30-Jan-2024

Johnson Controls International Plc (JCI)

Q1 2024 Earnings Call

CORPORATE PARTICIPANTS

Jim C. Lucas
Vice President-Investor Relations, Johnson Controls International Plc

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

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

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

OTHER PARTICIPANTS

Scott Reed Davis
Analyst, Melius Research LLC

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Nigel Coe
Analyst, Wolfe Research LLC

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Gautam Khanna
Analyst, TD Cowen

Chris Snyder
Analyst, UBS Securities LLC

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Deane Dray
Analyst, RBC Capital Markets LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Johnson Controls' First Quarter 2024 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note, today's event is being recorded.

I would now like to turn the conference over to Jim Lucas, Vice President, Investor Relations. Please go ahead.

Jim C. Lucas

Vice President-Investor Relations, Johnson Controls International Plc

Good morning, and thank you for joining our conference call to discuss Johnson Controls' first quarter fiscal 2024 results. The press release and related tables that were 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; Chief Financial Officer, Olivier Leonetti, and newly appointed Chief Financial Officer, Marc Vandiepenbeeck.

Before we begin, let me remind you that during our presentation today, we will make forward-looking statements. Actual results may differ materially from those indicated by forward-looking statements due to a variety of risks and uncertainties.

Please note that we assume no obligation to update these forward-looking statements, even if the actual results or future expectations change materially. Please refer to our SEC filings for a detailed discussions of these risks and uncertainties, in addition to the inherent limitations of such forward-looking statements.

We will also reference certain non-GAAP measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are contained in the schedules attached to our press release and in the appendix to this presentation, both of which can be found on the Investor Relations section of Johnson Controls' website.

I will now turn the call over to George.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Jim, and good morning, everyone. Thank you for joining us on the call today.

Now let's begin with slide 3. We are gaining momentum as we exit the first quarter. Our team has been unbelievable in managing through the recent cyber disruption, which occurred early in the quarter. While it is challenging to comprehensively quantify the overall business impact as we recovered from the incident, we are back on track.

In fact, over the course of the last 120 days since the cyber incident, we have connected with many of our key customers, solidifying already strong relationships and strengthening their trust and confidence in Johnson Controls. It is clear from their feedback that our value proposition continues to resonate, and customers believe in our products and services.

As we enter the new calendar year, we are seeing positive signs. During the quarter, we delivered solid first quarter results generally in line with our forecast. The fundamentals of our business are strong, as we met expectations for sales, margins and adjusted EPS in the face of headwinds from the cyber disruption, ongoing weakness in global residential HVAC and significant slowing in China. Olivier will discuss the details of our financials more specifically later in the call.

Looking forward, we expect fiscal 2024 to return to more normalized seasonality in our businesses and the operating environment to be more in line with what we saw prior to the pandemic and recent supply chain disruptions. Our position of building a leading digital Building Solutions platform continues to be core to our strategy, and we are pleased with the strength of our Applied HVAC business, especially as we serve the fast-growing data center market.

We are updating our fiscal 2024 guidance today, reducing the full year adjusted EPS range by $0.05, reflecting growing headwinds in China. Our commercially-focused portfolio and long cycle backlog-driven businesses, in addition to our record backlog, gives us more clarity of improvement as fiscal 2024 progresses.

Before we continue, I would like to take the time to thank Olivier for his partnership over the last few years, and wish him the best of luck in the next chapter of his career. When Olivier informed me that he was taking a role outside the company, we implemented our internal succession plan, and I am very pleased that Marc Vandiepenbeeck is assuming the role of CFO. Marc has been with Johnson Controls for nearly 20 years, with increasing responsibility in finance roles, including CFO of Building Solutions North America.

Last year, we moved Marc into an operating role as President of EMEALA. Marc brings deep finance expertise and understanding of our customers, global markets and operational knowledge. I am confident that we will continue to build on the foundations already in place, and I look forward to partnering with Marc in his new role.

Now turning to slide 4. I'd like to highlight the strong foundation of operational excellence at Johnson Controls and our value creation framework. We are capturing the secular trends across sustainable and healthy buildings. We have the right strategy and operating system in place to create value for our shareholders. And as part of our commitment to disciplined capital allocation, we remain focused on deploying resources to the right opportunities.

Our team has made great progress the last two years, creating a digital services model, and our investments have been a key enabler. The addition of FM:Systems gave us increased capabilities to serve our customers as they improve their workplace environments.

Digital is a strong enabler to creating recurring revenue, retaining customers and supporting higher, sustainable service growth rates. Within Service, we are changing the game from deploying a mechanical contractor to creating multiple options for our customers. We are increasing job size, improving margins and creating scalable solutions.

In addition, we are maximizing value creation through digitally-enabled offerings and accelerating our life cycle solutions entitlements across all of our domains. Our team's model has a strong foundation and we will continue to accelerate the pace of change. At the same time, we have successfully removed many layers of cost across the organization, but we know there is more work to be done. We serve an incredible market, and it is on us to capitalize on the opportunities in front of us. We will continue to simplify and standardize across our portfolio.

As we continue to focus on simplifying the company, we are always assessing opportunities to advance our transformation into a comprehensive solutions provider for commercial buildings. As part of the continuous evaluation of our portfolio, we are in the early stages of pursuing strategic alternatives of our non-commercial product lines, in line with our objective to maximize value to our shareholders.

