in North America trailer and auxiliary power units. Consistent with our guidance, we continue to expect bookings to decline in North America trailer. On balance the industrial businesses were down flat to down modestly and we are calling a broad based recovery in the near term.

Please go to slide 10. This slide provides a directional view of our segment revenue performance by region. In our climate segment we saw solid performance in both North America and Latin America and low single-digit growth in the Middle East. In our industrial segment overall performance was essentially flat with high single-digit growth in Europe, Middle East and Africa due to the shipment of large orders in the Middle East and mid-single-digit growth in Asia offset by declines in North America and Latin America.

Please go to slide 11. Climate performance was strong in the quarter and with organic revenues up 3% and adjusted operating margins up 90 basis points. Commercial HVAC organic revenues were up mid-single-digits, highlighted by exceptional growth in North America contracting up 17%. And unitary equipment in North America up low teens.

In Europe, business was unusually light impacted by the slowdown in activity during the summer holiday season driving mid-single-digit equipment declines. Europe services, contracting and parts were flat. Residential continued their outstanding year with revenues up low teens.

Transport organic revenues were down low teens in the quarter driven by weakening North America trailer and soft APU and marine markets. Despite lower revenues, margins expanded 110 basis points with increases in both North America and Europe, Middle East and Africa. This demonstrates the more resilient franchise we discussed. Growth in aftermarket parts and services, trucks and in Europe trailers drove higher margins and helped mitigate the impact of the downturn.

Please go to slide 12. Climate reported operating margins expanded 110 basis points year-over-year. Volume and mix were favorable across commercial and residential HVAC, partially offset by volume in transport. Price and direct material deflation and productivity also contributed to margin improvement. Additionally, we continue to invest in the business to drive innovation and growth.

Please go to slide 13. Third quarter industrial margins improved 180 basis points from second quarter trough margins on 1% organic revenue growth. Margin improvement was still solid at 70 basis points when accounting for Q2 2016 capitalized costs related to new product engineering and development of $8 million that we discussed last quarter. Excluding those costs, Q2 margin was 10.9%. Industrial end markets remained soft in Q3 and are expected to be soft through 2016.

Revenues were up mid-single-digits in compressors with growth in after market, oil free and large machines with easier comparisons to the prior year. Other industrial products were down low teens with material handling showing the largest decline due to oil and gas exposure. Small electric vehicles were down slightly in the quarter.

Please go to slide 14. Industrials reported operating margin of 10.9% was down 300 basis points versus prior year. Volume and mix were the largest drivers of this decline. Pricing offset materials, but given the continued low volumes running through our factories, productivity did not offset inflation in the quarter. We continue planned investment in our products and channel and restructuring to improve our cost base. Looking forward, we expect margins to improve in 2017 given ongoing margin improvement actions, although we do expect some variability due to cyclicality.

Please go to slide 15. September year-to-date precash flow of $992 million was favorable to prior year by $527 million. Strong operating income improvement and working capital performance were the primary drivers of the favorability. For the quarter, working capital as a percentage of revenue was 4.9%. Our 2016 goal is approximately 4%.

Based on strong performance year-to-date and our confidence in future cash conversion, we have raised our 2016 pre-cash flow forecast to approximately $1.3 billion. This is up more than $200 million from our prior range of $1 billion to $1.1 billion.

We have a proud history of returning cash to shareholders. Since 2011 our free cash flow as a percentage of net income has averaged 100%. Over that same time frame, we've returned more than $6.5 billion in cash to shareholders through dividends of $1.5 billion and share buy backs of $5.1 billion.

You may have noted that we referenced cash flow ROIC a few times today. Our definition is free cash flow divided by gross fixed assets plus working capital. Our goal is period over period improvement in this metric and we are doing well in 2016 with improved free cash flow and balanced capital expenditures and working capital.

Please go to slide 16. Our strong cash performance in the third quarter and our expectations moving forward enable us to, one, continue to invest in strategic growth programs as Mike outlined earlier. In addition to the core strategic investments, we're also investing in long-term growth through innovative and differentiated products in areas such as controls for buildings as a resource, intelligent monitoring and self-healing systems, just to name a few.

