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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Johnson Controls Third Quarter 2023 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

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

Jim C. Lucas

Vice President-Investor Relations, Johnson Controls International Plc

Good morning and thank you for joining our conference call to discuss Johnson Controls' third quarter fiscal 2023 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 Chief Financial Officer, Olivier Leonetti.

Before we begin, let me remind you that during our presentation today, we will make forward-looking statements. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of Johnson Controls. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to carefully review the risk factors and cautionary statements in our most recent Form 10-Q, Form 10-K and today's release.

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

I will now turn the call over to George.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

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

Let's begin with slide 3. Johnson Controls delivered another strong quarter that met the high end of our guidance. We delivered 9% organic sales growth, adjusted segment EBITDA margin expansion of 130 basis points and 21% adjusted EPS growth. Our longer cycle Building Solutions business continued to show strength globally. And Service momentum accelerated driven by our enhanced solutions and increased adoption of our digital offerings.

Orders grew 8% overall with Service orders leading the way with 12% growth. Our backlog ended the quarter up 8% to $12 billion across both Install and Service. We remain confident in the resiliency of our backlog and order momentum as our performance during the quarter solidifies our investments in building a world-class service organization. We continue to see a strong pipeline of opportunities and the outlook for orders in our longer cycle businesses remains robust.

In our shorter cycle Global Products business, our Applied and Rooftop businesses delivered another quarter of very strong double-digit growth and demand remained strong. We also continue to see strength in our Commercial Ducted and Fire Detection businesses. Consistent with trends in the industry, our Ducted North American Residential business remains soft. Overall, we are encouraged by the continued strength and good visibility across our Building Solutions segments.

As we look ahead for the remainder of the year with one quarter to go, we are narrowing our full year adjusted EPS guide to approximately $3.55, which represents the midpoint of the previous range. At Johnson Controls, we continue to expand on the solid foundation that we have built with strong order momentum and a record backlog driving consistent top line growth. We have made good progress enhancing profitability across our portfolio throughout the fiscal year. And we have significant actions underway that we believe will result in further margin expansion.

Now turning to slide 4. We have spent the past few years investing more strategically in our Service business. And we are seeing strong returns from those investments. During the third quarter, Service orders and sales both grew 12%. Our Service business has transformed from a traditional break-and-fix business to helping customers proactively and more efficiently optimize management of all assets in the building. Digital is becoming an important enabler to driving more Service opportunities and growth. We also accelerated sales of our higher-margin parts business, which once again grew at a strong double-digit pace in the quarter.

Decarbonization is an area of focus across the entire Johnson Controls portfolio. This includes our sustainable infrastructure or SI business as well as many products and solutions in our portfolio, such as heat pumps, energy-efficient refrigerants and digital solutions. In fact, nearly 55% of revenue comes from sustainable products and solutions. We continue to see strong demand in our SI business with orders growing 20% in the quarter. Heat pump sales were up mid-single digits globally with very strong double-digit growth in our Applied and Industrial Refrigeration businesses.

During the quarter, we acquired M&M Carnot, a leading provider of natural refrigerant solutions with ultra-low global warming potential or GWP. M&M designs equipment and controls that use carbon dioxide which has a GWP of 1. By contrast, traditional refrigerants can have GWPs in thousands magnifying rather than solving global warming.

We have spent the past few years defining our multiphase digital strategy to transform environments to more effectively use data to drive outcomes for our customers and we continue to gain momentum. In the quarter, we grew our connected revenue at a high single-digit rate and we surpassed 16,000 connected chillers. We are now expanding OpenBlue into connecting controls and security to better optimize customer assets and improve outcomes in buildings further differentiating our offering.

Historically, buildings required standalone systems to manage each asset within the building. Today, connected buildings are creating a single digital dashboard optimized for energy but still require multiple systems to manage the assets. We are making great progress in creating the digital thread throughout the building lifecycle. And connecting controls is the next step in the evolution of this journey.

Moving on to slide 5. We recently announced the acquisition of FM:Systems, which is an important next step in adding critical capabilities to OpenBlue. FM:Systems is a leader in the growing integrated workplace management system or IWMS sector. IWMS furthers our OpenBlue capabilities along with Johnson Controls to offer a one-stop solution that helps customers accelerate their digital transformation journey, improve building efficiency and reduce operational costs.

FM:Systems advances OpenBlue's capabilities and brings a significant amount of data including service, space utilization and real estate portfolio management. The addition of FM's capabilities into OpenBlue enhances Johnson Controls' relationship with customers by providing a full suite of integrated outcome-based solutions.

