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Carrier Global Corp. (CARR)

Stephens Investment Conference

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Tommy Moll
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MANAGEMENT DISCUSSION SECTION

Tommy Moll
Analyst, Stephens, Inc.

Good afternoon, everyone. I'm Tommy Moll, Equity Research Analyst here at Stephens, Inc. I appreciate and we appreciate everyone's attending our conference this week. We also appreciate the time of the Carrier CEO, David Gitlin; CFO, Patrick Goris. We appreciate you both joining us here today. Thanks for taking the time to come to Nashville.

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

Well, Tommy, thanks for having us. It's a real honor for us to be here.

Tommy Moll
Analyst, Stephens, Inc.

So format wise, I've got questions prepared for nearly the entire 45-minute session that we have planned. So I'll be working us through those questions. With that said, at about the half hour mark, if there's anyone in the audience who'd like to ask a question, by all means, raise your hand and ask direct. And then to start us off, I'm going to turn to Dave, who has just a couple introductory points he'd like to make.

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

Well, Tommy, thank you. Good afternoon to everyone. Four key messages from us today. First is that we're in attractive markets. We realize growth despite broader economic slowdowns. And it's because people need our products. They need heating and cooling and vaccines. They need fresh produce. They need fire detection despite economic cycles. So, there's demand for our products. And it's accelerating because a lot of the secular trends that we talk about, things like sustainability and a shift to electrification and demand for healthy indoor

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environments. And where we're spending a lot of our time and energy on is driving innovation and differentiation to win more than our fair share of these secular trends.

The second theme that we have is a very deliberate shift that we're making at Carrier from selling equipment only to life cycle digitally-enabled solutions. We have two key digital platforms that we're investing a lot and building out, Abound for buildings, Lynx for cold chain. And what we've committed to is very strong growth in our aftermarket and we used to grow in the 1% to 3% range. We've been consistently growing at double-digits as we've leaned into it into aftermarket focus. And what we said is that we were $4.5 billion of aftermarket sales last year and we'll be at $7 billion in 2026. So, a lot of traction and a lot of focus on the aftermarket and recurring revenues.

The third thing we have is productivity. We've spent a lot of time and energy on simplifying our focus. That includes portfolio with the subtraction of Chubb, the addition of Toshiba. We're going to continue to optimize and look at our portfolio, but we're also going to drive G&A reduction. We'll get $100 million of G&A reduction just this year. We're in the 7% range of G&A as a percent of sales and used to be in the 9.5% range. So, absolute reduction in G&A, but also as a percent of sales productivity in our factories supply chain, and I think one piece of good news for sure next year is going to be commodity tailwind as we go into next year. So productivity is very thematic for us, 2% to 3% productivity as a whole each year, but 5% operationally.

And then the last theme, Tommy, is balance sheet. And because of the work that Patrick and the team has done on our balance sheet, we can now play offense. So we're going to continue to invest in organic growth. We're looking at M&A. We continue to refine our overall pipeline on M&A. You saw that we announced an additional $2 billion buyback authorization that we'll be spending over the next 12 to 18 months and will have a consistent and growing dividend as well. So it's nice to have the balance sheet that we've developed to play more offense on capital deployment.

With that, we'll get into the Q&A.

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QUESTION AND ANSWER SECTION

Tommy Moll
Analyst, Stephens, Inc.

Q

Well, Dave, thanks for the great overview there. Really only leaves one topic which is resi.

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

A

Yeah.

[indiscernible] (00:03:51).

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

A

Let's ensure we spend the whole time on 25% of our business.

Tommy Moll
Analyst, Stephens, Inc.

Q

Yes. Jokes aside, I wanted to go back to the separation from your prior parent and just give us a little insight on the before versus after and what that pure play status has allowed you to do. Now there's some noise there because you're obviously dealing with some pretty sharp declines and then reaccelerations through the pandemic. But more fundamentally, what has that pure-play status conferred on Carrier?

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

A

I would tell you it's been transformational and it's been the most rewarding part of my career to be part of this journey so far. And we're just in the first inning of it. We tried to preserve what has made Carrier really successful over this past century. We have a great brand – many great brands. We have great channel. We have a great install base and we have a great team. So we tried to preserve what worked, but we were very deliberate about shaking up the team and more than half of our executives are new over the last 18, 24 months. We issued a new culture that we call The Carrier Way that really focuses being externally focused in innovation and investing in growth and being there for our customers. We said that we would take a very clinical approach to our portfolio. And with the sale of Chubb, the addition of Toshiba and some smaller deals, we've done some VC investments and we'll continue to shake that up. I can tell you with confidence the portfolio we have today won't be the portfolio we have in five years.

