

Trane Technologies – Q2 2021 Earnings Call

COMPANY PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Zachary A. Nagle

Good morning and thank you for joining us for Trane Technologies second 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 David Regnery, CEO; Chris Kuehn, Executive Vice President and CFO; and Mike Lamach, Executive Chair and former CEO.

With that, I'll turn the call over to Dave. Mike?

David Regnery

Thanks Zac. Before we jump in, I want to take a moment to recognize Mike Lamach. Mike has reinvented this company a couple of times over. He built our high-performance culture and incredibly strong team. I'm proud to have worked with Mike in his capacity as CEO and I'm looking forward to continuing to work with him in his role as Executive Chair until his retirement in the first half of 2022.

And now I'd like to turn it over to Mike for a few words. Mike?

Michael Lamach

Thank you so much, Dave. After we announced Dave as my successor, I appreciate that we're able to connect with a large number of analysts and investors. First, I want to personally thank everyone for the kind words and e-mails and letters. I'm thankful for the opportunity I've had to work with such a great group of people. In fact, today is a bit of a milestone, marks my 50th and final earnings call.

Second, I want to share how excited I am to have Dave leading Trane Technologies. As a retiring CEO, in my view, you only hope for two things. The first is that you're leaving things a little better than when you started; and secondly, that you have complete confidence and trust in your successor.

And I have absolute confidence in Dave, having worked closely with him for 18 years and spending the last several years co-architecting our strategy together. I'm extremely proud of what we've accomplished, and I believe we have tremendous opportunity ahead as a climate-focused sustainability leader.

Now, back over to you, Dave.

David Regnery

Thanks Mike and thanks to everyone for joining us on today's call. I've played an active role on these calls in the past several quarters, but this is my first official call as CEO. I'd also like to thank the long list of shareholders and

analysts who I had the pleasure of speaking with right after the announcement.

As Mike and I highlighted on those calls, this transition in leadership is an evolution, not a revolution. We co-created the Trane Technologies strategy and have worked closely together for many years.

Please turn to slide three. While the world has contended with unprecedented change over the past 18 months and continues to face significant challenges, our purpose-driven sustainability strategy remains steadfast.

The long-term sustainability megatrends that underpin our strategy have only intensified and our innovation leadership is transforming the climate industry, as the world decarbonizes. This is more critical every day, as the clock is ticking on climate change. Our aggressive goals and bold actions can dramatically reduce carbon emissions and accelerate the world's progress.

In addition, we are proactively addressing emerging trends, as we see heightened focus on indoor air quality, energy efficiency, cold chain and the need to upgrade aging infrastructure in our schools. We are committed to making a difference consistently, relentlessly and over the long term.

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

Moving to slide number four. After posting a very strong first quarter, we have significantly raised our 2021 guidance range to reflect top quartile EPS growth for the full year 2021. The raise reflected both a positive demand outlook and expected acceleration in global vaccination rates.

Through the first half of the year, demand is shaping up consistent with our high expectations, while the delta and other coronavirus variants continue to pose considerable risk, large portions of the global economy are rebounding and continue to gradually improve.

Our global teams delivered a strong second quarter, with robust organic bookings growth of 30%, driving backlog to a record high. Backlog is up 15% from record Q1 levels and up more than 50% from the end of 2020. It's also up more than 50% versus any quarter in 2019.

Net, our backlog is extremely strong, not only in the context of a modestly down 2020, but also in the context of strong financial performance in 2019. Demand for our innovative products and services is high and our record bookings and backlog provide good visibility into 2021 and 2022.

Performance was strong throughout the P&L, with organic revenue up 18%. Adjusted EBITDA margins were up 180 basis points on 30% organic leverage and adjusted EPS growth was up more than 50%.

In many ways, 2021 is shaping up largely as we anticipated on our Q1 earnings call. So I thought it would be constructive to take a few minutes and talk about what has changed and how that's affecting our approach to the second half of 2021.

There are two areas that are making operating environment substantially more challenging. The first is the speed and slope of material and other inflation that has risen dramatically.

You'll recall that we saw unprecedented inflation and tariffs impact in the 2017 to 2018 timeframe. However, if 2021 plays out as we currently expect, we'll far exceed the peak inflation in tariff numbers we faced during that timeframe.

In 2021, not only are we seeing higher material cost inflation. Trane Technologies, and from what we're seeing in the market, the entire industry are implementing price changes faster and with far less lag time than in 2017 to 2018. The net result for us is we are implementing about \$150 million of incremental pricing in the second half of 2021 to offset about \$150 million in incremental inflation.

To be clear, this is \$150 million above and beyond what was already baked into our guidance at the end of Q1 in both cost and price. Successfully executing the price action offsets otherwise negative EBITDA impacts, but also drives organic leverage on our incremental revenues lower in the second half of the year. However, our industry typically holds on to price. So long-term, we expect these actions to be a solid tailwind for our business.

The second thing that has changed is the strong economic environment, combined with other factors such as strained logistics systems and tight labor markets have further stressed already tight supply chains. This is resulting in higher cost and greater inefficiency throughout the value chain. We are fully leveraging our high-performance business operating system and transformation initiatives to manage and mitigate these impacts and meet the

needs of our customers. But there is no silver bullet. We believe we can limit the impact of these inefficiencies to a few points of leverage in the back half of the year as we work to meet our customers' expectations and strong demand.

