Trane Technologies at J.P. Morgan Industrials Conference

March 17, 2022

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MANAGEMENT DISCUSSION SECTION

Steve: All right, up next, the next HVAC player in the list here. Not in rank order in terms of favor, but we've got Trane. Very happy to have CFO, Chris Kuehn, and chairman and CEO, Dave Regnery. Dave, couple minute introduction. Thanks for joining us, and then we'll jump right into Q&A.

Dave: Yeah, great. Thanks. Thanks for having us, and again, thanks for hosting this conference in person. I don't know about everyone, but I'm certainly glad to be face-to-face versus what we've done for the last two years.

I was telling Steve earlier I'm tired of talking to a computer, and not necessarily know what the response is going to be. Thanks, your team has done a great job putting this on, so appreciate that and...

Steve: Take all the credit.

Dave: Happy St. Patrick's Day, right?

Steve: Yeah, St. Patrick's Day, a little different.

Dave: For everyone celebrating that.

Our purpose at Trane Technologies is to challenge what's possible, and innovate for a sustainable world. It's fundamental to our strategy, and it allows us to have differentiated shareholder returns over time.

The mega-trends around sustainability and decarbonization continue to intensify. Unfortunately, the pace of global warming continues to accelerate. In the last two years, they were some of the warmest on the planet. OK? We need to take action if we're going to bend the curve on climate change, and we need to take action now.

At Trane Technologies, we're scaling technologies that exist today that can dramatically reduce the carbon footprint for the world. These technologies exist today. We don't need to wait for new inventions. These technologies are available, and we're scaling them across the globe. With that said, we're also relentlessly working on innovation for tomorrow.

This unyielding approach allows us to outgrow our end markets and generate powerful free cash flow, which we deploy through our balanced capital allocation strategy.

In 2021, we saw record demand for our products and services, record demand across the globe, and like the broader industries, we also saw supply chain constraints. We're working very closely with our suppliers and working with our engineering teams. We believe the supply chain constraints will improve in the back half of the year.

We enter 2022 with a backlog that is nearly double a normal year. We are well-positioned for growth in 2022 and beyond.

With that, Steve, we'd love to take your questions.

QUESTION AND ANSWER SECTION

Steve: Absolutely. I'm just starting a little bit near term to check the box on some of the stuff that's going on out there. Maybe are you seeing anything in Europe? Any implications from what's happening with Russia?

Then we'll touch on China as well, but maybe we'll just start there.

Dave: The events that are occurring in the Ukraine, our hearts and prayers go out to all the people of the Ukraine, and our humanitarian support. From a business perspective, our revenue in Russia and Belarus is less than one percent of our revenue.

From a supply chain standpoint, we don't have any, what we call tier-one suppliers there, where we would buy directly from. We're still evaluating the impacts of tier 2 or tier 3 suppliers. This would be someone who would sell to someone who we would buy from.

Steve: Neon. We're learning about neon now, which I think is kind of crazy, but I guess that that's one of the keys to the electronics production out there. Didn't know that before, but...

Dave: Yeah, the coating of boards. That's what the tier 2 and tier 3, especially when you get into electronics is something that we're evaluating.

Steve: In China, any feedback from the boots on the ground there? As far as shutdowns or any implications for Trane with the re-emergence of COVID there.

Dave: I was just on the phone with our team in China actually earlier this morning. Yeah, they were very aggressively managing the COVID situation, and they're lockdown situation. I think it's locked down within a city. It's not necessarily locked down within a building any longer.

They tend to be short lived. They do a lot of testing, which is a good thing. If they if they see a problem, they'll have some quarantine for a period of time. I think it's too early to say what the impact would be. I know that rates are actually falling in China, which is a good news story, but we'll see how that that persists as we go forward.

Steve: Just give us an update on supply constraints. Would you say relative to where you were at the end of December, January, that things there are the same, better, worse, and maybe highlight a couple of...I'm sure that there are still a couple lingering areas that you're having at least lead time issues with.

What would those types of components be maybe outside of electronics? Maybe it is just electronics.

Dave: Well, I mean electronics, as we said our fourth quarter call, is the leading constraint that we have right now. Electronics and electronic components. As I said in my opening, we're working very closely with our suppliers to understand.