So we'll continue to be very clinical in our assessment there and really focus on what's going to drive focus for our organization in long-term growth. So that's why we call ourselves this hundred year old start-up, because we've preserved what worked and then we have this energy in the system of a start-up. So, focus on top line growth, aftermarket, recurring revenues, digitally-enabled, brutally tenacious on the cost side. We will always be aggressive on taking discretionary costs out of the system, which is important in any cycle. But as we go into economic slowdowns, potentially in North America and Europe, this is one team you don't need to worry about in terms of being aggressive on the cost side. So we'll continue to do that. And now we have this balance sheet that positions us well. So it's been transformational for the team.

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Tommy Moll
Analyst, Stephens, Inc.

Q

So I want to dive in to some of the particulars on aftermarket and digital. But before we do that, this is a conference with a number of generalists here. Some of whom may not be too familiar with Carrier just yet. So, for the benefit of those, just tick through really quickly the three businesses that you're in today, pro forma for some of the portfolio changes you've made.

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

A

Sure.

Tommy Moll
Analyst, Stephens, Inc.

Q

Just walk us through real quickly.

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

A

You could think of us this year about $20.5 billion of sales, $13 billion of that is HVAC, number one in the market, of course, in residential and that's been very positive for us. We have a very strong light commercial business in North America. We have very well positioned globally in our commercial HVAC business with chillers. And what we had was a gap around VRF, the variable refrigerant flow market, but we've addressed that gap through the phenomenal acquisition of Toshiba. Patrick and I were together in Japan with Chris and the team last week, and that's going to be a transformational acquisition. So, very well positioned in HVAC.

About $3.5 billion is our Fire and Security business where we're typically number one or two in the spaces we compete, whether it's access solutions or residential fire with Kidde smoke detectors and fire extinguishers and then commercial fire as well and a controls business in there as well. And then we have about $4 billion of refrigeration. And that includes transport refrigeration, a sensors business that's really well positioned, especially as we pivot to the cold chain. And then we have a little over $1 billion commercial stationary refrigeration business, primarily in Europe.

Tommy Moll
Analyst, Stephens, Inc.

Q

So let's move on to the aftermarket, which you have already touched on, Dave. But it's roughly a quarter of your revenue at accretive margins, correct me if I have any of those details wrong, but it's also something that going back to your Investor Day from earlier this year and post the spin, you've really hammered as an opportunity, which makes one wonder was it underemphasized pre-spin or what was it that happened that allowed you to seize this opportunity?

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

A

I think a part of it is a little bit the lens through which perhaps I grew up a little bit where coming much of my career from aerospace. If you're in aerospace, you make all of your margin in the aftermarket. So, I think perhaps I had a bit of a bias for focusing on it. One of the first calls I made when I came to Carrier was to the person who had been leading the aftermarket for Pratt & Whitney and then more recently for Collins Aerospace where I had been. So he joined us to help with the playbook. And then, the three segment presidents and the greater team

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have just completely leaned into this opportunity. So a lot of our spend has been around digital enablement, connecting our devices. We talked about having 20,000 connected chillers. We're going to connect our residential units, connect our buyer equipment as well, and all of our transport refrigerations.

So, when we talk about having a 100,000 linked subscriptions this year, that's coming off of a base that's pretty close to zero, you do that by connecting the devices. Once you have the devices connected. You look for value-added opportunities for your customers by having a platform that you add applications to and then you continue to create value for your customers. So, this is something that we just had our executive off-site couple of weeks ago and we spent internally a lot of time as a team focused on how do we drive growth and differentiation in the aftermarket. Our mantra internally is double-digit forever and we just have to continue to drive that kind of growth. And to your point, it comes with 10% higher margins than we do on the overall portfolio. So if we can drive outsized growth there and let that margin drop through, that contributes to our 50 bps of margin expansion a year.

Tommy Moll
Analyst, Stephens, Inc.

Q

And you've laid out before some of the components of driving that aftermarket growth rate, parts and service or two I wanted to ask about. And there's a branded initiative on each on parts, I think you call it the Breeze platform and then you've got the BluEdge service opportunity. But I think in both of those cases, you're ultimately talking about displacing a competitor, an incumbent. So it's a displacement kind of dynamic where you've got to go out and take the business from someone who's already got it, which is sometimes difficult to do. But what gives you the right to win on these opportunities?