Turning to slide 6. Extreme temperatures are increasingly straining buildings, putting at risk the ability to deliver comfortable and healthy indoor environments. Our OpenBlue digital solutions help optimize indoor air quality, comfort and energy consumption while monitoring outdoor air conditions ensuring our customers can meet their operating objectives even in the most extreme conditions. When paired with our OpenBlue digital services, we are uniquely positioned to help our customers deliver healthy indoor environments, while optimizing costs, reducing emissions and ensuring HVAC equipment is operating at peak performance ready for any condition.

We spoke earlier to the progress we are making expanding margins and we are not done. Supply chains are improving, which have normalized lead times allowing us to create better operating leverage in our manufacturing facilities. We continue to make progress in improving our SG&A structure and have additional actions underway to further optimize our performance.

On capital allocation, we have established a track record of being prudent and disciplined. In fiscal 2023, we have returned $1.3 billion to shareholders via share repurchases and dividends in addition to investing in several strategic acquisitions. Climate change is a defining theme of this century. With nearly 40% of emissions coming from buildings, we have the technology and the people to turn buildings from one of the greatest challenges into one of the biggest and best solutions.

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

Olivier Leonetti

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

Thanks, George, and good morning, everyone. Let me start with the summary on slide 7. Total sales grew 8% while organic sales increased 9% with strong double-digit growth in our Service business. FX was a 2% headwind in the quarter. Adjusted segment EBITA increased 17% with margins expanding 130 basis points to 16.4%. Price/cost was positive and we delivered strong productivity savings.

Turning to our EPS bridge on slide 8. Adjusted EPS of $1.03 was at the high end of our guidance and increased 21% year-over-year. Operations contributed $0.23 of the growth in the quarter benefiting from positive price/cost and our ongoing SG&A and COGS actions. Below the line, we saw headwinds from net financing costs, FX and non-controlling interest. Overall, we were pleased with the strong adjusted EPS performance in the third quarter.

Let's now discuss our segment results in more detail on slides 9 through 12. Beginning on slide 9. Organic sales in our shorter-cycle Global Products business increased 6% in the quarter with 8% of price offsetting a slight volume decline. Global Products continues to see strength in the Applied business where our Rooftop business in North America has nearly doubled this year.

Fire & Security grew low single digits with continued momentum within our Fire Detection products. Industrial Refrigeration had another strong quarter growing over 20% driven by North America. Our Global Products third-party backlog increased 8% from the prior year to $2.5 billion. Adjusted segment EBITA margins declined 10 basis points against a tough comparison to 22.1% as continued weakness in the Residential North America market offset positive price/cost and productivity savings.

Moving to slide 11 to discuss our Building Solutions performance. Orders increased 8% organically as demand remained strong and we continue to convert our healthy pipeline. For the third consecutive quarter, Service orders grew low double digits with 12% growth in the quarter as our focused strategy on transforming Services into a more predictable consistent business is paying dividends.

We saw Install orders increase 6% against a tougher comparison led by double-digit orders in North America in the prior year. Total sales grew 10% with organic sales increasing 11%. We saw strong double-digit growth in both Service and Install growing 12% and 10%, respectively. Adjusted segment EBITA increased 35% with margins expanding 240 basis points as we continue to execute higher-margin backlog and recognize savings from our productivity initiatives. Building Solutions backlog remains at record levels growing 8% to $12 billion. Both Service and Install backlog increased 8% year-over-year.

Let's discuss the Building Solutions performance by region on slide 12. Orders in North America increased 5% with continued strength across our HVAC & Controls platforms, up high single digits year-over-year. Overall, there was robust demand in our office, data center, government, manufacturing and education sectors. Service continues to perform well increasing 8% year-over-year driven by our shorter-term transactional business. Sales in North America were up 10% organically with broad-based growth across the portfolio. Our Install business grew 11% with over 20% growth in new construction.

Our Service business maintained its strong momentum with 9% growth. Sales across our HVAC & Controls platform grew low teens year-over-year while Fire & Security increased high single digits. Segment margins expanded an impressive 270 basis points year-over-year to 14.4% driven by ongoing productivity benefits and the continued execution of higher-margin backlog. This resulted in a strong price/cost performance.

Total backlog ended the quarter at $8 billion, up 11% year-over-year. In EMEA/LA, orders were up 10% driven by healthy growth in Service, up 19% year-over-year. Industrial Refrigeration and HVAC & Controls had solid results in the quarter with each growing over 25% driven by the decarbonization efforts in the United Kingdom and Northern Europe.