Our multiyear track record of delivering high-quality earnings and free cash flow fuels our balanced capital allocation strategy. Year-to-date, we've deployed about half the cash we expect to deploy in 2021. We have a solid pipeline of M&A prospects and continue to see value in our shares. Longer term, our purpose driven sustainability strategy continues to be focused on secular mega-trends that are powerful tailwinds for our business and support continued top-tier performance and differentiated returns for shareholders.

Please turn to slide number 5. We delivered robust organic bookings and revenue growth in the quarter, up 30% and 18%, respectively, with growth across all segments and business units. Our Americas Commercial HVAC business delivered robust growth in the quarter. Unlike many other peers and industrials who entered the quarter with easy growth comps after being down significantly in 2020, Americas Commercial HVAC organic bookings were up mid-20s and revenues were up low-teens in Q2 of 2021, building on mid single-digit declines in the prior year.

The Residential HVAC markets continue to be extremely strong, and our Residential HVAC team delivered high 30s bookings growth, with independent distributor sell-through up high 20s. We entered the second half of the year with record backlog, up significantly from record backlog at the end of the first quarter.

Our Americas Transport Refrigeration business continues to outperform the North American transport markets, delivering more than 30% revenue growth this quarter. Transport bookings were up low single digits, which may look like a miss, but actually it's a positive story and simply reflects a natural pause in orders from substantial bookings growth in Q1 as industry trailer production has largely maxed out capacity for 2021, and the focus has turned to booking slots for 2022.

We only recently opened up the order book for our first quarter of 2022, prudently keeping an eye on inflation, looking several months out. It's also worth noting that this quarter's bookings build upon very strong prior year truck and trailers, where bookings were up nearly 50%.

Turning to EMEA, our teams delivered 53% bookings growth in the quarter, with strong growth in both Commercial HVAC and Transport

Refrigeration. Revenues were also strong, up 28%. We continue to see strong demand for our innovative products and services that helped reduce the energy intensity and greenhouse gas emissions for our customers.

Our Asia Pacific team delivered bookings growth of 12% and revenue growth of 2% in the quarter, with growth in both Commercial HVAC and Transport. The impacts of COVID-19 pandemic continue to be challenged in the region, with low vaccination rates and partial lockdowns in some countries.

Now I'd like to turn the call over to Chris. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to Slide number 6. We drove strong adjusted EBITDA and operating margin expansion, supported by strong organic leverage of 30%, despite increasing headwinds as we move through Q2. Combined with strong revenue growth, we delivered outstanding adjusted EPS growth of 51%.

In addition, we increased business reinvestment in innovation, technology and productivity initiatives in the quarter. As Dave outlined at the beginning of the call, we're relentless when it comes to innovation to advance our proven sustainability strategy and fuel our growth.

Please turn to Slide number 7. In the Americas and EMEA, volume growth, transformation savings, productivity and price realization drove strong EBITDA margin expansion of 170 basis points and 460 basis points, respectively. Asia Pacific's margins declined modestly, but remained at strong levels, and we continue to be very pleased with the progress the region has made since implementing its direct sales force strategy in 2017.

Since 2018, Asia's margin improvement is impressive, up approximately 500 basis points. Further, on a two-year stack, EBITDA margins were up 270 basis points in the quarter or 135 basis points per year on average. As you look across our portfolio, a couple of common themes will continue to drive strong performance.

First, is our relentless focus on investments in superior innovation to help our customers solve their most challenging and complex problems and fuel market outgrowth over the long-term. The second is using transformation savings to fund business reinvestments and drive margin expansion. We're on

track to deliver \$300 million in transformation savings by 2023, which we'll touch on a bit later in the presentation.

Now I'd like to turn the call back over to Dave. Dave?

David Regnery

Thanks, Chris. Please turn to Slide number 8. Commercial HVAC Americas has significantly outperformed the broader markets over a number of years through strong focus, agility and execution, combined with relentless innovation for our customers. These defining characteristics power the business forward today.

End markets are improving with continued strong data center and warehouse demand. Demand in the education and office end markets is also growing. We're benefiting from increased demand across our K-12 customers, with federal stimulus funds supporting both current and more importantly, future growth.

We see this as a multiyear tailwind for our business, given our strong position in the education market and our direct sales force with deep relationships in this vertical. Vaccination rates are improving and end market indicators are generally strong, with ABI over 50 since February, as one example. Demand remains high for comprehensive indoor air quality solutions, with particularly strong interest from education, government and office end markets. We continue to see indoor air quality as a long-term tailwind for our business.

Though we remain prudent and cautiously optimistic, given the emergence of new COVID variants and the unpredictable impacts they may have, we enter the second half of the year with very strong backlog and are encouraged by the healthy demand picture that is forming.

Turning to Residential, we delivered record second quarter bookings and revenue and are entering the second half of the year with record backlog. Overall, we delivered a strong first half and expect a challenging second half against tough comps, 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, with weighted average transport market growth of approximately 24% for the year. Given strong demand for trucks, trailers and APU through the first half of the year, and supply constraints at OEMs limiting

the market size for 2021, we have pretty good visibility at this point, but our transport business will continue to have a strong year and that 2022 has the potential to be even stronger. I'll talk more about transport outlook in our topics of interest section.