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

A

Well, I say this and I think apparently it offends people, but I'll just keep saying it, is that it's our God given right to our own aftermarket. And that's just the reality is that – and aftermarket is an entire playbook that you can't miss one piece of it or the entire playbook doesn't work with how we deal with our suppliers, how we deal with our channel partners, how we innovate and drive, we won't have overall SKU reduction, but in some cases you actually might want a little bit of more SKUs to make sure that you're managing your aftermarket appropriately.

So, it's really viewing the world through the lens of optimizing for your life cycle, and it's also viewing the lens through what your customers really want as well. So, yes, are we selling more parts through a Breeze platform that we've introduced in the residential space? For sure, we're going to continue to do that. We have deals with some of our home builders, so they can buy direct that gets fulfilled through our channel. Are we going to continue to do more service work than we've done in the past and do we work with our channel partners on making that work? Absolutely. But we will work with our suppliers to put more Carrier labels on some of the highly engineered items that go into our product. So, we have a strategy for parts. We have a strategy for service. And we have a strategy through what you mentioned, BluEdge, which is a tiered offering that drives a certain mentality in the company that we will always sell a long-term agreement when we sell chillers. We're not there yet, but that's the objective we have.

Tommy Moll
Analyst, Stephens, Inc.

Q

So you went right to my next question, which was on the attach rate on chillers. It's a KPI that you've identified and updated us on periodically. What are the changes you have made operationally? Is it a different incentive structure for your sales force or what have you done to ensure that that number is moving in the right direction?

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

A

Yes. I mean, when we talk about the full playbook, how we deal with the number of salespeople we have, where they're located and how we incentivize them has fundamentally changed. So clearly we incentivize both our OEM and our aftermarket salespeople to drive a certain attachment rate. We have a Carrier One initiative where we put all of our players in a certain location under one roof, which sounds kind of basic, but in a city like Houston, we may have had a branch of people selling new chillers. We would have had a branch of people providing service. We would have had a branch of people doing controls. You put that group under one roof and you incentivize them to sell lifecycle solutions. And that's very, very powerful as well. So we fundamentally have changed how we think about incentivizing the entire system for upfront sales plus lifecycle sales.

Tommy Moll
Analyst, Stephens, Inc.

Q

Yeah.

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

A

Now we've talked about our attachment rate improving 5% a year. In this year, I think we're at 40%, on our way to 42%, 43%. That will continue to improve. I will say we've had peers talk about 100%. If you talk about for a chiller, are you going to get aftermarket sales? The answer is always. We will always sell parts. We will always provide some value-add to our chillers during the lifecycle of those chillers. So if we want to define it that way, yes, we're 100%.

We've taken a very strict definition, which is we are forcing ourselves and our system to get LTAs. And if we don't get that LTA, which is our expectation, you sell a chiller, it comes off warranty, do you get an LTA? That's the standard that we hold ourselves. I want that number to be 100%. It's not there yet. We're going to improve it 5% a year. The bigger number we look at, Tommy, is our overall coverage. This year we'll have 70,000 units that have coverage. We want that to go up 10,000 a year, because that out of 330,000 chillers that are out there, that's our end objective, is to have all those under some kind of long-term agreement.

Tommy Moll
Analyst, Stephens, Inc.

Q

So let's move on to digital. Another KPI you've thrown out is on the installed base connectivity. I think by 2026 the goal is to increase it tenfold. But just walk us through the benefits to you as the OEM and then – and ultimately the end user on monitoring and maintenance. What are the real objectives you're trying to achieve? And then we can dig into the P&L impact.

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

A

Well, we did at our Investor Day say that we'd have a 10x increase in our number of connected devices. It'll end up being a lot more than that. The goal is that everything that comes off our line from a new production perspective is connected or at a very minimum, connectable. But that only applies to a small group of like smoke detectors. Basically, if it's coming off our line, we expect it to be connected.

The units that are in the installed base, we got to go find. We have edge devices that we have to connect them, whether it's a large centrifugal chiller or a reefer unit that's – some of our reefer customers, we may have a couple hundred thousand container units that are some of our bigger container customers get the units, put an edge

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device on them, which is a two-way communication device, a modem, and then provide – use our digital platform, either Lynx or Abound, that we keep adding applications to. So, it may even start with healthy.