By region, we saw double-digit growth in the Middle East, Africa and Latin America. We saw strong demand in both our government and industrial sectors. Sales in EMEA/LA grew 9% organically led by mid-teens growth in Service as our shorter-cycle transactional business continues to have good momentum. Applied Commercial HVAC grew high single digits driven by healthy performance in Latin America.

Fire & Security grew high single digits within the quarter. Segment EBITA margins declined 10 basis points to 8.6% but increased 190 basis points sequentially driven by further improvement of higher-margin backlog conversion. Backlog was up 6% year-over-year to $2.3 billion. In Asia Pacific, orders grew 14% driven by double-digit growth in both Service and Install. By region, China grew 14% year-over-year with continued strength in data centers and manufacturing sectors. Northeast Asia had growth of high teens driven by controls.

Sales in Asia Pacific increased 16% with 90% growth in Service and 14% growth in Install. Overall, Commercial HVAC & Controls grew approximately 20% driven by the Install business within China while Fire & Security declined low single digits. China continued its momentum from Q2 reporting 25% growth in the quarter, which included double-digit growth in both Service and Install. Segment EBITA margins expanded 110 basis points to 13.9% driven by ongoing productivity savings and the execution of higher-margin backlog, resulting in positive price/costs. Backlog of $1.7 billion increased 2% year-over-year.

Turning to our balance sheet and cash flow on slide 13. We ended the third quarter with $1.1 billion in available cash and net debt declined 2.1 times, which remains within our longer-term target of 2 to 2.5 times. Inventory turns improved sequentially and free cash flow remains a major focus with inventory being a key driver to further improvement in the fourth quarter.

Now let's discuss our fourth quarter and fiscal year 2023 guidance on slide 14. We are introducing fourth quarter sales guidance of approximately 4%. We expect Building Solutions' momentum to continue while Global Products faces a tough year-over-year comparison driven by inventory reduction in Residential HVAC and certain Fire & Security indirect channels as lead time have materially improved.

For the fourth quarter, we expect segment EBITA margin to expand approximately 60 basis points and adjusted EPS to approximate $1.10, which represents 11% year-over-year growth. For the full year, we are narrowing our adjusted EPS guidance to approximate $3.55, which represents the midpoint of the prior range. This represents 18% year-over-year growth. We expect organic sales to grow high single digits and segment EBITA margins to expand approximately 110 basis points. We expect free cash flow conversion to be roughly 70% as we make good progress on inventory reduction while not at the level we were expecting given some inventory reduction occurring in our indirect channels.

We see good momentum continuing to build for fiscal 2024. Our longer-cycle Building Solutions segments continue to experience strong orders and backlog remains at record levels. Global Product is benefiting from strength in the larger Commercial HVAC space while Residential HVAC comps should ease entering the new fiscal year. We have made good progress on expanding margins this year and we are not done.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question will come from Nigel Coe with Wolfe Research. Please go ahead.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. Thanks for the question. Maybe we could just unpack a little bit more the fourth quarter sales growth, especially within Global Products. So it sounds like you're still seeing, I don't know, high single digit growth in the Solutions businesses and it looks like Products down mid-single digits or so. Is that correct? And maybe just talk about some of the headwinds. I think Resi HVAC, we understand. But maybe just talk about the Fire & Security products headwinds, maybe unpacked between geographies and end markets.

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

A

Yeah. Good morning, Nigel. Let me start by saying our overall commercial business, both products and services, remains incredibly strong and what I would say is across the board hitting on all cylinders. We do continue to see strong bookings in our Applied and in our Commercial Rooftop businesses across the board.

When you look at our Building Solutions, we made great progress during the course of the year improving the margins. And the Service momentum now is expected to continue. And when I look at our Building Solutions business, we've got a very strong backlog. And more important is within that backlog, the mix of services that are coming through with the momentum that we've been building. And now adding FM:Systems is going to be a big add to that.

Now, referencing the orders in Q4 and revenue in Q4. When you look at our Residential and Fire & Security businesses, we have been experiencing some short-term pressure in our shorter cycle book-to-bill business. And it's in those two areas. The inventories in the channel are resetting as we've been able to improve lead times. And so therefore, there are some short-term adjustments in the book-to-bill revenues.

But what I would say is with those adjustments, we're continuing to execute with the deployment of our new products and we're seeing good traction there. And as we project going forward, we still see that coming back and being very strong as we set up for 2024. So on the Resi, I think it's in line with what you're seeing across the industry. And on Fire & Security is mainly in our Products business, which ultimately is a book-to-bill business. And therefore, we're seeing that adjustment.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. That's clear and we'll follow up offline. George, you mentioned 2024. And obviously, we're turning the calendar into FY 2024 very soon. So maybe just talk about how you're thinking about the setup for 2024. I don't know. Based on the backlog conversion or customer conversations, how should we think about the top line environment for FY 2024?