Turning to EMEA, economic conditions are improving across the region. We expect continued improvement in the back half of the year with increased vaccination rates supporting the opening of an increased number and the ride of venues. Transport markets have been and remained strong. We are expecting 9% weighted average market growth. Our transport business is outperforming the broader markets and 2021 should be a very good year for us.

Turning to Asia, we expect growth in China in 2021, supported by increased vaccination rates and strength in data centers, electronics, pharmaceutical and healthcare. Outside of China, the picture is mixed. Vaccination rates generally remain low, with partial lockdowns in some countries.

Now I'd like to turn the call back over to Chris. Chris?

Christopher J. Kuehn

Thanks, Dave. Please turn to slide number nine. After an outstanding first quarter, we raised our full year guidance significantly with a clear goal of delivering top quartile EPS growth in 2021. Halfway through the year, we're seeing the market strength play out largely as expected.

Importantly, we continue to see our 2021 EPS growth guidance as top quartile among peers and other industrials, as we move through the Q2 earnings season. Given increasing inflation and supply chain headwinds, we believe our guidance remains prudent at this time.

We are raising our revenue guidance, largely to reflect the additional \$150 million in pricing we are executing to offset an additional \$150 million of inflation in the second half of the year, as Dave outlined.

Net, we've raised our organic growth estimate to approximately 11%, up from our previous guidance of 9%. We also expect to deliver strong organic leverage of approximately 30% for the full year.

Other elements of our guidance remain largely unchanged, as you can see on the slide. All in, total revenue growth is expected to be approximately 13.5%

and adjusted EPS is expected to be approximately \$6.05, which translates to approximately 36% earnings growth versus 2020. We continue to expect free cash flow to remain strong and equal to or greater than 100% of adjusted net income.

Please go to slide number 10. We've covered the main points of our guidance, so I won't spend a lot of additional time on this slide. The key takeaways are that we continue to expect strong organic growth, leverage and adjusted EPS in 2021.

Additionally, M&A and FX each adds additional revenues with modest EPS impact. The primary driver, which moves our leverage target from 35% to 30% for 2021, is the additional \$150 million in price we're executing in the second half of 2021 to offset incremental inflation.

Please go to slide number 11. We typically only provide annual guidance, however, given the comparisons from unusual 2020 throughout this year, we believe it may be constructive to provide some additional details on the second half outlook. Based on orders, backlog, and market visibility, we currently expect organic revenues to be up approximately 7% in the second half of the year.

Acquisitions are expected to add about 1.5 points of growth. Assuming FX holds at current rates, FX would add about another 50 basis points of growth. All-in, total revenues are expected to be up about 9%.

In the back half of the year, we continue to expect additional volume to generate strong underlying leverage in the high 20% range. Embedded in that expectation is a netting of transformation savings and other productivity programs, inflation, and continued reinvestment in the business. All of these elements were part of the full year guidance we provided in May.

As we've highlighted, the main change since providing guidance in May is \$150 million of additional price we discussed. Mathematically, this drives leverage around nine points lower in the back half of the year. We're also taking stock of where we are from a stressed supply chain and logistics standpoint, which is not unique to us, but carries with it real costs and inefficiencies.

Our business operating system and our transformation savings are mitigating a large portion of these inefficiencies and we expect to see just a few points of leverage headwind in the back half of the year. All-in, we expect organic

leverage in the high teens during the second half of 2021, with successful execution of price to cover material inflation.

The other piece of guidance we would provide at this time is that we expect the fourth quarter to have stronger revenue growth than the third quarter, with similar leverage in both Q3 and Q4.

Please go to slide number 12. 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 exceeded our initial cost reduction expectations, delivering \$100 million of savings in 2020, a full year early.

In 2021, we're on track to deliver \$90 million of incremental savings, for a total of \$190 million in savings. This performance gives us confidence to deliver \$300 million of run rate savings by 2023. We will continue to invest these cost savings to further strengthen our high-performance flywheel, which has a reinforcing and compounding effect over time.

Please go to slide number 13. 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 through relentless business reinvestment. 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 dividend 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 have a strong pipeline of M&A opportunities. We also continue to see value in share repurchases and as the stock trades below our calculated intrinsic value. All-in, we expect to consistently deploy 100% of excess cash over time.

Please turn to slide 14, and I'll provide an update on how we're deploying excess cash in 2021. We are on track to deploy approximately \$2.5 billion in 2021. Year-to-date, we have deployed \$1.3 billion in cash, with nearly \$700 million to M&A and share repurchases, including approximately \$250 million of share repurchases in July. We have paid \$282 million in dividends and \$300 million to pay down debt. As I shared, we have a strong pipeline of M&A opportunities and continue to see value in our shares.

Now, I'd like to turn the call back over to Dave. Dave?

David Regnery

Thanks, Chris. Please go to slide number 16. As we've done in the past couple of quarters, we want to provide an update on the transport markets. Our outlook for 2021 is largely unchanged, with modest adjustments to North America and EMEA numbers.

