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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Johnson Controls third quarter 2024 earnings conference call. [Operator Instructions] Please note, today's event is being recorded. I would now like to turn the conference over to Jim Lucas, Vice President, Investor Relations. Please go ahead.

Jim C. Lucas

Vice President-Investor Relations, Johnson Controls International Plc

Good morning, and thank you for joining our conference call to discuss Johnson Controls fiscal third quarter 2024 results. The press release and related tables that were issued earlier this morning as well as the conference call slide presentation can be found on the Investor Relations portion of our website at johnsoncontrols.com.

Joining me on the call today are Johnson Controls Chairman and Chief Executive Officer, George Oliver and Chief Financial Officer, Marc Vandiepenbeeck.

Before we begin, let me remind you that during our presentation today, we will make forward-looking statements. Actual results may differ materially from those indicated by forward-looking statements due to a variety of risks and uncertainties. Please refer to our SEC filings for detailed discussions of these risks and uncertainties, in addition to the inherent limitations of such forward-looking statements.

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

I will now turn the call over to George.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

Thanks, Jim, and good morning everyone. Thank you for joining us on the call today. Let's begin with slide 3. We were very pleased to deliver fiscal third quarter results that exceeded almost all of our targets. Organic sales growth was 3%, which was in line with our guidance of low single-digits. We delivered a robust 150 basis points of segment margin expansion to 17.9%, which exceeded our guidance of 17%.

We are also proud of our free cash flow generation during the quarter, which was more than $500 million higher than the comparable period one year ago. Service led the way, once again, with 9% growth, which continues to validate our transformation efforts. It is encouraging as we continue to build momentum toward meeting our full year financial objectives.

Orders grew 5% during the quarter. We expect some quarterly fluctuation in our order pattern, given the strong demand for our data center solutions. With the investments we have made over the last few years in technologies for data centers, the launch of a dedicated organization and our one-of-a-kind offerings, we remain well positioned in this fast-growing segment, with solutions that are clearly resonating with customers.

We have built a leading position in data centers in North America, due to a unique and compelling customer value proposition. As our customers expand internationally to meet the rapidly growing demand for data centers, we grow alongside them as they choose to partner with Johnson Controls around the world.

Our backlog grew 10% in the quarter, as we continue to see demand for our solutions, both systems and services. The growth in orders and backlog give us increased confidence in our ability to continue delivering sustainable long-term growth. As part of our ongoing business transformation, we announced two divestitures, our residential and light commercial HVAC business and our Air Distribution Technologies business. These two transactions represent roughly 20% of current sales.

At the same time as our earnings results, we announced this morning that I informed the board it is time to initiate our CEO succession plan. Following recent significant milestones in our portfolio transformation and as we move to the next phase of growth, I believe that now is the right time to begin the process of identifying the next leader of the new Johnson Controls.

Accordingly, the board has engaged a nationally recognized search firm and begun a comprehensive search for the company's next CEO. Once my successor has been named, I will remain Chair of the board to help facilitate a smooth transition. I am confident in our position as Johnson Controls enters its next chapter, and I remain committed to supporting the full team as we work to ensure Johnson Controls realizes its full potential.

Along with the initiation of the company's succession plan, we also announced that as part of our ongoing board refreshment efforts and following a constructive dialogue with Elliott Management, Patrick Decker has been appointed to our company's board of directors, effective immediately. Patrick brings experience to our board and having led a transformation of his prior company, and his appointment reflects our commitment to continuously refreshing our board to ensure the skills and experiences of our directors appropriately reflect our ongoing transformation.

Lastly, before moving to the next slide, we are tightening our full year adjusted EPS guidance to a range of $3.66 to $3.69 from a range of $3.60 to $3.75. Marc will give additional details later in the call. We have made tremendous progress on our business transformation into a simpler, higher growth company, positioned to deliver more consistent, predictable results.

Turning to slide 4. We have made good progress on simplifying our portfolio. Most recently on July 23, we reached an agreement to sell our residential and light commercial HVAC business to the Bosch Group in an all-cash transaction. The transaction includes 100% of our North America ducted business and our 60% interest in our Global Residential joint venture with Hitachi. The total transaction is valued at approximately $8.1 billion, which results in approximately $6.7 billion of consideration to Johnson Controls. We are expecting net proceeds of approximately $5 billion after tax and transaction expenses, the majority of which will be used to accelerate returning capital to shareholders and also address leverage.

The residential and light commercial HVAC transaction is expected to close in approximately 12 months, subject to required regulatory approvals and other customary closing conditions. We expect to report the operating results of the business in discontinued operations beginning in the fiscal fourth quarter of 2024.

In addition, on June 18, we agreed to sell our Air Distribution Technologies business to Truelink Capital. The sale of Air Distribution Technologies is also an important step in simplifying our manufacturing footprint, with the elimination of nearly 30% of our manufacturing facilities.

