Modine Manufacturing Company
Second Quarter Fiscal 2027 Earnings Conference Call
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Presenters
Kathy Powers, VP, Treasurer, Investor Relations
Neil Brinker, President & Chief Executive Officer
Mick Lucareli, EVP & Chief Financial Officer

Q&A Participants
Matt Summerville - D.A. Davidson
Noah Kaye - Oppenheimer & Co.
Christopher Moore - CJS Securities
David Tarantino - KeyBanc Capital Markets
Neal Burk - UBS Investment Bank
Brian Drab - William Blair
Tim Wojs - Robert W. Baird
Jeff Van Sinderen - B. Riley Securities
Manish Somaiya - Cantor Fitzgerald

Operator
Good morning, ladies and gentlemen, and welcome to Modine's Second Quarter Fiscal 2027 Earnings Conference Call.

At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session, and instructions will follow at that time. If anyone should require assistance during the conference, please press "*" then "0" on your telephone keypad.

As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Kathy Powers, Vice President, Treasurer, and Investor Relations.

Kathy Powers
Hello, and good morning. Welcome to our conference call to discuss Modine's second quarter fiscal 2027 results. I'm joined by Neil Brinker, our President and Chief Executive Officer, and Mick Lucareli, our Executive Vice President and Chief Financial Officer.

The slides that we'll be using with today's presentation are available on the Investor Relations section of our website, modine.com. On Slide 3 of that deck is our notice regarding forward-looking statements. This call will contain forward-looking statements as outlined in our earnings

release, as well as with our company's filings with the Securities and Exchange Commission. With that, I'm going to turn the call over to Neil.

Neil Brinker
Thank you, Kathy, and good morning, everyone. This morning, I'm going to start out with the segment updates and then turn it over to Mick to review the financial results for the quarter. Let's jump in.

Starting with data centers, we delivered another impressive quarter with revenues increasing 95% from the prior year. We achieved our fourth consecutive quarter of record orders, exceeding $1 billion in quarterly order intake for the first time in our history. Strong demand has pushed our backlog to another historic high.

In addition, we recently received a major new program award with a strategic hyperscaler customer. Through this partnership, we'll supply more than $400 million of custom air handling units through calendar year 2027, to cool next-generation data centers.

We have continually added manufacturing capacity to support the surging demand for our air handling products, since acquiring the Scott Springfield business in 2024. To that end, we are currently launching production at our third dedicated data center facility in Calgary and are actively increasing throughput at our facility in Franklin, Wisconsin.

Demand continues to be incredibly strong across our entire data center cooling portfolio, and we are strategically using 80/20 principles to manage this growth.

Regarding our overall capacity expansion, we remain firmly on track. We currently have 13 chiller lines up and running and remain fully committed to reaching 20 operational lines by the end of the fiscal year.

A massive part of executing this capacity expansion has been stabilizing our supply chain, and I'm pleased to report that we have made significant progress during this quarter. Over the past few months, the reliability of our supply chain has steadily improved, and we have entered into multiple LTAs with key suppliers to lock in volume for critical components in 2027.

We have also continued to share our future volume requirements with our suppliers so that they can confidently increase their own capacity, but their expansions take time to ramp. This supply-demand imbalance is leading to higher prices, incremental to the materials inflation and tariffs. We are working on cost-sharing and pass-through mechanics, but that takes time as well.

In addition, we occasionally get surprised by other smaller disruptions. While these may not result in material production impacts, they can still create delays and short-term inefficiencies.

Furthermore, we continue to leverage the specialized capabilities of our Commercial HVAC segment to support the rapid growth of our data center business. Commercial HVAC is already successfully producing V-block sub-assemblies for our chillers and recently passed testing for another critical component, officially adding them to our qualified supplier panel.

Scaling our supply chain as we expand capacity to meet demand presents a number of challenges that need to be continually managed. That said, we are in a much stronger position than we were 90 days ago, and I'm incredibly proud of what the team has accomplished.
Please turn to Slide 5. The Commercial HVAC segment also delivered a strong quarter, with revenues increasing 23% from the prior year. Our coils business continues to benefit from higher sales to data center customers. Our CHVAC segment has a significant opportunity to drive incremental growth in the data center market, and we are currently executing on several strategic fronts.

First, we have been selling coils directly to various external data center cooling companies for some time, which was a primary driver of our revenue growth over the past several quarters.
Second, we are capitalizing on a developing trend where hyperscalers are getting involved in downstream sourcing, specifically identifying qualified tier two suppliers for custom data center cooling products.

We are currently in active discussions with one of our strategic customers to become a key coils provider within their supply chain. This represents a major incremental opportunity for our Commercial HVAC business that could lead to significant future orders.

Additionally, our coil sales are creating a strong pull-through effect for our coatings business, as many customers request specialized coatings to prevent corrosion in harsh environments. Our coatings business had an outstanding quarter with revenues up 28% from the prior year.

