30-Apr-2021

Johnson Controls International Plc (JCI)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Johnson Controls Second Quarter 2021 Earnings Call. Your lines have been placed on a listen only until the question and answer session. [Operator Instructions] This conference is being recorded. And if you have any objections, you may disconnect at this time.

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

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 second 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 certain 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 organic sales and free cash flow are non-GAAP measures and are reconciled in the schedules attached to our press release and in the accompanying index (sic) [appendix] (01:52) 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. I will start with a brief strategic update, spotlighting a few specific areas related to our growth initiatives. Olivier will provide a detailed review of Q2 results and update you on our forward outlook. And we will leave as much time as possible to take your questions.

Let's get started on slide 3. We delivered another quarter of solid financial performance. Organic sales and order growth inflected positive as anticipated, which, when combined with our ongoing commitment to operational excellence, enabled us to grow EBIT by more than 20% year over year.

Despite some challenges in the macro environment, inflationary pressures, supply chain disruption, and the lingering impact of COVID-19, trends across most of our end markets continue to improve. And we continue to gain share.

We have maintained an incredible level of engagement with our teams globally, as well as with our customers and partners. And we continue to execute on all of our strategic initiatives, expanding our service attachment rate and driving higher recurring revenue, enhancing and connecting our installed base with our digital OpenBlue platform, and advancing our role in addressing the environmental needs of our customers.

Lastly, as promised, we are announcing our cost of goods reduction program on today's call, which targets $250 million in run rate savings by fiscal 2023. In combination with the SG&A actions we announced earlier this quarter, we expect to deliver $550 million in net savings, which provides significant margin expansion over the next several years.

These actions are a testament to our commitment of continuous improvement that will enable us to close our margin gap versus peers.

Let's turn to slide 4. As was the case last quarter, we have had a number of strategic announcements. A few of the more notable examples are listed on the slide.

Each of these is significant in its own right. But I do want to take a minute to touch on two in particular. And that's the announced acquisition of Silent-Aire and the partnership with Pelion.

We are extremely excited to welcome the Silent-Aire team into the Johnson Controls family. Their best-in-class portfolio of innovative cooling equipment and modular data center technology is tailored to hyperscalers. These specialized data center providers are building and operating the critical infrastructure that the world needs in the rapid global transition to consuming cloud-based software-as-a-service.

There is a well-established entrepreneurial spirit throughout Silent-Aire, combined with a customer centric culture, deep subject matter expertise, and a long history of seamless execution.

Expanding our exposure to the data center vertical and, specifically, a high-growth hyperscale market, has been a high priority over the last several years. Silent-Aire accelerates these efforts considerably. And together, we have an opportunity to leverage a best-of-both approach to fuel growth in this end market globally with a high return profile and immediate earnings accretion.

We also announced a transformational partnership with the leading technology player in connected IoT device management, Pelion, a division of Arm technologies.

Put simply, this partnership allows us to bring connected intelligence to all of the operational technology, be it heat pumps, security sensors, or air handling systems in buildings. This partnership will help remove the complexities associated with pushing that intelligent to the edge by leveraging Pelion's connected device platform with secure simple integrations across a diverse installed base of hardware.

Pelion's open flexible device management capabilities will allow OpenBlue to run on any device in any hardware configuration at cloud scale and address the challenges with monitoring and maintaining performance at the edge.

Moving to slide 5. Turning to the theme of sustainability, we wanted to spend a few minutes highlighting one of the more important secular trends that we expect will benefit our industry for the next decade plus, and that is decarbonization.

With buildings representing approximately 40% of global greenhouse gas emissions, large scale investment in decarbonization is at an inflection point. We have seen corporate commitments to meeting science based targets from over 1,000 companies and countless commitment to net-zero operations from the private sector.

Federal policies and stimulus to incentivize investment in the renovation of existing infrastructure is growing. And regulations designed to reduce emissions are increasing. We see the investment required for commercial buildings to achieve net-zero extending into the hundreds of billions of dollars.

We believe we are uniquely positioned to capitalize on this once-in-a-generation opportunity with a combination of efficient building systems and smart technologies that are connected via our digital infrastructure, OpenBlue, as well as our global presence, enabling us to convert on a local scale.

Turning quickly to slide 6, we are enabling net-zero buildings today with a value proposition that is centered around transferring the risk of delivering building decarbonization from the building owner to JCI, leveraging flexible, customizable, turnkey solutions and our proven capability of delivering energy savings and emission reductions.

One such solution is OpenBlue Enterprise Manager, a comprehensive suite of applications to monitor and improve energy efficiency, tenant satisfaction, asset performance, maintenance operations, space performance, and ultimately the comfort of all occupants.

Using a single pane of glass approach, Enterprise Manager delivers the next generation of smart building capabilities for portfolios ranging from commercial offices, health care, mixed use high end, transportation, retail, and K-through-12 school systems.

Turning to slide 7, another increasing area of focus when it comes to addressing decarbonization is the electrification of heat. This is a market that is growing at a high single digit CAGR overall with a lot of that growth being driven by demand in Europe and Asia, as a result of the increased level of environmental regulation in these regions that minimize the use of fossil fuels and mandate low GWP refrigerants.

