Corrected Transcript

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Lennox Fourth Quarter Earnings Conference Call. All lines are currently in 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 would now like to turn the call over to Chelsey Pulcheon from Lennox Investor Relations. Chelsea, please go ahead.

Chelsey Pulcheon

Director-Investor Relations, Lennox International, Inc.

Thank you, Madison. Good morning, everyone, and thank you for joining us as we share our 2025 fourth quarter and full-year 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.

Please note that the results being presented today reflect the FIFO accounting method adopted by the company as of Q4 2025. The rationale and the financial impact of this change are summarized on slides 15 through 18 in the appendix. The earnings release, today's presentation, and the webcast archive 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, Chelsea. Good morning, everyone. I am pleased with how our team executed throughout 2025 especially given the level of disruption the industry faced. It was a year marked by regulatory changes, softer demand, and broad market headwinds, yet the team remained resilient and delivered solid results.

Most notably, we achieved full-year margins above 20% for the first time in our history. This meaningful milestone reflects the structural improvements we have made in our production capacity and operational efficiency. I'm grateful for the continued support of our dealers, distributors, and contractors whose partnership played an important role in helping us navigate such a difficult year. Their loyalty, along with our team's commitment to excellence, continues to create value for our shareholders.

Let's turn to slide 3 for an overview of our fourth quarter and full-year financials. Revenue was down 11% in the quarter due to weak residential and commercial end markets. The impact was further amplified by deeper channel destocking and soft residential new construction activity. Our segment margin was 17.7% in the quarter, driven by volume declines and expected absorption headwinds. Operating cash flow was $406 million. Adjusted earnings per share for the quarter was $4.45.

Full-year revenue was down 3%, driven by volume headwinds from destocking and softer end markets. However, the team still delivered a record 20.4% segment margin despite tariff impacts and other inflationary pressures. Operating cash flow was $758 million, down from last year due to temporarily inflated inventory levels. Overall, 2025 was a complex, and challenging year, and I'm proud of the team delivering $23.16 in adjusted earnings per share. This is 2% higher versus last year's comparable $22.70.

Now, let's turn to slide 4 for an overview of end market conditions. 2025 was an eventful year for the North American HVAC industry and Lennox. We safely and timely converted our product portfolio to meet the low GWP requirement. However, the industry volume for residential products declined significantly, primarily impacted by channel de-stocking. The situation was further complicated with a low dealer and consumer confidence and the lack of housing recovery.

On the commercial side, we fully ramped our emergency replacement growth initiative in several metro regions while the light commercial HVAC industry declined for 17 consecutive months by December 2025. We are cautiously optimistic that the industry backdrop is going to shift favorably in 2026 as one-step channel de-stocking is nearly complete, and two-step channel de-stocking is anticipated to be complete in the second quarter of this year.

In addition, unique challenges from 2025 such as canister shortages have been addressed, and we expect housing to improve given lower market interest rates. Our internal growth initiatives such as parts and services growth, commercial emergency replacement coverage, and ductless product penetration are also expected to accelerate our growth this year.

Now, let us turn to slide 5 to review our investments that support our strategy of delivering differentiated performance. Our confidence in the outlook is reinforced by the strategic investments made over the past several years. Since 2022, we have deployed an incremental $300 million to broaden our capability, streamline our operation, and strengthen our competitive position. These investments are now embedded in how we run the business and are reflected in our financial statements. At the same time, the benefits they unlock are only beginning to materialize and will continue to build as we move forward.

We focus first on elevating front-end excellence to create a more efficient and responsive operating model. As part of this effort, we have expanded and reorganized our sales team to ensure alignment around pricing and improve coordination across the organization. This approach gives our teams clearer priorities and strengthens the connection between how we engage with customers and how we generate profitable growth.

We also expanded our portfolio through joint ventures that increase our share of wallet and allow us to offer more comprehensive solutions to customers. In addition, our AI enabled tools and upgraded e-commerce platform are making it easier to do business with Lennox by improving how dealers quote, order, and receive support.

Operationally, we have made meaningful progress. Our expanded distribution facilities enable a hub-and-spoke network designed to improve speed, reliability, and fill rates. We enhanced this with new IT systems for warehouse and transport management that reinforced network productivity and efficiency.

On the manufacturing side, we doubled the square footage dedicated to our commercial operations, completed a major product redesign to meet regulatory requirements, and continued to advance our heat pump portfolio for long-term electrification trends.

Looking ahead, we will continue to invest strategically to support future growth. In 2026, we will add new customer training and engagement centers and build our digital tech stack to enhance customer experience. We will also invest in automation across our existing labs, build new test chambers to insource certification, and expand our engineering capabilities through new R&D centers. We anticipate these investments will carry attractive returns, expedite innovation, and improve customer support.

In summary, Lennox is positioned to respond with agility as demand recovers while continuing to accelerate growth and improve margins well into the future.

With that, I will turn it over to Michael to review our 2025 financial results and 2026 guidance.

Michael Quenzer

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

Thank you, Alok. Good morning, everyone. Please turn to slide 6. As Chelsea mentioned, we updated our 2024 September year-to-date results to reflect the change from LIFO to FIFO inventory accounting. The appendix includes quarterly adjustments for both 2024 and 2025. Overall, adopting FIFO increased our 2024 full-year EPS by approximately $0.12 and raised EPS for the first three quarters of 2025 by approximately $0.55. Full-year 2025 EPS impact was approximately $1.

We have also included a page in the appendix outlining the rationale for this change which is driven by three key benefits. First, FIFO simplifies our accounting processes by eliminating the need to track detailed inventory layers. Second, it aligns cost increases more closely with the timing of price realization. Third, FIFO is the predominant method used by industry peers and better reflects the physical flow of goods.

