04-May-2022

Johnson Controls International Plc (JCI)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Johnson Controls second quarter 2022 earnings call. Your lines have been placed on listen-only until the question-and-answer session. [Operator Instructions] This conference is being recorded. If you have any objections, please disconnect at this time.

I will now turn the call over to Ryan Edelman, Vice President, Investor Relations.

Ryan Edelman

Vice President, Investor Relations, Johnson Controls International Plc

Good morning and thank you for joining our conference call to discuss Johnson Controls' second quarter fiscal 2022 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.

As a reminder, before we begin, during the course of today's call, we'll 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 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 appendix to the presentation posted on our website. Additionally, all comparisons to the prior year are on a continuing ops basis.

With that, I'll turn the call over to George.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Ryan, and good morning everyone. Thank you for joining us on the call today. I'm going to get started with a brief overview on slide 3. Our results in the second quarter reflect solid top line execution, as we delivered strong sales, orders and backlog growth in line with our expectations and at the high end of the guidance we provided. Demand for digitally enabled equipment and services that solve for sustainability and energy efficiency remains robust. And our sales teams are doing an outstanding job capitalizing on that demand. The reinvestments we have made to develop industry-leading products and solutions are delivering results.

Digitization is at the center of our strategic vision for the company, and we continue to advance those strategies every day. OpenBlue is accelerating the digital enablement of our solutions, allowing us to deliver increasingly differentiated offerings and capitalize on emerging secular trends. We're also seeing the benefit of the discipline we've instilled in our pricing capabilities over the last two-plus years. Price realization continues to accelerate, contributing nearly six points to overall organic revenue in the quarter. You see that most clearly in our shorter-cycle Global Products business, but it's also accelerating in our longer-cycle field businesses.

We also continue to gain traction on our key vectors of growth. Global efforts to decarbonize economies and ensure the health of indoor environments are accelerating, both supported by the adoption of new policies by governments and industry associations. At the same time, we continue to accelerate actions to optimize the efficiency of our cost structure, and we remain on track to deliver $230 million in productivity savings this year. We have deployed over $1.5 billion in capital year-to-date, including over $1 billion in share repurchase and more than $400 million in cash dividends.

Our M&A pipeline continues to build, with a number of active opportunities that would allow us to support our vectors of growth. I'm incredibly proud of the progress we have made towards achieving our strategic objectives year-to-date. As we have said in the past, we truly believe we are among the best in class when it comes to the ability to deliver fully integrated solutions designed to address the challenges associated with the global secular trends developing across our industry. We are operating in a very dynamic environment with heightened supply chain disruptions. Second quarter profit underperformed relative to our expectations. And while the anticipated supply chain improvement is happening, it is happening at a slower pace.

Let's turn to slide 4 for more detail on what we're seeing in the North America segment. Demand remained strong, with orders up 13%. Our backlog grew 14% to a record $6.9 billion. Just as in other parts of the organization, we are advancing our strategic priorities to accelerate growth by addressing the sustainability and healthy building needs of our customers.

Going into the quarter, we anticipated continued challenges related to supply chain disruptions and material availability, more specifically, inadequate supply of semiconductor chips and components for controls products. The margin underperformance relative to our expectations can largely be explained by the pace and mix of backlog conversion, resulting in lower absorption on our cost base.

As we described to you on our last call, in any given quarter, we are typically executing on about 40,000 projects across install and service. Each of these projects requires a significant amount of coordination. In the current environment, managing through our own material shortages, in addition to our suppliers and customer supply chain and labor constraints, magnifies any slippage.

Additionally, given the pace of orders we have seen and the backlog we have been building, we have maintained our investment in sales head count and service technicians. With revenue conversion and mix below our plan, we were not able to fully cover the higher cost of reinvestment in the quarter.

The last point I would make on this is on timing. Our initial forecast in late January assumed a modest recovery in supply chain conditions as we progress through Q2. Although there were some improvements in the quarter, the recovery was slower to materialize, which coincided with the seasonal ramp into our peak season during the month of March. Net-net, these two issues accounted for a $40 million profit impact in North America.

We expect a slower pace of improvement to continue throughout the second half, which is the primary contributor to our lower outlook for the year. Despite these challenges, we are confident the backlog is turning, driving higher revenue growth with more accretive margins as we think ahead to 2023.

Please turn to slide 5. OpenBlue remains the core of our strategy to digitize our portfolio to enable differentiated outcome-based solutions. During the quarter, we commercialized several exciting new offerings, including the OpenBlue Gateway, a cost-effective, easy-to-install device that will serve as a key enabler to accelerate the connection of our installed base. OpenBlue NetZero Advisor will be launching within the next several weeks and will help customers manage Scope 1 and 2 emissions in their journey to achieve net zero.

Lastly, OpenBlue connected controls will be the first full integration of OpenBlue into our legacy Metasys systems, which we believe will be a disruptive offering that will fundamentally change how building automation systems operate, increasing the intelligence of building controls by infusing AI. Importantly, this offering will allow us to extend our reach further into the mid-market with a compelling plug-and-play solution.

Let's turn to slide 6. We continue to make progress in the digital transformation of our service business, leveraging OpenBlue to further differentiate our capabilities. We're on a path to drive higher attach rates on our installed base, increase the level of connectivity of those assets, and then, as a result of differentiated service offerings, drive higher revenue per customer and lower our attrition rates. This service growth flywheel is a clear algorithm that helps us achieve above-market levels of growth expected to generate over $2 billion in sales through 2024.