Taken together, these two transactions represent significant milestones in our portfolio transformation. We are now even better positioned going forward as a pure play provider of comprehensive solutions for commercial buildings. Our efforts are turning into results, and the value of our transformation is coming into focus.

Slide 5 presents a pro forma look at the new Johnson Controls, representing the composition of our company going forward. Following completion of the two divestitures described earlier, we will be a simpler, higher growth company focused almost exclusively on our engineered solutions offerings.

These solutions include commercial HVAC, fire, controls, security and services, forming the smart building trifecta of energy efficient equipment, clean electrification and digitalization. The benefits of our transformed portfolio include an enhanced margin profile, less complexity, and a more focused operating model.

In addition, these divestitures further increase our exposure to the fast growing data center vertical to nearly 10% of sales from 7% as of fiscal year 2023. We expect this percentage to further increase over time given the robust demand we are seeing in this key vertical. While we will continue to look at opportunities to further enhance the portfolio, we believe that the largest elements of the portfolio transformation are now complete.

Turning to slide 6 to discuss our focused business model and how we plan to deliver more consistent, predictable outcomes for our customers and maximize value for shareholders over the lifecycle of buildings. Johnson Controls has a unique value proposition for our customers that directly translates to shareholder value creation. Our ability to serve our customers over the lifecycle of the building allows us to deliver safe, healthy, and sustainable buildings. As a simpler and more streamlined company, we are now better positioned to leverage our integrated domain expertise, coupled with our extensive branch network to significantly expand margins.

Our journey with the customer provides system and service solutions that maximize the opportunities around the lifecycle of the asset, delivering outcomes to the customer that save energy, reduce emissions, and optimize building lifecycle costs, all while improving the overall occupant experience.

Most importantly, our ability to drive direct outcomes ensures that we have long-term customers that use several of our services, which creates a compounded impact for the customer and for our shareholders. In fact, $1 of systems revenue has the potential to generate up to 10 times the revenue over the lifecycle of the solution.

It all starts with our local teams supported by our centralized engineering teams to provide operational excellence throughout the construction of the new building, starting with the product and technology development through the installation of the new systems. This grows the installed base. Throughout system deployment, our teams are building customer intimacy and confidence in our team to ensure we are creating linkage with our service offering.

We have redoubled our focus to build this initial relationship and greatly improved our operational execution over the past few years to drive an enhanced margin profile and grow service. Simply put, service and maintenance delivers recurring revenue for us, and this provides resilient revenue throughout economic cycles.

Moving to parts and repairs. Our service organization is digitally enabled and unlocks additional value by collecting data from the connected equipment within the building. Leveraging this data lets us detect issues before they occur, leading to reduced downtime and cost savings for the customer.

The last part of the cycle is the building retrofit, including the monetization and technology refresh of existing systems. We work closely with the building owner to discuss lifecycle planning and the prioritization of the building needs. We have found this to be the perfect opportunity for Johnson Controls to sell additional domains.

By compounding the effects of this cycle, we are able to deliver solutions to our customers, leading to significant margin expansion. The ongoing transformation of our portfolio into a quality pure play provider of comprehensive solutions for commercial buildings means that we can service these buildings to deliver outcomes that matter.

Accordingly, we are extending our journey with our customers, while capitalizing on attractive opportunities in the market. Together, this delivers value across our stakeholder base for customers, employees and for our shareholders.

With that, I'll turn it over to Marc.

Marc Vandiepenbeeck

Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

Thanks, George, and good morning, everyone. Let me start with a summary on slide 7. Total revenue of $7.2 billion, grew 3% organically, as strong high-single-digit service growth more than offset continued weakness in China system business. Segment margin expanded a robust 150 basis points to 17.9%, as we delivered another strong quarter of productivity and converted our higher margin backlog.

Adjusted EPS of $1.14 was up 11% year-over-year and exceeded the high end of our guidance range by $0.04. Operations contributed $0.18 of the growth in the quarter, as improved productivity and the conversion of higher margin backlog more than offset higher corporate costs related to additional IT investments, cybersecurity enhancement costs and increased centralization of functional costs. Below the line, we saw favorability from a lower share count. As we continue to build a more consistent and predictable business, we are pleased with the strong adjusted EPS performance in the quarter.

On the balance sheet, we ended up the third quarter with approximately $900 million in available cash and net debt decreased to 2.3 times, which is within our long-term target range of 2 to 2.5 times.

Year-to-date, adjusted free cash flow improved approximately $700 million year-over-year to $1.3 billion. We remain on the path to driving higher free cash flow conversion more consistently. Let's now discuss our segment results in more detail on slide 8 through 10. Beginning on slide 8. Organic sales in our Global Products business grew 3% year-over-year, with price offsetting a modest volume decline. Commercial HVAC remained a bright spot for the business, growing mid-single digit against a tough comp of mid-teens growth a year ago. Fire and security declined low single-digit, as a decline in fire suppression more than offset growth in fire detection and security video surveillance. Industrial refrigeration grew approximately 20%, with strong double-digit growth in both North America and EMEA/LA.

