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IR - Q2 2016 Ingersoll-Rand PLC Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Ingersoll-Rand second-quarter 2016 earnings conference call. (Operator Instructions). As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference Zac Nagle, Vice President of Investor Relations. Please go ahead.

Zac Nagle - ***Ingersoll-Rand PLC - VP IR***

Thanks and good morning, everyone. This is Zac Nagle and it's a pleasure to join you for my first Ingersoll-Rand earnings call as Vice President of Investor Relations. Welcome to Ingersoll-Rand's second-quarter 2016 earnings conference call.

We released earnings this morning at 6:30 AM and the release is posted on our website. This call is also being webcast and archived on our website at ingersollrand.com, where you will find the presentation accompanying our comments this morning.

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 the actual results to differ materially from anticipated results.

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

The participants on this morning's call are Mike Lamach, Chairman and CEO; Sue Carter, Senior Vice President and CFO; and Joe Fimbianti, Director of Investor Relations.

With that, please go to slide 3, and I will turn the call over to Mike.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Great, thank you, Zac, and officially welcome to Ingersoll-Rand in your first earnings call with us.

As you can see from our earnings release this morning, we had another excellent quarter. We had outstanding execution across the Company, delivering 15% EPS growth, record operating margins, share gains, and strong cash flow, despite challenging industrial markets. We are seeing strong momentum in the operating system that we have been installing and developing in the Company over the past six-plus years.

As we did last quarter, I'd like to start out spending a few minutes linking this quarter's performance to the longer-term strategic direction of the Company to help investors understand how we're building a more valuable, sustainable, and less cyclical company over the longer term. With our operating system, operational excellence and growth excellence have been cornerstones of the strategy from the beginning, with our goal of becoming the very best operating company within our diversified or multi-industry peer group.

This quarter, we continued to deliver best-in-class operating leverage of 47%, and our goal is to achieve top quartile organic growth for the quarter and for the year as well.

There were a number of noteworthy milestones that showed clear progress in these areas during the quarter. Our residential HVAC business had another outstanding quarter, with record revenue and profitability. We estimate that over the past quarter and 12 months we now have benchmark profitability in this business and are seeing the benefits of a five-year effort to refresh the product line, align and reposition the channel, and dramatically improve product management, manufacturing, and supply chain. Our residential business is also a model for the deployment of product growth teams, who are delivering market-share and margin growth.

Our commercial HVAC business in North America had record second-quarter bookings and revenue. Similar to our residential HVAC story, we have executed on a consistent strategy with a goal to have the freshest, most energy efficient, and reliable product line in the industry and have supported that with consistent operational improvements along the way.

We continue to see double-digit increases in our controls business and high single-digit growth in our service business, consistent with our strategy to balance equipment with controls and services. In the second quarter, Trane commercial led the industry with a strong pipeline of new high-efficiency products, many of which earn our EcoWise badge for innovation that improves energy efficiency as compared to legacy product platforms, while reducing greenhouse gas emissions.

Examples this quarter include the North American announcement of the new CenTraVac Centrifugal chiller portfolio, using next-generation low global warming potential refrigerant. The product is for large buildings and industrial applications in the US and Canada. We also announced a service program to retrofit the existing installed base for the next-generation low global warming potential refrigerant, which protects and provides a viable option for our customers' past investment, while achieving their own sustainability goals.

In Europe, we announced another four new products, the Sintesis eXcellent, a new air-cooled chiller with nearly zero global warming potential using next-generation refrigerant; Airfinity, a complete new range of HVAC rooftop units designed to comply with the upcoming European Union Ecodesign regulations -- they are light, compact, and modular plug-and-play HVAC units that are compatible with wireless technology and designed to save time and money when retrofitting and improve the efficiency of existing buildings across Europe; Xstream, a new range of water-cooled screw chillers now available in Europe and the Middle East. The efficiency and capacity ratings are unmatched by any other screw chiller in the market today. We hope this will become a preferred option for critical applications, like data centers, hospitals, process cooling, district cooling, and heating. And, finally, Trane's Balance, our second generation of innovative multi-pipe systems for high-efficiency simultaneous heating and cooling. The systems repurpose energy that is rejected and use renewable energy for heating.