Many of you have asked recently about our offerings in this space. And from my perspective, I would tell you we have one of the broadest portfolios of heat pump technologies in the industry.

As you can see, our portfolio spans all major building segments, residential, commercial, and industrial, covering a wide range of capacities and equipment configurations. We are the leader in the complex segment, which serves applications like district heating and industrial process manufacturing, with the most complete offering stretching between our applied and industrial refrigeration portfolios and utilizing natural and HFO refrigerants.

District heating is an exciting sub-segment of growth in this category, particularly across Europe and China. In fact, we have had several major district heating project wins in these two regions recently, supplying customers with customizable solutions to help achieve their environmental goals and lower energy costs substantially. We also have a strong market position across commercial and residential markets in China with leading technologies in applied and ductless.

Turning to slide 8 and staying on the theme of sustainability, our customers are challenged with balancing costs and achieving their sustainability goals. Our solutions are positioned to address those challenges and be more agile in providing outcome based solutions and services centered around integrated data that reduce energy and cost, while providing an attractive return on investment.

As you can see on slide 9, the enhanced capabilities enabled by OpenBlue, combined with our performance infrastructure business, are proving to be a powerful combination in the current environment. Our energy savings performance contracts offer customers a budget neutral way to fund the improvements necessary to reduce energy intensity and the environmental footprint of a building through guaranteed operational savings.

This is a business we have been in for two decades, having implemented well over 3,000 performance contracts in North America alone with a portfolio of over $6 billion in guaranteed savings.

Utilizing OpenBlue-as-a-service, we help our customers make and implement the decisions that improve a building's total cost of occupancy, energy and carbon profile, as well as the well-being of their occupants without customers having to manage the process. We ensure our consistent availability to buildings and a predictable cost of operations. As a result, building owners are able to focus on their mission and their business.

We are proud to be partnering with our customers on several new projects. We have listed five recent wins that showcase our ability to power sustainability for our customers.

Before I turn things over to Olivier to review the financial performance for the quarter, let me wrap up my opening remarks by saying, we had a very strong first half of the year. And I am extremely encouraged by the momentum we are seeing across Johnson Controls.

Our teams remain focused on execution and are committed to achieving top-tier performance. We have a number of initiatives in-flight designed to accelerate top line growth and improve profitability and ensure we expand our competitive advantages. We continue to reinvest in our portfolio, both organically and inorganically. And we believe we are extremely well-positioned to outperform as we look to the second half of fiscal 2021 and beyond.

With that, let me turn it over to Olivier to go through the details of the quarter.

Olivier Leonetti

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

Thank you, George, and good morning, everyone. Continuing on slide 10, organic sales inflected positive as anticipated in Q2, up 1% overall, with strong growth in Global Products and underlying trends improving across our field businesses.

The strength in Global Products was driven by continued high levels of [ph] the vend (13:03) in residential end markets, not only in our HVAC equipment business, but also in security products.

The field businesses continue to improve on a sequential basis with service revenues having inflected positive and installed down low single digits. We have been encouraged by the more recent development of our order pipeline with clear signs of notable improvements in long cycle project activity.

Segment EBITA increased 15% versus the prior year, and segment EBITA margin expanded 130 basis points to 12.7%. Despite the modest recovery in overall volume growth, we have maintained our disciplined approach to managing the cost structure, resulting in additional year-over-year cost savings. We also benefited from strong execution across the board, as well as positive price cost, helping to expand our gross margins by 80 basis points.

EPS of $0.52 increased 24%, benefiting from higher profitability as well as lower share count. We had another strong quarter of free cash flow performance, up significantly versus the prior year to over $500 billion (sic) [$500 million] (14:29) in Q2. I will review further details of our performance later in the call.

Please turn to slide 11. Orders for our field businesses increased 4% year over year, inflecting positive and stronger than originally planned, led by a strong rebound in retrofit project activity, which we include in install.

Backlog grew 4% to $9.6 billion with service backlog up 5% to $2.4 billion and install backlog up 4% to $7.2 billion. Conversion rates in our service backlog continue to accelerate, which gives us more confidence in our mid-single digit service growth outlook for the year. Our install backlog flow rate is improving, particularly given the rebound in shorter term retrofit activity.

Turning to our EPS bridge on slide 12. Operations were a $0.10 tailwind versus the prior year, driven by higher volume, positive price cost, and the incremental benefits from previous cost actions, which offset regional and business mix headwinds.

Net financing charges added an additional $0.02, mainly the result of favorable FX gains. And non-controlling interest was a $0.05 headwinds as a result of stronger year-over-year performance in our Hitachi joint venture. Lower share count and net favorability from other items were a combined $0.03 tailwind.

Let us turn to slide 13 to discuss our segment results in more details. My commentary will also refer to the segment end market performance included on slide 14.

North America revenues declined 4% organically, driven by a 7% decline in install. As demand for shorter term retrofit and upgrade projects continues to improve and comps become easier in the second half of the year, we expect the install side of our business to grow as we move forward.

