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Carrier Global Corp. (CARR)

Credit Suisse Industrials Conference

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MANAGEMENT DISCUSSION SECTION

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

All right. Good morning, everyone. Thank you for joining us again. This is the 9th Annual Credit Suisse Industrials Conference. I am John Walsh, our multi-industrial and industrial software analyst. Today is day one of the conference and we are very excited to have Carrier with us today. We have CEO, Dave Gitlin; CFO, Patrick Goris; and Sam Pearlstein, Investor Relations.

And with that, I'm going to turn it over to Dave for some opening remarks.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

Well, good morning, John, thank you so much for having us. Just before we get into the Q&A, I thought we'd give a couple of highlights on – color around Q4 and 2022. Sales and orders remain strong. It's too early of course to see the impact of Omicron, but we'll have to watch that. The two watch items we have COVID cases have been increasing in Europe, so we have our eye on that, no material impact thus far but we are watching that. And of course, China and the macroeconomic conditions there, but the encouraging news is that we do not have an orders issue. Orders have continued to be robust and that positions us well for the remainder of the quarter and going into 2022.

We do continue to see input cost headwinds and factory efficiency issues and they're really not moderating, still paying a lot for electronics, logistics costs remain high and it's causing some factory disruptions. But having said that, I am confident that our team is doing a much better job of offsetting the input costs issues that we see with price and the teams also being very aggressive on discretionary cost actions. So as we look ahead and we'll give a lot more color on 2022 early next year, but we go in with a very strong backlog much better than we've seen in prior years. Orders position us for continued growth and we've been seeing the benefit from the investments that we've been making in growth and these secular trends that we've talked about really position us for a strong growth next year.

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We do expect price costs to be at least neutral as Patrick has talked about, and we're taking very aggressive actions now to position ourselves on the price side for next year and discretionary cost items. The secular trends we talk about which we can get into the Q&A, healthy, safe, sustainable, intelligent building cold chain solutions.

These are incredibly compelling opportunities. The total addressable market is much bigger than it used to be at Carrier, because we think about providing solutions rather than equipment and -- in addition to providing equipment and we're very energized by the opportunities ahead of us because of these secular trends and how we're positioned in the middle of them.

Aftermarket growth continues to be encouraging. We committed to double digit growth this year in the aftermarket. We're going to see that and we're also the playbook is working and when we think about Chubb, we're coming down the home stretch. We are planning to close very early next year, I would say, hopefully within days or weeks of the -- of January 1. It's not months.

So we're closing very early next year. We're down to a couple of approvals that we still need and then we'll close early next year and we've said that next year as always we'll be very disciplined on capital allocation $750 million of debt pay down, $1.6 billion of share buyback for next year and we're increasing our M&A pipeline.

We recognize that because of the uncertainty around when we were going to close Chubb and the magnitude of Chubb, it's made folks modeling a little bit more challenging. So just the second of color there is that when we close Chubb, we first of all, our portfolio will have higher growth, higher margin and a more differentiated portfolio.

When we close Chubb, we will lose about $0.24 of EPS next year about $0.18 of that is operational, $0.06 is related to non-cash pension income and we do plan to offset that entire amount through operational performance and the share repurchase that we've talked about. And with the cash position we'll have significantly more firepower for additional capital deployment, including M&A to drive a continued more differentiated portfolio and create long term shareholder value.

So John, those were the upfront comments for you and the other listeners and with that happy to get into any Q&A.

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QUESTION AND ANSWER SECTION

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Appreciate the comments and thank you for also the modeling update around Chubb.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Yeah.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

I'm certainly grateful for that. I guess, maybe just following up on your opening comments. I mean, you said the order remain robust. Could you maybe break that out? I mean is there a particular area whether it's obviously, light commercial was the positive surprise on Q3. Is that where you're continuing to see it or maybe, it's more broad across the entire group, any comment there?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