Within our Thermo King North America, Europe, and Middle East business, we are demonstrating that we have a more resilient business than the past, expanding margins 270 basis points in a lower growth environment. As we noted in our initial guidance, we believe that we could maintain or even grow margins with a 15% North American trailer pullback and flat overall volumes. Today, the Thermo King business serves the refrigerated truck, trailer, marine container, air container, bus and rail, telematics, and auxiliary power unit markets, and the completeness of the portfolio has added to margins and the overall resiliency of the portfolio.

Also of interest, both our residential HVAC and Thermo King North America, Europe, and Middle East business units have been fully deployed on the new ERP system for the past couple of quarters, and we believe we are now seeing the expected productivity throughout these business units. We continue to deploy new sites routinely in other business units each quarter.

We continue to be pleased with the tremendous execution we are seeing in our HVAC and transport refrigeration business in Asia-Pacific and in Latin America. Both regions demonstrated substantial margin improvement and share growth. HVAC bookings in Latin America were up 36% on an organic basis for the quarter, a really outstanding performance by that team and that region. In Asia-Pacific, our transport refrigeration business continues to grow, with another 23% increase in bookings and 25% increase in revenue. Both are examples of finding pockets of growth within generally weak markets and then capitalizing on those opportunities.

Turning to our industrial segment, I want to start by saying that I have tremendous confidence in our leaders running these business units and they're operating in a very challenging environment. Within compression technologies in North America, which is our largest market for equipment, the 250 horsepower contact cooled rotary market is down 20%, and all other size ranges are also down in the high single-digit range, with only small 5 to 15 horse compressors showing year-over-year growth.

Against this backdrop, we are performing well and supplementing the business with service bookings of approximately 10% in the quarter. Remember, too, that the last time we emerged from a down industrial cycle we grew margins nearly 7 full points in a 24-month period.

Our fluid management business continues to perform well, with modest growth, and we are seeing continued weakness in the tools business and no sign of recovery in our material handling business, which provides hoist and winches for the oil and gas industry. Club Car continues to broaden its strategy and reach outside of golf with small electric vehicles in the commercial and consumer segments.

Turning to growth excellence, which encompasses the full value stream from strategic analytics, product management, new product and technology introduction, sales management, and service and support, this has been another cornerstone of our long-term strategy. We believe the product, channel, and service footprint investments we have made over the past five to seven years are paying off. It is clearly evident in the HVAC and transport refrigeration business units, and we believe it will also be the case for our compression technology business unit that has been doing a similar investment program over the past couple of years, which will continue over the next several years.

Even as industrial markets are challenging today, we continue the investment in the compression technologies business because we expect we will be rewarded as the market recovers. As one example, one of the product growth teams operates in the compression technology business and covers a specific product portfolio, which equates to about 10% of the overall revenue of that business.

Within the product growth team, we are seeing year-to-date bookings increases of 30% and revenues increasing by 17%. Its strength in our climate segment, capacity utilization in our shared climate and industrial plants and operations, and leveraging our technology teams that is allowing us the opportunity to stay the course on critical growth programs in our industrial segment.

We have continued to invest in strategic growth programs across the Company through both good and difficult times, and the benefits of doing so are clear. Our designated strategic growth programs, many of which are managed through our product growth team process, are growing at a rate three times faster than the underlying growth rate of the Company.

As another example, within the commercial HVAC business in North America, Europe, and the Middle East, our strategic growth programs are growing at a 14% rate this year, and for the Company, 80%-plus of our growth is coming from investment and focus on these critical strategic growth programs. So as is our model, we will leverage the success and build and accelerate on the full deployment of this element of our operating system in the years ahead.