Although we are still in the early stages of this process, our core service business, augmented by early results from digital services, performed well in the quarter. Sales were up 8% overall, with orders up 10%. Our attach rate improved another 130 basis points in the quarter, bringing us to over 200 basis points year-to-date, well on track to achieve our 400 to 500 basis point target for the full year. Digital services increased 7% in the quarter.

Turning now to slide 7. The global commitment to decarbonize economies continues to gain momentum, both in the public and private sectors. There is also increased recognition that economies cannot truly decarbonize without decarbonizing buildings, which contribute 40% of the planet's greenhouse gas emissions. Rising energy prices and the potential risk of supply shocks are forcing many governments to reconsider sources and uses of fuel. The combination of higher energy prices and security risks are making paybacks much more attractive. We continue to see policy moves and commitments from corporations that support the carbon reduction of buildings. Our deep understanding of the building ecosystem uniquely positions us to capitalize on these trends.

During the quarter, we completed the full commercialization of our NetZero capabilities. Our Performance Infrastructure business has evolved into a global organization we now refer to as Sustainability Infrastructure, backed by decades of experience delivering guaranteed savings, and an extensive network of subject matter experts.

The breadth of our installed base, the depths of our field presence, supported by an industry-leading portfolio of digital products and solutions, delivers a holistic solution for customers to achieve net zero. We continue to make progress. Year-to-date, our Sustainability Infrastructure business has booked over $450 million in orders, and our unfactored pipeline now exceeds $7 billion.

Continuing with our vectors of growth on slide 8, healthy buildings. We were encouraged by the recent initiative launched by the White House and the EPA. Both customers and government agencies increasingly see the long-term value of investing in improvements in building health and resiliency. And it is not just focused on K-12, nor is it only related to COVID response.

We are strategically well positioned to capitalize on the adoption of healthy building trends. We continue to develop and deploy new offerings with a focus on shifting the value proposition to longer term, more strategic asset management. During the quarter, our healthy buildings orders were up more than 30% to $150 million, and our pipelines continue to build.

Finally, on slide 9, we continue to demonstrate our leadership in sustainability and ESG. We are perhaps most proud of our own Chief Sustainability Officer, Katie McGinty, recently being named as the Top Woman in Sustainability in the corporate world.

To close out my prepared remarks, I remain extremely excited about the continued advancements we have made relative to our key growth vectors, and I couldn't be more pleased with the way our teams are executing in such a difficult environment. We remain laser focused on our strategic commitments, and to delivering the outcomes our customers need on the path to a healthy and more sustainable future.

Although we are navigating through a more challenging environment with increased uncertainty regarding the macro backdrop, I am confident in our path forward. Momentum within our short-cycled products business is solid. Our backlog is strong, and the margin profile is inflecting as we lap prior-year order intake, all of which sets us up well for 2023 and beyond.

With that, I'm going to turn the call over to Olivier to walk you through the financial details in the quarter and update you on our outlook. 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 10. Sales in the quarter were up 9% organically, at the high end of our original guidance for high-single-digit growth, with price contributing nearly 6 points above what we originally anticipated. We saw strong performance across our shorter-cycled Global Products portfolio, up 14%. Our longer-cycled field business also performed well, up 7%, with solid growth in both service and install.

Segment EBITA increased 8%, with margin down 10 basis points to 12.6%. Solid underlying volume leverage and the benefit of our ongoing SG&A and COGS programs were offset by higher inflation and supply chain related challenges, as George discussed earlier. Despite achieving over $200 million in price on the top line, price/cost was slightly negative in the quarter and, together with supply chain disruptions, resulted in a 160 basis points margin headwind.

EPS up $0.63 increased 21% year-over-year, benefiting from higher profitability as well as lower share count. Free cash flow was down as the prior year benefited from lower working capital needs and COVID-related benefits.

Turning to our EPS bridge on slide 11. Overall, operations contributed $0.10 versus the prior year, including a $0.08 benefit from our COGS and SG&A productivity programs. Underlying segment earnings were a net $0.02 tailwind year-over-year. Excluding the extra headwinds from price/cost and supply chain disruptions, underlying incrementals in Q2 were approximately 36%.

Please turn to slide 12. Orders for our field businesses increased 11% in aggregate with continued momentum on a two-year stack basis. Service orders were led by high teens' growth in our shorter-term transactional business. Install orders continue to rebound, primarily driven by demand for applied HVAC and controls systems. Backlog grew 12% to $10.9 billion, a $1.2 billion increase versus the prior year and up $500 million sequentially. Secured margin backlog is up 80 basis points in the quarter, reflecting our pricing discipline and the improving margin trend we expect as this backlog converts later this year and into 2023.

Let's discuss our segment results in more detail on slide 13 and 14. Sales in North America were up 6% organically, with broad-based growth across the portfolio, led primarily by strength in our Applied business, up low-double digits. Fire & Security grew low single digits. Order were up 13%, with low teens' growth in Applied, driven by continued equipment demand in the data center, K-12 and healthcare verticals. Sustainability Infrastructure orders were up mid-teens despite a strong double-digit compare, as we booked another large energy services project with a US public school system.

