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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. Welcome to the Ingersoll Rand 2018 Q3 earnings conference call. My name is Julie, and I will be your operator for the call today. The call will begin in a few moments with the speaker remarks and then a Q&A session. All lines will remain on mute for the duration of the call. [Operator Instructions] Please be advised, you are limited to one question and one follow-up question.

And with that, I would now like to introduce Zac Nagle, Vice President of Investor Relations. Zac, you may begin.

Zachary A. Nagle

Vice President, Investor Relations, Ingersoll-Rand Plc

Thanks, operator. Good morning and thank you for joining us for Ingersoll Rand's third quarter 2018 earnings conference call. This call is being webcast on our website at ingersollrand.com, where you'll find the accompanying presentation. We are also recording and archiving this call on our website.

Please go to slide 2. Statements made in today's call that are not historical facts are considered forward-looking statements and are made pursuant to the Safe Harbor provisions of federal securities law. Please see our SEC filings for a description of some of the factors that may cause actual results to differ materially from anticipated results.

This presentation also includes non-GAAP measures, which are explained in the financial tables attached to our news release.

Joining me on today's call are Mike Lamach, Chairman and CEO, and Sue Carter, Senior Vice President and CFO.

With that, please go to slide 3 and I'll turn it over to Mike. Mike?

Michael W. Lamach

Chairman & Chief Executive Officer, Ingersoll-Rand Plc

Thanks, Zac, and thanks to everyone for joining us on the call today.

Please go to slide 3. I'd like to begin with a brief review of the fundamental elements of our business strategy that underpin our quarterly results and create value for our shareholders.

First, our global business strategy is at the nexus of environmental sustainability and impact. The world is continuing to urbanize while becoming warmer and more resource-constrained as time passes. We excel at reducing the energy intensity of buildings and industrial processes, reducing greenhouse gas emissions, reducing waste of food and other perishable goods, and we excel in our ability to generate productivity for our customers, all enabled by technology. Our business portfolio creates a platform for the company to consistently grow in above-average global economic conditions, aided by the strong secular tailwinds I've outlined.

Second, our business operating system is designed to excel at consistently delivering strong top line growth, incremental margins, and free cash flow.

And lastly, over the years we built an experienced management team and a high-performance winning culture that makes our performance sustainable. When combined with our dynamic capital allocation strategy, we have a differentiated business model that drives strong shareholder returns over the long term.

Moving to slide 4, exiting Q3 and moving into Q4, we continue to execute well and are on track to exceed the guidance we outlined for investors on our Q2 earnings call. First, our end markets remain healthy, and we have continued to deliver excellent growth in bookings and revenues in both our Climate and Industrial segments. Additionally, our growth continues to be broad-based across virtually all businesses, products, and geographies globally, and services growth continues to be especially strong.

Second, our leverage and profitability are improving, as we are effectively managing all elements of the P&L to deliver results. In the third quarter, we achieved our second half 2018 leverage target of approximately 25% through strong volume and effective management of our price versus material cost and productivity versus other inflation metrics. We saw good margin expansion across the business, led by the Industrial segment, and healthy margin expansion in our Commercial and Residential HVAC businesses.

The second half of the year has become increasingly inflationary since we updated our guidance in July. We are embedding the impacts of additional material and other inflation, tariffs, and the knock-on effects of tariffs in our forecast.

In spite of this impact, we expect to continue to effectively manage these costs as we have in the second and third quarters and to maintain our guidance of approximately 25% leverage for the fourth quarter. We have raised our full-year adjusted earnings per share guidance to between $5.55 and $5.60, up from approximately $5.50 for fiscal 2018.

In October, our Board of Directors approved a new share repurchase authorization of $1.5 billion, bringing our total available authorization to approximately $1.9 billion. This reflects continued confidence in our ability to generate strong free cash flows going forward and gives us increased capacity as we execute our dynamic capital allocation strategy.

2018 is shaping up to be another strong year for us. As we move through the fourth quarter, visibility into 2019 is also improving. Based on virtually everything we're seeing, our major end markets look poised for another year of good growth. Strong bookings in 2018 are also setting us up with a solid backlog picture heading into 2019.

And finally, we are managing material and other inflation and tariffs, enabling us to drive solid leverage through the P&L and further expand margins. We expect to use the same processes and tools in our business operating system to manage these risks in 2019.

In summary, we're executing our strategy well, and this is enabling us to deliver differentiated performance in 2018. The second half is progressing consistent with our expectations, and we plan to close out the year on a strong note. Looking forward to 2019, we're expecting another good year for our industry and particularly for Ingersoll Rand.

Please go to slide number 5. The third quarter was highlighted by continued strong growth across the board, as indicated by the positive signs on the chart. Enterprise organic bookings and revenues were both up double digits. Climate led the way, with organic bookings and revenues of 12% and 10% respectively. Industrial was also robust, with organic bookings and revenues up 7% and 9% respectively. These results reflect continued strong execution of our business strategy, capitalizing on healthy end markets.

The one minus on the chart was a bookings decline in Commercial HVAC in the Middle East, where orders can be lumpy, and there were a couple of large orders in the third quarter of 2017 that did not repeat in 2018. European HVAC orders continued to be strong in the quarter.

Let's go to slide number 6. The next two slides provide insights and additional color into the key drivers behind the chart on slide 5 and how we're thinking about the markets for the remainder of the year and into next year.

In Commercial HVAC, we're seeing sustained growth globally in both bookings and revenues, with good growth in both services and equipment. North America growth was strong, with continued gains in services, contracting, controls, and equipment. Institutional growth was particularly strong, led by the education markets.

As we discussed on slide 5, Europe Commercial HVAC remained strong, with solid growth across the board in both services and equipment. China HVAC growth continues to outpace the market. Weakening economic indicators in China did not appear to be impacting the HVAC markets to date. Other markets in Asia continued to be mixed, as they have been all year. Our outlook for global Commercial HVAC remains healthy, and key economic and market indicators largely support our view, with increasing visibility into 2019.