Overall, Global Residential grew mid-single digits in the quarter. Global ductless residential grew low single-digit as strong double-digit growth in APAC more than offset continued declines in Europe. In conjunction with improvement in North America residential market, our global ductless residential business grew 10%, with strong double-digit growth in both North America and EMEA/LA

Adjusted segment EBITA margin expanded 240 basis points to 24.5%, as positive price cost and improved productivity more than offset mix headwinds from ongoing weakness in China.

Now moving to slide 9 to discuss our Building Solutions performance. Order momentum remained healthy with 5% growth in the quarter. Overall, service order grew 12%, with a broad-based growth across the region. Systems order grew 2% as North America offset decline in APAC. Organic sales increased 4% in the quarter, led by service growth of 9%. Systems revenue grew 1% as decline in APAC more than offset growth in North America and EMEA/LA. Building Solutions backlog continues to remain at record levels, growing 10% to $12.9 billion. Service backlog grew 7% and system backlog grew 10% year-over-year.

Let's discuss the Building Solutions performance by region on slide 10. Orders in North America increased 5% in the quarter, with mid-single-digit growth in both systems and services. As a reminder, our quarterly order growth can fluctuate based on the timing of certain large projects, particularly in the data center vertical. We remain confident in our competitive position in the data center and our pipeline remains quite robust. Sales in North America were up 8% organically, with continued strength across HVAC and controls, up over 20% year-over-year. Overall, our system business grew 9%, while service grew 6%.

Segment margin expanded 150 basis points year-over-year to 15.9%, driven by the continued execution of higher margin backlog, improved productivity and solid service contribution. Total backlog ended the quarter at $9 billion, up 14% year-over-year.

In EMEA/LA, orders were up 11%, with over 25% growth in service. Systems, although were flat as we continue to remain focused on driving higher quality growth with higher margin and improved cash flow conversion. Across the portfolio, we saw strong double-digit growth in controls, fire and security. Sales in EMEA/LA grew 8% organically, with broad-based growth across the portfolio. Momentum continues to build within our service business, up 15% year-over-year, driven by strong double-digit growth from both our recurring and shorter cycle transactional businesses.

Our system business grew low single digits, led by strength in controls. Segment EBITA margin expanded 170 basis points to 10.3%, driven by the positive mix from the growth in service and the conversion of higher margin system backlog. We've made tremendous progress in improving the profitability in EMEA/LA as well as the mix of higher margin service. A more disciplined funnel in systems gives us further confidence in continued momentum in margin improvement. Backlog was up 12% year-over-year to $2.5 billion.

In Asia Pacific, orders declined 2%, as we have focused on deploying resources to the most attractive part of the market and remain selective on the jobs we quote and ultimately book. Given our strong installed base in the region and our continued focus, we saw high single-digit growth in service.

Sales in Asia Pacific declined 19% as the systems business continue to be impacted by ongoing weaknesses in China. Our service business grew 8% in the quarter, with strong double-digit growth in our recurring revenue contracts. Segment EBITA margin declined 220 basis points to 11.7%, as weakness in China offset positive mix from our service business. Backlog of $1.4 billion declined 12% year-over-year.

Now let's discuss our fourth quarter and fiscal year 2024 guidance on slide 11. We entered the fourth quarter with solid momentum, led by our resilient service business and continued demand in our North America system business. Our margin-rich backlog remains at a historical level, and our Global Products book-to-bill business have stabilized and returned to growth. We are introducing fourth quarter sales guidance of approximately 7% growth, as strong demand in North America and EMEA/LA is somewhat muted by one more quarter of slower recovery in the system business in China. Global Products momentum is expected to continue as our book-to-bill orders remain positive throughout the third quarter and the tough comparison in China [ph] biz (00:20:11).

For the fourth quarter, we expect segment EBITA margin to be approximately 19% and adjusted EPS to be in the range of $1.23 to $1.26. For the full year, we are tightening adjusted EPS guidance to a range of $3.66 and $3.69. We now expect organic sales to grow approximately 3% and segment EBITA margin to expand approximately

110 basis points. Our working capital metrics continue to improve, and our free cash flow performance year-to-date has been strong.

We continue to invest capital in attractive areas, including data center manufacturing expansion and ongoing ERP consolidation. While this will be a slight headwind, we expect adjusted free cash flow conversion of approximately 85% or better for the full year.

With our recent announced planned divestiture, I want to highlight some financial details and future reporting on slide 12. As George mentioned at the beginning of the call, we were extremely pleased with our announced sale of the residential and light commercial HVAC business. This came just a few weeks after we announced so we tend to sell Air Distribution Technologies business. Together, these two transactions represent hopefully, 20% of the sale and the majority of portfolio we have previously highlighted as non-core.