We are very excited about our future and are confident we are on the right path to simplify our portfolio, drive margin expansion, deliver consistent cash flow, while serving our customers in the best possible way.

I will now turn the call over to Olivier to go through the financial details of the quarter. Olivier?

Olivier Leonetti

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

Thanks, George, and good morning, everyone. Let me start with the summary on slide 5. As George discussed at the beginning of the call, our team did an incredible job responding to the cyber incident. The disruptions we experienced during the quarter were factored into the guidance we provided last month.

Total revenue of $6.1 billion was flat year-over-year, while organic sales were down 1%, as continued declines in global residential HVAC and accelerated weakness in China's in-store business more than offset mid-single-digit growth in Service and continued growth in Applied HVAC.

Segment margins declined 90 basis points to 12.8%, impacted by tough comps in our shorter-cycle global products business, coupled with ongoing weakness in China's macro environment.

Adjusted EPS of $0.51 exceeded our guidance of $0.48 to $0.50 as we return to more normalized seasonality.

The quarter was impacted by lost momentum from the cyber incident, accelerated weakness in China and tough comps in our Global Products business. Below the line, we saw headwinds from net financing charges due to higher interest rates and increased debt levels, in line with historical trends.

On the balance sheet, we ended the first quarter with approximately $1.8 billion in available cash, and net debt increased to 2.2 times, which is within our long-term target range of 2 to 2.5 times. The elevated cash position was a direct result of proactive action to mitigate the potential impacts of the cyber incident on cash flow.

Adjusted free cash flow improved $180 million year-over-year, and we anticipate further improvement as we progress through the fiscal year.

Let's now discuss our segment results in more detail in slide 6 through 8. Beginning on slide 6. Organic sales in our Global Products business declined 1% year-over-year, with volume declines offsetting price. Global Products saw continued strength in commercial HVAC, which grew low single-digits after growing low double-digits in the comparable period one year ago.

We have been investing in our Applied HVAC business for the last couple of years, deploying resources to align to more attractive opportunities, resulting in further share gains in calendar 2023.

Fire & Security declined low single-digits. We believe that the majority of the tough year-over-year comparisons in the shorter cycle and direct business have bottomed out, and we should see a return to growth in calendar 2024. Industrial Refrigeration had another strong quarter, growing over 35%, driven by EMEALA.

Global Residential declined high single-digits, driven by greater than 20% decline in North America, which more than offset low single-digit growth in rest of world. North America continues to face market softness, and we believe we have one more quarter with these challenges before the industry begins to see growth in the second half of the year. We're improving our North America market share and see momentum building.

Despite ongoing weaknesses in the European heat pump market, rest of world benefited from strong growth in Japan. Our book-to-bill business continues to normalize with improved lead times, and our Global Products third party backlog decreased 10% from the prior year to $2.3 billion.

Adjusted segment EBITA margins declined 240 basis points to 17.9%, as we benefited from insurance proceeds from a warehouse fire in the comparable period last year. We are beginning to see better cost absorption in our factory and expect Global Products margins to improve throughout the rest of the fiscal year.

Moving to slide 7 to discuss Building Solutions performance. Orders increased 1% as mid-single-digit order growth in North America and EMEALA was more than offset by a greater than 30% decline in APAC, which was primarily the result of further deterioration of the China Install business.

As the China real estate market continues to weaken and the outlook remains mixed, we have begun to optimize our go-to-market strategy and have become more selective in the business we pursue.

Organic sales were flat in the quarter against a tougher comparison of low double-digit growth in the prior year quarter. Install declined mid-single-digits and more than offset mid-single-digit growth in Service.

Segment margins declined 10 basis points as accelerated weakness in China offset positive mix in the quarter. Building Solutions backlog remains at record levels, growing 7% to $12.1 billion. Service backlog is flat and Install backlog grew 8% year-over-year.

Let's discuss the Building Solutions performance by region on slide 8. Orders in North America increased 6%, as we continue to see strong demand across our HVAC & Controls platform, growing high single-digits, following heightened growth in the comparative period a year ago. Overall, there was broad-based demand in our healthcare, data center, government and education sectors.

Install orders increased 9% year-over-year, with solid growth in both new construction and retrofit. Sales in North America were up 4% organically, with strong growth across our HVAC & Controls platform, up low-teens year-over-year.

Our Install business grew 4%, with continued momentum in new construction up over 25% year-over-year.

Organic sales in Service grew 4% in the quarter, benefiting from high single-digit growth in our recurring revenue contracts. Segment margins expanded 20 basis points year-over-year to 11.5%, driven by the continued execution of higher-margin backlog and strength in our higher-margin Service business. Total backlog ended the quarter at $8.4 billion, up 11% year-over-year.

In EMEALA, orders were up 5%, with continued strength in Service, up 12%. Demand in institutional gained momentum in the quarter, growing 50% year-over-year, driven by public projects in Europe. Industrial Refrigeration had another strong quarter, with greater than 45% growth.

Sales in EMEALA grew 2% organically, led by high single-digit growth in Service, with high single-digit growth from our recurring contracts and strong double-digit growth in our shorter-cycle transactional business.

Applied Commercial HVAC and Fire & Security grew low single-digits within the quarter. Segment EBITA margins of 7.7% remained flat as the growth in Service was offset by the conversion of lower margin Install backlog. We anticipate strong margin expansion in EMEALA through the remainder of the fiscal year. Backlog was up 10% year-over-year to $2.4 billion.