This is an example where we've learned we have to swim upstream a bit. So, it's not just the broker you may be buying a chip from. It's, who's the manufacturer of the wafer, who's the manufacturer of the chip? What's the relationship there? So, all that activity is happening.

We're also doing a lot of work, too, to self-help in this area. Things like utilizing next generation chips that are more readily available. We're also doing some work with how you modulate fans at a more detailed level that is helping the situation as well, but it's going to persist through the first half of the year.

We think it's going to get better in the second half of the year, but we'll stay tuned.

Steve: That sounds kind of stable at this stage, like the stuff that you were seeing a couple months ago is the same stuff you're seeing today.

Dave: Yeah, stable isn't the word I would use, because I think it's pretty dynamic still, in the electronics components.

I will tell you that, if you go back to the September/October time period, I mean we were getting disruptions that were more extreme. We would be getting calls...if you were a plant manager, you'd get a call saying, "Oh, your copper tubing is not going to show up today." And those calls have subsided, which is a good news story.

All the electronics, electronic components. It's not just the chip either. It's electronic components that continues to be a bottleneck. If we had a clean supply chain, our revenue would be obviously much stronger than it is right now, with our backlog in the position that it is.

Steve: Chris, maybe you could just remind us of what you had said on that front, because you guys said that there were first some revenues that shifted in the fourth quarter and then some revenue shifted out of the fourth quarter.

Maybe just give us a status update on the timing of what those numbers were and in the timing of how those revenues make their way back into the fray in '22.

Chris: We said, Steve, actually in the third quarter of last year about $150 million of the revenue got pushed out of the third quarter. We thought we'd get 50 to 75 million of that revenue back in the fourth quarter.

We actually did a little bit better than that in the fourth quarter. It still shows that we didn't have as much revenue last year as we could have, and we had a very strong year in terms of revenue.

So, we guided 2022 to really high single-digit revenue growth, just based on the volumes we could see from a supply chain. It's not a demand issue. It's really a supply chain limiting factor issue, and if supply chain recovers more quickly, I think we'll have a stronger year. That call at 50 to 75 that didn't happen last year, that's baked in now into 2022.

Steve: Was there something that compounded in the fourth quarter, as well, or was it really just those third quarter sales that worked their way into this year? Because conceivably, maybe that built on itself. Is there a little more than that that happened in the fourth?

Chris: Think of it as, it is rolling. Right? So you missed the 150, we got 50 to 75 of that back. The 150 actually did get revenued in the fourth quarter, but then some of that slipped into 2022.

Steve: Got it. So, that's what you're saying. On just the quarter-to-date trends, Carrier talked about positive upside at resi and light commercial. What are you guys seeing in the US markets there on resi and light commercial?

Chris: What I would say, Steve, we don't get...

Steve: I'm asking him as well. He's turning towards you, but it's a question for both of you.

Chris: No, no, I appreciate it. We don't give inner quarter updates, but we did start the year in a great position in the resi business with record backlog. We generally manage that backlog, and we describe it in terms of weeks. We had months of backlog entering the year in terms of residential.

So, let's see how that kind of plays out. What we saw in the first quarter, is we gave a little more guidance around the first quarter, just to really dial in what we could see, try to be transparent.

We got to low to mid single-digit revenue growth, and that was really all from price. At the time we gave the guidance, we wanted to understand really where the supply chain was at. Let's see how that plays out through the quarter, but it was going to be a very low volume benefit on a year-over-year basis in Q1.

During the resi part of the question, it was a great year to start in residential with the backlog, much like our other businesses.

Dave: In our unitary business, if you look at the fourth quarter, our incoming order rates were up over 20 percent.

Steve: Right. Light commercial, light commercial.

Dave: Light commercial has been very strong. It's very strong in 2021.

Steve: How do we think about, resi order rates have...I'm not sure why you guys even report that stuff. I guess you have to talk about it because you report orders, so you have to explain.

Some of the numbers are just crazy. They're all over the place. How do we see that playing out over the course of this year? Carrier just talked about that number being down in the first quarter. You're going to have some tough comps in the first half. How do you see those order rates playing out in '22?

Dave: Yeah, I mean, just so everyone's grounded here, in 2021 we saw our order rates for resi to be up close to 30 percent. So, we don't anticipate that we're going to be up 30 percent every year in resi. So, we have some tough comps that we're going to be facing from an incoming order standpoint.