Finally, CHVAC has multiple opportunities to support our own data center business. As I mentioned, we're currently producing V-block sub-assemblies for our chillers and plan to start supplementing our current supply needs with additional CHVAC-manufactured products, later this fiscal year.

These are exciting opportunities that should drive revenue growth in the near term, fully supported by our disciplined 80/20 focus.

We are also seeing excellent growth opportunities elsewhere in the segment. Specifically, we are expanding our product line for portable heating products that we acquired as part of the L.B. White transaction, last year. Overall, there's a wealth of opportunities for both revenue growth and margin expansion, within the CHVAC segment.

Please turn to Slide 6. As you know, we successfully closed on the spin-off of our Performance Technologies business and merger with Gentherm on October 1st, as planned. Preparing for

this transaction of this scale was a massive undertaking for both teams, and I'm pleased to report that the initial phases of the transition are going smoothly. I want to extend my sincere gratitude to our internal team, who tirelessly managed the complex work streams required to execute this transaction, as well as to our external advisors.

Gentherm has been an outstanding partner throughout this process, and we are confident they will provide a fantastic home for that business. For Modine, this milestone represents a clean strategic separation that allows us to focus 100% of our resources on our highest growth, highest margin thermal management opportunities.

Finally, I would like to remind everyone of our upcoming Analyst and Investor Day, planned for November 18. We are holding the event in Chicago, with a live webcast for those not planning to attend in person. We will provide an in-depth review of the company's strategy, including growth opportunities for both segments, along with our new long-term financial targets. It should be a great event. With that, I will turn the call over to Mick.

Mick Lucareli
Thanks, Neil, and good morning, everyone. Please turn to slide seven to review the Q2 segment results.

Beginning with data centers, I want to highlight the exceptional rate of revenue and earnings growth, which continues to outpace the rest of the market with a 95% increase in sales. Americas sales grew 132%, driven by strong demand from hyperscale customers, and EMEA sales decreased 6%, mainly due to the timing of shipments. Adjusted EBITDA grew 66%, resulting in an adjusted EBITDA margin of 15.4%.

As I discussed last quarter, we reported a nice sequential margin improvement from the first quarter; however, this was somewhat lower than we anticipated. On the positive side, we continue to see a lower impact from the fixed cost absorption and expansion costs. This was relatively in line with our expectations.

However, the supply chain and material impacts were larger and are lingering longer than we had expected. These can be grouped into a few key baskets, including logistics, with a negative impact from tariffs, raw material inflation and higher prices paid to our suppliers to secure volumes. We are working on commercial actions for current and future programs to address these additional costs, and we're confident that we can recover these costs.

We remain excited about the overall positive momentum in this segment and anticipate further margin improvements through the second half of the year. Based on our updated revenue and margin outlook, we anticipate that the data center segment will generate earnings growth in excess of 80% this year.

Please turn to Slide 8 to review Commercial HVAC. Commercial HVAC also delivered strong revenue growth with a 23% increase in sales. HVAC technology sales increased 20%, and heat transfer solution sales improved 16%. Adjusted EBITDA increased 22%, while the adjusted EBITDA margin was flat to the prior year at 15.1%.

Similar to the data center segment, we anticipated a higher margin in the second quarter. The major driver of the flat margin was the mix of product sales, along with higher material and tariff costs.

Commercial HVAC remains on track for the year as the leadership team focuses on driving both growth and margin expansion through 80/20 initiatives. We expect double-digit earnings growth and incremental improvements in the adjusted EBITDA margin during the second half of the fiscal year.

Please turn to Slide 9. For Performance Technologies, I'll keep my comments relatively brief, given the recently completed spin-off and merger with Gentherm.

Sales were relatively flat, with heavy-duty up 11% and on-highway down 5%. Adjusted EBITDA declined 3% from the prior year, and adjusted EBITDA margin was 14.2%. These results were generally in line with our expectations. As Neil covered, the separation plan and merger with Gentherm was completed on October 1st.

We are very proud of the improvement made these past few years by the Performance Technologies business and its legacy for Modine. Gentherm and Modine are a fantastic combination with a bright future, and we wish them all the best.

Now let's review the total company results. Please turn to Slide 10.

Second quarter sales increased 35%, and I want to point out that if we just look at our remaining data center and Commercial HVAC segments, revenue growth was 59%. Gross margin declined by 160 basis points to 20.7%, driven by lower margins in all three segments, and largely due to the material cost inflation.

Although we continue to invest in incremental SG&A to support growth, we are controlling the spending as a percentage of sales. Reported SG&A also includes $14.1 million of expenses directly related to the spin-off of the Performance Technologies business.

I'm pleased to report that adjusted EBITDA increased $32.4 million, or 31%, resulting in a 13.7% adjusted EBITDA margin. As I previously discussed, the actual margin was somewhat lower than we anticipated, but there continues to be sequential improvements as we launch more volume and recover material costs.

In Q2, there was a 150 basis point improvement from the first quarter, and we expect to see further improvements in the second half of the year. Adjusted earnings per share was $1.35, 27% higher than the prior year. This excludes $29.5 million of income tax expense related to legal entity restructuring steps required to spin off the Performance Technologies business.