Moving to our quarterly results. Overall performance can be attributed to ongoing destocking, softer-than-expected residential end markets, along with better cost productivity in response to inflation. We continued to execute well on price, cost and expense management. This helped [Technical Difficulty] (00:10:27) EBIT declined 16% despite a 23% decrease in [Technical Difficulty] (00:10:33).

Turning to slide 7 [Technical Difficulty] (00:10:35-00:11:23). Disciplined actions resulting in the $19 million SG&A reduction partially offset the higher product cost.

Please turn to slide 8 for an overview of the Building Climate Solutions segment. BCS delivered another strong quarter with organic sales growth in down markets and continued margin expansion. Revenue grew 8%, as favorable mix and pricing actions offset lower organic sales volumes. The completed acquisition contributed approximately 7% revenue growth.

Light commercial industry shipments remained below normal levels, but strong execution in emergency replacement and national accounts limited organic volume declines to mid-single digits. Like HCS, product cost headwinds reflected absorption and pressure and the timing of inflation expense recognition under FIFO.

With that, let's move to slide 9 to review the full-year performance for Lennox. Overall, 2025 was a challenging year from an end market standpoint with channel destocking, R-454B canister shortages slowing new system adoption and tariff-driven inflation. Despite these headwinds, we executed well. We expanded profit margins to a record 20.4% and delivered more than $75 million in cost productivity while continuing to invest in long-term growth.

Please turn to slide 10 for cash flow and capital deployment. Free cash flow for 2025 was $640 million, above our prior guidance of $550 million. The team's focus on strong collections and disciplined payments helped partially offset temporary elevated inventory levels. FIFO inventory levels increased by $300 million compared to December 2024 partially to support key growth initiatives in commercial emergency replacement, Samsung ductless products and improved equipment fulfillment.

We also have about $200 million more inventory than seasonally typical, which will remain slightly elevated in the first quarter, but is aligned to meet second quarter peak demand. This inventory management strategy will create some additional absorption headwinds in the first quarter, but minimizes the disruption on our factory employees and suppliers.

During 2025, we repurchased $482 million of shares and deployed $545 million on bolt-on acquisitions and joint venture investments, all supported by a strong balance sheet that continued to enable repurchases, disciplined M&A and healthy leverage profile. Alongside these actions, we also invested $120 million in capital expenditures during 2025 to advance key strategic priorities.

Looking ahead to 2026, we plan to invest $250 million in capital expenditures, targeting strong return opportunities across innovation and training centers, digital technology, distribution network optimization, ERP modernization and AI tools.

Please turn to slide 7 (sic) [slide 11] as I review our 2026 guidance. We are initiating our full-year 2026 guidance, which reflects stabilizing end markets, normalized channel inventories and contributions from recent acquisitions and joint venture investments.

For revenue, we expect total company growth of 6% to 7%. Organic volumes are expected to be down low-single digits net of approximately 1 point of growth from initiatives across parts and accessories, commercial emergency replacement as well as Samsung ductless inducted heat pump products.

Sales volumes in the first half, especially the first quarter, is expected to be down more than the full year decline, followed by growth in the second half. Combined price and mix are expected to contribute mid-single-digit growth, driven by our 2026 price increase and carryover benefit from 2025 regulatory mix. M&A is expected to contribute mid-single-digit revenue growth, reflecting the full-year benefit of recent acquisitions and joint ventures.

At the segment level, we expect approximately 2% growth in HCS, reflecting down but improving end markets and a low-single-digit contribution from M&A. For BCS, we expect approximately 15% growth, supported by industry shipments returning to growth, strong emergency replacement and national account performance and a high-single-digit contribution from M&A.

On costs, inflation is expected to be up approximately 2.5%, reflecting tariff carryovers and moderating price-cost pressure. We plan to invest approximately $35 million in additional operating expenses to enhance our customer experience, ERP upgrades for recent acquisitions and continued expansion of our training and innovation centers. M&A-related amortization is expected to increase by approximately $15 million.

Productivity and cost actions are expected to deliver approximately $75 million in savings, driven by material and factory initiatives, distribution network efficiencies and SG&A productivity. Interest expense is expected to be approximately $65 million, reflecting the impact of our M&A activity and share repurchases. We expect a tax rate of roughly 20%.

Based on these assumptions, we expect adjusted EPS of $23.50 to $25. Free cash flow is expected to be between $750 million and $850 million, driven by inventory normalization and higher profitability. Overall, we are cautiously optimistic for 2026 as we expect to return to revenue growth and build on our momentum to deliver our fourth consecutive year of EBIT margin expansion.

With that, please turn to slide 12 and I'll hand it back to Alok.

Alok Maskara

Chief Executive Officer & Director, Lennox International, Inc.

Thanks, Michael. I want to highlight the progress we have made on our self-help transformation plan, which is now entering its final phase. From 2022 through 2024, the team focused on stabilization and consistent execution. During that period, we reinforced pricing discipline, restored commercial margin and built the organizational and operational foundation for sustainable growth.

In 2025, our priority shifted to diversifying the portfolio and strengthening our market position. The Samsung and Ariston joint ventures, along with Duro Dyne and Supco acquisition, broadened our product offering and will increase our share of wallet.

The new commercial manufacturing capacity improved product availability, especially for the emergency replacement market. By addressing constraints at our existing Stuttgart factory, we also created opportunity to grow our commercial and national account business.

Beginning in 2026, we move into the expansion phase of our self-help transformation plan. This stage focuses on scaling our footprint, broadening our product portfolio, and extending our reach across residential and commercial end markets. It includes adding training centers, customer experience centers, and new distribution capabilities.

