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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Lennox 2026 Second Quarter Earnings Call. All lines are in a listen-only mode, and there will be a question-and-answer session at the end of the presentation. [Operator Instructions] As a reminder, this call is being recorded.

I will now turn the call over to Chelsey Pulcheon from Lennox Investor Relations. Chelsey, please go ahead.

Chelsey Pulcheon

Director-Investor Relations, Lennox International, Inc.

Thank you, Madison. Good morning, everyone. Thank you for joining us as we share our 2026 second quarter results. Joining me today is CEO, Alok Maskara, and CFO, Michael Quenzer. Each will share their prepared remarks before we move to the Q&A session.

Turning to slide 2, a reminder that during today's call, we will be making certain forward-looking statements which are subject to numerous risks and uncertainties as outlined on this page. We may also refer to certain non-GAAP financial measures that management considers relevant indicators of underlying business performance. Please refer to our SEC filings available on our Investor Relations website for additional details, including a reconciliation of GAAP to non-GAAP measures. The earnings release, today's presentation, and the webcast archived link for today's call are available on our Investor Relations website at investor.lennox.com.

Now, please turn to slide 3 as I turn the call over to our CEO, Alok Maskara.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thank you, Chelsey. Good morning, everyone, and thank you for joining us today. Please turn to slide 3. The second quarter demonstrated the strength of our direct-to-dealer business model, our dedicated talent and proactive actions taken to manage the current operating environment. I want to thank our employees for improving our customers experience through enhanced digital and distribution capabilities. I also want to thank our customers and channel partners for navigating a dynamic market environment alongside us.

Lennox delivered a solid second quarter. Revenue increased 3% to $1.5 billion. Total segment profit increased 2% to $355 million, and adjusted earnings per share were flat at $7.72. Within Home Comfort Solutions, year-over-year quarterly performance improved sequentially, though the pace of end-market recovery remains muted. Elevated market rates, inflationary pressures and historically low consumer confidence are constraining underlying demand. Looking ahead, channel confidence is continuing to grow and consumer confidence is starting to rebound, which supports our positive long-term outlook for the market.

Building Climate Solutions once again performed exceptionally well. We are seeing signs of progress across commercial end markets, momentum and emergency replacement and strong execution in the field to gain share and grow margins. Taken together, the results from the two segments demonstrate the value of our portfolio and the balance it provides across market cycles. Our long-term demand outlook remains unchanged, even though the residential demand recovery has been slower than anticipated. As a result, we now expect the most meaningful recovery benefits to extend into 2027 rather than occur in the back half of this year.

While we are reducing our earnings outlook, several key elements of our 2026 financial framework, such as revenue and free cash conversion, have not changed. Our balance sheet remains healthy and we remain on track with our inventory reduction plans. Their combined strength and the industry's long-term outlook provides us with the confidence to continue investing in the business, advancing strategic initiatives and strengthening our competitive position.

Now, please turn to slide 4. Let me spend a minute on our recently completed acquisition of the Comfort-Aire, Century, and Coast Air brands. This acquisition is an excellent example of a disciplined, bolt-on M&A approach. The acquisition expands our reach into small and midsize distributed channel and broadens our product offering, allowing us to further accelerate growth. It also sharpens our focus on customer experience by enabling one order, one invoice, and one shipment to our distribution and contractor partners for most HVACR equipment, accessories and parts.

Finally, we see meaningful opportunities to drive margin improvement through product integration, logistic synergies, and streamline SG&A through the application of the Lennox Unified Management System and expect the business to be accretive to our EPS in 2027. This strategic bolt-on acquisition, along with Duro Dyne and Supco acquisition completed in 2025 and the AES acquisition completed in 2023, reinforced our disciplined capital deployment strategy.

Now, let's turn to slide 5 and discuss the current demand environment and how we are positioning the business for growth acceleration. The factors affecting residential demands today, including affordability pressures, weather variability, software consumer sentiment and suppressed new construction activity are, in our view, temporary. We believe that much of the shift from replace to repair represents deferred replacements, and the underlying demand profile remains unchanged. Our focus remains on controlling the controllables. We continue to invest in innovative heat pumps, emergency replacement capabilities and our direct-to-dealer model to make it easier for customers to work with Lennox.

