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Johnson Controls International Plc (JCI)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. Welcome to Johnson Controls First Quarter 2021 Earnings Call. Your lines have been placed on listen-only until the question-and-answer session. [Operator Instructions] This conference is being recorded. [Operator Instructions]

I will now turn the call over to Antonella Franzen, Vice President and Chief Investor Relations and Communications Officer. Please stand by.

Antonella Franzen

Vice President & Chief Investor Relations and Communications Officer, Johnson Controls International Plc

Good morning, and thank you for joining our conference call to discuss Johnson Controls first quarter fiscal 2021 results. The press release and all related tables issued earlier this morning, as well as the conference call slide presentation can be found on the Investor Relations portion of our website at johnsoncontrols.com.

Joining me on the call today are Johnson Controls' Chairman and Chief Executive Officer, George Oliver; and our Chief Financial Officer, Olivier Leonetti. Before we begin, I would like to remind you that during the course of today's call, we will be providing forward-looking information. We ask that you review today's press release and read through the forward-looking cautionary informational statements that we've included there.

In addition, we will use certain non-GAAP measures in our discussions and we ask that you read through the sections of our press release that address the use of these items. In discussing our results during the call, references to adjusted earnings per share, EBITA and EBIT exclude restructuring and integration costs as well as other special items. These metrics, together with free cash flow, are non-GAAP measures and are reconciled in the schedules attached to our press release and in the Appendix to the presentation posted on our website. Additionally, all comparisons to the prior year are on a continuing ops basis.

Now, let me turn the call over to George.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Antonella, and good morning, everyone. Thank you for joining us on today's call. Hopefully, the new year is treating you well so far. I will start with a brief strategic update and summary of our Q1 results. Olivier will provide a more detailed review of those results and update you on our forward outlook, and we'll have plenty of time to take your questions.

Let's get started on slide 3. We were off to a strong start in the first quarter with solid financial performance and accelerating momentum on all of our strategic initiatives. As we will cover in a few minutes, top line performance was at the high end of the expectations we communicated to you last quarter which, together with impressive operational execution across all segments, enabled us to grow EBIT by 5% year-on-year despite continued volume pressure related to the ongoing pandemic.

Although the promise of a vaccine is sparking modest optimism in several of our end markets, many of which continue to show improving sequential demand, there are still many regions of the world facing second and third waves with varying degrees of lockdowns and restrictions. With that being the case, we have remained focused on the commitments we made to our employees, customers and suppliers.

Our teams have come together to achieve truly extraordinary things, improving the fundamentals of our businesses and executing our overall strategy. During the quarter, we were honored to receive recognition from several organizations. Additionally, you – as you may have seen in a separate press release issued earlier this morning, we announced an ambitious set of new ESG commitments, reinforcing sustainability as a top priority in our leadership role in climate change.

Lastly, we continue to gain traction on several of our core growth initiatives which we have been discussing with you over the last couple of quarters, scaling OpenBlue, driving higher service attachment rates and sales growth, and accelerating new product introductions.

Please turn to slide 4. There's been a tremendous amount of engagement at Johnson Controls over the last several months, both with our teams internally as well as with our customers and partners. In early December, we announced an exciting partnership agreement with Microsoft as part of our global collaboration to build a comprehensive digital twin platform that supports the entire ecosystem of a building.

OpenBlue Digital Twin technology is transforming how buildings are conceived, built and operated, enabling the creation of digital replicas of physical spaces, systems, processes and people. The next one on the page reflects the incredible efforts in leadership by countless individuals across various businesses and functions throughout the organization. I want to congratulate our colleagues across the company as it underscores the commitment to excellence we have been driving towards over the last few years.

Additionally, I am honored to have been selected to serve as the Chair of the Energy & Environment Committee on the Business Roundtable. I look forward to working with my colleagues into having an opportunity to influence the nation's policies toward addressing climate change, the most significant challenge facing the planet today.

On slide 5, I would like to highlight the ambitious set of new ESG commitments we announced this morning. Sustainability is at the center of our vision for a healthy world and is integrated into our culture and values. Now with our OpenBlue platform, the value creation we provide to our customers is directly linked to ESG.

In terms of our new environmental commitments, we are setting a goal through our science-based targets which enable us to achieve net zero carbon emissions before 2040, which is 10 years earlier than required by the UN Framework Convention on Climate Change's goal to cap global warming by 1.5 degrees Celsius by 2050. Additionally, we will direct 75% of our R&D investment on new product development to products and solutions that address climate needs.

On the social and governance side, we intend to double the representation of women and minorities in management roles by 2025. And finally, in terms of new commitments, beginning in fiscal 2021 we are including sustainability and diversity goals in senior leaders' performance assessments and linking those directly to executive compensation to ensure accountability.

Turning to slide 6 for an update on OpenBlue, the rollout of OpenBlue is going very well and we remain encouraged by the high level of engagement we are seeing with customers and partners. We launched seven new offerings this quarter, the most significant of which is OpenBlue Healthy Buildings, the industry's most comprehensive suite of connected solutions.

This particular launch leverages the strength of our core capabilities which, together with data-driven AI technologies enables our customers to transform how people interact with their buildings; create intelligent, safe, dynamic environments; achieve their own green building goals; and maximize return on investment with shorter paybacks.

