IngersollRand

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Julian Mitchell: Okay, so I think we're due to start. Ingersoll Rand, it's great to have here Mike Lamach, CEO; and Sue Carter, CFO. Mike will give a couple of introductory comments, and then we'll move on to questions.

Mike Lamach: Great. Thanks, Joe, and Sue and I are delighted to be here. Thanks for making time for us.

So, starting my ninth year, and sometimes you don't hear a CEO say, well, they're more excited about the future than they were when I started in the role, but I think I am for a number of reasons. One, all the work we've done over the past years around the operating system of the Company, things are clicking. Second, very stable, very strong management team, great bench strength. And third, it's the first time probably that I can remember we've got both the climate (ph) segment and the industrial segment growing at single digits in '18. So, that's a strong backdrop for us.

I always talked about the strategic objective of the Company, quite simple. It's about a leadership position in durable markets. The durability part of the market for us means that it's always grounded in a strong macro. And for us, that macro is sustainability. And sustainability to reduce energy demand in homes and buildings and industrial processes is a driver that really connects most of our businesses. And that tailwind is getting stronger, not weaker.

Because of that, there's a very strong focus on investment and innovation throughout the Company. And we're very passionate about always delivering the most energy efficient, environmentally friendly products that are out there in the marketplace, and we excel at that. We excel at energy efficiency, reducing greenhouse gas emissions, reducing food waste, natural resource preservation, and generating the customer productivity. So, this healthy level of investment is all to sustain leading franchise brands. People would know us because Trane, Thermo King, Ingersoll Rand Club Cars as an example.

The business operating system that we've had in place now for eight years is designed around Lean, and it's all about delivering strong top-line incremental margins and free cash flow. That was the case again in 2017. We deployed $1.9 billion between dividend, share buybacks, and acquisitions. And so, I think it's about $8 billion we've given back to shareholders over the last five or six years.

So, I know that the audience will have a bunch of specific question, or I know at least you will, Julian, have a lot of specific questions for us, but I'm going to outline a few things that we said when we gave guidance. Namely on the Q4 earnings call, we talked about 2018, seeing mid-single digit top line growth. We'll see operating margin improvement through the whole P&L. We expect to be able to strong -- see strong pricing against a backdrop of rising material inflation again next year. And we'll expect to convert cash at least 100% of net income again next year.

We're going to continue to invest in strong ROI projects across the Company. We'll pay a strong and growing dividend at least equal to the rate of EPS growth across the Company for us. We will repurchase shares where the intrinsic value is below the value in the marketplace, and so, clearly, last year about two-thirds of our free cash flow went to buying shares back, and about a third of that went toward M&A. And we'll make sure that those acquisitions are in that strategic fit that we talked about in the core of the Company.

So, with that, let me turn it over and see if there are any questions.

Julian Mitchell: Great. So, one aspect, Mike, would be around -- as you said, it's been nine years. Maybe talk a little bit about how you've evolved in terms of the restructuring and the productivity efforts at the Company. At the beginning, there was sort of plant consolidation perhaps, then more recently some sense maybe that SG&A is coming under the microscope a bit more on productivity focus. So, maybe an update on those.

Mike Lamach: Yes. I look at it just a little bit differently, I would say more systematic approach than what we've taken in the first few years was really around the operational improvements around the Company, building operating system and transforming the Company into a more integrated model, and through that first three years really implementing the basics of Lean throughout the Company. We've continued to develop that.

Clearly in the early years, there was a lot of over-capacity, a lot of under-utilization of plants and footprint, so that was sort of in the early days. But, we were working on all the elements at that point in time. Around 2012 or '13, the emphasis around taking the operating system into the areas of growth and innovation and product development, product management, implementing the same sorts of operational rigor in that area of the business, and that's yielded great results around strong growth in the Company. In fact, the growth that we've had has been top quartile growth I think for the last eight or nine years. The incremental margins have been top quartile for the last eight or nine years across the peer group. And of course, the EPS growth and cash flow have been top quartile over those eight or nine years, as well.

So, as we've evolved through the operational basics through the investments around growth and innovation, continuing that progress, but moving now toward other elements in the business. As an example, there's an emphasis over the next couple of years around G&A, as well as some of the logistics and some of the warehousing footprint across the Company. And here, just a quick example, we've made such progress around working capital and around supply chains that we want to make sure that we kept the warehousing logistics footprint up to date, as well. And so, we think that between now and the end of 2019, there's $100 million to $175 million of run rate improvement there from a productivity perspective on the G&A, plus a little bit of the COGS portion of the portfolio.