When we started Abound and you go to an Atlanta Braves game, you will see, am I in a safe – in the indoor parts of the stadium, you'll see an application, a digital dashboard that tells you whether the indoor air quality is safe. Now, we're adding prognostics, diagnostics. We're adding sustainability. So, you could have a carbon calculator with a single pane of glass, track all of your emissions for a scale customer globally. So, once you connect the devices, it's endless, the amount of value-added opportunities.

And we've been benchmarking great companies. We had our off-site. We had John Deere who was kind enough to take some time and talk to us, but we benchmark companies that have gone from industrial-only to that digital-type life cycle solutions, and we'll continue to see Carrier transform ourselves in that same direction.

Tommy Moll
Analyst, Stephens, Inc.

Q

So, you already mentioned Abound as an example, but I wanted to maybe dig in a little deeper. I refer to Abound as your smart building platform; and then you've got Lynx, your connected cold chain platform. But just give us maybe more on the Lynx side because you already touched on Abound. What is an example of a use case? And then for both of these, Dave, I wanted to kind of get to the punch line question, which is, how much of this is a P&L kind of benefit from the digitally tied revenue? Or is this more meaningful to you, as Carrier, just by ensuring that ongoing relationship with the customer proactively recommending various services or components through the life of the equipment, et cetera?

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

A

Great question. Let me take the second first, which is many companies have established a separate digital P&L. We've debated it. My focus is using digital as an enabler to ensuring that we have maximum recurring revenues and customer solutions. So, I'm not as fixated on getting to a certain digital revenue number by a certain period of time. What I want is to make sure that as many of our devices out there are connected as possible, so we can offer value-added solutions.

So, an example, kind of a use case, if you take Lynx, if you want to ship bananas from Ecuador to the United States, those bananas need to be kept at certain humidity and temperature levels throughout their entire life cycle. And they will be in and out of a refrigerated environment 10 times. They come from the farm. They get put into a refrigerator environment, then they get taken out as they transfer from a local van to a truck, put into a trailer, put onto a boat, they're going constantly in and out.

We have to be able to monitor the temperature and the humidity levels throughout their entire life cycle. First of all, that provides assurances to the end customer, the supermarket taking receipt that the bananas have been properly stored throughout their entire lifecycle. Now, you can add other value-added services. You can look at geofencing. So, that gives the supermarket an approximation of when they can – they are going to arrive, so they have the appropriate shelf space waiting.

Now, you get into weather, so you can give information to the trucking, logistics provider where to avoid certain locations. So, once you're in, once you have the data, the amount of value-added opportunities you can provide either to the end customer, the supermarket, or to the logistics provider or to the actual producer are significant. We're working with pharmaceutical companies that we've never had conversations with before about these kind of value-added solutions.

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Tommy Moll
Analyst, Stephens, Inc.

Q

So, last question before we dive into some of the operational details here. You've hit on several themes that I would put under the umbrella of HVAC as an asset class. You're a pure play now, you weren't not that long ago. The number of investable opportunities in HVAC is a larger number now than it used to be, large companies. So, make the case for this asset class to the investor base.

There's some of the themes around digital and aftermarket that you've identified. You could talk about some megatrends. But if you just look at the multiples for this – for your stock and others, there was a period where you're at a big premium and then a period where you're in line to a discount versus some of the benchmarks. So, I think investors are still trying to digest what is this new asset class, so make the case.

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

A

I think it's a – I would say it's one of the most investable asset classes there is because in just the base business, there is just high demand for it through all cycles. It's fundamentally a replacement business. It's a business that's going to grow just with base – as the middle class goes up in places – like if you think about the fact that 3 billion – more than 3 billion people in the world today don't have access to air conditioning.

If you think about countries like India, which is a very hot country where 7% of the people have air conditioning and the base population is going to get – the income levels are going to increase. You're going to wake up one day, 20, 30, 40 years, that 7% is exponentially higher, like something like 3% of people in the UK have air conditioning. And what you have is a somewhat of a vicious cycle where the hotter that the planet gets, the more air conditioning that you need, the more air conditioning you produce because we contribute to climate change today as an industry. The more air conditioning you ship, the hotter that the planet is going to get.

So, we then have to drive solutions to be part of the solution. So, that's going to drive an enormous shift towards sustainability and demand for more energy-efficient solutions. What you're going to see in Europe with the shift to heat pumps is a once-in-a-generation opportunity. We're seeing it. Our demand, we're the number one player for commercial heat pumps in Europe. Demand is up 30% this year. Our orders are up 30% for heat pumps. And what you're seeing is traditional companies that had boilers are putting – they're decommissioning their boilers and buying heat pumps.