By combining these solutions, we create a holistic menu of offerings that prevent customers from having to choose between efficiency and sustainability. We now have 27 offerings available that solve the unique customer problems and serve a new market opportunity, which we size at $10 billion to $15 billion and is growing at a double-digit CAGR over at least the next five years.

We are ideally positioned with technologies and solutions that accelerate the transformation and reinvention of Healthy Buildings, which is directly aligned with the priorities of the incoming US administration. Our pipeline continues to build, and momentum with key partners like Microsoft, Accenture and Salesforce is gaining steam.

Turning to service on slide 7, service is an incredibly attractive business that is showing momentum, with profitability that is 2 times the company average. We are fully deploying resources to enhance our service offerings and leveraging the power of OpenBlue to drive mid-single-digit-plus organic growth on an annual basis, improve attachment rates and revenue per user, as well as reduce attrition.

Turning to new products on slide 8, as most of you know, we have been engaged in a significant amount of reinvestment in new product development over the last several years. Our engineering and R&D efforts have been aimed at reinvigorating our core product portfolio, ensuring new technologies are connected and future-ready while designing cost out of equipment and helping our customers reach their sustainability goals.

We think about product investment as having four primary themes or drivers: regulatory and environmental; electrification; digital connectivity; and more recently, healthy occupants. We launched several new products in the quarter that address all of these themes.

We continue to expand our chiller portfolio with equipment that uses low or ultra-low GWP refrigerants. And in Q1, we did that with one of our water-cooled screw chiller platforms. We also launched our Mercury [ph] II (00:09:47) smaller tonnage package split system that is already compliant with the 2023 emission standards change two years ahead of time. YORK is the first in the industry with resi and light commercial product that is ready for the 2023 changeover.

In Asia, we launched an exciting new Side Flow VRF system which is the first of its kind and opens a new market opportunity by enabling installation and building configurations that previously wouldn't accommodate top flow systems, and the modular design meets the needs of our customers who want to expand or retrofit existing spaces more easily and in a cost-effective way.

Electrification is another big theme, particularly in Europe and Asia, which is driving significant demand for more energy-efficient heat pump technology across both HVAC and industrial refrigeration markets. This trend towards electrification is geared to lowering energy use, carbon emissions and the reliance on fossil fuels.

In addition to making sure that every piece of equipment that leaves our factory is enabled for connectivity, we are also investing significantly in cybersecurity technology, which has become increasingly important in a more digital world.

Lastly, new demand for clean air technologies has resulted in some of the most rapid innovation sessions we have had. For example, our new premium Hitachi ductless system applies proprietary Frost Wash technology as well as more hygienic coils to increase the level of air quality in residential and small commercial applications.

Over the last 12 months, we've been increasing the cadence of new product introductions, generating a higher level of product vitality than we have had in years past, with over 150 new products planned in fiscal 2021. We are also investing in our channel to expand our points of distribution and leverage strategic partnerships with large dealers and other channel players. We are seeing tremendous validation of our investment in the marketplace and would expect that to continue over the next several years.

Before Olivier reviews slide 9 in detail, I just wanted to reiterate our solid start to the year with improved performance in revenue, orders, profitability and overall earnings per share. Additionally, free cash flow was exceptionally strong. Now let me turn it over to Olivier to go through the details.

Olivier Leonetti

Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

Thanks, George, and good morning, everyone. Continuing on slide 9, Q1 sales declined 5% organically, improving sequentially compared to the 6% decline last quarter. Relative to our expectations, Global Products outperformed, primarily the result of continued high levels of demand for residential HVAC equipment both here in North America as well as our Hitachi business in Asia Pacific, including China.

Segment EBITA expanded 80 basis points year-over-year to 12%, the highest margin rate in any first half since the merger despite volume headwinds related to the pandemic. EPS of $0.43 increased 8%, benefiting from the higher profitability I just discussed as well as lower share count as we have maintained a disciplined approach to capital allocation.

Our free cash flow performance in the quarter was strong, up about 10% on a reported basis to over $400 million. I will provide the details on our cash performance later in the call, but the strong start in Q1 puts us on a path to achieve 100% conversion for the full year.

Please turn to slide 10. Orders of our field businesses continue to improve, with the year-over-year decline moderating to just 3% despite our install business still experiencing pressure from slower non-resi new build activity, with retrofit activity showing signs of recovery. Service orders increased 2% overall, driven by EMEA/LA and supported by the recovery of our core commercial Fire & Security businesses in Europe.

Our Global Products book-to-bill was up slightly year-over-year, with extremely strong growth in our North American resi HVAC business, up over 170% year-on-year. Backlog accelerated up 3% over the prior year to $9.5 billion, with service backlog up 8% to $2.5 billion and install backlog up 2% to just over $7 billion. We are beginning to see conversion rates in our service backlog accelerate, which gives us more confidence in our mid-single-digits growth outlook for that business.

Our install backlog flow rate is improving, but still below historical levels. Where site access has been allowed, we have continued to execute larger projects that were funded prior to the pandemic. As those projects reach completion, incoming backlog is remixing towards shorter-cycle projects, which is positive for near-term margin outlook.