Now, we're going to still drive material productivity and labor productivity and indirect productivity in other areas, as well, and this is a bit of an incremental effort we're taking at this point in time. And it really spans across all the functional areas, so IT, finance, legal, engineering, procurement would all be affected by that.

Julian Mitchell: Understood. And if you think about that inflation or cost aspect, that's made some people sort of nervous about the incremental margins this year. Ingersoll Rand may be a little bit different to some of the other HVAC and refrigeration companies because of the China element within some of that margin pressure last year, so maybe talk a little bit about how your China position is changing, what the success of that market (inaudible).

Mike Lamach: Sure. Let me start with the first part of where I thought you were going, which is, of the last nine years, eight of the last nine years we were able to see pricing and see material inflation exception being in '17. Part of that was just what happened with steel, but also strategy we had in China. So, two -- all of our businesses had price exceeding material inflation, with the exception of commercial HVAC, and two-thirds of that issue was associated with the Middle East, for obvious reasons; and China, which aren't as obvious.

But, in China, we've made an effort over the past 18 months to put 350 commercial people into the front end of the business, direct sales and commercial people in the front end of the business, essentially displacing our distribution model that we had there. And if you think about any time where you've seen a company moved into a direct selling model while terminating a lot of its distribution, you actually expect a bit of a dip or a decline. And we saw almost an immediate 20% (inaudible) over the past year in our business there. So, clearly we're onto the right strategy.

It's put pressure on selling more equipment ahead of services. I mean, if you think about what we do, is we sell equipment, and we follow that up with services over (ph) time. So, for pushing equipment up 20%, it takes six to 18 months to see a service tail begin to follow on the commercial space. So, we think in '18, it's fairly neutral. In '19 and '20, we think it's a significant tailwind. China and Western Europe are places we think we could double our business with very little infrastructure investment beyond what we've already done, and the margins are great.

Julian Mitchell: And that's -- yes, you just touched on the -- sort of the competitive environment perhaps in China. How do you characterize that today?

Mike Lamach: The Middle East is probably the most competitive environment we see. China would follow. It depends on sort of what you're doing. So, in a situation where we're selling large systems into big infrastructure projects, about 10% of the total lifecycle cost of that system is in the initial price paid for the product. The balance of that is in the energy efficiency differential. It's in (ph) the maintenance and some of the maintenance intervals. It's in things like the refrigerant and the cost of those sorts of things.

So, what we're finding in China specifically is that you're seeing the government take a very active stance around environmental protection, around taking up standards, around committing to the environment and around greenhouse gas emission reduction. Five years ago, it would have been different. This year, I put China probably second to Western Europe in terms of its environment stewardship. And so, we're now having conversations with customers that are more holistic around the value. And where we are the first in the market around launching the next-generation refrigerants into our large HVAC systems, having a conversation around the fact that we're reducing greenhouse gas emissions by 90%, 95%, 99% through the use of the new refrigerants in our systems is resonating in the form of market share and growth in China.

Julian Mitchell: I see. So, the point is that, in China, you're winning a lot of share through the new product introductions. It's not really a price fight. It's just a mix issue around OE, and that naturally carries some larger mix (ph) in package.

Mike Lamach: The other thing you often see with distribution is distribution is looking for sort of quick book-and-turn projects, but a lot of what we want to do in these major markets is around bigger infrastructure activity, where the sales cycles could be 18 months. So, the only way to do that is through a direct sales channel that will build and develop those relationships and those specifications over time. And so, that's important to us.

The other thing is is moving into tier three/tier four cities, which of course as you move in, you're moving in with an equipment base and not a service base, and the service base follows. It's put pressure on margins in China. When I say "put pressure," though, the margins in China are still higher than the average across the HVAC segment. And on an absolute basis, they were accretive to EPS even in 2017. In 2018, it's fairly neutral to margin, and it's absolutely accretive to EPS. And again, in '19 and '20, we think it really supports the 2020 goals we've laid out at the May '17 Investor Day meeting that we had.

Julian Mitchell: And in the U.S., some of the companies here I guess have talked about new product introductions, someone earlier talking about a new large chiller. Are you seeing any sign of an improved or an enhanced competitive landscape in terms of those rivals having a product refresh for the first time in a long time, or you think it is part of standard business in the industry?