From an innovation perspective, we will invest in testing and certification labs, digital and AI solutions, and a healthy pipeline of new products. We remain on track to deliver on our most recent long-term commitment, and we will share updated long-term target at the 2026 Lennox Investor Day on March 4, where we will also provide deeper visibility into our strategic growth initiatives.

Now, let's turn to slide 13 for why I believe Lennox [indiscernible] (00:19:21) the industry. Lennox remains a highly attractive long-term investment. Our markets benefit from strong replacement fundamentals, and we operate with a direct-to-dealer model that differentiates our customer experience. Our margin profile is resilient, driven by disciplined pricing, operational excellence, and a portfolio aligned to the evolving needs of contractors and consumers. These trends are reinforced by a high-performing culture centered on advanced technology and execution which positions us well as we embark on the next phase of our strategy.

I'm confident in our strategic direction and remain committed to delivering sustained value for our customers, employees, and shareholders. I believe that we are building meaningful momentum and that our best days are still ahead.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Thank you. Our first question comes from Ryan Merkel with William Blair. Please go ahead. Your line is now open.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Hey, everyone. Thanks for the questions. I wanted to start with HCS revenue in the fourth quarter, down 21%. It was a little worse than I was thinking and clearly, it was hard to call. So, two questions. First, how did HCS trend through the quarter? My feeling is November and December were maybe a little worse in October. And then secondly, where was the surprise? Was it more the one-step or the two-step?

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

A

Sure. Ryan, great to speak with you. Thanks for your question. Yes, November and December were worse than where October was trending. So, I think that's a fair assumption. I think the surprise for us was more on the residential new construction site, which I think performed worse than we expected. But I think the one-step channel and two-step channel behaved similarly, both undergoing destocking. So while the two-step impact was more, that was expected, but I think they both went through destocking in Q4 that was more than we expected.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Got it. Okay. That's helpful. And then slide 4 is really helpful. Thanks for that. A few tailwinds into 2026. But, Alok, can you square those tailwinds with the guide for HCS up 2% because it implies volumes are down maybe 3% plus. I don't know if there's M&A in there, but just square that up for us, how you're thinking about that.

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

A

Sure, I'll take that. So yeah, within the HCS guide, we have about a mid-single digit decline in volume for the full year, down more in the first half as we're going to see continued destocking into the first quarter, specifically on the two-step channel, a little bit on the one-step. But as we get into late Q2 into Q3 and into Q4, that's when we start to see growth that will kind of normalize us and be a positive inflection in the second half of the year, but first quarter will drag down on the full year.

Ryan Merkel
Analyst, William Blair & Co. LLC

Q

Got it. All right. Thank you. Pass it on.

Operator: Thank you. We'll move on to Amit Mehrotra with UBS. Please go ahead. Your line is now open.

Amit Mehrotra
Analyst, UBS Securities LLC

Q

Thanks. Good morning, everybody. Hope you're all well. I wanted to ask about inventory levels. And obviously, they're up a lot year-over-year in dollar terms. I'm just trying to understand when you expect those to normalize and maybe you can talk about it from the perspective of both one-step and two-step.

Michael Quenzer A

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

Yeah. I mentioned that in the script that we have about $200 million more than seasonally normal at this point. We have another $100 million in there for just investments to get better experience with our customers. Within that $200 million, you'll see some continue to go down a little bit in the first quarter. But we also need to make sure that we have the right level as we hit the summer season in the second quarter. And right now, those inventory levels in December approximately align with what we'll need in the summer season.

So, a little bit of work to do in the first quarter to ramp factories down and get some absorption. But overall, we think we're going to be in a really good spot in the second quarter without having to do a ton of disruption on our factory by ramping it down significantly and then ramping it back up. We found that this is the best approach to mitigate some of these destocking industry issues that we're fighting through.

Alok Maskara A

Chief Executive Officer & Director, Lennox International, Inc.

And, Amit, if I could just add to that, first of all, welcome to the Lennox coverage universe. Great to have you on the call. Amit, your question was answered by Michael on our inventory levels. With channel perspective, Michael also mentioned we think one-step is completing the destocking and largely done in Q1, and two-step destocking will be done by Q2. So, that kind of inventory outside our four walls.

Amit Mehrotra Q

Analyst, UBS Securities LLC

Yeah, makes sense. Thank you. And then just as a follow-up, I know price/mix is guided up to mid-single digits this year. I'd be curious if you can just give a little bit of sense of how much of that is kind of the carryover effect and how much of that is prospective increases. Obviously, you make regular price increases this year. Just trying to understand the bifurcation between those two, would be helpful. Thank you.

Michael Quenzer A

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

Yeah. Little bit of a carryover in the first half, specifically on the mix benefit, a point-ish, maybe close to 2 points in the first half of the carryover mix, and then the rest is new price initiatives that we're going to start to launch into this quarter and into Q2.

Amit Mehrotra Q

Analyst, UBS Securities LLC

Okay. Thank you very much.

Operator: Thank you. We'll now move on to Joe Ritchie with Goldman Sachs. Please go ahead. Your line is open.

Joe Ritchie Q

Analyst, Goldman Sachs & Co. LLC

Hey, guys. Good morning. Can we just maybe just talk a little bit about seasonality and cadence of EPS and how to think about the first quarter just given all of the moving parts? Just any guidance that you can give us around 1Q would be helpful.

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

A

Sure. Obviously, it's been quite cold recently, Joe. So, that may impact a few things. But in general, remember, on the HCS side, we're going to be facing pretty tough comps. There was a lot of stocking up going on as some of the 454 items had just been launched, but people are still buying 410A.