Service revenues were flat in the quarter with our recurring contractual service business up low single digit, offset by continued pressure in transactional service linked to customers' lower discretionary spend. [ph] By domain, (17:03) Applied HVAC revenues declined mid-single digits, while Fire & Security declined mid to high single digits in the quarter. We had a very strong quarter in performance infrastructure, which was up mid-teens.

Segment margin increased 110 basis points year over year to 12.7%, primarily reflecting strong gross margin performance, up 150 basis points, and continued cost mitigation efforts.

Orders in North America rebounded sharply on a sequential basis and grew 5% versus the prior year. Applied HVAC orders were up low double digits overall, driven by strong retrofit activity. Backlog of $6 billion increased 3% year over year.

EMEA/LA revenues were essentially flat organically with the prior year with install up 1% and service down 1%. Market conditions remain mixed with varying degree of lingering COVID restrictions and lockdown across many parts of Europe and Latin America.

We saw low single digits growth in our Applied HVAC & Control business, which was more than offset by low single digit decline in Fire & Security, which improved on a sequential basis. Industrial Refrigeration grew mid-single digits.

By geography, revenue in Europe grew low single digits, while the Middle East improved sequentially due to an acceleration in HVAC demand. Latin America was down high single digits.

EBITA margin declined 40 basis points, including a 40 basis points headwind from FX. Excluding FX, EBITA margin were flat as favorable price/mix and continued cost mitigation efforts were more than offset by lower volumes and lower equity income.

Orders in EMEA/LA accelerated to up 5% in the quarter, led by mid-single digit growth in Fire & Security and over 20% growth in Industrial Refrigeration.

APAC revenues increased 9% organically with install up 15% and services up 3%, both led by a recovery in Applied HVAC & Control, which grew a little over 20%. Strength in HVAC was driven by the rapid recovery we are seeing in China, where revenue growth accelerated more than expected, up more than 60% year over year.

Conditions outside of China remain mixed with sporadic lockdown restrictions across part of Southeast Asia and a spike in COVID cases in India.

EBITA margins declined 10 basis points year over year to 12.3%, including a 20 basis point headwind from FX and a divestiture. Core margins improved by 10 basis points, as the benefit of volume leverage was partially offset by unfavorable country mix.

APAC orders declined 1%, despite a 40% increase in China orders, as the economic recovery in many of our other key geographies remained subdued due to the ongoing impacts of COVID and delayed rollouts of vaccines.

Moving to Global Products. Revenue grew 6% on an organic basis in the quarter. Our global residential HVAC business was up about 20% in the quarter with strong growth in all regions.

In North America, resi HVAC grew 35% in the quarter, slightly ahead of our expectations, as the market seems to remain in a V-shaped recovery. And we continue to gain share as a result of expanding our points of distribution and new product launches. Orders in the quarter were nearly up 90%, and we exited the quarter with a record level of backlog.

In Asia Pacific, [ph] our H2H (21:17) residential HVAC business was up in the mid-teens percent range with growth across all of our major regions, Japan, Taiwan, and India. Although not reflected in our revenue growth, Our Hisense JV in China grew revenues 90% year over year in Q2, which explains the majority of the growth in our equity income this quarter.

On the commercial HVAC side, the sales decline significantly moderated to low single digits, as high single digit growth in our indirect applied business was more than offset by a decline in light commercial.

Fire & Security products grew low single digits overall, led by continued strength in our security business with flattish performance in commercial fire detection and suppression markets.

EBITA margins expanded 280 basis points year over year to 14.2%, as volume leverage, positive price cost, higher equity income, and the benefit of mitigating cost actions was partially offset by negative product mix.

Turning to page 15. Corporate expense was down 15% year over year to $70 million, benefiting from cost mitigation actions and continuous structural cost reductions. We do expect corporate expense to step up in the second half, as some temporary cost reductions begin to reinstate.

Given the favorable performance year to date, we now expect corporate expense to be in the range of $285 million to $295 million for the year. For modeling purposes, we have included an updated outlook for some of our below-the-line items.

Turning to our balance sheet and cash flow on slide 16. Starting with the balance sheet at the top of the page. Similar to last quarter, no significant changes versus the prior period.

During the second quarter, we repurchased approximately 6 million shares for roughly $315 million, which brings us to around 14 million shares year to date for just under $700 million. We remain committed to completing $1 billion in share repurchases in fiscal 2021.

As a reminder, you may recall that in mid-March, we announced an increase to our annual cash dividend of 4% to $1.08 per share, remaining within our target payout ratio of 40% to 45%. This is the first dividend raise since the divestiture of Power Solutions back in 2019. And we believe we are positioned to resume a pattern of solid dividend growth going forward.

We also announced an increase to our existing share repurchase authorization, which gives us the capacity for a little less than $6 billion in buyback.

Our balance sheet remains healthy with leverage of roughly 1.8 times, still below our targeted range of 2 to 2.5 times.

On cash, we generated $539 million in free cash flow in the quarter, bringing us to nearly $1 billion for the first half. This is a significant improvement compared to our normal seasonality and has been driven by solid trade capital management, lower CapEx, and timing of payments.

As we enter our back half, we would expect lower conversion levels than what we have seen in the first half and compared to our historical seasonality, given the expected acceleration in our top line and CapEx spend.