Going forward, we see multiple investment opportunities to deliver long-term growth through innovation and differentiation of the product, software, and services we provide. I don't think anyone on this call needs another presentation on the Internet of Things and the possibilities for how that will transform competition and opportunity. This macro trend is squarely centered on nearly every growth and productivity strategy in our Company, whether it is connected buildings, intelligent monitoring of service, diagnostic and self-healing systems, telematics, consumer marketing and fulfillment, and too many other digital concepts to list.

We are funding a number of these ideas centrally within the corporate expense line and are likely to accelerate this incubation investment later this year. Incremental 2016 investment for this activity is already embedded in our guidance.

Finally, building on the culture element of our model, high-quality teams and deep employee engagement are critical to any sustained transformation and I'm pleased that we continue to excel in these areas. One source of great pride within Ingersoll-Rand is our ability to walk the talk on sustainability. To make the point, we continue to see benchmark levels for employee engagement; world-class safety performance for any segment of industry; energy reduction of 5% on an absolute, not volume adjusted basis; a 14% reduction in water consumption, also on an absolute basis; and similar reductions of both hazardous and nonhazardous waste.

So Sue will take you through the quarter in detail. I felt it was important to line how today's results reinforce the strategy of the Company, how we intend to keep delivering great results, and why you should believe we are building a more valuable, sustainable, and less cyclical Company for our shareholders. And with that, I will turn it over to Sue.

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

Thank you, Mike. Let's go to slide 4. This is a summary slide that I would like to begin with and give you some takeaway from today's call.

As Mike has discussed, Q2 was another strong operational quarter for us and it shows through the financial results that we posted. In the second quarter, we drove year-over-year organic revenues higher by 3%, adjusted margins up 80 basis points with a leverage of over 45%, and adjusted earnings per share up 15% against the backdrop of a very slow growth environment and particularly challenged industrial markets.

Adjusted earnings per share of $1.38 exceeded our guidance range of $1.27 to $1.32 by $0.08 at the midpoint and $0.06 at the high end. Our $0.08 beat versus our midpoint was driven by exceptionally strong performance in our climate segment, partially offset by challenged markets in our industrial segment and about a $0.06 beat from a lower tax rate in the quarter. And as I will discuss in detail later, we believe we will maintain a 200 basis-point lower average tax rate than our previous guidance of 24% to 25% for 2016.

We also posted strong year-to-date free cash flow of $348 million, up $293 million from the prior year. We are seeing the benefits of our focus on working capital management and our business operating system, and with that, we are raising our free cash flow forecast to $1 billion to $1.1 billion, excluding the proceeds from the sale of Hussmann.

Let's turn to segment results. The climate segment continues to exceed expectations, driven largely by outstanding execution in both commercial and residential HVAC with mid-single digit growth and high single-digit growth, respectively. Margins also showed healthy expansion, driven by strong volume, productivity improvements, and material deflation of nonferrous commodities. We also continue to invest in the business in order to derive sustainable growth.

The industrial segment's end markets are more challenged than previously forecast and we experienced negative growth in all the major end markets except small electric vehicles, which is our Club Car business, and fluid management, where we continue to see growth. Across industrial, we continue to take measures to drive productivity, shift our mix further towards more profitable aftermarket services and parts markets, and to make prudent cost reductions in the business.

We continue to be committed to a dynamic capital allocation strategy, focused on delivering high returns to shareholders over the long term. Our strong free cash flow generation and cash balances provide us important options as the markets evolve.

And lastly, we've bumped up the bottom end of our guidance range by $0.05, and our current, adjusted, continuing operations earnings per share for 2016 is $4 to $4.10. This update reflects expected continued strong growth in our climate segment and tailwinds resulting from a lower go-forward structural tax rate of 22% to 23%, partially offset by continued weakness in our industrial end markets, where we are not seeing the signs of recovery we had originally anticipated in our prior guidance.

Now if you'll go to slide 5, let's begin discussing additional details regarding the second quarter. Our business operating system again guided us through good execution in our factory and in our cost centers. Our focus was on good operating results in a low growth environment, and we delivered against that objective.

Enterprise revenues were up 3% organically, with climate up 5% and industrial down 3%. HVAC revenues grew in each of our climate businesses, led by commercial and residential HVAC in North America. Thermo King North America and EMEA truck and trailer revenues continued to be strong in the quarter.