Turning to Residential HVAC, bookings and revenue growth continued to be strong. Replacement markets, where the majority of our sales are derived, showed continue strong growth in the quarter, and this is expected to continue through the remainder of 2018 and into 2019.

Please go to slide number 7. Our Transport Solutions business continues to be globally diversified and resilient. We've seen good order growth for North America trailers in 2018, and the estimate for market revenues has improved from the beginning of the year as well. The Americas Commercial Transportation Research Company, also known as ACT, has taken their forecast for North American refrigerated trailer shipments to 43,700 units, which represents approximately 3% growth over 2017. Our capacity to ship refrigeration units exceeds the industry capacity to supply trailers, so we should have solid backlog heading into 2019.

Auxiliary power unit growth was strong in both refrigerated and non-refrigerated segments. As with North American trailers, backlog will be strong going into 2019 as well. Overall, the transport markets remain healthy in 2018, and we expect this to continue heading into 2019.

Compression Technologies growth has been solid, consistent with industrial production and other key leading indicators. In quarter three, we delivered good growth in bookings and revenues in both aftermarket and equipment, with particular strength in China. We are seeing some signs of pause with our large Chinese exporter customers, as U.S.-China trade negotiations continue and China economic indicators weaken, but it's too early to call what impact this will ultimately have, but we're continuing to monitor the situation carefully. Overall, we expect to see solid growth broadly across key products, services, and markets through the year end and into next year while maintaining optimism that the U.S.-China trade negotiations will come to a favorable resolution.

Small electric vehicle bookings and revenue growth were strong, driven largely by continued success of our consumer vehicle. We're also seeing strong growth across our high-margin Industrial Fluid Management, Tools, and Material Handling businesses.

Now I'd like to turn over to Sue to provide more details on the quarter. Sue?

Susan Carter

Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

Thank you, Mike.

Please go to slide number 8. As Mike highlighted, Q3 was another strong quarter for us, with continued robust bookings and revenue growth, improved leverage, solid margin expansion in both our business segments, and 22% year-over-year adjusted continuing earnings per share growth.

The third quarter was right in line with our expectations regarding how the second half would play out when we provided our updated guidance on our Q2 earnings call, which gives us confidence we'll continue to trend and achieve that guidance, with $0.05 to $0.10 of upside on the EPS line, or a revised adjusted earnings per share range of $5.55 to $5.60, up from approximately $5.50.

Looking at our third quarter results in more detail, bookings and revenue performance remained strong, with sustained growth in virtually every major product category and geography. Services was once again a standout with 11% growth, outpacing 9% equipment growth, as we continue to focus on our growing mix of stable, high-margin, recurring revenue streams. We continue to target free cash flow equal to 100% of adjusted net income for 2018.

Year to date, we've been able to sustain very high levels of revenue growth across the business at 9% organic for the enterprise. We've been able to maintain this growth in part because we've appropriately raised our inventory levels to keep up with the robust demand for our products and to meet the needs of our customers. As a result, we're sitting at a higher working capital level at just over 5% of revenue. This is consistent with 2017, and we expect this to improve as we return to a more natural 3% to 4% level for us in the fourth quarter.

We maintain our commitment to a dynamic and balanced capital allocation strategy and to returning 100% of excess cash to shareholders over time, whether it be through our strong and growing dividend or through share repurchases as we've consistently demonstrated over many years, or through value-accretive M&A.

Through September, we have returned over $850 million to our shareholders in the form of dividends and share repurchases. In October, our Board of Directors also authorized an additional $1.5 billion share repurchase program, bringing our total available share repurchase authorization to $1.9 billion, demonstrating our commitment to share repurchases as an important element of our capital deployment strategy and giving us good flexibility on how and when we execute the program.

We also continue to have a healthy and accretive acquisition pipeline that presents opportunities for value-accretive M&A. Our year-to-date spend is approximately $280 million. This spend is primarily related to the ICS Cool Energy acquisition and the Trane Mitsubishi JV. Both acquisitions are performing well and ahead of our initial value-creation models.

Please go to slide number 9. As we've discussed, Q3 was a strong financial quarter top to bottom. At the enterprise level, we delivered 10% organic revenue growth, 100 basis points of adjusted operating margin improvement, and adjusted continuing earnings per share growth of 22%.

Importantly, we also achieved operating leverage of approximately 25%, which is improvement versus our leverage of approximately 19% in the second quarter and consistent with our guidance for the second half of

2018, as we continue to manage through increasing inflation, new tariffs, and other inflation in areas such as freight and wages.

Please go to slide number 10. Focused execution of our strategy in operational excellence drove strong core business operating income contribution in both of our business segments, which combined for approximately $0.28, or virtually all the earnings per share growth in the quarter. The quality of earnings for Ingersoll Rand remains high in that we had a very clean quarter with strong results across the board.

Please go to slide number 11. Strong execution drove 100 basis points of adjusted operating margin improvement in the quarter. Price versus material inflation was positive by 10 basis points. Productivity versus other inflation was flat. We're effectively managing tariffs, material cost increases, and other inflationary impacts consistent with our guidance for the second half of 2018.

Please go to slide number 12. Our Climate segment delivered a very strong third quarter with 10% organic revenue growth and 50 basis points of adjusted operating margin improvement. Results were strong across the board, consistent with our expectations.

Please go to slide number 13. Our Industrial business also delivered very strong results with 9% organic revenue growth and 190 basis points of adjusted operating margin improvement. Similar to Climate, the strength in the business was broad-based, and it was a very clean quarter. We continued to see strong leverage in our Industrial segment, driven by commercial improvements, restructuring returns, and productivity improvements.

Please go to slide 14. We remain committed to a balanced capital allocation strategy that consistently deploys excess cash to the opportunities with the highest returns for shareholders. We maintain a healthy level of business investments and high ROI projects, which is helping to drive our strong growth in both our Climate and Industrial segments this year.