We expect to report the residential and light commercial business as discontinued operation with our fiscal fourth quarter results and will provide our official fiscal year 2025 guidance on a continuing operation basis. While the two transaction would be dilutive to EPS prior to any cost offset, we have actions in place to address the stranded cost and we are working on accelerating some of these actions prior to closing. Through the combination of share repurchase, debt pay down and restructuring, we have a plan in place to fully offset the stranded costs. We will provide more details when we report our fiscal fourth quarter results.

Before we open up the lines for questions, I want to conclude with a summary of our recent transformation on slide 13. We have spent the last few years transforming the company into a comprehensive solution provider for commercial buildings, and this continues to be a differentiator for Johnson Controls. We took a major step in simplifying the portfolio with our two recently announced divestiture, and we believe one operating model will enable us to deliver more consistent, predictable results.

We operate in many attractive markets, which allows us to build our backlog with margin-rich jobs that have a service still throughout the lifecycle of building. Our systems backlog, coupled with our resilient business, positions us for sustainable and continued margin expansion. As our margins continue to improve, coupled with our commitment to disciplined capital allocation, we would expect double-digit EPS growth.

As George mentioned earlier, the result of our portfolio transformation is now a faster-growing, more profitable, less complex and more operationally focused Johnson Controls, and we are excited for the next chapter.

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

QUESTION AND ANSWER SECTION

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

Scott Reed Davis
Analyst, Melius Research LLC

Q

Hey, good morning, George and Marc and Jim. And congrats, George, on the announcement.

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

A

Thanks, Scott.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Morning, Scott.

Scott Reed Davis
Analyst, Melius Research LLC

Q

I wanted just to dig in on the data center kind of impact on backlog a bit. I would assume that a big chunk of that backlog growth is data center, but maybe you could give us some color on the impact of materiality of that growth in that vertical? Thanks.

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

A

Yeah. Let me give you a framework, and then Marc can talk a little bit more about the – how it's being built in backlog and converting. We're already now – we said in the prepared remarks that we're about 7% a year ago. When we look at the business today, it's about 10% of sales on a pro forma basis. It continues to be very strong. We're working across all of the hyperscalers, colos. We've got a global team now, making sure that our leadership technology and all of our domains, that we're positioned now to be able to provide the best solutions globally. So that pipeline is continuing to build.

And I think as we think about our orders and backlog, certainly, this is going to be a higher mix of backlog playing out. In many cases, it is a multiyear backlog. And for us, we look at the next 12 months as far as how we book the backlog. And then as we think about the growth, Scott, going forward, this is going to be strong double-digit growth in 2024. It's going to be, for this year, a strong double-digits and continuing to accelerate over the next few years given the work that we're doing. Marc, do you want to talk about the mix a little bit?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yeah. So Scott, if you look at that growth in backlog of 10%, almost $13 billion in backlog. The mix remains consistent year-over-year because a lot of those data centers, as George mentioned, are multiyear. There is clearly more data center work in that $12.9 billion. But that mix will continue to evolve more towards the data center as we churn that backlog. We will maintain our definition of backlog as what we see in revenue for the next

12 months. And with that consistency, you'll see a change over time more tilted towards the higher growing segments of the market.

Scott Reed Davis
Analyst, Melius Research LLC
Q

Okay. That's helpful. And guys, I'm just looking at this slide 6 and the 10 to 1 numbers on service and digital versus the OE side. I don't remember seeing that before. Maybe you've put it up and I just have missed it. But is this kind of a theoretical number? Or you actually have expectation that these are achievable type ratios going forward?

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

So the algorithm that we've been working for multi-years now as we've been building the service business depends on – it starts with the installed base, Scott, relative to not only what we're putting into the installed base, but going after the existing installed base.

When we can, right out of the gate, get connectivity and ultimately, that first level service and then now with OpenBlue and with connectivity with the use of data, the significant value propositions that we add on to what would be historical maintenance and break/fix. And so as we now are seeing that over the last couple years, we're getting to that level of multiple relative to what we see on a run rate basis that over the lifecycle can achieve that level of revenue. So that is real data with customers that we've had connectivity. We've had installed base connectivity. We're using data and we're now adding on additional services. That is absolutely real.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc
A

And that revenue multiplier evolves based on market vertical and product lines. And we've tried to lay that out on that chart. HVAC is a multiplier, that's a little lower than [ph] 10 turn (00:28:03), while you go through security controls and then fire provides the higher level of multiplier over the lifecycle of the product. So depending on the market vertical, depending on the product, that multiplier expands. But this is real experience data that we've looked through over the past few years, and we believe we can continue to deliver that through that operating model we've now implemented.

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

I think it's important, Scott, that we're – it's really tied to outcomes versus just the traditional by-the-drink type service. And so as we're now converting not only the technology and the product, but with our OpenBlue and data, that that really changes the game. And then from an attrition standpoint, it significantly reduces the attrition, which continues to build our base going forward, for service going forward.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thanks. Good morning and congrats, George, on a very good run.

