Q1 2021 Trane Technologies Plc Earnings Call

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Presentation

Operator

Good morning. Welcome to the Trane Technologies Q1 2021 Earnings Conference Call. My name is Mariana, and I will be your operator for the call. The call will begin in a few moments with the speaker remarks and a Q&A session. At this time, all participants are in a listen-only mode.

I will now turn the call over to Zac Nagle, Vice President of Investor Relations.

Zachary A. Nagle

Thanks, operator. Good morning and thank you for joining us for Trane Technologies first quarter 2021 earnings conference call. This call is being webcast on our website at tranetechnologies.com, where you'll find the accompanying presentation. We are also recording and archiving this call on our website.

Please go to slide two. 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 anticipated results.

This presentation also includes non-GAAP measures, which are explained in the financial tables attached to our news release.

Joining me on today's call are Mike Lamach, Chairman and CEO; Dave Regnery, President and COO; and Chris Kuehn, Senior Vice President and CFO.

With that, please go to slide three, and I'll turn the call over to Mike. Mike?

Michael W. Lamach

Thanks, Zac, and everyone, for joining us on today's call. Please turn to slide three. While the pandemic continues to present significant challenges around the world, our strategy as a global climate innovator remains steadfast.

We are innovating rapidly to address complex and pressing sustainability challenges for our customers and for our planet. This is even more critical, as the clock is ticking on climate change and the battle intensifies. Our aggressive goals and bold actions can dramatically reduce carbon emissions and accelerate the world's progress.

We are committed to making a difference consistently, relentlessly and over the long term, our unwavering focus on innovation has been fundamental to our ability to drive market outgrowth and share gains in recent year and it continues to be a path forward for long term value creation.

At Trane Technologies, we've never built strategies around episodic investments which may increase for a year or two to drive growth and then slow in favor of margin or cash or any changing new priority.

Our approach is markedly different. We remain confident in our ability to lead precisely because our investments are continuous and ongoing. They are focused on our clear purpose-driven strategy, a consistent operating system, and goals and expectations focused always on top quartile results for our stakeholders.

This relentless approach drives market outgrowth, which in turn helps us deliver strong margins and powerful free cash flow to deploy through our balanced capital allocation strategy. The end result is more value across the board for our team, for our customers, for our shareholders and for the planet.

Moving to slide four. Our global teams drove exceptional performance in the first quarter, which positions us well, as we look towards the balance of the year. We delivered broad-based market outgrowth and share gains in each of our segments and business units, with total enterprise organic revenues up 11%, while at the same time delivering more than 400 basis points of margin expansion in every segment and for the enterprise as a whole.

We delivered double-digit bookings growth in all segments, growing our backlog over 30% sequentially versus December 2020 and up more than 30% versus our already strong backlog at the end of 2019 heading into 2020. Adjusted earnings growth was also exceptional, up 135%. Although it's still early in the year and overall visibility remains limited, our strong quarter 1 performance, growing backlog, improving markets and optimism for improved vaccination rates gives us confidence to raise our full year 2021 guidance for both revenue and adjusted EPS above the high end of the prior ranges.

We also continue to make excellent progress towards our transformation savings goal of $300 million by 2023 and expect to realize approximately $190 million in total savings in 2021. That's up from $100 million in 2020. These transformation savings help fund superior innovation, market outgrowth and share gains with sustainable strong leverage. We expect a strong growth in leverage in 2021 to once again deliver powerful free cash flow which further strengthens our balance sheet and fuels our balanced capital allocation strategy.

We've raised our capital deployment expectations for 2021 by $500 million from approximately $2 billion to $2.5 billion to continue our commitment of deploying 100% excess cash overtime. Lastly, our core strategy remains focused on backward sustainability mega trends of energy efficiency and sustainability which are becoming more pressing everyday.

We're one of just a handful of companies to achieve validation for our second set of science based targets, and our path to net zero carbon emissions. For those of you know as well, you know sustainability has been at our core for a very long time. Our first set of science-based targets were approved in 2014 and we achieved those in 2018. We also have revised our annual incentive compensation plan for approximately 2,300 leaders beginning this year to link directly to ESG metrics, including both carbon emission reduction, and advancing diversity and inclusion.

In addition, all salaried employees must now include at least 1 sustainability-related goal in their annual performance plans. Our commitment couldn't be stronger. With our purpose to challenge what's possible for a sustainable world, we are uniquely positioned to solve pressing challenges for our customers. This passion powers us forward to deliver top-tier financial performance and differentiated returns for our shareholders.

Now I'd like to turn the call over to Dave to discuss our bookings and revenue performance in the quarter. Dave?

David S. Regnery

Thanks, Mike. Please turn to Slide number 5. We delivered robust organic bookings growth of 31% in the first quarter with growth across all segment and business units. We also delivered strong revenue growth in each segment. Our Americas segment delivered growth in both bookings and revenue, up 36% and 9%, respectively. Our Americas Commercial HVAC business has remained resilient since the start of the pandemic, delivering strong Q1 bookings growth of low single digits in the quarter. We're especially pleased with this performance relative to the mid-teens growth comp in the first quarter of 2020, making the 2-year growth stack for America's Commercial HVAC high teens.

Revenues were flat in the quarter, which also represents strong performance relative to the growth in the first quarter of 2020, making the two year stack up mid single digits. Services were up low single digits. The residential HVAC markets remain robust and our residential HVAC team delivered strong revenue growth, well in excess of 30% in the quarter as they once again grew market share. We entered the quarter with a strong backlog, and exited the quarter with an even stronger backlog, putting us in a strong position entering Q2. Our Americas transport refrigeration business outperformed the North America truck and trailer markets in the quarter, delivering strong revenue growth, up mid-teens and exceptional bookings growth in the quarter.

Turning to EMEA, our team's delivered 18% bookings growth in the quarter, with strong growth in both commercial HVAC and transport refrigeration. Revenues were also strong, up 12%. EMEA Commercial HVAC bookings were up high single digits and revenues were up mid-teens once again outperforming the market.

We continue to see strong demand for our products and services that help reduce the energy intensity and greenhouse gas emissions of buildings. EMEA transport bookings were up over 20% in the quarter and revenues are up high single digits, outperforming the broader transport markets.

Our Asia Pacific team delivered bookings growth of 14% and revenue growth of 34% in the quarter, laughing a soft Q1 2020 that was heavily impacted by the COVID-19 pandemic. China continues to outperform the rest of Asia, where a number of economies are still struggling with the impacts of the pandemic and low vaccination rates.

Now, I'd like to turn the call over to Chris to discuss our operating performance and margins. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to slide number 6. Dave provided a good overview of our revenues on the prior slide, so I'll focus my comments on margins.