Now, moving to cash flow metrics, please turn to Slide 11. Free cash flow was negative in the second quarter, primarily due to the working capital and capital investments in data centers, along with expenses related to the Performance Technologies spin-off. As expected, we are deploying cash for working capital to support our growing data center customer demand and protect our production from supply chain constraints. In addition, we incurred $27.7 million of cash payments, primarily for restructuring and disposition-related costs.

Lastly, cash taxes were higher than normal due to some unique situations and significant customer LTA payments. Net debt was $211 million higher than the prior fiscal year end, but we received approximately $200 million from Gentherm on October 1st, which was used to repay debt. Based on our current outlook for earnings and cash flow, we expect the leverage ratio will decrease further, by year-end.

Now let's turn to Slide 12 for our FY 2027 outlook. As announced in our press release, we're updating our FY 2027 guidance to reflect our higher revenue outlook for our remaining businesses and the successful spin-off of the Performance Technologies business. Starting with the third quarter, we'll report historical results for this business as discontinued operations, so our current outlook now excludes Performance Technologies revenue and earnings for the full year.

A table is available in the appendix providing a recast of financial information for net sales and adjusted EBITDA by quarter for fiscal year ‘26 and year-to-date fiscal year ‘27.

We expect total company sales to be in the range of $3.1 billion-$3.2 billion, representing a 50%-55% increase from the prior year, excluding Performance Technologies revenue from both periods. We expect data center sales to grow 80%-90% and expect Commercial HVAC sales to grow 10%-15% from the prior year. I want to highlight that both of these ranges represent an increase from our segment outlook, last quarter.

With revenue expectations increasing, we're still expecting continued margin improvement in the back half of the year. However, we believe that margins will improve at a lower rate than originally anticipated, mostly due to ongoing cost increases, across the supply base.

Given the revenue outlook and ongoing improvements in margins, I'm pleased to say that we expect fiscal ‘27 adjusted EBITDA to be in the range of $470 million-$500 million, representing a growth rate in excess of 50%. Again, this outlook excludes Performance Technologies from the full fiscal year.

From a free cash flow perspective, we expect to generate positive cash flow for the full year, making up for the use of cash in the first two quarters. As I previously mentioned, we received approximately $200 million of cash on October 1st, and while it is not included in our free cash flow calculations, it was used to repay debt.

To wrap up, we remain excited about our fiscal '27 outlook with outstanding revenue and earnings growth. Very few companies are generating earnings growth in excess of 50%, and I'm proud to say this would represent our fifth consecutive year of adjusted EBITDA growth in excess of 20%.

We're looking forward to our next chapter as Modexus Solutions, as we're truly a new company and have an exciting future to share with our shareholders. As Neil mentioned, we're holding an Analyst and Investor Day on November 18th. Neil and the entire team are looking forward to providing a new strategic update on this next phase of our transformation, along with an exciting financial outlook for fiscal '28 and for fiscal '29.

With that, Neil and I will take your questions.

Operator
Thank you. If you have a question at this time, please press the "*", then "1" key on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press "*", then "2" if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset, before pressing the star keys.

One moment, please, while we poll for questions. The first question is from Matt Summerville from D.A. Davidson. Please go ahead.

Matt Summerville
Thanks. Morning. Can we maybe start with data center margins? To keep it easy, if you did roughly 15% EBITDA in the first half of the year, sort of implies you need to get to somewhere in the low 20s, let's say, in the second half of the year, if data center profits are set to rise by 80%, as indicated in the deck and in prepared remarks. Can you specifically spell out what gets you there? Why not maybe de-risk that cadence more meaningfully?

I guess, why should investors feel that this is a dependable sort of outlook? Can you bridge how much of this gap between, say, 15% and 21% first half, second half, how much of that is sort of solved by price capture? If you can comment on the cadence between the two quarters, that would be helpful, then I have one follow-up. Thank you.

Mick Lucareli
Hey, good morning, Matt, it's Mick. As we look at second half of the year, we continue to expect a step up each quarter, sequentially. You're right in the high-level math based on our

public comments there. Q3, we'd expect to see 100 - 200 basis points sequential improvement, and then another step up in Q4 with the target of getting to 20% or above in Q4.
Two major drivers. We've talked a lot about first half of the year around labor and overhead. Those have been, as expected, those were coming in much in line with our outlook for Q2. As we talked about, materials has been a significant increase, and in the quarter, that was about 375 basis points.

When we look to the second half of the year, there's two big drivers. One, volume is a big one. The conversion rate on incremental volume is quite high, way above, as you can imagine, it's at a variable level. So, more volume we're putting through is coming through at a much higher margin than our targets of being at a 20% level.

Secondly, we are going to recover material costs, and we have contracts in place. We already have commercial negotiations. So, that recovery of material costs is going to improve our material margin. Again, if you just look at first half, second half, Q2 was 375 basis points at a minimum between all of our material cost increases. This was kind of the headwind or the penalty in the quarter.