Before we turn to our guidance update, as George referenced at the start of the call, we're launching phase two of our three years cost program, presenting the detail of our cost of goods saving plan on slide 17. Similar to our SG&A savings plan announced intra-quarter, we completed a bottoms-up analysis of the entire $15 billion based of cost of goods sold. And have thoroughly evaluated plan to optimize our spend in selected area.

We have included a breakdown of the addressable spend category on slide 18. Based on our review, we have built a firmed roadmap to $250 million in net run rate savings to be realized over the course of fiscal 2022 and 2023.

Nearly three-quarter of these savings are tied to plans that improve labor productivity, standardized project execution practices, and streamlined by [ph] core (26:17) activities across our branch based businesses.

The remaining 25% primarily address cost in our manufacture facility and supply chains, including leveraging best practices of our Level 3 GCOS facilities and deploying them across our manufacturing base.

We have combined our SG&A and COGS saving programs into a single consolidated view on slide 19. As you can see from the chart, we are targeting $550 million in combined net savings over the course of the next 2.5 years, which in addition to normal base margin improvement related to revenue growth, improved mix, and annual productivity, provides significant margin run rate potential.

Delivering on this plan will ensure we close the margin gap versus peers and, in turn, create significant shareholder value.

Please turn to slide 20, where we are initiating fiscal Q3 guidance for adjusted EPS of $0.80 to $0.82, which is predicated on mid-teens organic revenue growth and more modest segment EBITA margin performance compared to what we have experienced in the first half, given the significant temporary cost actions taken last year during the third quarter.

For the full year, we're raising our guidance once again. And now our target adjusted EPS in the range of $2.58 to $2.65. This compares to our most recent EPS guidance of $2.50 to $2.60 and our initial guide in January of $2.45 to $2.55. You may recall that we provided updated EPS guidance intra-quarter in conjunction with our SG&A cost reduction plan in late February.

Based on our strong performance in the first half, and continued underlying momentum we are seeing in most of our end markets, we are raising our organic sales growth outlook to the high end of our previous range.

Segment EBITA margins are tracking towards the high end of our most recent range. And we now expect 70 to 90 basis points of expansion for the full year. Free cash flow conversion is well on track for 100% for the full year.

Before we get into our questions, I would like to point to our slide 21 and ask you to save the date for our 2021 Investor Day, which will be held on September 8. More details to follow in the coming month.

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

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

Operator, can you open the line for...

QUESTION AND ANSWER SECTION

Operator: Thank you. Thank you. [Operator Instructions] And our first question is from Nigel Coe, 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

This has been a strange quarter for the calls [indiscernible] (30:14). So yes, first of all, just want to touch on the COGS and SG&A actions. I'd be curious what prompted the sort of the second round of efficiency programs? What prompted the review? And is it a case of having lived through COVID and remote working that you found more efficient ways of doing things? Is it the case of Olivier coming in and having a fresh look? I mean what prompted these actions?

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

A

So, Nigel, good morning. Thank you for your question. After the merger, following the merger, we created the conditions to go to another level of profitability improvement. And when I started, George ask us to now look at levers to close the productivity gap to our competition. So that was the driving force. And that was communicated, Nigel, about seven months ago.

So we have been – and we said, we will go and update you as plans are unfolding. So first was SG&A and today is our COGS plan. And as you can see from the numbers, Nigel, we believe we are going to add significant profit to the bottom line. And we are well on track to close the gap to our competitors.

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

A

And, Nigel, it's really a continuation of the work that we did with the integration. We've got strong fundamentals now across the board. We've got the right leadership team. And then the work that we've been doing, we recognize that there's a significant opportunity to continue to improve. And what we've done as a team is to be able to detail that. And then we're very confident that we're going to be positioned to be able to deliver on those benefits.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thanks, George. Thanks, Olivier. And then service orders down 3%. I recognize the backlog is up, but maybe just talk about what caused that decline? Just given the initiatives you have in trying to drive growth in services. And, I heard transactional was under a bit of pressure in North America. But what is your confidence that orders start to impact positive from here?

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

A

Nigel, as you know, we have an incredible base of service, over $6 billion. And what I would say here, with the service strategies that we've been executing, I'm incredibly proud of the progress we made. It's one of our biggest growth vectors. It's being able to increase market coverage, enhance technology with OpenBlue, create new service capabilities, really now being able to leverage the underserved installed base. And then ultimately deliver very attractive margin profile.

When you look at the quarter, service orders were down slightly. And it's mainly just timing of conversion. We had an extremely strong March, which is continuing in April. Our service pipeline is up double digit. And then with the site access improving, that's also helping us to accelerate our L&M and our L&M contracts, which is labor and materials.

And so our attach rate, when you look at our attach rate for service with our install projects, is up significantly, up 300 basis points year to date. And so when you look at our backlog up 5%, the strong pipeline, and then the work that we've done executing on our strategy, we're very well-positioned for a strong double digit second half in both orders and revenue.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks, George. I'll leave it there.