The same is happening in the United States. And you're going to see the same with residential, heating business in Europe, and then globally in places like – one of the reasons that VRF is so prominent in Asia is because it's fundamentally a heat pump business, so it's more energy efficient. So, you start with a growing business that can withstand the cycles, you add some of these megatrends around healthy and sustainable and intelligence, and you've increased your TAM, which increases the opportunity for all of us in the space to grow significantly through differentiation.

Tommy Moll
Analyst, Stephens, Inc.

Q

So, moving on to some of the operational issues. I wanted to start on light commercial and commercial HVAC. Some of the updates you offered on the last quarter were quite constructive. I think on the light commercial side, your backlog was up 3.5 times. On the commercial side, revenue was up in the teens.

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I think there was a healthy contribution from price and volume there. So, you've got some recent trends that are constructive, order books that are full. At the same time, we all read the same recession-related headlines. Every morning we roll out of bed and read the Wall Street Journal. So, what gives you the confidence of the durability of that demand going forward?

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

A

Well, we start with the fact that our backlogs are at historic levels. So, we're going to be going into 2023 on the commercial side with a good chunk of the year booked, which is never the case for us. So, backlog has been strong. The Architectural Billings Index, which we all know is a leading indicator or six-month leading indicator of when buildings get constructed, has been over a 50 for about 20 months straight.

So, we'll see what happens tomorrow when the new number comes out for October. But that's been consistent and demand has been consistent globally. We talked about double-digit order growth in North America, Europe, Southeast Asia and China. So, it's not isolated to one part of the world. We're seeing continuous demand not only through new construction, but you're seeing a lot more modernizations for commercial buildings.

They're not waiting – our customers are not waiting for the end of life to replace the chiller. They're doing it earlier most of the time because of energy efficiency, because customers are making their own net-zero commitments. But they're also worried about energy prices, especially in places like Europe. So, you're seeing an early upgrade cycle, which is driving continuous demand. And light commercial has been just a great cocktail of strong backlog movement, [ph] buying (24:52) from our channel, low inventory levels, continuous demand in places like K-12.

If I pause on that, Tommy, for one second is that the federal government in the United States has allocated $190 billion for K-12. They haven't allocated $120 billion of that $190 billion. So, that's still to come. And that presents an enormous opportunity. And our orders just in K-12 this year are up 35%. So, a lot of these – not every vertical will be perfect. So, will multifamily residential in China slow? Yes. But what did we do? We made a very hard shift from multifamily property to industrials, which is growing very well in China.

So, data center is good. Warehouses, we got to keep an eye on. K-12, very strong. Commercial buildings has been strong. But in the category of when you fish, which Patrick does, you go where the fish are. In business, you go where the customers are. And our team has been very adaptable at focusing on the verticals that are particularly strong and the regions.

Tommy Moll
Analyst, Stephens, Inc.

Q

So, we do need to talk about resi even if briefly. But you've talked about, I believe, the term is balanced field inventories by the end of this year. So, maybe for those who are less familiar with this theme, just give some context on what your starting point is there as you hope to achieve the balance. And then what level of visibility do you have today? How does that compare to prior examples?

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

A

We very closely monitor the inventory levels in our channel, which is something that I will tell you that Chris and Justin and the team have done more and better this year than we've ever done in our company's history. So, we have visibility into the inventory levels in our channel, and we have set a target for ourselves to end this year with

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inventory levels in balance to where they were last year. And that for us is one of the most important metrics that we have in residential.

We watch movement, which is movement from our distribution channel to our dealers. We, of course, watch orders. We watch sales, our sales into our channel. We watch all of these different factors. But we've made a very conscious effort to make sure that we do not allow inflated inventory levels in our channel because we know eventually that would bite us.

So, we have very consciously worked distributor by distributor, state by state, region by region to keep those inventory levels in balance. And if you looked at our sales in the last quarter, that is not – I mean, we watch that, we watch our volume, but we really want to make sure that going into next year, we're properly positioned for 2023.

Tommy Moll
Analyst, Stephens, Inc.

Q

And is there any regional variation there? I'm thinking like northern US versus southern US or any trends worth calling out on that front?

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

A

Well, I think that the folks watching know, but we are going through a very significant change, where the entire portfolio in the United States is changing, where in the south, we are – everywhere we're going up one SEER level; and in the south, it's based on the date of manufacture; in the north, it's based on date of installs.