Turning to our EPS bridge on slide 11. Operations, net of mitigating actions, netted to a $0.02 tailwind versus the prior year. Similar to the past several quarters, we experienced broad-based volume pressure and unfavorable mix. We remained in a positive price/cost position, and we continue to keep tight control on SG&A cost, including ongoing efforts to mitigate COVID-related volume declines. Net financing cost and controlling interest were each $0.01 headwind with lower share count benefited us by $0.03.

Let us turn to slide 12 to discuss our segment results in more detail. My commentary will also refer to the segment end market performance included on slide 13. North America revenues declined 6% organically, with install down 9%. Sales in the new construction channel remained depressed, as customers continued to delay large projects. And although retrofit activity was still down year-over-year in Q1 due to the drop in orders we experienced last year, we would expect this part of our install business to inflect over the next two quarters.

Services declined 2%, with our recurring contractual service business up low single digits across all domain, offset by weakness in transactional service linked to customers' lower discretionary spend in the current environment. Segment margin increased 50 basis points year-over-year to 12.5%, primarily reflecting strong gross margin performance, up 90 basis points.

Continued cost mitigation efforts and favorable mix also benefited us in Q1. Orders in North America declined 7%, improving slightly on a sequential basis, but impacted by significant declines in our federal government business. Persistent softness related to managing the pandemic was exacerbated by the disruption due to change in the administration. Backlog of $5.9 billion increased 1% year-over-year.

EMEA/LA revenues declined 5%, with install down 11% and services flat. By geography, we saw continued challenges across our major regions, with most geographies back under significant restrictions or full lockdown due to the spike in COVID cases in the second half of the quarter. Europe declined low single digits, while the Middle East saw significant pressure, down high teens against this quarter, with continued weakness in HVAC business. Latin America was down low double-digits.

EBITA margins rebounded, expanding 80 basis points from the prior year, as favorable mix, cost mitigation efforts and better fixed cost absorption more than offset the volume deleverage. Orders in EMEA/LA grew 2% in the quarter, and backlog of $1.8 billion was up 5% year-over-year.

APAC revenue, were down 6%, with install down 11% and service up 1%. Sales in China turned positive, growing 2%, while other geographies throughout the APAC region have deteriorated modestly since last quarter due to renewed lockdowns and restrictions related to COVID-19 in areas like India, Southeast Asia and parts of the Pacific. That said, continued strength in China, a healthy backlog, stronger service activity and easy comps should allow us to post solid revenue growth over the next couple of quarters, with more modest growth in orders.

EBITA margins improved 140 basis points year-over-year to 12.8%, as favorable mix and the benefit of mitigation actions more than offset the volume decline. Orders declined 1% in Q1 despite China orders growing 60%, as renewed lockdowns and restrictions in several other key geographies offset. Backlog of $1.8 billion grew 12% year-over-year.

Moving to Global Products, revenue declined 2% on an organic basis in the quarter, better sequentially with continued outperformance from our residential HVAC and security businesses. North America resi HVAC grew 46% in the quarter, as the market continues its sharp recovery and we continue to gain share as a result of expanding our points of distribution and new product launches. We would expect these trends to begin decelerating over the next several months, but sales growth should still be relatively strong.

In Asia Pacific, our resi HVAC business grew 2%, with growth in Taiwan and India more than offsetting a low-single-digit decline in Japan. Although not reflected in our revenue growth, our [ph] Nsense (00:21:19) JV in China grew 30% year-over-year in Q1. On the commercial HVAC side, sales declined at a high-single-digits rate as the commercial market remains under pressure, particularly in light commercial [ph] inventory (00:21:37).

Fire & Security products declined low single digits overall, with strong growth in our Security business, more than offset by continued weakness in commercial fire detection and suppression markets. EBITA margin expanded 90 basis points year-over-year to 11.9%, as positive price/cost and the benefit of mitigating cost actions more than offset the volume decline and related absorptions as well as negative mix.

Turning to slide 14, corporate expense was down significantly year-over-year to $67 million, benefiting from cost mitigation actions and continuous structural cost reductions. We do expect corporate expense to step up next quarter and throughout the course of the second half, as temporary cost reductions begins to reinstate. Given the favorable performance in Q1, we now expect corporate expense to be in the range of $300 million to $320 million for the year.

Turning to our balance sheet and cash flow on slide 15. Starting with the balance sheet at the top of the page, no significant changes versus the prior period. In the quarter, we repurchased approximately 8 million shares for roughly $350 million. As we have said, the balance sheet remains in very good shape.

On cash, we generated $424 million of free cash flow in the quarter, which is truly remarkable performance for a quarter which typically experiences a cash outflow. As a reminder, beginning this year, we moved away from the adjusted free cash flow construct, so this represents true available free cash.

Our cash from operations and reported free cash flow last year included a $600 million tax refund as well as $100 million cash outflow related to integration cost. While there were clearly some timing benefits driving the substantial year-over-year increase, with CapEx still in process and ramping back up, underlying operational performance was the primary driver.

Now, let's turn to slide 16 for our outlook. Although the market remains uncertain, given the solid start to the year and slightly more visibility, our confidence in the outlook for fiscal 2021 has increased. In addition to initiating fiscal Q2 guidance, we are also providing formal guidance for the full year.