As we've discussed on prior calls, in 2018 we have also increased our capital expenditure investments, primarily related to a number of footprint optimization initiatives and new product development projects. These investments will help us make a more cost-efficient and resilient business. We maintain a strong balance sheet with significant optionality as our markets continue to evolve. We maintain our longstanding commitment to paying a strong and growing dividend at or above net income growth.

We continue to invest in share buybacks when the shares trade below our calculated intrinsic value. And as noted earlier, our Board of Directors approved a new share repurchase authorization of $1.5 billion in October to a total available authorization of approximately $1.9 billion. Year to date through Q3, we have returned over $850 million to shareholders in the form of dividends and share buybacks.

Please go to slide 16. One of the main topics of interest is how we are managing tariffs and inflation. We've discussed this topic a fair amount throughout our remarks, so I won't spend a lot of additional time on the topic here. This slide gives a good summary of how we are managing all of the associated cost risks, so we've included it in the presentation for your reference.

Please go to slide 17. A second topic of interest is our visibility into 2019. As Mike highlighted earlier in the presentation, as we move into the fourth quarter, our visibility into 2019 is improving. We expect to continue to have healthy end markets, and our business portfolio creates a platform for the company to consistently grow above average global economic conditions, aided by strong secular tailwinds. Strong bookings in 2018 should also set us up with solid backlog headed into 2019.

We're factoring in the expected impacts from inflation and tariffs into our planning process for 2019, and our objective is to effectively manage these impacts by managing the whole P&L to drive solid leverage, as we've done in 2018. We plan to provide full 2019 guidance when we hold our fourth quarter 2018 earnings call in late January.

The last topic is restructuring. We have updated our full-year 2018 guidance for restructuring cost to $0.28, up from $0.20, reflecting recently announced initiatives related to the company's ongoing footprint optimization, which drives operational efficiencies and reduces cost. Until these footprint optimization initiatives were announced, it would have been premature to include them in our estimates.

Now I would like to turn the call back to Mike for closing remarks. Mike?

Michael W. Lamach

Chairman & Chief Executive Officer, Ingersoll-Rand Plc

Thanks, Sue.

Please go to slide 18. We believe the company is extremely well-positioned to deliver strong shareholder returns over the next several years. Our strategy is firmly tied to attractive end markets that are healthy and growing profitably. Our products and services portfolio is at the nexus of global energy efficiency and sustainability megatrends, which provides a tailwind for growth above average economic conditions over the long term. Unless you believe the world is getting less populated, cooler, and less resource-constrained, these secular megatrends will continue to create growth opportunities for Ingersoll Rand.

We have an experienced management team and a high-performing team culture that incorporates operational excellence into everything we do. Our business operating system and our culture are a differentiated and sustainable competitive advantage.

And lastly, our business model generates powerful cash flow, and we are committed to dynamic and balanced deployment of capital. We have a strong track record of deploying excess cash to shareholders over the years.

And with that, Sue and I will be happy to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Jeffrey Sprague with Vertical Research. Your line is open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everyone.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Good morning, Jeff.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

A

Good morning.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

I was wondering if you would help us out a little bit more with tariffs. I understand that it's included in your guidance. But specifically thinking about this List 3 at 10%, can you give us some idea of what headwind you are overcoming there? And obviously, the follow-on thought, obviously, is then what we're going to think about what that means if we do go to this 25% and how you take actions against that.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Jeff, everything we know on Lists 1, 2, and 3 and Section 232 combined would have been a headwind for 2018 of around, say, $30 million, probably a little bit less than $30 million, but close to $30 million. And in 2019 it would be an incremental, say, $80 million. And our view toward that has always been we're going to cover material cost with price and we're going to cover productivity over other inflation.

So we did that in Q2. We did it in Q3. We think it's flat in Q4. Price is still building through the system, and you've seen that and will see it through any of the engineered systems that we produce in the company, whether it's HVAC or air compressors, into 2019. So I feel like we've got a handle on it, managing the impact of that, can handle that with the strategies that we've had historically in the company over the last few years.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great, thanks for that. And then separately, there's been a lot of talk about consolidation and the like in the industry. I just wondered if you could update us on your thoughts on what your priorities are, whether you think the market is right for such a move, and what exactly you'd be looking for.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Our views haven't changed over the last few years, which would be fundamentally at the heart of it. We're in great shape strategically. We don't need to do anything. So anything that we would do would need to be very compelling from a shareholder's point of view. Having said that, we've played all the game theory that's imaginable on us and clearly know what would make sense for us competitively and how we'd react to all of the above. So on that, there's really nothing more to add on that at this point in time.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

All right, thanks. Solid quarter, guys.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thanks, Jeff.

Operator: Your next question comes from Steve Tusa with JPMorgan. Steve, your line is open.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, guys. Good morning.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Good morning, Steve.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

A

Good morning.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

I just wanted to follow up on Jeff's question just so we level-set ourselves. I guess this year, when all is said and done, your price material inflation equation is, I guess, like modestly negative here for in total, negative 40 bps in the first quarter and then flattish for the rest of the year. Is that correct for the year?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Fundamentally, it was flat for the back half of the year, and that's where we think we're going to track is flat through the back half of the year.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

So I guess just thinking about that $30 million from tariffs alone, there was obviously some pretty substantial just base inflation that you guys are covering with what, like 1.5% of price this year, something like that?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Roughly.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yes, so we should think about that $80 million in the context of what was in total inflation obviously a much bigger number than the $30 million of just the tariff-related stuff in 2018. And arguably, maybe that stuff is not as severe on a year-over-year basis in 2019. Is that the correct way to look at it?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

It is, Steve. I think again, the pricing that we've put in is what contemplated all of this. If anything has changed, it's been a little bit more around some of the retaliatory approach that China has taken to some of the U.S. imports. I think we've got a strategy to deal with all of that within the planning process. If we had perfect information on input costs for 2019 or if costs didn't change from this point in time, we would target the same 20 – 30 basis points of margin expansion, price over material inflation, that we normally would put into effect in the planning process. I believe that that's where we'll land in 2019.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yes, including the $80 million, including the $80 million, correct, that you just talked about, what you know today?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Exactly.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Sorry. Go ahead, Sue.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

A

That's right. So I just wanted to point out that if you were looking at the total impact on Ingersoll Rand, the dollars that we're talking about would be just under $30 million and in the $80 million are from the Section 301. So there's also the Section 232 impact that we built in, in the July guidance, which was about $38 million in 2018, and it's roughly $20 million for 2019. So I don't want to lose track of the fact that we were also trying to overcome the Section 232 piece of that in our pricing and our other mitigating actions for the price material cost equation.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yes, I just wanted to make sure that everybody – the $80 million – anyway, I just wanted to make sure everybody understands what the all-in dynamics are because you've covered a lot more than that in 2018 successfully, and pricing obviously remains strong.