Two, we've paid an annual dividend for 106 years and have consistently raised the dividend over time. Over the past five years we've raised our annual dividend at a 20% compound annual growth rate. In October we announced a dividend increase of 25% to $0.40 per quarter or to $1.60 per share annually.

Three, we will continue to purchase sweeping shares sufficient to offset dilution, roughly $250 million per year. Four, we continue to see an increasing number of positive potential acquisition targets.

And five, we strive to maintain a strong balance sheet with triple B metrics to provide optionality as our markets continue to evolve. We will continue to create long-term value for our shareholders through capital allocation as we have consistently done for years.

Please go to slide 17. Our intention is to give you our best view of what we're seeing in our end markets sitting here today and how that translates to our revenue guidance for the remainder of 2016. We've broken it down by major end markets and geographies. As you can see by the variation of colors and symbols, our end markets are seeing a wide variation in trends.

Markets for North America commercial and residential HVAC as well as European transport and commercial HVAC are generally positive while global industrial markets remain soft. We are forecasting global transport markets to be down low single-digits.

Our forecast for North America trailer volumes has not changed and we expect the market to be down slightly for the year. This implies a decline in the second half after single-digit growth in the first half of the year.

Asian HVAC markets are expected to be flat to down and industrial markets in Asia remain under pressure. Golf cart markets are slightly down, offset by increases in the utility vehicle markets.

All of our revenue growth forecasts are shown on an organic basis. We are forecasting mid-single-digit growth in commercial HVAC in total, high single-digit growth in residential HVAC, which is essentially an all North America business for us, and a small decline in transport globally.

Please go to slide 18. Aggregating those market backdrops, we expect organic revenues for the full-year 2016 to be up approximately 2% versus 2015 with foreign exchange presenting a headwind of about 1 percentage point. We expect organic revenues to be up approximately 4% for climate and down 3% for industrial.

Adjusted operating margins, which exclude restructuring costs, are expected to be at the high end of our previous ranges for the enterprise at 12% and for climate at 14.5%. Adjusted industrial margins are expected to be at the midpoint of our previous range of 10% to 11%.

Please go to slide 19. Transitioning to earnings, the reported earnings per share range is estimated to be $5.62 to $5.67 and the adjusted range is $4.17 to $4.22, up $0.14 to $0.15. At the midpoint, this represents a 12% increase in earnings per share over 2015. Adjusted numbers exclude restructuring and the Hussmann gain.

We have raised our full-year guidance for free cash flow more than $200 million to approximately $1.3 billion from $1 billion to $1.1 billion, reflecting continued strong cash flows through 2016. For the fourth quarter of 2016 we expect climate revenues to be up 2% to 4% organically while industrial revenues are expected to be down 6% to 8%. Adjusted fourth quarter earnings per share is forecast to be between $0.88 and $0.93 excluding restructuring charges of about $0.02. The midpoint is consistent with or slightly higher than our previous guidance midpoint of $0.90 per share.

With that, I will turn it back to Mike for a few closing comments.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Thanks, Sue. As we conclude I want to emphasize a few points that I think are important for you to have as takeaways as we head into the final quarter and into 2017. First, we're performing well with a solid strategy punctuated with excellent execution over time. As a result, we have delivered consistent, reliable top tier financial performance on organic growth, EPS growth and cash flow over industrial and climate cycles.

Second, our management team effective at anticipating and seeing around the corners. Our commercial HVAC business is strong and focused on the right growth areas with equipment, controls and service. We believe we have turned the corner with our industrial segment and starting to realize margin improvement versus the quarter two trough.

And our transport refrigeration business is resilient. Our team is capturing margin expansion despite downward sales.

Finally, we're building a stronger, more valuable, more sustainable and less cyclical Ingersoll Rand. The results we reported today are a direct result of the strategic work, persistence and tenacity of the talented people that represent the unique culture we've built. I'm proud of our people who continue to deliver for our customers and our shareholders. Our momentum is strong as we conclude the year and head into 2017.

And with that, Sue and I will now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question for today comes from the line of Nigel Coe with Morgan Stanley.

Nigel Coe - *Morgan Stanley - Analyst*

Good morning.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Good morning, Nigel.