I think if we look at our resi business, which by the way is about 20 percent of our total business, we have a very strong backlog, a very strong price realization, and we have some leading brands in the marketplace. So, we'll see how the year plays out. It's still early.

Steve: Got it. I'll get back to resi cycle in a sec, but just wanted to clean up some of the details on the guide. Price cost, can you maybe remind us of what you guys had talked about on the call? Then, I have a follow-up question on pricing.

Dave: Sure. You want to start, Chris?

Chris: Yeah, happy to, Dave. I actually think, and Dave and I have talked about this before, that the ability to price last year is probably one of the most improved parts of our business operating system.

It really started with getting the forward look of input costs, as best as we could. We had started last year very early with that first price increase. It really was in the December 2020 time frame, or January 2021.

It really led to the first half of the last year being very strong on the price-cost equation, and then that narrowed as we got into the second half of the year. Ultimately at the end of 2021, we were price-cost positive.

That's the same guide we gave for 2022, to be dollar price-cost positive on the year, but in terms of just taking as much price as we exited in Q4, which is around five-and-a-half points of price in the enterprise, that is going to carry over to the first half of the year, but we're comping against very moderate inflation.

That's why we see the price cost dynamic being negative in the first half of '22, Steve.

Second half, it's going to get easier. That's how we thought about the guidance back in January. Price should continue to be strong. We had our fourth price increase in 14 months that went out in the January time frame.

We remain nimble, in terms of if we need to execute more price for the input costs going up higher, we have that ability, but we see the second half being stronger because we're going to moderate against the inflation, and the price is going to continue.

That's going to put a margin headwind ultimately on the full year, just the dollars being almost equal on the price-cost side. That will be around 50 basis points of margin headwind, would be our expectation.

Dave: Steve, I know you were involved early on in this, when we started with our product growth teams, and how we put that as part of our business operating system. That's how we're really able to stay ahead of what these teams are seeing from a pricing standpoint.

So, if we have to take another price increase, we took one in January in most parts of the world, if we have to take another, we'll act accordingly.

Steve: Carrier did nine percent across most of its North American businesses. Is that the right magnitude that you guys did in January?

Dave: We were in the range.

Steve: In the range. Then, does your guidance assume...? Your guidance, I'm sure, embedded that price increase. Does your guidance embed another price increase? Or that next price increase whenever it comes will be whatever, in response to...?

Dave: Obviously, we embed in the price increase, and we embed in what we were anticipating to see from an inflationary standpoint. If those equations start to change, we'll change.

The good news is the ability of our teams to see around that corner has dramatically improved from where we were, we'll say, I don't know, seven or eight years ago.

Steve: Right. So, I mean, it's an absolute part of the strategy.

Dave: Absolutely.

Steve: Could there be a time here where steel goes down, some of these inflationary periods subside, where you have on an annual basis a much more significant spread than the 20 to 30 that I think you...? Or maybe it's 30 to 40, whatever you had talked about historically as your entitlement, if you will.

Could there be a time period where it could be a lot bigger than that on an annual basis? Because what's strange about this cycle is that even with all the inflation, you guys all did an unbelievable job of staying at least neutral on an absolute dollar basis. It hurt the margin, but it was still neutral on a dollar basis.

Dave: Right.

Steve: So, is this all just good news? That when it comes down, you're going to have a windfall type of event at some point in time?

Chris: Well, I think that's the question for me, is what point in time, right? When I looked at the futures three, four weeks ago, just on aluminum and copper, it didn't look like those prices were coming down. Steel was starting to see a little bit of a recovery retreat.

We lock-in steel for six months. So, from a pricing perspective, whatever happens in the month of March, we should really start seeing in the month of September, October.

So yes, could there be a spread? We go into any year thinking 20 to 30 basis points of a spread, but we have to just see what that landscape is. It's an industry that typically sticks onto price.

So, we have to just see what is that landscape, going out. For this year, we're thinking about price-cost, positive on the dollar basis, on the full year. Let's see how that plays out, but I'd love to be in that environment and test the theory of, where does it go?

Steve: Well, I guess, strategically though, this is almost a question for you. He comes to you with the numbers and says, "Here's 100 basis points, spread." Do you say, "All right, let's book it and squeeze the shorts?"

Or do you say, "OK, let's figure out how we're going to strategically allocate it to either investments or maybe take a little bit of market share in a geography we want to be in?" What's the mindset there?