Industrial markets declined in the quarter consistent with the overall market. Club Car performed as expected, with mid single-digit growth year over year. Our adjusted operating margins grew 80 basis points year over year, with operating leverage exceeding 45%. Our strength in margin expansion was driven through price realization, productivity gains, and direct material deflation. We have inserted a margin table on the slide and that will illustrate some of the items I just talked about.

We completed the sale of our remaining interest in Hussmann on April 1, 2016, for a gain of approximately $398 million.

Let's go to slide 6. Orders for the second quarter of 2016 were up 3% organically. Climate orders were up 6% organically. Organic global commercial HVAC bookings were up high single digits, similar to the first quarter, led by low teens growth in North America applied and unitary and strong growth of 36% in Latin America, which was against a relatively easy compare in 2015. Asia bookings continued to be lumpy from quarter to quarter and were down in Q2 overall, while China was up low single digits. We continued to see excellent growth in service, controls, and contracting, with low teens growth in the quarter. Residential bookings were up low teens, representing the fourth consecutive quarter of bookings growth above 10%.

Organic transport orders were down mid-single digits, with order growth in overseas markets offset by declines in North America trailer and auxiliary power units. Consistent with the expectations we set out earlier in the year, we continue to expect bookings to decline in North America trailer in the second half of the year, and this is built into our guidance.

Transport orders in Asia were up 23% in the second quarter.

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Overall, we anticipated some recovery in the industrial markets as we moved through Q2 and the balance of the year, but we are seeing continued challenges and market declines. Net orders in the industrial segment were down 5% organically. We saw high single-digit order decline in compression technologies and services.

Services continued to be a bright spot and were up high single digits, as we continue to focus on the business with higher-margin product streams. We saw a low teens decline in other industrial products and a high single-digit increase in Club Car.

Now if you will go to slide 7, please. This slide provides a directional view of our segment revenue performance by region. In our climate segment, which was up 5% in the second quarter, we saw solid performance in North America and low single-digit growth across Europe, Asia, and Latin America. We saw a decline in the Middle East consistent with the contraction in the number of building projects planned, primarily in Saudi Arabia, and we would expect this to continue for some time as low oil prices are driving an investment pullback.

Our industrial segment performance in the second quarter, which was down 3%, is representative of the ongoing volatility and declining markets that continue across the globe in industrial markets. Our regional industrial markets declined, except for Europe and Asia, which were up.

Let's go to slide 8, please. Climate revenues of $2.9 billion for the quarter were strong, up 5% organically. Commercial HVAC organic revenues were up mid-single digits, led by 20% growth in North America contracting and upper single-digit growth in unitary equipment shipments in North America. Europe had equipment growth in the midteens and high single-digit growth in services, contracting, and parts. The Middle East revenues declined, largely due to a sharp pullback in Saudi Arabia, as I mentioned earlier. Residential revenues were up record levels and up high single digits in the second quarter.

Transport organic revenues were up low single digits in the quarter. Truck and trailer organic revenues were up high single digits overall, with improved revenues in North America, Europe, and Asia. We also had a high single-digit improvement in aftermarket volumes. Marine container organic revenues declined more than 60% in the second quarter, reflecting a soft first half at various box builders for 2016. We also had lower sales of auxiliary power units, reflecting the decline in the Class 8 sleeper market.

Please go to slide 9. Our climate operating margins grew 250 basis points year over year. Our strength was broad based, based on volume, price, direct material deflation, and productivity gains, and we continue to invest in the business for sustainable growth.

Please go to slide 10. Second-quarter revenues for the industrial segment were $753 million, down 3% on an organic basis. Compression technologies and services' organic revenues were down low single digits versus last year and industrial products were down midteens, with growth in fluid management and declines in material handling equipment and tools. Small electric vehicles, also known as Club Car, organic revenues were up mid-single digits versus prior year from gains in equipment and aftermarket.