Nigel Coe - *Morgan Stanley - Analyst*

So obviously a very good execution in a really challenging macro, any signs of softening as you enter the quarter? I'm just thinking here about North American commercial you're up 9% orders. Obviously a very good number but you pointed to double-digit for this quarter and I'm just wondering if there was any tailing off towards the end of the quarter that there may be because you missed that 10% bogey.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Like a tenth of a point, Nigel, was the difference. So the good people here would not allow me to round that up as they should not have allowed me to round that up. So but that's the difference.

Nigel Coe - *Morgan Stanley - Analyst*

Okay. And the kind of the funnel of activity -- you mentioned some larger projects in the hopper -- maybe just give some color on that, Mike.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Largely institutional, but we're seeing them around the world. There are some large, lumpier projects. So it's difficult to always know the exact timing but the pipeline looks pretty strong going into 2017. So the backlog 2016 ending will be greater than it was of course 2015 ending and then we've got a good pipeline coming into 2017. So we feel like the earlier comment about 2017 looking a little more like 2016 with perhaps more institutional tailwind and if anything a little less commercial headwind will net out to a pretty good year.

Nigel Coe - *Morgan Stanley - Analyst*

Okay. And then a quick follow-up. TK for next year -- you talk about North American trailer down 20% but you think there's offsets. Can you maybe just talk about -- round out where you see the offsets to that and what do you think is the break point where perhaps it turns into a bigger headwinds for IR? Thanks.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

First, when you think about the TK in and of itself you've got North America down maybe as much as 20%. You've got APUs down. You've got global marine down. Pretty much everything else is going to go up. It's North American truck, truck and trailer, Europe and Asia, air, after market, bus and rail should all go up. So there's a chance that TK pulls off something close to mitigating that. But when you back away and look across the Company, institutional -- it's going to be strong. We think industrial margins will recover. So there's a lot of levers to pull inside the Company and a lot of confidence in the teams that we've got across the Company to make it work. We see EPS growth next year so that's how I would look at it initially.

Nigel Coe - *Morgan Stanley - Analyst*

Great. Thanks, Mike.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Thanks, Nigel.

Operator

Our next question comes from the line of Steve Tusa from JPMorgan.

Steve Tusa - *JPMorgan - Analyst*

So just on the fourth quarter, industrial I think -- just correct me if I'm wrong -- industrial profits are going to be essentially flat quarter-to-quarter. I know there's some moving parts around Cameron that change the seasonality a bit. It's usually up. Anything to read into there? And then secondly, your free cash flow guidance of $300 million, I believe, for the fourth quarter is down pretty substantially from the third quarter. It's bounced around a bit but last couple of years it's been actually definitely stronger than that. So just curious as to those two dynamics and I have a quick follow-up.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Sure, Steve. Let me start out with the industrial comment and the fourth quarter. So you're correct that the operating income is about flat. But what you have is a dynamic in the fourth quarter where you really have more of the large compressors on a year-over-year basis. It's going to a tough comparison. It's going to one of those areas you have tools and material handling which are high margin businesses that are going to be down on a year-over-year basis. So in essence you're going to have a volume challenge. You're also going to have some investments that are occurring in some of the business. For instance we're doing some investments in the club car business as well as in new products for the CTS business. So it's really a story about volume and investments and a little bit less on the industrial side with commodities but also some impact there.

Steve Tusa - *JPMorgan - Analyst*

Okay. Free cash flow?

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Then -- yes, free cash flow -- that's a great question. So what we've done in 2016 is we've really changed the way that free cash flow has come in. So every quarter as we've started out 2016 we've had positive cash flow as opposed to having everything really back end loaded. So, again, I think where we're at $992 million at the end of the third quarter is fabulous.

We've brought it forward and we've brought it forward by paying attention to things like terms on accounts receivable, making sure that accounts receivable is balanced with accounts payable terms across the globe with working through inventories and making sure inventories were there to serve the customer but not too much to have additional product on hand. So we've really managed this very, very carefully. And so what you see in the fourth quarter is really that instead of doing heroics to end the quarter, we've normalized it, which is really how we want to operate the business and how we want our cash flow to come in.