Dave: It's an industry, obviously, that has typically not given back price. OK? I don't remember a time, and I've been in this industry a long time, where we've had four price increases in a year, just to be fair.

So, it's an industry that's pretty disciplined from that perspective, and as far as investing in our business, we love to invest in our business. Some of the highest returns we get. So, we're always looking for opportunities to redeploy money.

By the way, that's why our framework is 30 and 25. There could be a period of time where it's lower than that, based on what investment opportunities we have in the company.

Chris: The incrementals and the 30.

Steve: The incrementals.

Dave: The long-term incremental is 25 percent plus. So, we'll see how that plays out year by year.

Steve: Yeah, so I guess if you didn't get those because of price-costs over a couple of years, maybe you would overdrive on that, because that's your average entitlement over time.

I mean, people are trying to figure out whether there's this kind of windfall dynamic coming in. It happens for maybe a quarter sometimes, but historically even with a good couple quarters, you don't tend to see it in the actual drop through of margin, because you guys smartly say this is free money for me. I'm going to go and invest in growth.

Dave: Well, I wouldn't say it's free money, but its ability to fuel our innovation pipeline.

Steve: Right. Well, I guess, an upside surprise, right?

So, moving into the businesses, a little bit. On the resi front, maybe what's your latest and greatest on the cycle and age of system? This is the question that we have to ask everybody.

Dave: No, no, that's OK. I mean residential. I have a unit at my home, and hopefully everyone in the audience has one at their home, and it says Trane on the outside, or American Standard.

Yeah, look...

Steve: I guess, how old is it, and when are you going to replace it?

Dave: [laughs] I'm building a house.

Steve: You roll it every three...? You're building a new house. That's probably a lot of systems. Maybe a commercial system.

Dave: No, no, no. It's a single split system, three and half tons. I'm just kidding.

I'm just kidding. Look residential, it's about 20 percent of our total business. OK? So just keep that as a framework.

Over the long term, we look at resi as a GDP-plus business. I think you could get caught up a lot in these cycles, but look at it as a GDP-plus business. If you look at what drives that business, it's consumer confidence, it's GDP, it's unemployment.

Those are key indicators as to how that business is going to be performing. If you look at what we're expecting in 2022, we see growth in new construction. If you've tried to buy a house, or build a house, there's a lot of demand out there right now.

Although, it's a smaller part of our business, we see that having growth in 2022. As far as the replacement cycle, we don't see it. We don't see a lot of movement there. We don't see it falling off a cliff. We don't see a lot of movement.

As far as the run time on equipment, yeah, I mean, the planet unfortunately is getting warmer. Right? So, cooling degree days are up. There's more heat pumps that are sold into the marketplace. So, yeah, units are running longer. I can't quantify that as to what that's going to mean in a replacement cycle.

Steve: Right. The data is obviously fragmented and tough to...

Dave: Yeah, exactly.

Steve: Yep, tough. Anything on the competitive dynamics there? I mean, things change around, I feel, in waves every couple years. Somebody pops up and takes a little bit of share, and then that kind of normalizes. What are you guys seeing from your competitors?

Dave: I mean, I think overall there's good competitors out there, which makes it a great industry. We haven't seen a lot of movement in competition.

Steve: Then, just to clarify on the resi side, and maybe this bridges to the commercial discussion, in Europe there was lots of buzz around them pressing on incentives for residential heat pumps.

I don't believe any of the US guys have a substantial business in residential. Correct me if I'm wrong, but how do you guys play there, if you do play there?

Dave: Yeah, we're predominately on the applied side in Europe. Understanding that the European residential play, it's really a heating market. Most homes that are in the built environment in Europe are not AC. They're heating.

I think really it's going to come down to heat pump technology, but it'll be a little bit different than what you're seeing here in the States. They don't have split systems. They don't have ducts running through their home. It would be more of a variable-flow type system that you'd be able to get heating and cooling for.

Steve: You guys don't have one of these JVs. That's a market that you'd have to really invest a lot to get into.

Dave: Yeah. Our joint venture with Mitsubishi does not cover Europe.

Steve: That's the US, right.

Dave: Again, we're not in the resi space in Europe. Is it an opportunity? We look at lots of opportunities. We really like our applied business in Europe, and we really like the innovations that we've been able to develop there specifically around decarbonization with our heat-pump technology systems that we've been able to deploy.