Adjusted EBITDA margins were strong up 460 basis points, driving adjusted EPS growth of 135%. We delivered strong operating leverage in all regions, supported by superior innovation for our customers, strong productivity and cost containment actions. Price cost tailwinds were particularly strong in the first quarter, driven by realization of premium pricing on leading innovation and pricing actions taken to remediate increasing material cost inflation in 2021. In addition, we maintain high levels of business reinvestment in innovation, technology, and productivity.

Please turn to slide number 7. In the Americas region, market outgrowth, cost containment, productivity and price drove solid EBITDA margin expansion of 400 basis points. Likewise, the EMEA and Asia Pacific regions delivered strong market outgrowth, productivity and cost containment to improve EBITDA margins by 540 basis points, and 1,160 basis points, respectively versus 2020.

Our market outgrowth in each region is supported by relentless investments in superior innovation to help our customers solve their most challenging and complex problems, fueling new product and service offerings. We delivered strong productivity from both our robust pipeline of projects and structural transformation initiatives that we outlined at our December 2020 Investor Event.

Now, I'd like to turn the call back over to Dave to provide our market outlook. Dave?

David S. Regnery

Thanks Chris. Please turn to slide number 8. Commercial HVAC in Americas has significantly outperformed the broader markets since the beginning of the pandemic through strong focused, agility, and execution combined with relentless innovation across products and services to our customers.

Demand remains high for comprehensive indoor air quality solutions and we continue to see indoor air quality as a long-term tailwind for our business. End markets are mixed with continued strong data center and warehouse demand. The pipeline for our education end market is also strong. To-date we've engaged with many of our K-12 customers to perform indoor air quality assessments in anticipation of the time when Federal stimulus funds will be made available.

At this point, the full impact and timing of the stimulus remains to be determined, but it's clearly a multi-year tailwind for our business, given our strong presence in the education markets, and our direct sales force with deep relationships in this vertical.

End market indicators are improving with ABI over 50 and both February and March, both positives for the road ahead. In summary, though our visibility into some end market verticals remain somewhat limited due to continued uncertainty related to the pandemic, we continue to see solid prospects for continued underlying market improvements in the second half of 2021, given positive progress and trends related to increased vaccination rates.

Turning to residential, we saw record first quarter bookings and revenue, which puts us in a strong backlog position entering the second quarter. Overall, we expect a strong first half and a challenging second half with tough comps in the back half of the year given record bookings and revenue in the second half of 2020.

Turning to Americas transport, we're expecting continued strong growth for the balance of 2021 as markets continue to improve. Orders were very strong in the quarter with many customers placing orders for the year. All-in, we expect 26% weighted average market growth for the year, reiterating our prior outlook.

Turning to EMEA, the recovery continues to be country-dependent with some countries and additional rounds of lockdowns. It's early to call the recovery broadly in Europe, but we expect continued improvement in 2021 with increased vaccination rates in the region. Transport markets, in particular, are expecting approximately 8% market growth, given the current rates of economic improvement, reiterating our prior outlook.

Turning to Asia, we expect continued growth in China in 2021, however, the rest of Asia has been slowed due to virus and vaccination rates remain low. Overall, we see a mixed picture for Asia in 2021.

Now, I'd like to turn the call back over to Chris to update you on our guidance for 2021. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to slide number nine. Based on our strong first quarter performance, our growing backlog and the expectation for improving pace of global vaccinations, we have raised our full year guidance for both revenues and adjusted EPS for 2021.

As Mike indicated earlier, we expect to deliver a strong organic financial performance with organic revenue growth of approximately 9%, up from our previous guidance of between 5% in 7%.

We expect to deliver strong organic leverage over 35% for the full year, with organic leverage of approximately 30% for the balance of the year. We continue to see about 1.5 points of revenue growth from the channel acquisitions, we announced last quarter, which will carry about five points of operating margin and deliver EPS accretion of about $0.05.

All-in, total revenue growth is expected to be approximately 10.5%, and adjusted EPS is expected to be approximately $6, which translates to approximately 35% earnings growth versus 2020.

Our updated guidance reflects both our strong performance in Q1, and an improved outlook for the remainder of the year. We also raised our free cash flow guidance with our increased EPS growth. We expect free cash flow to remain strong and equal to or greater than 100% of adjusted net income.

If you project current FX rates out to the end of the year, FX would likely be a tailwind, albeit too early to call given market volatility. Our FX exposure is largely translational and each point of revenue would translate at approximately translational OI rates. Net, each point from FX would translate into about $0.05 of EPS.

Please go to slide number 10. As we outlined during our investor event in December, by transforming Trane Technologies, we initially identified $100 million of fixed cost reductions by 2021. We've exceeded our initial cost reduction expectations, delivering $100 million of savings in 2020, a full year early. And we expect to deliver a $90 million of incremental savings for a total of $190 million in savings in 2021. We are now targeting and are on track to deliver $300 million of run rate savings by 2023.

As we outlined in December, we will continue to invest these cost savings to further strengthen our high performance flywheel, which has a reinforcing and compounding effect over time. First, we invest a significant portion of the savings into unrelenting business reinvestments in innovation and leading technology. This fuels the second element, sustained growth above our end markets.

Third, we invest another significant portion of the savings into an improved cost structure, which drives the fourth element, improved and sustainable incremental margins at or above 25% over the mid to long-term. When combined, this creates a compounding effect of high-quality earnings growth and free cash flow year-after-year.

Please go to slide number 11. We remain committed to our balanced capital allocation strategy that is focused on consistently deploying excess cash to opportunities with the highest returns for shareholders. We continue to strengthen our core business with high levels of business reinvestment and high ROI technology, innovation, and operational excellence projects, which are vital to our continued growth product leadership, and margin expansion.

We remain committed to maintaining a strong balance sheet that provides us with continued optionality as our markets evolve. We have a long-standing commitment to a reliable, strong and growing dividends that increases at or above the rate of earnings growth over time. We continue to pursue strategic M&A that further improves long term shareholder returns. And we continue to see value in share repurchases as the stock trades below our calculated intrinsic value. All in, we expect to consistently deploy a 100% of excess cash over time.

Please turn to Slide 12. And I'll discuss how we plan to deploy excess cash in 2021. Looking at full year 2021, after fully reinvesting in the business, we plan to continue executing our balance capital allocation strategy. And have increased our capital deployment target to approximately $2.5 billion, a $500 million increase to our prior guidance. We anticipate deploying the additional $500 million between value accretive M&A and share repurchases, taking the total target for M&A and share repurchases to approximately $1.5 billion for the year.

In the first quarter, we raised our dividend by 11%, deployed $174 million to M&A and share repurchases and paid down $300 million of debt. We plan to retire an additional $125 million in debt as it reaches maturity in the third quarter of 2021, taking the total debt retirement to $425 million for the year.

This guidance increase reflects our strong balance sheet and liquidity position, our commitment to deploying 100% of excess cash over time and our continued confidence in our ability to deliver powerful free cash flow to execute our balanced capital allocation strategy.

Now, I'd like to turn the call back over to Dave and Mike to cover key investor topics of interest and to close with a summary of key points. Dave?