Steve Tusa - *JPMorgan - Analyst*

Okay. Great. And then, Mike, just a quick one. You mentioned EPS growth next year. I think in prior presentations this is fall you talked about top tier EPS growth. I know you had a bit of a low tax rate that helped that growth a little bit this quarter -- still top tier even without that low tax rate. Is there something outside of the fundamentals (technical difficulty) the tax rate going back up or pensions or anything else that kind of will keep you from getting to top tier? And I guess with the fundamentals as they are with all that in, are you still talking that way or is this just hey the bogey is really just growing earnings given the headwinds that we have in TK et cetera.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

I think, Steve, it's a balanced and diversified portfolio. Lots of service. We're investing heavily in the service channel as we've done all year long and that's paying dividends. So I think we have our eyes wide open on some of the challenges but not talking about top tier growth from operations. Sue, you might want to comment --

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Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

So let me comment on the general business first. Steve, as we're going through and we're looking at the business, we still see strength in the commercial business for next year. We see strength in the residential business going into next year. We'll see improving margins coming out of the industrial business. So we're going to get some good play on that.

We're going to remain focused in terms of the price cost spread. We know we'll have a few headwinds on the steel side but we'll still have a bit of deflation that occurs on the basis of copper that we already have locked in and some of the aluminum that we have locked in for 2017. We're also going to hit productivity really, really hard in the business. That's part of our hallmark of our operational excellence and we're going to offset inflation. We're going to continue to press on corporate.

So earnings per share growth next year I think is going to come from all of the different parts of the business as well as tax. Now tax is something that we're really proud of and we're really proud of because it's -- we started to talk about a low 20s tax rate earlier in the year. We got there faster than we expected. But we got there by really doing what we call operationalizing tax, which is basically we assign tax partners to each of our SBUs. They're working projects within the SBUs to actually work down the effective tax rate -- things like trading hubs, things like energy credit, things like really legal entity simplification.

So we've really operationalized that. I think it's kind of cutting edge. I still don't think our tax rate is going to go below the low 20s. I think that's where it should be. So, yes, we'll get some tailwind out of that going into 2017 because I think the low 20s is where we project the rate. But I think it's operational also and something I think that is really good for Ingersoll Rand.

Steve Tusa - *JPMorgan - Analyst*

Right. So the low tax rate is sustainable. That's kind of the bottom line of that conversation. Tax rate is sustainable.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Yes, that is absolutely -- the low 20s tax rate is sustainable.

Steve Tusa - *JPMorgan - Analyst*

Okay. Awesome. Thanks a lot, guys.

Operator

And our next question comes from the line of Julian Mitchell from Credit Suisse.

Julian Mitchell - *Credit Suisse - Analyst*

Thanks a lot. So I guess my first question would be on Thermo King. You sized the 25% of the business is North American trailer. I just wondered if you could give any further splits out of that business in revenue terms. And also just focusing on Europe for a second, you sounded confident about Europe next year. A lot of the truck OEMs there have actually been talking about Europe slowing and maybe volumes falling next year on truck. So maybe just give a little more detail on your Europe perspective for TK.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Hi, Julian. So we start with the quarter that we've got in North America. You can add about 20% or so to Europe and the rest of the world in terms of trailer. Truck is a little less than 20% after market -- a little bit less than 20%. APU and container are high single-digits, bus air and rail are low double-digits. So you've got North America trailer down. We feel pretty good about our plans, pipeline and the other businesses with the exception of [rig] container which we don't think will recover much next year.

Julian Mitchell - *Credit Suisse - Analyst*

Thanks. Then my second question just around the balance sheet. Your net debt has come down very rapidly. There was no buyback in the last few months and you talked a little bit about a fairly attractive M&A pipeline. It's been a while since the last couple of deals. So maybe just give us an update on how you're thinking about sort of size of preferred acquisitions and any sort of financial criteria for them.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Yes, I think one of the things we want to highlight for you was that in the last five years -- and we could go probably a little longer than that -- but 18% per annum cash flow return on invested capital, we're doing well. So even with the timing on Cameron not being great, we didn't lose a beat last year and we're not using a beat this year in maintaining a strong cash flow ROIC.

The kinds of things that seem to populate the list for us would be channel investments and product extensions where we're selling products through existing channels that we have today with the sales force that we have today. There's a healthy pipeline of that. It's probably 50/50 of cross channel versus product. And it's important to be patient there. They would be more accretive if they can be closed than say share buyback at this level. So the optionality is important, to wait it out and make sure that we do the right thing.