It's -- frankly, John, it's really broad. It's -- when we look across the order trends that we saw in Q3. It's all of those areas have continued into 4Q. So resi's continued to have strong order trends, a lot of continued demand there. Light commercial as you said was -- has been extremely robust, continues to be so. Globally -- for our commercial HVAC business continue to see robust orders there and same with refrigeration, [indiscernible] (00:05:49) strong, container is extremely strong. And then with our fire and security portfolio, a lot of demand there, especially in the fire side of the portfolio. So it's been pretty broad. Demand right now in orders is not -- it's not our issue. It's just making sure that we do everything we can to keep up with that demand.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

And then maybe just taking that thought another layer, I assume that this probably results in record backlog. How should we think about that backlog phasing into 2022 and beyond? I mean, obviously, supply chains will have some impact but is there any kind of round number or thought that you have around that?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, let me put it this way is that we are usually not entering the year with the kind of backlog that we have now. So when we look at our booking levels for 1Q and even into Q2 – 2Q, we're much more booked than we normally would be going into the year. So normally when we look at the percentage of new orders we need to drive [ph] to hit (00:06:59) how we're thinking about the growth profile we see in the first and second quarter of next year, our booking levels are much higher than historical levels, which give us confidence certainly in that first half growth profile that we've been modeling internally.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

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Great. And then maybe just, thinking about Carrier 700 and maybe at least for us, I just want to make sure we are understanding it, right? You laid that out. There was also some offsets from investments and then there's this kind of 30% leverage that you think the business is entitled to. So as we think about what's left to execute on Carrier 700, do is it 30% plus then that drop through or do you need the Carrier 700, to help get you to that 30% given the inflationary environment we're in? I just want to make sure I understand that correctly?

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

A

Yeah, John, I'll take that question there is a lot there. So Carrier 700 as you know has been our cost savings program. It's a net number meaning the Carrier 700 was meant to include both the impact of our productivity, our cost saving actions, as well as the impact of material inflation. Clearly, given what we've seen this year in terms of input cost inflation, it's been a lot more difficult to achieve our $225 million target we had for $221 million, $225 million of savings this year.

So we updated you in October, we mentioned that this year we expect $75 million of savings associated with Carrier 700. Given the sale of Chubb that Dave just referred to obviously we're going to reset Carrier 700 just because that $700 million included some savings associated with Chubb. It does not change our overall focus and the opportunity in terms of cost takeout. We see continued significant opportunities in our material purchases, our factory footprint, our logistics and our G&A footprint as well. So there is no change there, we'll update you at Investor Day or whenever we come out with our guidance in February. But our focus on cost takeout does not change.

With respect to the earnings conversion question you asked, longer term, we see ourselves as the company that should be able to deliver earnings conversion in the high-20s close to 30%. With respect to next year, we expect and you'll recall this from our October earnings next year, we expect another significant year of input cost headwinds and price tailwinds. And as Dave mentioned, we expect price cost to be neutral at minimum.

Obviously, price cost has a significant impact on the reported earnings conversion. Taking that out, we do expect earnings conversion to exceed 30% in 2022. And the reason for that is we expect another significant tailwind from Carrier 700 or the productivity items that we're driving and so we expect that – some of that to fall through the bottom line, that will be partially offset by investments. But as I mentioned, absent price cost which impacts of course reported conversion, we do expect our earnings conversion to exceed 30% in 2022. I hope that kind of provides you some context.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

No, that's very helpful. And I would also imagine it's probably a tale of two halves, as the pricing actions and then kind of the hedges on some of the higher priced steel. So I would expect you're probably exiting the year in a much stronger leverage position than you start the year, is that fair?

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

A

Yeah, at this point, John, I'm not going to provide quarterly comment on for 2022. I would just say that we're very focused on managing the price cost equation. We target that to be neutral at minimum. At the same time, you heard us talk about the big opportunity we have from a cost side and we're of course, very focused on delivering that as well.

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John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. One of the things that I took away from the Q3 call that I think was definitely underappreciated is really how strong your heat pump business is. So I'd love to get a little bit more perspective on how you expect that business to grow. And I think, given the way your portfolio is, you have not only a heat pump offering for the US, but also for global as well. So if there's any difference in those growth curves, we'd love to understand that as well.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, a major theme for us, John, is obviously sustainability and electrification is a big piece of that, and heat pumps is a big piece of that. So, it's very much in our wheelhouse, in the residential business, in the United States. I mentioned on the 3Q call that we did receive an AHR 2022 Innovation Award and I do think that many do regard our Infinity 24 heat pump with green speed intelligence as really best in class.