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

A

Nigel, what I'd say is that we're still building the 2024 plan. But I'd touch upon some key items here that I think really set us up well for 2024. When you look at the commercial markets, and as I talked a little bit earlier, that we see that are incredibly healthy and are playing to our strengths especially with the secular trends that are underway within the commercial space. And so that we see with our orders up 8%, with our backlog up in our Building Solutions business at $12 billion. And even in our Global Products business despite some of the inventory adjustments, we are up about 8% in our Global Products business also. And so when you look at that, that momentum is going to continue.

Now, if you add the stimulus spending that we don't believe has really been materialized yet, is in the background. And I believe with these secular trends and the combination of what we're doing in HVAC with our digital platform. And now Services are going to benefit really nicely from the investments that ultimately are going to be needed to drive sustainability. Then if you look at our backlog – we look at this very closely – it's very resilient and very strong with the idea that we believe that even through the next quarter, we've got an incredible pipeline that we're converting. We're working to develop the backlog so that when we plan and ultimately enter next year, we're going to have a nice backlog to work from.

Then the last is really the acceleration of the transformation of our Building Solutions business to Services. That proposition is playing out. I would call it our flywheel which has been accelerating, which is about creating an installed base, getting that base connected with higher attach rates, with higher revenue per customer. That leads to lower attrition. And then all of that spins out additional business like with our spare parts and upgrades and the like. So I feel that the current trends that we see and how we're being set up, we're going to set up for a nice 2024. But again, we can't predict the environment. But the trends that are underway do play to our strengths.

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

An additional comment on the margin, Nigel. First of all, in gross margin, we see expansion in gross margin. George mentioned it. Services is growing faster than Install now. We are using Install as a vehicle to drive Service. So we should see gross margin expansion. And also we're working on further SG&A leverage as we standardize and leverage also functional excellence across the organization. So top line and margin, we believe we are well positioned for 2024.

Nigel Coe Q
Analyst, Wolfe Research LLC

Okay. That's good detail. Thanks, guys.

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

Thank you, Nigel.

Operator: Next question will come from Steve Tusa with JPMorgan. You may now go ahead.

C. Stephen Tusa Q
Analyst, JPMorgan Securities LLC

Hi. Good morning.

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

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Can you just walk through a little bit the fourth quarter and this sales deceleration as well as maybe some color on what you would expect for the margins by segment? The growth seems to be slowing pretty significantly here. Just wanted to see if that's concentrated in any particular business. Maybe just some segment color for the fourth quarter.

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

So if you look at the top line today, in the Building Solutions business, the top line is very strong. The order momentum is expected to continue in the fourth quarter. We have good visibility today based upon where we are today in the quarter. You have in the top line some inventory adjustments happening in the channel that is impacting our shorter-cycle business, Resi and Fire & Security. George mentioned that that would be an impact on Global Product. But we see that as being temporary. If you look at the margin, we believe that our Solutions business margin will keep improving.

In the Global Products business, we see the margin being slightly flat. What is happening in the Global business, you have that in Q3, it's happening in Q4. So it's some absorption as we are ramping Applied volumes to drive market share and lead time. We have had some absorption impact. And also, we have normalizing inventory. Inventory in finished goods went down by about 20 days in about two quarters. That is impacting also absorption. So that's the story in terms of margin, Steve, and revenue.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah. I guess for Global Products, what do you expect for revenue maybe either organic year-over-year or sequentially, however you think about it? Because I think that's kind of where the hole is on revenue here, it seems like.

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

Well, revenue in Global Products would be growing low single digits to flat. And the margin would be expanding to flat for Global Products because of the two phenomenons I've mentioned, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Yeah, okay. Then sorry, one last quick one. How much price did you get in the field business in the quarter?

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

We don't talk about price anymore for the Building Solutions business. Because we sell a solution, it's difficult to differentiate price from volume anymore and we have discussed about this. But overall, pricing and value proposition is resonating with our customers.

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

A

So Steve...

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

So I guess how do you calculate – if you don't calculate price, how do you calculate price/cost then in your slides, on slide 12, for the Solutions business?

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

A

It's mainly going to impact our Global business and to an extent also the field.

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

A

And Steve, just to comment on that. As we've discussed, we've been building robust models from a cost to value proposition standpoint. And it's calculated based on the inflation that we've built into our long-cycle businesses and then how that plays out to then the value proposition that we bring to our customers with the differentiated Install and then ultimately which then leads to our Service growth. And that's what's in the overall equation there as far as price.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

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

A

Thank you, Steve.