Just one other quick one, on the productivity and other inflation, you talked about it's been weak so far year to date, but you talked about a significant improvement in the fourth quarter. What is driving that significant improvement? Is that something that can carry through into 2019?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Yes, Steve, that's a good point. First of all, thanks for the clarification on the $80 million support. People know that we're covering that still expect to get 20 – 30 basis points net of Section 232, Section 301, and all of that.

As it relates to productivity, it's been the same discussion all year long, which is just the way that productivity projects will load into the year, there will be a substantial increase in the fourth quarter. Some of these were larger footprint moves or complexity reduction projects across the company that really bear fruit in the fourth quarter. So it is a step up in the fourth quarter. Those projects are underway. They're implemented. They're defined. It's a pipeline. So it's not that we're hoping that productivity comes into the fourth quarter. We've got the projects that support that estimate.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Can that carry into 2019?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

We haven't done 2019 yet. But the key with 2019, just like price material inflation, what we'll do from a pipeline perspective is look at productivity offsetting all other inflation. Anticipating wage inflation, anticipating logistics pressure, anticipating all the Section 232 stuff coming in still, we'll cover that through productivity. And if you go back again in the operating system of the company, the question we ask ourselves is do we have 125% of what we need to do in the pipeline primed and ready for 2019. And that will be the emphasis here as we exit the year is making sure the health of the pipeline is going to be the 125%, which historically is what we've done and what we think we can continue to do for some time into the future.

Charles Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

All right, great detail, guys. Good execution, thanks.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Thank you, Steve.

Operator: Your next question comes from Steven Winoker with UBS. Steven, your line is open.

Steven Winoker
Analyst, UBS Securities LLC
Q

Thanks, good morning. Nice to see the progress, everybody.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Thanks, Steve.

Steven Winoker
Analyst, UBS Securities LLC
Q

Maybe just going back, I want to just clarify. That 25% operating leverage that you're getting this year, that is inclusive of that flattish price material inflation in the second half, or not?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

It's all in, Steve. So we're saying that it's all in for the back half of the year. Q3, Q4. 25% is a good number, and that's mitigating anything coming in.

Steven Winoker
Analyst, UBS Securities LLC
Q

Okay, great. And maybe just on that $80 million that you just referenced and those headwinds, can you talk about the base that that's on? In other words, maybe just put that in context of the actual China import volume or dollar volume to the U.S.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Steve, probably not on this call we're going into that detail because we have to separate a lot of what is more opportunistic supplier pricing coming in from what's a direct tariff. It's a very difficult analysis to make. At the end of the day, the analysis of that isn't so important as to know what we think the right numbers should be and then how to offset that with productivity and price. So it would be difficult to pull out in the call and give you anything reasonable.

Steven Winoker
Analyst, UBS Securities LLC
Q

Okay, fine. And then on the resi growth side, are you seeing any direct benefit from other supplier challenges in supplying their channels? And is that a meaningful amount for you guys?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Yeah, we don't really – as you know, we don't talk about this relative to any other competitor. But it's clear and last quarter was no exception in that for the past four years there has been substantial share gain and margin expansion in the residential business, and that continued in the quarter.

Steven Winoker
Analyst, UBS Securities LLC
Q

Okay, all right. I will leave it there for later. Thanks.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Thanks, Steve.

Operator: Your next question comes from Julian Mitchell with Barclays. Julian, your line is open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good morning.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Good morning, Julian.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Good morning. I'm just trying to stick to two questions. The first question just on the incremental margin point, you have more productivity in Q4, but you're saying the incremental margins stay in the mid-20s, consistent with Q3, so just wondering what's moving there. And allied to that, are 25% incrementals the right level for the current macro environment as you look out with high tariffs, high cost inflation, high volume growth?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Let me do the second part first, and Sue might come back on the first part. But I think with the volatility of the environment we're in today, we've always said that we think that incremental margins should look like gross margins, but we always guided you all to think about that as 25%, allowing some room for breakage, allowing some room for investment in the business, and all the things that create a healthy business for the long run. And that's what we're saying here.

So I do think that leverage could go higher, particularly if we saw larger compressors coming back into 2019 as an example, continued mix toward services being higher than equipment. That's certainly supportive of higher leverage as well. But I think with the environment we're in, the volatility we're in, 25% incremental is pretty good performance. I think it's really good performance. And I think that that is something that we're committed to for the back of the year.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

A

And, Julian, on the other side of that with the first part of your question, it's interesting as we go through the fourth quarter and all of the pieces that you see. So our pricing was in effect as we went through the guidance in July. We are adding in the impact of the additional tariffs that we didn't know in July when we gave that guidance, so you have a little bit of impact there. You have some additional productivity.