On the BCS side, we had a tough quarter with our own production move and some other key account challenges. But net-net, we would expect Q1 to be down. We would expect first half to be down and second half to be up overall. But, yeah, we don't expect a great first quarter right now.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. Thank you, Alok. And then just going back to your assumptions for resi volumes this year, I think you said that you had it down mid-single digits for the full year, down more in the first half. I guess as you're kind of thinking through like the swing factors as you progress through the year, like maybe just talk through some of your key assumptions on the mid-single digit number as you progress through 2026?

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

A

Sure. I mean, I think obviously like we got more than 11 months still to go. But from where we are, we're going to be closely watching consumer confidence which remains uncertain, interest rates in housing, both existing home sales and new home sales is something we'll be closely watching. We'll obviously be closely watching our dealer confidence as well which was shaken last year by the transition and the lack of – canister shortage, which I think is improving. So, they're clearly outlined on page 4. Those are the key things we'll be watching for.

From our perspective, Q4 and Q3 were significantly impacted by destocking, and we remain fairly confident that that's going to be behind us in the second half. So, that's probably shaping our overall view. The largest factor on 2025 performance was destocking. And the fact that it's going to be behind us, that's going to help us get to a better number this year.

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

A

And, Joe, I'll just add to that. I mean, we'll watch the seasonal demand. I mean, if it turns into a hot summer early and there's a lot of replenishment of inventory that happens, that could happen very quickly, and we're at a really good position for that. So, I think that's one thing we'll start to watch as the season play out as we get into March and April as well.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you, guys.

Operator: Thank you. We'll now move on to Tommy Moll with Stephens. Your line is now open.

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

Good morning, Tommy.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Alok, on pricing last quarter, this is specifically to resi, if I recall correctly. Last quarter, there was conversation about maybe a mid-single-digit increase in [indiscernible] (00:28:49), something in the low-single digits range. Is that still a reasonable bogey to use for this year?

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

A

Yeah, I think for a new pricing, that's still a reasonable bogey. And then Michael mentioned, there's a carryover effect, right? So while we can't be too precise, I mean, I look at a mid-single digit as a combination of new pricing, which we have announced already across the entire business portfolio, and then carryover. Remember last year, we talked about the mix was going to be roughly 40% 410A, 60% 454B. So that 40% 410A is gone, and it's all going to be 454B. So, I think the price/mix lift from last year used to be overall number of mid-single digits that we have put in our guide.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Great. Thank you. And then looking on resi here for volumes and even more specific on the one-step, it sounds like destocking is nearly entirely in the rearview mirror here. So, in the outlook you've provided for resi volumes, would one-step be implied up for the full year or you still assuming, even without destocking headwinds, that there may be some additional headwinds? Thank you.

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

A

I would say – listen, I mean, 70% of our business is one-step. So, I think the way we would look at it, one-step is going to be flattish to maybe slightly up. Two-step is going to be down. So, I think that's as much precision as we have in our forecast at this stage. But, yeah, one-step will do better than two-step, especially given that two-step would be going through destocking until second quarter.

Now at the same time, if something changes and Michael said if we land in a early start and hot start to summer, then two-step might come back and start holding more normal level inventory. But current assumption is exactly what you said.

Thomas Allen Moll
Analyst, Stephens, Inc.

Q

Okay. All right. Great. Thank you. I appreciate the insight, and I'll turn it back.

Operator: Thank you. We'll now move on to Jeff Hammond with KeyBanc Capital Markets. Your line is now open.

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

Q

Hey. Good morning.

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

A

Hi, Jeff.

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

Q

Can you hear me?

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

A

Yeah.

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

Q

Maybe just starting with BCS, the 15% growth, if you could unpack similarly like you did for the res business, price, volumes, M&A in there. And then just maybe I think you were saying that you thought that would maybe start to turn and what you're seeing, just remind me, on the commercial unitary business?

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

A

I'll give some guide points within that. So, we expect within the 15% high-single digit growth from the acquisition, most of that M&A kind of lean toward the segment with the Duro Dyne business. From a volume perspective, we expect up mid-single digits with recovery in end markets and share gains. And then price/mix combined are going to be kind of more in the low-single digits on that side of the business.

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

A

Yeah. And I think from what we are seeing in the market, and I mean, we've gone through 17 straight months of decline as per the AHRI data by December, so I think just comps get better, and we are seeing good uptake in quotations and good uptake in the backlog as well. So while it's not boom years, I think it's going to become less of a barrier as we go into 2026.

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

Q

Okay. And then just on the repair/replace dynamic, how are you building that into your path? As you talk to more of your contractors, the view that the consumers' tightness persists or it was mostly a canister issue and it kind of goes away?

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

A

Sure. I mean, first of all, we look at that dynamic more as deferred replacement because anything that you repair will come back for replacement typically in 12 to 24 months. So, I think that's the way we would look at it.

When we speak to our contractors, we find that the dealer confidence on the new product, the dealer confidence on upselling to a replacement, the dealer confidence because of canister shortage was a large part of the impact. Clearly, there's consumer sentiment there as well.

Now, the fact that the dealer sentiment has turned to more positive going into the year makes us a little bit more favorably inclined towards that trend this. But so far, like what we have assumed is it's not going to get any worse. We haven't assumed that's going to get better either. So, we think it'll remain at the 2025 level, which had heightened repair versus replace.

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

Q

Okay. Appreciate the color.

Operator: Thank you. We'll now move on to Noah Kaye with Oppenheimer. Your line is now open.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Good morning and thanks for taking the questions. I think, Michael, you mentioned a couple of times the absorption factor for 1Q. Can you expand on that and would that lead decrement on volumes in 1Q to be kind of worse than the typical 30-ish percent decline?

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

A

I think we have some cost actions that we're trying to mitigate within it. You saw we did some really good SG&A cost productivity in the fourth quarter. Some of that's going to repeat into the first quarter. A lot of material cost reduction programs are on tariff mitigation and other things are going to soften it. But Q1 is kind of a light quarter from a volume perspective.