As we discussed earlier, trailer production capacity is constrained in 2021, which is shifting volume to 2022. EMEA added one point of overall growth on truck and trailer strength. Halfway through the year, we're seeing considerable strength in both of these markets across bookings, revenue and backlog, which supports the forecast from ACT and IHS, with an even higher degree of confidence than when we reported our first quarter results. The other point I'd like to highlight is that ACTs forecast for 2022 stands at 51,100 units, up 17% from 2021. This is another strong tailwind for us as we look towards 2022.

Please go to slide number 17. 2021 is shaping up to be a strong year for us overall. Our current guidance firmly places our EPS growth in top quartile of industrial companies, supported by high-quality free cash flow. Energy efficiency and sustainability megatrends are only growing stronger, and we are uniquely positioned to deliver leading innovation that addresses 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. This will enable additional reinvestment to expand margins and further strengthen our ability to outgrow end markets. When combined with the megatrends underpinning our strategy, strong demand in our end markets, our exceptional ability to generate free cash flow and our balanced capital deployment, we are well-positioned to continue to drive differentiated shareholder returns.

And now we'd be happy to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator

Thank you. Your first question comes from the line of Julian Mitchell with Barclays.

Analyst: Julian Mitchell

Question – Julian Mitchell: Hi, good morning. Maybe just honing in on the color on slide 11, which is very helpful. On the operating leverage, is there any sense when you look at that second half all-in sort of mid-teens leverage figure, which geographic segments may be hardest hit by that, if any? And any context around commercial HVAC versus Transport versus Residential? Any big changes in the operating leverage or divergences across those categories?

Answer – Christopher J. Kuehn: Hey Julian, it's Chris. I'll start and then Dave may jump in. As you know, we don't guide specifically to margins or revenue growth by segment. We are anticipating in the second half, high teens organic leverage, really mid-teens all in, when you factor in M&A and FX for where we see it today. Underlying leverage across the businesses is strong. What we're factoring into the second half is additional price to cover material inflation, which is driving down those incrementals by approximately 9 points versus our previous guide of 30% organic leverage for the second half of the year.

That, plus the supply chain constraints that Dave talked about earlier, are really factoring in why we think it's high teens organic leverage across the second half of the year. And really, when you think about supply chain and price, it's really impacting all of our segments. When I think about the Americas, EMEA and Asia, we're all being impacted by similar concerns around raw material inflation, around supply chain constraints, they're happening in all the regions.

Answer – David Regnery: Yes, Julian, this is Dave. Thanks for the question. Yes, as Chris said at the end, we're really seeing this across the globe. Supply chain constraints are real. They're not unique to Trane Technologies. I think the entire industry is seeing these and the material inflation, I've never seen it like this before, and I've been in this industry for a long time. but it's really -- it's accelerating certainly in the -- at the end of the first quarter to the second quarter, and that's why we've taken out our third price increase of the year.

Question – Julian Mitchell: And you gave some helpful context around the sort of third and fourth quarters having similar operating leverage across both of them. Let me try and look a little bit, say further out beyond the next few months and what you've announced on extra price increases. And when you take into account the sort of rolling of hedging rates and sort of cost

management, do we think that you get back into balance with more normal operating leverage early next year? Or it's too early to call that, and there's too many sort of moving parts right now?

Answer – Christopher J. Kuehn: Julian, I think the latter end of your point there, there's just a lot of moving parts at this point for us to call 2022. As we talked about in our December Investor Day, we're really looking towards 25% organic operating leverage on an annual basis. We still think, we've got the demand and the internal structure and cost takeout transformation actions to support that. But as we get closer to 2022, we have a much better view of that inflation environment, supply chain environment as it exists and call it as we get closer to the year.

Question – Julian Mitchell: Great. Thank you.

Answer – Christopher J. Kuehn: Thanks Julian.

Operator - Your next question comes from the line of Jeff Sprague with Vertical Research.

Analyst: Jeff Sprague

Question – Jeff Sprague: Hey, thanks. Good morning everyone. Just two for me. Just first on capital deployment. How active is the M&A pipeline? I fully understand if it doesn't materialize, sounds like you'll toggle to share repurchase. But is there kind of a decent shot on goal that there's a sizable chunk or two going into M&A here as we close out the year?

Answer – David Regnery: Yes, Jeff, this is Dave. I won't give you too much specifics there, but our pipeline is very robust, okay, with M&A. And by the way, we've had a great track record with the M&A that we've been able to deploy or actually acquired in the last several years, whether it be on the channel side or on the technology side. So our M&A pipeline is robust and we're hopeful, we can execute on some of that.

Question – Jeff Sprague: Okay. And just as a follow-up, and I missed the first few minutes of the call, so I'm sorry if you addressed this. But on the supply chain in general, I'm sure kind of labor and other issues, are you actually at a point of kind of capacity constraint, where you're not fully meeting kind of end demand, as it's currently materializes in front of you? And how do you see that playing out in the back half?

Answer – David Regnery: Yes. I mean the good news, Jeff, is the order demand really across the globe has been extremely strong, not only in the second quarter but also in the first quarter. And we have stressed our supply chain. I don't think this is unique to Trane Technologies. I think the all industrials are facing this. But yes, we have some challenges in the supply chain.