Operator: Thank you. Our next question is from Gautam Khanna with Cowen. Your line is open.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Yes. George, I wanted to ask, in your opening remarks I think you talked about supply chain constraints. And wondered if you'd expand on that? And just did it actually prevent you guys from delivering equipment in the quarter? Maybe if you have any sort of quantification of how that may have affected first quarter results? And then I have a follow-up.

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

A

Yeah, Gautam, I mean, our team is doing incredible work across our supply chain, as we're working to be able to support what we see to be an accelerating pipeline of opportunities across our businesses. We're gaining share in every platform. And so as we're working to make sure that we've got secured components and materials to be able to support that new demand, certainly we're working it hard.

I believe that our team has done a good job to mitigate most of the impact. I think where we're seeing significant demand in residential on unitary, as well as commercial unitary product, we're continuing to work that. And not only expand our supply chain but also our manufacturing footprint. And so we're working through that.

Our backlogs are up in those businesses, are record highs. And so we are working to continue to accelerate our supply chain to be able to address and support the increasing demand. But overall, I'm very proud of the team and the work we've done to be able to support our customers and ultimately deliver on the product that's being demanded.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

And just as a follow-up, George. Any quantification of specific IAQ orders that you guys have had in the quarter? And perhaps any color on the front log of opportunities that are IAQ-specific? Thank you.

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

A

Yeah. When you look at the progress we're making with OpenBlue across the board, not only digitizing our core business, but now being able to, with the data that's being extracted and the solutions that now we're bringing to the market, truly now positioning us to capitalize on these significant accelerating trends.

So when you look at healthy buildings, our OpenBlue Healthy Buildings launched in mid-January with a solution portfolio of over 25 unique products and services, which is targeted at healthy people, places, planet.

The market opportunity continues to grow. We originally sized it at $10 billion to $15 billion, and that continues to increase. Our pipeline is nearing $1 billion. Year to date, we've secured over $150 million. We expect this to continue to play through with a few hundred million in 2021.

We partnered with schools. We've got an incredible base of business with K-though-12 schools. We're working closely where we have presence with over 6,000 districts. We're working with sports venues and the like to bring back people to sports events.

And so when you look at what we're doing, it's really a robust approach that ultimately starts with a detailed assessment. And then through monitoring, remote maintenance, and optimization that we can do, ultimately driving the best solution. And so we're extremely excited.

And then lastly, with OpenBlue in general, across the board, it's really translating to multiple elements. It's improving our service attach rates. It's improving profitability in our businesses with the book margins that we're booking. It's making us more competitive now in the overall smart buildings with our leadership in sustainability and decarbonization, which I talked a little bit about in my prepared remarks.

And then the overall acceleration of digitization within our existing service base through connectivity, going back and getting our install base connected, has given us an incredible platform now to become much more intimate with our customers and bring our new capability to really change the game in how we serve them.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Thank you.

Operator: Thank you. Our next question is from Jeff Sprague with Vertical Research. Your line is open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everyone.

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

A

Morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Hey, good morning. Hey, two questions for me. First one, it looks like you're telling us you're going to absorb these cash restructuring costs and still convert at 100% free cash flow conversion. I just want to confirm that's the case.

And if so, what's really allowing you to do that? I guess it has to be working capital? And if it is, maybe you could elaborate a little bit more on the working capital opportunity that's bridging you across that?

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

A

Good morning, Jeff. So you're right. The 100% free cash flow will include both the restructuring cash impact of our SG&A and COGS pronounce – COGS programs announced today.

You're right. More profit will be part of how we get there, and also enhanced working capital. If you look at today, for the second quarter, we have improved cash conversion cycle by about 24 days, 8 in DSO, about 11 days in DIO, inventory, and about 5 days in DPO.

And we have built over the quarters, even before I took the position, a great machine to have a high focus on working capital. And you see that keep delivering.

And we are actually very confident in our ability to deliver 100% free cash flow this year, but also the following years, right? If you do some math, Jeff, just in the first half, we are converting at 140%. So we have quite a fair headroom to now achieve 100% for the year.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. And then maybe secondarily, just on the COGS program, the mix of savings are interesting. I guess if I was going to field a guess of where the costs would come out, I would have surmised maybe more in manufacturing and distribution and less so in field labor.

I wonder if you could just kind of address the manufacturing and distribution piece. It looks like you've got a $3.2 billion cost base there, if I'm interpreting the chart right. And you're targeting $70 million of savings there.

I guess these plans might not be fully mature after kind of a seven-month exercise. But would there be kind of more room in some of these numbers as you look forward?

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

A

So the – so a few things. We said that – I'm going to repeat it – those savings are net, meaning they will flow to the bottom line. If you look at the mix, our team has done a great job in managing direct materials over the few quarters.

And we think now the biggest opportunity – that's why we have announced the numbers we have announced – are in the standardization of our field operation across all the elements of field operation, install, services, and procurement.

Now the other question was, is there more possible? That's, of course, the case. We want to be prudent. And we keep informing you as we go through the quarters. But we have a high level of confidence in our ability to execute this COGS program.

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

A

And, Jeff, I think it's important to note that as we went through the integration, we developed a robust operating system for the field, which enables us to be able to take all of what we do to put into that one operating system.