So, if you think about $10 million to $15 million of absorption, that can have a pretty big impact within the decremental. But we think as you get through Q1, that absorption goes away and we get back into cost productivity across factory, materials and our distribution network, but little headwind as we get the inventory to the right spot for Q2.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay. That's helpful. And then, I believe I heard you say the CapEx number would be $250 million for the year?

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

A

Correct. Yes. It's normally about $150 million of just normal recurring CapEx and then we have $150 million of specific strategic innovations that we're doing and a good proven track record of ROIs and organic investments.

So, I think we have a good pipeline of these projects that have really strong ROIs for the next several years and going to keep investing in them and it's about the customer experience and that's where we're focused on, both digital and our physical distribution network.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Yeah. Yeah. I think the second part of the question was just to ask whether we should view those growth organic investments in CapEx as something more permanent or should we think about kind of future reversion more towards the typical maintenance CapEx range?

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

A

No, I would not think of it as permanent. I think our maintenance/regular CapEx remains in the $125 million range, $125 million to $150 million. Three years earlier, we had called out Saltillo investment and we had said if there are any other big investments, we'll call it out. So now, we're just calling out that we're going to be spending like additional $100 million or so. And those are really good projects.

Many of these projects are deferred because all our engineering and other resources were tied with A2L. But no, I would say, after that, we go back to our usual maintenance type CapEx.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Very helpful. Thank you.

Operator: Thank you. We'll now move on to Chris Snyder with Morgan Stanley. Your line is now open.

Chris Snyder
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. I wanted to follow up on company inventory and the associated absorption headwinds that come from that. It seemed to me that inventory was kind of flattish quarter-on-quarter into Q4 when normally it would step down maybe to like the mid-single digit level. So, I guess, has there not been any destocking yet? And maybe that's the first part of the question.

And then the second part is, why do the absorption headwinds end after Q1? It seems like this $200 million excess inventory will be sold into peak summer demand. But I would think that that means underproduction up in those summer months and I would expect that – I would have thought that the absorption headwind comes through on a lag as it flows off the balance sheet into the P&L. Thank you.

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

A

Sure. Chris, on the inventory piece, yes, we did ramp down production. But as you saw, our sales came in much lower than expected in Q4. So, that's why the inventory didn't go down meaningfully. It did go down slightly. So, now, we have to ramp like production even more and which we did towards the end of the quarter.

On the second question on absorption, Q1 will have the largest impact, because this is the time to start ramping up for selling product into Q2. So now, the manufacturing for sales into Q2 [indiscernible] (00:38:03) happening in

Q1, just given the lead time from when the product is manufactured to when it's sold. Hence, we called it out. There will be some impact of the absorption in Q2, but most of it will be in Q1.

Chris Snyder
Analyst, Morgan Stanley & Co. LLC
Q

Thank you, I appreciate that. And then, maybe just following up on the cost inflation, the 2.5% came in below what I was expecting, just kind of based on some of the tariff wrap and then the metal inflation – and other cost inflation we're seeing in the market. So, can you maybe just kind of help us unpack that number? How much is tariff wrap? How much is new cost inflation? And I think it seems like there's maybe some offsets there in mitigation that's perhaps keeping that number a little bit lower than we would have thought. Thank you.

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

Yeah. That's a correct interpretation of the guide. So, right now, what we apply is the 2.5% to our total cost. So, it'd be manufacturing costs, distribution costs and SG&A costs. Not all are going up the same. We are seeing a little bit more inflation on the commodity side, but we also have hedging programs that delay some of that cost increase. And we've significantly moved away from copper and have more of an aluminum product. So, that's softening at least from the metals perspective why it's not as heavy within the guide.

Tariffs, there will be kind of some wrap-around impact of tariffs. It's about $125 million full-year 2025. We'll have a little bit of carryover in the first half of that, assuming the tariff structure stays the same, which is what we've built within the guide. But overall, we assume that inflation and then we're going to drive productivity and investment actions against that inflation number.

Chris Snyder
Analyst, Morgan Stanley & Co. LLC
Q

Thank you.

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

Yeah. If I could just add to that, we have significant cost reduction that went into effect in 2025. We have 1,000 less employees than we had before we went into the cost reduction spree and we are not going to bring all of that costs back. Some of the benefit that you see is, from our perspective, the productivity aspect of it, both on materials, manufacturing and SG&A, is something that we have baked in going forward.

Chris Snyder
Analyst, Morgan Stanley & Co. LLC
Q

Thank you. I really appreciate all that color.

Operator: Thank you. We'll now move on to Julian Mitchell with Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Hi. Good morning. Maybe just wanted to start with overall operating margins. I don't think that's been fleshed out too much yet. But just wonder is it fair to say the full-year guide is embedding operating margins down slightly maybe year-on-year? And then, you've got between the segments, anything you'd flesh out, perhaps BCS up for the year and anything you could help us around kind of first half versus second half year-on-year the margin front, please.

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

Yeah. So overall, the guide implies EBIT, ROS expansion of about 20 basis points. I mentioned that in the script. We're looking at the fourth consecutive year in a row of margin expansion. Within BCS, it's going to be up more. Within HCS, it's going to be flat to slightly down as the end markets there are down, so that volume leverage within BCS, you'll start to really see that within their margin expansion.

Within the seasonality, I will talk a little bit about that. But when you look at 2025, the seasonality first half to second half, from a revenue perspective, was about 50/50. As we think about next year or 2026, it'll be 3 or 4 points less than 50% in the first half, 3% or 4% higher in the second half. Normal incrementals on the volume that we talked about, 35% on the decrement – incremental plus the cost inflation and productivity initiatives. So overall, a little bit more headwind in the first half, but the margin expansion will definitely start to show in the second half.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

That's helpful. Thank you. And just wondered kind of any perspectives on the market in HCS. Maybe last year, the market was, I don't know, 7.3 million, 7.4 million units, and the sellout just under 8 million. Just wondered your thoughts around how we're thinking about those very big moving parts for 2026 and what degree of repair normalization you're expecting this year in the industry?