Matt Summerville
Thank you for that. Then, I'm sure you guys internally have been talking about potential election outcomes, and I would imagine if I don't ask, it's going to get asked on the call. But does this outcome change the shape of your growth trajectory or the fundamental thermal backdrop for you in the United States? Putting that aside for a second, just given that we're looking at a stock price sub $100, how are you thinking about potential aggressive share buybacks, given the state of your balance sheet? Thanks again.

Neil Brinker
Matt, this is Neil. Yes, certainly we've all thought about the outcome of the elections, and I don't think there's really a big surprise here in terms of what shook out last night. I know that we're seeing a robust, healthy backlog that goes well beyond two to three years, and there's an immediate demand, even today.

So, there's already many data centers that are in flight that have been permitted that are going to require multiple years of building and preparing. So, those things are kind of in position and in place.

For us, I believe that we're going to see even increased demand from this because, as you remember, when we broke into the data center market, we broke in as the sustainability play. We broke in as -- our first data center customers were the only customers that offered a carbon-neutral data center.

When you offer a carbon-neutral data center, you have to have the best power usage effectiveness and the best water usage effectiveness. You have to be able to ensure that you

are conserving energy and water, and that has been our niche, and that has been our play. I believe going forward with data centers, particularly in many local communities here in the United States, that that's going to be important for people to understand that you're using the best technology in order to drive down energy costs and drive down water usage. That's our play. That's our differentiation. That's how we broke into the market. I think that's going to continue to trend that way.

Mick Lucareli
Matt, on the buyback, we are, like everybody this morning, we're digesting the news to the elections and how the markets reacted to the data center space. But too your question, at the current share price, that will obviously be a big topic with our board as soon as we meet with them. More to come there, but that will clearly be a topic with our board.

Matt Summerville
Thanks, guys.

Operator
The next question is from Noah Kaye from Oppenheimer. Please go ahead.

Noah Kaye
Hey, good morning and thanks. I would like to follow up on the margin trajectory, as well. Mick, I think you said maybe 100-200 basis points step up is what you had contemplated for 3Q on data center margins. Is that correct?

Mick Lucareli
Yeah, correct.

Noah Kaye
Yeah. So, that would imply 4Q margins materially above 20%. I want to confirm that and understand what is sort of the, if any, outsized sort of margin benefit you get in that quarter. I don't know if there's a timing that's anticipated on material recoveries, or is that kind of really the right level to think about as a jumping-off point going into '28?

Maybe you can comment on that, and maybe even following up on Mick's point, the visibility you now have into the cost base through some of these LTAs that I know have been a big lift for the company, over the last couple months.

Mick Lucareli
Yeah, I'll go first, though. There's a lot to what you said there about try to hit it all. Yep. So Q4 would be another sizable lift from if we're in a 16.5%-17.5% margin in Q3 and Q4. The big driver in Q4, besides continued improvement in our material cost ratios, is volume. If we look at second half implied volume, that's kind of in an 80%-90% range. Q3, I would see in another like 80% type growth rate, and obviously Q4 gets us 90% +.

So, that level of volume going through is a big lift. Also, the more programs that we are quoting, launching, and so forth, are all adjusting pricing real time. What I kind of want to make sure we cover with all of you is when we've talked the last few quarters, we've started seeing a few key components, and we talked to all of you about that, and we've gone back to our customers to recover those.

At the same time, there is just general inflation we are seeing across aluminum, copper, steel, 30%, core Q1, 30% Q2. These are things we did not necessarily anticipate in the agreement, so they've had to go back, and Neil can comment. Our customers are very supportive about recovering those.

Still, we have a little bit of a lag effect on that element, but then certainly as we are quoting new programs and receiving new POs, we're negotiating that upfront, which is a combination of tariffs, raw material costs and purchase component costs. That's the impact in Q2, but the opportunity set for us as we go into Q3 and Q4.

Noah Kaye
To tie into that, I'm sorry, Neil, I didn't know if you were going to add anything else. To tie into that, I mean, this is four quarters of record orders. Your book-to-bill was greater than two, this quarter. I guess, how is the better pricing that you are talking about embedded in the orders in the backlog? Can we just get a sense of where this backlog coverage really puts you, both for the back half and even into '28?

Neil Brinker
To build a little bit on what Mick was saying, obviously, when we negotiate these LTAs and we negotiate these program wins, we want to make sure that we can open up the agreements when there are things that are material in terms of margins. And we have been able to display that willingness to work with our customers, and that's where you're going to see some of this improvement in the back half, to Mick's point. Certainly to your other question, this will be very clear in the IR day update for FY '28 and '29. Next week. Two weeks. Sorry, two weeks.

Mick Lucareli
I do not know where your mind is at.

Noah Kaye
We're looking forward to it like it's next week. I know there's a whole bunch of other questions, so I'll turn it over. Thank you.