Leveraging our successful acquisitions, we are expanding our parts, accessories and service offerings, thus creating additional touchpoint with customers. At the same time, we are leaning into initiatives that strengthen our long-term competitive position, including distribution network optimization and partnerships like Samsung and Ariston to grow share of wallet. Rather than getting weighed down by short-term market fluctuations, we are executing our strategy and investing in the capabilities that matter most when demand returns.

With that, I will turn it over to Michael to review our financials.

Michael Quenzer

Executive Vice President & Chief Financial Officer, Lennox International, Inc.

Thank you, Alok. Good morning, everyone. Please turn to slide 6. The quarter reflected a mixed operating environment across the portfolio. Residential demand is still challenging, while strong commercial execution and contributions from recent acquisitions help support overall performance. We continued to navigate cost inflation and factory absorption pressures associated with lower residential production levels. These headwinds were partially offset by pricing actions and the timing of certain tariff refunds. Cash generation and a disciplined focus on the working capital management support a strong cash flow performance during the quarter.

Against that backdrop, let's turn to Home Comfort Solutions on slide 7. Residential market conditions remained challenging during the second quarter, although year-over-year demand trends improved compared to the first quarter. Compared to the prior year period, revenue declined 7%, driven primarily by a 12% decline in unit volumes. Favorable mix and pricing contributed 3% growth, while acquisitions added another 2%, partially offsetting the volume decline. While volumes were down year-over-year again, this represented a meaningful improvement from the 21% decline experienced in the first quarter.

Performance varied across channels. Two-step volumes were relatively flat compared to the prior year, while one-step volumes declined in the mid-teens, driven largely by continued weakness in residential new construction, where revenues were down approximately 30% during the quarter. Segment profit declined $30 million. Lower sales volumes created approximately $50 million of EBIT headwinds during the quarter. Mix and price were favorable and mostly offset cost pressures, including ongoing inflation and approximately $10 million of factory absorption headwinds as we align inventory levels with market demand. Product costs also benefited from approximately $25 million of tariff refunds that we had originally expected later in the year.

Let's move to slide 8 and discuss our Building Climate Solutions segment. Following strong growth in the first quarter, Building Climate Solutions maintained its momentum in the second quarter, supported by improving commercial end markets and continued execution on our growth initiatives. Revenue increased 24% with organic sales up 12%. Growth was driven by success with national account customers and an increase in emergency replacement activity.

Our service business also grew as customers increasingly leveraged our combined equipment and service capabilities. Mix and price contributed 3%, while acquisitions added 9%, primarily from Duro Dyne. Segment profit also increased benefiting from higher volumes and favorable mix and price. Product costs reflected inflationary and production cost pressures, and were partially offset by approximately $5 million of tariff refunds. Within other costs, Duro Dyne contributed approximately $11 billion of M&A accretion, offset in part by investments in customer facing digital capabilities and innovation.

Now, let's turn to slide 9 to review cash flow and capital deployment. We generated $172 million of operating cash flow in the second quarter and delivered 92% trailing 12-month free cash flow conversion, reflecting disciplined working capital execution and progress on inventory reduction. While inventory dollars were flat to December due to inflation and tariff-related cost increases, unit inventory levels continued to decline, and we remain on track to achieve our full year inventory reduction implied in our full year free cash flow guidance. Our balance sheet is strong, with net debt to adjusted EBITDA of 1.3 times at quarter end. During Q2, we repurchased approximately $130 million of shares, and after quarter end, we completed the acquisition of the Comfort-Aire and Century brands using approximately $200 million of debt. We're also refining our full year capital expenditure outlook to approximately $225 million, down from $250 million. The change reflects project timing, but our key investment priorities are unchanged.

With that, let's turn to slide 10 and discuss our updated financial guidance. As Alok outlined, we are updating our full year adjusted EPS guidance range to $23 to $24. While our overall revenue growth outlook holds at approximately 8%, the composition of that growth has evolved since our prior guidance. At the segment level, we now expect Home Comfort Solutions revenue growth of approximately 1% compared to our prior expectation of 4%. Building Climate Solutions revenue growth is now expected to be approximately 20%, compared to our prior expectation of 16%. These changes reflect lower expected residential volumes, stronger commercial demand, and approximately 1 point of enterprise revenue growth from the Comfort-Aire and Century brands acquisition. This acquisition adds approximately 2 points within HCS.