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

Yeah. Julian, we get in trouble every time we try and predict the number of units in the market, and I know you guys have pretty sophisticated models just like we do. I think from our perspective, [indiscernible] (00:42:49) has been that the sell-in number was heavily impacted by destocking, and the end of destocking would lead to automatic improvements.

Our assumption is that the repair versus replace activity is stabilized going forward. So, we're not expecting it to turn back, but we are expecting it to stabilize at least going forward. So, net-net, I mean, on a sell-in basis, you will see higher numbers than where we ended the year, as you said, 7.3 million, 7.4 million. And on a sellout basis, I mean, those numbers are really not that reliable. So, we focus less on that.

What we have seen in our own one-step channel is that the confidence of dealer has come back, and people are now looking at 2026 as a fresh start with R-454B. That's probably the best news out there, Julian, given all the other potential headwinds, including consumer confidence and numbers that don't seem to be improving, including yesterday's number where consumer confidence was very, very low.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

That's great. Thank you.

Operator: Thank you. We'll now move on to Jeffrey Sprague with Vertical Research. Your line is now open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Hey. Thank you. Good morning, everyone. Hey, look, maybe just coming back to the – a piece of that last point. Just on repair versus replace stabilizing, that is sort of a thesis at this point or do you think there's actual evidence of that?

And I guess maybe aligned to that point is within the mix, any evidence that people are trying to mix lower? Obviously, you got the mix carryover on the refrigerant coming through, and I guess it's getting harder to mix lower as all the SEER levels have continued to move up. But is there any evidence of just consumer distrust on what kind of units they're buying and whether it's a replacement or a repair?

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

Yeah. So the first one, it's supported by our own research and data now. We don't have regular data on all the dealers, but we do serve quite a few of the dealers and have a direct conversation with them. Is it statistically relevant? I mean, that goes down to a [indiscernible] (00:45:12) road that I won't go to. But I'd say it's more than just a hypothesis. It's definitely something that we have vetted out and it's stabilizing.

On the second part on mix, I mean, remember, 70% of the sales are now to the lowest SEER as the minimum SEER has gone up. Are there trade downs that are happening? Yes. Are they going to be meaningful impact to us? Unlikely given that 70% of it is already the minimum SEER numbers. Now, it comes down to single stage, variable speed, and some of those things that we are continuously looking to refine and put forward. But you will see overall that, from our perspective, the mix will improve because for 454B [audio gap] (00:45:54) versus 410A. There's a carryover effect coming forward.

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

And, Jeff, I'll just add on the repair side, we expect the input costs there to be up significantly more than systems starting this year and into the next few years. The R-410A gas is going to be up. The cost of the technician complexity is going to be – continue to go up. So, we expect that equation within the repair versus replace to lean more toward system replace over the next year to two as well.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Yeah. No, understood. And then maybe just on capital deployment. Obviously, you became a bit more active on the M&A side here. Is there an active pipeline? Should we anticipate more in 2026? What are your thoughts there?

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

Yeah. We maintain a pipeline. We obviously have to digest what we bought and make sure the integration goes well. But bolt-on acquisition, as per our consistent strategy, remains the focus. I would say, over the next couple of years, you should expect more. Can't be definite about anything in this year but the size of what we've bought is something we like. So, I think we will look at similar size, maybe slightly smaller acquisitions in the pipeline.

And our focus will remain on things that we can ensure two plus two is going to be greater than four. So, like things that we can apply our stores network, things that way we can apply our national account team, and that's where we're very happy with the Duro Dyne and Supco acquisition because it's a net add to us and there's significant room for improvement on the margin side as well.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Okay. Great. Thanks. I'll leave it there.

Operator: Thank you. We'll now move on to Nicole DeBlase with Deutsche Bank. Your line is now open.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Thanks. Good morning, guys.

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

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Just to circle back on the question about quarterly cadence, I think, Michael, you answered that with respect to revenue. When we think about that one-half to two-half split, Is that kind of reflected in EPS as well or is it may be a bit more pronounced because of the underabsorption in the first quarter?

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

A

Definitely into the first quarter, you'll start to see that. But there's also going to be some more cost productivity as we get into the second quarter to mitigate some of that absorption. So, first quarter is going to be tougher. But I think from a revenue perspective, that's the main thing that drives the margins at 35% decrementals and then offset with some productivity and/or absorption. That's the main driver of [indiscernible] (00:48:29) margins.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Understood. And then just coming back on price as well, when you guys kind of look out over the competitive landscape, we've heard some noise around maybe some price competitiveness, particularly in the new construction channel recently. I guess, what are you guys seeing out there in the market and do you think that your competitors are kind of aiming for a similar level of price increase for 2026 as you are? Thank you.

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

A

Yeah. Based on everything we have seen so far, yes, we see our competitors are aiming at similar price increases. So, not surprised. Yeah, we have seen some of the low-end RNC business get more competitive, and we talked about that earlier. We've chosen some of those not to go down that path and instead focus on our core dealer network and get the right kind of customer experience there. But nothing is surprising and nor is there any major deviation from the path. If I believe on one sales person in one small territory, they will tell me that they are facing significant price competition. That's probably true for all our competitive scenario. But if you look at broad base across US full basis, industry remains very disciplined, industry remains very focused, and we compete on technology, we compete on availability and service, and that's how we compete.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks a lot. I'll pass it on.