So we're very proud of the heat pump technology we have for the ducted heat pump space in the United States. We've now added Giwee, our acquisition in China. With that comes the VRF heat pump capability, air to water heat pump segment. We also talked about accelerating the heat pump adoption and things, as an example as we've been working with -- in the United States here the Department of Energy and we've entered into a residential cold climate heat pump challenge.

I actually reviewed it this morning and we're going to be doing testing in their lab in the National Laboratory for the Department of Energy in Oak Ridge early next year to really prove out the heat pump capability in some of the colder temperatures, the way the challenge is set up is it's 5 degrees F.

So we're investing a lot in the technology, in the residential space. The commercial space globally, it's very much in our in our wheelhouse. We just introduced the next gen air cooled chiller heat pump platform in Europe and improved GWP by 70%, energy efficiency by 30%. We have in the -- in Europe, we also have our [indiscernible] (00:13:51) business, which is a traditional boiler burner business, but we're also because we have this great channel we're also looking at investing in residential heat pump capabilities to leverage the channel that we have for some of the traditional burner boiler technology in as that continent continues to migrate more towards heat pumps. So we want to play obviously about 30% of our heating sales in the United States in residential heat pumps, we're seeing the global phenomenon on the commercial side and we're also looking to play there on the resi side in Europe as well.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

And so as this transition happens to heat pumps or electrification of heat, what does that mean from a financial impact to Carrier? Is this at a higher ASP? Are the margin profiles similar? We'd just love to get some kind of color because this transition is happening, right?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, long term as you look at this trend, it will come, it will provide long-term tailwind. So it actually what we're trying to do is make sure that with our heat pump technology, it's differentiated to the point where it drives higher margins. You actually may end up selling fewer actual physical units depending on how it all plays out. So we'll have to see what it means as an apples-to-apples. But what I see is that it will drive early replacement. So that's our goal is that if there's enough incentives to get customers, whether it's on the commercial side or on the

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residential side that if especially in places like Europe and in the United States, if people are incentivized to replace the unit to drive more energy efficiency, which drives lower carbon emissions, and you get an earlier replacement than you otherwise would have, it would drive additional sales and margin into the system. And again, we're hoping to drive differentiation, so it's at a better margin point.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

So, just to dig into that a little bit deeper, because I think you hit an important point. HVAC has historically been a replacement driven market, and so I guess, are you actually seeing customers replace early or are these conversations that you're having with customers where they're saying, hey, we might actually replace this piece of equipment early because of the incentives we're getting from a utility and/or a government?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.
A

No, I think what you're seeing is on the residential side, if someone was going to just replace their air conditioning and not touch the heating part of their house because it had more life in it, with the incentive to drive more energy efficiency on the heat pump they may elect to replace the heating side of the equation earlier than they otherwise would have. And especially because with the heat pump you're driving that integrated unit between the AC and the heating side, there is a desire and an incentive for people to replace the heating earlier than they otherwise would have. And it's certainly on the commercial side, especially in places like Europe, you are seeing more of a take rate for people to drive an earlier replacement than they otherwise would have.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

Interesting.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.
A

And I. I'm sorry.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

No, no, go ahead.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.
A

No, John, I was just going to say that this is why we're so focused and energized by all things sustainability. It is – it's not a trend of the future. It is here significant regulatory focus in the United States and in Europe. There is -- when we meet with customers, they not only want to do it for energy efficiency, but they are way out there in traffic with their own ESG goals, and they really are prepared to spend more than they otherwise would have to drive not only the carbon reduction commitments that they've made but they now want their customers to see that they're driving those kinds of carbon reduction targets. So it really is something that's very encouraging on the regulatory side, but on the customer side as well.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

