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Carrier Global Corp. (CARR)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Carrier's Second Quarter 2023 Earnings Conference Call. I would like to introduce your host for today's conference, Sam Pearlstein, Vice President of Investor Relations. Please go ahead, sir.

Sam J. Pearlstein

Vice President-Investor Relations, Carrier Global Corp.

Thank you, and good morning, and welcome to Carrier's second quarter 2023 earnings conference call. With me here today are David Gitlin, Chairman and Chief Executive Officer; and Patrick Goris, Chief Financial Officer.

We will be discussing certain non-GAAP measures on this call, which management believes are relevant in assessing the financial performance of the business. These non-GAAP measures are reconciled to GAAP figures in our earnings presentation, which is available to download from Carrier's website at ir.carrier.com.

The company reminds listeners that the sales, earnings and cash flow expectations and any other forward-looking statements provided during the call are subject to risks and uncertainties. Carrier's SEC filings, including Forms 10-K, 10-Q and 8-K, provide details on important factors that could cause actual results to differ materially from those anticipated in the forward-looking statements.

Once the call is opened for questions, we ask that you limit yourself to one question and one follow-up to give everyone the opportunity to participate.

With that, I'd like to turn the call over to our Chairman and CEO, Dave Gitlin.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Thank you, Sam, and good morning, everyone. Our theme at Carrier remains, performing while transforming. And I am proud of our team as we are progressing well with both. You see that strong performance in our Q2 results on slide 2.

Organic sales growth grew 6% with both HVAC and Fire & Security up 9%. We drove strong double-digit growth in light commercial and commercial HVAC, global truck and trailer controls and aftermarket. Within Fire & Security, growth was broad-based across security, residential, commercial and industrial fire. Total company backlog remains well above historical levels, up 30% on a two-year stack.

Adjusted operating profit and adjusted EPS were up 12% and 13%, respectively, and free cash flow was strong at over \$300 million. Price/cost was increasingly positive in Q2. Toshiba Carrier performance came in stronger than expected, and we are on track to deliver \$300 million of gross productivity this year. As a result of our strong first half performance, we are raising our full year guidance for organic growth, adjusted operating margins and adjusted EPS.

A key driver of our sustained organic growth and robust backlog is the result of our team leaning into secular trends around sustainability and healthy buildings, as you see on slide 3. With our clear and unwavering focus on being the global leader in intelligent climate and energy solutions, we continue to see traction from our sustainability driven growth initiatives.

Resi heat pump sales in North America have been up double digits year-to-date. We saw another quarter of over 20% growth in commercial heat pump sales in Europe, and electric transport units doubled in Europe.

Our healthy buildings pipeline is up over 2x to \$1.6 billion, driven in part by K-through-12 in the US, where orders were up over 20% in the quarter. We are clearly positioned at the core of a transition to a more sustainable planet. We published our 2030 ESG report yesterday, in which we now disclose sustainability progress through the CDP. After completing our portfolio moves, about half of our sales will relate directly to clean tech, and we expect that proportion to continue to increase.

We remain on track to reduce our customers' carbon emissions by more than 1 gigaton by 2030, while achieving carbon neutrality in our own operations. Our laser focus on digitally enabled aftermarket solutions continues to gain traction, as you see on slide 4. Q2 saw yet another quarter of double-digit aftermarket growth, with the first half up mid-teens compared to last year, and we remain on track to deliver double-digit growth this year and beyond.

The playbook is working, expanding the capabilities and deployment of Abound & Lynx, our key digital platforms; increasing parts sales supported by agile pricing and improved fulfillment rates; increased attachment rates and overall coverage across the portfolio; and deploying connected devices to increase recurring and subscription-based revenues.

We are also embedding AI and generative AI capabilities into Abound to drive solutions for our customers. By analyzing sensor data patterns and performance metrics, generative AI can help prevent equipment failures, drive improved air quality by controlling ventilation, and increase energy efficiency by controlling temperature set points, airflow rates and scheduling strategies. So, our execution is progressing well.

A brief update on our portfolio transformation on slide 5. On Viessmann Climate Solutions, the short version is, the more we get to know them, the more excited we are to close. Our integration planning team in Frankfurt is actively working to ensure that we hit the ground running on day one.

Viessmann Climate Solutions is performing very well, ahead of their projections. First half sales were up an impressive 20% year-over-year, with heat pump sales up over 40%. Viessmann Climate Solutions' profitability is also up significantly compared to last year, and they remain on track to deliver €4 billion in sales and €700 million in EBITDA this year.

We remain confident in the €200 million of cost synergies, driven primarily by supply chain in-sourcing and value engineering. The growth opportunity for the combined business is even more compelling. The prime focus areas include: expanding Viessmann's sustainable heating and home energy management offerings globally; driving incremental sales through Viessmann's European channel using a multi-brand strategy; and building on Viessmann's digital platform to provide even more differentiated end-to-end solutions globally.

Moving to the Fire & Security and commercial refrigeration exits. The good news is that strategics and sponsors have expressed considerable interest in these superb assets. We are tracking to the sequencing we've established for these exits. We expect to have commercial refrigeration, now including pro forma mechanical systems and the security business, in the market in September, with residential fire initiating its sale process a month or so later. Commercial and residential fire exits will follow.

The result is the new Carrier that you see on slide 6. The combination of the acquisitions of Toshiba Carrier and Viessmann Climate Solutions, together with the tremendous positioning that Carrier has established over the past century, positions the combined entity to become a true global climate champion in very attractive and growing market segments. Focus matters, and our focus on sustainability differentiation position us as a pure play, high-growth company. Our combined channels, brands, technology and world-class talent will create solutions for our customers, our people, and the planet for generations to come.