The reduction in our EPS outlook is primarily driven by lower net volume expectations, as stronger commercial demand is more than offset by lower expected residential volumes. We now expect approximately $60 million of productivity versus our prior expectation of $75 million, reflecting ongoing absorption headwinds from lower residential volumes and the delayed timing of some material cost reduction initiatives as resources were shifted to tariff mitigation.

Interest expense is expected to increase to approximately $70 million and M&A amortization to approximately $25 million following the Comfort-Aire and Century brand acquisition. Importantly, our free cash flow outlook remains unchanged at $750 million to $850 million, reflecting confidence in our inventory reduction plans and working capital execution. Other guidance assumptions, including inflation, investment, tax rate and share count, have not changed. While residential demand is still below our expectations, the strength of our commercial business and continued cash generation position us well for the balance of year profit growth.

With that, I'll turn the call back to Alok.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thanks, Michael. As we close, I want to reemphasize that while current market conditions are dynamic, I believe the long-term growth trajectory of the industry is very attractive. What gives me confidence is the performance of our portfolio, the durability of our cash generation and our ability to continue investing towards growth. We are committed to innovation and operational excellence, while continuing to allocate capital to expand our capabilities and improve our customer offerings. Most importantly, the dedication of our employees and the values that define our culture continue to drive excellence at Lennox. Our fundamentals are strong, our strategy is clear, and our best days are still ahead of us.

Thank you. We are happy to answer your questions now. Madison, let's go to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Thank you. And we will take our first question from Ryan Merkel with William Blair. Please go ahead.

Ryan Merkel

Analyst, William Blair & Co. LLC

Q

Hey, everyone. Thanks for the questions. I wanted to start on the resi revenues. The down 12% for the one-step is surprising. What are the key issues, Alok? And then, any steps you're taking to improve the results?

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. Ryan, majority of the decline was due to residential new construction where we talked earlier about we walked away from really low margin business, and a large portion of that impact is being felt in Q2 due to seasonality. That doesn't mask that the underlying sell-through also remains weak, but is improving both sequentially and as we look at this going forward. So [ph] that's a really kind of (00:15:16) look at the negative 12%. And we have internally done a lot of analysis and feel confident that that starts improving because we lap some of the residential low margin loss in the second half and the comps get easier even on the overall [indiscernible] (00:15:33) market dynamics.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Got it. Okay. That's helpful. And then, on the guidance cut, it sounds like you had included the refunds from tariffs in the guide, so just confirm that for us. And then, it looks like resi, you're going to have weaker margins in the second half. Is that just the fixed cost absorption on the lower volumes, or is there anything else in there that's pressuring the margins?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

That's correct. On the tariff guidance, we had built an inflation assumption of 5% that included the net impact of all increases within the 232 tariffs that we saw earlier in the year, and the IEEPA refunds that we expected initially in the second half of the year that we've now gotten most of them in the second quarter now.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

And there's nothing else...

[indiscernible] (00:16:22)

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

...based on the second question, Ryan. It is just simply impact of lower volume and the absorption impact related to that.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Okay. Got it. All right, thanks. I'll pass it on.

Operator: Thank you. And we'll move next to Tommy Moll with Stephens. Please go ahead.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Good morning, and thank you for taking my questions.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Hi, Tommy.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Alok, first question for you on the one-step trends for resi. Noted that there's the new construction headwind. Some of that relates to low margin business you've walked away from. I'm more interested on the replacement side there. What's your view on how market share has progressed? Have you seen any evolution or pressure there?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. On replacement, we have seen a small market share gain, while in new construction, we have seen a significant loss as we talked about earlier. And we continue to, like, build our distribution network efficiencies, continue investing in the sales team, but we are pleased with our market share position in the replacement, which has actually ticked up over the past 12 months.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Related question for you on pricing, Alok, specific to resi. It seems like there have been some different strategies year-to-date. Some have raised and then lowered depending on differing tariff assumptions. Others have been slower to move. Just characterize for us what the Lennox strategy has been there and what you've seen across the market. There's just been a lot of volatility on that point.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. Putting residential new construction aside because that's a different story, we continue to see higher inflation being offset by pricing actions across the wide spectrum. We continue to remain focused and do price competitively. A large portion of the 232 tariff pricing is going to go into effect on 1st July, which is consistent with how some of the other competitors have done. And we feel good about, like, where we are on the replacement side of the business on the residential portion. And obviously, we continue monitoring it. We want to be fair with our channel. Some of the early arrival of tariff refunds also, like, impacted how we thought about pricing and how we're going to take this going forward. So, we were able to delay some of the pricing actions because of the early arrival of the tariff refunds.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Thank you, Alok. I'll turn it back.