David S. Regnery

Thanks Chris. Please go to slide number 14. We've covered the main points of our guidance, earlier in the presentation, so I won't spend a lot of additional time on it now. The objective of this slide is to lay out how to think about organic growth and leverage and the impact of the acquisitions.

It also provides some helpful modeling guidance elements outlined on the bottom of the slide. The key takeaways are that we're expecting strong organic growth, leverage and EPS and the M&A adds additional revenues and modest EPS accretion in 2021.

Please go to slide number 15. We want to provide an update on transport markets, as we know this is a topic of interest for investors and analysts. The net takeaway is that our outlook for 2021 is largely unchanged from our prior outlook, where we highlighted that we expect to see approximately 26% weighted average market growth for transport Americas, and approximately 8% weighted average market growth for transport EMEA.

While ACT has raised their outlook slightly on North America trailers, about 1% from 39% growth to 40% growth, they modestly lowered their outlook for truck, which nets out to be a wash on total growth. EMEA is in a similar boat with IHS lowering their 2021 forecast slightly, but not enough to shift our view.

In total, we've seen very strong demand through the first quarter in both transport markets, and we think that ACT and IHS have called the market about right for 2021, which means transport globally should have a very strong year for us. This is consistent with our prior 2021 view, but I'd say, we have greater confidence after our first quarter performance and our growing backlog.

The other element I wanted to highlight for transport North America is that, ACT has increased their trailer forecast for fiscal year 2022 to 51,100 units, which represents an increase of about 13% over their 2021 forecast.

While on the subject, we are occasionally asked about the historical cyclicality in the North America trailer market. Data would suggest the patterns have changed. The North America trailer market took a step-up in 2015 and has been above 40,000 units ever since with only one exception, 2020.

2020 saw market declines intensified by the pandemic. So I'm not sure how informative it is about the future. The driver logs, driver shortage and added economic activity appears to have fundamentally shifted the market to new levels above 40,000 units, excluding economic disruption.

ACT's forecast for 2023 is also at the mid-40,000 unit level. If they are correct in their forecast for 2021 through 2023, it will be eight of nine years where the North America trailer market has been in the mid-40,000 unit range, plus or minus 10%. Net, 2022 and 2023 are shaping up to be strong years as well.

I'd like to now turn the call back to Mike for closing remarks. Mike?

Michael W. Lamach

Thanks, Dave. Please go to Slide 16. Energy efficiency and sustainability megatrends are only growing stronger, and we are uniquely positioned to deliver leading innovation that intersects with these trends and accelerates the world's progress. And we're not only focused on investments in innovation and growth, but also on investments in our business transformation. We are on track to deliver $300 million in savings that will continue to improve the cost structure of the company and enable additional reinvestment to expand margins and further strengthen our ability to outgrow our end markets.

When combined with the long-term sustainability megatrends underpinning our end markets, our exceptional ability to generate free cash flow and balanced capital deployment of 100% of excess cash over time, we are well positioned to continue to drive differentiated shareholder returns. I've said that Trane technologies has the essence of a startup with the credibility of a market leader. That unique profile fosters a culture of inclusion, ingenuity and performance that delivers results as we demonstrated in the first quarter. It's this type of passion and purpose that sets Trane Technologies apart and is how it will change the industry and ultimately change the world.

And now, Chris, Dave and I'd be happy to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator

Your first question comes from the line of Jeff Sprague with Vertical Research **Partners. Your line is open.**

Analyst: Jeff Sprague

Question – Jeff Sprague: Thank you. Good morning everyone.

Answer – Michael W. Lamach: Good morning, Jeff.

Question – Jeff Sprague: Just wondering if you could just dig into kind of the price/cost dynamics a little bit. I'm not surprised to hear you were nicely ahead of the curve in Q1. Just a little more color on the year. It sounds like you expect to stay positive all year long. But is there any particular point, and I'm thinking perhaps Q2 where actually you end up on the – on the negative side of this as prices catching up, you're waiting for price to catch up, that is?

Answer – Christopher J. Kuehn: And Jeff, this is Chris. I'll get started. Thanks for the question. So yes, Q1, we did see particularly strong price/cost in the quarter. When thinking about our first round of price increases, they went effective in November and January, really just trying to get ahead of what we saw to be the rising material inflation coming into 2021.

With that, that helps drive some really strong price/cost in the first quarter. But for the balance of the year, we're really seeing from Q2 to Q4, that price/cost spread really being flattish. We've announced and put into effect the second round of price increases here in April, but continued material cost inflation has just continued to climb up as well.

So we're really seeing the balance of the year at being roughly flat. We continue to manage and monitor where we can, material inflation. We've got our playbook that we're executing well at this time between our copper locks, 70% of that is locked at any point of time. The steel pricing and roughly a 6-month lag we see in terms of steel pricing. We're still executing the playbook. But I'd say, for the balance of the year, we're seeing that really moderating and becoming flattish.

Question – Jeff Sprague: Great...

Answer – David S. Regnery: And the only thing I would add to that, Jeff, this is Dave, is that our innovation really helps us with price realization as well. So as we have a really robust pipeline and we keep on executing our new product launches, it's always nice to go to a customer and tell them about the value that we've created and how the solution could add to their bottom line.

Question – Jeff Sprague: And just secondly, Mike, on the strategic angle, interesting raising the capital deployment, and obviously, the cash flow is there and looks solid. Is your confidence level on finding interesting M&A rising here? I understand if it doesn't materialize, you toggle the share repurchase. But just interested in your visibility and confidence level on the M&A front?

Answer – Michael W. Lamach: Yeah, Jeff, it starts with really confidence in earnings and the ability to turn it into cash. And so it's really the commitment we've had for a long time about deploying cash to shareholders over time. And so, the confidence there on the $0.5 billion is really that.

Further, there is a strong pipeline. We are very, very disciplined about how we look at acquisitions. We still feel the intrinsic value of our own share price offers opportunities. So, I'm confident that one way or the other, we'll split it. But as – yeah, we'll be able to spend it. But as I said on the last call, the pipeline is robust, and I'm sure that that we'll find some value before the end of the year there.

Question – Jeff Sprague: Great. Thank you.

Operator

Your next question comes from the line of Julian Mitchell with Barclays. Your line is open.

Analyst: Julian Mitchell

Question – Julian Mitchell: Hi and good morning.

Answer – David S. Regnery: Hey, Julian.

Question – Julian Mitchell: Maybe – hi. Maybe I just wanted to clarify on organic sales growth. So, you took up the guide for the year, about three points, I think. Maybe just help us understand, it sounds like transport refrigeration, no real change. So, the weighting of that, commercial versus resi HVAC? And within Americas commercial HVAC, flat sales in Q1. How do you see that playing out from here?