Our team is doing a great job of managing it. They're helping our suppliers ramp up. But we anticipate that through the third quarter, this challenge will continue. We see it getting a little better in the fourth quarter as some of our key suppliers are able to ramp up. And by the way, in the industry, a lot of competitors use the same supplier. So this is not unique to Trane Technologies.

But again, it is constraining us a bit, it's causing some inefficiencies. Team is doing a fantastic job of getting components to the factory. Unfortunately, they're just not showing up exactly when we need them. So we're constantly having to reschedule lines and rebalance output to meet our customers' demand and expectation. Again, it will be challenging through the third quarter. We see again a little bit better in the fourth quarter.

Question – Jeff Sprague: Great. Thanks for the color. Appreciate it.

Answer – David Regnery: Thanks.

Operator - Your next question comes from the line of Josh Pokrzywinski with Morgan Stanley.

Answer – David Regnery: Hey, Josh. How are you doing?

Answer – Christopher J. Kuehn: Good morning.

Analyst: Josh Pokrzywinski

Question – Josh Pokrzywinski: Good, thanks. So just one follow-up on Resi. Obviously, between supply chain and kind of different instances of sell-in versus sell-through, I think the numbers have moved around a lot this quarter. Yes, I apologize, much like Jeff, I missed the first few minutes, but could you say where you ended up in the quarter and then how you sort of feel about backlog or kind of ability to deliver in the second half vis-à-vis supply chains or inventory out there and the independent channel, et cetera?

Answer – David Regnery: Sure. I'll then give you a little more color around Residential in total. First of all, we're seeing very, very strong demand in Residential. Bookings in the quarter were up 37%. Year-to-date, our bookings are up over 40%. So really, really strong demand. Sell-through through our independent wholesaler distributors was up in the high 20s, very close to 30%. So that's good news. That's really how they're serving their dealers.

Sell-in to the channel was less. It was up in the mid- to high teens. Revenue in the second quarter for us was at record levels. So revenue was record levels. And backlog was also at record levels. We typically measure backlog in this business in weeks. We're now talking about backlog close to two months. So again, very strong demand that we're seeing in this space.

Everyone in the industry is seeing eye-popping numbers in Residential. And it's kind of an odd time. I've been in this industry a long time and everything you make right now is sold. So, the more you make, the more you're going to sell. Demand is so strong that it has outpaced the capabilities of our supply chain as I mentioned earlier. So, we're in the process of helping our suppliers ramp up and again, we see challenges continued through the third quarter, I think we see the supply chain a lot stronger in the fourth quarter.

So, I think our incremental growth rates in the third quarter will be less than what we're going to see in the fourth quarter. And again, the supply chain constraint is not unique to Trane Technologies and we believe that, hopefully, in the fourth quarter, this will start to work through.

The other point I would add is that in the resi space, we typically think about production like you have peaks and -- peak times and you have trough times, we see peak time continuing for an extended period of time. And we see us running at peak rates at all of our factories for a continued period of time.

The other thing I would mention there is -- and I know there's probably some questions out there about share in residential, I would tell you that over the last six years, we've gained share in our residential business.

I would -- you're going to have some disconnects at least in the short-term here with how many order share versus shipping share. But over time, when backlogs deplete themselves to get back to a normal level, we see that evening out and we see ourselves gaining share in the future.

Question – Josh Pokrzywinski: Got it. That's comprehensive. I appreciate that. And then I guess on the commercial side, in the Americas, there's also a

whole lot of different factors at once. We've seen the light commercial bounce back pretty solidly. Cyclically, obviously, those customers seem like they would have been most impacted during COVID. But maybe on the applied or larger unitary side, new construction benefit or energy retrofit side, how would you sort of carve off the strength that you're seeing as being tilted toward one or the other?

Answer – David Regnery: Yes. I mean if you look at across the verticals in our commercial HVAC business in the Americas, I don't think there's a time that I've seen where every vertical had growth and we play in all verticals. So, the strength is widespread, which is a good thing.

Obviously, on a macro level, you have ABI, which has been very strong since February. So, that's going to be a strong tailwind. Look at that six months out. But we're seeing strength everywhere.

And indoor air quality is certain part of it. Office strength coming back, which is nice. A lot of strength in the education vertical right now, we're starting to see stimulus funds be used for upgrading the infrastructure of our schools. It's really a broad based. The more energy-efficient your product is and the greater your innovations are, you're really able to capture a lot of these opportunities.

Question – Josh Pokrzywinski: Great color. Thanks guys.

Answer – David Regnery: Okay. Thanks.

Operator - Your next question comes from the line of Nigel Coe with Wolfe Research.

Answer – David Regnery: Hey Nigel.

Analyst: Nigel Coe

Question – Nigel Coe: Hi, good morning. Thanks for the questions. Hi guys.

Answer – Christopher J. Kuehn: Good morning.

Question – Nigel Coe: Let me go back to residential, just to be clear. So, this isn't Trane capacity constraints, this is supply chain competitors on residential. Just curious, where are you seeing the major pinch points on the

supply chain? And you mentioned you're suppliers to cope with that, what measures are you taking to help them with that?