Operator
The next question is from Chris Moore from CJS Securities. Please go ahead.

Chris Moore

Hey. Good morning, guys. Thanks. Obviously, lots of noise out there. Maybe just kind of how you would characterize two things from a customer standpoint. One would be what you're hearing in terms of from availability from a cash flow perspective to build, and two is the kind of certainty in terms of the final geographic destination. Is that still up in the air on a lot of the work that you're doing at this stage?

Neil Brinker
I think for the work that we're considering that's beyond '28 into '29 and '30, certainly, there's some of that in terms of locations and exact size of gigawatt campuses. There's a little uncertainty there, but we're working through that in terms of how to close that gap.

In the immediate 24 months, it's there. Remember, Chris, we're one of the last products to go into the data center. So we can see a site that's been permitted and they start the construction of the site, and that can take anywhere from 12 to 18 months, and then you start to bring our equipment in. So, the equipment that we're preparing our inventories around that we're going to be building over the next several years are for sites that are permitted and are in place.

So, more of the backlog that we're working on in terms of size as well as locations, where that may change from state to state, which we have seen that happen in the past, and size, they continue to get bigger, rather than smaller. That's beyond two years from now, Chris.

Chris Moore
Got you. Very helpful. Maybe just, I know that with Gentherm, there's still, I think, $20 million-$25 million additional costs in the second half for the transition services agreement. Are these costs included in the EBITDA estimate, or they'll be adjusted out?

Mick Lucareli
Great question. In our guide is about full year, and when we do disc ops, we remove Performance Technologies from the full year, there would be about $10 million-$15 million of temporary stranded costs. Obviously, we had PT for half the year, but if you just back them out, in our guide, that includes that. And when we first announced the spinoff, we said we didn't anticipate much in the way of stranded, and we still believe that. Where those costs will be reabsorbed is through the data center growth.

In other words, all those resources we had working on Performance Technologies at the rate of growth we're adding on data centers will also be fully absorbed, by next fiscal year. It's just more of an internal accounting. But to be clear, in this interim period, with now with PT gone, $10 million-$15 million, and it's really a half a year's impact in the second half, about, I'd say, $7 million-$8 million here that we need to redeploy into the data center business. Hope that answers your question.

Chris Moore
It does. I will leave it there. I appreciate it.

Operator
The next question is from David Tarantino from KeyBanc Capital Markets. Please go ahead.

David Tarantino
Morning, everyone. Maybe following up on the data center margins, can you just take us through how these headwinds progressed through the quarter? I'm particularly thinking back to last quarter's commentary around margins improving in June. So, could you give us some color on how this evolved through the quarter and through October as you locked down more supply and worked on price with your customers?

Mick Lucareli
Yeah. Neil can add more color, David, but I would say that, and I go back to what we talked about last quarter, was what really started was we were surprised by some short shipments of a few key components, and Neil talked quite a bit about working through those.

What continued to happen, I would say, through the quarter, would be other suppliers coming forward either with shortages or their own volume challenges, and then what comes with that, when I talk about material costs, we have expedited freight and logistics and tariffs. A couple things that was happening as the quarter continued to go on, and I think Matt Summerville had asked a good question. We're trying to get in front of it and make sure why we talked about reducing our outlook for the rate of margin improvement is expecting that this will linger longer.

But in some cases, we had some sheet metal suppliers or something that weren't hitting their deliveries. Other cases, we're getting the deliveries that we asked for, but they show up on a Friday instead of a Monday. Or we're shipping parts that we have in Europe over to North America so we can utilize them.

So, a lot of inefficiencies getting the product in the door to keep the lines moving. I know it's a lot, that it isn't just that, hey, someone called us and we're negotiating a price increase or an LTA that we should have known about. I think it's just almost a day-to-day evolution. Neil, any other color?

Neil Brinker
No, I think that's good color. Ultimately, we have a decision to make. When we have these challenges in the operations environment or with the supply chain, you can look at your customer and apologize and not do anything, or you can react to it and try to continue to delight your customers. Sometimes, that decision to react to it and do the best you can to meet their commitments and our expectations to meet our delivery schedules is, it gets quite costly.

When we have key components that are sourced locally and they fall through, we have to then use their international sources to get the components in. To double that, you expedite the freight at the same time. So, there are many instances where we had some suppliers prior to

the LTAs that were not able to meet their commitments, locally. We had to go with international shipments with expedited freight in order for us to keep the delivery schedules.

David Tarantino
Okay, great. Maybe could you give us some color on the pricing discussions in data center? My understanding is there were pass-throughs for inflation, but securing supply at a higher cost is somewhat unique. So, what does the pricing look like in the LTAs from your suppliers? Where are the discussions at this point with your customers on price, and how much more work is there to do on these discussions?

Neil Brinker
Well, I think the important piece here, David, is that it's not fixed. We've got the agreement with our customers that the pricing is variable, especially when we have challenges in the metals inflation as well as tariffs, expedited freight costs, those kind of things. There's a willingness to have a conversation, and there's a willingness to help us in terms of making sure we can meet their delivery commitments and help share the costs in order to do that. Those are very active conversations that take place on a sometimes weekly basis with some of our biggest customers.