But the other part when we think about the overall bridge and those overall incremental margins, we're also continuing to invest in the business. And when I look at fourth quarter spend, we're not trying to cut back any of those good investments in – whether it's in new products or whether it was in the footprint in the fourth quarter. And so we've got some good investment spend also in the fourth quarter. Again, it's not an outlier compared to other quarters in the year but it is slightly higher, and we are continuing to do that throughout the year.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thanks. And then my second question would just be around Industrial segment demand. There seem to be more question marks around the sustainability of the backdrop for it. It sounds like, though, the only weak spot you have seen is some of those Chinese exporters around large compressors. If you could, just confirm that's the case, or if there are any watch areas that you're focused on.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Julian, let me take your question and expand it to a broader commentary around China just to give a sense for what we think is going on. And of course, we're trying to triangulate this not only with our own customers but with other companies that have reported earnings as well. The Industrial business versus the HVAC business are really two totally different worlds right now.

Think about China's desire for clean air, clean water, and the fact that 15% to 25% of all greenhouse gas emissions happen with HVAC in buildings. Compound that with Transport refrigeration, where you've got a diesel engine powering a refrigeration cycle on a trailer or a truck. Compound that with process cooling and air compressors going into industrial factories. Now anything to do with the clean air, clean water, and retrofitting the economy, the built environment in China is going to be a good business and it might diverge a bit from the narrower industrial economy.

On the industrial economy, what we think we're seeing, and this is before bookings. This is the pipeline. This is customer communications and contact that we have. Chinese customers that would have had a bit of a U.S. export model are pausing to understand what the rules of the game are going to be and whether they're going to be in play for the long term. These customers, though, with that supply are going to point that supply somewhere else in the world eventually.

So midterm/long term, this excess capacity in China for exporters will find its way to other markets outside the U.S. Inevitably, that's going to happen. But there is a bit of a pause I think on that export model from China to the U.S. based with what's happening with the current negotiations around tariffs. And so we're just anticipating that that could impact in the short run some of that. But these are customers that make decisions very quickly when there is an opportunity, and so it's also something that could change very quickly for the positive.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great, thank you.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thank you.

Operator: Your next question comes from Gautam Khanna with Cowen & Company. Gautam, your line is open.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Thanks. Good morning guys.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Hey, Gautam.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc

A

Good morning.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Just to disaggregate the Climate bookings a little bit in Q3, first, do you still think that Q2 had a pull forward of about $80 million to $100 million? And how much did price contribute to the 10% bookings growth organically in the quarter?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Our pull-through estimate wouldn't have changed there. It was just really strong across-the-board bookings, and you really can't find a soft spot. The only one that showed up on the chart was a little red dash, which happened to be the Middle East off a really tough comp. But everything is extremely strong, whether it's Residential, Transport, Commercial across the world. If you pull apart Commercial and look at applied versus unitary versus services, everything strongly in the green there as well. So the color is good.

If you go around the world, you're seeing nice recovery in parts of Latin America for us. We're seeing of course outperformance in Asia-Pacific, particularly with what we're doing in China. So all those things are contributing to a strong growth rate, but it's across the board.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

Okay. And price on a net basis in that number, the 12%?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

So price remains strong in Climate across the board. Of course, the short-cycle inventory in residential or in light commercial, very quick there to have price effectivity. On the applied longer lead engineered systems, that's still building through the system. Of course, it's going to be shipping well through 2019.

At this point, we built considerable backlog there, as well as building considerable backlog in the trailer market in North America and in the auxiliary power unit market for North America. So I think when those products ultimately ship in 2019, you're going to see more price carry-forward there as well. But price effectivity in Climate is the strongest I've ever seen it.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

One follow-up on your comments on consolidation. Just I noticed you underlined balanced allocation of capital on slide 4. Mike, should we expect that large acquisitions aren't really part of the plan here? It's going to be more of what you've been doing, the tuck-ins, or do you see it, in any case, for something larger to actually unfold?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

I think maybe the bigger thing to talk about first is just making sure everyone knows that we're not changing the methodology and the discipline we've had around capital allocation for a long time now. Fundamentally, where we can invest organically in the business, we tend to see the highest ROICs and the quickest ROICs, and so that's evident with share and margin expansion that we've had over time.

We believe in the fact that the dividend should grow at or equal to net income over time. So we're continuing to make sure that investors are seeing that come through with announcements that we make on dividends. Dilution, we like to control that, so there's always going to be a little bit of buyback there to control dilution.

And then look, at the end of the day, it's looking at the available pipeline. And if we're seeing that we're able to generate return on invested capital in excess of our weighted average cost of capital, that we're building economic value for the company, we've been disciplined about that, we'll continue to do that. And clearly we've bought back shares. I want to say we bought back $6.5 billion or 150 million shares since 2011. So that's been a big part of the equation. So we're looking to create long-term economic value, however we do that, through that allocation of capital. We're going to continue to do it the same way we've been doing that.

Bolt-ons, certainly easy to do and less risk. And as I said to you, on the large strategic, more transformative things, we don't need to do anything. If it was incredibly compelling from an investor's point of view, we would look at that. I'm sure investors would want us to look at that and understand what our role in that could be. But at this point in time, it's all hypothetical, and it's not really worthwhile to discuss the details around those things for us.

Gautam Khanna
Analyst, Cowen & Co. LLC

Q

I appreciate it. Thank you.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thank you.

Operator: Your next question comes from Josh Pokrzywinski with Morgan Stanley. Josh, your line is open.

Breindy Goldring
Analyst, Morgan Stanley & Co. LLC

Q

Hi, this is Breindy on for Josh.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Hi, Breindy.

Breindy Goldring
Analyst, Morgan Stanley & Co. LLC

Q

Hi. You mentioned that you've been gaining some share in Residential. And we know that one of your competitors had a recent outage that would require some share shift in the industry. Is that part of where the share gain came from? And given that it should be a greater impact in 4Q, is that included in your current guidance, or could we see some upside on share gain there?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Breindy, we about five years ago, four or five years ago redid most of the product line in res. We entered the opening price point. We modified our channel structure to be able to make sure that we have a product for every home and a channel partner for every product, if you will. So all of that has led to a long-term share gain margin expansion story for the company. And then we just don't talk about the specifics of any given competitor and share shifts between competitors. We just think it's best for our shareholders that we keep that close to our vest.