Starting with our full-year guidance, we still expect organic revenue growth in the low to mid-single-digits range, turning slightly positive in Q2 and then ramping significantly in the second half. As I mentioned last quarter, we will continue to manage cost over the course of the year, including the return of cost that were subject to temporary mitigation actions last year and we'll look for additional opportunities to streamline some of this cost out on a permanent basis.

We have many levers to continue to improve overall profitability through actions focused on gross margin as well as SG&A. This, along with our continued strong execution, is expected to result in solid EBITA margin expansion of 40 basis points to 60 basis points for fiscal 2021. Q2 margins are expected to expand by 80 basis points to 100 basis points, with continued benefits from cost actions. EPS for the full year would be in the range of $2.45 to $2.55, up 9% to 14% over 2020, which, as you will recall, was up 14%.

Q2 EPS would be in the range of $0.47 to $0.49. Given our strong cash performance in Q1, we are raising our outlook for free cash flow conversion on a reported basis to approximately 100% for the full year, overall, continued strong performance in what remains a challenging environment.

With that, operator, we can open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Nigel Coe with Wolfe Research. Your line is open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Good morning Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

So, first of all, thanks for the additional details on the slides, really, really very helpful. So, looking at the margin guide for the full year, the implied back half is obviously much flatter. I realize we've got temporary costs come back into the equation here. But is there anything else that we should think about in terms of mix, raw materials? Anything else that would kind of cause that margin to flatten out in the second half?

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

So, Nigel, good morning. Indeed, the guide implies that the margin rate for the second half is going to be marginally up. We discussed that in prior calls. In the second half of the year, some of the cost we mitigated last year are going to come back. The net for the year we discussed is about $40 million, but the second half is going to be a headwind.

As I indicated last quarter, we're working on mitigating those costs coming back. We have plans in place. It's too early for us to commit to an improvement in margin in the second half, and we'll come back when those plans are a bit more structured, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. No. That's clear. And then, the attachment rate initiatives, 35% service attachment rates, looking to increase that by 300 basis points for the year. I'm just curious how you're looking to achieve that. What sort of incentives do you have in place to sales or technicians and what role is OpenBlue playing in that? So any help there would be helpful.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yes. So, Nigel, when you look at our $6 billion service business, of course, as we've laid out, it's a very attractive vector for growth, and that has been accelerated with the healthy buildings trends. So, when you look at historically, we've been under-serving our installed base and so, we've been going back after that and we believe that that's a real material opportunity and a competitive advantage for us. We have been increasing our market coverage with people as well as enhancing the technology that we're deploying within our solutions with OpenBlue.

When you look at the margin profile, it's 2x the overall company EBITA margin. And as we now look at our new capabilities, differentiating our services with connectivity and utilization of data, that really gives us an opportunity to be able to get longer-term contracts, being able to solve bigger problems, be able to attach contracts and ultimately drive that attachment rate.

We've seen great progress here in Q1. We're up about 90 basis points sequentially in Q1. We expect for the whole year that our attach rate will move up 300 or 400 basis points and will actually accelerate as we enter 2022. And so, it's a combination of all of that, that truly positions us to be able to take what we've done historically and truly now move the needle with how we can attach a lot more to what we do to serve that installed base.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Thanks, George.

Operator: Thank you, Mr. Coe. Our next question is from Deane Dray with RBC Capital Markets. Your line is open, sir.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Good morning, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey. I really like seeing the slide right upfront profiling the opportunity in healthy buildings, this whole indoor air quality theme that we think is really meaningful post COVID. And George, was hoping you'd give us a little bit more of granularity in how you arrive at that $10 billion to $15 billion. Maybe a sense of how much is equipment, services, digital. And how much of this benefit are you seeing today?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yes. So, when you look at what we launched here, Deane, the OpenBlue Healthy Buildings, it does represent our new comprehensive strategy to be able to address both the clean air, which we said was a few billion dollars previously, and then all of what else we do within a building around Healthy Buildings. And holistically, it's about $10 billion or $15 billion of new addressable market when you look at it holistically.

Now, when you look at across industries, more than half of businesses now have implemented some type of healthy building initiative. OpenBlue Healthy Buildings now addresses this next phase, where not only are we driving efficiency, but we're driving health and safety. And we're positioned to be able to then drive sustainability and reduce the energy to be able to achieve those outcomes.

When you look at what we do, it combines all of our core. It tailors what we do to each individual customer. And now we have about 25 unique solutions of services that, to your point, it takes our products, it takes our service technology, it now takes our data services that we're developing truly now to be able to create these new outcomes.

So, it's aimed not only at helping customers return to work, but also optimizing their performance of their infrastructure longer term, not only through efficiency and energy reduction, all of which contributes to their sustainability goals. So, it's really a combination of all of that, that allows us to really differentiate what we can do to deliver these type of solutions.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Great. And just as a follow-up there. If you had to split the opportunity between, let's say, a onetime windfall of new equipment, higher filtration and so forth versus an ongoing service opportunity, the monitoring, the digital side of this, what's the split? How much is pure equipment upgrade versus the ongoing recurring connected building opportunity?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Well, to give you an idea, and this will be within our Global Products. We've seen huge increases with filtration. Orders up strong 20%, 30%. We've got our IsoClean, our potable air purification units. We see growth of well over 100% year-on-year. We're seeing our pleated filters up 500%. We're seeing filtration products up kind of 50%.