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

A

Thanks, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

In terms of – yeah, I suppose just first off, wanted to start with the overall kind of top line growth outlook and sort of two elements of that. I think one is, the total company this year is growing about 3%. When we look at the sort of the go-forward business, the $22 billion revenue base or so, is that sort of 3% rate abnormal in any respect when you're looking at the backlog and assuming no big changes in interest rates or US policy kind of as we're looking ahead?

And related to that, the fire and security business is something that you've known for a long time. It looks like sales are flat there this year, and that will be about 45% of the go-forward revenue, I think. What do you think foreign security can grow at sort of medium term?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Oh, great question. So let's start first with the 3% for the full year. Really, we had a lot of cyber headwind in the first quarter that have muted somewhat that overall growth rate year-on-year. So I'll tell you for a longer-term algorithm, 3% is absolutely not what our expectation would be. It'd be closer to mid-single digits, and that's really on the basis of a mid- to high-single-digit growth in our service business and a mid-single-digit growth into our systems business overall.

And so those fundamentals driving a better mix overall are different, depending on the different product line. And right now, HVAC is benefiting from a lot of tailwind coming from decarbonization, data center and other market verticals that have really propped up the growth there.

And you're right. We've seen a little bit of softness overall in the market on fire and security this year. We're seeing, particularly in our book-and-bill business, some sign of recovery, and we think we can maintain that mid-single-digit growth over time for that business, as the service and recurring component aspect of that business will continue to be higher than that mid-single-digit target.

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

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks, good morning. And George, you had one hell of career, so congratulations and good luck with your next steps.

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

A

Thanks, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Yeah. So just on that topic, do you have a timeframe in mind for this succession? I know you obviously want to find the right person and do a very thorough search. But any timeline? And then maybe just touch on Patrick's appointment to the board. Obviously you know Patrick very well. What sort of skills kind of made him the right person for the board? And I wonder if maybe he's under consideration for next year.

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

A

The timing of this, I mean, we've made great progress on our portfolio with the moves we've recently made. I think it's clear that we have a lot of confidence now in the strategy playing out, and we're starting to see that, the results from that. And we've also put a strong leadership and team, and I'm very confident of their capabilities and the work that they're doing that's going to position the company to continue to be successful.

Now the board, working with the board, we've had succession plans that we've been building over time. So that's well underway, and we're looking at both internal and external candidates. The board is engaged directly with a national recognized search firm and making sure we're also looking and developing at our internal candidates. So it's hard to define the timeline, but we are moving forward.

And as far as myself, I couldn't be more committed and more passionate and energized relative to where we are, committed to make sure that we – I see through a very smooth transition to my successor, and then I'll continue on as Chairman of the board. So that's kind of where we are. We'll keep you up to date as we make progress through the year and through the remainder of the year and keep you updated.

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

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hi, good morning.

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

A

Morning.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And congrats, George.

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

A

Thanks.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

The free cash flow in the quarter was pretty good. How do you see that playing out in the fourth? I know 85% conversion would suggest. I think somewhat of a step down in the fourth. And you're already – on a trailing basis you look like you're already very close to 100% conversion. So just curious as to how sustainable this good result is.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Great question, Steve. So you're right, we saw a really solid improvement year-on-year, and the momentum year-to-date has been quite strong. We're seeing working capital fundamentals continuously improving and continue to trending very positively.

The work we've done on lowering inventory and improving our S&OP/S&OE process have allowed us to really drive overall more predictability to the working capital. As far as that 85% plus conversion for the year, we continue to invest aggressively in parts of the market that are attractive to us, particularly increasing the capacity in our data center as we expand more lines in our factory in North America and elsewhere as well as continue to involve the investment in our ERP landscape. We do believe that the momentum allows us to probably do better than 85%. And structurally, in over term, we'll be able to continue to improve on that. But as of today, I'll tell you, 85% plus is where we're comfortable.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And then just as far as the guide is concerned next year, anything – any details that you can give as far your strategy, there's obviously going to be a bit of a dislocation moving these things to disc ops with a lag in the capital deployment? How do you plan to address that on earnings?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yes, we'll start providing guidance next quarter on continued operation and you're right, there's going to be a little bit of noise, but we are very comfortable that the algorithm we've committed to for next year, will hold through as we navigate to that continued operation.

As you know, some of that residential and light commercial business had solid cash flow. But the momentum that we see in our core business, thanks to that singular operating model, is really providing strong tailwinds that will allow you to continue to improve on our free cash flow conversion and our overall free cash flow performance.

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

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks. So in the release, there's a call out of the gain, the significant gain on some of the insurance recoveries from that AFFF settlement. Can you just walk us through where your expectations are in terms of actual cash outflows relative to the $750 million settlement that was previously disclosed, now that you've gotten some benefit from insurance and maybe talk through the timing of those outflows?