Breindy Goldring
Analyst, Morgan Stanley & Co. LLC

Q

Okay, that's fair. Thank you.

Operator: Your next question comes from Nigel Coe with Wolfe Research. Nigel, your line is open.

Bhupender Bohra
Analyst, Wolfe Research LLC

Q

Hey, good morning guys. This is Bhupender here filling in for Nigel.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Good morning.

Bhupender Bohra
Analyst, Wolfe Research LLC

Q

Hey, can you guys hear me?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Yeah, we do, go ahead.

Bhupender Bohra
Analyst, Wolfe Research LLC

Q

Okay, this is Bhupender here for Nigel. So I just wanted to focus on – I think Sue mentioned about the service strength here in the quarter of 11%. Could you give some color from what actually is driving that growth in services, especially the contribution from digital and some software initiatives that you have in place? Thanks.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Yes, it's a strategy. It's been a long-term strategy we've been executing for years to try to drive the mix of the company up in services. And if you go back historically, a decade ago that might have looked more like 30% for the company. And if you look at the service-related businesses, which would be HVAC, Commercial, and our Industrial air compressor business, it's much closer to 50% today, and for the company we're all into the 40s.

So I think that it's been a long-term strategy. It's not a single event. It's a system of things. So it's the channel, it's a direct footprint, it's investing in people and in systems and tools because people are hard to come by at this technical skill set. We've had to – and it's been a good investment around technology to help leverage the ability for our people to get out and see more customers or to handle things remotely. So a lot of the diagnostic work in the background where the connected buildings or connected equipment has been very helpful to us in that.

And then, of course, selling different value propositions, using the data and analytics out of systems to improve either building performance or industrial process has been well received. And one of the fastest-growing numbers that we have across the company is the number of connected buildings or connected assets today. It's a number that every time I report it it's up 500 or 1,000 buildings or customers the next time I report it. So that continues to be a really solid investment for us. We would say digital, but it's more than just digital. It's the whole connected experience.

Bhupender Bohra
Analyst, Wolfe Research LLC

Q

Okay, that's great commentary. I just wanted to follow up here on the – you guys have given some commentary on 2019 visibility here. When you look at the backlog, would you be able to comment on how Commercial HVAC backlog actually look by geographical regions, puts and takes basically going into...

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

It's record backlogs coming in. What you see here is institutional backlogs that are very strong that are continuing. We've talked in the past about large projects flowing through. It's interesting, the numbers that we've been reporting all year haven't actually included any what we would think to be large projects. These large projects are still out there. We still think they're in scope for even this year, let alone 2019. That starts to set up very long-term visibility into 2019 and potentially even to 2020 on some of these larger projects. So backlog there is great.

Thermo King, it's pretty clear that the industry is under-capacitized for trailers and for tractors. The demand is there. So as soon as a tractor needs an APU or a trailer needs a refrigerated unit, we're ready. We're able to meet that demand. So that's a definite backlog build going into 2019.

And then large compressors, we'll wait and see what happens here for the balance of the year. We're coming off a tough comp, quarter four of 2017, as it relates to large compressors, but we'll see how that plays out. But that gives us great visibility into 2019 as well, these large engineered compressors that we sell.

Bhupender Bohra
Analyst, Wolfe Research LLC

Q

Okay, just one more actually because you brought in the large compressor here. I just wanted to get a sense of China industrial compressor business, if you look at that. Do you think the margins would be comparable to the fleet average, or they would be like the segment average or below that? Just to get a sense of...

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

They're above. They're average to above. They're excellent. They're great. China is important for the compressor business for us, and China is important for compressors globally in the market. About half the world's air compressors are sold into China. So it's important to keep an eye on China.

And as I said to you, that capacity in China is going to go somewhere. Maybe it goes along one belt, one road, which you can think about that might be brilliantly timed in terms of where that capacity may end up. But these customers are aggressive. They'll make decisions quickly. That capacity will go somewhere. But in the short run, that's where I was cautioning that there could be a pause in some of that business.

Operator: Your next question comes from Scott Davis with Melius Research. Scott, your line is open.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Hi. Thank you for fitting me in, guys. Good morning.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Hi, Scott.

Scott Reed Davis
Analyst, Melius Research LLC

Q

I want to back up a little bit. Obviously, the market over the last month or so sees something – thinks it sees something daunting out there. And you guys have come up with a pretty darn good quarter, one of the best quarters I think I can remember. How do you reconcile really what – you've seen homebuilding stocks drop 50%. You've seen anything that touches even non-res construction get hit hard. How do you reconcile that fear that you see out there with the fact that what you see is still a fairly healthy environment?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

When you think about the markets we're serving, again, 15% to 25% of the world's greenhouse gas emissions are happening from HVAC systems in buildings. And if we've launched technology two years ago in the applied space that eliminates greenhouse gas emissions by 99.9%, that's going to be a great business. If you think about trailers, the refrigeration cycle running off a diesel engine that can be electrified using again a refrigeration cycle that eliminates 99.9% of those greenhouse gas emissions, and you walk in industrial plants, process cooling and air, we are center cut for a world looking at reducing greenhouse gas emissions.

And so I don't know that you can just lump us into an Industrial business selling machinery. I think you have to look at the businesses we're in. We happen to be in great businesses with technology that's differentiated and a channel that's differentiated, and a service model that's differentiated. I think this is a long-term great story. So when you see these disconnects in the market, we hope there are investors out there saying this is a great entry point in a company like ours that's got great businesses and a track record of executing very well, with smart capital allocation supporting all that.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Got you, it's a fair point. And again, just to back up a little bit, do you guys get a sense, Mike and Sue, that it's easier to get price out there now than it has been in the past, partially just because of the front page news that tariffs have been and maybe partially just because of the answer you just gave, just some differentiated technology? Does it feel easier to you guys at least or seem easier because you seem to catch up to the price/cost curve pretty quickly?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

If you think about the engineered systems, it could be large applied systems, large air compressor systems. That's where 10% of the cost of the total lifecycle is the actual purchase price. 90% is the energy, the maintenance, the refrigerants, et cetera, used. It's easier if you've got a value proposition that allows customers to see the efficiency advantages, the refrigerant advantages and so on, and so forth to get price. So certainly that helps.