Regionally, the decline in organic industrial revenues was led by a mid single-digit decline in the Americas and the Middle East. Asia and Europe were up modestly, partially offsetting the declines.

Please go to slide 11. Industrial's operating margin of 9.1% was down 250 basis points compared with last year. Lower volumes were the largest driver, partially offset by pricing, material deflation, and productivity. Despite the downturn, we continued to invest in the business for the long term.

Additionally, capitalized costs related to new product engineering and development were reclassified to the income statement in Q2, which were a drag on margin of approximately $8 million or 1.1 percentage points for the industrial segment. Excluding this adjustment, industrial adjusted margins were 10.9% in Q2.

Moving forward, we expect industrial segment performance to trend with the market. We are planning on expanding margins in a down market in the second half of the year through aftermarket growth, productivity gains, and cost controls.

Please go to slide 12. Our June year-to-date free cash flow of $348 million was favorable to prior year by $293 million. Strong operating income improvement and improved working capital performance were the primary drivers of the favorability. Because of our strong start to the year, we have raised our free cash flow forecast range to $1 billion to $1.1 billion from our previous range of $950 million to $1 billion.

For the quarter, working capital as a percentage of revenue was 5.6%. We had strong collections in the quarter, with our days sales outstanding improving 0.6 days over the prior year and days payable outstanding improving 0.7 days. Inventory is on plan for the quarter and we are well positioned to serve our customers.

Please go to slide 13. Our cash performance in the second quarter and our expectations for the year enable us to, one, continue to invest in the strategic growth programs that Mike outlined earlier. In addition to the core strategic investments, we are also investing in long-term growth through innovation and differentiated products in such areas as connected buildings, intelligent monitoring, and self-healing systems, just to name a few.

Two, we will also maintain a strong balance sheet with BBB credit metrics. And, three, we will also maintain -- we will also retain optionality relative to paying a competitive dividend, acquisitions to build the business, and share repurchases.

Please go to slide 14. As always, our intention is to give you our best view of what we are seeing in our end markets sitting here today and how that translates to our revenue guidance for 2016. We have broken it down by major end markets and geographies. As you can see by the variation of colors and symbols, our end markets are seeing a wide variation in trends.

North America commercial HVAC and residential HVAC, as well as European transport and commercial HVAC markets, are generally positive, while global industrial markets are declining. We are forecasting transport markets in North America to be down low single digits. Our forecast for North America trailer volumes has not changed and we expect the market to be down slightly for the year. This implies a decline in the second half, after single-digit growth in the first half of the year.

Asian HVAC markets are expected to be flat to down and industrial markets in Asia remain under pressure. Golf car markets are slightly down, offset by increases in the utility vehicle markets.

All of our revenue growth forecasts are shown on an organic basis. We are forecasting mid single-digit growth in commercial HVAC in total; high single-digit growth in residential HVAC, which is essentially an all North America business for us; and a flat to small decline in transport globally. We expect compression-related products and other industrial equipment to be down high single digits. We expect Club Car to be up low single digits.

Please go to slide 15. Aggregating those market backdrops, we expect our organic revenues for the full-year 2016 to be up 2% to 3% versus 2015, with foreign exchange presenting a headwind of about 1 percentage point. We expect climate revenues to be up 4% to 5% organically. For industrial, we expect organic revenues to be down 4% to 5%.

For operating margins, we're excluding restructuring costs to get to adjusted margins. We expect adjusted operating margins in climate to be between 14% and 14.5%. We expect adjusted industrial margins to be between 10% and 11%, and for the enterprise, we expect adjusted operating margin of 11.5% to 12%.

Please go to slide 16. Transitioning to earnings, the reported earnings-per-share range is estimated to be $5.47 to $5.57 and the adjusted range is $4 to $4.10, versus our prior guidance range of $3.95 to $4.10. Adjusted numbers exclude restructuring and the Hussmann gain.

Our full-year guidance reflects a tax rate forecast of 22% to 23% and an average diluted share count of approximately 261 million shares. The tax rate reflects a 200 basis-point improvement versus prior guidance of 24% to 25%.