In Asia Pacific, as I mentioned earlier, orders declined 31% due to further deterioration of the China Install business, and we are being more strategic in the deals we select. Overall, APAC [ph] set of (00:16:22) orders grew low single-digits, driven by high single-digit growth in our shorter-term transactional business.

Sales in Asia Pacific declined 21%, as the installation business was impacted primarily by accelerated weakness in China. Our Service business grew 5% in the quarter. The weakness in China's Install business was broad-based across the overall portfolio, with HVAC & Controls down high-teens and Fire & Security down 20%.

Segment EBITA margins declined 140 basis points to 9.1% as weakness in China offset positive mix in our Service business. Backlog of $1.3 billion declined 21% year-over-year.

I would now like to turn the call over to Marc to discuss our second quarter and fiscal year 2024 guidance. Marc?

Marc Vandiepenbeeck

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

Thank you, Olivier, and good morning, everyone. Before I discuss our guidance on slide 9, I want to say how excited I am for the opportunity to partner with George as we simplify and transform Johnson Controls into a comprehensive solution provider for commercial buildings.

We exited our first quarter with the cyber incident behind us and the momentum we lost at the start of the year has recovered. We entered the second quarter with a backlog that remains at historical levels, a healthy pipeline of opportunities and strong momentum in our industry-leading Service business. We are introducing second quarter sales guidance of approximately flat year-on-year, which assume continued weakness in China and global residential HVAC. We expect strong contribution from North America and EMEALA led once again by our resilient Service business.

As we return to seasonality more in line with historical patterns, Global Products has one more challenging quarter before stabilizing in the second half.

For the second quarter, we expect segment EBITA margin to be approximately 14.5% and adjusted EPS to be in the range of $0.74 to $0.78. For the full year, we continue to expect the top-line growth of mid-single-digit, led by stronger performance in North America, further improvement in EMEALA, stabilization in Global Products and a cautious outlook on China. We expect segment EBITA margin to expand approximately 50 to 75 basis points for the full year, as price cost remain positive and mix continue to improve throughout the year.

As George mentioned earlier in the call, given the weakening macro outlook in China, we are updating our adjusted EPS guidance range to approximately $3.60 to $3.75. The overall guide assume a return to normal seasonality, second half stabilization of Global Products and a conversion of higher-margin backlog in Building Solutions.

We continue to expect adjusted free cash flow conversion of approximately 85% for the full year. The improvement we saw in cash flow for the start of the year demonstrate that our working capital improvement are gaining momentum.

With that, operator, please open up the lines for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] And today's first question comes from Scott Davis with Melius Research. Please go ahead.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Hey, good morning. Good morning, guys. Can you hear me okay, hopefully?

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

A

Yeah. Good morning, Scott. Can you hear us?

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

A

Good morning.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Yeah, fine. Thanks. George, I think it's been a tough couple quarters. Maybe if we take a step backwards, what do you think long-term this portfolio, the growth rate and margin levels and the cash generation, what is kind of your – I don't want to call it dare to dream, but what is the vision of where you think you can get two, three, four years down the road when – in a more normalized environment?

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

A

Yeah. So let me start, Scott, by just saying that, as you know, we've been through a significant transformation here into becoming a comprehensive solutions provider for commercial buildings. And then as part of that, continuing to focus on how do we transform the business model and how we bring our differentiated solutions to our customers in the commercial space. And so, as you look at what we've been doing, we are well positioned to invest and lead in the overall Building Solutions space, capitalizing on significant secular trends, sustainable buildings, smart healthy buildings. We've been allocating our resources and building out the capabilities.

When you look at the content of how we differentiate the solutions, it's not only through the leadership of the product, the applied product and continued investment that we're making in product, but also now deploying those products with a leadership platform with OpenBlue that we believe is going to now lead the industry. And that all is converting into how we change the outcomes for the customers that we serve, and that's through our engineered commercial solutions and converting what we do within Building Solutions to a digitally enabled service.

So when you look at the margin structure, as we go forward, not only are we getting a more focused approach to the differentiation with the value proposition right from engineering through install to then ultimately getting the life cycle services, when you project the overall performance going forward, we believe that from a growth standpoint, we'll be well-above market on capitalizing on the secular trends with the differentiation. And from a margin profile, we'll have a much higher recurring revenue within our services, demanding a much higher margin with the content of the software-enabled services.

And then from an overall return, when you look at the conversion to cash, we're getting now for the value proposition we bring, we're getting much more cash upfront relative to that value proposition and ultimately, being able to deliver very strong free cash flow. So I would say well-above market growth, continued expansion of margins to what we believe is kind of mid- to higher-teens and then very predictable cash flow with the mix of the content of what we do for our customers.

Scott Reed Davis
Analyst, Melius Research LLC

Q

That's helpful, George. And when you think about asset sales, and there's some nuance here, clearly, but is it more a function of simplifying the portfolios you can execute on those KPIs that you just mentioned? Or is it – or do the asset sales themselves kind of change the growth and margin profile of the company?

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

A

Let me reflect on the transformation that we've been going through, we've been continuously evaluating the portfolio, kind of where we are with the transformation of a comprehensive solutions provider in commercial buildings, and then making sure that our resources are being deployed to the highest priorities.