And then with that globally, be able to focus on the variation at each one of the cost levels and be able to drive improvement. So the work that we've done is we actually have that detail to that level across the board in how we're driving improvement within that operating system for our field based businesses.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thanks. Very encouraging. Good luck.

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

A

Thank you.

Operator: Thank you. Our next question is from Scott Davis with Melius Research. Your line is open.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Hi, good morning, everybody.

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

A

Morning, Scott.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Kind of – I'm kind of – I'm curious kind of logistically and otherwise, what an outcome based contract really looks like? I mean are you deferring getting cash in the door? How long does it take to kind of prove the outcome that you're promising?

Just can you walk us through at a high level, without giving away your trade secrets here or contract secrets? But can you walk us through at least at a high level, what a contract like that looks like? I'll just leave it at that, George.

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

A

Yeah. So, Scott, it's similar to our performance contracting that we have today, where we ultimately do a survey of a customer's site. We identify opportunities to be able to reduce energy, improve operations, and the like.

And when we do that, there's significant improvement to be made. I mean buildings historically have been very inefficient. They've been very energy intensive. And so our opportunity here is to be able to create an outcome, energy savings, higher operations, and then do that.

We – in some cases, we bring in financing for the project. And ultimately then get a recurring revenue that goes over – it can be over 10, 15, 20-plus years, depending on the type of projects. These are great returns, great recurring revenue that's tied to that initial install project. And ultimately delivering on the outcome.

And our track record in being able to deliver on the commitments that we make with these type of contracts is extremely high. So it's – we do manage a bit of risk, but it's relatively low. And we ultimately make sure that with the technologies and capabilities that we provide, that we deliver on the outcome that we commit. Olivier?

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

A

One statistic, Scott, and we haven't disclosed this before. If you look at the energy saving performance market in the US, which is a $4 billion market, the company has a market share which is 50% higher than our number two competitor.

So we have a strong position in the energy saving outcome base market. And we believe that we're going to leverage this capability going forward as buildings decarbonize across the planet.

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

A

And, Scott, I think it's important to understand that today that buildings are about 40% of the carbon footprint globally. And about 75% of that is operational.

And so when commitments are being made to get to net-zero carbon emissions, buildings become very important in how they ultimately drive towards getting to that outcome.

And so we have an incredible opportunity with the capabilities that we have now with the – not only what we've done historically with performance contracting, but now with OpenBlue to bring together holistically complete systems that, with the use of the data, we can drive a lot of optimization in what we ultimately deliver for the customers to be able to meet their objectives.

Scott Reed Davis
Analyst, Melius Research LLC

Q

That certainly makes sense. And is it harder to collect in those contracts where you – is there kind of disagreements of what the data shows and the sustainability of that and with the savings? It seems like there'd be some gray area items in there, but perhaps I'm wrong.

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

A

Scott, it's the opposite. It's very predictable. And I think our track record relative to the projects that we've executed, that has been very strong.

So we make sure that as we look at these type of projects with the customers that we're doing these projects for, that we're, obviously, mitigating any risk and ultimately focused on executing on the commitments that we make.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Perfect. Thank you for the clarification. Good luck and congrats, guys. I'll pass it on.

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

A

Thanks, Scott.

Operator: Thank you. Our next question is from Steve Tusa, JPMorgan.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, good morning, guys.

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

A

Morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Can you just talk about – a little bit more about price cost? What was the spread in the quarter? And how you're seeing kind of pricing and costs evolve over the next couple quarters? And is there any – given your kind of fiscal year-end timing, any leakage into next year?

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

A

Yes, Steve, let me start, and I'll turn it over to Olivier for some of the – more of the details.

But as you know, over the last three years, we've really built strategic pricing capability across the company. And if you look at the last couple years, we were able to be able to deliver net 100 basis points on the top line as a result. That has served us extremely well as we get into the cycle with accelerating inflation.

So with that, we have improved discipline in the field. We're executing projects better at better margin rates.

And then within our product businesses, where you see the impact sooner because of the material cost, we've been able to have a very dynamic pricing model that had been deployed across to each one of our platforms to ultimately not only see what's happening in the near term, but longer term, being able to be very dynamic in how we pass that along into the channels.

And so to-date, we've – in the second quarter, we had about a 30 basis point benefit. And we believe that the work we're doing, not only in productivity, VAVE, direct material and productivity, designing material costs out of our products, and then ultimately driving just improved productivity across the entire supply chain, that we're still in a position to be net positive here in the second half. Olivier?

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

No, nothing more to add, Steve. And when you look at the slide 19, when we say 30 basis point base margin improvement, we are factoring also our best view on next year price cost. But we have a great process across the organization to maintain that going forward in this very fluid environment.

C. Stephen Tusa Q
Analyst, JPMorgan Securities LLC

Okay. Any other mechanical items for next year that we should be aware of as you move through this year that flip either positive or negative outside of the kind of obvious restructuring and the activities you've already kind of talked about?

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

Nothing more than what we all read in the news. It's still a fluid environment. We feel very bullish about how the economies across the world are rebounding. George mentioned that earlier in this call.

Our order flow is increasing significantly. And something important, if you look at our install business, which is about 35% of the revenue of the organization, we see this business now growing. And that is done at the back of the retrofit market.