For the third quarter of 2016, revenues are forecasted to be up by approximately 3% organically. We are projecting climate revenues to grow mid-single digits in Q3 and industrial to decline low single digits. Adjusted third-quarter earnings per share are forecasted to be between $1.25 and $1.30, excluding restructuring charges of about $0.01.

For the full year of 2016, we also raised our free cash flow expectations and now expect free cash flow to be between $1 billion and $1.1 billion, excluding restructuring charges and proceeds from the sale of Hussmann.

And with that, I am going to turn it back to Mike for a few closing comments.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Okay, great. Thank you, Sue, and let's go to slide 17.

So to conclude, we had an excellent quarter, grounded in solid execution. I am proud of the many people within Ingersoll-Rand that continue to deliver for our customers and for our shareholders. I am pleased with the progress and the momentum in the implementation of our operating system and the growing depth and bench strength throughout the Company that makes the operating system come to life through continuous improvement. We're building a stronger, more valuable, more sustainable, and less cyclical Ingersoll-Rand than ever before, and it is exciting to me and leaders throughout the Company to be part of that transformation and to help create a bright future with more individual development possibilities for all our people throughout the world.

The results we reported this morning are a direct result of the strategic work, the persistence, the tenacity of the talented people that represent the unique culture we're building. It is a strategic advantage and it is the toughest thing in any business for a competitor to copy.

There are a few takeaways I want to point out to you as we head to the back half of the year and into 2017. First, the industrial businesses are running effectively in a very tough market environment. The management team is aggressively taking and will continue to take the right actions to reduce the overall cost structure of the business and is committed to protecting the key product and service investments that will build long-term growth and margin expansion when the markets improve.

Second, the transport market is performing as we expected. As we said at the beginning of the year, we expected the first-half results to be up and the back half of the year would be down. The management team has done an effective job anticipating and seeing around the corners and is proactively taking the actions to ensure strong margin performance continues.

Third, commodity deflation has been a tailwind during the first half of the year and it is going to moderate to neutral in the back half of the year. We have a long track record of managing the price to material input equation very effectively and we're going to continue to do so going forward.

And then, finally, let me say we are proactively reviewing both prior restructuring considerations, as well as new actions, as our business, markets, and even the input variables into our own models continue to evolve. Although we don't have any immediate additional restructuring actions to take or announce today, we won't hesitate to take additional prudent restructuring actions going forward.

So with that, Sue and I will be happy to take your questions.

QUESTION AND ANSWER

Operator

(Operator Instructions). Nigel Coe, Morgan Stanley.

Nigel Coe - ***Morgan Stanley - Analyst***

Before I ask my question, I just wanted to clarify. Sue, did you mention the tax rate, 22% to 23%, is now a structural tax rate going forward?

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

Yes, it is 22% to 23% and that's the ongoing rate.

Nigel Coe - ***Morgan Stanley - Analyst***

Okay, great. That is very clear. Mike, obviously very strong booking orders, bookings for North American commercial HVAC in North America low teens. You mentioned a 25% number on the last call. I am not sure we are comparing apples to apples here, but maybe just clarify that 25% is the low teens that you actually booked. And maybe if you could just dig into the health of the light commercial versus applied unitary markets.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, Nigel, thanks for the question. Actually, I would expect two quarters of similar growth, two quarters of teens versus one 20-plus quarter, so I think that's intact.

The pipeline, frankly, has never been healthier than it is right now, and it is healthy through all the institutional large project work. Commercial is maintaining some resiliency that we are seeing here, and unitary, at the light levels, are still strong for us. So residential all the way up through light commercial still remains very strong for us across the board.

Nigel Coe - ***Morgan Stanley - Analyst***

Okay, great, so no signs of weakness there. And then, just on the climate margin outlook, you have done 13.8% in the first half of the year. The low end or the mid to lower end of your margin guidance at climate would suggest basically flat margins in the second half of the year, which seems pretty bearish. Maybe just contextualize why you see an outlook for maybe 14% at the low end.