So, we are seeing benefit in the products that ultimately go into our solutions and what we can do to look at every aspect, filtration, disinfection, the recircularization as well as isolation that ultimately we provide with our solutions. And so, it really – it's a combination of all of that, Deane. And then, as we're now upgrading these systems, the more connectivity that we can gain with how we utilize our – when we use our Metasys platform to collect data and then being able to optimize the outcome that we can produce is the advantage that we have with the 16,000 people that we have deployed across the globe that are intimately working with customers in delivering these solutions.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

That's great. And just congratulations on all of your ESG commitments. That really does put you guys best-in-class here. Thank you.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Thanks, Deane.

Operator: Thank you for your question, Mr. Dray. Our next question comes from Scott Davis with Melius Research. Your line is open, sir.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Hi. Good morning, everybody.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Good morning, Scott.

Scott Reed Davis
Analyst, Melius Research LLC

Q

George, is there a preference between M&A and buybacks in 2021? Or any kind of opening of M&A markets that get you more interested?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yes. So, as we've been improving our fundamentals here, Scott, and getting a lot of confidence here with the continued improvement that we're going to deliver on that we think that M&A is a space that, as we're building our pipelines, that is attractive in being able to take what we're doing with our organic investments and be able to contribute more in how we ultimately deliver growth.

So, as we look at our priorities for the year, we are not only supporting strong dividend, but also opportunistically doing the buybacks and we committed $1 billion that's still remaining from the Power Solutions sale. But on a go-forward basis, see M&A as being an area that we can contribute 1% or 2% growth on a go-forward basis on an annual basis because of the pipeline that we see, the ability to be able to enhance our technologies, our go-to-market, our services, and then accelerate the work we're doing with OpenBlue.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Makes sense. And then, just switching gears to service. You've, on slide 7, referenced a mid-single-digit growth rate, and attachments at 35%. I mean, you say the entitlement is double the current rate, but what can get you there? I mean, you're not there yet. So, what needs to happen either within the sales force or within, perhaps, customer education or something else that kind of gets you driving to a higher growth rate in service?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

So, if you look, before the pandemic, Scott, we had got our growth rate to 4%, 5% and it was pretty much at the market rate, and that was a lot of blocking and tackling. Now, strategically, we've been investing in new services. We've been enhancing those services with OpenBlue. We've been targeting our installed base in a much more aggressive manner because we have an opportunity to be able to bring that forward with new technologies and be able to – to be able to address some of the new challenges that our customers are facing.

So, when you put all of that together and you look at our performance here, in Q1, we've been sequentially improving. We're only down – when you look at our – service was down 1%. It was down 3% in Q4. We're projecting here on a go-forward – our orders were actually up 2% in the quarter. On a go-forward basis, we see our orders continuing to improve. We're getting a higher mix of longer-term contracts within those orders. And that we believe that from a revenue standpoint, we turn positive here in Q2 and it'll continue to ramp Q3 and Q4.

So, it's really a combination of not only mining the installed base, adding additional capabilities within the field and being able to do that, be able to enhance the offerings, be able to get it connected, utilizing data, creating new outcomes, and then ultimately being positioned here to attach. Our attach rate in the first quarter was up 90 basis points sequentially, and we see that improving 400 basis points or 500 basis points over the year and then accelerating beyond that.

So, that gives us confidence here, Scott, that through the year, we'll get to mid-single-digit growth in 2021 and that we believe that we can accelerate from there with very attractive margins going forward.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Sounds encouraging. Good luck, George. Thanks, guys.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Thanks Scott.

Operator: Thank you for your question Mr. Davis. Our next question is from Steve Tusa with JPMorgan. Your line is open, sir.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, guys. Good morning.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Hey, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Can you just fill us in on kind of what you're seeing in your core, like the commercial HVAC equipment market in the US? Just kind of hard to tell like what the real trend is. I mean, non-res construction obviously remains kind of weak, but you've got all these opportunities on ESG and IAQ, et cetera. But just curious as to how this cycle is shaping up versus prior maybe on [indiscernible] (00:38:36) equipment.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Sure. So, when you look at our commercial HVAC market, let me start with applied. So, applied HVAC orders were down low single digits. This is globally, now about 3%. We did see continued sequential improvement in the market through the quarter. We did see some pressure in North America, where it's purely due to timing of orders as well as some federal business there that got pressured, and again, timing. And then, Asia Pac continues to accelerate. China was up over 20%.

When you look at the sales now, following the orders, the sales were down low- to mid-single digits globally, about 4%. We did see sequential improvement in North America, as well as APAC. APAC actually came back to being flat. And a lot of that is being driven by our service growth and the traction we're getting there.

The North America install is better and we're seeing the – as Olivier said, we're seeing more retrofit, quarter-on-quarter. And then, when you look at unitary markets, they generally remain under pressure. They're down low-single digits in Q1. The mix of that is – light commercial, smaller tonnage units was down slightly in the quarter. Larger tonnage units are actually weaker, because of the larger projects being delayed or deferred. We continue to gain share as a result of the investment that we've made in both new products as well as channel.