And with that, let me turn it over to Patrick. Patrick?

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Thank you, Dave, and good morning, everyone. Please turn to slide 7. We had record reported sales of about \$6 billion, up 15% versus the prior year, with 6% organic growth. 9% growth from acquisitions and divestitures was substantially driven by Toshiba Carrier, whose results will become organic starting in August.

The deconsolidation of KFI was not material to Q2 total company sales, but had a three-point negative year-over-year impact due to Fire & Security segment reported sales. Q2 adjusted operating profit of \$964 million was up 12% compared to the prior year.

Adjusted operating margin in the quarter was 16.1% and includes a 100 basis point headwind from the consolidation of Toshiba Carrier. This means adjusted operating margins would have expanded about 60 basis

points, excluding the impact from the TCC consolidation driven by volume, productivity and price/cost, as well as strong margins in TCC.

Core earnings conversion was about 30% in the quarter. Adjusted EPS of \$0.79 was ahead of our expectations, mostly because of stronger-than-expected sales, price/cost, and TCC performance. Free cash flow generation of \$310 million was up significantly compared to last year, helped by inventory reductions. This positions us well to deliver approximately \$1.9 billion of free cash flow for the full year.

You will notice that our US GAAP results include the impact of the deconsolidation of KFI and the mark-to-market adjustments related to foreign currency hedges associated with the Viessmann acquisition. You may recall that we fully hedged the cash portion of the euro-dominated purchase price. As of yesterday's rates, most of the Q2 non-cash loss on the hedges would be neutralized. We exclude these items from our adjusted results.

Now, please turn to slide 8 to cover our segment performance in more detail. HVAC had an excellent performance in Q2. Organic sales were up 9%, driven by high-teens growth in commercial HVAC, double digit growth in aftermarket and controls, and over 60% growth in light commercial. North America residential HVAC sales were down mid-single digits in the quarter, a bit weaker than we expected. Overall, residential volumes were down mid-teens as we adjusted to slower than expected movements in the quarter.

North America residential revenues continued to benefit from price realization and mix up from the 2023 SEER transition. Adjusted operating profit for the HVAC segment was up 29% compared to last year, driven by volume, productivity, TCC performance and favorable price/cost. Adjusted operating margin was up 70 basis points compared to last year, despite a 200 basis point headwind from the consolidation of TCC.

All three businesses within HVAC had strong margin expansion. Residential light commercial, commercial, and Global Comfort Solutions. Based on the first half performance, we now expect 2023 full year HVAC segment margin to be closer to 16% versus our prior guide of over 15%.

Let me move to slide 9 and provide a brief update on our Toshiba Carrier acquisition, as we closed that transaction about one year ago. As a reminder, we acquired Toshiba Carrier for \$900 million, about 10x EBIT. We committed to \$100 million in cost synergies in five years and projected to achieve mid-teens EBITDA margins in that same timeframe. Our Tokyo-based team is doing an outstanding job and performance is running ahead of all of our projections.

Japan returned to profitability earlier this year. We are already achieving double digit operating margins and are now projecting \$200 million of cost synergies, which would drive EBITDA margins in the high teens rather than mid-teens. In short, excellent performance by that management team, and we are, of course, using their experience and playbook as we plan for the Viessmann integration.

Moving to Refrigeration on slide 10. Reported sales were down 7% in the quarter with organic sales down 6%. The difference is the small divestiture we discussed in the first quarter. Within transport refrigeration, North America truck and trailer sales were up double digits, and European truck/trailer was up mid-teens. This continued strong performance was more than offset by container, which was down roughly 35% in the quarter year-over-year.

Importantly, we delivered more container units sequentially, and we expect the sequential improvement to continue in Q3 and Q4. As a result, we expect the container business and the entire Refrigeration segment to return to organic sales growth in the second half of this year. Commercial refrigeration was down high teens year-

over-year, as our European food retail customers continued to see pressures. The commercial refrigeration team is doing a great job managing working capital and adjusting our cost base to position this business for strong financial performance as the top line improves.

Adjusted operating margin was down 240 basis points compared to last year, mainly due to the volume declines in container and commercial refrigeration, and the absence of the \$7 million gain in last year's second quarter. Price/cost was favorable. Excluding the one-time gain on sale in the first quarter, Q2 adjusted operating margins for Refrigeration grew 250 basis points sequentially from Q1, and we are pleased with the progress this segment made in the quarter.

Moving on to Fire & Security on slide 11. Fire & Security sales were up 5% on a reported basis. Organic sales were up 9%. This was partially offset by 1% currency and a 3% decline from the deconsolidation of KFI. We saw strong organic growth across the F&S portfolio, including double-digit growth in industrial fire and security and high single-digit growth in both residential and commercial fire.

Adjusted operating profit was up 1% versus the prior year, which includes the year-over-year headwind from the deconsolidation of KFI, which was about \$10 million, or about \$0.01 of adjusted EPS to Carrier. Adjusted operating margins were down 50 bps in the quarter, as favorable price/cost, volume and productivity were offset by mix and the year-over-year impact of the KFI deconsolidation. Sequentially, adjusted operating margins were up 230 basis points, and we expect adjusted operating margins to improve as the year progresses.

Turning to slide 12. Total company organic orders were down mid-single digits in the quarter, as lead times continued to normalize throughout our businesses. As you can see on the left, backlogs remain at very healthy levels, about 2x 2019 levels, and for our longer-cycle businesses extend into next year. We believe that strong backlogs and normalizing supply chains are reflected in our order rates.