But as you get sliding into the more of the commodity products, you get into residential HVAC with standard SEER levels, this is where operational excellence matters and where the dealer and distributor matter and why it's so important for us to have the best dealers and the best technology and most cost-efficient operating footprint that we can to be able to really survive in that model. So there are mixed models around price, but clearly, where you're able to differentiate on technology is an advantage.

Scott Reed Davis
Analyst, Melius Research LLC

Q

Sounds good. Okay, I'll pass it on. Thank you, guys, good luck.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thank you.

Operator: Your next question comes from Andrew Kaplowitz with Citi. Andrew, your line is open.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Hey, good morning guys.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Good morning, Andy.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc.

Q

Mike, so I think you mentioned last quarter that the Chinese HVAC market you sell is growing in about 5% range or so, and that Ingersoll is growing in multiples of that. From what you could you tell, is the market still growing at close to that rate? And have you been able to actually accelerate your outperformance in that market given you now have obviously the direct service model in place for a while, but you also talked about that service pull-through beginning to kick in?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Yes, I think you're going to find over time that HVAC in China and the built environment in China might differentiate from the industrial economy in China as it relates to the tariffs discussion. The built environment in China is 10 times larger than the built environment in the U.S. A lot of that environment was built not at the highest level of code, standards, or efficiency levels, and so enormous retrofit opportunities to go in, make them more efficient, and clean the air in doing this. So I think that that is going to potentially be a good market for a long time independent of what's happening in the narrower industrial economy.

This is why we put the strategy in place to do what we did last year and made the investments that we made. And we're really pleased with what's happening not only with the penetration into the equipment side of that, but the linkage rates that are happening with services are very high, and it's given us a lot of confidence that's not only was it the right strategy, but the pace at which it's working is faster than what we would have thought. So I feel good about what's happening there, and I think we'll continue to outperform in China specifically.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc. Q

Maybe a similar question on North America institutional HVAC. So when you look at that strength, obviously, some of the strength is just the market itself. But could you give us a little more color on your performance over the markets in the sense that – I know you do performance-based contracting. Your digital-capability on these bigger projects has improved. So has penetration there actually accelerated versus the market? And so as you look into 2019 and 2020, that's what results in this good visibility because you're really going to outperform the market based on what you see?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc A

If you take the $4.5 billion to $5 billion Commercial North American HVAC business and you just split it and say half of it is service and half of it is equipment, and of the equipment, 85% of that is going to be replacement, it's a real opportunity to go create demand around the installed base and go create demand around energy efficiency.

What you're finding now in addition to that is the institutional cycle started last year probably in earnest, still I think relatively early to mid-cycle in that. And then some of the larger projects tend to happen later in the cycle as it relates to larger campus environments, larger customers that have got more complex solutions to put in place, take more time to get that designed, engineered, and implemented. And so I think we enter that phase here in the next year or two.

Andrew Kaplowitz
Analyst, Citigroup Global Markets, Inc. Q

Thanks, Mike. I appreciate it.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc A

Thanks, Andy.

Operator: Your next question comes from Joe Ritchie with Goldman Sachs. Joe, your line is open.

Evelyn Chow
Analyst, Goldman Sachs & Co. LLC Q

Good morning, this is Evelyn Chow on for Joe.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Hi, Evelyn.

Evelyn Chow
Analyst, Goldman Sachs & Co. LLC

Q

Maybe we'll just start on the Industrial incrementals. You have seen really nice progress on those incrementals throughout the year. If I think about it, it sounds like the mix of bookings of large compressors and service all seeming to grow. It seems like you're getting price. What then are the offsets to get us from the mid to high 30% type incremental range we're seeing in 3Q down to that 25% number we've talked about for the enterprise?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Industrial leverage is higher than that. It's running in the high 30s, and it will continue to leverage into the 30s throughout the fourth quarter. They're doing it across the board though. They're executing well at the plant and operational level. They're executing well at the service level as well, so in the field, and are investing in the business.

And so the investments really have been relatively substantial, in fact, as you think about what they've been trying to do to upgrade some of the product portfolio over the last year with that kind of leverage in place. So they're building it for the long run, and I think that this continues to get leverage well north of 30%, and we'd expect it to lever north of 30% in 2019. And we've always said, as these larger compressors, if they do come back in at some point in time, we tend to get very high leverage off those, so larger fixed costs that we have in place.

Evelyn Chow
Analyst, Goldman Sachs & Co. LLC

Q

That's great, Mike. And then maybe just turning to the $80 million of tariff-related inflation and ways that you might mitigate, is there any thought on potentially pre-buying some of your inventory instead of letting working capital normalize into 4Q? And then maybe as an addition to that, Sue, if you could provide us any color on how much metal spend you either bought or hedged into 4Q and 2019, that would be great.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

I think every time we look at fundamentals of lean versus pre-buying lots of inventory, it comes down to you want to really run the business as lean as possible and you want to make sure the supply chain is as short as possible. It tends to favor suppliers that are more localized than long-distance suppliers. And so I think we continue on the journey that we've been on around lean throughout the company and look at that, the supply base or the extension of our lean efforts there.

So I won't on that front – I don't see us doing any pre-buys other than where there are constraints in the industry. So if there's a constraint around semiconductor boards or circuitry or a constraint around diesel engines, those are places that we buy ahead or make larger commitments. But for the run-of-the-mill stuff we buy and the bill of materials, we would continue to run that in the leanest way possible.

Susan Carter
Chief Financial Officer & Senior Vice President, Ingersoll-Rand Plc
A

And, Evelyn, I think when you think about our strategy around purchasing materials and all that and the impact on 2018 and 2019, we're obviously doing buys each and every quarter for not only the commodities, but some of the Tier 2 components. So if you think about 2019, I would say that you might be 50% – 60% bought or committed for the first half of the year and then less so in the second half of 2019.