Julian Mitchell - *Credit Suisse - Analyst*

Thank you.

Operator

An up And our next question comes from the line of Jeffrey Sprague from Vertical Research Partners.

Jeffrey Sprague - *Vertical Research Partners - Analyst*

Thank you. Good morning, everyone. Two topics, the first one just back to industrial. The comment broad based recovery -- really want to understand what you mean by that. It would appear you clearly mean controlling what you can control and improving operations internally. But are you also, notwithstanding the pressures you still see in Q4, actually calling a turn in those end markets and see visibility of that happening.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Jeff, we're seeing flattening, really, not improving markets -- flattening markets and easier comps coming into 2017. A lot of what we'll do in 2017 is improve margins through the op excellence, restructuring cost activity and then very good product launches coming in this quarter, fourth quarter and next year as well. That's really our game plan for industrial for 2017. We're not counting on a broad based industrial recovery, Jeff.

Jeffrey Sprague - *Vertical Research Partners - Analyst*

Okay. That's what I thought. Thanks. And just back to kind of the institutional markets and what you're seeing in the project book, are those skewed towards new projects? Or is there a lot of retro fit going on in the institutional outlook? And maybe just in general if you could speak to kind of the retrofit pipeline that you're seeing.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

I'd say it's largely energy efficiency retrofits replacing old antiquated systems with newer systems. And those projects can get very large. So we'll see it from universities to healthcare to municipalities, state governments, federal installations. This is pretty much the market that we anticipate continuing through 2017.

Jeffrey Sprague - *Vertical Research Partners - Analyst*

Great. And just actually just one really quick one maybe for Sue -- just pension next year, Sue? Any initial thought?

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

So our pension, I believe, as we look at it at this point is going to be flat for year-over-year in terms of pension expense. So I know lots of people are calling headwind on pension because of discount rates falling. And of course obviously ours are down 75 basis points from year end also. But I think with the way that we have the portfolio set up with the asset returns that we've got, my expectation is that we're going to be flat.

Jeffrey Sprague - *Vertical Research Partners - Analyst*

Right. Thanks.

Operator

And our next question comes from the line of Joe Ritchie from Goldman Sachs.

Joe Ritchie - *Goldman Sachs - Analyst*

Thanks. Good morning, guys.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Good morning, Joe.

Joe Ritchie - *Goldman Sachs - Analyst*

So my first question, Sue, going back to your comments earlier on cash flow -- good job on the working capital. I'm just curious as we think through the bridge to 2017, are there any items that reverse in 2017? Or is the right way to think about your free cash flow growth really EBIT growth should equal free cash flow growth in 2017?

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

What we're focused on is really exactly what you said that the EBIT growth should be the free cash flow growth. And that's exactly what's happening in 2016 is the operating income growth is falling through. Our percentage on working capital is remaining true. We're not having to invest heavily in terms of capital. But we're also doing all of the projects and all of the items that our businesses bring forward that make financial sense. And so if we can keep that rigor going, that is exactly the model we want, which is the EBIT flowing through.

Joe Ritchie - *Goldman Sachs - Analyst*

Got it. That makes sense. And then, Mike, I just wanted to square some comments you made earlier on Thermo King. So with North America trailer down next year and your comments around hoping to offset with other parts of the Thermo King portfolio, can you square that with what your expectation is for op income for Thermo King? Would you expect it to be up next year given that you think there's some natural offsets on the growth side?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Joe, I'm going to punt that down the road here a little bit for us to be honest. We want to dial in what North American trailer volumes will be. We're going probably center around a 20% down number and make sure we don't do anything in the event that it's only down 10% or if it's down 30% we want to optimize cost structure to match it. So I know that at down 15% we're working the plan to be relatively flat. We'll see as we get closer and dial this in but we need a few more months on this before we can really back to you on that.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. Fair enough. Thanks, guys.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

You're welcome.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Thank you.

Operator

And our next question comes from the line of Steve Winoker from Bernstein.