David Tarantino
Okay. Thank you.

Operator
The next question is from Neal Burk from UBS. Please go ahead.

Neal Burk
Hey, good morning. On the Commercial HVAC guide, you guys have just done two quarters of pretty good double-digit organic sales growth, but I think the guide assumes a step down in the back half. Can you elaborate on that? Do comps get harder, or is there some timing, or is this just conservatism?

Mick Lucareli
Yeah, with the heating season, one thing that was positive here and helped with HVAC in the really strong Q2, we've had a really good preseason for heating, preseason orders. So we are being a little bit cautious that, for those that have been with us a while, you know what, unfortunately, weather is going to be. So there is one element of we try to go in with a relatively conservative heat outlook.

Secondly, that new leadership team is really going through a heavy lift on 80/20, and we have planned exits, cost reductions and attrition, much like, again, people who have been with Modine for a while will see, because also implied in there is a pretty healthy second-half margin lift.

Again, from the first half, I think we would probably be looking at least 300, 400+ basis point, plus, improvement in the second half of the year, and part of that is from the 80/20 activities, along with price recovery on material costs because there was also a little bit of that in the HVAC segment for Q2.

Neal Burk
Yeah, I wanted to follow up on that. I think last quarter, you were pointing to kind of maybe 200 basis points of margin expansion climate for the year. So, can you kind of update where we are now relative to that? I mean, you kind of just guided back half, but was Q2 how much worse than you expected, and what's the sort of ramp in the back half? How do you kind of break that out between cost recovery and price?

Mick Lucareli
Yeah, I see the full year being up, call it 100 basis points or so. When we look to the back half of the year, I expect a 50-100 basis points year-over-year improvement in Q3, and then another big lift in Q4. Again, in where, as far as Q2, we were a little bit light, and that was also, majority was around material costs, and mostly raw material costs on the coils business. Really strong order intake. In fact, a lot of growth driven by data center business, but that's a lag in timing recovery of like copper, aluminum, and steel.

Neal Burk
Great. Thank you.

Operator
The next question is from Brian Drab from William Blair. Please go ahead.

Brian Drab
Thanks. Can you touch on that opportunity that you have with the data center customer within the coils business, with the timing of that, and how significant could that be for that segment?

Neil Brinker
Yeah, that's definitely significant. We're going to have to do a lot of 80/20 work there to ensure that we're using the appropriate capacity for this key customer. Definitely is significant in terms of the revenue growth, and it would be helping them secure supply so that they can continue to navigate the shortages in the supply chain.

We've talked about fans as a shortage in the supply chain. You've heard lots of companies talk about that. We've talked about things like evaporators and compressors. Coils is now bumping up as to one of the areas where they're seeing a severe shortage in the industry, and the fact that we are the largest independent coil producer in the world is in our advantage. So, we have a lot of opportunity there, and we can partner with them, and we are partnering with them. That will be a significant mix shift in that business, going forward.

Brian Drab
Can you say what the specific application is for the coil? Like, what type of system or unit it is going, would be?

Neil Brinker
Liquid cooling, radiator heat exchangers, liquid cooling for direct-to-chip.

Brian Drab
Okay, got it. You just mentioned the shortages of fans and other components. Can you sum up at this point, like, how many suppliers are an issue? How many parts are an issue? This has been a very acute problem throughout the last six to 12 months, but is it still an acute problem, or has it kind of broadened?

Neil Brinker
Well, it hasn't broadened. You had limited supply with four key components. Of those four key components, fan was one. We have now entered into an LTA with one of the fan suppliers. We've also entered into long-term purchase agreements, a blanket PO that's out 12 months with a second. So, we have comfort now that we'll be able to get the requested supply that we didn't have that comfort, 90 days ago.

With the evaporator suppliers, we've entered into an LTA. With the compressor supplier, we're in negotiations, and I would expect to close an LTA on that relatively soon. It's just a matter of how much more capacity that they need to add and how many more plants they need to add to support us. What we see now in coils, obviously, is the last, and we're vertically integrated with coils, so that's a non-issue for us. It is for others.

With these LTAs, we have targeted the ones that were critical, quarterback that had caused a lot of disruption. And as we enter into these LTAs and we enter into these agreements with our suppliers, this is beginning to stabilize around the strategic supply chain.

You still have the other suppliers that need to deliver. Those are more acute in terms of an issue where you kind of work through it. Maybe it delays you a week or maybe it delays you a couple weeks, but you have an alternative source that you can ramp up quicker, much quicker, because they don't have the same level of technology.

So that, for us, is a different challenge, but the first and the most important thing to do was to lock up your suppliers that are strategic, and then we'll work on the ones that are more of an acute issue throughout the weeks and months.