Overall, HVAC orders were down 5% to 10% in the quarter, with both business units seeing some declines. Commercial HVAC orders were down mid-single digits, but the backlog remains robust and grew sequentially excluding NORESKO. Over the past month, commercial HVAC orders have returned to growth.

Refrigeration orders were up 10% in the quarter, with growth in transport refrigeration and a decline in commercial refrigeration. Global truck and trailer demand remain strong with orders up about 40%, and those were partially offset by declines in container. Container orders were about flat sequentially as demand begins to recover. Orders in industrial fire remained strong and were up double digits, with lead times improving in security, and commercial fire orders moderated and were down in the quarter.

Now moving on to guidance on slide 13. Performance in the first half of 2023 was better than we expected. We now expect 2023 revenues to be a couple of hundred million dollars more than \$22 billion with mid-single digits organic growth. The increase is primarily driven by commercial and light commercial HVAC and somewhat higher net price.

We now expect adjusted operating margin to be between 14% and 14.5%, a little higher than what we previously guided, driven by slightly higher organic sales, improved price/cost, and better performance at Toshiba Carrier. We now expect full year price/cost to be about \$300 million positive for the year.

As a result, despite a \$0.03 adjusted EPS headwind from the deconsolidation of KFI, we are increasing our adjusted EPS guidance range by \$0.05, and we expect full year adjusted EPS to be at the midpoint of the new range. For your benefit, we included an adjusted EPS guide to guide bridge on slide 17. As for free cash flow, we

continue to expect to generate approximately \$1.9 billion this year. So, overall, another good quarter and an improved outlook for 2023.

With that, I'll turn it back over to you, Dave.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Okay. Thanks, Patrick. Let me first correct something that I misstated on the business exits. We expect to have commercial refrigeration and security in the market in September, industrial fire a month or so later, and then resi and commercial fire will follow.

So, just in summary before we get into the Q&A, Carrier continues performing while we are transforming. Despite resi HVAC declines, we realized mid-single-digit organic growth in the first half of 2023. Secular trends and our aftermarket focus continue to drive demand. Price/cost improvements and productivity are helping operating margins and funding growth investments.

Toshiba performance is well ahead of schedule and giving us further confidence in the upcoming Viessmann integration. Our exciting portfolio moves are tracking to schedule, and we are raising full year guidance for organic growth, adjusted operating margins and adjusted EPS.

And with that, we will answer the questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Jeffrey Sprague with Vertical Research Partners. Your line is open.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC

Thank you. Good morning, Dave and Patrick.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Good morning, Jeff.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC

Dave, would love your view on kind of the political wrangling in Germany on the heat pump-related incentives and how that plays into, or does not play into your view on kind of Viessmann growth as you look forward the next couple of years?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Well, we're confident in the Viessmann growth regardless of specifically how the German legislation plays out. I mean, keep in mind, the proposed legislation that's being debated now was proposed in April, well after we had

already approved our business case. And what we're going to see in Germany is a clear transition to heat pumps. We're going to see continued – you may see more district heating than we thought previously, which will be good for us. So, what we know is that regardless of whatever legislation gets approved in September, our business case stands fully intact. And perhaps, what Viessmann continues to do, is under-promise and over-deliver, and that's what we saw in the first half of the year. I mentioned 20% overall growth, 40% growth in heat pumps without this proposed legislation. And by the way, Germany is less than 50% of their total sales. I think it's just over 40%.

And more broadly, in Europe, there are 17 countries that have announced or implemented bans on fossil fuels. Nineteen countries in total have heat pump incentives. Twelve European countries have bans on fossil fuel boilers for new builds. So look, we'll continue to monitor the specific German legislation, but our confidence in the transition away from fossil fuels towards electric heat pumps, towards solar PV, towards batteries remains very, very confident.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC

Q

And then also maybe you could elaborate a little bit more on the link you're indicating between TFC and Viessmann. And I guess for the spirit of my question, right, is Viessmann is not about head count reductions. And culturally, those were difficult, and I don't think a big part of what you've done at TFC, but you are seeing better synergy capture. So maybe just elaborate a little bit on what you mean by that playbook and lessons learned that you're going to apply to Viessmann?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Yeah. Look, the first aspect of the playbook in TCC has been cultural integration with a multi-country representation, pulling together as one team to drive results for our customers. You look at what Saif Siddiqui and the team have done there. It's really been being very culturally sensitive to what's working extremely well and not breaking what works well, and just focusing clearly on value creation. We had similar constraints in terms of head count in Japan that we do with Germany. Most of the synergies, which as Patrick said, will be far higher than the \$100 million, we're looking at least \$200 million now for TCC, that's coming from the same kind of areas. It's coming from sourcing. It's come from value engineering. There are some elements of in-sourcing. So that same playbook on the cost synergy side applies there.

But we're also seeing tremendous synergies on the revenue side. Toshiba has tremendous technology that we've cascaded globally. Viessmann's Climate Solutions has tremendous technology that we plan to cascade globally. We want to be very culturally sensitive.

And look, Viessmann Climate Solutions is a phenomenally well-run company. Thomas Heim will be running our European business, which will include Riello. Our goal is to make sure that we allow them to go do what they need, what they know how to do better than anyone in the world while we look for areas of combined value creation. That's worked with Toshiba and that same playbook will work here.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC

Q

Great. Thank you.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thank you, Jeff.

Operator: Thank you. Our next question comes from Steve Tusa with JPMorgan. Your line is open.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Hey, guys. good morning.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Good morning, Steve.

