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Turn down the a/c

Evan Lorenz writes:

"No buyers, no sales," reports a Harrisburg, Pa., homebuilder, in reply to a survey question. "We'll cut starts 60% to 70% in 2023," adds another respondent, this one from Jacksonville, Fla. The man behind the canvass, Rick Palacios, Jr., director of research at John Burns Real Estate Consulting, says his queries have elicited some of the grimmest housing commentary he's seen to date.

The comprehensive post-Covid housing bust—from construction to repair to redecorating to remodeling—hurts alike Trex Co., Inc. (a Feb. 4 *Grant's* pick not to click) and Mohawk Industries, Inc. (a Dec. 10, 2021 *Grant's* pick to click). It will take its toll, too, on air-conditioning giant Lennox International, Inc. (LII on the New York Stock Exchange), we are about to contend.

A slowdown in home sales needn't have cast such a uniform shadow over home-related businesses. It might, indeed, have produced a bump in remodeling activity. The 87% of borrowers with mortgage rates below 5% are, to a degree, prisoners of their own low cost of capital. In a different world, in lieu of a move they would rather not make, the thwarted sellers might build a new backyard deck, install some luxury-vinyl tiling—or upgrade their air conditioning.

The trouble nowadays, Matthew Saunders, who leads building-products research at John Burns, tells me, is that the customary drivers of remodeling activity are operating in reverse. House prices (not rising, sometimes falling), real incomes (definitely falling) and retirement accounts (ditto) are among these culprits. Besides, lots of people, in possession of stimulus dollars, or of loans priced at interest rates suppressed in the stimulus era, have already repaired and remodeled. In effect, their purchases borrowed from the future, leaving the home-renovation industry in an air pocket just as business activity slackens or recedes.

To be sure, the passage of time is a natural curative. Houses of a certain age—say, 20 to 39 years—need lots of TLC. "We estimate," says Saunders, "that around 24 million homes are going to reach prime remodeling years by 2027," a material number relative to 128.3 million American households. Why that bulge? Credit the low interest rate interlude of the early 2000s.

"Discretionary-repair categories are more likely to be deferred," says Saunders, hopefully, "but that just means on the back end of the recession that we anticipate a historic boom in remodeling activity."