Fire & Security orders were up low-double digits, and backlog ended the quarter at $6.9 billion, up 14% year-over-year. Segment margin decreased 210 basis points to 10.6% as volume leverage and cost savings were more than offset by a 250 basis point headwind from the pace and mix of backlog conversion and lower absorption, as George described earlier.

In EMEALA, we saw continued strength in the core Fire & Security business, which grew at a high-single-digits rate in Q2. Industrial Refrigeration grew high-single digits, driven by the conversion of several large industrial heat pump projects. Orders were up 8%, led by low-double-digit growth in our core Fire & Security platform. Backlog was up 9% to $2.2 billion.

Underlying margin performance was driven by volume leverage, positive price/cost, and the benefit of cost savings, offset by supply chain disruptions and lower equity income. Sales in Asia Pacific were led by low-double-digit growth in Applied HVAC. China continued to outperform with revenue up nearly 20%, led by strong double-digit growth in Industrial Refrigeration and mid-teens growth in Applied.

Orders increased 8% with continued strength in Applied, driven primarily by continued momentum with the industrial vertical in China, with a continued pipeline of infrastructure investment across key verticals like petrochem, semiconductor and data center, as well as healthcare. Backlog of $1.8 billion was up 5% year-over-year. The decline in margin was primarily the result of headwinds from price/cost and unfavorable project and geographic mix.

Global Products continued to perform well, up 14% in Q2, with broad-based strength across the portfolio, led by mid-teens growth across our HVAC equipment platforms. Global Residential HVAC sales were up 15% in aggregate. North America resi HVAC was up 27%, benefiting from both higher growth in our equipment and parts business and strong price realization. Production in our new facility in Mexico continues to ramp, and contributed meaningfully to volume growth in the quarter.

Outside of North America, our resi HVAC business grew low-double digits, led by strong double-digit growth in Europe, driven by strong demand for our Hitachi residential heat pump. APAC resi HVAC sales grew high-single digits, led by strong growth in India and Taiwan. Commercial HVAC product sales were up high teens in aggregate, with strength in Light Commercial, driven by strong performance a Hitachi as well as 20% growth in North America and more than 20% growth in VRF.

Fire & Security products grew low-double digits in aggregate, with strong demand across the entire portfolio. Although not recorded in our official field order backlog, Global Products orders were up mid-teens organically, and our third party backlog exceeded $2 billion. EBITA margins expanded 170 basis points to 16.1% as volume leverage, higher equity income and the benefit of productivity actions more than offset headwinds from price/cost.

Turning to our balance sheet and cash flow on slide 15. Our balance sheet remains in great shape. We ended Q2 with $1.8 billion in available cash and net debt at 2.1 times, still at the lower end of our target range of 2 to 2.5 times. Free cash flow was an outflow of $200 million in the quarter, driven primarily by higher year-over-year working capital requirements, higher CapEx, and the absence of prior-period tax credits and other COVID-related benefits. Trade working capital as a percentage of sales declined 50 basis points to 8.6%.

For the first half, we are fairly neutral on free cash flow, which brings us back in line with our normal first half, second half seasonality. We repurchased another 7 million shares for just over $500 million in the second quarter, bringing us to just over $1 billion for the year.

Now let's discuss our revised guidance on slide 16. Underlying demand trends across most of our businesses continue to improve, and I'm encouraged by the pace of order growth we have seen year-to-date. As George highlighted in his remarks, the ongoing supply chain challenges impacting the pace and mix of our backlog conversion in North America is driving a reduction in our outlook for the rest of the year. As a result, we are revising our full-year adjusted EPS range to $2.95 to $3.05, which represents 11% to 15% growth year-over-year.

On the top line, we still expect to grow 8% to 10% organically. Price is now expected to contribute 6 to 7 points, up an additional 1 to 2 points relative to our prior expectation, fully offsetting additional inflation. For the full year, we still expect to be slightly positive on price/cost. Segment margin is now expected to come in flat to down 30 basis points, reflecting pressure related to additional price on the top line with minimal margin contribution and the mix impact associated with the supply chain disruptions in North America.

Combined, these two factors results in a 80 basis points margin headwind relative to our prior guide and now account for nearly a 150 basis point headwind versus the prior year. As it relates to the ongoing lockdowns in China and the conflict in Ukraine, we are monitoring the developments daily.

From a planning standpoint, although it is difficult to model precisely, we have embedded some incremental contingency to account for the additional uncertainty surrounding the supply chain for the balance of the year.

This is reflected in our updated segment margin guidance for the year. Full-year free cash flow conversion is now expected to be about 90% as the inventory buildup in the first half, combined with slower backlog conversion, creates nearly a $200 million headwind to our prior guidance.

Turning to Q3. We expect the headwinds related to supply chain to skew slightly more towards the third quarter, with EPS expected to be in the range of $0.82 to $0.87, which assumes organic revenue growth of high-single digits, and a segment margin decline of 80 to 100 basis points. Although our expected backlog conversion rates are challenged near term due to supply chain issues, I'm confident in our long-term outlook. We have strategically positioned the company to accelerate growth, aligned with competing secular trends impacting buildings for the next decade. We continue to make good progress on our cost productivity program. And as backlog conversion normalize in 2023, margins are expected to recover, keeping us on track for the fiscal 2024 targets we provided at our Investor Day last September.