Usually, 50% of install is associated with new buildings. The new buildings today are depressed. So as this new building is starting to rebound, and it is in the US and across the world, we see our business really taking momentum. And that will translate into, of course, more Global Products products being sold, higher service mix. So we feel very positive about what we see in front of us.

C. Stephen Tusa Q
Analyst, JPMorgan Securities LLC

Great. Thanks a lot. Appreciate it.

Operator: Thank you. Our next question is from Julian Mitchell with Barclays. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good morning.

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

A

Morning, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Maybe – morning. Maybe a first question around Fire & Security. You've got good sort of recovery trends, very evident on the HVAC side of the house. Fire & Security sales still down mid-single digit. So maybe help us understand how you see the slope of that recovery from here? And perhaps how big of an impact is the sort of retail piece in there as a headwind?

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

A

Yeah. Julian, let me start by just framing up Fire & Security and what we saw in the quarter and what it means as we go forward. It is about 40% of our total revenues. It's core to building systems. It's got a very attractive margin profile due to the product and service mix. We've got a large installed base, which ultimately drives the recurring revenue.

And this combined now with OpenBlue, we can truly differentiate what we do longer term to get a higher percentage of that recurring revenue. And security now in the new world, in the digital world, that now is becoming a critical asset, as we think about our smart buildings, to be able to collect data and apply analytics.

When you look at the sequential trends, our short cycle business in Fire & Security is up nicely. When you look at products up, total products is going to be up – it's up about low to mid-single digits. And then our service actually inflected positive in the field businesses, which as you know, because of all of the shutdowns, we had a lot of difficulty over the last few quarters to be able to get in and perform the service.

So I think as we go forward, those trends on the shorter cycle is coming through very nicely. And then on the install side, as these new projects are coming to market, both in retrofit and in install, which are longer cycle, we're getting more than our fair share on that. So as they're coming to market and these projects start to be deployed, we're very well-positioned to be able to start to pick up the install revenues.

But I would tell you, the shorter cycle piece is actually performing very well. And so even though the install revenues were down, it's mainly just a function of timing of conversion. And we see the orders now picking up very nicely in the second half.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you. And then maybe switching to a topic that's relevant across the company. There's a lot of interest, obviously, in the US education stimulus money that could flow over the next three years. Maybe help us understand what the scale of JCI's exposure is to that education vertical, as you're looking across the field and Global Products business?

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

A

Yeah, Julian, let me summarize it quickly here. The three large COVID relief packages, they totaled about $5 trillion in aid over the last 12 months, much needed relief for our customers.

We were very active in participating and making sure as those bills were put together, that certainly was focused on healthy buildings and making sure that as we – whether it was bringing students back to the school room or the like or buildings, we were very actively involved in making sure that the details of what was going to be needed to be able to address some of the new challenges were actually incorporated in the bills.

And when you look at the funding directed to upgrading facilities in the vertical markets that we have the highest exposure and deep relationships, it is K-through-12, higher ed, and then state and local government, which play to our strengths.

And so when you look at your question on education, K-through-12, we have relationships across North America or the US with about 6,000 school districts. And then at the higher ed level, about 1,900. They all – this all plays right into our strengths.

And so in K-through-12 alone, there's been about $195 billion allocated. And so what we've done is making sure that not only right from the front end of building the build to now executing state by state with what we have as a program management office. We're making sure we're detailing all of the flow of that stimulus. And that we're positioned to be able to address the challenges that they're going to deploy that stimulus to be able to address.

And so we think the TAM for the US, you're in billions of dollars relative to the opportunity that we see as we're going after this. And the healthy buildings market itself, we said was originally $10 billion to $15 billion. That continues to be expanded with the stimulus that's coming into the market.

So we believe that we're in the early stages with the pipeline that we see, that it's in the hundreds of millions of dollars that we can be well-positioned to execute on.

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

A

And, Julian, I would just add that when you look at education, it is a big vertical for JCI overall. And particularly when you look at North America, it's about 20% of the revenue.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's great. Thank you.

Operator: Thank you. Our next question is from Josh Pokrzywinski, Morgan Stanley. Your line is open.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Hi, good morning, guys.

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

A

Hey, good morning, Josh.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

So, George, if you wouldn't mind just kind of taking a step back. I know with the nature of the field business and kind of the mix of Fire & Security and HVAC in there, it sort of makes benchmarking tough.

But if I look at what we've kind of seen so far through the first quarter, it seems like maybe from an orders perspective, commercial HVAC is running up kind of mid-teens at the market level. I think you mentioned low double digits in Applied North America.

But what's your sense on kind of the product side of commercial HVAC? And where we should sort of see order rates here? Whether it's this quarter or kind of here in the medium term?

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

A

Yeah. Josh, I think as you look at our mix, certainly, we're a longer cycle with the installs, service part of our portfolio. But as you dig into the specific products, in every category, we're gaining share. So if you look into, for instance, in the unitary business in the commercial side, new orders in North America for RTU equipment for the rooftops is up mid-teens. And with March up over 30%, our backlog is up 100%. Now, those orders are in our product based business. So you wouldn't see those orders. It's in the – obviously, inherent in the book and bill.