Answer – David S. Regnery: Yeah Julian, how are you doing? This is Dave. I'll start, and Mike and Chris can add in. If we just really go around the globe, overall, we're expecting to continue market improvements with the increased global vaccination rates in 2021, but on a global level, that is. If you look at Americas commercial HVAC, we'll start with seeing nice demand in data centers and warehouses. And we've seen that for a while now.

But I would also tell you that the education vertical is also showing strength. So, we're pretty happy about that. Hospitality is also still weak. However, health care is showing some strength. So, it's kind of mixed right now. But you got some leading indicators. ABI is strong, which is a good read for us in the future.

One point, I'd point out in the Americas, if you look at the incoming order rates, we run it with the Americas. So, it's North America and Latin America. If you look at just North America, their incoming order rates were up mid-single digits, where Latin America was actually down mid-teens. So, we're seeing some strength in our commercial business in the Americas.

If you go to residential, continued strong bookings, continued strong backlog going into Q2. That's going to be a story of first half or second half. First half will be very strong. Second half, we have some very tough comps that we're going to be facing there. But overall, we're still positive on our residential business. I think if you look at the full year, the prevailing consensus is that,

that would be up in the mid-single digits, and we have no reason to disagree with that.

Transport, I talked about, it's going to be a strong year. And the nice thing about that is if you look out in the 2022 and 2023 forecast, that strength continues, which is a good sign. EMEA, it's really dependent. We still are seeing some lockdowns occurring. But we're seeing nice results there with our innovation and really around our heat pump, especially in the commercial business with our heat pump solutions that are really making a benefit to our customers.

EMEA is another one, you got to break that down. If you look at Europe, our incoming order rates in Europe were up mid-teens. And actually, our incoming order rates in the Middle East were down mid-single-digits.

Asia Pacific shown strength in China for sure, data centers, electronics, pharma, health care, nice strength there. The rest of Asia has been slow, right? And we're hopeful that vaccine – can start to pick up their vaccine distribution rates and then it could bounce back. But if you look at the first quarter, incoming order rates for the rest of Asia were actually down in the mid-single-digit range. So, a lot of strength there in China. So hopefully, that helps you with seeing what we're seeing for the outlook.

Question – Julian Mitchell: Yes, that's perfect guys. And then maybe a broader question around that Commercial HVAC business, sort of Equipment versus Service. I understand there's a push to do a lot more contractual type service keep the attachment rates high, try and deliver to customers to solve for that sort of IAQ versus energy efficiency conundrum. Maybe help us understand kind of where Trane is on that service push within Commercial HVAC and what the uptake is from customers for any kind of newer service offerings?

Answer – David S. Regnery: Yes. We continue to see strength in our Service business. It was up low single-digits. Attachment rates, very high on the Applied Systems side. Indoor air quality, continue to see tailwinds there. The neat thing about indoor air quality is not only are we seeing indoor air quality audits being conducted with – in the education vertical, we're also seeing an uptick in the offices. Vaccines are being distributed and people are thinking about getting back to the office, we're seeing a nice uptick in our office inquiries and actually the activity.

As far as your question about like indoor air quality and energy efficiency and buildings, I think you're aware. We do a very comprehensive audit. We have the day one, which is let's make sure the building is as safe as possible today. Day two, what's the long-term infrastructure improvements that you could make to not only make your building healthier but also to reduce the energy intensity of your building.

And we're seeing a lot of traction with those audits, and we're starting to see the day two activity come through, especially that, combined with some of the stimulus funding that's starting to flow in the education vertical.

Answer – Michael W. Lamach: Julian, I'd add a little bit by saying, we had a view that we thought there'd be a tailwind kind of 1% to 2% with IAQ going forward. That's turning out to be right in last quarter and this quarter and as near as we can talk for the pipeline for the balance of the year. It's been pushing toward the 2% end of that range versus the 1% of that range.

Over time, it's going to be difficult to necessarily parse that out as you get more design and more standards being written in a way that it's written in as opposed to a retrofit. So – but for now, we're seeing that pan out to be 1% to 2% kind of trending closer to the 2%, which gets to the question as well about what's different and what's changed? And an example why is North America Commercial a little bit better as we're seeing strong uptake on the offerings that we've got.

Question – Julian Mitchell: Great. Thank you.

Operator

Your next question comes from the line of Steve Tusa with JPMorgan. Your line is open.

Analyst: Steve Tusa

Question – Steve Tusa: Hey guys, good morning.

Answer – Michael W. Lamach: Good morning, Steve.

Question – Steve Tusa: Just a follow-up on that. I mean you guys had highlighted, I think, last year that you did have in the Americas weakness in services and parts impacted due to lockdowns. I would have thought the comp was a bit easier and you were growing pretty nicely in the second half of last year. So up low single digits in that – on that side of the house and Carrier, I think, put up double-digit growth or something in services anything going on there with regards to timing? Or is this just kind of a -- can this business be lumpy? I thought of it as more -- being a little bit more consistent?

Answer – Michael W. Lamach: Yes. Steve, in quarter 1 last year, you didn't really have, at that point in time, service lockdowns and the complete absence of being able to service buildings physically. That really occurred in quarter 2, as I recall, it was pretty strong.

Answer – David S. Regnery: It was strong in Q1.

Answer – Michael W. Lamach: Yes, strong in quarter 1 as well. Obviously, around the world, as buildings are closed and you're delivering more digital services and physical services. So that changed. And you're seeing just a constant drumbeat toward more and more reopenings with the exception of important economies like India and Brazil, parts of Europe, as an example, some parts of the Middle East, but it's a healthy recovery. It was a good sign for us to see growth in the quarter, quarter 1 in service again, really continuing along that pattern.

And it doesn't appear that we're really going to see any fallout from a contractual basis at this point relative to our service base, which is the other thing you worry about when you see the economy snapping back and we seem to be renewing those relationships and those contractual agreements in an effective way.

Question – Steve Tusa: Got it. And then just to clarify as a follow-up, I didn't quite get the answer to Julian's question on what precisely you're raising the guidance around, what revenue source, just simply you're raising the guidance around? And then just one nitpick. Will you be – I guess, you'll be positive in that 20 to 30 basis points range this year, all in, on price cost? Or will it be -- will that end up being kind of a normal year on price cost spread? Thanks.

Answer – Christopher J. Kuehn: Steve, I'll take it. So for the full year, revenue increased, call it, 3 points. We had a strong first quarter. So we're passing that on to the full year. We've got price increases to cover material inflation. That's being baked into the guide. And we're still HVAC predominantly company, right? The first quarter is kind of our lightest quarter of the year. So we've got some visibility into the second quarter and some optimism around the second half of the year. But that's ultimately what's driving the 3-point increase we're seeing on revenues right now. But the Q1, the pricing from actions here to control material inflation and then a little bit more optimism we're seeing for the second half.