When you look at the non-commercial product lines, they are excellent businesses, but they do not necessarily – are they consistent with the go-forward strategy over the longer term? And that's now why as we are now pursuing the alternatives here. Because these are good businesses, and there's an opportunity with these businesses now to be able to create even more value for our shareholders as we look at the alternatives.

We're very excited about the future with the prospects that we have and the opportunities that we're driving towards. We believe that we're on the right path now to simplify the portfolio, continue to drive margin expansion, deliver much more consistent cash flow, while most important is really differentiating the value proposition that we can bring to our customers, which is going to be fundamental to the growth.

Operator: Thank you. And our next question today comes from Steve Tusa with JPMorgan. Please go ahead.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning.

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

A

Good morning. Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

It would be great if Marc can answer this question. But for the second quarter, could you just talk about the various segments and how you get to this 14.5% operating margin target, maybe on a year-over-year and sequential basis? And what do you expect out of them? And then I have a follow-up. Thanks.

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

A

Yes. Thanks, Steve. So first, I want to address the change in guidance, right? Since we issued our guidance in December, the impact of the economic environment in China on our business has deteriorated. And we have factored originally a fairly cautious outlook in China in the initial guide. However, that outlook has further worsened. We refocused the organization going through that tumultuous environment in China. When we see a path of recovery to that volume and recovery of the backlog as well in the second half of the year, but it started to bottom out in Q2. We have more clarity on some of the actions we've taken around productivity and cost structure, and that supported the recovery in that backlog.

Now focusing on Q2 on the different business. If you look at our field-based business, Building Solutions, the cyber disruption is really behind us. And the loss momentum that we had in Q1 is now recovering and supporting the shorter-cycle businesses, particularly our Service mix.

If you look at North America and EMEALA, particularly, the margin we have put in the backlog over the last six months, particularly during the first quarter, gives us confidence that we're going to be able to deliver on the margin rate for those businesses. There's a lot of benefit of cost actions we've taken early on in the year and later last year, but there's also more return to seasonality in our Global Products business as we see the volume providing [ph] marginally (00:27:09) in those operations. If you combine all of that, I think we see with confidence that margin being attainable, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay. And then just, George, for you, I guess. It's kind of hard to reconcile the commentary on momentum in your strategy with basically negative organic growth this quarter. Do you consider that positive momentum?

And then secondly, what was the – what drove the timing on this announcement of evaluating strategic alternatives? I mean, it's not like you have anything really lined up here, official to announce. So why are we kind of just throwing this out there today versus maybe over the last couple years where you've been kind of pursuing the same strategy? Just curious on kind of a straightforward answer on both of those. We don't need a lot of verbiage. Thank you.

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

A

So let me just comment on the quarter as far as momentum. We did have a significant disruption, as Marc said, for about six weeks of the first quarter, and part of that did have an impact on our momentum and our ability to be able to convert and the like. And so that was more of a short-term impact in Q1, in addition to the year-on-year adjustment that we've had in Global Products.

As far as the timing, I'm sure you can appreciate, Steve, that the board and the management team, we've had a very thoughtful approach to the strategy, we assess all avenues that will deliver value to our shareholders. Our strategy – our transformation has been focused on really leveraging all of our combined strengths and our differentiated product, our digital platform. And then from a go-to-market standpoint, the depth and expertise that we have from an engineering standpoint to ultimately be a comprehensive solutions provider and our ability to be able to take the value proposition and be able to convert that to recurring revenue through services.

We're seeing that momentum, which is beginning to convert and as we look at the difference in the business models within the businesses when we talk about the non-commercial businesses, there is a different business model relative to how we serve the market. And I think this allows us to be able to position those businesses for continued growth, while we're creating value, while we're focused on really now accelerating the progress we've made within our Building Solutions business.

Operator: Thank you. And our next question today comes from Jeff Sprague with Vertical Research. Please go ahead.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Hey. Thanks. Good morning, everyone. I wonder if we could just drill a little bit more, George, into kind of the portfolio review. And specifically, as you know, the business is complex day-to-day for you running it. It's even more complex for us on the outside looking in. So can you just size for us what we're talking in non-commercial assets? I think I put an estimate out there. I don't know if I'm in the ballpark or not, but just give us some sense of the total revenues that we're talking about that are under review and consideration and maybe kind of the average profitability across that basket?

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

A

Yeah. When you look at the overall revenues of these businesses, it would be less than 25% of the portfolio.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And how did the margins stack up versus the average at JCI?

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

A

Overall, when you look at the mix of the margins, it would be in line with the overall JCI.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Okay. And then just kind of coming back to maybe a more granular point on this then. Even preceding you, I think, as you well know, there was always this debate about, can you extract resi from kind of legacy, YORK, the resi and then Light Commercial, Applied are tied together, and maybe it undermines your larger commercial effort if you exit that business. So maybe you found a way to separate resi and Light Commercial or you think you can, but can you provide any additional context on that? And how the Light Commercial business, in particular, might factor into your strategic thoughts on where the business goes from here?

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

A

Sure. So if you look at resi, Light Commercial and the businesses now are really back on track. I mean we've had a really nice quarter here picking up share, both in resi as well as Light Commercial. [indiscernible] (00:31:59) business in North America was up double-digit, which was supported with 40% growth in commercial, and with resi being down about 7%. So the businesses now are performing – positioning to perform going forward.