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Good morning.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Just turning towards resi and light commercial. On the resi side, where do you see channel inventories now, relative to where you were in the first quarter?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Yeah. We – when we look at inventory levels, Steve, we basically closed 2Q in balance. And underneath that, furnaces were down about mid-single digits. Splits were higher than we would have liked. We do expect some destocking there in the second half. And what I'll say more broadly, Steve, is that, obviously, you know we get a lot of questions on resi. And we've been saying that it's 20% of our portfolio and that we can grow, of course, with resi down. And that's exactly what we saw in the last quarter. We saw HVAC grow 9% with resi being down mid-single digits.

So look, as we calibrate where we are for resi for the rest of the year, remember, for the full year, we said that sales will be flat with volume down high single digits. That still feels about right to us. Even though 2Q was a little bit lower than we had thought, because we will see some level of destocking on splits in the second half. But when you look at it more recently, obviously, the heatwaves will translate into movement, which will help our replacement business.

We had thought that the new construction piece, we came into the year saying residential new construction will be down 20% to 25%. That looks like it's going to be better than we thought, probably down closer to 10% or so. So as we look at the full year, we still feel calibrated in what we said. I mean could instead of it being flat, it will be down a point or two, perhaps. But we're still in the zone. And remember, in the second half of the year, we have easier comparison. We're pleased with some of the recent trends. The only other thing I'll say on inventory levels, is splits was down sequentially in terms of inventory levels in the channel.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

And then light commercial, these are pretty big numbers. You're catching up on backlog, obviously, but even backlog's up a lot. I mean, like what's the driver of that? And is that like a tough comp for next year at all? These are like some pretty big numbers on light commercial.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, look, any time you produce sales over 60%, you create inherently a tough comp. But look, I think we could not be more pleased with how the – Justin and Christian and the light commercial team are doing. And it's, frankly, it's a good example of where we've invested in technology differentiation. We are seeing results in growth and share gains.

We've talked a lot about this vane axial fan, which is far more energy efficient than the previous generation. And that has proven to help us take share the right way because we've been getting a lot of price. We talked about 60% sales, but about half of that was volume, and the other half was about price and mix and a whole bunch of other things. Because remember, there's mix involved in light commercial just like there is in the residential piece.

So, overall, light commercial, it was an easy compare in terms of versus 2Q of last year. But that team is performing very well. We'll continue to track inventory levels in the channel there. But the good news is backlog is very robust. Backlog's up over 60% year-over-year, and it gives us strong coverage through the rest of 2023 that extends into 2024.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Got it, great. Thanks a lot.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thank you.

Operator: Thank you. Our next question comes from Julian Mitchell with Barclays. Your line is open.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Hi, good morning. Maybe just a first question perhaps for Patrick around the cadence of sort of earnings and the top line within the second half. So, should we be thinking that sort of EPS is flattish sequentially in Q3 and then a normal step down? And then on the organic sales front, I think you grew low to mid-single digit organically first half and then the year is up sort of mid-single. So, do we think about an acceleration year-on-year kind of in Q4 being up, I don't know, mid- or high single digits. Is that the way to think about sales?

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

A

Julian, on the first question, you can think of operating profit being very similar in Q3 than in Q2. A key difference will be the effective tax rate, we think will be closer to 25%. And basically, that gets you to an EPS that's very similar, maybe \$0.01 or \$0.02 below. And so, then you have after that normal drop down in Q4 that you were referring to. So, that's kind of the sequence.

In terms of organic growth for the full year, we are now at mid-single digits, which is better than the low to mid-single digit which we had before. Similar organic growth in Q3, that we expect, as we've seen in Q2. And then the balance, of course, would be in Q4, which means that Q4 would be a little weaker. That's our current assumption.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Thanks very much. And then just my second question, looking at slide 12, where you have the backlog trend chart on the left-hand side, and clearly different markets and geographies are sort of rebalancing, lower at different times as lead times shorten. But when you're thinking about the backlog trend from here next, call it, 6 months to 12 months, just wondered how you're thinking about kind of the aggregate for Carrier. Do we see the backlog naturally moderate because of normalizing supply chains? Just any thoughts around that, please?

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

A

Julian, that is one we were looking at. And I think it depends to what businesses we're looking at. If you look at some of our shorter-cycle businesses, and we've seen that the best example is probably residential HVAC. Typically, we would have four, maybe six weeks in backlog. A few quarters ago, we were talking of backlog of more than one quarter. And so, as supply chains have normalized, we've seen the backlog normalize – for example, residential HVAC – we're back in the four weeks to six weeks range, and you don't get to that without an adjustment of the order intake. And that's why we've seen some of the big declines in orders year-over-year as those backlogs normalize.

So I would expect that some – for some of our short-cycle businesses – we will see a more back-to-normal backlog level. At the same time, there are some longer cycle businesses, like commercial HVAC, those are businesses that have backlogs of six months, in some cases longer. And there, we see continued growth, that we see continued strong demand.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

What I'd add, Julian, is that if you look at sort of the anomalies of the environment that we've seen over the last couple of years, COVID leading into supply chain issues, looking purely at year-over-year order trends is really not the best indicator of future growth projections. So, what we've been looking a lot at is the backlog levels, which we feel still very good about with commercial light, commercial HVAC, and some of the longer pieces of Fire & Security, we like where the backlog levels are. So, we're looking at, do we have the backlog and incoming growth order rates to support our growth projections, and we do feel good about those.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thanks.

Operator: Thank you. Our next question comes from Deane Dray with RBC Capital Markets. Your line is open.

Deane Dray

Analyst, RBC Capital Markets LLC

Thank you. Good morning, everyone.

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Good morning, Deane.

A

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Good morning, Deane.