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

A

Let me just frame this up here. We did – just going back, we reached a settlement with plaintiffs relating to the PFAS liability. This settlement obviously resolved a significant amount of our PFAS liability. Just also, you might recall that [indiscernible] (00:37:22) July 2023 that we're going to discontinue the production of the sale of our fluorinated firefighting foams by June of 2024 which is what we've done. So that's behind us. And we have a significant amount of insurance through more than 20 insurers that is applicable to these claims. And so that's the framework. And you've seen that we did receive $351 million from our insurers. And maybe, Marc, you can talk about as we – what we expect going forward.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yeah. So from a timeline, Noah, we took the charge in Q2 for $750 million. That's part of the settlement. And in the third quarter, we had received from the first few agreements with our insurer of about $351 million. So we recovered almost half right off the bat. And those payments will go back to the water provider according to our agreement. There's more payments that are going to come and come in over the next few quarters, and we believe that we're well covered from an insurance standpoint, and the net effect overall will be de minimis. The timing between the recoveries and payments may slip from one quarter to the other. But overall, we think we're in good shape there.

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

Joe Ritchie
Analyst, Goldman Sachs & Co. LLC

Q

Thanks and good morning, everybody. Congratulations, George, on the succession announcement. Marc, I want to – just one quick clarification on the 4Q guide. So is discontinued ops out of the 4Q guide? And if so, what is the impact of that? And then going forward into fiscal year 2025, how should we think about GP margins at this point? You guys put up a great number this quarter. Just trying to understand kind of like the puts and takes of the moving pieces with some of the portfolio divestitures.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Sure. Thanks, Joe. The fourth quarter guide we just gave is for the full payment of the company. We'll start breaking it down at the next quarter. So that guide really holds together, with perspective that we are going to continue to see sequential improvement, both for the business that we have contemplating to divest as well as the core of our businesses.

Now if you look at the Global Products margin and if you reflect on the year, Global Products really has benefited from improved processes from an S&OE/S&OP process that really drove massive improvement in our material handling and our inventory. And that improved inventory management, created massive absorption benefit as well as productivity and net-net better conversion costs. That means that any incremental volume you saw created good leverage and solid leverage in that business.

Now that performance in Q3 that we see continuing improving in Q4, as you look into 2025, we'll go back to a more regular seasonality, right? So you'll see that the first half of the year performance more in mid-teens, given the volume that business sees in the first six months of the year. And then I think we are now very comfortable seeing that business clocking in the 20s in the second half of the year as a natural seasonality and volume ramp up in the second half.

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

Joseph O'Dea

Analyst, Wells Fargo Securities LLC

Q

Hi, good morning. Congrats, George, and congrats to all of you on the portfolio announcements over course of the quarter. Just curious if you can outline on ADT, the anticipated proceeds, as well as any revenue margin kind of EPS related to that exit. And then separately, just wanted any clarity on destock this year. What you saw during the quarter? Confidence that you think that's behind you? And any sizing of the overall headwind Global Products in 2024 from some of those destock pressures?

Marc Vandiepenbeeck

Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yeah. Let me start with ADT, and then I'll give some color on destock. But George, you can add some more. So that business, we signed on June 18, we expect to close the transaction actually this quarter. We've not disclosed the financial terms of the business because it is a smaller transaction and really not that material.

I think what's important to remember is this is really part of our simplification journey. We really eliminating – I'm sorry, about 30% of our manufacturing footprint, but we're also eliminating a whole series of SKU and complexity. This is a very commodity business, and accessory business and it's evolved a lot over the past decade since we acquired that business. But it's an important step in our journey as a pure play provider. And the net effect of that divestiture after we buy back some shares is immaterial to the overall company. On destocking...

Joseph O'Dea

Analyst, Wells Fargo Securities LLC

Q

Thank you.

Marc Vandiepenbeeck

Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yeah.

Joseph O'Dea

Analyst, Wells Fargo Securities LLC

Q

Apologies. Please proceed.

Marc Vandiepenbeeck

Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

On destocking, I think we see a stock level getting back hopefully to normalization. They're some pockets of the market that are still simplifying a little bit their stock level. But overall, I think that for the most part, that large destocking is behind us. And we feel very confident, particularly when product have been refreshed that we have a new norm and a new standard on our stock levels, and the distribution seems to be holding up pretty good.

George R. Oliver

Chairman & Chief Executive Officer, Johnson Controls International Plc

A

Yeah, being very familiar with these businesses, when you look at what we've done around, Marc mentioned it, as it related to productivity with material planning and the like, and then the work that our team has done really simplifying our SKU base, we've done a really nice job now, not only reducing the inventory, but really decreasing our lead times.

And so I think we're well positioned now from a commercial standpoint, to be able to pick up volume because of our short lead times while we're continuing to reduce inventory. So we're back to where we were prior to this ramp up because of all of the disruption in the supply chain. And I feel confident that now on a run rate basis from a growth standpoint, we're starting to see the come back and we're doing it with less inventory.

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

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Good morning, everyone. And George, good luck on whatever is next. Just want to come back to the portfolio changes. Obviously, you're not going to report Q4 or 2024 on the basis with which you guided given things going to disc ops. So maybe you could just actually share with us, given where your guidance stands today and what you're doing on stranded and other costs, what the reset 2024 base looks like on an equivalent basis relative to your current guide?