Operator: Thank you. We'll move next to Noah Kaye with Oppenheimer. Please go ahead.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking the questions. I guess just to make sure that we've got it, then, on the revised guide, two points. One, so I think you'd contemplated resi volumes down mid-single digits for the year. Does that sort of shift now to down high single digit, down 10%? Can you give us a finer point on that? And the guidance on inflation expectations remaining unchanged with the 232 partial reprieve, was there an offset to some of that goodness to keep the inflation guide intact?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Sure, Noah. I'll give you a little bit insights on that. Yeah, so within the HCS volume guide, it now is high single digits. We expect most of the balance-of-year growth to happen within the indirect channel, as you have a favorable comp year-over-year. On the direct channel, we expect balance of year to be down kind of low single digits or so within the direct channel balance of the year. And then within the inflation, we still expect it to be 5%.

There's a little bit of benefit that we saw with the adjustment to the 232s, but then we continue to see inflation on commodities, fuel, memory. Those mostly offset that benefit.

Noah Kaye
Analyst, Oppenheimer & Co., Inc. Q

Okay, thanks. And then, when we look at the two segments and the demand trends juxtaposed, I mean, really it is seemingly a tale of two markets. Feels a little unusual to have such bifurcation. But can you talk a little bit about the drivers of the light commercial strength? You mentioned some nice wins, clearly national accounts, emergency replacement. But how much of this is sort of underlying versus Lennox share gains?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc. A

I think there is significant Lennox share gain that I want to give credit to the team. As we build a new factory, we are focused a lot more on emergency replacement, and that's clearly playing out as we expected, maybe slightly better than we expected. At the same time, the extra capacity is helping us win back the national accounts. But also from end market perspective, remember this is the end market that was from AHRI data down continuously for like 17, 18 months in a row, and now is finally turning around the corner. But I would say among the improvement, a large portion is share gain, and then there's definitely a benefit of the market not declining anymore and showing some signs of life.

Noah Kaye
Analyst, Oppenheimer & Co., Inc. Q

Yes. Helpful. Thank you, Alok.

Operator: Thank you. And we will move next to Jeff Hammond with KeyBanc Capital Markets. Please go ahead.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc. Q

Hey. Good morning, guys.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc. A

Morning, Jeff.

Jeffrey D. Hammond
Analyst, KeyBanc Capital Markets, Inc. Q

So, just back – it looks like you're – HCS, you're bringing down 5 points on a core basis. Like, is that just all sell-through demand weakness, or is, like, this RNC walkaway a bigger number, or is there some other nuance in there? And then, just my second one would be just repair/replace. A lot of people are saying like it's normalizing exiting A2L and this canister issue and – just what are you seeing there?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc. A

Sure. So, the answer to first is it is all one-step. Two-step, we continue to see good growth, and we are forecasting, like, the lack of destocking leading to good growth in the second half as well, so for two-step. One-step, the RNC loss is within the one-step. So, I think that's why those two numbers overlap. I would say the large part of the decline in Q2 in one-step was driven by RNC, and that's a heavy quarter for RNC, as you know. And even our reduction in the second half is primarily due that.

Now, we do see some underlying demand recovery that's been delayed, but we think from our perspective, the repair versus replace trend has stabilized. We see the channel confidence, which was impacted last year because of canister shortage, has returned fully. And we all know that the consumer confidence is sort of bouncing along based on war and other pieces. But a short answer to your question, Jeff, is that a large portion of the one-step decline is residential new construction, a low-margin business that we walked away from.

Jeffrey D. Hammond Q
Analyst, KeyBanc Capital Markets, Inc.

Yeah, but I guess my question is, is that walkaway number bigger now than you thought, or you knew that was there and your revision's really all underlying replacement weaker?

Alok Maskara A
Chief Executive Officer & Director, Lennox International, Inc.

It is bigger than what we had originally looked at. That market remains extremely competitive and the margins were there, were just not acceptable. So, it is little more than what we'd originally thought and talked about.

Jeffrey D. Hammond Q
Analyst, KeyBanc Capital Markets, Inc.

Okay, appreciate it. Thanks.

Operator: Thank you. And we will move next to Jeff Sprague with Vertical Research. Please go ahead.