Operator: Our next question will come from Joe Ritchie with Goldman Sachs. You may now go head.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks. Good morning, everyone.

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

A

Good morning, Joe.

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

A

Good morning, Joe.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Maybe just going back to the destocking comments in Global Products. I'm sure you guys have had conversations with your channel partners. There might be a little bit of uncertainty. But you did mention, Olivier, I guess, that you expect this to be temporary. What kind of sense do you get in terms of the timing of destocking and how elevated their inventories are today? I'm just trying to get a sense for how quickly we should get back to normal demand patterns in that business.

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

A

Well, let me take that, Joe. On the Resi side, I think in line with what everyone is seeing in the industry, we've seen a significant adjustment. And we've taken that in the first half and now through the third quarter, a pretty significant adjustment. We believe we're now in line with the industry relative to our volumes and the like.

Now when you look at we do believe there's some additional destocking in Q4. But I think through that, we'll set up here in the first quarter. For the second quarter of next year, I think we'll be pretty normalized. The other, on the Fire & Security, when you look at those businesses, it is mainly a product of when we saw a significant ramp when lead times were extended, we developed significant backlog. And we've been working down that backlog.

The good news I see now is on the input side. As we're now moving forward, we're starting to see a pickup now of some of that backlog. And so our ability to be able to then take on the orders, create the backlog and then be positioned from a supply chain to respond; we're in a much better position. And so we'll see some of that play out here in the fourth quarter as it relates to Fire & Security. But we do believe it's short term. And we do believe it's totally aligned with the lead time adjustments that have been made. And I would tell you that when we look at some of the core products and new products that we're bringing into that segment, we're seeing some nice pickup on market share with some of the new products.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. That's good to hear, George. I guess maybe my second question. Just going back to 2024 and just thinking about the Service growth that you've seen over the last three quarters, obviously, that is going to be mix accretive to the business. How do we kind of think about the margin impact that's in backlog right now and that we should see come through in 2024 in the Building Solutions business?

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

A

Well, as it relates to the overall growth and I think this is the first that we've seen where now our Service growth on a sustained basis is outpacing our Install. And so when you go back to the strategy of the company with our Building Solutions business was to make sure we use Install very strategically and how we build our Install base with our assets, with our equipment and then with the digital assets that enable us to be able to extract over the lifecycle the Services.

And now with the digital content that we have, we're not only enhancing what historically we've done, but it's now given us the opportunity to add additional services with the customers that we're serving. And so we feel very good about continuing to sustain that growth rate in Services. That'll be a natural mix with the revenues that turn within our Building Solutions business globally. And we're seeing it. The traction is in every one of the regions. I mean, this is not isolated into one vertical or one region. It's pretty much across the board. And so with that, that combined to what Olivier said around margins, we continue to drive strong productivity both in COGS as well as SG&A. So that combined with the mix of Services is going to continue to accrete margins within our Building Solutions business.

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. Thank you.

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

A

Thanks, Joe.

Operator: Our next question will come from Noah Kaye with Oppenheimer. You may now go ahead.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking the questions. First, it looks like guide is now for higher amortization of intangibles. And that's driving about a $0.05 EPS headwind versus the prior guide. Can you, a, confirm that math and then, b, talk about the timing expectation for accretion on some of the acquisitions you've made? I assume those acquisitions are what's driving the higher amortization for the year.

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

A

No, you're right. I'm confirming the number. What we do probably at some stage, we need to think about how we treat amortization of intangible, Noah. Relative to our peers today, we're not guiding EPS in the same way. We look at this and we expect the accretion to start at the start of next fiscal year.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

All right. That's helpful. And then just to better understand the free cash flow conversion dynamics. It sounds like you do expect some inventory reduction here in 4Q. But as we think about what needs to happen for you to kind of get back to close to that 100% free cash flow conversion as we set up for 2024, what are you going to be focused on?

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

A

Noah, you mentioned it. We had a good progress in inventory reduction in Q3. We have good momentum. As I indicated, we have reduced our finished goods level inventories in days by about 20 days. So that's where the focus is. As lead time is improving, we have seen some inventory adjustments in the channel. And that is impacting on the short term our ability to dispose of the inventory at the speed we had anticipated. But we believe it's a short-term phenomenon. And we believe that we are absolutely going to return to a 100% free cash flow conversion next fiscal.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Appreciate that. Thank you.

Operator: Our next question will come from Jeff Sprague with Vertical Research. You may now go ahead.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Hi. Thank you. Good morning, everyone.