A

Deane Dray

Analyst, RBC Capital Markets LLC

I was hoping to go through some of the price/cost dynamics in the quarter, and you mentioned the higher mix contribution from the new SEER. Could you take us through that? And then, the pace of improving price/cost, that \$300 million, what was the – if you kind of decompose that, how much was, let's say, the raw materials, better pricing there as well? Thanks.

Q

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Okay, Deane, Patrick here. In terms of the quarter, you can think of – the 6% organic growth we had, think of that as pricing being about 4 points and think of volume and mix – so we put the mix up as part of volume/mix – as being the remainder, the 2 points. So, that's kind of the overview for the quarter. For the full year, we think that the price realization, it won't be 4%. We think it will be a little less than 4% for the full year, probably closer to 3%, which is, of course, to be expected as we lap some of the price increases from last year. And then the second part of your question was?

A

Deane Dray

Analyst, RBC Capital Markets LLC

Just, you said the pace of improving price/cost.

Q

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Yes. You may recall that in Q1, we mentioned that price/cost was modestly positive. It was – it had a few tenths of a basis point positive impact on our segment operating margin, and we said that Q1 would be the weakest price/cost of the year. You can think now of price/cost being closer to \$300 million positive versus \$200 million in the prior guide, and it's about 100 bps benefit for the full year year-over-year. So, better than in Q1, which is basically what we expected.

A

In terms of the equation, both – price is a little bit better; on the cost side, we're seeing some pluses and minuses. The area where we probably see the best – the most favorable impact is on logistics.

Deane Dray

Analyst, RBC Capital Markets LLC

All right.

Q

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Yes, we're seeing some on material. There are some plus and minuses there, but logistics and freight is probably the area where we see the biggest benefit on the cost equation.

Deane Dray

Analyst, RBC Capital Markets LLC

That's real helpful. And then just as a follow-up, Dave, you gave a lot of specifics on the sale processes going on and the timing and so forth, which is really helpful. And just from a management side to this, how do you keep each one of the units focused when there is this change in ownership pending? And just how do you keep the eye on the ball here?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Well, we are so fortunate to have a phenomenal team in both Fire & Security and commercial refrigeration. Jurgen and his team in Fire & Security, Tim working with Marcus on commercial refrigeration, they're true professionals. And they know what we know, which is that the opportunity for these businesses in the hands of someone who's either a strategic or a sponsor who at the core of what they do will create value for their people for generations to come. So, we are very lucky. It's one of the reasons why the decision was so tough, because we're parting with team members that come to work every day, put their heads down and do a phenomenal job for their customers and create value. They're performing very well.

So, we're lucky to have great people. We work closely with them to paint the vision for the future for them in their businesses. Phenomenal franchises, phenomenal brands. I've been very, very pleased with the level of interest, and we've shared that with both respective teams. So, we know it's just like when Carrier spun, there was a fair amount of uncertainty as we spun from UTC. But we knew that – and Greg knew, that us as an independent company would create value for us and our customers and the same will be true for them.

Deane Dray

Analyst, RBC Capital Markets LLC

Thank you.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Thank you.

Operator: Thank you. Our next question comes from Nigel Coe with Wolfe Research. Your line is open.

Nigel Coe

Analyst, Wolfe Research LLC

Thanks. Good morning, everyone. Thanks for the question.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Good morning, Nigel.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Hey. Just want to go back to price and maybe mix, Patrick. Obviously, light commercial, 60% growth. How much of that would have been price and mix? And maybe the \$300 million of price/cost, if you can just maybe be a bit more granular in terms of how that phases through the year?

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

A

Yes. For light commercial, more than half would be volume and the remainder about equally split between the mix up and price realization. And then, on price/cost, the way you can think about it, Nigel, is – so I mentioned \$300 million for the full year. I mentioned 100 bps benefit for the full year, weakest by far was Q1. The next two quarters will be similar, and I think Q4 will be a little bit stronger than Q1.

So, I can't share the exact numbers by quarter. But clearly, we've seen a significant pickup in the second quarter. We expect that to continue for the year. And from a year-over-year margin perspective, the margin impact on Q2, Q3, Q4 will be similar to get to the 100 bps for the year. So, basically, a little over 100 bps every quarter, Q2, Q3, Q4. That's kind of the granularity I have.

Nigel Coe

Analyst, Wolfe Research LLC

Q

That's great. Thanks, Patrick. And then my follow-on is coming back to the portfolios. I mean, based on the indication of interest you've clearly seen from both PE and strategics, are you at a point now where you can rule out a spin process? Do you think there's a buyer out there potentially for the whole package of assets, maybe excluding commercial refrigeration, but the whole Fire & Security assets? And I know there's many parts to this question, but is the KFI Chapter 11 still a gating factor for the fire sales?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Yes. The way I would describe it, Nigel, is that for commercial refrigeration, and then the security business and industrial fire, those will be divestitures. We mentioned that we'd have the first two of those three. We're targeting having those in the market a bit after Labor Day. So, we're targeting having those out in the market before the end of September.

And then, industrial fire will follow a month or so later, and that will also – we also plan that to be a divestiture. And we're still weighing through all of our options with respect to the commercial and residential fire pieces of that portfolio. And those can take a whole bunch of different forms. They can be divestitures, spin, split – like that – the different forms those can take and go in a lot of directions, and we're going to be weighing all of those. But right now, we're focused primarily on those first three to make progress and try to get signed executed deals here in the coming months on those.

And in terms of the KFI process, that's being, of course, handled by the independent board of KFI. It's our sense that they've been progressing well and appropriately through the Chapter 11 process. All of the AFFF litigation against KFI was automatically stayed upon the filing. And since then, all of the AFFF claims against Carrier and F&S have also been stayed, and that came with the consent of the Creditors Committee. So that whole process is proceeding as planned. We anticipate the sale process that the board will do for KFI will begin as they start to sell themselves in the next couple of months.