With that, operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now start the question-and-answer session. [Operator Instructions] Our first question comes from Nigel Coe of Wolfe Research. Your line is open, sir.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. Thanks for the question.

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

A

Good morning, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Maybe just talk about – hi, George. Maybe just talk about, did you get de-commitments from suppliers that caused some of this pressure in North America? And when did this start to really manifest? Was this more of a March issue? Or was it something that developed through the quarter?

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

A

Yeah, what I would say, Nigel, is as we indicated on our prepared remarks, I'd start with the value proposition of our field-based businesses, particularly in North America, is resonating very well with our customers. You saw our orders up 13% year-on-year. We're up 18% with a two-year stack, strong demand for the vectors of growth from services and sustainability, indoor, environmental quality, and that's in North America. But across the board, we're seeing significant pickup in our digital capabilities.

And so I think as you look at the quarter, a combination of things that created the shortfall. We had recovery plans. We've been working with our chip manufacturers and semiconductor material suppliers for the last year. And we've been working at the most senior levels, myself personally involved with CEOs, in understanding what their long-term plans are and how does that align to supporting our growth. And we've made a lot of progress. And that includes also having to redesign chips and ultimately making sure that we're going to be positioned where the supply will occur and have much more resiliency in our plan going forward.

And so when we look at short term, it certainly was the plans that we had had have moved to the right. They continue to improve but, Nigel, it's the same time that we're ramping up with our seasonal build. And so typically, we're up usually 10% to 15% into March, as we plan for our third quarter and ultimately fourth quarter. And so that is ultimately what happened. And so we weren't able to convert the backlog. And a lot of this is our high-margin mix as it relates to controls.

And the good news is, when we look at our digital, our orders, the orders in our controls-based businesses were up over 30%. And so our backlogs are significantly up in spite of the supply chain improving. And so it did have a disproportionate impact on our revenue conversion in the field because of this high margin. And when you think about products, products multiply in the field. So not only once we deliver the product, we get multiples of revenue for how we not only support a project, but more important, how we complete the service. And so it's about 40% of our revenue does convert as we ramp, especially going into our peak season in the last month, and that resulted in about an impact of $40 million in the quarter.

Now as we have – certainly, we've been working this for the last year. We've gone back and making sure that, as we understand now what is the commitment, not only in additional capacity, but how we are positioned relative to that capacity, I feel really good because our suppliers are totally committed and aligned with our growth strategy. And so this will play out with a recovery in the second half.

And I think as I think about not only completing 2022, but the setup we have for 2023, with the margin that we put into backlog, and we're seeing that in our Global Products with the book-and-bill business, we've seen tremendous agility relative to pricing. And we've done the same in our field-based businesses, although there's a little bit of a lag, that we're going to be set up for not only strong high-single-digit pricing, but now with the revenue conversion, as we get into recovery in the fourth quarter setting up for the first quarter, you could assess that we have $1 billion to $2 billion of additional capacity to take on the recovery.

When you look at our backlogs, we think we start to accelerate recovery as we get through fourth quarter and then ultimately set up the first half in 2023. So that's what we've been experiencing. It's been a full-contact sport, everyone totally aligned working with our suppliers and making sure every step of the way, we're positioned to deliver the growth and ultimately get to the volume growth and the returns that we've committed, which I believe we're going to be in good shape to do over our long-term plan.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay, thanks, George. And just maybe just clarify, did you say high-single-digit pricing in the backlog? I just want to clarify that point. But maybe turn to Olivier. So basically, the $0.27 revision to the midpoints guide, $0.16 is kind of like coming out versus consensus 3Q and $0.11 in 4Q. I'm curious, how much do you have baked into 3Q and maybe 4Q for the China lockdowns and weaker growth in China real estate? Obviously, FX is a little bit of an impact. But I'm more curious on the North American impact, how that's impacting 3Q and 4Q? And do we have any spill forwards into 2023?

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

A

So, if you look at today, the guide we are proposing for the second half of the year, we are planning minimum amount of improvement. We are ramping in the second half relative to the first half in volume. If you disaggregate what is going on in the second half in our guide, we expect to be price/cost positive by about $50 million, but we expect disruptions to still impact our business. We have factored about $100 million due to disruption. Again, we are doing that in the abundance of caution. Obviously, we're watching what's happening in Europe. We're also watching what is happening in China.

But as we said earlier, we have build year-on-year in Q2, $1.2 billion worth of backlog. And we believe that we will have the manufacturing capacity and also supplies capacity in at the start of next year to flow the backlog at a very enhanced margin. And as George indicated as well, Nigel, we couldn't be more pleased with how our value proposition is resonating with our customers. If you look at orders, if you look at services, sustainability, healthy building, all the indicators are very positive. So today, it's a temporary conversion question that we have to face.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Okay. Thank you very much.

Operator: Thank you. The next question comes from Josh Pokrzywinski of Morgan Stanley. Your line is open.

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

Hi, good morning guys.

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

Yeah, morning, Josh.

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

Morning, George. Want to follow up on that last point that, I think, Olivier, you made on the margins when this stuff exits the backlog and ultimately supply chains improve, that those should be healthy. I guess if some of the issue is that the field force is sort of underutilized when you can't get this product, I mean, isn't there sort of kind of a bandwidth on how much they're able to do on the other side? I'm just trying to think through like, should we expect above-normal incremental margins on the way out? Or is it just as simple as you can only install stuff so fast and the field force can only be so productive with the number of hours in the day?