Your other question was on price cost. Yes, I think we expect it to -- that spreads going to narrow, and we expect it to be flattish. Could it be net positive, 20, 30 basis points in the full year? It could be. But this is a volatile area, as we know. We're monitoring and tracking the material inflation. And I wouldn't roll off the table if we needed to another set of price increases depending on where that goes. But it could be net positive, but it would be kind of in that very low 20, 30 basis point range to flattish on the full year.

Question – Steve Tusa: Great. Thanks for details.

Answer – Michael W. Lamach: You got it.

Operator

Your next question comes from the line of Andy Kaplowitz with Citigroup. Your line is open.

Analyst: Andy Kaplowitz

Question – Andy Kaplowitz: Hey good morning guys.

Answer – Michael W. Lamach: Good morning Andy.

Answer – David S. Regnery: Good morning Andy.

Question – Andy Kaplowitz: Mike, so I know we aren't even halfway through the year and likely still in the early in the transport up cycle. But as you know, many investors get concerned regarding the cyclicality of the business and you just talked about the strength that could last into 2022 and 2023. So, maybe you could talk about the durability of the strength you're seeing now. How much of the underlying trends that we're seeing last mile cold storage, maybe more significant channel-related related growth are helping you. So, as you go out into the out years, there still could be good demand in that business.

Answer – Michael W. Lamach: Yes. Thanks, Andy. I'll let Dave start that out, and I can put a little color on the back end, maybe.

Answer – David S. Regnery: Yes. I mean, for sure, the trailer demand in North America, as I said earlier; I think there's a new tipping point there. It's 40,000 units, eight over the last nine years. So, this is no longer a business that's going to dip down, at least in North America into the 20s range. Thermo King is a very diverse business right now. So, we're very happy with the growth rates we're seeing in trailer, not only in the Americas, but also in Europe. But because of our diversification, we're seeing growth in other areas as well, especially on the electric side with home delivery. We're very excited about some of the new products we've been able to develop there that are in the market today, more to come.

And we're also -- this whole refrigerated container solution and really helping with the vaccine distribution and storage capability. And as vaccines now supply is starting to outpace demand, these vaccines, especially the mRNA ones, need a place to be stored. And we have solutions for that on a global basis. And we're certainly helping out in areas like India, working with the World Health Organization to make sure that they have the products that are required to make sure that they can get as many people as vaccinate as possible.

Answer – Michael W. Lamach: Yes, Andy, the volatility always seems to come in the booking area, not so much in the revenue side of this thing. As we look at the heartbeat of our operations and units, it stays really constant. We don't get the volatility from a revenue perspective. And David's points are exactly on.

I think what you're seeing here with some of the larger trailer customers, particularly in the US, would be looking out over a year and getting the orders in over the period of a year. So, -- and maybe that's a little bit different, although the larger customers tended to give you an indication of what they were going to do for the year. Here, I think we've got customers just lining up for firm orders earlier in the year.

Question – Andy Kaplowitz: Mike, that's helpful. And then recently, you suggested that your opportunity for the electrification of heat could be $2 billion versus -- what we initially thought a $1 billion opportunity in Europe and China, maybe even the US. But maybe you could give more color, how much, for instance, of your EMEA revenue at this point of heat pumps and how fast is it growing? And what are you thinking in terms of growth this year? And what kind of opportunity could be in China or the US over time?

Answer – Michael W. Lamach: Yes. We say electrification of heat and heat pump kind of became the poster child for that because it's an easy concept for people to understand. These are complex systems that really are combined boiler plant and chiller plant into a single unit, capable of doing air to air, air to water, water to -- any combination you can think of using heat sources that would move from sewage to seawater to lake water to -- you name it. And so, we're seeing this applied both on a building level, even on a city level, and we're seeing great wins there.

It is, by far, the fastest-growing part of our business. And I believe, it's going to be a meaningful part. It is a meaningful part of the business today. It's going to continue to be a meaningful part. So, yeah, I think it's at least a couple of billion dollar opportunity globally.

It's centered right now, primarily in Western Europe. We're seeing some implementation in parts of China. And we think that there is further opportunity, commercial opportunity, moving into the colder North American climate.

So over time, it just seems to creep further and further north, not just because the temperatures are getting warmer, but also the technology is getting better to be able to work with lower ambient temperatures or hot ambient temperatures and make it work in the reverse cycle. So very positive on that. Dave, do you want to add any color?

Answer – David S. Regnery: I mean, the only thing I would add, Andy, is just it's -- as Mike said, today, 95% of buildings operate with two silos, right? The cooling side, the chiller plant and the heating side, the boiler plant. But by combining them, you're really able to have an impact on efficiency.

A conventional system has a, what we call a total energy ratio of two, meaning that every unit of energy goes in, you have two coming out. When you're able to combine these two with our heat pump technology and our sophisticated controls, and I won't go into the detail for competitive reasons, but we're able to get total energy ratios of like eight.

I mean, that's four times conventional systems. So the value prop to our customers is very, very accretive for them and the value to the environment, these are very, very green solutions. So this is a bit -- this is going to -- this is a big market today for us in Europe. And it's expanding very quickly.

Answer – Michael W. Lamach: Discussion today is happening in California, in Norther California. It's happening all over the world, and I think this is going to be a very important global strategy for net-zero emissions the buildings would be using.

The electrification of heat, the absence of fossil fuel boilers and the more you can green the grid, as they're doing particularly in Europe, you're going to get to a net-zero solution on day one. And as we put sort of the next-generation refrigerants into these systems, we're offering complete net-zero solutions, when the green -- when there's sustainable power coming off the grid.

Question – Andy Kaplowitz: Very interesting, guys. Appreciate the color.

Answer – Michael W. Lamach: Thanks, Andy.

Operator

Your next question comes from the line of John Walsh with Credit Suisse. Your line is open.

Analyst: John Walsh

Question – John Walsh: Hi. Good morning, everyone.

Answer – Michael W. Lamach: Good morning, John.

Answer – David S. Regnery: Good morning, John.

Question – John Walsh: Hi. So, I was just wondering, obviously, gave us the help on the incrementals. We have a really unusual comp coming here in Q2. How would you think about the business? Should we think about kind of sequential growth rates?

Just -- I mean, you talked earlier about the two-year growth stacks. You could even argue go back three years; next quarter is even easier for you. But how would you help us think about what kind of lift we should see here in the second quarter?

Answer – Christopher J. Kuehn: Hey, John, it's Chris. Yeah, I think about the second quarter where organic revenues are probably around that mid-teens range. When you add in acquisitions, they're driving about 1.5 points of growth for us for the year, and that's continuing. We saw that in Q1, and we'll see that again. When you stack organic and acquisitions together, we're probably in the mid to high teens range of revenue growth. And then we're expecting that continued strong organic leverage, we'd expect about 30% leverage here in the second quarter. When you factor in the acquisitions, it's probably high 20s on a reported basis for leverage. But that's how we're kind of thinking about the second quarter right now. It's a little early to call the third and fourth quarter. Again, the second quarter will be a big quarter for us, it's a predominantly HVAC business. But hopefully, that gives you a little bit of context around how we're thinking the second quarter can shape up.