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

A

Good morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

I just wanted to come back to Service margins, George, and you addressed this to some degree in a prior question. But certainly, the key KPI in my view in this quarter was the significant lift in North America margins in the quarter and you delivered on that. Is Service mix playing a really significant role in that performance in the quarter? Or are we actually just seeing more kind of COGS and SG&A programs and other things you're trying to do on productivity? And maybe you could just give us a little bit more color on how you would expect that North America margin to progress into the fourth quarter?

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

A

Yeah. Let me reflect here, Jeff. If you go back to North America and what played out last year, you might recall that a lot of the backlog that was built up during 2021 prior to the significant ramp-up of inflation and the backlog that turned is really what caused the margin pressure last year. And then the work that we've done since then with our cost models and value proposition and pricing as a result on a go-forward basis, we've been building very strong margin and backlog across the board, not just North America but across our Building Solutions business over the last 18 months. And so a significant piece of that is the margin we've been putting in the backlog after that ramp-up of pricing and the accumulation of the inflationary costs that we took into consideration and into our models.

That being said, North America is starting to turn relative to Service as a percent of revenue. And you're going to start to see that accretion on a go-forward basis contributing. Now, also on a margin rate, with the value proposition that we've had with Service, throughout the inflationary cycle, we've been able to maintain very attractive margins. And so it has been through that cycle very strong. And now with the mix going forward, it's going to continue to be accelerating the accretion and the benefits that we're going to get in the margin rate on a go-forward basis.

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

A

I would add, Jeff, and they go together. We are now driving Install to drive Services. It wasn't the case before. So you will see a margin expansion also because we are very selective on Install. And to your point on SG&A, much more is to come in terms of SG&A leverage as we standardize our operations further and we're in the middle of this and leverage functional excellence. And we have said that and our level of conviction is actually increasing. We believe we can deliver over the next year and forward 30% incremental for the company because of those two phenomena, margin and SG&A.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Right. And sounds like you're noodling on maybe moving to an ex-amortization EPS construct. I wonder if you'd opine a little further on that. And just the amortization that we see, how much of that is directly kind of deal-related amortization versus maybe amortization of software or other things that are running through the system?

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

It's quasi-exclusively relating to deals. And if you look at our peers today, we are the only one to have not adjusted for deal amortization in our EPS. So we are looking at that as a potential for next year, Jeff. But all deal-related. And the Tyco-Johnson Controls merger would be the lion's share of this amortization.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Great. Thank you.

Operator: Our next question will come from Julian Mitchell with Barclays. You may now go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thanks very much. Maybe just wanted to start off with how you're thinking about that sort of slide 7 and the profit drivers from price/cost and productivity benefits. So you're running very strong on productivity benefits in 2023. Maybe just remind us what's the incremental saving into 2024 that's left under the cost-out program. And then how quickly should we expect that big price/cost tailwind to narrow towards parity next year? Thank you.

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

So on productivity, we are far from being done. Our program that we announced about two years ago is going to end. We are well on track. We'll deliver about $340 million for FY 2023 through SG&A and COGS. But much more is to come in terms of productivity, both impacting sales and G&A. Again, standardization and driving functional excellence are going to be the drivers for this.

Price/cost, George mentioned it. We are very bullish about the value proposition of offering either through Solution and including Services, but also through the Product portfolio where we have a strong and commercial sustainability offering. So all of that should drive margin expansion through G&A, scaling gross margin and price/cost.

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

And Julian, relative to just pure price when we're planning through 2024, we see continued pricing now certainly at a reduced level. But given the continued inflation and how we're booking that inflation into our backlog, we still see pricing playing out as we planned for 2024.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

That's helpful. Thank you. And then I guess my second question on the top line. So looking at slide 12, you have the 4% Install orders growth in North America and EMEA/LA in the third quarter. Just wondered, given the sort of the macro data out there, Dodge start square footage and so on and interest rates, do you think those Install order numbers decelerate from that 4% in the two regions or they can sort of hold the line when you look out?

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

A

Yeah. So when you look at our go-to-market and we look at this very closely on a weekly and monthly basis. When you look at our pipeline, our pipeline is continuing to grow. And so as we look at whether it be by domain or as we look at our Building Solutions now addressing these secular trends, we're building a very strong pipeline.

And on a run rate basis, as we project Q4, we still see very strong order growth in Q4. And so it is hard to dissect exactly from a vertical standpoint because we see pretty broad strength across whether it be industrial, data centers. We talked about government. There's a lot of strength that we see here. And we're making sure that from a go-to-market standpoint, we're going to be positioned to be able to capitalize where the growth will occur.