Brian Drab
Okay. And then if I could just ask, now that you have those LTAs in place, you have an understanding of the pricing that goes along with those, and I guess this is asking you to maybe comment on a time period further out than you want to, but in the past, we've talked about the

potential for EBITDA margin for the data center business to be well north of 20% once you get to some sort of steadier state. Is that still where you're trying to drive the business toward? What is the goal for EBITDA margin for this business?

Neil Brinker
Yeah, that's absolutely what we're trying to drive the business for. But remember, we are in the middle of a ramp. We are ramping products, we're ramping new launches, we're ramping chiller lines, we're ramping air handling units. We're adding $100+ million of capacity and expanding in a way that we've never done in the past.

So, there's going to be challenges with the ramp in terms of margin compression with all the things that we talked about. We're what, 13 lines into the 20 lines for chillers now complete. You go back a quarter ago, it was half of that.

So by the end of the calendar year, we'll have the capacity in place and you'll start to work through these inefficiencies, but there's often margin compression in the middle of a ramp, and that's exactly what we're in to keep up with the enormous demand that we have for the most efficient product in the industry.

Brian Drab
Alright. Okay. Thanks very much. I got it.

Operator
The next question is from Tim Wojs from Baird. Please go ahead.

Tim Wojs
Hey, everybody. Good morning. Maybe just on the data center guidance, the midpoint going from 70% growth at the midpoint to what is 85% now, how much of that is volume versus price?

Mick Lucareli
In terms of, majority of that is volume-driven, Tim.

Tim Wojs
Okay. I guess when you're thinking about kind of the commercial actions that you need to do to kind of recover the higher component costs, I mean, how much of that have you already went and gotten versus how much you still need to get? I guess what is embedded in the fourth quarter? Because, I mean, there's still a pretty sizable ramp from Q3 to Q4, and I'm just trying to kind of understand your ultimate visibility to that at this point.

Mick Lucareli
Let me try to answer it. Not the best way I can. I would say based on two things we have happening at any one time. We have one or two major long-term agreements with a couple

hyperscalers. One we announced last year. That had well-defined pricing mechanisms in there, and as Neil said, they're open to it, and in some cases, both sides didn't contemplate some of the things we saw coming. So we're working through those now, and there's a lag effect on getting those approved, then into the system, the invoice, and so forth.

The second element is every single new discussion we're having commercially, Neil and I are having the teams ensure all of this is upfront and such that incremental programs are addressing, even if it is six months between award and completion, we want to be sure that if there is inflation between us getting award for a new site, that we can adjust that price before we ship the product.

And from what I can kind of see, just on pricing we have agreed to and passing through, I see at least like a 250 basis point lift for us on discussions we have already had with customers on current activities. So, hope that gives you a little bit of transparency. Then obviously new programs, new POs, where our full intent is to get those priced up front when those ship.

Tim Wojs
Okay. Yeah, that's helpful. So when you think about, you are not necessarily guiding this, I'm putting words in your mouth, but what's implied is probably a 450, 500 basis point improvement Q3 to Q4 in EBITDA margins. Part of that is price that you do kind of have visibility to, and there is a lag to it. Then parts of it will also just be kind of volume growth and better efficiencies within the existing lines. It's really like those two main factors?

Mick Lucareli
Yeah, that's a good summary. I mentioned a few minutes ago, I see in Q2 a 375 basis point material headwind. Then I mentioned to you that what I can see in our system is at least, call it 250 basis points catch-up right now that we've gone, and then you have new programs. The other thing, right, we have to get in front of, and it's a little bit of what we're talking about, is then make sure we're factoring in what could come that we're not aware of yet as far as asks from the supply base.

I think I'll let Neil comment. I think we're well in front of that. I'm not raising that because it's a message we're trying to send. It's that if we have all this catch-up, then we have to make sure we don't get surprised with any incremental price increases from our supply base. I think where we're at today, I feel good about. Neil, I don't know if you disagree with me.

Neil Brinker
Agreed.

Tim Wojs
Okay. I guess when you're thinking about the supply chain itself, is there a way to give us some color on just how supply has tracked for you, over the last few months? I mean, are you, I guess for Q3, are you kind of operating at that margin level today in terms of the data center

business? And are you seeing like weekly or monthly sequential improvement in supply, or is it still pretty kind of whack-a-mole?

Neil Brinker
We have seen improvement. September was the first time that we hit 100% on-time delivery from each of our chiller plants. October was the second time we hit 100% on-time delivery for our chiller plants, and that's because of some of the stability we've got back in the supply chain.

Tim Wojs
Okay. Awesome. Appreciate the call, guys. Thank you.

Operator
The next question is from Jeff Van Sinderen from B. Riley. Please go ahead.

Jeff Van Sinderen
Hi, everyone. You sort of just answered part of my question. Was going to ask you, though, have you seen any customers pull forward demand with more urgency, considering the political backdrop?