Steve Winoker - *Sanford C. Bernstein & Co. - Analyst*

Thanks and good morning all. Sue, just want to clarify the commentary around price cost heading into the fourth quarter. You've been talking about 20 to 30 basis points spread for the second half. So given the 60 basis point this quarter, should we be looking at flat next year -- next quarter and then into 2017?

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Yes, so let's talk about the fourth quarter first. So you're right. If you do the math and you have an 80 basis point spread for the year, it would get you to flat to maybe 20 basis point spread in the fourth quarter. But what we see happening -- and, again, the third quarter came out better than we had hoped at 60 basis points, which was really about 50/50 material deflation and the other price.

As we start to look at 2017, I think what 2017 does is it reverts to what we've said all along, which is that we would have a 20 to 30 basis point spread between price and cost. And as we start to look at commodities for 2017 -- so steel has moved around a little bit. We saw an increase earlier in the summer to over $800 a ton. We currently see spot prices back in the $700 range. So we have about a six month time lag between when those prices move around and when we see it. Translated, that means I'm going to see some steel inflation in the fourth quarter as well as probably the first quarter of 2017.

However, I still continue to see tailwinds coming out of copper and aluminum going into 2017 helping us to offset that balance. So we have line of sight to what we think the commodities are going to do. And therefore we have line of sight to what our costs are so that we can price per our operating model with top line margin expansion and get back to the 20 to 30 basis points for the year.

Steve Winoker - *Sanford C. Bernstein & Co. - Analyst*

Okay. And, Mike, lean obviously has been so important to your story for IR. But I'm just looking at climate and at industrial this quarter excluding volume and mix and 20 basis points on productivity versus other inflation for climate and down 100 for industrial. What's going on, on a lean path here?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Yes, really it's the volume running through industrial so low on the large equipment, which is where the big heavy fixed costs really tend to sit. So it's more volume dependant. If you look at what's actually flowing through, there's good productivity on that lower volume. So, Steve, the long story short is volume helps productivity. Cost reductions we've taken need volume to apply them too and that's -- it needs to happen in the industrial business.

Look, fundamentally you'll see us turning up the gas again in 2017 and we'll make sure the pipeline -- we try to keep the pipeline 125% of what we think it needs to be. We try to calendarize that by quarter. So what we're doing now and we do every month is make sure that we've got that pipeline lined up to be 125% percent of what we want it to be for our plan, allowing for things to break or timing to be different.

Steve Winoker - *Sanford C. Bernstein & Co. - Analyst*

Okay. Mathematically, though on [page] 14 where you show volumes separately in the water fall chart versus productivity, you're actually saying, look, there's a volume effect running through the productivity as well as in the volume part of that chart.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Absolutely. Because we try and separate productivity on volume from volume and standards.

Steve Winoker - *Sanford C. Bernstein & Co. - Analyst*

Right. Okay. And just -- sorry, one last thing. The replace -- you talk about the replacement market being so significant for IR. Are you seeing as a result of the new investments break-even paybacks coming in shortening for customers -- that's sort of driving shortening of the replacement time frame for specific end markets in any kind of big way?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Yes, I think the combination of sort of the regulatory effect and the thought about getting in front of that when customers have the opportunity plus, from our point of view, there's a passion in the Company around energy efficiency and sustainability. I think you hear that every time you talk to us. That combination I think is helping our people in the field make the story more compelling. And I do think it's led to why we're seeing share gain globally across the board.

Steve Winoker - *Sanford C. Bernstein & Co. - Analyst*

Okay. Thanks.

Operator

And our next question comes from the line of Andrew Kaplowitz from Citi.

Andrew Kaplowitz - *Citigroup - Analyst*

Good morning, guys.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Good morning, Andy.

Andrew Kaplowitz - *Citigroup - Analyst*

Mike or Sue, last quarter you gave us a breakdown of what your industrial business looked like and its major sub-segments. You talked about club car, aftermarket, large machine, small [rotary], small air. You said larger machines I think were trending down 50% and smaller equipment was down a little. How would you characterize those segment -- the sub-segments in 3Q? Did you see any improvement in your large factory exposed air business and do you have any initial thoughts as we head into 2017 on those sub-segments?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Yes, you're seeing some of the smaller equipment growing, which is a good sign. You're seeing really severe contractions in large machines. But we're ready to lap that I think next quarter. And so that's why I think it's going to stabilize where it is. And you're seeing still good growth in oil free machines and contact cool machines that would be supplied into pharma, food and bev, in particular markets. Which, again, the earlier comments

I made were really trying to direct more of that proactive activity into the markets that are actually growing. We don't see a lot of relief coming in iron, steel, air separation, those sorts of markets.