Mike Lamach: Yes, and you would know this, because we have been investing heavily for seven or eight years. And for the first three or four years, it was a bit of a science project, how do you get next-generation refrigerants, which are inherently less energy-efficient, to be more energy efficient in the system? And we were able to do that. So, we were able to do that. We've been able to get in the marketplace. We've been able to put a significant amount of IP around some of that, because that is a very difficult science project, to have the next-generation refrigerants be more energy efficient in the systems that they're utilized for.

So, yes, over time, competition needs to move to that, but we consistently are spending 50 basis points a year into investments back into the business around the next generation, and the next generation beyond that of development. So, we've got -- if we stopped today, there's a point and time where competition would catch up, but there's no intention to stop, and there's no shortage of ideas to stop.

Julian Mitchell: On the one aspect of HVAC technology, VRF announced a partnership recently. Maybe give a bit more background on that, and maybe how does it affect your pre-existing relationships in that technology?

Mike Lamach: You're talking about North America for the most part, and markets there for ductless have been growing about 15% over the last few years. We've been compounding it 40% to 50% over the last few years, so we've built a pretty significant market share in ductless. It really tells you the power of the channel in being able to use at that time sourced product with the channel developing products -- projects to implement ductless.

I think ductless over the next, say, five years begins to level out and look more like unitarian in general. And it'll be applied just like you would apply any type of product to the right -- the right system to the right application, the right type of building use. So, for us in the joint venture with Mitsubishi, it was taking what we knew to be best-in-class technical product -- we had tested about a dozen OEMs over a multi-year period around the quality and the efficiency of the product. Mitsubishi always came out on top of that.

And really, I think that when you saw the power of the channel over the last few years of really turning our own organization onto the VRF and the fact that we can grow it at 40% and 50% per year shows that the channel is really going win in that equation. And so, the opportunity then to sit with Mitsubishi and say, look, let's put best technology with best channel. Let's put that together in a branded environment where we can service and support that should be a home run.

Julian Mitchell: On the energy efficiency, I think you surprised people. One of the biggest surprises from that Investor Day last year was about the energy controls business, how large that is, how quickly it's grown. So, maybe give some color as to the size of it today, the profitability, and what kind of growth you're seeing there, and why do you think you've been able to take so much share quite quickly.

Mike Lamach: It's probably because, when we think about controls and the digital overlay that we put across buildings and systems, we think about it as being ubiquitous, right? We don't even distinguish anymore. Everything that leaves the factories is going to be instrumented and ready to communicate and talk to our systems and other systems that are out there. 10 years ago, there might have been 20% attachment of controls to equipment. Today it's 100% when you think about that in the commercial setting. So, we don't distinguish between the two. It all comes together.

When we were able to launch several years ago a wireless cloud-based solution using open systems to be able to connect to other systems for customers that wanted that integration across the top of their facilities, we were able to grow our controls business at double-digit rates now for the past few years. And the combination of sending more sophisticated equipment with more instrumentation from the factories into the field, and then simply in a wireless format, being able to connect these together with other building systems, has changed the whole installation game. You're not needing electricians and running conduit and wire and sort of getting involved in the construction process. You're coming in at the end of the process, and you're able to use our own technicians to put in these systems.

Which actually takes the pressure off a lot of the building trades right now, because it is hard to find electricians and plumbers and welders and carpenters out there to build buildings. So, it's a home run when you think about solving a problem with skilled trades available.

Julian Mitchell: And I think you'd sized it at about $1 billion or so.

Mike Lamach: Again, it's pretty ubiquitous. I would tell you that, if we're selling equipment, the controls are on it, yes. So, how much of that is controls and how much of that is equipment, it's harder and harder to tell. And then, put telematics across the top of the mobile assets, or the rental assets, so we're doing a lot of telematics to be able to track and provide information to customers around mobile applications.

Julian Mitchell: If we take a step back and look at the cycle in HVAC in the U.S. in particular, people have been nervous for about four years that commercial construction or non-res in aggregate may be close to a peak. Any kind of perspectives you'd like to share on that?