Steve: I'm going to get to that in one sec, but I just wanted to clean up the resi discussion. How are you guys approaching the '23 and '25? Where are you on the technology development there? Do you plan on updating everything at once, or is it a step-by-step process across the portfolio?

Dave: We've taken a philosophy, this goes back probably 8 to 10 years, where we're not going to wait for regulation to come up with a better solution. In resi, it's a little bit different. We have all the product or majority of the products available today that can meet the 2023 regulation. It's about efficiency, and I could go into a lot of detail, but I won't. We're ready for that.

We don't see a prebuy, if that's the next question. There'll be a prebuy, but it won't be like what happened, Steve, that you'll remember with the refrigerant change from 410 to R22. The industry's more disciplined for that to occur.

As far as the refrigerant change that's happening in that in 2025, that's where you just need to, you need to...The solutions exist, so I'm not worried about that. It's just how they get rolled out, will be the timing. A lot of that has to do with building codes, just to be, so you understand how that works.

Steve: Right, but for you guys to prepare for that, do you know what you need to do product-wise at this stage?

Dave: Yeah, absolutely. We're well on our way. We have no concern at all on the product side or from an engineering standpoint.

Steve: Got it. On the commercial front, just sticking with Europe because we were there, talk about how your heat-pump solution is growing, and how it's a hybrid solution over in Europe on the commercial front.

Dave: If you go back a little bit, we acquired a company probably about six years ago now called Thermocold, which was a, at the time, we thought a novel innovation, which was called a simultaneously heating and cooling was called a four-pipe chiller.

We took that technology, and we added to it. We put our controls on top of it, and then augment it to create systems around it. Now we basically have the ability to eliminate the need for fossil fuel in a building like this in all climates.

You do that through creating a system. It's not just a heat pump. There's different elements within that system.

It's a really simple concept here. A fossil fuel, besides the greenhouse gas, is really inefficient. Right? Because when you're burning fossil fuel, you're creating energy, and when you create energy, there's a cost.

So, a unit of energy that goes into a boiler, on average, which is always dangerous, equals .8 on the other side. You're creating energy.

When you use a heat pump solution, you're basically moving energy. So, a unit of energy equals three-and-a-half on the back side. So, these are so much more efficient, these systems.

Just think of the impact of eliminating fossil fuels in buildings, like this.

Like next door that's being built. Right? These are very important as we start thinking about how we're going to decarbonize tomorrow.

The other argument, and I've heard this already, is what if the source of the energy is coming from coal, the source of the electricity? The efficiency is so great that you still have a reduction in your greenhouse gas.

So, these are solutions that are scaling, and we're very, very successful in Europe as you could see by the results and what we've been able to do.

Chris: It's a great example, too, of an acquisition, a bolt-on acquisition, early-stage technology, Steve, that we brought into a deep channel, and then the cash flow returns on that one specifically are 80 percent plus.

So, we love that combination of the early stage technology and deep channels in our markets, and this one's playing out very, very well.

Steve: Yeah. I think Frigoblock has been also...

Dave: Frigoblock is on the Thermo King side. Thanks for bringing that up. That's again our Thermo King business. I know we haven't talked about it. I'm sure you have lots of questions on it.

Our Thermo King business is really moving to electrification. Right? How do you eliminate the need for a diesel-burning engine within your units? Frigoblock allows us through their inverter technology to really accelerate that.

That's why we acquired the company. That's why you see us really first to market with some of the electric solutions we have. We're starting, obviously, with home delivery, because that's where the market is the most mature, but we have solutions all the way through including trailers.

Steve: Carrier mentioned they were the first to come to market with an all-electric trailer solution.

Dave: I don't know exactly. We do a lot with our modeling and simulations. So first of all, a commercially viable trailer. There's not a lot of all-electric tractors. In fact, I don't think there's any.

Steve: Right.

Dave: So you need, if you're going to be, you have to think that all the way through.

We have units that are driving down the highways today that we're really using for...it's more about data gathering and how we can help our customers use their units.

I mean, there's some really cool stories I could tell you about what we've learned working with customers, as they're migrating to the electric solutions, and how they should be operating tomorrow, and even in their distribution centers to make them greener. It's amazing the learnings you have when you're close to the customer.

Steve: So, how big is the European heat pump business now? I think you guys had said there was a 100 million or something, plus.