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

So, Nigel, let me start out and then Mike can add his comments as we go forward. So as I think about a climate in the back half of the year, you're going to have a couple of different dynamics, the first of which, as we talked about, was that direct material was going to moderate in terms of its deflationary environment, so let me talk about that for just a second.

What we expect to see in the back half of the year is we expect to see that steel, particularly in the fourth quarter, is going to turn more inflationary then deflationary, so that's part of what is happening with the flatter margins. We're also going to continue to invest in the overall business in the back half of the year. Again, we have got some significant product launches and we see this as an area that really sets us up for success.

So, it is really price, a little bit of mix that comes from us lapping the 14 SEER in residential, and then investment in the business.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

And Nigel, I would just say to me the biggest number on the page is we're putting 0.5 points -- 50 basis points of margin back into investment, and it is a formula that has worked for us, it sets us up well for 2017, and we like what we are getting out of those investments.

Nigel Coe - ***Morgan Stanley - Analyst***

Okay, thanks a lot, guys.

Operator

Julian Mitchell, Credit Suisse.

Julian Mitchell - ***Credit Suisse - Analyst***

Just on the industrial margin guide for the second half, so it looks like you are looking at a margin of maybe 11%, 11.5% in the second half. The clean margin was 10.9% in Q2. So I thought maybe there would be a bit more coming through to support margins from productivity or cost reduction, so I just wondered why maybe there wasn't a bit more urgency around getting the cost out because it looks as if the margin decline is going to be similar second half as first half.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Julian, starting, I would say that again to me the most important thing that is happening there is they're really, say, 40% through an investment cycle there that there is just no reason to stop and go on that. And so, that continues for the balance of the year for us and that's something that I think is vitally important.

There is a tremendous effort underway at reducing cost in that business, much of what is not just visible through what you would say would be qualified restructuring. Much of that is just reduction in place and just other containment actions being taken in the business.

So when I say the business is being run effectively, I have no doubt that all the rocks are being turned over, with the exception of protecting this critical investment pool that is important to us going forward. And I used that one example for you because it happened to be the example of the products growth team is the one product area that we have launched in that portfolio and we're getting tremendous results with that.

So, again, this gives us some confidence that although it's not a great story for the third and the fourth quarter, we are not running the Company for the third and the fourth quarter. We're running the Company for the long run and we hope investors see that, and that's part of the reason I think taking good success around the climate business, keeping utilization up through the combined factory structures that we have got and leveraging the networks of excellence across the compression-related businesses that we have give us the opportunity to stay the course on these investments, and that's really important.

Julian Mitchell - ***Credit Suisse - Analyst***

Very clear. And then, my follow-up would just be you touched on the input-cost impact in Q4. I think the last numbers I have on the COGS split are from 2010 or 2011, the last time materials were an interesting issue. Is there any update you could give on the breakdown of COGS in terms of raw materials versus processed materials and components and so forth?

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

Sure. So if you think about -- and what I will do is I will give it to you in terms of dollars, so if you think about direct material spend for the Company, Julian, it is about, say, $6 million -- or $6 billion a year in direct material spend. If you then break that down into the commodities that we are talking about, it is roughly about 10% to 12% of that, and as you think about then breaking that down even further, steel is going to be the largest component, with copper and aluminum following that. And so, the price pressure that we are thinking about in the back half is on steel because copper and aluminum are pretty much staying the course with what we have seen.

Julian Mitchell - ***Credit Suisse - Analyst***

Great, thank you.

Operator

Jeffrey Sprague, Vertical Research.

Jeffrey Sprague - ***Vertical Research Partners - Analyst***

Mike, just thinking bigger picture here strategically, you guys are actually doing a really solid job operationally, and I can't help but look at Lennox at 22 times earnings and Atlas Copco at 22 times earnings and just wonder if you are actually reevaluating the portfolio. I know you went through the exercise with Allegion and the businesses that you retain are air-oriented businesses, but do you have any thought or response to that question or that idea?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, Jeff, it's a great question and thanks for the opportunity to step back and look at it, because I look back over the seven years that I have been in this role and I remember when industrial was the sweetheart of the portfolio, right, from 2009 to 2011, even through 2013, and we were expanding margins so fast that it afforded us the opportunity to do all the great investment we made in the Trane residential and commercial businesses, which is really why you are seeing the numbers that you are seeing today in that business.