But I think the more important piece of how we buy, whether it's the commodities or some of our other materials, is I don't think you'd want to assume that because of where things are today that you would go and buy that, even if it meant that you were a slightly higher percentage of revenue.

And why I say that is the tariffs and the whole discussion around inflation is a really volatile equation, and you can find yourself buying because you think it's a great idea, and then all of a sudden maybe something goes away or speculation comes out of a commodity, say copper, and you have a lower price. I think you're better off following a routine, following a process, and layering in your materials as you go throughout the year and making sure that you have the right blended rate for the materials that you're buying in, and that's exactly what we do as we think about that.

And my comments around working capital and where it goes, the 3.5% to 4% is a really natural level for us to really be able to support on-time deliveries and to support our customers. So while it comes down from Q3 to Q4, it isn't because we're unnaturally forcing it down. That's really just the normal cycle of inventory for us. So if there is an opportunity to have something that would be different, we'd certainly look at that. But I really think that ratably buying and following our natural processes is the right way to go.

Operator: Your next question comes from John Walsh with Credit Suisse. John, your line is open.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

Hi, good morning.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

Hi, John.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

So definitely a lot of ground covered. And I just want to make sure I understand or maybe put a finer point around the visibility into 2019. But we have talked about applied backlog being stronger, service growth, what's going on in Industrial around compression. Is there a way to quantify the better visibility you see into 2019 as of today versus maybe historically or even last year? It would feel like you would have more visibility just given the way the dynamics are playing out than you've historically had into 2019.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc
A

The merchant services business being what it is, you get more visibility because you have to believe service is going to continue. And in fact, if there's a downturn, you're going to see service go up as people extend the asset life. So I would think that service growth as it relates to visibility is a better way of thinking about the mix over the long run. That helps.

And then if you take the equipment and systems businesses, nothing has really changed there other than the fact that you can see the backlogs building. And you can understand from a correlation of the metrics that we use to establish a demand forecast that they still tend to be favorable. So between what's in the backlog, what's in the pipeline, and the metrics that are before the pipeline that would be the leading indicators that we use, and there are different indicators for different businesses and different segments of the business and products even if the business, we're able to feel good about 2019 at this point shaping up. Unless there's a dramatic geopolitical event, a dramatic event that's not seen today, we feel like 2019 is shaping up to be a good year.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you. And then as we think about the energy retrofit business in the U.S., obviously that's driven by replacement, the age of the assets if it breaks, energy code or new regulations. But are you seeing any changes around customer demand due to new financing mechanisms as new money enters that market to fund some of these upgrades? Is that helping drive some of this growth, or is that not something you're seeing at all yet in the market?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

No, the vast majority is going to come through traditional customer financing, their own deals. Then there's performance contracting, which lends itself toward institutions that may not have the capacity at all times, plus this is an asset that they can – it's one of the few assets that an institution has that can have a return. If you think about the assets an institution will generally hold, buildings being one of them, it's fortunate that the largest driver of their operating budgets often is going to be utilities and some of the maintenance facilities. So that's always a great place that they would use financing in other areas and then use performance contracting as the way of getting at facility upgrades and improvements at their facilities. So no real changes though in how customers think about that today.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay, thank you.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thank you.

Operator: Your next question comes from Rich Kwas with Wells Fargo. Rich, your line is open.

Richard M. Kwas
Analyst, Wells Fargo Securities LLC

Q

Hi, good morning, everyone, just a couple for me, Mike. Mike, on the mix for 2019, knowing what you know now with your backlog and understanding there's still short cycle stuff in the business you can't necessarily predict, would you say the mix is neutral, better, or worse than what you've seen in 2018 mix of sales?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

We're pulling AOPs together now. We haven't taken a look at mix yet. But what I'd say is it comes back to running the whole P&L, understanding that we want to get leverage, EPS growth in the business, cash flow ROIC to be where it's been historically, and we'll work with each of our business to figure out what that's looks like. But we don't have an early read on mix. At this point, if you're modeling anything, I'd model neutral mix. We wouldn't have any better advice for you at this point.

Richard M. Kwas
Analyst, Wells Fargo Securities LLC

Q

Okay. And then institutional, I think you're thinking it will be probably be a better year 2019 than 2018, right? So does that end up having been a positive to mix with service or neutral?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Long run it's a positive because it's where the service business gets built is on the engineered systems. And then in the short run, you get a little bit of a gross margin hit, but overcome eight-fold over the long run with the service business that tails on top of that. So as you're modeling 2019, it's negligible, but it would lean toward a little bit more compressed margin. But as you lean toward the out years, the service starts, even in the warranty period, it tends to be a very good story.

Richard M. Kwas
Analyst, Wells Fargo Securities LLC

Q

Okay. And then last one on Industrial, on compressors, can you level-set us on service? You noted that is growing, outpacing equipment this quarter on orders. Where are you in terms of percentage of revenues on compressor service?

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

About 50%, it's about half the business.

Richard M. Kwas
Analyst, Wells Fargo Securities LLC

Q

Half the business. Okay.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Yeah.

Richard M. Kwas
Analyst, Wells Fargo Securities LLC

Q

Great. All right, thank you.

Michael W. Lamach
Chairman & Chief Executive Officer, Ingersoll-Rand Plc

A

Thank you.

Operator: We have reached the end of our question-and-answer session. I will now turn the call back over to Zac for closing remarks.

Zachary A. Nagle

Vice President, Investor Relations, Ingersoll-Rand Plc

I'd like to thank everyone for joining us on today's call. As always, Shane [Lawrence] and I will be available to take calls and questions today and certainly over the next several days and the coming weeks. We'll be on the road in New York and in the mid-Atlantic, so we hope to see some of you very soon. Thanks.

Operator: This concludes today's teleconference conference call. Thank you for your participation and you may now disconnect.