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

Yes. So if you look at – you're absolutely right. So we expect largely that the backlog issues will normalize in the first half of the year. If you look at today, the margin at which we price orders today, we're pricing in anticipation of inflation, and we're pricing today high-single digits. So we believe we are going to have a very healthy set of revenue based upon the orders we book now, and those will flow at the start of the year. We have the capacity, and we believe we're going to be well positioned from a margin standpoint.

In addition, and I know we spend a lot of time on our field business for good reasons, our Global Products division is really outperforming, strong revenue growth and strong profit rate improvement. So again, very pleased with the value proposition of our company, Josh, and we believe second half – first half of next year, we will see a significant margin improvement going on.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then...

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

A

Hey, Josh, just to – Josh, just to add to that because I think it's important to understand the pricing dynamic. As Olivier said, with the book and bill business, we've been very agile, as I said, with the pricing, and we're getting, on the 14% growth, about 10% pricing that's embedded in that. As the inflation began to accelerate last year, we began to then, as on a forward-looking basis within our field-based business, to be able to forward look much higher levels of inflation. So we've been putting into backlog over the last number of quarters, much higher anticipated inflation.

So what you're seeing converting now are projects that, prior to last year or early last year, that are still converting. But with what we've been putting into the backlog is priced much differently, and that becomes to be a higher mix as we get through the second half. And then more important, as we look at our turn in the backlog going into 2023, that's where I said that we have – we're positioned for high-single-digit conversion relative to the price that's in backlog.

So that is the work that we've been doing over the last, it's really been the last two years with the work that we've done around pricing. But we're very confident that with the fundamentals we have in place, and it's demonstrated in our product businesses, that we're getting great traction with the initiatives that we have in place.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. And then just on digital services, I saw the 7% growth. Is there something I'm missing in kind of the base that that's off of? I would have thought things like OpenBlue and some of the newer kind of digital offerings would have been growing a bit faster. Is there some legacy stuff that is maybe a bit slower or being kind of made obsolete by OpenBlue that kind of altering that base?

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

A

No, I mean Josh, when you think about our OpenBlue, it's really digitalizing all that we do. It's strengthening our products, and it's fundamentally becoming embedded in all of our services. So when you look at OpenBlue, it's the connectivity. So it's the ability to be able to connect. And then with that connectivity, we're increasing our attach rate of contracts, long-term contracts. It allows us then to, with these new service offerings leveraging the data and the AI that we're applying to the data, that fundamentally differentiates the service offering. So that's incremental revenue per customer.

And then with the connectivity, it allows us to be able to significantly reduce attrition. And that's, when you factor in all that the digital does, it contributes to that high-single-digit service growth that we're committed to achieve. And we're making great progress. Like, when you look at the new services that we've launched here in the last, just the last quarter, whether it be the connected – our new gateway that is going to be fundamental to all of the assets that we have in the installed base, in how we get them connected. And then now we're launching our advisory services, energy advisory services and associated services, so there's a lot of – it's now IAQ as part of our healthy buildings service. It's the enabler now of those additional services with that connectivity that ultimately drives the revenue per customer. And the revenue per customer price as well as additional service is significantly growing.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Appreciate the color there. Thanks, George.

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

A

Yeah, maybe an additional comment, Josh. This is important. Most of those capabilities and those we believe are unique in the market. When you speak about OpenBlue Gateway, which is a easy way to connect all devices in the building, if you speak about also OpenBlue connected with BMS, which allows you to control a building remotely, that's unique in the market. And our edge capability to the now implementation to our ecosystem of [indiscernible] (00:39:44), those are unique capabilities. We believe game changing for the building business, those are also new. So we will start to see more of an inflection point forward as well, Josh.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Oh, appreciate that. That's helpful context. Thank you.

Operator: Thank you. The next question will come from Steve Tusa of JPMorgan. Your line is open, sir.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hi guys. Good morning.

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

A

Hey, good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Morning. Olivier, maybe just a couple things on the numbers. First of all, on the quarter, can you just maybe give a little more context around maybe a couple of examples that had amongst the larger impacts on the margin in the quarter, just from a fundamental on-the-ground perspective, just to give us a better picture of what's actually going on and what the headwinds are? And I assume you're viewing these as kind of like discrete headwinds. You're not covering your fixed costs, so they should kind of reverse next year.

And then number two, you mentioned that you do have some contingency built in to the second half of the year. Maybe could you give us some more precise financials around what normally would have happened, and then what you're assuming? Most companies are assuming some improvement in supply in the second half. You're kind of saying that you're not assuming much at all. Maybe just clarify with some financial detail to help us understand how the comps work into next year.

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

A

Absolutely, Steve. Nice to talk to you. Let me give you an example on North America. If you look at our North America business, which is our most sophisticated business, the value proposition of what we do is resonating in the market. And that's important. I will answer to your question precisely. But if you look at the underlying trends, order growth, 13%, 18% on a two-year stack; backlog growth, 14%; services growth, 7%; Sustainability Infrastructure two-year stack, 60%; healthy building orders growth 85%. We have tremendous demand for our North America business. The challenge today is a short-term conversion.