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And then I guess to build on that, you obviously still have a fire and security products business within the portfolio, when a commercial customer is looking to upgrade their HVAC system to take advantage of this. Is it pulling through other products within the portfolio as well? Or are these viewed as discrete projects where they're going to focus on their HVAC and what they can do there from an energy perspective, they're not also going to say, hey, while we're doing this, let's look at what we're doing on fire and security?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, it's traditionally been a bit distinct but what's happening now is that as we drive really more sales of Abound, which is really one of our top key focus areas as a company is this platform that we're developing out called Abound. That will be a big pull through for the portfolio. Because it really connects the dots between the HVAC side and the fire and security product side of the portfolio. Because once you can install Abound what's really started as our approach to address the healthy trend as people were focused on IAQ and indoor air quality, we came up with this agnostic platform that you could install without affecting the wiring, all based on sensors, batteries.

You could install it and it would give you visibility into the indoor air quality as you know, we have it with the Atlanta Braves and Truist Park, we have it with school systems, we have it with some commercial office buildings, but we're in the first inning on Abound. We're now incorporating sustainability into it. We're going to incorporate other parts of the portfolio like we have a MyWay app that is used for a contactless frictionless approach to entering a building when you – from your garage to your office that's part of our security portfolio, but now we're incorporating that into Abound as well. So as we think about EcoEnergy incorporated to Abound, MyWay incorporated to Abound, that's going to be the connective tissue that starts looking at intelligent solutions for the building owners.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

And that might be a perfect segue into kind of the next question, you've put out this target of having an extra 10,000 applied systems under a service contract. I would think that Abound is part of that equation to do it. But could you also talk about your channel on the commercial side? Kind of maybe how much is direct versus independent? And if that impacts the ability to convert to a higher service percentage at all?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

It does not. I mean, if you think about our commercial HVAC business, outside the United States we're 100% direct, so no issue there. And then in the US it's a split, some through depending on the city in the United States, some is through our channel and some is direct, where we go through our channel is best-in-class channel. So we're very pleased with our channel partners and we've had very direct discussions on what we need to do better, what our channel partners need to do better.

And that collaboration has resulted in win wins. And it's really not impacting our ability to provide the aftermarket service agreements that we expect. Many of our peers that have similar kinds of channels have managed over time to provide that service directly. We're doing the same. And if we do it well, it can create a symbiotic relationship where some of our channel partners end up benefiting where they can do some aspects of the onsite service, some of the wrench turning, we provide digital differentiation. So it is not a barrier to us seeing the kind of growth we expect.

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We've talked this year about going from 50,000 of our chillers under contract to 60,000. We have more than 300,000. We'll get more color in February on our approach to connecting these devices, but we need to go and connect our refrigerated units that are out there, our reefer units. We need to connect our chillers, we need to connect our residential units and then we need to kind of keep providing differentiated, digitally differentiated solutions and drive towards a 100% coverage.

We won't get to 100% coverage, but that's the goal that we've set for ourselves internally and we just got to tenaciously drive to it.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

Great, and then you mentioned that the differentiator there is really on the technology. How do you think about the make versus buy on that? And obviously you've already been acquisitive on some of these technologies, I think you're describing. But can you take us through that decision process?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.
A

Sure. It's going to be a mix of everything as we kind of build out, connected devices as we build out more of these two major platforms we have, Abound for the building space and Lynx for the cold chain space and we continue to build out those platforms. In some cases, we'll make some of the technologies ourselves, in some cases, we're in partnership with others.

In some cases, it will be a minority investment that we'll make kind of like a VC type investment and then in some cases, it'll be a full acquisition. So we plan to really have differentiated platforms to do that, we like partnerships with AWS, they have been a great partner of ours on both Abound and Lynx, keep that going and then for some of the startups that bring some level of differentiation and agility to the platform, we'll either buy all or perhaps an investment in those companies.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

Great, and then you talked or you started early in the presentation talking about an increased total addressable market. I don't know if you have a number to size that now or if that's something we'll get on Analyst Day. But, could you kind of talk a little bit more about how much it's expanded?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.
A

Well, we'll talk more about it, John in February at the Analyst Day on February 22, but we've already sized the healthy space, $10 billion of TAM there. We know that the sustainability market is orders of magnitude higher than that. So we'll try to give some dimensionalization on how we think about the TAM, but what we do know is that if we can get really differentiated platforms and we can get them in with scale customers and use those platforms to then develop apps in parallel with them and then have it pull through solutions for our customers and pull through product that the market opportunity is significant.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