Operator: Thank you. We'll now move next to Joe O'Dea with Wells Fargo. Your line is now open.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Can you elaborate a little bit on the price/mix trends in HCS over the past few quarters? I think we saw that step down a small amount from Q2 to Q3. Q4 was a few hundred bps below the Q2 level on similar comps, and so just in terms of what you're seeing on the price side or the mix side that's been contributing to that.

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

A

Yeah. Joe, it did step down a little bit in the fourth quarter versus the third quarter. It's mostly related, just the bigger decline in condenser sales where we saw the bigger mix lift up. So, we had a bigger proportion of furnace and parts and accessories and things that didn't have that same big mix lift up in the fourth quarter, the same proportion as the third quarter. That's the main driver. Besides that, price/mix continues to stick within each product channel.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Makes sense. Thank you. And then, can you just talk about like what you're doing with your dealers to help kind of position them for posturing toward more selling of replace over repair, understanding that last year and kind of the introduction of a new refrigerant had its challenges along with canisters, but just entry-level economics and what the message is, as well as any color on what is an entry-level cost today versus what it was five years ago because I think that's something that seems like face value, it's a – there's a little bit of shock value with it, but how the economics are compelling on sort of the replace versus repair side and what your messaging or helping on the marketing side with dealers?

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

A

Sure. I'll start by saying our contractors and dealers are naturally inclined to focus on replacement versus repair because, A, it's higher margin to them; and B, they are of the clear understanding that repairing is just deferring replacement, and they try and communicate that to their own consumers and make sure that they make the smart choices.

Remember, repairs are hard to finance than replacements. We help them with financing. We help our dealers with training. We help them with the sales collateral and material and run appropriate promotions with them, especially when it comes to financing and rebates to incentivize replacement versus repair. We clearly didn't do a lot of that last year given the transition, and I think they are back to that mode now that the dealers have good confidence on it.

On a price perspective, compared to sort of pre-COVID level up to now, the price from manufacturer to the contractor or the channel has definitely gone up, but the price from the channel to the consumer has gone up even more. Some of it reflects the higher labor cost as the skilled labor shortage persists and grows across US. Some of it also reflects the fact that consumers were not getting as many [ph] quotes (00:53:14) and we see now consumers are getting many more [ph] quotes (00:53:17) and that's coming more back to normal. So, I see any price pressure is going to play out for between the consumer and the channel versus the channel and the manufacturer.

And then finally, as we look at this going forward, what I started by saying holds true is any repair is simply deferred replacement. So, a lot of things that were patched up and then repaired last year may come back again for replacement this year, if not definitely next year. So, we feel very good about the long-term trend despite some short-term disconnect that we all saw last year.

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

And, Joe, I'll just add to that, we expect – or we believe the expectation that electricity costs are going to continue to increase. There's a potential monthly savings in utility bills that homeowners can get with the new system. The minimum system efficiently has increased significantly over the last few years and there's a lot of cost savings that a homeowner can get with the new system now as well.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC Q

Helpful details. Thank you.

Operator: Thank you. We'll now move on to Steve Tusa with JPMorgan. You're line is now open.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC Q

Hey, guys. Good morning. Thanks for all the details as usual.

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

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC Q

Just on these other items from slide 10 from the last quarter where you had growth in the value tier. I know Jeff touched on the repair versus replace, but the rationalization of low-margin RNC accounts, any change in those? I don't see them on the tailwinds, headwinds slide. Any change in those dynamics?

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

No, no change in those dynamics. And we talked about they are impacting Q4 already. So, I think that continues the move towards trade down we touched on the Q&A. But no, nothing changed. What we highlighted on slide 4 this time was out of comparison to what we think things are going to improve or be different in 2026, but those two factors remain the same, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay. And then, just lastly on this accounting change, how would that have kind of impacted the shape of the year? And I guess you guys hedge as well on copper, maybe a little more aluminum, like what kind of would we – what would we have seen and maybe when does that kind of recouple to wherever these commodities are moving?

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

A

Do you mean the 2026 year or 2025 year?

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yeah, 2026. I mean, you gave us the differences in 2025. So, just how would the shape of 2026 – I mean, it all normalizes in the end, right? But like, how would the shape of 2026 may have been a bit different?

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

A

Yeah. I think it leans to that absorption comment and make the first quarter where some of that's going to come into the first quarter of 2026, you're going to see some variations in the fourth quarter of 2026 go to 2027. Just that's the natural timing of FIFO versus LIFO. But net, kind of neutral impact for the change FIFO to LIFO in 2026.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thanks a lot.

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

A

Yeah.

Operator: Thank you. We'll now move on to Brett Linzey with Mizuho. Your line is now open.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Hey. Good morning, all. Just wanted to follow up on the repair/replace one more time here. Did you actually see positive parts growth in the fourth quarter? And then, are there any regional or efficiency level observations where the trade down might be more pronounced?

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

A

The answer to the second question is no. We don't see any specific regional differences that could – that going to drive repair versus replace or trade downs. On the first part, yeah, I mean, parts have been growing more than equipment in pretty much most of 2025. Now, you see that in the AHRI data. We also see it in our own data. So, yeah, I mean, we do have actual data to support the fact that parts grow more and we heard that from other conference calls in our distributors as well.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Got it. And then, just to follow up on NSI and the parts strategy, maybe an update on how NSI is now tracking organically [indiscernible] (00:57:33) in the organization. And then as you continue to build out that parts pull-through strategy and better throughput, how do we think about incrementals in the context of better branch flow and volumes going forward?

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

Sure. So, yeah, I think NSI acquisition overall, we remain very pleased with it. We only have sort of two months of data from last year, but I think the sales performance is as we expected. It is just like other parts business is growing. I mean, they obviously have some destocking impact, too.