Jeffrey Todd Sprague Q
Analyst, Vertical Research Partners LLC

Hey, thanks. Good morning. I just wanted to get some insight into how to think about sort of margins for HCS into the back half. So, we've got some absorption issues, right? But we're walking away from lower-margin business. I guess you have some time for price to catch up a bit. So, can you just give us some insight on how you think margins progress over the balance of the year in HCS, maybe relative to what we posted here in Q2 or relative to last year? Certainly, it'd be helpful.

Michael Quenzer A
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

Yeah. Jeff, we expect the margin headwind year-over-year in the second half to be better than the first half, even after you adjust for some of the tariff refunds, mostly driven by the volume growth that we expect now of low single digits balance of the year. So, you get the 35% incrementals on that. Also, we had a much heavier first half absorption headwind, and then we're going to pick up 1 point or 2 of price in the second half versus first half as some of the new pricing initiatives that Alok mentioned starting in July come in. So, better margin performance in the second half as the volumes start to come back.

Alok Maskara A
Chief Executive Officer & Director, Lennox International, Inc.

And Jeff, to your earlier point, I want to add that our product mix is positive right now because of walking away from loss-making accounts. That's just masked by the other factors that Michael mentioned because of all the noise around absorption and the pieces. But the underlying mix is positive for us given our decision to not compete on those lower-margin, negative-margin accounts.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Is it overly optimistic to think that HCS margins are up on a year-over-year basis in the back half?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

We're going to get some headwind from the M&A that's a bit dilutive. Price cost is a bit dilutive. The volume is accretive. So, all of that still might lean to slightly negative.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

No. So I think the overall question is, we think it's pretty balanced, Jeff. We don't think it's optimistic, nor do we think it's super conservative. We're trying to put a very balanced picture forward.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Right. But something around sort of flattish to slightly down margins in the back half, I think, is what you're indicating. I read that right?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Yeah, that's basically within the guide, that's approximately...

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Within the range, yeah.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And what do you actually think industry volumes were in Q2?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

The June AHRI data and everything else that we looked at, like, continues to show us continued difference between sell-in and sell-through. That's obviously going to become a much longer conversation, Jeff. But we think the sell-in has obviously improved substantially, and we see that in our numbers. And I think the sell-through, we still have to get more data and see how everybody comes through. And I think that still remains under pressure.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And maybe last one. Do we still have a little bit more work to do on channel inventory as it relates to Lennox and some related absorption headwinds from that in the back half?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

No, I think we are pretty complete on that, Jeff. The channel inventory is pretty normalized and there's no more destocking.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Okay, great. Thanks, guys. I'll leave it there.

Operator: Thank you. And we will move next to Steve Volkmann with Jefferies. Please go ahead.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Great. Good morning, guys. Thanks for taking the question. Maybe just to put a sharp point on it, the one-step down 12%, are you willing to sort of say what you think the walkaway business was of that 12%?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

No, we're not willing to kind of go into that level of account details of where it was, but we can just tell you a vast majority of that 12% was residential new construction.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Okay, all right. Worth a shot. Well, look, I think on previous calls, we've talked a little bit about sort of affordability and inflation in the end market and maybe some demand destruction. And I think your view was that the most likely source of kind of give there was going to be in the installer margins. And I think that was two or three quarters ago we had that conversation. So, I'm curious if you're starting to see any sort of price normalization to the consumer that might sort of address this affordability issue.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

We are, and I think this obviously – the problem is synonymous with the repair versus replace. So, consumers, when there's demand destruction for equipment, they still have to repair it, and we do see movement there. I think our contractors are running more promotions. They're getting more aggressive. We are and all the other manufacturers are running more consumer-based promotions to take this forward. So yes, I think we are all very aware of that, and both the channel and the manufacturers are doing our part to increase affordability and make sure promotional dollars get applied to consumer purchase.

Stephen Volkmann
Analyst, Jefferies LLC
Q

Okay, appreciate it. Pass it on.

Operator: Thank you. And we will move next to Chris Snyder with Morgan Stanley. Please go ahead.