And then within the next year, we do anticipate Chapter 11 discharge for KFI, which would resolve the AFFF lawsuits against KFI, Carrier and the other entities. So, I think that's progressing as I think their board would have expected it to progress.

Nigel Coe

Analyst, Wolfe Research LLC

Okay. Thanks, Dave.

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Thank you.

A

Operator: Thank you. Our next question comes from Joe Ritchie with Goldman Sachs. Your line is open.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Hey, thanks. Good morning, everyone.

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Good morning, Joe.

A

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Hey. Just maybe just starting off on the lead times normalizing comment. I'm just curious, how far above normal are we still with lead times? And when do you expect that to fully normalize?

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Joe, it varies a little bit by business. Light commercial has come down, but it's still above normal. It looks like resi is getting closer to normal. It's closer, kind of Patrick said, in that four to six range, with four to six week range would be normal. And starting to kind of approach those levels that we've seen in the past for resi.

A

Commercial HVAC still has a very strong backlog. That would be above normal, and it almost varies by region. In places like Europe and China, it's a little bit closer, but higher than traditional backlog levels. But in the United States, we've had some operational challenges in our Charlotte facility, which the team is working very hard to address, has been making a lot of progress on some of the underlying issues. But until we get those fully in the box, we'll continue to see elevated backlog levels that go well beyond this year into next year. So, it's nice to have the backlog, but we still do need to make, in that particular site, more progress on the supply chain issue. So in general, it's getting closer to traditional levels, but it kind of varies by region, by business. and it varies a little bit based on our supply chain overall performance.

What I will add, Joe, is that one thing that we're doing, is doubling down on the basics. We brought in a new team to help with our SIOP processes, our sales inventory operations planning. Because we're in an environment where there is some fluidity on the demand side, and we still have some longer lead times for things like chips. So, we need to have very agile demand and materials planning so we can give our customers what they want and

what they need when they need it, and not get stuck in the middle with inventory levels, and that's been a whole focus area for us internally.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Got it, Dave, that makes sense. And I guess maybe just connecting the dots with the backlog. It was good to hear that backlog grew sequentially. It sounded like the commercial business had started to reaccelerate, but don't want to put words in your mouth. So, just maybe just talk to us a little bit about the order trajectory there and what you're seeing on the ground real time.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Yeah. I think that with respect to commercial, Patrick mentioned that – I think, Joe, the question is about commercial HVAC?

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Yeah. Just I would say commercial, and applied more broadly.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Yeah. Yeah, I think that – look, it was nice to see over the past four weeks or so, we've seen that demand positive. You look at the commercial HVAC business. We still have, in some cases, as I mentioned in North America, for example, backlogs that go well above – well beyond historical levels. And that does have an effect on incoming orders. So, as those backlog levels will start to moderate, especially in North America, we do expect that the demand will continue to be there. You look at ABI was over 50 – the Architectural Billing Index – was over 50 in both May and June. It's been over 50 three of the last four months.

And I think when I look at the job that Gaurang and the team are doing, they've been very agile. We talk a lot about when you fish, you go where the fish are. When you go – when you're in a business like ours – you go where the customers are. So K-through-12 has been strong, healthy buildings. Industrial activity has been strong. Data centers continues to be positive. Healthcare is positive. And then we transition away from some of the areas which show some areas of weakness. So, commercial and residential real estate in parts of China were weak. We pivoted hard to industrial infrastructure, and that's been driving a lot of demand. So we feel good about the backlog, and it's nice to see the order rates over the last month or so.

Joe Ritchie

Analyst, Goldman Sachs & Co. LLC

Great. Thanks, Dave.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Thank you.

Operator: Thank you. Our next question comes from Josh Pokrzywinski with Morgan Stanley. Your line is open.

Joshua C. Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Hi. Good morning, guys.

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Hey, Josh.

A

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

Hi, Josh.

A

Joshua C. Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Dave, I wanted to just pick your rain a little bit on a follow-up to that last question. What's your sense on non-residential construction? I think some of the data is getting worked around by the mega projects, which I think maybe the HVAC content is a little harder to tease out. Obviously, things like warehouse that are declining, but maybe not as important. So, what's your sense on that market now? The data seems like it's good. You've talked more about backlog normalization and real demand shifts. But are you seeing anything on the ground level there?

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Well, yes, I think that clearly, we've seen the areas that have been a bit weaker, it's some areas of retail, but interestingly, some of the lower end retail has been positive. So not all retail, but some areas of retail in our applied business and areas of commercial real estate have been weaker. And that's – and you know this, Josh – but remember that commercial real estate is less than 10% of our North American applied business.

A

So, we watch it. We watch some of the reaction that we were going to see with the regional banks. But there's been nothing terribly acute. And I think on the flip side, some of the areas that continue to be very positive is K-through-12. I mean, we still have a significant amount of that ESSER funding to be spent. Higher ed has been extremely strong. And then you look at industrials – CHIPS Act – bringing some new construction back to the United States in that space has been positive.

Data center is good, health care good.. So, we look at it globally. I think in general, the theme is around real estate is a watch item. I will tell you on the flip side, it's encouraging. You know that ABI is about a six-month leading indicator for new order activity. So, to see ABI showing some growth, it could indicate that folks see an eventual moderating of rates, which should drive some new construction activity on the real estate side, six months out. So, we'll have to watch and see if that happens. But in the meantime, some of the other verticals have been strong. And as you mentioned, warehouse has been a bit on the weaker side, I would say.