Let me give you an example. In North America, we need to orchestrate our own supply chain, the one of our partners and the one of our customers. And the issues we are all facing in industrial world are being amplified in this sophisticated business. So that's what is happening. And as George has indicated, it's mainly due to controls. And for $1 of revenue with controls, you have a tremendous impact on the total revenue for North America.

To your question, will that reverse next year? The answer is yes. We expect today, if you look at in aggregate for the company, the sum of the headwinds are going to be about 160 basis points for our company for the full year. If you look at the underlying margin, they're increasing by more than 100 basis points, Steve. And we expect that to be flowing through next year. So that's the first part of your question.

On the second part of your question, we are being prudent. We are September year-end company, so we'll have less time to see what's happening, for example, in Europe or in China, which is largely today, in some parts of the operation, in lockdown. We are planning, as I indicated, more disruptions in the second half. I said about $100 million of disruption; that's prudent. We believe we have factored the risk in the appropriate manner, and we see some positive price/cost. So prudent approach to supply chain, and we expect first half of next year to be a very positive start for us as we convert backlog at a very high margin.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Right. So when you guys guide next year, you will assume that, for lack of a better term, the comp is very easy so that you'll be guiding to above average or above what you would have expected incremental margins and the earnings kind of flow through next year as opposed to this year. So when you guide, that would be the case, all else people, correct?

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

A

That's absolutely the case.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Okay.

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

A

If you look at all the indicators today, Steve, regarding the health of our business, it's actually very strong, and the margin rate should increase significantly next year above averages, no question.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks a lot.

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

A

Steve, I think it's important – Steve, it's important to note that, when you look at our backlogs, both in our book-to-bill were up significantly year-on-year still, and that's continuing to build. And then our field-based businesses were up significantly. And so we're working this such that with the recovery as we see going through the peak in the third quarter and then we begin to recover, we have one to two, we believe in the beginning in the fourth quarter, first half of next year, with the commitments we're getting on supply right now, that that's the capacity that we have to really begin to accelerate the recovery with the backlog we've built. And the demand continues to be very strong, especially as it relates to our digital components, and that's a reflection of the work we're doing with OpenBlue and across our digital platform.

So I think we have confidence at this stage that going into the year, we should have real good tailwinds with the margin in backlog and then the ability to be able to convert with an improved supply chain.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks, guys.

Operator: Thank you. The next question comes from Gautam Khanna of Cowen. Your line is open, sir.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Yeah, thank you, guys. Olivier, just to clarify your answer to Steve's question just now. I want to ask, if you were to take the sum of fiscal 2023 and fiscal 2022, before we walked into today, do you still think the sum of the two is going to be equal? I mean, in other words, these are – the full catch-up in 2023 [indiscernible] (00:46:32) 2023 numbers should actually go up from where we were as there's a catch-up in the first half? I just want to be clear. Should we take down kind of the forward curve in entirety?

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

A

Absolutely, the math is correct. If you take the sum of the two years, we would be able to recover the margin rate. And again, if you look at the top line today and the indicators we have in term of orders and now that will convert, we feel very positive about top line and margin improvements when you take those two years together. Correct.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Okay. And just given...

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

A

Hey, Gautam, I think, Gautam, maybe, Gautam just a...

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Yeah, please.

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

A

Gautam, just a point on that is with the supply chain, because a lot of this is really impacting our digital mix and the recovery of – we've got commitments now on the recovery of the microchips and semiconductors. They are weighted to the first half of 2023, but some continue through. So it's tied to both the supply with the ability to be able to get the leverage with the mix and the completion of the projects and services we're completing. But that would be, as you model, as we begin to think about 2023, that's ultimately what our goal is.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Okay. I appreciate that. And maybe related to that, do these delays have any dampening impact on incoming orders? I'm curious, like is there a customer saying, hey, if you can get it to me and with conviction in nine months, we'll place the order now. But if you can't, we're going to hold off. I'm just curious if you're seeing any dampening impact on orders given the stretched lead times?

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

A

Well, what I would say is it's the opposite. Right now, our demand, and of course we're not overcommitting based on what we're learning relative to our ability to convert. But I would tell you that with the strategies that we've been executing services, digital, this trend on decarbonization, healthy buildings, ultimately automated buildings, we're operating at a much higher level within our customers, because these are now problems that the C-suite or the CEO is focused on. And so even in the environment we're in and with the economic environment, that the demand is still coming in strong. And so we feel that the way that we're committing and the way that we're booking the business is ultimately in line with what we can achieve and what our customers are demanding.

So at this stage, we have seen very little or none, relatively low cancellations. And when you look at our – so you look at our short-cycle business, as I said, our short-cycle business, our backlog is significantly up year-on-year. And that's after a quarter of delivering 14% growth. In the quarter, we had actually orders that exceeded that in the quarter. And then when you look at our field-based businesses, these are longer-cycle projects that are typically financed. And we're working upfront with owners and developers, especially now with OpenBlue, where this becomes fundamental to their infrastructure, the digital infrastructure within the building. So as we sit here today, and I think even if we were to get into a slowdown, given the importance of what we do and how we're deploying our capabilities, it's still going to be high demand.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Thank you. Appreciate it, guys.

Operator: Thank you. The next question comes from Scott Davis of Melius Research. Your line is open, sir.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Oh, good morning. Thank you. Good morning, everybody.