So, when you look at the whole space, we're still pretty bullish that these are very attractive end markets with long-term secular trends that align very well with our core and a lot of focus now on energy and sustainability, which is going to drive – I think, is going to drive the industry. And we've been leading with the investments we made in our YZ chillers and the increased tonnage that we're launching there, our rooftops, our Premier Choice and select rooftops. And ultimately, now we're investing more heavily in next-gen air cool technologies, electrification with heat pumps and heat transfer units and advanced VRF technology.

So, when you think of the space, there is some changes happening in the space, but we're invested to really capitalize on that going forward. And now with our larger installed base and now with the connectivity with our digital offering, does give us an opportunity to really leverage that and build the service business that we've been building.

And so, I think the trends are sequentially positive, some pressure on the larger, nonresidential construction that we see being pushed to the right a bit, but we are seeing sequential improvement, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And just a simple one, do you think the applied markets in the US will be, on a calendar basis, down in 2021, the biggest ticket stuff in the market?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc
A

So, when you look at the overall market driven by non-resi construction, the overall market will be slightly down.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Okay. Got it.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc
A

Now, when you look at our mix, we have been remixing towards the higher growth end markets and we've been focused on – obviously, with the new demand around healthy buildings and the like, we've been doing more shorter cycle projects and putting that into the backlog and we're projecting our North American business will be positive for the year.

And now that's gaining share. That's above the industry metrics that you follow, whether it be ABI or construction starts. But with the work that we've been doing, with remixing our capacity, focusing on high-growth end markets, and then with the acceleration we see with some of these upgrades and retrofits is what's going to drive our business for the year.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Great. Thanks. I appreciate it.

Operator: Thank you for your question, Mr. Tusa. Our next question is from Jeff Sprague with Vertical Research. Your line is open, sir.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Thanks. Good morning, everyone.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc
A

Good morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Good morning. Just two unrelated questions, first on – back on service attachment, I think you're actually probably being conservative saying 35%, right, because you're saying like a full-service contract. But I wonder if you could give us a sense of your aggregate service reach.

And it does seem like you believe you can score some early points on this. And so, I'm wondering if this is a function of really ramping up the service activity at customers you're engaged with and you're taking it to kind of a different level, or the service attachment is being driven primarily by kind of attachment on new installations.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

No. It's all of the above, Jeff. So, what we're doing is, as we've really brought our strategy around service to a whole new level here, we brought on new leadership, we've got it structured such that we've got all of the key metrics that we're driving. It starts with understanding the installed base, where we are today with the services that we provide. We have significant opportunity to go back into that installed base and bring that forward. And that includes bringing holistic solutions, being able to get longer-term contracts with how we deploy those solutions, and then, ultimately, getting a recurring revenue that comes out of that work.

And so, it's been both. We're not only getting a higher attach with the new projects that we're engineering and deploying and getting a higher attach rate because of the value proposition that we can bring with our OpenBlue capabilities combined with our service capabilities in the field, but at the same time, being able to get additional volume by leveraging the installed base and bringing that forward with some of the newer technologies and capabilities. And that all is supported with what we're doing in the field and being able to expand our technicians and the capabilities and capacity that we have in the field to be able to actually deliver the new solutions that we're providing.

And so, as we look at going forward, we believe that not only do you get a higher attach rate, you get higher revenue per customer because of the connectivity and the data and the solutions that are being provided, which ultimately are going to both contribute to our ability to be able to get our growth rate, get that continuing to increase through the course of the year and then setting up 2022 very well.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And then, second unrelated question, probably for Olivier. But I wonder if we could just dig a little bit further on what you're doing on cash flow. It's really encouraging to see the 100% kind of benchmark here now in the target zone. In particular, to me, it seems like there's some huge opportunities in DSOs. I'm sure that's not the only thing you're working on, but can you elaborate on what you are driving to make this cash flow number work here?

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

Yes, Jeff. So we are very pleased with the performance we have had in cash flow in the quarter. By the way, last year was pretty good too. And if you remember, Jeff, during the prior call, we said that we are – we believe we are 100-plus free cash flow conversion company, the debate was when. And we were concerned this year with some of the tax, cash tax benefit we took in 2020 headwind this year. But despite that, we believe we're going to be at 100% this year.

So what is happening? Few things. First, the level of profit is strong and we believe we have the ability to make that stronger. And to your point, on working capital we have a strong discipline happening. To your point, DSO has been trending well. We believe we have further opportunities to improve DSO, and we have today at the top of the house weekly reviews to make sure we keep the momentum on cash flow generation. It's also part of our incentive plan at the level of the enterprise. So all the lines are aligned today, Jeff, to keep performing on cash, we believe.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thank you. I'll pass it on.

Operator: Thank you for your question, Mr. Sprague. Our next question is from Andy Kaplowitz with Citigroup. Your line is open, sir.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, guys.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Good morning.

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

Good morning.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

George, last quarter, you mentioned you might see a pullback in product-related revenue in Q1 given somewhat of a pent-up snapback that you saw in Q4 but perhaps actually improved in terms of the revenue decline. So, obviously, some of that improvement looks like it was North American residential, but it seems like Fire & Security product – products continue to improve. So I guess more color on what you're seeing in that category in particular moving forward.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yeah. Let me start by – again, I was very pleased with the performance in Global Products in the quarter, with the underlying trends and the overall output we saw. It really is built on the depth and breadth of our product portfolio which, as we have been reinvesting, is industry-leading. We've been gaining share. We've had various new product introductions related to both the core HVAC and Fire & Security products, as well as now products that are enabling the COVID response and healthy building opportunities.