Going forward, I think this year is obviously going to be focused on integration and we have expenses and all that associated with that. And Michael referred to that as part of some of our ERP conversion cost in there, but we would expect pull-through on NSI to be at or better than our overall margin levels going forward. And by 2027, I think it'll definitely be on the better side compared to our usual incrementals.

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

And I'll just add to that, yeah, we're really excited about the platform that that brings. It brings culture and experience on parts and accessories that we didn't have. We had about $500 million of legacy parts and accessories within our existing business and joining that with that existing parts and accessory business is going to help us really get that attachment rate into the 20% to 25% of our sales. Currently, it's only about 15% in the HCS segment. So, really excited about the opportunities that we have around that acquisition, helping our existing parts and accessories business as well.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Appreciate the details.

Operator: Thank you. We'll now move on to Nigel Coe with Wolfe Research. Your line is now open.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Thanks, guys. Good morning. We cut lot of ground, but I did want to go back to the two-step versus one-step for both the quarter and FY 2026. Obviously, we've got the AHRI data through to November. Looks like 4Q was trending down, I don't know, 40%, 45%. Is that what you saw in your two-step which would imply one-step down 20%, 25% in units? And then in 2026, look, you mentioned one-step up low-singles. Just want to make sure you're inferring that two-step is down probably mid, high-single digits?

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

Yeah. So, I think let me start with the Q4 numbers, right? I mean, obviously, December data is still to come. But, yeah, we saw similar behavior on the two-step and that gives you the right calculation to interpret what happened on the one-step for us in Q4.

And I'll let Michael answer the guide question.

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

A

Well, I was talking to the full-year revenues. If you break the volume down mid-single digits, slightly less down in indirect, that business will come back a little stronger. And then on the direct, we've got a little bit of headwind in there from RNC as well, just being weaker on that side of the channel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. But you still think you'll grow low-singles with the RNC headwind, is that fair or...

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

A

Correct. Yeah.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay.

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

A

Once you've taken it – that's with mix and price.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay, okay, that's with mix and price. Okay. Got it. Okay, understood. And then just a quick one on the $25 million of productivity in 2026. That's a big swing in the bridge. I think you've got some compensation benefits in 2025, which I'm assuming would impact that number as well. So, maybe just unpack the $25 million in a bit more detail. And maybe just if you could just clarify, I think this is Michael, the material productivity is in the 2.5% inflation number, and so the $75 million would not include that.

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

A

Right. Yeah. So, we start with basically cost inflation of 2.5%. And then from there, we drive productivity against it. So, we have $75 million of productivity against that overall inflation. It's really across several things. It's within the factory. We're going to finally start to leverage a lot of the productivity within the BCS factory. That's going to be fully up and running. And throughout the year, we're going to see distribution investments we've made on the efficiencies on our network.

You saw in the fourth quarter, we recognized a lot of SG&A cost actions. Alok talked about the head count reductions, that will carry into 2026, as well as technology and AI investments around systems that will help drive some of that cost productivity.

And then finally, it's about tariffs. We've seen a lot of tariff costs within 2025, and we now have to mitigate some of that. So, it's a new cost pool that we can drive productivity against. But we feel really focused on the productivity number and hope to exceed it.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Okay. Thank you.

Operator: Thank you. And we will move to our last question from Deane Dray with RBC Capital Markets. Your line is now open.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone. Thanks for fitting me in.

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

A

Good morning.

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

A

Morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, just a couple of quick ones for Michael. It looks like you all did a really good job at containing your decrementals [audio gap] (01:02:41) quarter. That benchmark to try to keep it in a down market to a decremental of 25% looks really well done. I just was curious. Are you managing to that number, or is this more of an outcome? Because it looks like you took out a lot of SG&A at the right time to hit that decremental. But just love to hear kind of behind the scenes how you're managing that.

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

A

Yeah, definitely. We managed two main things within that. First, it's the price cost equation to make sure we're positive on that. So, that helps in the decremental. And then two, as we saw end markets deteriorate in the second half of 2025, both BCS and HCS took some cost actions, and you start to see those in there to help mitigate the decrementals that we know are just temporary. And we believe that we've restructured the organization in a way that when the volumes come back into Q2, that we'll be able to drive strong incrementals at the 35% with the cost structure in place now.

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

A

Yeah. And I think, Deane, we have, every year, our strategic planning process. And during that, we have ABC [indiscernible] (01:03:47) terms that we would pull if markets go down. Last year was the year we had to pull all ABC and maybe some B items as well given how steep the volume decline was. So, it's not that we are managing to a number, we just have a strategy and a set of processes that we leverage to make sure that costs flow in line with our growth or revenue.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's really good to hear. And just a quick one on free cash flow, which was a real strong point in the quarter despite carrying more inventory...

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

A

[indiscernible] (01:04:19) you will say that, Deane. The whole thing was designed. I was telling Mike this morning, I hope Deane notices this.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Okay. Well, I noticed and just the idea, you carried more inventory, so that would have worked against you but looks like you really came through on the receivables side. Just were there any one-timers in there? Did you pull any – those receivables forward? Just some color there would be helpful because it was a really standout quarter in free cash flow.

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

A

I would give Michael full credit for it. I think he's done a really good job centralizing our AP/AR teams, consolidating accounting, moving things to shared services, and driving some really good processes, especially around collection and timely pay. So, there were a lot of process improvements. And you would see there's a good trend of us managing AP/AR, more disciplined fashion that we have done in the past. So, I wouldn't say there's any one-timers there.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Good to hear. Thank you.

Operator: Thank you. Thank you for joining us today. Since there are no further questions, this will conclude Lennox's 2025 fourth quarter conference call. You may disconnect your lines at this time.