Mike Lamach: Well, first of all, for our company, you have to realize that different parts of the world are growing at different rates, and we're all over the world with a full suite of products and services across the world. You also have to realize that, in the HVAC business, we're getting very close to a 50/50 mix between product and services. So now, when you start talking about North America and equipment only, you've really (ph) got to bifurcate again and say how much of that is commercial, how much of that is industrial, and how much of that is really institutional.

Commercial, which is about half of the equipment in North America, is probably very peakish, and we expect that to grow at a slower rate. Institutional is just really starting to ramp this year, and we'll see that for the next couple of years. The building stock in North America has been pretty evenly split 50/50 between institutional, and then the combination of commercial and industrial. And what's happened over the last four or five years is the commercial/industrial has grown now, with a mix of, say, 60% in favor of it versus 40% institutional. Institutional is still 25% below its peak, with a lot of necessary infrastructure work that has to happen in schools, cities, hospitals, right, higher education facilities.

And that work is what we're seeing book now, and that'll continue at least through 2019 and early 2020 just basis (ph) the bookings that we're seeing today and the activity out in the marketplace. And even something as simple as ABI, Architectural Building Index, would support that this is sort of the early inquiry, the early activity going on for institutional. So, we're really seeing an institutional market take off.

Now, I contend it's going to be a longer institutional cycle, too, and one of the reasons it's going to be a longer cycle is there's just not enough skilled trades out there to build buildings. They're taking longer to build buildings, frankly.

Julian Mitchell: Makes sense. On industrial, you have a nice spike finally in some of the large compression bookings that have been under pressure for maybe three or four years. Do you think that strength can sustain itself, or do you think it's more of a quick catch-up, and then it plateaus or calms down again?

Mike Lamach: Yes. Look, I wish I knew the answer to that. I can tell you that the activity is high in terms of quotes and what we're looking at. I think some of the tax reform certainly will help in terms of larger activity. We're seeing great leverage on the big compressors, so for us, that's a very, very important part of the story of margin improvement in industrial. We're still about $300 million below the 2014 peak where we were in the compressor business, split evenly between sort of legacy Cameron and legacy Ingersoll Rand compressors.

So, we feel fairly good about that $300 million gap being filled over the next couple of years, and we generally would look for leverage in the 50% range on that bigger equipment basis, with fixed cost reductions we've taken and the integration work we've taken around the product portfolio between Cameron and Ingersoll Rand large compressors coming together, the best of both platforms coming together.

And we've also found that, like we thought when we did the acquisition, we can grow significantly the service component of the Cameron portfolio. That's happening, as well.

So, all in, it feels like we're at or ahead of schedule in terms of industrial for 2020 with our targets.

Julian Mitchell: Yes. Perfect. Maybe we'll pause for audience response, please. Number two, please.

Mike Lamach: Well, you've got to ask me some more questions, and I can get this neutral to change, right?

Julian Mitchell: Next, please. Number four, please. Okay, so (inaudible) about buybacks. Number five. And the last one? So, maybe one facet that comes up as a concern, you see it a little bit on the margin performance there, is we already discussed it, but it seems it can never be discussed enough, is around cost pressure and the management of that. You said the material cost side, it sounds like you have that in fairly good hand in terms of the price increases and the competitive discipline in the industry. Just confirm if you think that's right, but also just you have this -- the other inflation category beyond raw materials. How manageable do you think that is when you look at your productivity measures this year?

Mike Lamach: Well, look at '18, and you think about 50 basis points of margin expansion at the midpoint of what we've guided. But, 30 bps of that comes from the volume mix equation, because we think we're in a pretty good environment there. We're actually relatively conservative right now on what we think about price material inflation. We've said neutral, but if we're plus-30/minus-30, we think we can manage that.

We see an opportunity for other productivity over other inflation of about 70 basis points, and then we'll invest about 50 basis points back into the business, netting back out to 50 basis points of growth. So, I think we've got '18 well understood. I think about what we need to do, and I think, again, we're on track for the 2020 targets that we've laid out.

Do want to point out, too, I mean, the quality of earnings, the cash flow here has been great for a long time. We've been more than 100% of that income. We've had cash flow ROIC for the past five years. That's been right around 20%, just maybe a tad under, right? So, we are generating a lot of cash. We have a lot of optionality around that cash. And I think that for us, it's been clearly a focus on investing back into the business first, about making sure that we're paying a good and growing dividend. This whole share buyback/M&A equation, we've been pragmatic about it. The shares are trading at less than what the intrinsic value of the stock actually is, and it does make the M&A equation a bit more difficult. That favors share buyback.