So, we have 100% switched over to the new product line, which is 95% different versus the previous product line in the south. We started in July. Every unit we ship in the south is now the new version. In the north, we've already started, almost everything we ship in the north is transitioning to the new. There will be – some of the northern dealers want some inventory on hand for the new units going into next year. But that's going to come with a 10% to 15% price increase.

So, we will watch volume. We expect residential new construction volume to be down next year. We don't know the exact number yet. We'll size that up for our investors here in the coming months. We'll look at volume on the replacement market, which is about 80% of the business is in that replacement range.

So, will new construction be down a little bit more than the replacement on the volume side? Yes. Do we make less margin on the new construction side? Yes. Do we have three different mix factors that can really help offset that? Yes, we do, which we're very confident. We have the mix, 10% to 15% with the new units, the shift to the higher SEER. We have people buying cooling only moving to heat pumps, and we should have people moving from entry-level heat pumps to the – at least the mid-tier heat pumps, all those mix changes weigh favorably.

So, there's a lot of reason for optimism. We'll go in very sober next year and very pragmatic and realistic about what the true volume numbers will be, but we're going to get carryover pricing from this year, significant carryover pricing. I don't think that's the end of the pricing that we'll see. We'll have the 10% to 15%. I would expect us to have another price increase next year, not at the same levels we've been doing, which is 6 price increases over 18 months. But I think I would expect additional pricing as we go in next year on top of the 10% to 15%. And then we'll have to see how that all shakes out in terms of our growth levels for next year.

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Tommy Moll
Analyst, Stephens, Inc.

Q

So, you went right to my next topic, which was price/cost. And, Patrick, if I remember correctly, from your recent earnings call, you talked about several hundred million dollars of price wrap. Am I remembering that detail?

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

A

Yeah. Several hundred million dollars of price carryover.

Tommy Moll
Analyst, Stephens, Inc.

Q

Carryover.

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

A

Into next year from prices that we implemented during the year, this year.

Tommy Moll
Analyst, Stephens, Inc.

Q

Okay. And so that would be inclusive or exclusive of the step-up on the efficiency.

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

A

Excludes.

Tommy Moll
Analyst, Stephens, Inc.

Q

Would be exclusive. Okay.

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

A

That excludes it. What we also said is, besides the pricing carryover, we do expect there to be some inflation carryover as well. The net of the two would still be positive.

Tommy Moll
Analyst, Stephens, Inc.

Q

Right. Okay. And yeah, so going onto the cost side of the equation, maybe just unpack for us. As an OEM, the benefit you might see from commodities deflation, assuming you can hold on price, which it sounds like you can, versus some of the other input cost items where you may continue to see some inflation.

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

A

Yeah. Maybe a little bit of context here. If you look at the last, if you look at last year and this year, we've probably seen inflation headwinds of between $1.5 billion and $2 billion. And a chunk of that, of course, relates to commodities, copper, steel, aluminum. And we block these or hedge these and we hedge these on a declining

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scale. So typically, the current quarter we're almost 100%, call it hedged, and 75% the next quarter, 50%, 25%, and so on. And so, in the current environment where we've seen the spot prices drop, we obviously would expect to see some benefit from that next year. As I said on the last earnings call, we don't expect a lot of benefit this year just because of our [ph] locked (00:31:47) positions, but clearly a significant opportunity for next year.

And then besides the commodities, of course, the question is what else is an opportunity. Freight and logistics, as you know, we spent a tremendous amount of money on expedited freight – airfreight because of the supply chain challenges. Supply chain challenges have not completely gone away. But I would say improved and associated with that, we would also therefore expect our expedited freight costs and premium freight costs to come down as well.

And then the last bucket, of course, is the items that are, call it, the components that we purchase. And some of these, there is some copper or steel. And then, of course, that becomes a negotiation with some of our vendors as well. So, there's a lot of work to be – being done to set us up well for next year and go after that opportunity.

Tommy Moll
Analyst, Stephens, Inc.

Q

So, the last couple of questions I have prepared are on the potential for a recession and how you think about that scenario. And then I'll turn it over to anyone in the audience who'd like to ask a question directly. But just on the potential for a recession, as I referenced earlier, we all read the same headlines. And notwithstanding your backlog, we're still aware of all these possibilities. So, if you can bring us in on how much C-suite and board level time is committed now versus in a typical environment to just scenario planning, I mean, forgetting about the details of the process which you maybe don't want to share, but just the process itself, has it risen on the order of priorities or not yet?