On the ductless side, when you look at JCH, it's where we had strength in Japan, offsetting some of the weakness we saw in Europe and India. So when you look at the go-to-market, I think it's important to understand that these non-commercial product lines are excellent businesses. But when you look at the go-to-market, they're not consistent with what we're doing as we build out our Building Solutions over the long term. And so, we believe that when you look at the value proposition that we bring with our customers, that although there's an overlap with some of the applied rooftops, that can be managed with the structure that we put into place going forward. And so, I think when you look at the – it does not erode any value proposition in our comprehensive commercial solutions, but also positions the business to be able to take an incredible asset and create more value through growth.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

All right. I'll leave it there. Thanks.

Operator: Thank you. And our next question today comes from Nigel Coe with Wolfe Research. Please go ahead.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. So another question on the portfolio review. So, the press release on Friday highlighted Hitachi, but also talked about residential, light commercial for YORK. And I just wanted to make it very, very clear that we're talking here about just the US residential assets. But there's also a mention of the ADT business as well. So, any more color in terms of the non-commercial assets because it does feel like there are some commercial businesses here. And then on the Hitachi side, obviously, Hitachi still has 40% of that business. How much flexibility do you have to seek options for your majority control of the asset?

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

A

I think you'd appreciate, Nigel, at this stage, with the ongoing transformation, I would caution against making any assumptions at this stage and how we will effect it. I think the communication here today is that we're in a – we are pursuing strategic alternatives. We're going to continue to simplify and standardize across the portfolio. But we're in the early stages. And at this stage, I'm not going to comment relative to any one of the potential assets that we would look to create value with.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Worth a try there, wasn't it? But if we do assume that you execute on some form of strategic realignment for the portfolio, if you had, let's say, $5 billion of cash coming in the door today, how would you look to deploy that, George?

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

A

Yeah, as we look – I mean, we're, again, speculating on what would happen. I think as we look at what we do within our comprehensive commercial solutions business, we have been doing bolt-ons. We'll continue to be able to do bolt-ons in supporting the technology and our go-to-market as we strengthen that across the globe. And our intent would be to make it accretive as far as whether it'd be through bolt-ons and/or deployment back to our shareholders to offset the dilution that any divestiture might have.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. I'll leave it there. Thanks.

Operator: And our next question today comes from Noah Kaye with Oppenheimer. Please go ahead.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Great. First, a shorter-term one. You did mention signs of bottoming out in Fire & Security on the short cycle. Can you just give us some more indicators and confidence there?

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

A

Yeah. When you look at the business, whether it be at the product level or in the field, as far as the demand signals are coming through strong, we've gone through some adjustment relative to backlog as well as in the product business, the book-to-bill business. We see this really differentiating our overall commercial solutions and how we're utilizing these businesses and differentiating our solutions.

On a go-forward basis, we have – when you look at our pipeline of opportunities, it's pretty robust, and we're working to continue now to execute that into backlog and ultimately then the conversion revenues going forward. So, I think it's more short-term based on what we've seen here with some of the adjustments in the market, but we're confident that with the pipeline we have, we're going to be positioned to be able to continue to support the growth that we're committing to.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Thanks. And I think I'd like to return to the why now question that was asked earlier, and maybe frame it slightly differently. Obviously, the US market went through a tough year last year with volume trends. But certainly, there's some secular tailwinds as we look out over the next couple of years, refrigerant transition, ongoing price mix benefits, easier comps and then you have the transition, both in North America and globally towards heat pumps.

So there seem to be some positive prospects, both North America and globally for residential. And at the same time, there's, I think, overarching concern from many investors around non-res, right, commercial weakness. And so, I guess in that context, why now is particularly acute question, because I think from a cycle perspective, the market doesn't necessarily see the same trends ahead that would seem to inform this decision. So, maybe kind of talk to us about why this makes sense for you and why now?

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

A

Yeah. So as I said earlier, we've come through a very disruptive period, and there's been significant progress that has been made across these businesses, and these businesses are positioned to perform. And so as I said earlier, as you can appreciate, we're constantly reviewing the portfolio and understanding how we manage the assets to be able to deliver value for our shareholders. We've taken a very thoughtful approach to the strategy, and this has been continuous and making sure that we're assessing all avenues on how we ultimately deliver value to our shareholders. And so that's what's been playing out.

And I think tied to – as we think about our acceleration of becoming the leading comprehensive commercial solutions provider within commercial buildings, this is part of that path forward. And in line with – consistent with how we continue to update our shareholders, we'll continue to provide those updates as we continue to make progress with these potential divestitures.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Appreciate that thoughtful answer. Thanks, George.

Operator: And our next question today comes from Joe Ritchie with Goldman Sachs. Please go ahead.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Thanks. Good morning. Congratulations to Marc, and Olivier, we'll see you on the other side.

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

A

Thank you.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

The – let me just start with Asia because you referenced China a few times on your prepared comments. I'm just trying to understand like how much of the weakness that you saw this quarter was just the market deteriorating versus your own selectivity? And then as you kind of think about the next few quarters, should we be expecting material order declines to continue?

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

A

I'll take that, Joe. Last year, when you look at, where we were last year, we were working to recover our backlog from the second wave of COVID shutdowns in China. As the economic environment in China has slowed, we continue to make sure that we're streamlined with our organization and aligning our resources to the market to be able to maximize what we believe is our entitlement. And then make sure that we're executing with discipline to achieve what we see to be very strong lifecycle value creation with our services. This is what we played out in North America and which has been very successful for us.