Andrew Kaplowitz - *Citigroup - Analyst*

Okay. Mike, that's helpful. And then on climate, can you give me a little more color? You just had a marginal change in your guidance this year to 4% versus 4% to 5%. When I look at the sort of the pieces, it looks like the only change here is in transport down low single-digits versus flat to down last quarter was your guide. Is that North American trailers, it's just ATUs or marine still being weaker than you thought or is it something else?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

I'd say it's exactly that, Andy. It's exactly what you just said. It's North American trailer, APU and marine being weak and not really a surprise. We've been thinking about this really all year. We thought it would actually be earlier in the year. It's actually in the back half of the year but certainly that's the change really as you come through now the final quarter.

Andrew Kaplowitz - *Citigroup - Analyst*

Got. And as you look into 2017 though, marine is very, very low. Right? So we really shouldn't have an impact from marine anymore at this point.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

I would hope not. We're trying to look at crop yields and other fundamental factors that determine if you're going to see produce and food and perishables move. So structurally you're getting to a pretty low level here.

Andrew Kaplowitz - *Citigroup - Analyst*

Okay. Thanks, guys.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Thank you.

Operator

Thank you and our next question comes from the line of Shannon O'Callaghan from UBS.

Shannon O'Callaghan - *UBS - Analyst*

Good morning.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Hi, Shannon.

Shannon O'Callaghan - *UBS - Analyst*

On the institutional improvement, not only in 2016 but you talked about 2017, when it first started for you, it seemed like it was mainly in K through 12 education. Now it sounds a bit broader than that. Can you talk a little bit more about how that's developed and what kind of visibility you have into it?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

It's the typical way it does evolve. It really is always kind of a K through 12 led institutional recovery in that it moves up through higher ed, through healthcare and eventually with state, city and federal projects. And a lot of that is based on just property values and the ability to tax against those values and have bonds pass local city vote. And so you're into that cycle here now. It's still about 25% below where it was last time on a volume basis. So there's quite a bit of room I think in the institutional side to continue to grow.

Shannon O'Callaghan - *UBS - Analyst*

Okay. Great. And then, Mike, you were talking about some of the M&A in terms of channel investments, product extensions, which all sound like good places to go but they also don't sound very big. The buyback you talked about over the last bunch of years was several years ago. Can you just maybe update us on your current philosophy around buyback? I mean given where the stock is traded, obviously we talked about it for a while but it doesn't seem like there's big M&A on the pipe. So maybe just update us on your philosophy on buybacks.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Maybe to step back even one step further, the first thing we want to do is make sure that we are absolutely investing in the business fully. And I can check the box and say we're absolutely doing that. I can check the box and say we've now put the dividend in a good place relative to the peer group and we're proud of that. So it really does come down to what do you do the with the pieces of this thing.

And if you think about it in the long run, roughly half of the cash either acquisition or share buyback -- we certainly would like to grow the Company but we're not going to do that at the expense of making a poor capital allocation decision. So what you see right now is a large number of channel and potential product extension investments that might fit the portfolio. If we could close, it would be worth the -- the juice is worth the squeeze on those. So that's really why you're seeing us hold back here.

Now, with all that being said, we've continued for at least seven years -- I guess now that I've been saying this -- always controlling dilution of the share count. So as Sue alluded to the fact, that's roughly 2.5 to 4 million shares and we'll continue to make sure it's part of the program going forward.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

And I think what you're seeing, Shannon, just as another point on that is we're going to be patient with this and with the cash that we have because we really want to create long-term value. We'd really like to invest in some of these opportunities. To your point, some of them in the smaller size with channel investments but also in new products. And so it doesn't mean that we are going to just make an either/or decision. We're being patient with the cash that's on the balance sheet and we're finding the best opportunities. But we want to let some of those M&A opportunities play for a little bit and see if we can close them because we think that's important, too.