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

A

I'll start here. I'd say one, the organization is still very much focused on growth on the aftermarket, what's in our control. We know the levers to use if and when there would be a recession. We know the cost levers. And I also mentioned on the last earnings call, if you look at the last couple of years, we have had very inefficient manufacturing operations. I talked about the expedited freight and logistics costs. We talked about potential deflation that may work to our favor in a downturn.

So, I'd say the broader organization still very much focused on growth, including the aftermarket, which would dampen, of course, any economic downturn. A smaller team of people have been focused on, okay, what's – what are some what if scenarios and we'd like to keep that to a smaller team just because we don't need to get everyone involved into that because we know the playbook.

Tommy Moll
Analyst, Stephens, Inc.

Q

Yeah. Inventory is another topic I wanted to ask, maybe both of you about. But again, you've got this compare and contrast with the backlogs and the order rates which are quite constructive and then the scenarios that you referenced, Patrick. And so, one of the items that you have to be thinking about there is inventory and risk to the inventory which by historic standards is quite high right now. And as we know, the market can turn quickly. So, just help frame for investors what magnitude of risk there is on that inventory line and how much of your time you spend thinking about it?

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

Well, one of the reasons why, and Dave spoke earlier a lot about the residential HVAC and making sure our inventories are in balance, meaning in unit being flat year-over- year. And that's not the only business where we have focus, of course. Part of that is, is that we want us to set ourselves up well for next year. We don't want to end the year in a situation where inventories are higher than we think they need to be. Same like in some of our other businesses. If we believe that demand is a little weaker, we'll take some extra downturn in our facilities. Now we will end up the year with higher inventories than we'd like. But I do believe that we're already taking action in across our businesses to ensure that we end the year with inventories that are what we say more in balance.

Tommy Moll
Analyst, Stephens, Inc.
Q

Yeah.

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

And to avoid a situation that you refer to, although it's not our base scenario that there will be a downturn next year.

Tommy Moll
Analyst, Stephens, Inc.
Q

Right.

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

But it's certainly something that we're looking at, have the scenarios and we'll be ready.

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

But I would add, Tommy, at kind of a high level is, I think that the supply chains of the future will be fundamentally different than the supply chains in the past. I think we've learned a lot, what the last couple of years have really revealed flaws that all of us had in our supply chains that we were able to manage in normal times. And when you have tight supply chains, it just unveils inefficiencies that we all had. So, as we think about hidden costs with logistics, we'll see a more balanced regional approach.

So, we'll see. We will put more, perhaps in places like Mexico for North America, Eastern Europe for Europe, Southeast Asia for Southeast Asia, and perhaps parts of Europe, and then China for China. We're looking at India more than we used to in the past. We're looking at really fundamentally having a transformational improvement on our SIOP processes. And we'll be announcing a new lead for – internally for a SIOP leader to make sure that demand planning, materials management, a part – a plan for every part as we think about the what parts we really do need to stock, how we think about dual sourcing, how we think about fast runners for slow runner inventory. I think all of us as an industry, but I can look Carrier, look at us in the mirror and say we need to up some of our game in terms of how we truly manage our whole inventory and logistics and supply chain processes. And we're going to really – this is going to be one of the big opportunities and focus areas for us.

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Tommy Moll
Analyst, Stephens, Inc.

Q

Any question from the audience. If anyone asks, I'll repeat it for the benefit of those on the webcast and let one of these gentlemen answer. Surely somebody has got a question. I'll keep firing away if not. Well, let's, let's...

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

A

We got one in the back.

Tommy Moll
Analyst, Stephens, Inc.

Q

Oh, we got one in the back. Where are we?

Q

[indiscernible] (00:38:16-00:38:34).

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

A

Well, we look at price in the aftermarket through...

Tommy Moll
Analyst, Stephens, Inc.

Q

I'll repeat that question.

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

A

Oh. I'm sorry.

Tommy Moll
Analyst, Stephens, Inc.

Q

It's all right. Just to repeat the question here where the question was regarding aftermarket pricing and long-term contract opportunity.

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

A

Yeah. I think when we look at pricing in the aftermarket, number one is specifically on the part side. We've come up with much better elasticity curves by part number to make sure that we're pricing every single component appropriately. And those models did not exist, and now, they do. And it gives us a lot more fluidity around rapid pricing in an appropriate way during the course of the year as opposed to, one, across the board price increase that you announced in January, that applies for the rest of the year. We have much more agility and refined approach to how we think about part pricing.