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

A

Hey, good morning, Scott.

Scott Reed Davis
Analyst, Melius Research LLC

Q

The $500 million that was released by the White House, does that have to be spent? Are there any terms around that? Does it have to get spent in the next year? Does it have to get spent on filtration versus just – versus can it be just basically upgrading chillers? I mean how – any color on that would be helpful, George.

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

A

So the color on that, Scott, is that we've been actively involved in all of these bills that have been tied to our industry with Katie McGinty, myself. We've been very actively involved, not only in the US, but across the globe, with each of the governments, in helping to define how they deploy these resources to get the biggest impact. And so we have been very active, like, for instance, with heat pumps and the opportunity to get a 3:1 benefit by deploying heat pumps and replacing some of the boilers and older equipment and upgrading with heat pumps, you get significant reduction of energy required ultimately with that capability and you get a good payback just purely with the economics.

And so there's a high mix of that that is tied to all that we do. It's not only HVAC, but it's with the digital capabilities that enable us to be able to significantly enhance energy reduction, upgrade the indoor air quality, all of that together, Scott. So it's not broken down into any one domain. It's more in line with what is the output that they're trying to achieve. And the two outputs are getting to a higher standard of indoor air quality while, at the same time, we're reducing energy, not only here in the US, but actually, as we work with the European governments, how do they quickly deploy heat pumps to ultimately put into district heating and cooling and other applications that can significantly reduce demand. But a lot of that is because we've been actively involved in defining how those resources should be applied.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Okay. That's really helpful. And then NetZero Advisor, what does that actually do? Are you just basically cataloging energy consumption and carbon? Or are you actually advising on how to improve it? Which I think was part of the original OpenBlue also perhaps, but maybe you can clarify a little bit. That'd be helpful. Thanks.

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

A

Yeah. The whole idea of OpenBlue Advisor is really making a building autonomous. And you can take all of the data in a building. And then, with AI and other applications, you can then understand, what is the best way to optimize the building. And so not only taking what the current energy being consumed, but then how do you then advise based on what entitlement is to how you get to the most optimized energy usage within the building. And it takes into account all the factors of a building. So not only the HVAC equipment, but presence and a lot of the other factors that ultimately really help contribute to how you get to that best outcome.

And so it's really – think about it, Scott, as taking all of the intelligence of a building, being able to put it into one platform, apply AI, and then being able to work with our customers to define what the best solution is to be able to achieve their net zero commitments that have been made. And this ties well with our net zero building offerings. When we go in, we can do a full offering where we upgrade equipment; we deploy digital. We can take an as-built building, and when you look out towards 2050 and with all these commitments to get to net zero, 70% of the building stock today will still be in operations. And so we're seeing high demand to go in and ultimately upgrade, deploy digital, consume the data, apply AI and then ultimately advise what the best solution is to get to the energy commitments that they've made. So that's, in essence, Scott, what we're doing.

Scott Reed Davis
Analyst, Melius Research LLC
Q

Very cool. Well, best of luck, George. I thank you for this. I'll pass it on.

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

All right. Thanks, Scott.

Operator: Thank you. The next question comes from Julian Mitchell of Barclays. Your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Hi. Good morning. Maybe just wanted to circle back on that point around contingency in that second half margin guide. Because it looks as if, I think, you need a sort of 40%-plus sequential operating leverage in the second half operating profit versus first half. And that's not – on the face of it, it doesn't look that different from what JCI did historically post the power exit. So I just wanted to check, is that maths roughly right? And is it right that you're assuming operating leverage not that different from previous years in the second half?

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

That's correct, Julian. What we had anticipated originally was to be able to beat those seasonal trends. And we had expected that we would have the ability to flow some of the increased backlog we had. For the reasons we have been presenting today, this increased conversion of backlog will be delayed by two quarters.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

I see. But you think a normal seasonal trend is still possible or probable, even with all of the supply chain constraints?

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

Absolutely. Correct. The increase in the normal flow is not happening, but we believe today that we will be able to meet these to record seasonal trends.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thank you. And then maybe following up on North America field specifically, that's a business that, of the four segments, it has the highest margin ramp dialed into the medium-term plan. So it's clearly crucial for it just in terms of that rate of change, but also the scale of the business today. I think the margins there have been down year-on-year four quarters in a row now. Before, it was temporary costs that were the issue; now it's inflation and supply chain. So I guess maybe give us an update on the confidence in the state of that business in aggregate on the margin plan. And then what should we expect there for that second half margin improvement in North America field specifically? So sort of a second half question on North America field, and then also just taking a step back, given the margins are down four quarters straight, what's the conviction on that plan?

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

A

So if you look at today, the North America business, this is the one which is the most sophisticated in the portfolio. And if you look at today at demand signals, and we have – we put together a slide on this in our slide deck, all the indicators are actually resonating well with our customers: service, sustainability, healthy building. Due to the complexity of the North America supply chain, we're having more headwinds than we have elsewhere in the portfolio. Net of those, the underlying margin in North America is actually improving. And we feel confident that this business will add margin to the bottom line of our company. All of those issues today are amplified and temporary, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

And is the operating leverage in North America field in the back half, is that sort of 40% as well half-on-half?

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

A

About that amount.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Perfect. Thank you.