Christopher M. Snyder
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. I wanted to follow up on some of the HCS margin discussion. I guess if we adjust out $25 million from Q2 operating profit, it seems like it takes that 23.7% to like a 21.0%. So maybe just like, is that right? And then it seems like almost every year segment margins decline sequentially into both Q3 and Q4. And I guess the question is, like, should we be running sequential declines off that 21% number? I couldn't really follow all of the communication before. Thank you.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. Let me start by that saying, we wanted to give you the tariff refund number for the sake of transparency and that's how we are as a company. I don't think it's fair to exclude the tariff refunds as one time because remember, our overall impact of tariff, pricing, all of that continues in the second half. A lot of our pricing actions are going into effect in beginning of Q3. So while we gave you the numbers for sake of transparency, I don't think it's fair to take it out fully, because pricing would have offset portions of that if it hadn't come through. The margins in Q2, Q3, yes, there's a – Q2 is typically a highest margin, but I think today and this year is not the normal environment given lots of changes around pricing dynamics, tariff, inflation. Michael mentioned all those pieces. So I mean, we feel very comfortable for the full second half guide as we have given, but it's difficult to break it down between Q3 and Q4 at this stage for you guys.

Christopher M. Snyder
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. I appreciate that. And I wasn't really commenting on whether or not it's appropriate to leave it in the EPS. I was just kind of more trying to figure out what like the true underlying margin was in Q2 as we build into the back half. So is it fair to run the declines off of the 23.7% or the 21.0%? If that question makes sense.

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Yeah, I would focus more on just our guide points that we expect volume second half to be up low single digits. You get 35% incrementals on that price. Price cost neutral, more price coming in. I think that's what I would focus on the second half and that's what we're focused on delivering.

Christopher M. Snyder
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. I appreciate that. And then if I could also just follow up on the second half. It seems to me, like, you guys are calling for HCS revenue in Q3 just to be, I don't know, maybe mid to high single digits above Q2. So, is that right? And I guess, the question I have is, I think the only year where HCS, the revenue increased sequentially into Q3 was Q3 2024, which was of course the start of the refrigerant build. So I would just kind of want to make sure I have that sequential top line movement right on HCS. Thank you.

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

We don't give quarterly guidance. What I'll say is keep looking back to the second half that we expect Q3 year over year better than the Q2 year over year and Q4 year over year better than Q3. So we continue to see improve year over year as we go through the balance of the year with the volumes up low single digits balance of the year, mostly around the indirect channel.

Christopher M. Snyder
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Operator: Thank you. And we'll move next to Nicole DeBlase with Deutsche Bank. Please go ahead.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, thanks. Good morning, guys.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Hello. I guess, I just have a few nitpicky ones since we've been through a lot in Q&A already. I guess first, under-absorption, I feel like you guys were kind of implying that you had seen most of that headwind in the first half, but that maybe there could be a little bit in the second half. Can you just give us a sense if under-absorption is still a headwind in the second half?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Yeah, there's a small headwind within the guide now. We reduced some of that cost productivity for that additional absorption, mostly related to now that we have lower sales volumes, we still want to hit our inventory reduction targets within the free cash flow. So a little bit of absorption headwind went into the second half in our new guidance.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Understood. Thanks, Michael. And then BCS, the incrementals here have obviously been pretty good, high-20s in the first half. Are you guys expecting that high-20s to kind of continue in the second half within your guidance framework?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Overall, we continue to see volume growth there, get 35% incrementals. We're focused on price cost neutral within that side of the business as well.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. And we're very pleased with BCS performance. I mean the three businesses within BCS, the services business, the refrigeration business and the rooftop business, all continue to do very well. And that's particularly just a result of great execution and good supporting market dynamics. So we believe that...

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Got it.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

...like, we are now at the cusp of HCS reaching similar performance as we turn around the corner on market dynamics.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thanks, Alok. I'll pass it on.

Operator: Thank you. And we will move next to Nigel Coe with Wolfe. Please go ahead.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Yeah. Thanks. Good morning, everyone. Look it definitely bears mentioning BCS was fantastic, but understandably, there's a lot of focus here on HCS. I just want to make sure I understand the moving pieces on the guide change for HCS. The plus 1% now includes the acquisition of Heat Controller. So did I hear right that's 2 points to HCS and now we have about 4 points M&A coming in there, so the core is down 3? Is that right?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