We do have a very healthy pipeline as we assess the market, which we are converting. We are anticipating a slower recovery of the backlog and ultimately, the projected revenue, which now has been pushed to the right. And so those are the factors really updating our guidance there, Joe, but I'm confident that we have incredible product for the market, making sure we have the right go-to-market structure and then ultimately, being able to execute on what we see still to be a very attractive market.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks, George. And I know that you don't want to provide a ton of specificity on what noncommercial means. Just maybe for my own edification and remembering that the old Tyco assets, I mean I think you still had some Residential ADT's international assets as well. Just correct me if I'm wrong, if you don't. And then also just a point of clarification. The Light Commercial business is showing at roughly 6% of sales. I think, the last several quarters, we've been seeing it closer to 9%. Did you guys shift a portion of the Light Commercial sales into Applied? Just want to understand that a little bit, too.

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

A

When you look at the mix within our ducted business, which is mainly what drives our Light Commercial, is we're up 40%. And like I said, in our ducted business, when you look at resi being down slightly and then commercial being very strong, our whole ducted business was up 10%. And so this has been the differentiated product that we've been bringing into the market, getting – we've increased share, Joe, by – it's been roughly about 300 basis points over the last year with the recovery of the commercial market, and we've invested in the capacity to be able to do so. So as far as – that is the core of our light commercial business, and we've been performing extremely well.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

So, was there a reclass because it's showing like that business is lower as a percentage as your total sales than it was in the last few quarters?

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

A

It takes into account the VRF.

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

A

Joe, the difference is that the 9% is off fiscal 2022 sales in the prior year versus when we moved forward, it's now our fiscal 2023, now that, that year is final. It's just a – it's a math exercise.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Actually, that math doesn't really tie well, but I can follow up off-line. Thank you.

Operator: And our next question today comes from Andy Kaplowitz with Citigroup. Please go ahead.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning, everyone.

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

A

Good morning.

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

A

Good morning.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Could you give us a little more color regarding your order cadence within Building Solutions and what you're seeing? Obviously, most of the slowdown in orders as you said in Q1 was because of the slowdown in China. But did you see a dip in orders because of the cyber incident and then improvement? I think you changed your incentive comp structure for some of your salespeople as well in the quarter. So a lot going on. How are you thinking about orders and backlog from here?

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

A

Yeah. So as we talked about, we did lose some momentum because of the cyber incident. And so when you look at the sales conversion cycle, it did lengthen in the first quarter by about a week, a little bit better than a week. And so when you look at our pipeline, continues to expand and it does support the acceleration of orders in Q2 and through the remainder of the year in line with what we were projecting prior to having the impact that we had. So we're very confident that with the pipeline – with the generation – pipeline generation and then our ability to be able to convert with the cycle times we convert with, we're back to where we were. Then that also being combined with our success in services in being able to continue to build strong pipelines for services, convert to PSAs, building backlog and then ultimately, supporting our ability to get services, deliver high single-digit services for the year.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Thanks for that George. And this question might be for Marc. I know you ran Building Solutions in EMEALA at least for a little while. So obviously, those margins have continued to be challenging. Can you give us more color into what is holding down that segment, projects ending there and maybe better margin going forward? And then talk about the changes you began to institute and when they might have more impact on that segment?

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

A

No, a great question. So right away, when I took the role last year, we started to work on implementing our enterprise field operating model. That's very similar to what we did in North America a few years ago. Johnson Controls operates in markets that are very sizable and complex, but that provides ample opportunity for us to grow. But when you face large market, it's important to remain focused and disciplined on the subsegments of that markets that provide the right level of product capabilities, leverage our engineering talent and our solutions. And we are looking for those subsegments of the market that provide the most value for both our customer and the company.

As we continue to simplify, standardize and I would say, rationalize that business, the operating model becomes easier to adopt in the field, in the regions and the benefits of that model get amplified. We get a lot of leverage. And that's really what we've been focused on over the last six to eight months. There's still work to be done, but I see great improvement in our book margin. And as we start seeing the benefit of that model and the actions we've taken, so I'm very confident that EMEALA will return to a comparable profit level that the other field segment are seeing.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Appreciate the color, guys.

Operator: And our next question today comes from Julian Mitchell with Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. And thanks, Olivier, and congrats to Marc. Maybe just on slide 9, the guidance for the sort of existing portfolio. So, you're looking at sort of 4% organic sales growth, let's say, for the year. So the second half is implied, up 8%. How should we think about that plus 8%, splitting between Global Products and then Building Solutions? And just trying to confirm, does that second half growth guide of plus 8% include growth in both US Resi HVAC and also China Building Solutions? Thank you.

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

A

Yeah. So, thank you. So as you look at the breakdown between our Business Solutions segments and Global Products, we see a recovery in growth in Asia Pac in the second half of the year. So that will turn positive. And as we continue to see the other segment, BS&A in North America and EMEALA continuing to clog at mid-single digit. You can see the balance of those two offsetting and getting very strong single digits all the way to almost double-digit in the second half of the year. That supports the growth you're seeing on the slide.