Answer – David Regnery: Yes. First of all, the supply inconsistencies is really throughout our entire business on a global basis. I think it started, Nigel, really with the freak storm that hit the southeast and knocked out all the resin supply and the knock-on effects that, that continues to have through the supply chain, whether it be wire harnesses or you have and it certainly has an impact on electronics. And as our products have gotten smarter through the years, electronics is everywhere. And it's not just the controller for the unit. We're seeing in fans, motors, compressors, they all are interconnected within the system. They all use electronics to connect. So it's very broad-based.

I mean, I think our team is doing just a fabulous job working 24/7 to mitigate this, but it's a little bit of a whack-a-mole, where you see one supplier fixed, the next one goes -- has a little bit of problems. And what we're doing though is, we're working with our strategic suppliers as partners here, and we'll actually have teams help them with their ramp-up. And that's why I said, we have some visibility, we know Q3 is going to be -- continue to be challenged. We see the fourth quarter, some of our ramp-up plans with our suppliers getting better. So, we think the fourth quarter will be a bit better than the third quarter.

Question – Nigel Coe: Okay. That's great color. Thanks. And then on the M&A pipeline, you've seen some pretty richly priced deals to put it mildly coming through amongst some of your industrial peers. Is the major barrier pricing? Or is it more fit at this point? And are you focused mainly on hardware acquisitions? Or are you looking more software technology?

Answer – David Regnery: Yes. At the end of the day, I mean, our M&A pipeline is very robust right now. We're using the same model that we've always used, okay? So, we're going to make sure that it clears our hurdles. We're not going to buy for the sake of buying it. There are -- there is some value out there. We've certainly seen that in some of our channel acquisitions, and we certainly have seen it in some of our technology acquisitions. So stay tuned and our pipeline is robust.

Question – Nigel Coe: Okay. Thanks Dave.

Operator - Your next question comes from the line of Andrew Obin with Bank of America.

Analyst: Andrew Obin

Question – Andrew Obin: Yes, good morning.

Answer – David Regnery: Good morning. Hey Andrew how are you?

Question – Andrew Obin: I am good. Thank you. If you hear children in the background, my apologies.

Answer – David Regnery: That's okay. I think we're all getting used to that in our COVID world.

Question – Andrew Obin: Its – if we could talk about resi, just sorry to hammer it, but it sounds like if you think about seasonality, September and October are just much lower volume months. So, is it fair to assume that you could have been up year-over-year in Resi, given the demand backlog, if it wasn't for supply chain constraints?

Answer – David Regnery: Yes. I think there's a couple of things there. Obviously, our backlog is very large right now in our Residential business. Again, we usually look at this as 1 to 2 weeks. Now we're close to 2 months. So obviously, as you burn the backlog, you'll get back to a normal rate. Supply chain is certainly part of the constraint. I would also tell you that, if you remember back in February, a freak storm went through the Southeast and hit our plant in Tyler, Texas, where we had a partial roof collapse of our building there. A relatively small portion of the building, but we did have to recover from that and I think our team did a great job of recovering that, even during peak season.

I think first of all, nobody was hurt, which is a good thing. I think the plant was up and running, producing product within 5 days. And that ramp-up is going as scheduled. It is a ramp-up though. So, it was a disruption that we've overcome. We're producing at rate now. And obviously, we're producing a lot of product, because we had record revenue in the month of -- or in the second quarter. That said, supply chain is really our constraint right now, and we're managing through it and we have line of sight to seeing the fourth quarter to be a bit better than the third quarter.

Answer – Christopher J. Kuehn: Dave, what I would add is from a second half perspective of 2020, the residential was a very strong performance, coming out of lockdowns. I think we saw mid to high teens growth in the second half of last year in residential. So either way, it will be tough comps

into the second half of 2021. And to Dave's point, the supply chain matters are really endemic to the industry, but we're working with customers. We're meeting demand with customers today, and we're continuing to do that, and we expect to do that through Q3 and Q4.

Question – Andrew Obin: Thank you. And just maybe for applied business, can you just talk about visibility on your key institutional verticals and particular education and healthcare? Thank you.

Answer – David Regnery: Yeah. We're seeing -- certainly saw strength in the second quarter in both education and healthcare, very strong verticals for us, and we're seeing nice activity there. Our pipeline going forward remains very robust. Our pipeline is defined as orders that aren't yet closed that were we're talking to customers about. So we have a great value proposition in both of those verticals. So we see strength there for -- into the future.

Question – Andrew Obin: I leave it at that. Thank you very much.

Answer – David Regnery: Thanks.

Operator - Your next question comes from the line of Andy Kaplowitz with Citigroup.

Analyst: Andy Kaplowitz

Question – Andy Kaplowitz: Hey, good morning guys.

Answer – David Regnery: Good morning.

Question – Andy Kaplowitz: So maybe if I could ask Andrew's question in a different way. You've talked about IAQ demand trending toward the high end of your 1% to 2% range for this year. Now that you've had some time to analyze the behavior of your customers, are you seeing more customers asking you to come in and do the day two type work? And could you talk about longevity of the cycle for the verticals such as education offices? I know you said in your prepared remarks that this could be a multiyear cycle, but do you see a 2% tailwind for several years at this point?

Answer – David Regnery: Yeah. We do see it as a 1% to 2% tailwind for our business into the future. That said, this year we'll be closer to 2%. We are seeing day two activity in the education vertical as we provided roadmaps to our customers, how they could upgrade their infrastructure and obviously, now

with stimulus funding becoming available, some of that is happening. So that's good news.