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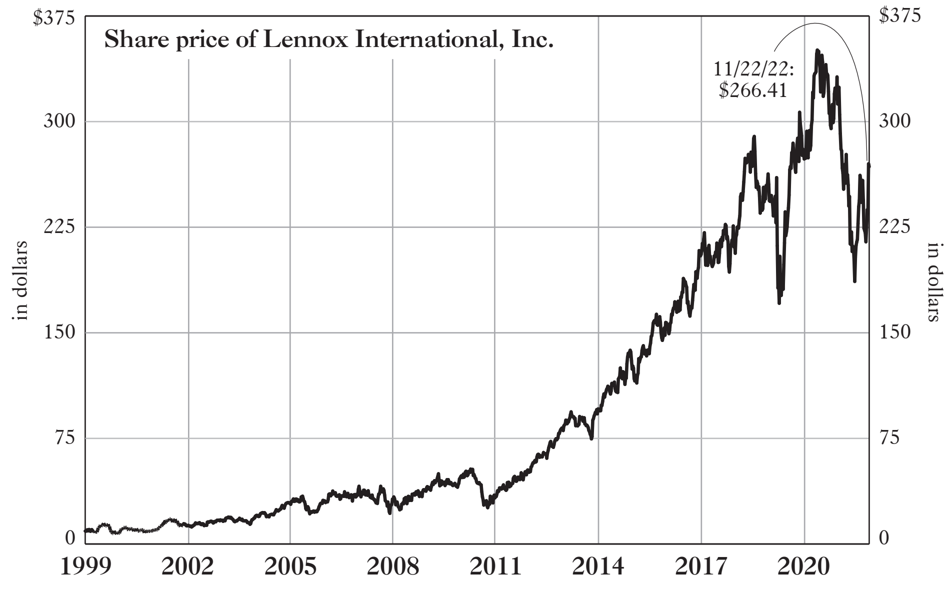
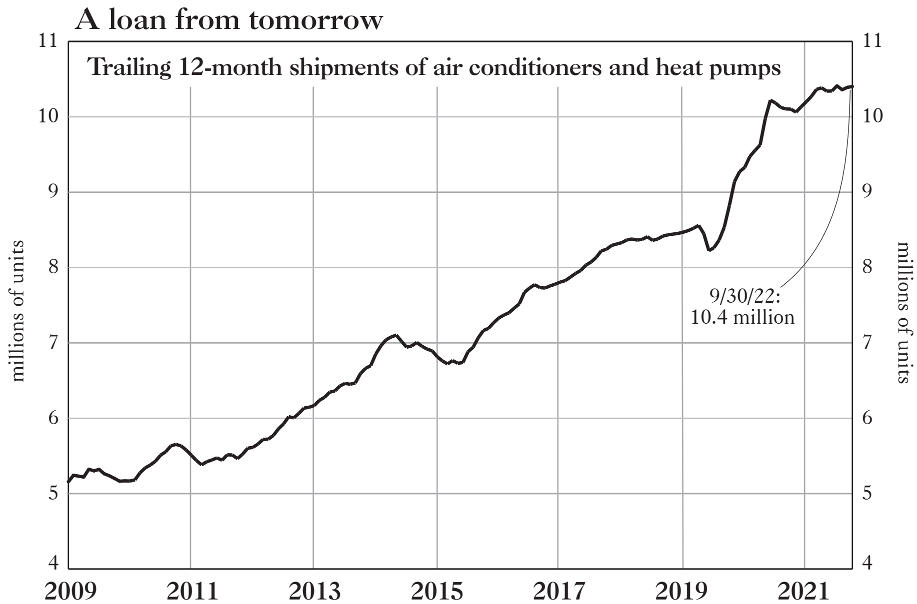
In 1895, inventors Ezra William Smith and Ernest Bryant drew up plans for a riveted-steel, coal-fired furnace. Looking for someone to build it, they approached Dave Lennox, owner of a railroad-machine repair business in Marshalltown, Iowa. Shrewd Dave agreed, and he accepted the Smith-

Still too hot



source: The Bloomberg



source: Air-Conditioning, Heating and Refrigeration Institute

Bryant patent in lieu of the inventors' cash. Thus was born the Lennox Furnace Co., now headquartered in Richardson, Tex. To this day, under the name Lennox International, it continues to book more sales north of the Mason-Dixon line than south of that regional demarcation.

Not relinquishing furnaces but moving well beyond that legacy product, Lennox today manufactures residential air conditioners, heat pumps (a more energy-efficient alternative to furnaces and A/Cs), commercial heating and cooling systems, condensing units and other systems and components used in commercial refrigeration.

Energy efficiency is today's corporate talking point. "The difference in Lennox versus our competitors is we literally have the highest-efficiency heating and air-conditioning units on the market," Steve Harrison, vice president of investor relations, tells me. "So we go all the way up to 28 [on the seasonal energy-efficiency ratio] for air conditioning. On furnaces, we also have the highest-efficiency units, of over 99% efficient."

Lennox divides its business into residential heating and cooling (68% of trailing sales), commercial heating and cooling (19%) and refrigeration (13%). The residential unit brings home the bacon as well as the revenue, accounting for 81% of trailing 12-month operating income. The 50 states contribute all but 12% of sales, followed by Canada (6%) and parts undisclosed (6%).

A Lennox bull won't fail to mention that demand for residential heating, ventilation and air conditioning (HVAC) is basically non-deferrable. If your air conditioner breaks down on any given still and sweltering July evening, you can replace that unit or deal with the heat. In the winter, a wool sweater is a poor substitute for a working furnace.

Neither will the bulls forget to cite the concentration of HVAC competitors. According to Wolfe Research, LLC, the top-five players control 87% of the market. They are Carrier Global Corp. (24% share), Daikin Industries, Ltd. (19% share via its Goodman brand), Trane Technologies plc (17%), Lennox (15%) and Rheem Manufacturing Co. (11%). Inflation brings out the latent oligopolistic pricing power. The unitary air-conditioner component (i.e., machines that both heat and cool) of the Producer Price Index has shot higher by 29.7% since year-end 2019, outpacing the 15.4% rise in the overall Consumer Price Index.