Just quickly, HVAC, we've had the continued tonnage expansion of the YZ chiller platform. We've had the Premier Choice Select rooftops. We've had the YORK Affinity series in residential and as well as additional heat pumps. In controls, we continue to advance our Metasys 11.0 with continuous upgrades to enhance the capabilities and the better user interfaces.

Security, with our Qolsys business, we're now in a leadership position and we're a leader now in providing smart home solutions. Electronic fire, that's been very strong. Electronic fire has been more around connectivity, notification, enhanced interfaces, and fire suppression, although we're pressured over the last year or so in the high hazard business, we have continued to advance our sprinkler heads and we're getting good traction there. So, overall, the business recovers nicely.

There was some – some pressure in the non-resi space remains, but when you look at Q1, we definitely saw better than expected performance in – and it would really be broken down into rest of world residential, which is our JCH business, with better performance and a better recovery there and gaining share, and then we saw stronger sequential improvement pretty much across each one of our product businesses within the quarter.

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

And, Andy, we mentioned that in our prepared remarks, we are going to accelerate the number of new product launches in the rest of the year. So we have launched already some new exciting products in Q1, but that will accelerate. So, we are optimistic about what this business can keep doing for us.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

And your second question, Andy, was around Fire & Security?

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Yeah, in particular.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

So, in total, I'd start by saying Fire & Security remains very attractive to us. 40% of our revenues are in this space. It's core to building systems, very attractive margin profile due to the service mix. We've got an incredible installed base which creates significant recurring revenue in service.

And then when you look at these attributes, they're critical to what we're doing with OpenBlue and being able to really drive a comprehensive solution within the building, deploying technology in our go-to-market. And Security now is coming to the forefront because it takes all of what is done in a building and it brings it together interactively, and then being able to then manage the data that gets collected throughout the building. So that's been very important.

When you look at the performance, we did moderate – the service moderated in Q1. We're only down roughly about 1%, 1% or 2%. We saw North America recurring service revenue turn positive and a lot of that was our ability to be able to drive long-term contracts in the Fire business. EMEA/LA, the overall service turned positive and Asia Pac is slightly down.

When you look at where the pressure is right now, it's in install, and it's mainly due to project delays and general prioritization of HVAC around indoor air quality that's driving some of the resource allocation of our customers. But I believe that that's only a timing issue. These projects will be released and will be able to be positioned and capitalize on those going forward.

And the only other one to note, Andy, is the retail. Retail continues to be under pressure. It's down about the same that it was down in Q4. So we are – it's a great business, it's a high value proposition within the business, but given what's been happening in retail, we've been working to reposition ourselves to be critical to the essential retailers at the same time while we're helping the less essential or the apparel retailers to expand their omnichannels in addition to their brick-and-mortar infrastructure. So that's where we are in Fire & Security, but still a very attractive business for us.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Very helpful. And just a quick clarification on price versus cost. I mean, I assume it's in your forecast, Olivier, for 2021, but you've been able to cover rising inflation in the past, just any thoughts on price versus cost in 2021.

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

It's still positive. It was in the quarter, Andy, and we believe the discipline in the organization is strong and price/cost will remain positive for the back of the year.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

And to reinforce that, Andy, we've put in place very strategic pricing over the last couple of years, and we've demonstrated strong performance, being able to net 100 basis points to the top line every year. Yes, we are seeing the commodity costs increase, but I can tell you, with the work we've done, there's more than enough mitigating actions across – with the other levers that we're deploying around VAV, direct material productivity, around supply chain, leveraging our buy.

So we're very well-positioned to be able to have positive price/cost, and the margin guidance that Olivier provided incorporates the updated price/cost headwind that we see.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Very helpful, guys. Thanks.

Operator: Thank you for your question, Mr. Kaplowitz. Our next one's from Julian Mitchell with Barclays. Your line is open, sir.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good morning. Maybe just the first question around the install outlook. So the orders were down 7% in the quarter. Understood why there's some weakness in Fire & Security and so forth in different regions, but maybe help us understand globally when you think that figure may return to growth, and also what we should expect for install revenues for fiscal 2021.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yeah, Julian, let me start. When you look at the market indicators coming out of 2020, they were pointing to a weaker new construction. That was ABI in construction starts and the like. And then when you look at the verticals, certainly mixed. There's some verticals that still have strong growth and there's others that are being more challenged.

So when you look at new construction starts, it's still under pressure. We are seeing retrofit activity related to healthy buildings and service beginning to pick back up. We do see our install business growing low single digits this year in spite of those metrics because we've been reallocating our resources to the higher growth verticals and then being able to now capitalize on the retrofit opportunity that we see, both short and long-term.

When you look at the verticals, there's certain verticals that are under more pressure than others. When you think about the growth areas, better than 25% of our sales go into institutional markets and both health care and education are – they're definitely receiving a lot of attention right now with respect to building [ph] health (00:54:59).