The other thing we're seeing is we're seeing a lot of demand in the office space for audits, is the indoor air quality audits as people are thinking about how they're going to get their employees back to the office. So that's upticked nicely. And we're going to go through the same exact process we did with the education vertical and the office vertical. So we see that coming back as well.

The other thing I would tell you, Andy, is it's getting more and more difficult to say what is indoor air quality versus what is just part of an applied system. So it's very similar to maybe like controls, where it's -- if you tell me the controls number, I'm not sure what you're referring to. It's getting to be that on the indoor air quality as these solutions to have better indoor air quality are being embedded in our applied systems.

Question – Andy Kaplowitz: Very helpful. And then if I shift gears and talk about transport refrigeration, obviously, there's a lot to ask there. But let me ask you about the longevity of the cycle. You've mentioned the slower orders in the quarter, given capacity constraints. But given the backlog you have and the constraints out there, would you say transport refrigeration still grows double digits in 2022? And you really have good visibility into 2023 now, given what's going on out there.

Answer – David Regnery: Yeah. I wouldn't be concerned at all about the low order intake in Q2. I mean if you go back to Q1, we had unbelievable bookings growth. So – and it's really just customers placing orders for the full year. So we're not concerned about the order intake in our Thermo King business at all.

That said, we are seeing some constraints on the trailer OEMs, okay? And every trailer that they don't manufacture, we see that volume pushing into 2022. Obviously, you're not going to sell a trailer reefer unit if you don't have a box to put it on.

If you look at 2022, at least in the Americas, if you look at the ACT Report, they now have the trailer market at 51.1%, which is 17% above what they have 2021 -- I'm sorry, for 2022, they have it at 51.1%. So it's 17% above 2021. So it's going to be robust.

If you go out to 2023, they're forecasting now, at least the trailer market, to be in the mid-40,000 range, which, by the way, is where the industry has been in

North America for really nine of the last 10 years, if you exclude 2020. So we see, certainly, 2022 will be a strong year. I think it's a little early to call the exact percentage there, but it will be a strong year for our Thermo King business.

Question – Andy Kaplowitz: Appreciate it.

Answer – David S. Regnery: Thanks, Andy.

Operator - Your next question comes from the line of Steve Tusa with JPMorgan.

Analyst: Steve Tusa

Question – Steve Tusa: Good morning and congrats on the transition, et cetera, et cetera and best of luck. Just on price cost, I mean, you talked about the incremental impact of pricing cost. Can you just talk about what you had initially planned for the year, so what the total numbers are? And then what you booked in the quarter?

Answer – Christopher J. Kuehn: Steve, I'll go. This is Chris. In Q2, I'll start there. Price cost was positive, and we were positive in the first quarter and positive in the second quarter. But in the second quarter, we saw direct material inflation, roughly 4 times the size in Q2 as we did in Q1. So it was really starting to ramp up, and that continues to ramp into the second half of the year.

With the guide in the second half now, where we added \$150 million of price to offset \$150 million of inflation, it's about 2 points of price in the second half of the year to cover inflation. That \$150 million, it's a little bit more than what we had in the original guidance for the second half of the year. So I won't size it exactly, but it's a record, certainly for us, in the last 10 years in terms of inflation.

What we do see different around this cycle is where we've been on par or ahead of pricing to cover material inflation. I think about 2017, 2018, that last inflationary cycle, it took us many quarters, five, six quarters to catch up on price cost.

This time, we're positive Q1, we're positive Q2. We expect that to be flattish in the second half of the year, just given trying to keep up with inflation. That \$150 million is really an increase just from when we last talked in May. So it

still remains volatile here. So, hopefully, that gives you a little bit additional color.

Answer – David S. Regnery: I mean, the operating system that we have in place today, Steve, versus what we had in 2016, 2017, I mean, we're able to really hone in what we need to do in pricing real time almost. And remember, most applied jobs are -- there's not a price list for an applied job.

Question – Steve Tusa: So what is total absolute dollar cost headwind for the year?

Answer – Christopher J. Kuehn: Yeah. I don't think I'd describe an actual dollar cost number. I think, I would say, for the full year, we expect to be flattish on price cost. It could be a little bit favorable, depending on where things fall out. But I think it's very volatile to call the year.

Second half of the year, we've got from a commodity perspective, roughly 70% locked with copper, actually 60% locked now with aluminum. That's a step-up for us with some recent hedging that we've done in that space. So I think we still have a little bit of exposure on commodities for the second half of the year. So I hate to try to peg it to any one number, just given the volatility we've seen, but it's significant.

Question – Steve Tusa: Right. And then lastly, just on light commercial, how did that -- how did a light commercial unitary do in the quarter? Equipment?

Answer – David Regnery: Yes. Our unitary business was up well over 30% on an incoming order rate basis. So we're very strong in unitary.

Question – Steve Tusa: Same in revenues?

Answer – David Regnery: No, revenue, a little bit of back -- actually, it's pretty close in revenue, too, but a bit -- a little bit less than that.

Question – Steve Tusa: Okay. Great. Thanks for color. Appreciate it.