Dave: I think we said the market opportunity was a billion, to be fair. I don't know why the market opportunity isn't everything. Why do we need fossil fuel? Right? I ask everyone, "Why do we need fossil fuel? Why do we want to put fossil fuel in a new construction?" It doesn't make any sense at all.

It's one of those things...I was in London a couple days ago, and someone asked me from the audience. They said, "Well, it's so compelling. Why do we have people that still put fossil fuels into buildings?"

My answer was, "I don't know, but help me spread the word." Right? I mean, the world is getting warmer, and this is a technology that exists today. It exists today. It's not something new, right? We've been selling this for three or four years, and we improve it every year.

We need to get the word out. We need to have this technology deployed throughout the globe. It can have a dramatic reduction, dramatic reduction in greenhouse gas.

Steve: So, that's a billion dollar market opportunity that's growing at 10 percent plus.

Dave: I think you need to be careful with the growth because that could be growing, but maybe conventional units will be coming down. So, you always have to be looking at what's being eroded on the other side.

Steve: Right. So, I guess on net, you would think your European HVAC business can grow mid-singles on that. Is that...?

Dave: We like the growth that we've been able to demonstrate in that business over time, and we have a great team there. They're constantly challenging what's possible and innovating for tomorrow. So, stay tuned.

Steve: OK.

Chris: Steve, like Dave mentioned before, residential HVAC, GDP-plus business, we think those commercial HVAC businesses are a multiple of GDP. There is one example, decarbonization regulation, indoor air quality, all those contribute to that viewpoint.

Steve: Turning to the services side of your business -- and I think you guys were out in front of most of your competitors in targeting services -- maybe talk about how that strategy has evolved. A lot of these guys are giving attachment rates. Can you talk about your attachment rate and then how you define that? Everybody defines it differently.

[laughter]

Dave: That's the problem with attachment rates. Tell me someone's definition. I would tell you, on a new applied system, we're always attached. Why would we not be? The unit's under warranty, customer wants to make sure that the unit is operating the way it was designed.

By the way, that's evolving too, not just the way it was designed mechanically, but how much energy it's using. Why would you ever want to use more energy than you need? We're always attached to new installations.

If you look at our service business...I always tell people that at Trane Technologies, we're a great company because of a system of things, not just one, but a system of things, whether it be our direct sales force, whether it be our product breadth, whether it be our controls capability, or whether it be our service capability.

Our service business and our commercial HVAC on a global basis, over the last five years, has grown high-single digits, compounded annual growth rate. That includes 2020. We all know what happened in 2020. It's not just about what's been said or what people are going to do.

If you look at our performance over time, you hit it, Steve. Yeah, we've been thinking about service, and how we grow it for an extended period of time. We've demonstrated with our results.

What's changing is really on the energy side. Service agreements are no longer just break/fix. They're now moving to energy performance contracting, which is an energy service agreement, which is how much energy are you using, and why are you using too much?

That's what's going to allow you to roll a truck to say, "I need to come take a look at your building because you're using too much energy today." That's where that industry is going. You think about connected strategy, being connected to assets, being connected to buildings. This is where you have a service organization.

Again, it's a system of things that makes Trane Technologies a great company. That's a key element of it.

Steve: That performance contracting structure has been around for a while. That's not necessarily new. Honeywell does some of that. JCI does some of that.

When you think about either those deals or maybe a long-term standard service agreement that may have some elements of that in it, how much of the installed base do you believe you're penetrated on for agreements beyond warranty?

Like a three- to four-year agreement, however long it is. What's the penetration? Then, therefore, what is the opportunity?

Dave: I could tell you it's different than the ESCO business. It's a little bit different. You're not giving a guarantee, although we could give a guarantee. You're not giving a guarantee, and then going to float a bond, and then paying for the bond with the savings. It's a little bit different model.

If I look at our service business, depending on where we are in the globe, we have about 20 KPIs that we look at. We call it our dashboard. I'm not going to go through every single one of what we look at, but I would tell you it's things like, how many assets are connected? How many buildings are connected? How many energy contracts do you have?

Those would be things that we would be looking at. We call them driver metrics. I think of a driver metric as something that's going to have a more strategic impact long-term. We also have a lot of watch metrics that we look at. This is, are we seeing the results that we want?