Joshua C. Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Got it. That's helpful, very comprehensive. And then just a follow-up, and if someone asked it already, I missed it, I apologize. Heat pumps in IRA, something that was obviously very topical, kind of six, nine months ago, and it's maybe gotten a little less attention lately. It seems like the heat pump market in general has been strong, but

Q

what's your sense on the IRA uptake and maybe any kind of tighter quantification of what you think that might be worth over the next, I don't know, 12 months, 18 months?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

You know, it's hard to exactly dimensionalize it. But I will say what happened is the legislation got passed, and then we went into a bit of a lull period while that was actually getting effectuated. And in some cases, you're dealing with not only the IRS, but a state-by-state implementation. So, I think that I would call like 2023 the year of things getting codified. 2024 is going to be the year where we start to really see the benefit of it.

And I think it's going to kick in really in the first quarter of 2024, and we're very pleased with how it's gotten codified overall, which has been that the \$2,000 incentive for heat pumps in the United States getting applied to that mid-tier level, which was very important to see the kind of take rate that you would want to see to have the impact you would want on consumers, but also on the planet.

There still is one area where how they define some of the levels for heat pumps in the North and the South; there's a variance there. We'd like the definition that we're seeing in the South applied equally to the North because in the background, we're working on the technology for cold weather heat pumps. So there's still some, I think, improvement to be made in the legislation for the northern part of the country. But I expect we'll start to see, I think, a tangible benefit as we get into 2024.

Joshua C. Pokrzywinski

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Helpful update. Thanks a lot.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thanks.

Operator: Thank you. Our next question comes from Noah Kaye with Oppenheimer. Your line is open.

Noah Kaye

Analyst, Oppenheimer & Co., Inc.

Q

Good morning, guys. Thanks. Just wanted to get maybe a deeper update on the regulatory approval process for the spin. You mentioned on track to close by year-end. But maybe just take us through where the regulatory approval key steps are at? And any potential for slippage around those timelines?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, it's been progressing very well. Hats off to the team because we got the FDI approval in Germany. We've gotten various country approvals as we've been going along, such as China, that was positive to see. And I think the key one that we'll be down to is in the European Union, and that's frankly progressing very well, and it's progressing well because there's really no material overlap between us and them. So, we said that we would close around year-end, and we remain on track for that.

Noah Kaye

Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Switching to different topic, aftermarket and services. Aftermarket, another double-digit quarter. Services sales up 16%. And Dave, you mentioned in the prepared remarks around embedding generative AI and Abound and the digital platform. And I was wondering if you could maybe help tie together for us some of those investments and the sales traction you're seeing. How does AI and generative AI actually help increase penetration of digital and aftermarket?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, we've – working with Bobby George and the digital team, we're establishing an AI generative AI center of excellence as a skill set. Look, we've been using it for a while. There are some areas where it's a bit more basic, like in our call centers, where we can drive much more efficiency and responsiveness for our end customers in our call centers using generative AI, and that's very encouraging. And I think in the area of things like our digital platforms, Abound and Lynx, what you're really looking at is capturing data and using that data to make – using algorithms to anticipate issues before they occur that can then affect the controls and ultimately drive automation.

And that – as we build out all of the applications and capabilities around Abound and Lynx, the fundamental capabilities around generative AI are going to be very significant. We've been at this for many years. We're now taking it to a new level because of some of the advances we're seeing in the AI capabilities, where you start to anticipate a failure of equipment before it occurs because you're looking at certain physics-based algorithms associated with the temperature, pressure, and other aspects of the equipment. You start to look – use Lynx to use geo-fencing and other capabilities that go beyond temperature controls and prognostics and diagnostics on the cold chain side. So, it's very exciting. It's yet another distinguishing feature we can add to our digital platforms.

Noah Kaye

Analyst, Oppenheimer & Co., Inc.

Q

That's really interesting. Thanks for the color.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thank you.

Operator: Thank you. Our next question comes from Stephen Volkmann with Jefferies. Your line is open.

Stephen Volkmann

Analyst, Jefferies LLC

Q

Great. Good morning, guys. Thanks for fitting me in here. Just a couple of questions, maybe a little bit longer term. But I'm trying to think about – or how you think about pricing in 2024, 2025? Do we kind of go back to the historical norm, do you think? Or is there a reason it might stay a little bit higher? And is there any reason that mix wouldn't continue to improve as we go a little bit longer term?

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, look, I think that I do see pricing continuing, but being more at historical levels. I mean, you have to keep in mind that you look at pricing over the last couple of years, we were dealing with, I think, close to a couple billion

dollars of price over the last two years. And we're going to continue to see, I think Patrick said, around \$600 million of price this year. So, I think that we will be in the normal – well, we resume to more typical levels on price. We don't certainly see price reductions, but we see continued price increasing, but not at the kind of pace that, of course, we've seen over the last couple of years.

Mix continues to be positive. We'll continue to see the 2023 benefits that we saw in the SEER change extend into next year on the residential, light commercial side. We also see mix benefits on the refrigeration side. The same transition that we're seeing on the HVAC side, we're seeing in places like United States and Europe, as they transition to lower emission, diesel-powered truck and trailer units, but also a transition to electric. That mix up is very beneficial to the truck/trailer side as well.

And then as we get into the parts of 2024 that extend into 2025, in North America we'll have the refrigerant change as well, which would be a further mix up. So, mix will continue to be positive on both – on all aspects of the business, and then we'll resume normal pricing levels.