And then I guess, just given such an increase in TAM here with de-carb, with sustainability, are you seeing any changes on the competitive landscape, either niche players trying to come into the broader market with an

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offering and/or potential new entrants that might have focused on a particular geographic region trying to expand their base?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Yeah, look – we look at our traditional OEM competitors. We look at some of the software – I mean you had mentioned we did some M&A on some of the smaller software companies. So we see some of them coming in and, as I mentioned, we will look at partnering or buying or investing in some of those as well. You have some of the bigger players like the AWSs of the world, and we've taken a very purposeful approach of partnering with them. We announced another further partnership with AWS this morning, we're participating in their Las Vegas re:Invent conference in a very profound way, which we're very proud to be partnered with Andy Jassy and the team out there and Adam.

So, we're seeing the competitive landscape evolve a little bit and we'll have to be agile as we see new folks either come in or play more in the smart building space. But we think that we have some real differentiation between the platform and the apps that we're building out with it. The product portfolio that we bring to the table where we have very recognized brands and very differentiated technologies and the ability to marry up the industrial space and the products that cut across the portfolio with some of the software in the digital space, I think really positions Carrier very, very well in this space.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Right. And then I guess, just as we continue to kind of navigate the supply chain issues for everybody, how are you thinking about, working capital needs in the next year? I mean, do you think you're going to run higher inventory? And then from a CapEx side, how are you thinking about maybe investments in automation or other technologies?

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

A

Yeah, John, I'll take the working capital one. You may recall, about a year ago, we on purpose built some extra inventory that helped us out earlier this year. I think it helped us with availability of products, and obviously we think in some cases we outperformed some of our competitors having the product availability to us. I'd say that inventories have remained higher this year than usual. And there are several reasons for that. One is, of course, the higher input costs. But two, on purpose, we've been building some safety stock. We expect that to continue into 2022, maybe not as much, but as Dave mentioned, we're still in the challenging supply chain environment. The other reason why inventory is a little bit higher, frankly, is our inability to ship, we may have 99% of the components to ship something, we're waiting for that 1% to come in.

And so that's impacting our working capital as well. So I'd say next year, I see more of a tailwind from working capital than a headwind. I see that not just on the payables side, but I frankly, I see it also on the inventory side. I do expect that our inventories will be a little bit higher than we otherwise would expect by the end of this year. And so I expect that to bleed off a little bit next year, and that would be more of a tailwind.

On the CapEx side, you mentioned automation, that is absolutely something that we're looking at. And so within our factories, there is probably going to be a higher percent of CapEx going towards automation opportunities than some of the other CapEx alternatives that we've seen in the past. And so that absolutely is something that we're focused on.

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John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. And then maybe just sneaking one in here under the wire. As you think about your business and labor, is labor a governing factor at all for Carrier and then as you think about the end market, is labor a factor on kind of governing growth as well?

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

A

Well, our labor challenges have, for the most part, been isolated to a few sites in the United States. Remember 80% of our people are outside the United States. So the good news is Collierville, Tennessee, where we've had an acute labor challenge, we're starting to see a little bit of progress there. We're still probably about 100, 150 people short of what we would want in that facility. But we've had to get creative where we're using more part-time labor on the factory floor. We've come up with some creative ways of having people, use specific hours and doing some pilot lines where people come in at certain hours and we can do things we've never done before with effectively part time labor on certain lines there.

So we are -- labor is a challenge especially in probably three or four sites in the United States. But I would tell you that the biggest challenge that we have in terms of output is not yhe labor issues. It's generally in some very specific part challenges that we have, usually on the electronic side.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Great. Well, I'd like to thank the Carrier team for being with us today. We hope that everyone stays well and safe and look forward to continuing the dialogue next year.

David L. Gitlin
Chairman & Chief Executive Officer, Carrier Global Corp.

Thank you. Thank you, John.

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

Thanks, John.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

All right, thank you, everyone.

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