We have a very sophisticated way we look at our service business. That's part of the reason why we've been able to demonstrate compounded annual growth of high-single digits over the last five years, including 2020.

Steve: How many assets are connected? How many contracts do you get?

Dave: This is where I could get too far ahead. We're not going to give a complete roadmap because I've done that before. It's meaningful. If you think about our service business, in the Americas, in our commercial HVAC business in the Americas, 50 percent of our business is services.

In Europe, it's 50 percent of our business. In Asia, and Latin America, and Middle East, it's less, but two very big markets, 50 percent of our business is service.

Chris: That mix has grown over 10 points since the last downturn. That was a directional, deliberative action by the company to go do that.

Steve: Then, just lastly from me before I turn it over to the audience, the trends in US applied equipment or North America applied equipment, what do you guys see in there? What's the expectation for the year? Any hiccups with inflation where projects are getting canceled or anything like that?

Dave: We're not seeing any cancellation. In fact, I was with several customers yesterday when I flew in. We met with...They're not seeing cancellation. It was one of the questions I asked them. These are major developers here in New York. They're not seeing cancellations.

You think about it. To cancel an applied project, there's a lot of people involved. You have an engineer. You have an architect. You have probably a GC, probably mechanicals, and an end customer. It's a long cycle. If it's going to get canceled, it's going to get canceled early on. We haven't seen that.

Steve: What is your...? I think you guys have given this before, like the IAQ side of the story. What's the backlog there? What's the least order rates on the IAQ stuff? You guys have given this before.

Chris: It was two percent of revenues last year in terms of growth. We started the year in '21 thinking it was one to two percent and wound up being at a higher end of that range, Steve. It's embedded in that $5.4 billion of backlog we ended the year with. I think it contributes to that multiple of GDP view that we have for commercial HVAC.

It's really hard to split that out from an order though today because it's a bundle of services and other equipment we're putting together. It's hard to say, "Well, I know this is an IAQ order," versus two years ago when just the start of all those indoor air quality audits were happening. Those were very clear. Now, it's really hard...

[crosstalk]

Dave: It's embedded in systems.

Steve: Absolutely.

Dave: One of the things about IAQ is, early on, there were a lot of people that jumped to different solutions. They're starting to learn that some of those solutions were not...They weren't the best solutions. By the way, some of them use a lot of energy. We're doing a lot of work to help our customers on that roadmap.

Steve: What are they honing in on now, just a higher level of filter and, therefore the machine runs harder?

Dave: It's, again, taking a system view, understanding what the use of the facility is going to be, and then coming up with the optimal. It could be very sophisticated like dry hydrogen peroxide. It could be bipolar ionization. That works great in certain applications, and not in another application. It could just be the density of your filter.

Make sure your system is designed to handle the density of your filter. It could be just fresh air exchanges. Understand the fresh air exchange is energy. You're going to bring in more air from the outside, you're going to have to condition that air. To condition that air requires energy.

Steve: Yup. Well, they're building that big thing next door that...

Dave: I happened to see it. It's very loud...

[laughter]

Dave: In my hotel room. I was hearing it.

Steve: Hopefully that one doesn't get canceled.

Dave: So, is your office on the top?

Steve: No, you can see the basement from here, right down there. It's fine. I like being in the basement.

Any questions out there?

OK. On China and your strategy there from a commercial perspective, anything to speak of as far as changes there or further investments? It seems pretty steady state relative to what you did a couple years ago.

Dave: I mean...

Steve: You put a bunch of feet on the street.

Dave: Five years ago or so we made a significant investment. We took some chapters out of our business operating system in the Americas and moved them to China, which meant a direct sales force. We made the effort at that time to, if you remember, we were explaining that for a while on different earnings calls, as to, were we getting a return.

If I look back on that in five years, I believe we're up 500 basis points in margin.

Chris: Over 500 basis points, yeah.

Dave: Again, it's about having a strategy, sticking to it. Don't become short-term thinking. Go for the long-term. We know what happens.

You have a direct sales force. You have a longer appetite to close orders. You start to become basis of designs. You're working with architects. You're working with engineers. You're working with end customers. That's a solution that works. It doesn't matter where you are in the world. We're very happy with the results that we've been able to achieve in China.

Steve: Lastly on Thermo King, ACT just extended out a year, and they now have a down '24 after stronger-than-expected '22 and '23.