And the M&A that we've done, it's been smaller bolt-on technology in distribution. And clearly, those have been really additive for us. It's an example of what the roughly $450 million or so that we spent in '17, we add about $0.15 of EPS to that. We wouldn't have got that through share buyback. But, this tells you the hurdle rates were (ph) higher for us around M&A than for some others.

Julian Mitchell: Does that mean, I guess, the acquisitions probably stay in that smaller range, and whether you see any difference in appeal in terms of general M&A multiples on the climate side versus industrial?

Mike Lamach: If the criteria doesn't change, it's doubtful that you're going to have much of a change in the outcome. And we're not really relaxing the criteria. I mean, the only criteria -- for example, if we've got ROIC above WAC (ph), if we're EPS and ROIC accretive in three years or less, the cash payback might be something that we de-emphasize a little bit, less than five years. We might go longer than that, as an example. But, those are great investments for us, and that's been kind of what we've been doing. We actually did 17 acquisitions in 2017. They were just bolt-ons. They were distribution. They were technologies. So, it's active, but it's been more difficult to get larger, affordable, actionable stuff that fits the strategy.

Julian Mitchell: Right. It sounds as if you may -- yes, there may start to be assets coming freer in the buildings environment. Honeywell have talked about a spin-off. Johnson Controls today were talking about up to 10% of their buildings division being divested. UTX last night implied they may do -- or yesterday would do a full separation of their CCNS division. Are there assets within some of those larger conglomerates, if they break free, that would be of interest, or you'd prefer, again, sort of smaller, more focused entities?

Mike Lamach: We would look at all that. We would want to be part of that discussion for all that. But clearly, I think there's a lot of opportunity for consolidation in the HVAC world globally, so about 15 global players. There probably ought to be three to five significant players at the end of the day. Industrial air compressors, there's 15 or so names that we watch. After you get past the first three, most people in the room probably wouldn't know four through 15. It's harder for them, over the long run, to compete. That'll be a consolidating world, as well. So, I think that it lends itself to some of the scale, and we've certainly seen that with the Cameron acquisition, that the synergies were significant in that.

Julian Mitchell: Yes, understood. Any questions from the audience? One over here, please.

Unidentified Participant: Just a question on the HVAC side. With the push from HFCs to HFO as far as the refrigerant goes, I think there's only two guys that kind of do that. What does that do to your cost structure? How quickly do you think that will come? And do you have to kind of re-engineer the HVAC equipment to handle an HFO? So, just kind of the trend for the next three to five years on that.

Mike Lamach: Joe, little bit of an echo for me up here. Can you repeat that?

Julian Mitchell: The HFC/HFO transition, what that means for your cost structure.

Unidentified Participant: Cost structure in just the trend, and do you get a price up on an HFO piece of equipment and make more money on that?

Mike Lamach: Well, when you think about 40% of greenhouse gas emissions coming out of buildings in mature economies, and 40% of building emissions coming out of HVAC, it's a major topic of discussion around reducing greenhouse gas emissions. So, moving from HFCs and HCFCs to HFOs is absolutely going to happen, and we were the first to it. And then, the ability to protect customers' investments as regulations change over time, and there's more of a drive toward even more environmentally-friendly, safer refrigerants, that will be a big barrier for entry. It'll be a big opportunity for the industry, as well, to be able to both price, but also have a technology advantage over that, because they're relatively difficult science problems to handle.

When we started on the HFOs, we started eight years ago on a piece of paper two-dimensional molecules, working on with eventually test tubes, working then to 40-gallon drums, which were in light supply, to now where you're seeing HFOs into the marketplace. Clearly, we've been working beyond that to make sure that we're looking at next-generation beyond the current HFOs about how they'll interface into systems and how we can make the overall assemblies more agnostic to the next generations of refrigerants, over time. And there's a significant advantage to that. Again, of 10% of the total cost of ownership is the price of the initial product, 90% being the energy efficiency, the maintenance, and the refrigerant, and the refrigerant optionality. We have a significant advantage to all three of those. And it's an opportunity to price the equipment accordingly.

Julian Mitchell: Great. I think we're out of time. Thank you very much.

Mike Lamach: Thanks very much. Thank you.

Julian Mitchell: Thanks, Mike. Thanks a lot.