Ryan Edelman
Vice President, Investor Relations, Johnson Controls International Plc

A

Brad, we'll take one more question.

Operator: Thank you, sir. Your final question will come from Nicole DeBlase of Deutsche Bank. Your line is open.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, thanks. Good morning.

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

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

I appreciate you guys squeezing me in. So I guess maybe just starting with a little bit more explicit detail around what's going on in China. Could you guys just describe what you're seeing? And maybe you could give us a sense of comfort in what's embedded from here, like what you're looking for in the back half in the Asia Pacific business.

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

A

Yeah. What we're seeing – well, let's – what I would say is order trends. When you look at all of Asia Pac, because that's how we report, the order trends continue to stabilize. And they've been pressured over the last year outside of China, but those economies are coming back as they exit COVID and are actually doing very well. You see order momentum in Northeast and Southeast Asia very solid, mostly in Japan and India. India's doing very well. We're up almost 30%. There's lots of infrastructure investment. And when you look at US, specifically on China, we're seeing good demand in China HVAC. It's led by strong industrial vertical work with our Industrial Refrigeration supporting petrochem and downstream. And then when you look at orders in the quarter, we were up 6%, but that was to a 39% prior-year compare. And so when you look at the environment, that's now, from a commercial standpoint, we're actually doing very well.

Now, when you look at your question relative to the current environment, we have began to see impacts in March, both in China and Hong Kong. Our headquarters in Shanghai and two of our plants, and I'll talk about those two, have been into some amount of shutdown, lockdown, but we are back and operating today in both plants. So we have a Wuxi plant, which is chillers, and that's our – not only supporting China, but also other parts of the world. And we have Wuhu, which is our JCH factory. And interesting, during the shutdown, we had many of our employees actually stay in the plant, live in the plant, and ultimately continue to create output, but that was to a much lower volume. Both now have been reopened and are operational, but not quite to where we need to be. So that's some of the pressure that Olivier talked about.

Now when you ask about the China supply chain, since the pandemic, we've been doing really good work, our sourcing team, in looking at all components that come out of that supply chain supporting the rest of the world. And so as we look at the lockdowns impacting other parts of our business, it's minimal at this stage, although we're watching this closely. The Shanghai port is, I think, operating like at 40% capacity and making sure that, with what is left, that we're – we've got contingency with other supply. But I feel really good about that. And so I think the concern, Nicole, short term is are there going to be additional lockdowns with any additional spread of the virus, and then continuing to make sure that we're getting the proper supply for anything that's left within the supply chain supporting the rest of our businesses. But overall, I think we factored that into the framework we provided.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thanks, George. And then I don't think we've talked about resi HVAC today. I know it's a smaller business for you guys versus some of your competitors. But could you talk a little bit about the order activity in that business? I mean, my understanding is that we've seen orders turn negative year-on-year on tough comps. I'm just curious if you've seen that trend as well.

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

A

Yeah, so for us, it's maybe a little bit different. Our North America – so when we look at resi globally, it's both ducted in the US and our un-ducted business with Hitachi. And so we're up about 15% globally. Now when you look at North America, so we had sales up 27%, but our backlog continues to grow. And we're at a point, Nicole, that because we're at our capacity, we're bringing on new capacity as we speak in our Mexico facility, we're governed right now by being able to take orders to our capacity expansion in Mexico.

And so at this stage, it's hard to look at our orders because it's book and bill, and we're ultimately not taking orders that we can't support here reasonably within the timeframe that they're looking for delivery. So that's a little bit of a factor for us as far as on the order side. But we still believe that on a run rate basis, that the demand that we see coming in is still very strong to be able to support the distribution that ultimately we supply to. And because of the investments that we've made in new products and now with the expansion of our capacity and distribution, we still feel really good about the prospects for that business.

Now in the resi in the non-ducted, that's performing very well. We're up 13% year-on-year. And this has been driven by – we've been strong in Asia-Pac, up high-single digits. That's been driven by Taiwan and India. And then Europe, actually, and this should be a big strength of ours going forward because of the heat pumps and the mix of heat pumps in our portfolio there, that we were up 23% and our VRF is up 53%. And so incredible success there with the adoption of VRF and some of our new air-to-water heat pump technology. And so I think overall, this is an important segment for us. We're making the investments, and I think we're seeing the success with the investments we're making.

Nicole DeBlase Q

Analyst, Deutsche Bank Securities, Inc.

Thanks, George.

George R. Oliver A

Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Nicole.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

So on that, operator, let me add a few comments here to close the call. I want to thank everyone for joining us this morning. I think, overall, executing extremely well on our strategic initiatives. Ultimately that will position us to accelerate profitable growth. We've positioned the company to capitalize on some tremendous trends here that are facing our industry for the next decade plus. And although we've had short-term supply chain disruptions, and they remain a challenge, I can tell you that our teams are executing well. I'm personally involved on a regular basis in making sure every step of the way, we're taking the actions required to ultimately recover.

And I think with the strength of our orders in backlog provides us added confidence on our growth outlook going forward. And of course, we always remain focused on – although we've had some impact short term, we are very much committed to deliver results for our customers and ultimately, the long-term plan that we've committed to our shareholders.

So I look forward to speaking with many of you soon and over the next few days. And operator, that would conclude our call today.

Operator: Thank you all for your participation on today's conference call. At this time, all parties may disconnect.