But in the background, it's our job to drive productivity. So, we talked about 2% to 3% net productivity forever. The team is driving a few hundred million this year. And one of the things that our new Head of Operations, Adrian Button, and the team are doing very well is not only looking at productivity for 2023, but we have one source of the truth, one digital platform that everyone looks every week. And we're using that digital tool to set ourselves up for 2024 productivity as well. So, we get really good line of sight going well beyond 12 months.

Stephen Volkmann

Analyst, Jefferies LLC

Q

Perfect. Okay, thanks. And then just a quick follow-up maybe for Patrick. How should we think about the cadence of TCC as we get into 2024? Is it still margin dilutive? Thank you.

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

A

The key – well, the key reason why this year it's margin dilutive is instead of recording equity income as we did prior to the acquisition, now we're consolidating the entire P&L. So, this year, I mentioned that their operating margin would be – it's already at the double-digit level, so a little bit lower than the company average.

I would expect that to continue to improve. And next year, it might not yet be at the overall company average, but I would expect to get significantly closer to it. But the main reason why it is dilutive this year is because we basically consolidate \$2 billion of revenue with \$100 million plus-ish of incremental operating profit. That's the dilutive impact.

Stephen Volkmann

Analyst, Jefferies LLC

Q

Perfect. Thank you, guys.

Patrick P. Goris

Chief Financial Officer & Senior Vice President, Carrier Global Corp.

A

Thanks, Steve.

Operator: Thank you. And our last question comes from Vlad Bystricky with Citigroup. Your line is open.

Vladimir Bystricky

Analyst, Citigroup Global Markets, Inc.

Good morning, guys. Thanks for taking my call.

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Hey, Vlad.

A

Vladimir Bystricky

Analyst, Citigroup Global Markets, Inc.

Hey. So, I just wanted to ask about the uptick in China orders in the quarter. I know a year ago, comps got easier. But China is one market. I think we're just trying to understand a little better what the trends are there. So, can you just talk about what you're seeing in terms of underlying demand trends in China and how you're thinking about the potential to maintain positive orders momentum there going forward over the next couple of quarters?

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Yeah, Vlad, I got back recently from China. And just to level set, it's about 9% of our total sales. And our overall outlook in China is promising. We see it up double digits for us this year. The comps are a bit easier, but we still do see underlying growth. The first half was up just over 20%.

A

Now, Q2 had some easy compares, because remember, there were the COVID lockdowns in Q2 of last year, and Q2 was up 30% or so for us in China. But when we look overall, we see growth in applied in China, especially on the industrial side. The industrial verticals were up over 20% in the first half, and it was verticals like the renewable energy, medical pharma was strong. And that helped – that's been helping us offset some of the weakness that we saw in the commercial real estate side.

And by the way, I think I might have said that the first half was just under 20%; not over 20%, but it was kind of in that range. And the other thing I'll say about our teams in China, and this applies to commercial HVAC, it applies to the residential, light commercial side that's part of our GCS business, our Fire & Security and Ref side, is we've seen the key to success is being very agile. That's true globally. But I think it's true especially in China. If you look at where we are at commercial HVAC, just five years ago our mix was 70% property, 30% industrial. It's now 40/60, the reverse.

So, we've been very, very purposeful about shifting our sales folks – our sales incentives to go after where we see the growth, which has been extremely strong with some of our partners over there in that I&I space. So – and I do believe the government will continue to incentivize further growth there. So we – overall, it's not going to be a straight line – but overall, we remain bullish on China.

Vladimir Bystricky

Analyst, Citigroup Global Markets, Inc.

Okay, great. That's really helpful, Dave. And then just as my follow-up, maybe shifting to North America. I know you mentioned, and you've seen obviously good strength in the K-to-12 vertical. One question or concern that we hear from some investors is around potentially peak-ish spending in that K-to-12 market, just given the strength we've seen there. So, can you talk about how you're thinking about growth runway in the K-to-12 vertical, broadly going forward? And whether you are seeing any signs of sort of increased budget constraints in – from those customers?

Q

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Yeah. I actually – I view it the opposite of that. I think there's tremendous runway on K-through-12. And remember that, this is the first time in decades where the K-through-12 area has had dedicated and sufficient funding. And they've allocated – the federal government has added – allocated \$190 billion of ESSER funding – or to \$190 billion. There's \$190 billion in the ESSER fund over the next 15 months, and \$90 billion of that has still yet to be allocated. So \$90 billion of the \$190 billion still has to be allocated over the coming 15 months.

Now whether or not that's physically possible remains to be seen and whether or not there will be an extension of that remains to be seen. I would suspect there needs to be. But in the meantime, there is actually more runway ahead than there has been growth in the past. I mean we continue to see orders have been up double digits for a long time. We saw K-through-12 orders up 20%, as I mentioned, in the quarter. Our pipeline in Q2 is now up 60% over where it had been.

So, we think it's a very attractive vertical. And the way that funding gets spent is some of the initial funding is the lower lead time, less expensive type projects. As you get into ESSER III funding, and there's still \$120 billion of the \$190 billion is in ESSER III, that's when you get into things that have to do more with like HVAC. So, we think there's a lot of runway ahead in K-through-12 in the U.S.

Vladimir Bystricky

Analyst, Citigroup Global Markets, Inc.

Q

Appreciate the color, Dave. Thanks.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

A

Thank you.

Operator: Thank you. I'd like to turn the call back over to Dave for closing remarks.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Well, look, my thanks to the 55,000 team members at Carrier. We have a lot of moving parts in the system. The team continues to work tirelessly on behalf of our customers and achieve great results. So, my thanks to everyone at Carrier and our thanks to our investors. And of course, Sam will be available for questions as we go through the day. So, thank you all.

Operator: Thank you for your participation. This concludes the program, and you may now disconnect. Everyone, have a great day.

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