Question – John Walsh: Thank you for that. And then I think there's obviously a lot of funding, right, and excitement around not just K-12, as you highlighted, but it's broadening. Is there anything as you look forward, because of supply chain or labor, that would kind of govern the growth or anything that would slow down kind of the pace of being able to do these energy efficiency and IAQ kind of retrofits?

Answer – David S. Regnery: Yes. John, I'll start on the supply chain. I would tell you that we have a pretty robust process managing our supply chain. We have very detailed roadmaps we developed early on during the pandemic, and we continue to execute to those. So, I won't say it's easy because it's not. But I would tell you, our teams are doing a great job of managing through any kind of constraints to make sure that we have the proper component so that we could manufacture our products and meet our customers' demand. So, as far as the labor, I think it was your second one. Again, yes, it's tight, but we're managing through it and we have some great processes in place that allow us to do that.

Answer – Michael W. Lamach: Yes, John, I think from our own internal labor perspective, we're fine. I think when you think about sort of the broader context of skilled trades doing large construction and infrastructure work, particularly in the US, if we were to pass a major infrastructure plan in the US, you tend to have more -- I'm sorry, you tend to have less skilled trades.

People come back in after every downturn in the economy. We saw that in the 2008-2009 timeframe, and it had the fact of taking institutional project cycles out a bit longer to get them completed. And my sense is you could see the same thing here, which, frankly, in our world, it's fine. It just really extends the new construction or retrofit portion of institutional construction, it extends that a little further.

Question – John Walsh: Great. Thanks for taking the questions. Pass it on.

Operator

Your next question comes from the line of Josh Pokrzywinski with Morgan Stanley. Your line is open.

Analyst: Josh Pokrzywinski

Question – Josh Pokrzywinski: Hey good morning guys.

Answer – Michael W. Lamach: Good morning Josh.

Answer – David S. Regnery: Good morning Josh.

Question – Josh Pokrzywinski: Just a question on some of this IAQ assessment and kind of day one versus day one plus another number? I guess how much are you guys able to do upfront in sort of a timely manner as these customers want to reopen versus stuff that might weigh into 2022 or even later just as a function of kind of natural bottlenecks in the process?

Like is that -- is this something that lasts two to three years with maybe more on the back end? Or is more of the activity front-end loaded? Just thinking about folks who want to get into offices, basically right now, we might need to do something a bit more comprehensive. Clearly, there's going to be some sort of Band-Aid approach in the short-term.

Answer – Michael W. Lamach: Yes. Josh, when you think about noncommercial construction, and you think about the 400 billion square feet of space around the world, and you see around people trying to figure this stuff out. And you think about our portfolio, hundreds of thousands of customers that need help, if not more than 1 million that we have, it's very difficult to average this. And so, we always -- I kind of think about things more in archetypes.

You've got institutional customers that are critical to making the economy work, think about healthcare, think about education. If they're healthy healthcare systems and they're healthy school districts or university, they're going to move quicker.

Healthy, meaning, if property taxed or tax or bonds can be passed, that may help to some extent. In other extents, if there would be stimulus that would be available to K-12 and higher education, that's going to help people in terms of progress. It's very, very difficult.

You can think about movie theaters, right, a year ago, six months ago, right? There wasn't really anything happening in terms of any investment going on in movie theaters. But as you think about those opening up, you're going to find that something like that, large retail complexes, retail malls are going to need to sort of reengage with this stuff.

So there's no averages here. It really comes down with some archetypes between, maybe institutional, healthy versus unhealthy, commercial, perhaps markets that are healthy would be the data centers, warehousing, versus those that are going to be challenged, which might be retail mall complexes in some regard, the light commercial, which you're seeing higher vacancies there. No averages there.

But what we do have is a very good set of pipeline management tools and analytics that go into building pipelines from the ground up, from individual sales people in the field. And so, there's a strong sense about what's in the pipeline and what the win rates, close rates might look like and the time-line there, which is what gives us some confidence to have some visibility through this. But it's not through averaging.

And even the Dodge data, frankly, disconnects from our own data because of that. Part of it, because only 15% of our revenues could be explained through Dodge data and partly because we've got really good data coming through with the entire global sales force using more sophisticated pipeline tools to give us the actual details around pipeline and orders. A long-winded answer to your question is, there's no averages.

Question – Josh Pokrzywinski: Got it. And then, as you just think about the mix of business today and maybe 1Q, because it's off season, it's not the best example. But is this still sort of kind of post-crisis management where folks are catching up on delayed activity or want to talk about indoor air quality? Or are we sort of back to the normal business of replacing things that are at end of life, doing energy retrofits, kind of, the core HVAC business as we've known it over time? Thanks.

Answer – Michael W. Lamach: Perhaps on the front end of the latter part, which is some return to normalcy in some parts of the world, some parts of the economy, frankly, but largely, we're still very, very focused on the indoor air quality constraints, getting people to open safely, figuring out where investment dollars from our customers should be spent with regard to the facilities. And so, really, really innings, frankly, around reopening in my mind.

Answer – David S. Regnery: No, I totally agree. And that's why I made the comment earlier about office vertical. We're now starting to see a lot of activity there where six, nine months ago, we weren't seeing a lot of indoor air quality audits there. But as people now are realizing that, hopefully, we could all get back to the office relatively soon, we need to start thinking about reopening. So that's driving a lot of demand there.

Answer – Michael W. Lamach: Yes, six to nine months, Josh, we would have been advising our customers on the kinds of technologies and things that they could do, really educating the marketplace largely on what the potential strategies could be versus actually in the commercial office space now getting in and helping them execute those audits on those plans. So, it's moved from conceptual what do I do to specifically what am I going to do to open this facility in building.

Question – Josh Pokrzywinski: Great. Thanks for the color. Good luck guys.

Operator

Your next question comes from the line of Scott Davis with Melius Research. Your line is open.

Analyst: Scott Davis

Question – Scott Davis: Good morning and I'll echo some of the congrats on a great start to the year.

Answer – Michael W. Lamach: Thanks Scott.

Answer – David S. Regnery: Thanks Scott.

Question – Scott Davis: I guess when you see this kind of growth, it begs the question of, at what point do you have to take CapEx up to another level? And perhaps a better question to ask really is what kind of growth can you handle without spending money, meaning after all these years of implementing Lean and being such a productive company overall that has -- can productivity, I think, which kind of probably suffered a little bit during COVID -- the high times of COVID, but can productivity step up and help deliver the kind of unit volume that perhaps prevents you from having to spend a ton of capital on the backside of this?

Answer – Michael W. Lamach: Scott, what I love about Lean is it never stops. The old adage, you don't have to be bad to get better, really applies. One of my favorite stories was in our Tyler operations in residential, where we have the roof collapse on a part of the production system there. Team goes to work. You're working weekends and mornings and nights and shifts and comes back with adding 20% capacity to a smaller footprint.