Neil Brinker
We have seen a lot of that. I don't know if it's completely driven by the political backdrop or if it's more driven by just the breakneck speed that we see around the competitive forces with AI and high-performance compute. There is a scramble for building out as much capacity as fast as possible and outpacing their competitors, and you're starting to see a lot of interesting new technologies, as well as requests, for us to be able to pull some of these schedules in, whether part of that is politically driven or if it's just the pure competition in order to add the capacity faster.

Jeff Van Sinderen
Okay. You said you're adding 100% on-time delivery for chillers now. If you could produce more data center product right now, do you have other data center customers or potential customers that want that product?

Neil Brinker
Yes. We have more demand, more requests, even with the amount of capacity that we're putting in place with air handling units, with CDUs, with chillers, dry air coolers, adiabatic coolers, all these products that go into the data center space far exceeds our capacity.

Jeff Van Sinderen
So, you really, at this point, you're having to sort of turn away some potential customers or you're having to, I do not want to say put on allocation, but it's almost as if you're sort of allocating to some degree.

Neil Brinker
We are trying to navigate these relationships. We leverage 80/20 with how we identify customers that we consider are what we call perfect prospects internally because of their cash position, because of their ability to win, because of their technology, because of their strategy. It aligns with our technology roadmap. When there's a high degree of fit of partnership, we have preference for those customers. It would just be a longer lead time for the others.

Jeff Van Sinderen
Understood. Sounds like a good way to operate. Then just given the balance sheet considerations of some of the smaller data center players, how are you thinking about mitigating, like, smaller-player customer balance sheet risk, if you will.

Neil Brinker
We typically don't engage. We have enough demand.

Jeff Van Sinderen
Just don't engage.

Neil Brinker
Yeah, we have enough demand from our top 10 that we don't have to engage.

Jeff Van Sinderen
Okay. Fair enough. Thanks for taking my questions.

Neil Brinker
Sure.

Operator
The next question is from Manish Somaiya from Cantor. Please go ahead.

Manish Somaiya
Good morning, and thank you for fitting me in, Neil, Mick, Kathy. My first question is on the inventory buildup and the working capital ramp that you have had in anticipation of product deliveries. My question specifically is, if customer site schedules move to the right, how fungible is that inventory across customers and projects?

Neil Brinker
Typically, we build a product that is anywhere between 70% to 80% that's scalable. The last 20%-30% is more customizable, so the majority of the product would be able to be shared with other projects and other demand.

Mick Lucareli

Yeah, most of the inventory is actually in raw state, and we try to time shipments and even negotiations of when our products are done that they take possession of them. Most of it is raw, as Neil said, and then you can reuse that for various products.

Manish Somaiya
Okay, that is helpful. Then on '27 CapEx, I think you have guided to $150 million-$200 million with the 20 chiller lines targeted by year-end. How should we think about '28? I mean, does that kind of normalize from a capital intensity perspective? I guess looking ahead to cash conversion, if you can just help us with that as well.

Mick Lucareli
Yeah, so a few items I'm going to push out, as Neil did, to IR day, only when we are looking into '28. Directionally, we'll see a more normalized level of capital spending. I expect it will decline, but as the size of the company kind of stay at, for sure will be over $100 million a year, I would expect, just for preventative maintenance and to support future growth.

The conversion we expect will fully improve as we go forward from a free cash. While I would like to see two things I would say. While I would love to see bigger free cash flow conversion this year, I think it is a really big positive that we're generating 90% data center growth, and the company is fully funding from operating cash flows our growth, which is great.

Also, just this year is a little bit of a unique situation when you look at our full year and even year to date with regards to the spin-off of the company. We mentioned that we'll probably have somewhere between $30 million, $50 million this year of cash separation costs, plus some capital to separate the company.

Then we had talked about cash taxes, both because of the spin-off and frankly, the LTAs, where we got a large upfront payment. We have about $70+ million of higher-than-normal cash taxes. Just in this year, I think we've got $100 million of non-normal operating cash items that I would not expect to continue into the future.

Manish Somaiya
Lastly, we're sort of in the middle of the third quarter for you guys. As I process the discussion we've had for the past one hour pertaining to the targets for '27 with margins, etc., from your perspective, Neil, what are some of the biggest risks that you are focused on that we should at least be aware of?

Neil Brinker
We have to hit the schedules for our customers. The demand that we have is critical for them to be successful. And marrying the supply chain ramp with the factory ramp with the labor ramps has been a delicate balance, over the last couple quarters. We're getting better at it, no doubt about that.

Just making sure that we can continue to meet our customers' delivery schedules is critical for the future of our success, because the projects and programs that we have with them extend well out into 2030, so 2031. We want to make sure that we're meeting the commitments early, even if it's more costly for us to do it because we see this as strategic customers with long-term potential.

Manish Somaiya
Great. Thank you so much.

Operator
There are no further questions at this time. I would like to turn the floor back over to Kathy Powers for closing comments.

Kathy Powers
Thank you to everyone for joining us this morning. The replay of the call will be available through our website in a couple of hours. We're looking forward to seeing many of you on November 18 in Chicago. Have a great day. Thanks. Bye.

Operator
This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.