And then when you do have the proceeds to deploy, should we expect you to kind of solve to your same leverage ratios that we see today kind of split between share repurchase and debt reduction to kind of maintain the same leverage? Or will you do something different with how you structure the balance sheet? Thank you.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Got you, Jeff. So on disc ops, this is not changing any of our commitment and is actually – we feel very comfortable with where we've guided from a full portfolio as well as where we think the continued operating business will go.

As far as the use of proceeds and what we plan on doing, so we expect the transaction to close in the next 12 months. And we plan to return most of the net proceeds to shareholders through a share repurchase program, very similarly to what we did a few years ago when we divested our Battery Power Solutions business.

As far as addressing our leverage, it will very much depend on the timing of the closing. We're thinking 12 months, but it could go three months either way. And so we could easily see ourselves growing into our existing debt level and not have to redeploy much, or we could see ourselves in the transaction close much, much quicker than we're anticipating, having to address some leverage at that point. Our goal is to remain committed to our investment-grade rating, and we'll work with the agency, depending on the timeline, as to what's most appropriate to be able meet that commitment. And I'll leave it at that.

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

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Good morning, everyone. George, congratulations.

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

A

Thanks, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Could you update us on what you're thinking regarding the ability to start growing backlog in earnings in Asia Pac, and what your expectations are for Q4 bookings and backlog? Backlog was up slightly sequentially in Q3. And I know you've talked about expecting a bigger uptick by the end of year, while telling us today that China is still muted. So do you still see bookings beginning to accelerate in Q4? And do you still see recovery in that region in FY 2025?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

No. Great question. And you partially answered it. Yeah, we continue to see sequential improvement. There is a slower recovery than we had initially anticipated. So one of the reasons we tightened the guide for the year and why you see a revenue growth a little lower than we anticipated. But that momentum has continued to build. And the order intake we saw in Q3 was sequentially a good improvement from Q2, and we see that sequential improvement continue in Q4.

While we expect one more challenging quarter in the fourth quarter here, we're still probably declining revenue year-on-year in the low-single digits. That of the momentum is going to turn positive positioning as well as we enter 2025. So we absolutely see that business recovering in 2025, particularly on a year-on-year compare. The comps are going to become easier given the challenging year we just went through.

The backlog, as you mentioned, has been sequentially improving over the last few quarters, and we continue to redeploy the resource in this most attractive part of the market, but we continue to remain very disciplined in the type of job and the counterparty we deal with in the market in China as that market continues to be pretty challenged.

Operator: Thank you. And our next question comes from Andrew Obin with Bank of America. Please go ahead.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Hi. Yes, good morning and George, congratulations.

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

A

Thanks, Andrew.

Andrew Obin
Analyst, BofA Securities, Inc.

Q

Just a question, just maybe a little bit more detail. You highlighted more disciplined approach in EMEA systems. What did you do? And what's your ability to apply this approach elsewhere in the portfolio?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Great question. So the discipline that we've put in place is really part of our overall operating model. And that operating model really started as we refined it in North America a couple of years back. And you can see North America really benefiting from that discipline over time and that focus.

There's really two things that are happening. We centralize more the decision-making process as which vertical and which markets we really approach. And we really focus that commercial organization towards those parts of the market where we see a very much attractive margin as we can sell value and we have customers that are interested in our product and see value over the lifecycle, but also parts of the market where you see a stronger service attach.

And when you do that, you're able to actually drive modest growth in the system business, but a much larger growth in our service business as that service attach yields better outcome overall. So that operating system has been really fully deployed in North America. That's probably where the maturity is at the highest.

EMEA/LA is still going through that. I see EMEA/LA closing the gap with its regional peers. Asia had a strong operating model. I think the market moved on us very fast, and we are repivoting as quick as we can. But you'll see, as I mentioned on the prior question, you'll see APAC repivoting very quickly, and that operating model maturing across the board outside of North America, including in EMEA/LA.

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

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone, and I add my congrats to George.

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

A

Thanks, Deane.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Hey, I don't think you've given much detail here, but could you share us with any of the economics of the divestiture of Air Distribution Technologies?

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

Yes. As I mentioned, Deane, while this is a critical step in our simplification journey, the financial terms are not disclosed because they're really – it's really a smaller transaction and not very material for the overall value of the enterprise. We struck what we feel is a very attractive deal for the enterprise with [ph] trading (00:52:22) capital. We're hoping to close that business very, very quickly and hopefully within the next few weeks.

Deane Dray
Analyst, RBC Capital Markets LLC

Q

Got it. Thank you. And then second question, George, there's been a lot of interest in your peers regarding not just data center, but liquid cooling technologies in data center. You've seen your peers make direct investments in technologies, businesses. Is this something that you all are looking at as well? You've got certainly components that are part of these technologies, but there's a big developing opportunity high growth, and it seemed like it would be a good fit.