And then the value propositions that we have as it relates to these secular trends, it really does tie to be able to create the most amount of value. And then in our Solutions business, really build an attractive Service business from that. And so as I set up for 2024, it's going to be critical here as we pace through the fourth quarter with the order rates to really set up a backlog because our Building Solutions business, at least from an Install standpoint, is pretty predictable over the next 12 months. And that backlog continues to build and our pipeline and conversion right now in Q4 suggests that that's going to continue at a very strong rate.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Perfect. Thanks very much.

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

A

Thank you, Julian.

Operator: Next question will come from Nicole DeBlase with Deutsche Bank. You may now go ahead.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, thanks. Good morning, guys.

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

A

Good morning, Nicole.

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

A

Hi, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.
Q

Maybe just starting with the price/cost dynamics in EMEA/LA specifically. So I know that segment is kind of lagging a bit with respect to execution of higher price backlog. Is the expectation that price/cost turns positive – could that happen in the fourth quarter or is that more of like a 2024 event?

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

So Nicole, if you look at EMEA/LA, there was nothing fundamentally different with this business, which would prevent us to reach a strong level of segment EBITA margin. What you have happening in EMEA/LA this quarter, and that's about 150 basis points of headwind in margin, is two things. One, pension costs and also FX in our business in Argentina. We have a strong business in Argentina in our subscriber business. So if you were to remove those, the margin in EMEA/LA would have increased by about 140 basis points in the quarter. You will have some of those impacts again in Q4 impacting EMEA/LA. But again, nothing structural in EMEA/LA.

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

Nicole, when we look at all the work we've done on the price/cost over the last couple of years, especially in this inflationary environment, when you look at the margins in backlog in our EMEA/LA business are very strong going forward. And so it's a matter of just the timing of the conversion.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.
Q

Got it. That's clear. Thanks, guys. And then just thinking about the overhang that you're seeing with Global Products margins and very tough prior year comps. I guess, how do you think about fiscal 2024 from that perspective? Like do you see the potential to start expanding margins in this business again?

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

The answer is absolutely yes. If you go back to the quarter, we are ramping the manufacturing of Applied. We wanted to be very competitive in lead time. We have a very competitive set of products. So as we are ramping manufacturing of lead time, we had an impact in conversion costs. Again, as we have normalized for inventory, we have produced less. That is impacting conversion cost as well. The combined impact of those two elements is a bit more than 1 point in the quarter, Nicole. And we believe that we will have some of that happening in Q4. But we see absolutely margin expansion happening in our Global Products business.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.
Q

Thank you. I'll pass it on.

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

Okay, Nicole.

Operator: Our next question will come from Chris Snyder with UBS. You may now go ahead.

Chris Snyder
Analyst, UBS Securities LLC

Q

Thank you. I wanted to follow up on the destock headwinds on the indirect side for Resi Fire & Security. Can you just maybe quantify what that headwind means for fiscal Q4 organic growth in the guide? Like where would that 4% be if it wasn't for these headwinds? Thank you.

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

A

I would say that, on the year, this impact is about 1% to 1.5%. And then you could do the math for also Q4. It's in the ballpark of 1% to 1.5% of full impact on the year.

Chris Snyder
Analyst, UBS Securities LLC

Q

Thank you. I appreciate that. And it sounds like from some of the prior commentary that you guys would expect this headwind to alleviate in the early part of fiscal 2024. So obviously, that's a tailwind to the 4% organic guide for the fiscal fourth quarter. Are there any sort of negative offsets there? Is anything kind of getting worse from here as we try to build the organic bridge into next year? Thank you.

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

A

So when you look at those businesses and the Applied Fire & Security products we put through our Building Solutions business and we're starting to see that that's very strong and picking up. And it's critical to our Building Solutions business as far as how we create value and ultimately create service. So that is coming back nicely. And then on the indirect channel where we see the pressure, the same has happened there relative to the timing of orders based on the reduced lead times.

And so our assessment based on the intimacy that we have with our distributors and the pulse that we have across the globe that that's going to come back, that we're starting to see sequential improvement and then getting a baseline here that for 2024, assuming the economic conditions are somewhat stable, we have been outperforming with our products and our new product launches and the like. So we're confident that's going to come back and we're going to be positioned to be able to pick that growth up as it adjusts.

Chris Snyder
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Our next question will come from Gautam Khanna with TD Cowen. You may now go ahead.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Thanks. Good morning, guys.

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

A

Good morning, Gautam.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

I'm wondering if you could comment on supply chain and your own manufacturing lead times and whether you anticipate that'll have any impact on orders. Just as lead times shrink, is there a risk of kind of an order – less urgency to place orders that could show up in any given quarter? And if so, when would you expect that to be a potential factor, if at all?