Shannon O'Callaghan - *UBS - Analyst*

Okay. Great. Thanks.

Operator

And our next question comes from the line of Joshua Pokrzywinski from Buckingham Research.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Hi. Good morning, guys.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Hi, Josh.

Sue Carter - *Ingersoll-Rand PLC - SVP & CFO*

Good morning.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Just a couple questions. First on industrial margins, Mike, you talked about some of the initiatives there to get margins back up, obviously some progress this quarter. But to see the kind of jump back to even 2015 levels for margin -- 2015 levels -- does that require a particular mix to get there beyond just some productivity improvements and running the business more efficiently?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Well mix matters, Josh. I mean definitely if you look at the high margin material handling and tools businesses, they matter a lot. But if you look at a normal mix that we would have seen sort of pre-downturn, about 70% of the downturn that we've seen has been volume-related. The balance being some currency and then some mix. So fundamentally we do need volume to return. But with that being said, if volume doesn't turn next year and we have the same mix of business that we have today, we have a healthy expectation to expand margins in 2017 in the industrial business based on the actions we know we can take at these low levels of volumes. And we'll be bold about that. And you'll see us commit to that probably in February.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. And then just following up on some of your comments on institutional and some of the bigger projects that are in the pipeline, I guess that triggers off a little bit of an alert on performance contracting. So I'm trying to understand maybe some of the mix of orders that are coming in that are more project-related and have some pull-through revenue versus pure equipment-type. I guess it wouldn't be book and ship but more of your own content-type orders. Can you maybe help to mention some of that out for us?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Yes, Josh, I don't have an exact split for you. But I'm amazed at the size of equipment and controls orders that we're getting that are not performance contract-based like the Chunnel Tunnel and I could name a handful of marquee projects like that. So we're winning a lot of that work and we're loading up on that work as well. With that being said, performance contracting is an interesting place for us to play and there is a healthy amount of pull-through that comes both not just in equipment but in service. Performance contracts always have a healthy service component that comes along with the guarantee.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

And when we think about a more institutional mix in 2017, that would have that type of flavor to it?

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

It's going to be large applied and performance contracting. And so it will be equipment and controls and service with and without an energy guarantee is the way to think about that.

Joshua Pokrzywinski - *Buckingham Research Group - Analyst*

Got you. Appreciate it. Thanks.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

You're welcome.

Operator

And we have time for one more question. Our final question for today comes from the line of Robert McCarthy from Stifel.

Robert McCarthy - *Stifel Nicolaus - Analyst*

Good morning, everyone.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Good morning.

Robert McCarthy - *Stifel Nicolaus - Analyst*

Obviously we've covered a lot here, but I guess I'll try on 2017 one more time. I mean, Michael, in the context of the last couple of years on the third quarter call you've definitely -- one year I think you provided a constructive range for EPS growth. And then last year you just talked about kind of the rhetoric around what you liked in terms of your overall HVAC portfolio. But are -- do you think you have a good line of sight to 2017 on a forward basis versus previous periods, in other words from 2014 to 2015? Or are you -- do you think there's more uncertainty in terms of the outlook this time versus the last couple of years when you reported in 3Q.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Robert, I'll tell you I don't have a public point of view that's prime time at this point. So good try. I appreciate the last question as one more shot at it. But we're putting our plans together now and there's a process of all companies to put that together. So I don't want to sort of play our hand here too soon on that. But we understand what top quartile will be. We understand what our goals are, what our operating system is set out to do. And so there's not a lot of acrimony inside the Company to understand what good performance looks like. So that's what you'd expect for us next year and I'll dial that in as we get closer into next year.

Robert McCarthy - *Stifel Nicolaus - Analyst*

Thanks for your time.

Mike Lamach - *Ingersoll-Rand PLC - Chairman & CEO*

Thank you.

Operator

Thank you and that concludes our question and answer session. I would like to turn the conference back over to Zac Nagle for any closing comments.

Zac Nagle - *Ingersoll-Rand PLC - VP of IR*

I'd like to thank everyone for joining today's call. As always, we'll be available for questions today and over the next several days. And we look forward to speaking with you soon. Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may now disconnect. Everyone have a great day.