Covid and Uncle Sam have both contributed their mite to the prosperity of the air-conditioning industry. At home with their laptops, office workers cranked up the a/c, naturally accelerating the demand for replacement units. And as cash-out refinancings and home-equity lines of credit fund a portion of HVAC replacements, the house-price levitation of 2020–21 boosted customer borrowing, hence spending, capacity.

Sales of so-called existing homes, which had flatlined at 5.34 million in 2018 and 2019, soared to 5.64 million in 2020 and 6.12 million in 2021. This

Lennox at a glance

all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
residential heating and cooling	$3,115.2	$2,775.6	$2,361.5	$2,291.1	$2,225.0
commercial heating and cooling	861.6	864.8	800.9	947.4	900.7
refrigeration	612.6	553.7	471.7	568.7	7758.2
total sales	4,589.4	4,194.1	3,634.1	3,807.2	3,883.9
residential heating and cooling	587.9	540.3	428.5	464.6	399.4
commercial heating and cooling	68.7	110.9	136.9	165.4	157.5
refrigeration	73.3	49.1	32.8	61.3	68.1
corporate	-94.3	-96.4	-91.5	-82.4	-84.4
total operating income	635.6	60.9	506.7	608.9	540.6
net income	486.3	464.0	356.3	408.7	360.3
earnings per share	13.51	12.39	9.24	10.38	8.74
diluted shares	35.9	37.5	38.6	39.4	41.1
cash	48.2	36.5	129.0	40.2	46.3
debt	1,604.5	1,237.8	980.6	1,171.2	1,309.3
operating leases	204.9	199.8	197.8	183.7	-
total assets	2,625.8	2,171.9	2,032.5	2,034.9	1,817.2

* For the 12 months ended Sept. 30, 2022.

source: company reports

activity, too, provided a bump in residential HVAC demand.

Beginning next year, the U.S. government is boosting the energy-efficiency requirements of home HVAC units. On the Oct. 27 earnings call, Lennox said that only around 60% of residential models meet today's minimum efficiency standards and that units that tick the right boxes for 2023 are enjoying a "double-digit" uplift in price. Starting next year, thanks to the Inflation Reduction Act of 2022, buyers of favored heat pumps may qualify for a tax credit of up to $8,000. (Underscore the words "may qualify," as terms and conditions apply.)

In the three years prior to the pandemic, the Lennox commercial HVAC division produced $160.7 million in average annual operating profit; in the 12 months ended Sept. 30, it generated only $68.7 million. Supply-chain snarls, raw-material sourcing dilemmas and staff shortages all played their familiar part in the troubles. A little less familiar was the nature of the people problem at the Lennox plant in Stuttgart, Ark. (population 8,056).

"If you don't know Stuttgart, Ark.," CEO Alok Maskara told the Nov. 8 Baird Global Industrial Conference, "it means you are not into duck hunting. If you were into duck hunting, you would know. The only reason the factory is probably there is because many years ago, somebody was a fan of duck hunting. It's very hard to get labor there."

To put things right, management is building a new factory in Saltillo, Mexico (population 807,537), and scouring the Arkansas duck country for willing hands. If all goes according to plan, and if commercial demand recovers to pre-pandemic levels (it has fallen by 9% since 2019), then, according to the front office, annual commercial-division earnings should return to pre-Covid profit levels by 2025.

Rated Baa2/triple-B, Lennox showed net debt and operating leases of $1.8 billion on Sept. 30, amounting to 2.5 times trailing Ebitda. In the third quarter, operating income covered interest expense by 17.7 times.

There's lots to like, in short, but none of it's secret. Despite declining by 17.9% in the year to date, LII trades at 18.9 times trailing earnings and 17.8 times next year's estimate. For comparison, the S&P 500 changes hands at 19.4 trailing earnings but 17 times the 2023 guess.