When it comes to Global Products, we continue to see an improvement in orders. As we said, we believe that Q2 is really the bottoming out and the stabilization of that business, and we see quite good momentum in the recovery into Q3 and accelerating into Q4 supporting that number you see on the slide.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Got it. So both GP and Building Solutions grow at a similar rate in the second half to each other?

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

A

That's right.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. And then just a second question. I understand you can't talk too much about the portfolio. So maybe thinking about some other items. Just wanted, Marc, on the perspectives of sort of receivables factoring from here and what the approach will be in terms of does that factoring get unwound now because lead times are going back to normal. And Pillar 2 has come in. So should we think about the medium-term tax rate moving up to the high teens? Thank you.

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

A

Yes. So starting on that last question on tax rate. Obviously, there are some headwinds there with the [ph] good (00:49:12) changes in the rate. We are continually assessing it, and we'll continue to look at it. But you're right, there is a headwind longer term on the rate. When it comes to factoring, we always look at different methods to finance the company. And as you said, when lead times got difficult, when inventory were a little bit more elevated than traditionally, factoring became a logical avenue. We will continue to review the most economical ways to finance the company and we'll make sure that we take appropriate action against that program to align it with the financial commitment we've made to you, both in terms of profitability and free cash flow conversion.

Operator: Thank you. And our next question today comes from Gautam Khanna with TD Cowen. Please go ahead.

Gautam Khanna
Analyst, TD Cowen

Q

Hey, good morning, guys.

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

A

Good morning.

Gautam Khanna
Analyst, TD Cowen

Q

I was wondering if you could comment on pricing in the various verticals, what you're seeing with respect to pricing power? And then I have a follow-up.

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

A

Yeah. As part of that simplification of our business model, one benefit that comes in, we have more clarity on our cost accumulation and our ability to drive price, focusing the businesses, particularly our Business Solutions segments towards better vertical and better product lines and solutions. We are able to drive more price to the market than we have been historically chasing less – the segments of the markets, where competitiveness, but also value is hard to sell to the end customer. So as part of our Building Solutions operating system, you can see a great improvement both on the price we can command in the market, but also the price realization we see in our backlog and in our executed margin.

When it comes to Global Products, we've always tried to shy away from the more commoditized part of the market. For the parts where we actually have differentiated product, we see tremendous momentum both on pricing, but as well as the margin that comes on the back end of that. I'm particularly thinking about our Applied HVAC businesses that have been operating at very strong margin over the last few months and continue to see quite good momentum from a price cost standpoint.

Gautam Khanna
Analyst, TD Cowen

Q

And could you expand that commentary on the resi market as well? Are you still able to get price? Is there any pushback? Are you seeing any evidence of trade downs or movement to repair versus replace and the like? Thanks.

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

A

No. As we've said previously, we've continued to lead on pricing, making sure that with all of the reinvestments that have been made to support these regulatory changes that we're positioned to be able to get the proper price and that continues. And so, in spite of us being maybe not one of the top players, we've been very disciplined relative to how we're creating the value proposition and ultimately, how we're pricing in the market.

Gautam Khanna
Analyst, TD Cowen

Q

Thank you.

Operator: Thank you. And our next question today comes from Chris Snyder at UBS. Please go ahead.

Chris Snyder
Analyst, UBS Securities LLC

Q

Thank you. So for revenue, you guys are guiding March up about 10% sequentially, which is a good deal stronger than the typical mid-single-digit ramp that we've seen most years. Maybe can you just talk about the drivers of this – the sharp increase into the March quarter? I understand, there's a couple of points of cybersecurity catch-up, but it sounds like GP maybe is yet to stabilize. I think you said it troughs in the March quarter, so I would expect some headwinds there still remain. Thank you.

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

A

Yeah. It's coming, and I think, you mentioned it in your question. There's some return to normal seasonality versus the prior year. As we were flowing through the backlog, you can see that seasonality picking up, and that's lifting us a couple points. But you're absolutely right. The cyber disruption and the loss of momentum it had created in the quarter. There were very few orders that were lost, but the cycle time of our commercial team extended as we were going through the quarter. And that created challenge in the first quarter that now provides tailwind from a growth standpoint in the second quarter.

Chris Snyder
Analyst, UBS Securities LLC

Q

And was it one – I know you guys called out one point in the December quarter, if I remember correct. Was it one point again from cyber in the March quarter?

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

A

I don't believe we were that prescriptive, to be honest with you. It's really hard to measure with precision how much was cyber versus the market at the time. But I think, if you look at the momentum we've built now in Q2, I would tell you it's a few points of benefit that we are seeing.

Chris Snyder
Analyst, UBS Securities LLC

Q

Got it. Thank you. And then for my follow-up, on Global Products, you guys talked about seeing stabilization. Can you maybe talk about the respective product lines within that, being resi, Light Commercial and Fire & Security? Are they all showing stabilization, or are any leading, any lagging on that normalcy? Thank you.

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

A

When you look at our – the Global Products and more of the transactional businesses book-to-bill, we went through a significant inventory adjustment last year in the channel. When you look at our order rates now coming in and now what we're projecting in revenue, we're seeing that positive across the board.

Again, in the ducted business, resi still is down. It's still down about 20%, with price, we're down single-digits. That will continue to improve as we go through the year. But beyond that, across the board, we're seeing very strong orders in line with what we're projecting for revenue as we go forward.

Chris Snyder
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Thank you. And our next question comes from the Nicole DeBlase with Deutsche Bank. Please go ahead.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Thanks. Good morning, guys.