And then when you look at commercial office, it is more mixed with lower utilization rates near-term. But we do believe that there's going to be a demand because there is a lot of interest in solutions now for what the new normal will be within these buildings. And so when you look at the overall impact of COVID, we believe that it has delayed the investment decisions which is creating some uncertainty and limited visibility beyond the six months, but we believe that what we see with our pipeline, our pipeline has actually been growing. And we see now in North America, for instance, with the access restrictions continuing to be eased, we'll see some headwinds here in Europe and LatAm with some of the shutdowns and the like, but as we get into the second half of the year, we believe we start to recover on orders. I mean, orders are actually going to be recovering here in the second quarter. That will continue to improve through the course of the year and set us up well for 2022.

We do have a $9 billion backlog and that is up year-on-year. We believe the mix within that backlog is shorter cycle, so that is helping us book in turn through the course of the year which is helping us be able to outperform the market within the non-resi market. And then with service recovered now with PSAs, that is beginning to offset the pressure that we've had with some of these site restrictions.

So, I believe you'll see that we're going to outperform through the course of the year, the market will continue to recover, and you'll start to see positive expansion within the industry metrics in 2022.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. That's helpful. And then just a quick follow-up on the margin outlook across the four segments. So, you've got that plus 50 bps figure firm-wide for operating margin for the year. Anything you'd call out on segments that should lead or lag that? And perhaps, in particular, what kind of operating leverage do we expect in Global Products?

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

So, actually, the margin profile of the business is going to be equally up in the year. If you look at the various regions, the various install services or products, we see margin going up. And we have said before, and let me repeat this, we believe we can increase the margin of the enterprise, EBITA margin by about 50 to 60 basis points.

We have the ability to be at this level this year despite the negative impact obviously of the pandemic. But we feel good today about our ability to keep improving the profitability of this business, and we are lining up a series of activities to deliver on this promise.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Thanks, Julian.

Operator: Thank you for your question, Mr. Mitchell. Our last question will come from Joe Ritchie with Goldman Sachs. Your line is open, sir.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Thanks. Good morning, everybody, and thanks for fitting me in.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Good morning.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

So, I'm just going to ask one question and I want to go back to the attachment rates that you're discussing. I guess my question is, when you think about the investments that's needed in order to expand those attachment rates, maybe talk about what the quantification of those investments over the next couple of years. And then specifically, around like where you're actually taking share, any discussion around like the types of like competitors that you expect to start to take some share from as you increase your attachment rates?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yeah. Yeah, so the investments that we're making is really – was enabling our ability to be able to get a higher attach rate. It's not only making sure we have the right capacity deployed across the regions and being able to go after – so historically, going after the installed base that's out there today that we've underserved, and then being able to bring those forward by upgrading and getting new technology deployed and getting a recurring revenue contract.

But on – then on new solutions, in how we now bring our technology investments and embed those into the overall solution and then being able to then tie that to a long-term contract that enables us to be able to get that attached, that is the underlying strategy. So the investments that are being made are built into our products within – at the product stage, they're built into our digital capabilities we're building with OpenBlue, and then it's ultimately making sure that we've got the infrastructure deployed within our regions to be able to successfully deliver that to our customers.

And we have all of those elements that have been built into the plan in our reinvestment, and this has been ongoing here for the last 18, 24 months. And so we're starting to see the fruits of our labor with the work that we're doing. We're beginning to get the attachment rate on the new projects, we're beginning to get a pickup in service on the installed base, and all of that is leading to not only the higher attach rate but higher revenue per customer and, ultimately, accelerating the overall service growth rate.

Olivier Leonetti
Executive Vice President & Chief Financial Officer, Johnson Controls International Plc

A

Joe, just to make it clear, we will deliver on those investments while scaling SG&A as a proportion of revenue. So we do not believe we need to add OpEx as a proportion of revenue to deliver on the service strategic initiative.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. That's – no, that's helpful. But then I guess maybe just that second part question about where you're going to be able to take share, is there any color that you can provide at this point?

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Well, I'd say when you look at our – it's in line with our installed base, with – where we are strong in each of the verticals. I think you've got a breakdown of the key verticals. It's broad-based. The strategy is such that historically it's been more of a – just more of a mechanical service that we provided to maintain break and fix, and some of that was done through long-term contracts. The difference now, Joe, is that with the connectivity, with the use of the data, not only can we improve the value proposition or solve problems that customers haven't historically been able to solve, but then being able to do that on a longer-term basis with the connectivity and the use of the data.

So, it's really across the board on our – on all of our new product installations whether it be health care, education, or industrial, or government. Any one of the spaces, I think we are uniquely positioned with our business models, with our performance, contracting, and some of the business models that historically we've had that has successfully delivered an outcome, we are now embedding our service technologies and capabilities so that we then – with that installed base, we can generate a lot more service with the use of the data that we collect and ultimately deploy.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

That makes sense, George. Thank you both.

George R. Oliver
Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Joe. And I think we're at the hour here so let me close. I want to thank everyone again for joining our call this morning. I'm incredibly proud of how our teams continue to execute in what remains a challenging environment. I can tell you, I'm extremely pleased with our continued strong performance and the resiliency of our global teams that have just continued to execute across the globe in spite of the pandemic.

I hope that you and your families remain safe, and certainly look forward to engaging and speaking with you – many of you soon. So, operator, that concludes our call today.

Operator: Thank you so much, sir. Thank you all for participating in today's conference call. You may now disconnect, and have a great rest of your day.