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

Absolutely. We're incredibly well positioned with all of our hyperscaler and colos customers. And from an R&D standpoint, understanding what their next generation is. How do we leverage our – what we would say is a leadership portfolio with a lot of IP?

And then as we go to liquid cooling, with the cooling distribution unit at the end of – it's still going to require a lot of the cooling technology that we deploy while making sure that we're going to be positioned either producing those units and/or partnering to make sure that we have the full solution and how position with our hyperscalers and colos. And so we see this playing out as an incredible opportunity for us and one that we've been investing in not only in our core technology, but our application of that technology with overall liquid cooling.

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

Gautam Khanna
Analyst, TD Cowen
Q

Hey, thanks. Good morning and congrats, George.

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

Thanks.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc
A

Morning, Gautam.

Gautam Khanna
Analyst, TD Cowen
Q

I wanted to ask on that CEO search, what – George, from your perspective, like what kind of attributes are you looking for from whoever succeeds you? What do you think they need to bring?

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

Well, I mean as we think about the company and the simplification of the company, it's important that we bring a lot of domain expertise and industrial expertise. We're a company that is a product technology company. We're a service company and how we deploy that technology.

Certainly, we're solutions in how we actually go to market. So there's a lot of experiences there that we'd be looking for to complement. As we did the board refreshment with Patrick, just to talk to that a little bit, we are constantly looking for qualified board candidates and how we think about refresh and succession. And Patrick is a fantastic addition, a world-class executive with experience transforming Xylem, and similar experience going from an industrial products company into an advanced technology service solution enterprise.

So as we think about CEO succession and the like, obviously, strong operating experience, strong domain experience and the ability to be able to take the incredible foundation that we've built here to the next level, leading the new Johnson Controls.

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

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Thanks. Good morning, guys. And I'll add my congrats to George on the announcement today. Just wanted to ask about orders. So you guys mentioned lumpiness around data center may be contributing to the 5% organic growth this quarter. I guess how do you think about the potential opportunity for order acceleration from here based on what you're seeing in the pipeline today as we try to calibrate expectations for the next few quarters? Thanks.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc

A

As you know, we try to shy away from providing guidance on all those. But what I can tell you is you're absolutely right. We see lumpiness in the orders, particularly coming from the data center vertical. That also means that there's going to going to be a quarter where you're to see very large order, and we continue see an increased pipeline in that particular vertical.

That gives us confidence that you will see a pretty large order quarters over the next few coming quarters. This particular [ph] last (00:56:45) quarter, we have a tough compare year-on-year. We had very solid orders, particularly in the data center vertical in the third quarter of last year. But again, the pipeline remains healthy and that lumpiness will probably not go away anytime soon.

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

A

And I think just to add on to that, when you look at the value proposition that we bring to data centers with our portfolio multi-technologies, in the way that we've been building out capacity to be able to serve our customers as they achieve their growth. These become multiyear agreements. And so as we're positioning, you can get very large orders multiyear.

And that's what we're seeing as we're partnering and making sure that we're positioned to get more than our fair share bringing our technologies and capabilities with the full solution to our customers globally.

Operator: Thank you. And our final question today comes from Brett Linzey with Mizuho. Please go ahead.

Brett Linzey
Analyst, Mizuho Securities USA LLC

Q

Hey, good morning and congrats to George.

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

A

Thanks.

Brett Linzey
Analyst, Mizuho Securities USA LLC
Q

Just wanted to come back to the fourth quarter guide. So the 19% EBITA margin, I wanted to understand your level of visibility there. Is this something that you're converting out of backlog and you have line of sight, too? Just any color towards that 60% incremental margin.

Marc Vandiepenbeeck
Executive Vice President, Chief Financial Officer & President-Building Solutions EMEALA, Johnson Controls International Plc
A

We absolutely have strong visibility to it. And if you look year-on-year, for sure that 19% looks pretty heavy with 250 to 300 basis points year-on-year improvement. But now if you look at it sequentially, when we went from Q2 to Q3 and Q3 to Q4, jumping from almost 18% to 19% is absolutely part of that sequential run rate.

The same fundamental we saw from Q2 to Q3 having a strong backlog, having really our book-to-bill business both in the field and our Global Products continuing to driving more volume. And the comments I've made on Global Products and the incredible work that's been done there to take care of the base cost and conversion cost, allowing us to really drive a lot of bottom line benefit for small volume increment, gives us very strong confidence that we can achieve that margin rate in the fourth quarter.

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

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

Thank you, operator, and I'd like to thank the entire Johnson Controls team for their incredibly hard work and dedication in getting us to where we are today. Our transformation into our pure play provider of comprehensive solutions for commercial buildings is substantially complete, and we're well positioned to now deliver long-term sustainable value for our shareholders as a simpler, higher growth company.

We know we're on the right path as our strategy is already delivering results, we are looking forward to this next chapter for our company. I am proud of the growth Johnson Controls has been able to achieve and couldn't be more excited about where we go next. So with that, operator, that concludes our call today.

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