Then when it comes to LTAs, Tommy mentioned before our BluEdge agreements, there's three tiers, there's base offerings, there's sort of enhanced offering and elite offerings. There's different pricing for all of our different

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offerings depending on the value-add that we're providing to our customers. When we get into our elite offering, in some cases we're making guarantees, we're making firm commitments to our customers that we will give them certain outcomes. It enables us to price those higher. It's more risk on us. But with the right digital tools, we feel confident in those offerings.

So, as we drive to more stickiness in the aftermarket, a big part of that comes with pricing. But I'll tell you, one of the biggest things we focus on internally is customer outcomes, as opposed to going to our customers and telling them, focusing it through the lens of Carrier, we put ourselves in our customer's shoes and what we are doing differently now than we've ever done in the past is we're meeting with scale customers and we're saying, okay, well, you have 10,000 facilities globally. What are the outcomes you're looking for? And instead of thinking of Carrier as an air conditioning company or a heating company, it's a solutions company. And how do we use digital and more broad offerings to help you reach your sustainability or your energy efficiency targets as well, which is a major shift for us as a company.

Q

[indiscernible] (00:40:54-00:41:02).

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

A

I think it has. The question is around – I'm doing your job, Tommy.

Tommy Moll
Analyst, Stephens, Inc.

Q

Yeah. Go for it. No.

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

A

Yeah.

Tommy Moll
Analyst, Stephens, Inc.

Q

You will do a better job.

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

A

Yeah. No, I won't. The question is around heat pumps and is it unique to Europe or is it global?

And it's really a global phenomenon. I think it'll be most accentuated in Europe right now. Europe is in a very, in my opinion, a very unique acute situation where it has to very aggressively shift away from fossil fuels, whether it's diesel or coal or other fossil fuels for its heating. And I think Europe can get through this winter because of the storage levels they have. But when 40%, 45% of your gas comes from Russia, they are, with subsidies and other incentives, making a rapid shift from diesel to electric heat pumps in Europe. And I think part of it is just necessity. That has to happen in Europe. It will happen in Europe. You'll see hydrogen, you'll see other clean forms, you'll see more certain propane and other things, but you will see a rapid shift to electrification in Europe.

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But in the United States, 30% of our split cells today are heat pumps. In Europe and in Asia, you have a very high dominance of VRF, the variable refrigerant flow systems, which are in and of themselves heat pumps. So, I really believe it's a global phenomenon. I think it'll continue to accelerate, especially as we improve the technology where we can get, for example, the same level of coefficient of performance. At colder ambient temperature in the United States, you'll see it get more rapid adoption in the US, but globally it'll continue to increase.

Tommy Moll
Analyst, Stephens, Inc.

Q

Who else? Who else? We haven't talked about M&A or capital allocation. So, I'll ask a question that'll probably be all we have time for. But with rates rising and the potential of a recession looming, I'm curious what, if any, impact there is on capital allocation decision making or forget about the recession and maybe just speak to in a rising rate environment, where cost of capital is increasing, has that changed the relative priorities, if at all?

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

A

In short, the answer is no. Our priorities for capital deployment are very clear. Funding organic growth, those are the best returns we can deliver. That's number one. Two, acquisitions, there again, our priorities have been clear, sustainability, a digitally-enabled aftermarket growth, geographic expansion, some adjacencies and after acquisitions, a growing sustainable dividend, we expect to get to about a 30% payout next year and then share repurchases and as Dave mentioned I think earlier, the board approved an additional $2 billion share repurchase authorization.

So, we will remain disciplined, but it will be within those priorities, and the current rate environment really does not cause us to shift between these priorities. The excess cash, in essence, will be toggled between what do we see as acquisitions and then share repurchases?

Tommy Moll
Analyst, Stephens, Inc.

Q

And do the sellers or owners of these tech businesses, perhaps, adjust their expectations in this kind of an environment or is that something yet to be seen?

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

A

It's, first of all, it's not only tech companies. So, we have a little bit of everything that we are looking at, but within our fairway, of course. But some of the companies, frankly, are not public. And so, they sometimes may be a little bit slower to adjust than what we see in the public markets.

Tommy Moll
Analyst, Stephens, Inc.

Yeah. Well, thank you, Patrick. Thank you, Dave, for the time today. We appreciate the insight, as always, and thank you all for your interest in Carrier.

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

Thanks.

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Tommy Moll

Analyst, Stephens, Inc.

I appreciate it.

Patrick P. Goris

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

Thank you, Tommy.

David L. Gitlin

Chairman & Chief Executive Officer, Carrier Global Corp.

Thanks, Tommy. Thank you. I appreciate it.

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