And then when you look at our unitary share, we're up about 40 basis points year over year. And so as we look at the backlog being up 100% and the projected growth here in the third quarter, in North America unitary, we're projecting we're going to be up 30-plus percent in the quarter and third quarter. So that would be the commercial side.

On the residential side, our orders were up again about 88%, record level of backlog there. Our sales were up about 35% with – our units were up over 40%. We're seeing strong sell-through through that channel. We're going to see continued strength in Q4 – on Q3 and Q4. And so that's continuing.

When you look at – and that the same holds true in our Hitachi business in Asia Pac, we got strong double digit revenue there, mainly driven by Japan. And that's been because of a gain share with our new product introductions.

And then when you look at even in North America, when you look at even though our install shows our orders were up about 5%. And underlying in those orders, in North America we saw mid-teens growth in applied equipment orders. So that is going to play out very nicely for us in the second half. And ultimately set us up for increased service attach and service revenue going forward.

So you got to look at the detail to understand that in every category, whether it be through our distribution or as we now set up our install business, that we're setting it up for the longer term that's going to be very attractive.

And just building off one thing that Olivier said, when you look at our install business, we have significantly outperformed through this cycle. With the non-resi construction down as much as it is, we were able to actually fill most of that void with short term retrofit upgrade orders, which in North America alone were up 20% in the quarter.

Now we're seeing a fundamental that with the short term demand, that's going to continue. It's going to continue around healthy buildings and sustainability projects. That's going to now combine with what we see happening in non-residential new demand coming through.

This is the first that I've seen the two coming together. And it's going to play out very well in the second half for strong orders, as well as beginning to convert to strong revenue in the second half.

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

Josh, and one statistic again, which gives – allows you to put all that together, Global Product in aggregate. For next quarter, we believe we're going to be able to grow revenue in the 20%-plus range. So that gives you an idea about what is going on around all the elements of the portfolio, 20%-plus revenue year-on-year growth expected.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Hey, that's super color. Maybe just one follow-up on Scott's question on performance contracting.

George, I think to your point, this is a business that you guys have been around in for decades now. I'm surprised that giving how compelling that is for a customer, that the industry isn't bigger or JCI's exposure to that isn't bigger. I mean it almost seems kind of like a free upgrade, providing you bond support to get that work done? What's been kind of the bottleneck to that historically?

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

It's a great question. So we're working with all of our customers. And historically, a big customer has been the government, both at the federal level, at the state level, and at the local level with our 3P type contracts and performance contracts.

And so we've been working with them. And some of it is how they account for the projects. And ultimately, how they look at it as an upfront cost. And how they account versus an ongoing operational cost.

And so we've been very active working with our customers to make sure that they're addressing some of their internal challenges that get in the way of doing a contract like this, which is very attractive in being able to get returns that pay for the cost of capital.

And so we're working to really start to create that market, above and beyond what it is today. And we believe that we're very well-positioned to be able to then capitalize on that opportunity, Josh.

Joshua Charles Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Perfect. Thanks, George. Good luck, guys.

Operator: Thank you. And our final question comes from Andy Kaplowitz with Citigroup. Your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning, guys.

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

A

Morning, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Morning. Olivier, can you give us a little more color on how to think about the 550 basis points of total cost out? And what it actually means for incrementals over the next few years?

It looks like inclusive of the core margin improvement of 30 basis points that you're dialing in on average, you think you can get something like 300 basis points of margin improvement over the three-year period with, on average, 100 basis points and core incrementals in the 40%-plus range. But I just want to sort of confirm those numbers.

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

A

No, good morning, Andy. Your numbers are absolutely correct. If you remove Silent-Aire in the next fiscal and the one after that, would be in the 40% incremental.

After that, we believe we will have created the conditions to deliver on our 30% incremental. And we will unpack all – I mean we gave you a lot of data already, Andy. And we'll give you even more on earning – on Investor Day in September.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Very helpful. And then, Olivier, maybe a follow up in terms of, we know that JCI is obviously an inverted company. So we wouldn't expect a big impact from Biden's corporate tax plan.

But how are you thinking about the resiliency of your tax rate, if there is some kind of global minimum tax agreement? And what kind of levers can you pull to maintain your relative low tax rate advantage?

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

A

So the situation is fluid. We – all of us are reading the papers, all of us have insights on what could happen.

So one, we are, of course, committed to the 13.5% tax rate for this fiscal. And going forward, we have run various scenarios. We are highly confident that our tax rate will remain competitive relative to the industry. And we have various levers to achieve that. Some of it is, of course, where we are registered as a company and the complexity of our legal entity structure. We believe it's going to be and remain a competitive advantage.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Very helpful, Olivier. Thank you.

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

A

Thank you, Andy.

Operator: Sir, would you like to do some final comments?

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

Yeah. Let's wrap up the call this morning. As I mentioned earlier, we've had a very strong first half of the year. And the momentum we are seeing across our portfolio, coupled with our strategic focus and improved execution, gives me high confidence in our ability to be able to outperform as we go forward.

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

Operator: And thank you. This does conclude the call. You may disconnect your lines and thank you for your participation.