That's correct. So within the guide, yeah, you picked up 2 points within M&A for the HCS revenue guidance and then you lost 5 for volume. So you went from 4 points positive to 1 point positive.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. And there's a bit more M&A. Okay, great. And then, look, just taking a step back, you've had a very transparent strategy of high-grading the customer base, firing lower margin customers, pushing price. Where are we in that process? Are we more or less complete in that process at this point, or is there still some ways to go? And maybe, Mike, could you just maybe just clarify, is there any more IEEPA refunds in the second half guide? Thanks.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Sure. So let me take the first one. I would say we're nearly complete on the lower margin. And some of it was just driven by highly competitive RFP processes where we didn't want to go into negative margins. But at this stage, like, some of that volume went away faster than we thought. And our offsetting growth in the AOR side is coming through just a little slower than we expected. I think that's what you're seeing in Q2. It's like the perfect storm of, like, we lost the RNC business a little sooner, and the share gain in AOR was a little slower than we expected. But net-net, we feel good about where we are to protect our margins and make smart business choices so we don't fall victim of taping $100 bills to every unit that is being shipped out to some of these accounts. So we don't want to do that again. We have done that in the past. So we feel good about where we are. And I'll let Michael answer the IEEPA question.

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

So on the refunds, we recognized 100% of our expected refunds that we think we're entitled to within the quarter. And we've also received a lot of that cash flow already related to the gain on those refunds.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thank you.

Operator: Thank you. And we will move next to Deane Dray with RBC Capital Markets. Please go ahead.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Morning, Deane.

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.

A

Morning.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. Sorry to circle back on the walkaway business, but just would be really interested in hearing, Alok, did you change your return requirements this quarter in any way? And I would suspect not, but just maybe some color there in terms of how much of the price competition surprised you.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Yeah. No, we didn't change our return requirements, Deane. I think our return requirements have been pretty steady over the past 4 to 5 years. And yes, I was surprised by the price competition in the residential new construction. At the end of the day, our focus is going to remain on our valued replacement customers, our valued new construction customer where there's appreciation for the value that we provide versus the commodity type business. So I think we feel good about where we are. But we do understand there's short-term repercussions for that, and we are going to work through that and appropriately adjust our cost structure and our sales force accordingly.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good. That's helpful. And then it sounded like there was some good news on the emergency replacement business and the re-entry there. And have you gained share? Any update would be helpful.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Yes, we have definitely gained share. Within emergency replacement, our core contractor business in commercial, our residential dealers and working through distribution, all three have gained and we are pleased with the progress there. The new factory is doing very well. And the freed up capacity in Stuttgart is also helping us strengthen and gain share in the key account business. So we feel good about that strategy. And the results there are, as you can see in the P&L and otherwise, just working out as we expected, maybe slightly better than we expected.

Deane Dray
Analyst, RBC Capital Markets LLC
Q

Good to hear. Thank you.

Operator: Thank you. And we will move next to Brett Linzey with Mizuho. Please go ahead.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Hey. Good morning, all. Just a follow-up on the emergency replacement there. So you called it out as a growth driver. Sounds like you're taking some share. I guess from a margin perspective, historically, I know ER was above segment margins. Where are we in that ramp process? Is it accretive to segment margins now, or do you still need more scale and uptake in that business? And any thoughts on the future profitability there?

Michael Quenzer
Executive Vice President & Chief Financial Officer, Lennox International, Inc.
A

Yeah, overall, it's attractive business. The margins are in line with some of our large national account business. We like that business. And we have opportunities to continue to expand those margins as we work on our distribution excellence within the channel. So it's really a good business. And many years of growth opportunities still in front of us.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.
A

Yeah. And I don't remember it being better than the segment average, but we have always said it's kind of in line with segment averages.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Okay. No, that's helpful. And then on the tariff mitigation, sounds like you shifted some resources there which did delay some of the material cost reduction initiatives and led to that productivity cut. When do you think those deferred cost out initiatives resume? And are they volume dependent and that's really the driver of that or is it just timing and maybe there's an opportunity to recapture some of that $15 million here in the coming months and quarters?

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

It's mostly timing dependent. I mean, there's obviously a small element of volume, but it's mostly timing dependent as we move resources. I wish I could tell you that we can get all in 2027 and we will. If there are no more changes to the tariff and the tariff rules, the continuous evolution of tariff rules and tariff changes, and Mexico and Canada and just that's taken up a lot of our engineering and other resources to mitigate that. But assuming a stable thing, we get it all next year.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Okay. All makes sense. Thanks a lot. Best of luck.

Alok Maskara
Chief Executive Officer & Director, Lennox International, Inc.

A

Okay.

Operator: Thank you. Since there are no further questions, this will conclude Lennox's 2026 second quarter earnings call. You may disconnect your line.