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

A

Well, Gautam, we've seen that. It's already been playing out here over really the last couple of quarters as it relates to our Global Products business because as supply chain began to improve and lead times reduced, it allows our customers to be able to back off what they have to carry and still be able to deliver on their commitments. So that has been playing out. We think that there's still a little bit left here with Resi going forward. Still a little bit more in the indirect Fire & Security. But we've already seen a lot of that impact on our book-to-bill business over the last couple of quarters. So we're positioning here to get through that over the next quarter or two. And then we'll be positioned to be able to build backlog and have conversion, strong growth in 2024.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Has there been any spillover effect to the direct channel...

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

A

No, on the...

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

...the lead times have come in?

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

A

No, on the direct channel actually because ultimately, from end to end, we're responsible for delivery to the customer. So whether it be even in our Resi direct stores, we saw a nice growth in our Resi direct stores because we ultimately own the channel and we saw a nice pickup there. On our Building Solutions business, as far as the predictability of our projects and how we're converting, we're very tight relative to what is going to be consumed and how we're going to deploy it to the field.

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

A

And George said that earlier, Gautam, the order rate for the Building Solutions business is very strong in Q4.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Yeah. Thank you very much, guys.

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

A

Okay.

Operator: Our last question will come from Andrew Obin with Bank of America. You may now go ahead.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Yeah. Good morning. Can you guys hear me?

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

A

Yes, we can, Andrew.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Yeah. So as we think about these semi fabs and EV plants, I think Eaton was kind enough to give a sort of range for average content per plant. Could you guys just sort of do something similar? How big a unit goes on average into one of these so we can just sort of size the opportunity? And then the part two, when do you guys actually book these projects in your backlog formally, at what stage? Is it a year into construction? Just trying to sort of follow up on your commentary how you should start booking more equipment eventually but just trying to size the timing and scope of this into 2024. Thank you.

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

A

Let me talk about on the front end the demand. And so what you've seen over the last couple of years, we have been very aggressive not only with the development of our product portfolio but also our capacity to be able to serve the market. And if you look at our orders in Applied, we have been getting more than our fair share. We believe that market share-wise, we're up a number of points here on a year-on-year basis. We've been building backlog in our Applied equipment. And we can follow up and get you an average size. But right now, because of the expansion, we've more than doubled our capacity. And we're pacing with full utilization of that capacity. So we're ultimately making sure that we're going to be positioned with the demand. And from a lead time standpoint, that's been very important to be able to then be able to respond and be able to create the value with our offering and then be able to then convert on time to be able to capitalize on the demand.

Some of these projects are they can be over a year. But a lot of the – there are now a lot of projects coming into the market that cycle time matters. And you can create a lot of value because you have a shorter lead time where we have orders that we're taking on now that we're going to deliver next year in 2024. And so from a positioning in the market, we have positioned ourselves to get a very strong order book in our Applied business. And that is a core strength of ours across the globe. And it relates to what you said, EV plants, data centers, the chip manufacturing plants and the like. And so on the average size, you can imagine, when you get these large data center customers, they have very large installations and have multiple pieces of equipment that are deployed to be able to support the capacity that they're building.

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

A

An additional color, Andrew. We mentioned that earlier the stimulus we have had in the US or in Europe, so the IRA or the equivalent stimulus in Europe have not impacted demand so far. So we believe that those trends we are starting to see are going to be maintained. And last one, we book an order when we've received a signed firm contract, Andrew.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Got you, okay. And just a follow-up question on supply chain. Are you seeing any ability – as some companies are talking about disinflation or even deflation, are you finally getting back ability to extract pricing concessions from your supply chain into 2024?

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

A

Yeah, we've always said them. When you look at our procurement organization and the work that they do even through this period of time, we've been strategically sourcing and making sure we're leveraging our scale and demand to drive productivity, drive savings to try to offset some of the inflationary pressures on the commodities and the like. So our team has done a really nice job through this cycle to do that. And the answer is, of course, yes. We're now planning for continued strong productivity with our scale and with our buy, making sure that we're positioned at the lowest cost with the leverage of our overall volumes. That gives us a competitive advantage when you look at our product cost or all of our costs within our cost of goods.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Thanks so much.

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

So on that, I want to close the call. I want to thank everyone for joining us this morning and certainly your continued interest in Johnson Controls. I do believe we're at the beginning of an era. And it'll be defined by decarbonization and sustainability. And we are, as Johnson Controls, well positioned to be an important contributor to empowering our customers in every industry to create healthy safe spaces for people on the planet. And I think our strategy is clear. It's playing out. We have a strong portfolio and now it's just about continued execution.

So with that, operator, that concludes our call today.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.