And it's the sense of really challenging possible. We say it around the company, it's true. And I don't see it. We're looking at scenarios. Obviously, TK is one where we're seeing a strong snapback in orders. But we've got playbooks built for different volumes.

And a lot of our facilities, still the opportunity to run a third shift or a weekend or -- so we've got a lot of capacity, theoretical capacity that can be turned in actual capacity very quickly. So, I do not see the need for us to add for the sake of handling demand. I do think there is an effort that we're taking on to think about resiliency differently inside the company. And you could think about that in the context of climate change and other risks that would be involved with all companies.

But where do we need to have resiliency in the supply chain or additional resiliency in our own manufacturing operations. So that resiliency would be more of what we're looking at versus pure capacity.

Question – Scott Davis: That makes a lot of sense and is encouraging. And actually, what my follow-up question was going to be that a lot of companies, including Trane out there with emission targets and other kind of ESG commentary, which is great, but not always a lot of details around it.

And just high level, because this is probably an entire day conversation overall, but how do you get to zero emissions? I mean how -- what's the playbook of when you think about -- I mean you already run pretty efficient productive factories. They need electricity. You can't move to all solar overnight. How do you get there? And does it require spending money? Is it iterative and just takes time? Is it -- are the step change things? I mean, again, relatively high level due to time.

Answer – Michael W. Lamach: Yes. Scott, you're right. It would take a day, and this is where our passion is. What I would tell you as an initial step, would be to ask investors to go to our website and look at our just published ESG report. It's about 100 pages long, but there's short ways to kind of recap and there – get a sense for the totality of what we are doing in the metric and you'll find a tremendous amount of transparency there about sort of where we are and where we're going, but lays out that roadmap specifically that you're asking. And so, we're really excited about this and we think that as investors kind of dig into that, you'll get an absolute sense for the answer to your question. So, the ESG report just published on our website, please take a read.

Question – Scott Davis: I cant' wait to read it.

Answer – Michael W. Lamach: Thank you.

Question – Scott Davis: Kind of joking. I will definitely read it, but there maybe a fear or two involved in the process.

Answer – Michael W. Lamach: Fair enough.

Question – Scott Davis: Good luck.

Operator

Your next question comes from the line of Nigel Coe with Wolfe Research. Your line is open.

Analyst: Nigel Coe

Question – Nigel Coe: Yes. Thanks. I can well imagine Scott going through 100 pages of that. So, thanks requesting. So, on residential, we haven't spent a lot of time talking about that. It's obviously very strong trends. We've heard several channel partners and several of your competitors talking about how, with stimulus dollars in pockets, how some equipment is being replaced as opposed to maybe repaired in normal times. Do you think the strength we're seeing today because of stimulus, etcetera, is taking some demand out of '22 and maybe '23 into this year? Any thoughts on that, repair versus replace cycle?

Answer – David S. Regnery: Yes, I'll start. I mean we had a very strong quarter, obviously for Res. And I would tell you that, not to talk too much about Q2, but that April was another strong month as we thought it would be. I don't believe that it's taking out of the future. I think people are working from home. They realize that being in a comfortable environment is important. We're seeing an uptick in the SEERs that we're selling. So people are going for the higher SEER product. I don't – we don't see that really, really pulling ahead, if that's where your question is, demand from '22 and '23.

Answer – Michael W. Lamach: Yes. I think you see a lot of sort of optimism at this point, economic optimism out there you're finding, I think, as you look at unemployment rates going down and really reaching at some point, probably again at a very low level. And you compound that with this whole future of work that we're looking at. We've talked about in the past, even in our own company.

You're finding people with jobs and the likelihood of having a job, with increased home values, with the notion that they're going to be spending more time at home. So again, I think this is just really an upgraded cycle phenomenon based on what we're seeing with COVID. But I don't really see it changing and pulling forward replacement. I think people are just opting right now to place with whole systems from higher SEER systems.

And I think that as you get into '23 and some of those out years, you're going to find, I'm sure we'll see another change in regulations there and it's going to drive again more towards full system replacements with more expensive and more efficient systems. So, I think it will be a good business, probably a GDP plus business over the long run. possibly when you see regulations really impacting that as they have over the last decade.

Answer – David S. Regnery: Yes. And just to clarify, too, you got to look at them in years, right? You can't really look at first half last year because it was really low and then the second half last year was really strong. In totality, low single-digits, mid-single-digit is kind of the range that it's been in. So, the swings happened really by the quarters which were driven by the pandemic.

Question – Nigel Coe: Right, right. And then a follow-up on M&A. We just saw Melrose sell their HVAC assets for, I think, 11, 12 times EBITDA. I mean theoretically, that would have been a very sort of down the middle acquisition to you at very accretive rates, et cetera, et cetera. How should we think about philosophically where you're looking for M&A? Are you looking at future trends, justification software digitalization, et cetera. I mean how should we think about where you may land on your M&A strategy?

Answer – Michael W. Lamach: Well, first of all, Simon and the Melrose team did a great job with that business. It's a bit of parts that would have ranged from bathroom exhaust fans and kitchen hoods, all the way through to some interesting data center technology. So obviously, that's something that we would have looked at very closely and done our homework around that.

Ultimately, it's part of that business, which would have made great sense for us in parts of the business, which really wouldn't have made sense for us. So, I think that's indicative of just staying disciplined around the process and kind of what we pay for things. But yes, I think the pipeline is robust. I mean, again, 88% plus of what we look at is strategic in nature, meaning it's something that would have been discussed in our strategies before it becomes something that shows up on an M&A screen.

There's always 20% of the ideas that are out there that come from different sources and people. We don't think of every good idea nor do we want to. So, we look at those as well. So obviously, the activity is high, valuations are relatively high, and we're just going to be selective through that, Nigel. But my hope is we can lean further into it, and find the right deals for us.

Question – Nigel Coe: Okay. Thanks, Mike. Thanks, Dave.

Answer – Michael W. Lamach: Thanks, Nigel.

Answer – David S. Regnery: Thanks, Nigel.

Operator

Your next question comes from the line of Joe Ritchie with Goldman Sachs. Your line is open.

Analyst: Joe Ritchie

Question – Joe Ritchie: Hey, good morning, everybody.

Answer – Michael W. Lamach: Hey, Joe.

Answer – David S. Regnery: Good morning, Joe.

Question – Joe Ritchie: Hey, Mike, maybe just following on Nigel's question there. You know the pipeline is robust. You also had JCI announced the acquisition of Silent Air to get bigger on the data center part. When you think about your portfolio, are there any pieces of the portfolio or end markets where you feel like you need to get bigger to get after the opportunity, whether it's in data centers or warehousing, and I know you've been very enthusiastic around the pump opportunity.