Only two of the 17 analysts who cover the stock are declared bulls, while 11 say "hold." Short interest sums to 4.6% of the float, which, while elevated from the average 2.5% short interest in the companies making up the S&P 500, is not at nosebleed levels. Insiders sold 28,173 shares over the past year for proceeds of $8 million, and not one bought a share.

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Domestic shipments of residential air conditioners and heat pumps, which never topped 8.5 million units in 2018–19, leapt to 9.33 million in 2020 and 10.20 million in 2021, according to the Air-Conditioning, Heating and Refrigeration Institute.

The useful life of a typical HVAC unit is about 15 years. "If you strip out demand from new single-family homes, we've been replacing roughly 9 million units," Nigel Coe, who rates LII a sell for Wolfe Research, LLC, tells me. "So, 9 million units on the installed base of 110 million units is about an 8.2% replacement ratio, i.e., you are roughly replacing units at a 12-year clip. The replacement level is near peak levels." By pulling forward hypothetical 2023–24 sales to 2021–22, the industry may have front-loaded its prosperity.

To fix or replace a broken unit? Lockdown-induced shortages of parts and labor caused the question to be rephrased: Would you, dear homeowner, care to wait several weeks in the summer heat for parts to arrive, or would you rather sleep through the night with a new unit? Stimmie-enhanced households opted to replace units that they otherwise might have repaired.

With hourly wages falling short of inflation by 2.8 percentage points in October, the residential HVAC industry's aggressive pricing over the past three years may also constitute a headwind. Unclogged supply chains are making it easier for repair shops to secure replacement parts. The government's efficiency mandates are inflating prices for the cheapest units. All in all, consumers may choose to repair rather than replace, perhaps a green decision but not one likely to contribute to the cause of a higher LII share price.

Since, as noted, air conditioners last for roughly a decade-and-a-half, the units sold between 2020 and 2022 are replacing units installed during the mid-aughts housing bubble. As a refresher: Existing-home sales, in millions of units, totaled 7.08 in 2005, 6.48 in 2006 and 5.02 in 2007; new-home completions, also in millions of units, summed to 1.93 in 2005, 1.98 in 2006 and 1.5 in 2007. Unfortunately for Lennox, the next three years will lap the housing bust. Existing-home sales fell to 4.12 in 2008, 4.33 in 2009 and 4.18 in 2010; new-home completions collapsed to 1.12 in 2008, 0.79 in 2009 and 0.65 in 2010 (again, all units in millions).

Industry-wide HVAC shipments peaked at 8.7 million on a 12-month basis in early 2006 and bottomed at 4.8 million units in late 2009. Residential HVAC sales did not top 8 million units again until 2018. "Even taking away the pre-buy and rising mortgage rates," Coe tells me, "we would still be cautious on demand because of this element." Yes, the company acknowledges, replacement demand for units installed during 2005–07 has lifted sales. "We think there'll be a flattening out in the market from that regard," says Harrison. "Maybe the market grows slower, or maybe it's more flattish." Key to the IR man's view is that working-from-home is not going away and hotter summers mean air conditioners are being run more intensively. Still, there will be many fewer units to replace in the 2008–12 cohort.

Air conditioners are among the last items builders install before turning over the house keys to the buyer. According to the Census Bureau, a record number of single-family houses and apartments—a grand total of 1.74 million—were under construction in October. The HVAC industry is, of course, a beneficiary, but the mortgage rate–induced collapse in home buying means that developers are starting fewer new houses.

Is the Street paying attention? Consensus estimates for next year anticipate a 1% rise in sales and a 60 basis-point widening in Ebitda margins, to 16.2% of sales. Implicit, it seems, is that residential HVAC sales might fall by 1% to 5% and that Lennox will benefit from the higher prices attached to the higher-efficiency units that Washington has mandated. For his part, Coe says that volumes could easily fall by 10%–15%, which would slam operating margins.

But even that dire prediction could turn out to be sanguine. From its 2007 peak to its 2009 trough, Lennox's revenues dropped by 23.8%, and the top line did not overtake the 2007 high-water mark until 2017. Replacement demand, which Covid has already pulled forward, is set to mimic the lean years that followed the housing bust—that is, the bust before the current bust. It's getting hard to keep them straight.

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