What's your visibility on the sustainability of growth with the supply constraints that are out there? How do you feel about that, that business..., ability to deliver, and then because things have been pushed so far and you're controlling the backlog, how should we think about orders as we move through the course of this year?

Dave: Obviously, again, that's another business like residential. We had very high incoming order rates in 2021, so you'll have tough compares all year there.

As far as ACT, and how their ability is to forecast the North America trailer market and tractor market, which is where they focus, actually, they lowered their number a little bit for the full year of 2022 already by about 500,000 units. It's not significant. They did not push that out. I don't know where that's going to go. We have to ask them. I think that they have it about right.

Steve: They didn't raise '23 a little bit?

Dave: No.

Chris: What they did is they held '23, but they lowered '22 by 500 units.

Steve: They held '23.

Dave: I mean, the good news about just…not getting caught up in ACT, I mean at the end of the day, they're forecasting for the next several years, and I'm talking more than three. More like five or six years that the market is going to be in the mid-40,000 range, and that's a very strong market.

By the way, we're not....what's this year at? 30 or 40?

Chris: Low 40s for this year, and it's going to 50,000.

Dave: I mean, this is a business that's...the trailer market will be, I'll call it stable, but Thermo King is more than just a trailer market. It's a very diversified business there.

I ran this business 10-plus years ago, and used to be trailer and truck. That's all we talked about. We now have auxiliary power units. We have units for airplanes. We have units for rail cars. We have units for buses. We have marine systems. So, this is a very diversified business

If you think about some of the fundamentals, this is about moving perishables, OK? You think about the fact that 30 percent of all food that's produced is wasted, and about half of that is wasted because of the way it's transported. We see the demand for controlled atmospheres to move perishables. We see a lot of room there.

Steve: One more question just on the balance sheet. You guys have generated a lot of cash flow over the years, and your balance sheet is pretty clean. You talked about bolt-ons, but is there a potential to do something maybe bigger than a bolt-on? I would characterize a bolt-on as a couple billion dollars.

Chris: Yeah, that's how we think about it, too. We don't feel we have any holes in the portfolio per se, Steve, but you're right, we've got an outstanding balance sheet, a lot of firepower. We think about deploying that cash, to first funneling investments, and making sure we're outgrowing markets.

Growing the dividend and growing that with their earnings over time. Then, we're going to look at M&As, strategic M&A. The examples we gave earlier in those early stage technologies, and bringing them through the channel, those are great, great deals.

We've done some channel acquisitions in the Americas, Australia, and New Zealand in the last 13, 14 months. Those are great returns as well. Those are 30 to 40 percent return, cash flow return on invested capital, but if M&A is not there, we're going to look at the share repurchase option as well. We have a lot of ability to deploy.

On the M&A side, just being the large HVAC company, we are HVACT, we see a lot of deals. So, we would look at everything.

Steve: But sounds like bolt-ons.

Chris: Bolt-ons.

Steve: I mean, I'm not even sure what's out there of size, unless you're starting to get a little more global, I guess.

Dave: Yeah, I mean, we like being a pure play. I'll say that.

Steve: Do you feel comfortable with your position in data center?

Dave: We like our position in data center. We love dealing with daily data center customers, because they tend to be the ones that are pushing you the most on being greener, and helping develop solutions.

Our engineers love it because they get to think creatively, and be challenged. So, we like our position in data centers.

Steve: Are you happy with both product and channel there? Like, your in to the customer on that front, or is that something that you could possibly reinforce, because...?

Dave: We like our position in data centers.

Steve: EON has done Base X, and JCI has done Silent-Aire.

Dave: We have a portfolio of products that plays well in that space. So, it's not about products. It's about the innovation that you're driving there.

We had a really cool project, listen to this one, in Europe where we basically...data centers generate a lot of heat, right? That's why they need cooling. When you have cooling, you're removing heat, and we basically found a way to recycle the heat, and we were actually heating a local school.

It's a closed-loop system, so it goes back into the data center, and there's a temperature differential of the water coming back, so it's very economical for the data center.

By the way, you have a great PR relationship with heating a local school. So, those are the types of solutions that we like to get pushed by our data center customers, and they always have creative ideas.

Steve: Guys, thank you so much for coming. I appreciate it.

Dave: Thanks everyone. Appreciate it.

Chris: Appreciate it.