Answer – Michael W. Lamach: Yes, Joe, thanks for the follow-up because that's part of the dilemma. The answer is no. There's not any gaps in the portfolio. There's nothing strategically that we feel is lacking. And so, there's a more discerning eye spent on it. And of course, we don't want to do M&A for the sake of M&A. I think that could value destructive. So, the answer is no.

So therefore, we found novel technologies that just need some scale in a home to develop them or we found potentially bringing inside the channel partners that we may not have been running the service business, and therefore, we can do an effective job running the service business and with our systems. So those have been what we've seen.

Again, we're looking at both channel and some of the technologies that are out there, but some of the scale here can be smaller. Interestingly, I think through the pandemic, I always talk about sort of the largest four HVAC companies and then kind of players five through 15. I do think that there could be consolidation still in five through 15. But one of the things I think we're realizing through the downturn is it's a much heavier concentration through the pandemic of the top four. And I think it makes a lot of that merger potential opportunity messier. I think it's more restrictive. I think it certainly has got more hurdles to clear.

So you could find value in some of the more sizable company, sort of, five through 15 or five through 80, because they actually go that far, if you incorporate some of the Western European, which is very fragmented. There's some players there, they get fairly small. But those are the opportunities, I think, that might be of scale for us.

Question – Joe Ritchie: Got it. That's super helpful, Mike. And maybe just a follow-up question. There's been some discussion already around price/cost. It seems like you're managing it really well this year, and we're in a pretty tough inflationary environment. What do you think is different for you guys this time around versus maybe what we saw like the 2017, 2018 timeframe and your ability to really manage through this well?

Answer – Michael W. Lamach: One thing is, if we go back now really 10 years, the one thing I can tell you is that operating system is not different. So, we really had great success over long period of time in doing that. But the difference back in that really volatile 2016, 2017 time period was that it became very speculative in areas like copper. And it was something that – it was very difficult to really understand the veracity, of which it was changing and the speed it was changing.

Here, the visibility towards the changes have been little bit easier for us to recognize and see and a little bit more capability switching between some of the commodities. Copper and aluminum has helped us over time mitigate some of that as well. So, the systems have not changed. The top-line, margin expansion, operating system fundamentals in the company are exactly the same, just a bit more predictable in the rate of change here versus the volatility of the last one.

Question – Joe Ritchie: Got it. That's helpful. Thanks guys.

Operator

Your next question comes from the line of Gautam Khanna with Cowen and Company. Your line is open.

Question – Dan Fleck: Hey guys. This is Dan Fleck on for Gautam. Thanks for getting me on.

Answer – Michael Lamach: Hey Dan.

Question – Dan Fleck: So just one question here. I was hoping you could explain some of the moving pieces on the operating leverage target for the remainder of the year coming down to 30%, which was so strong in Q1. And whether that's – is that related to absolute R&D dollars coming up, or is it ball COGS? Any pieces on that would be helpful.

Answer – Christopher J. Kuehn: Hey Dan, this is Chris. Yeah, we had strong leverage in the first quarter. But as we think about the balance of the year, we're still targeting 30% operating leverage, consistent with our prior guide. For us, when I think about the performance flywheel we have within the company, let me start off with the first step and the first step is really reinvesting. We fully expect to have stronger investments, Q2 to Q4. We had strong investments in the first quarter. But those are really going to ramp up as we move throughout the year as well. We've talked a bit about the innovation pipeline where we're seeing new product development. All of that combined would really materialize in a strong step-up in investments for Q2 to Q4.

Second, that price/cost spread is going to narrow. So, we're going to see price, but we're going to see cost roughly approximating price, Q2 to Q4. So that's not going to bring – those pricing increases don't bring a lot of leverage with that, of course. So that's going to be a headwind versus where we were in the first quarter.

And then ultimately, we're still managing through the return of some temporary cost takeouts from last year. That was part of our guide three months ago for 30% organic leverage. It's still part of our guide today. So all in, 30% for the balance of the year, and we raised the full year to 35%, just given where we stood in the first quarter

Question – Dan Fleck: Cool. That's helpful. Thank you.

Answer – Christopher J. Kuehn: No problem.

Operator

Your next question comes from the line of Deane Dray with RBC Capital Markets. Your line is open.

Analyst: Andrew Krill

Question – Andrew Krill: Hi. Thanks. Good morning. This is Andrew Krill on for Deane. I wanted to go back to resi HVAC and can you give a sense of sell-through you saw in the first quarter with distribution? Just was that close to the plus 30% you cited for yourself and for sales? And then, can you just give us a sense on how you see inventory heading into the peak selling season? Thanks.

Answer – David S. Regnery: Yeah. This is Dave. I'll start. I think most of you know our resi business, think of it as 50/50, 50 were direct, 50 we sell through the independent wholesale distributor channel.

On the IWD side, we saw -- the sell-through was strong, okay, in the 20s. So we saw some strength there. Obviously, the sell-in was stronger than that, as they filled some of their barns and their inventory.

We're not seeing a significant build in their inventory levels from the visibility that we have. We have some pretty good visibility there. So it was just a solid quarter for our resi business. Our teams performed well. They executed to customer demands, and we fulfilled and hopefully made a lot of homes more comfortable.

Answer – Michael W. Lamach: Yeah. The data that I saw, I think, it might have been like -- were three months. Let's just use that, I think it's pretty close to being what you think would be sort of a run of the mill inventory level would be. It might be 3.5 months. So, there might be two weeks, which I think is prudent basis where we were last year. And some of the underestimation that distribution had. So, it's marginally increased, but not enough where any flags would be raised.

Question – Andrew Krill: Got it. Makes sense. And then just a quick follow-up and we're going into overtime a little; but just cash flow in the first quarter, looks very strong, a lot of times actually use. Just anything you would spike out there and then any other big moving parts to be aware of as the year progresses? Thanks.

Answer – Christopher J. Kuehn: Yeah. This is Chris. No, we're happy with first quarter performance. I think it was 96% free cash flow conversion to earnings, so high-quality earnings there. I'd say, we've continued to make structural improvements around our working capital, where, I think it was around 1.5% at the end of the first quarter.

I think a mid- to long-term target for us is going to be a little bit higher than that, and we're going to modestly invest in inventory here through the year. But our days sales have improved from two years ago. Our days payable have improved from two years ago. And even inventory turns over the last two years have improved.

So we continue to make, from an operational excellence perspective, improvements in working capital. And really, you're seeing that play out here in the first quarter. Full year, we're still guiding to greater than or equal to 100% of net earnings, cash flow and 100% in net earnings. So, I think we've got the structural ability to really hit those numbers, if not, slightly exceed for the year.

Question – Andrew Krill: Thank you.

Answer – Christopher J. Kuehn: Thank you.

Operator

There are no further questions at this time. I will now turn the call back to Zac Nagle for closing comments.

I'd like to thank everyone for joining on today's call. As always, Shane and I will be available for today and for the coming days to answer any questions that you have, and we certainly look forward to connecting. Be safe, and we'll talk soon. Thank you.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.