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

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

So we've covered a lot of ground here. I guess the last thing I just wanted to ask about is, I'll just keep it to one question, is you guys gave guidance and reported earnings obviously pretty late in the fourth quarter, with only a couple weeks to go. So how did China take you by such a surprise where we're only a month later and we have to cut guidance by $0.05? Thank you.

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

A

Yeah. The disruption that came from the cyber incidents also slowed down the pace at which data flows through the organization. And as I mentioned in the opening remarks, we had factored a fairly cautious outlook on China.

But our ability to really pin down exactly the impact, it was actually going to have in the current quarter and following quarter, as we are now about six weeks smarter and more educated about the challenge and that outlook has worked on further. We discussed it in a prior question, it's a combination of the market condition and us being more selective in the type of deal and the type of transaction we decide to pursue.

Operator: Thank you. And our next question comes from Joe O'Dea with Wells Fargo. Please go ahead.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. In your reference to simplifying and standardizing costs across the portfolio, I think, you've been on some kind of notable cost out as it relates to both COGS and SG&A. Is this sort of setting up for the next chapter, or can you talk a little bit about where you see the biggest opportunities on simplifying some of the cost structure and any sizing of those opportunities?

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

A

Yeah. So let me reflect on that. I mean, we've been through a major transformation, taking a set of businesses that were a lot of variation in the fundamentals within the operating system. We now have standardized that across the board. That has allowed us to become much more efficient, reducing layers and ultimately, the cost that is required to support the business. And as we continue now, so it's twofold not only standardizing the processes but then with automation and IT supporting those processes with good data, that has all accelerated within the company, which has allowed us to be able to now capitalize on more simplification. That's one element.

And then from a selling standpoint, as we then standardize our operating system around commercial, we've also been able to align our commercial resources in line with the market, with the segmentation that we're driving to be able to drive our growth, and we're seeing significant pickup there also. So it's really across the board on all of our cost elements in line with being much more simple, much more standard and more agile in how we now pursue growth.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

And then could you talk about service order trends by region when we look at EMEA/LA, the last couple of quarters, we're looking at low double-digit, mid-teens type of growth in service orders in each of those quarters, whereas in North America, we've been seeing low single digit? So what you're seeing in terms of sort of differences in terms of those growth rates, demand trends on the service order side in field?

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

A

Yeah. Let me just touch upon the fundamentals, and Marc can talk a little bit about the orders. The fundamentals here, we're increasing our attach rates and now we're up to mid- to upper 40 percentile. We're getting a more – a higher percentage of our installed base served. This year, we're going to be able to expand our connected assets by well over 10,000. We're going to be able to get PSA growth longer-term services up over 20%. And then when you look at the way that we're connecting our services, we're getting much lower attrition rates. That all now is playing out and positioning us for a strong high single-digit service growth again this year. On the order rates, as we look at any one of those elements, we're consistently driving that strategy across all three regions. So, Marc, maybe you want to comment?

Marc Vandiepenbeeck

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

A

Yeah, commenting on the three regions. So North America is our largest service business, and was also unfortunately the most impacted by the cyber disruption. So that's why you see a little bit of softness in Q1. It's a very transactional business, day-to-day business that has a lot of automation and reliance on our system to be able to order – book orders and execute that revenue rapidly. The fundamentals of that business hasn't changed, and I think the recovery is coming in the balance of the year, and we are seeing now in the second quarter a really strong pickup in that business.

If you look at EMEA/LA and Asia, touching on EMEA/LA first, those are mature businesses, but at a different part of the cycle when it comes to growth. There's enormous amount of opportunity in getting after our installed base and continuously maturing our business model similarly to what we've done in North America to really drive long-term double-digit growth in those service business. And in Asia Pacific, particularly in China, part of our refocus on the market is really focusing on those subsegment of the market, where we see a strong long-term service profile for our business in order for us to really maximize the whole life cycle of those opportunities.

Joseph O'Dea

Analyst, Wells Fargo Securities LLC

Q

Thank you.

Operator: Thank you. And our next question today comes from Deane Dray at RBC Capital Markets. Please go ahead.

Deane Dray

Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone. Just a question from me please. Regarding the potential or expected divestitures, or separation of resi. What would that do to RemainCo in terms of free cash flow potential? Just maybe down to the level of working capital. Just, does that change your ability to hit this target of 100% free cash flow conversion?

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yeah. Not at all, Deane. I mean we've been working on our free cash flow and the fundamentals of that across both the Building Solutions to be able to get more billing upfront and more in line with revenue, and then in our Global Products business have significantly improved not only the inventory, but also our ability to be able to collect. So as far as the commitment to our free cash flow target, we're going to be well positioned to be able to deliver on that target.

Operator: Thank you. And ladies and gentlemen, this concludes our question-and-answer session. I'd like to turn the conference back over to George Oliver for any closing remarks.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

Yeah. Just to wrap up, as we've discussed here today, we've been on a transformation journey for a number of years and have made incredible progress and have had many successes. While we're building strong fundamentals, we're also better leveraging our people and portfolio and ultimately, serving our customers in a better way. We're very confident we've built a very robust operating system across the portfolio and are going to be well positioned to deliver for our shareholders. And I do look forward to updating all of you as we continue to make progress. So with that operator, that concludes our call.

Operator: Thank you, sir. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.