Answer – David Regnery: Thanks, Steve.

Operator - Your next question comes from the line of John Walsh with Crédit Suisse.

Analyst: John Walsh

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

Answer – David Regnery: Hi, John.

Answer – Christopher J. Kuehn: How are you, John?

Question – John Walsh: Good, good. Thank you. Hey, I apologize if I missed this earlier, but could you talk about -- I mean you made the point applied projects are -- there's not a standard price list. Can you talk about if your customers are delaying any projects as they just see broad-based inflation? I'm thinking this is a little bit more on the new construction side, but I would just love to get your perspective there.

Answer – David Regnery: Yes. We're not -- obviously, with the incoming order rates, we're seeing very strong demand, John. So we're not seeing delays there. But what we are seeing is we are seeing delays in job sites being ready to receive equipment. So we have seen that. It started to pick up in the second quarter. I think the construction industry is certainly struggling getting skilled labor. And we have seen several job sites push out, which is causing our backlog again to be very strong in our commercial space. Obviously, we're not going to ship a product to a job site if the customer is not ready to receive it, not on the incoming side, but certainly on the outgoing side, we've seen some delays.

Question – John Walsh: Great. And then just on Europe, I was wondering if you could just give us a little bit more color there what you're seeing in the market around heat pump demand? Obviously, we saw that fit for 55%. And then I don't know if I saw what your Commercial HVAC orders did in Europe in the quarter. I apologize if you said that in the prepared remarks, but I was just looking for that number in particular. Thank you.

Answer – David Regnery: Sure, John. I mean, a little color on Europe, okay? Order rates up 53%. Revenue up close to 30%. I think it was up 28%. And we saw substantial strength in both businesses, both our Commercial HVAC and our Thermo King business, and it's really led by innovation. And if you look at our Commercial HVAC business, we're seeing high demand for our variable water flow systems, which is really the electrification of heating. We're also seeing high demand for industrial process cooling as we've been able to expand the operating maps of our products so we can now work in the industrial cooling space. So again, it's really led by innovation.

If I go to our Thermo King business, I would tell you that the Advancer product that we introduced 1.5 years ago, I mean we're just -- it is exceeding customers' expectations. I had a customer that I talked into ordering some Advancer units early on. And I told them about the expectations they should have for this product. The customer literally emailed me about a week ago and said you were wrong in your expectations. And I was concerned that I read out in the e-mail and have said, you actually exceeded what you told me you were going to do from an energy efficiency standpoint for the Advancer product and I want to order more. So, the Advancer is really just -- it's a step function change in the trailer reefers space in Europe, and we couldn't be happier for -- I couldn't be happier for that team and I'm so proud of that team, what they've been able to accomplish. So, it's a great story for us in Europe and we expect continued success in the future.

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

Answer – David Regnery: Sure.

Operator - And your next question comes from the line of Joel Tiss with BMO.

Analyst: Joel Tiss

Question – Joel Tiss: Hey guys. How is it going?

Answer – David Regnery: Good. How are you Joel?

Answer – Christopher J. Kuehn: Good. Good morning.

Question – Joel Tiss: All right. I wonder if we could just zero in on Asia for a little bit and just I don't know if there's any implications from the government cracking down for you guys to rethink or is there attractiveness in residential to start to push into there? And are you still gaining market share? Just a little bit of color about what's going on there?

Answer – David Regnery: Yes, I think our Asia business continues to execute well. In the quarter, I think our incoming order rate was in the low teens, which is nice growth. We're continuing to see margin expansion, is another great story. Chris talked about that earlier. We had, I think, it's 270 basis points of margin. If you look at it on a two-year stack, if you go back four years from when we made the significant investment we did in our sales force, it's up over 500 basis points. So, we're very happy with our performance, what's happening right now in Asia.

If your question is really around China, we see what the government is doing there as a tailwind for our business. You think about what they're doing in the carbon trade market, I think they launched that in July. Again, that's -- we're all about decarbonizing the built environment, and we have the portfolio of products to do that.

So, -- and again, if you look out further with their goals to be carbon neutral by 2060, we have -- we're going to play a big part in helping the government there achieve those targets. So, there's a big built environment there. There's a lot of product to replace and we have a great portfolio to help with the mission to decarbonize China specifically, but really the whole world.

Answer – Christopher J. Kuehn: Dave, I'd add. I think that team over the last several years has also really struck a great balance with revenue growth and margin expansion, just looking at both sides of that equation and really the margins in the backlog continue to hold up well.

So, I think from the quarter perspective, it's really a law of small numbers, but the discipline they have on both revenue growth and margin expansion has really been outstanding.

Answer – David Regnery: Yes. And Chris brings up a good point there. The discipline around the order side as we get closer to the customer and we can explain our value proposition, it's a great story there. The whole build-out of the direct sales force becoming basis of design, we're very happy with our results in Asia right now.

Question – Joel Tiss: That's great. Thank you very much.

Answer – David Regnery: Thank you.

Operator

Thank you. I'll now turn the call back over to Zac Nagle for closing remarks.

Thank you everybody for joining today's call. As always, we'll be available at any time to take your questions. We look forward to seeing you all soon and have a great day. Be safe.

Operator - Thank you. This does conclude today's conference call. You may now disconnect.