And so, now it has flipped. You remember that was all happening with no real commercial -- certainly no institutional support coming from construction markets. Now that has flipped and it has allowed us the opportunity to keep factories fairly loaded. It has given us the opportunity to keep technical professionals highly engaged in development of product, and all that, really, it just really sets up where at some point when the commercial market in HVAC slows down, when institutional eventually fades, our hope is that we have got a strong, refreshed, energy-efficient, reliable portfolio sitting, particularly in compression technologies, and we are going to leverage that, just like we did from 2009 to 2011 when it grew 7 full points.

We are very leveraged here toward some of those fixed costs. Where we play in the market is in the big machine. It is not the Cameron -- I am not talking Cameron, I am talking about Cameron plus all the 250 to 400 horse centrifugal air compressors, of which we are the leader now in that area, and we don't really participate much in the vacuum and blower business, which had some growth in it.

So, we have a product portfolio and a position in the market in these larger machines. That is what is getting hurt right now, and we're not going to throw the baby out with the bathwater here on that, for sure. That's why in addition to -- I had mentioned the product development, but the machining investments, as I mentioned last call and this call, those are going to continue, and we will put $50 million into machining in this downturn so that when we emerge out of this thing, we're going to be more productive. The hope is that it is not just 7 points of margin; it is more than 7 points of margin coming back.

So Jeff, I think -- I really have got my head around the value of what we have created around integrating the portfolio, and over the long run not really so interested in a flash in the pan around some multiple for short cycle. I'm really interested in building the value of the Company over the long run. And again, step back to 2009, Jeff. If you invested back in 2009, you are a very happy investor and I thank you for all the Christmas cards we get to that effect. But it is because we've had the portfolio that we've had.

Jeffrey Sprague - ***Vertical Research Partners - Analyst***

Yes, I had a heroic buyback in 2009. Thanks for that perspective. Also, then, just on the balance sheet, Mike --

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Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Jeff, just before you do that, incremental margins every single year have been in the top quartile. Organic growth rates almost every single year have been in the top quartile. We have done that with elements of the portfolio firing and not firing at various points in time, and I just have to believe that there is value in that and there is industrial logic around what we are doing around sustainability and energy efficiency fronts of the business. So go ahead.

Jeffrey Sprague - ***Vertical Research Partners - Analyst***

I agree. Your performance has been great. You are not getting fully paid for it.

The balance sheet, what is the plan for the year-end? Sue gave us the generalized color, but with the Hussmann proceeds and the strong cash flow, would you be opportunistically looking to step in share repurchase this year? I can't imagine the M&A pipeline is that active, but perhaps it is.

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

So Jeff, let me take a shot at that, and then I'm going to let Mike jump in. But I am going to use some of the same passion that Mike had in his comments on the multiples and what we have built at Ingersoll-Rand.

From a perspective of our cash generation and then our ensuing capital allocation, we're really trying to create longer-term shareholder value with the cash that we are generating. And so, what we have seen that has been really successful for us is investing in our products, investing in areas like energy efficiency and sustainability. Those are proven for us in terms of building our growth excellence.

If we look at operational excellence, all of the work that we've done and invested in the Company, whether it is in our factories or in our overall processes with the business operating system, all of that has shown to be something that has worked very well for us. So our preference, as we think about capital allocation and your question, is to really invest and grow the Company. So to be more specific than in terms of what that means, it means I want to continue to invest. It means I want to continue to do all of those things. It means we want to look at the M&A pipeline.

But what we have is an opportunity where we can be patient, we can wait for the right opportunity and not just take the cash that we are generating and run out and buy something. So we're really, really thinking about investments. We are thinking about M&A. Dividends are extremely important to us. We understand that and we're going to continue to have dividends that are in line with our peer payout ratios, and we will also be opportunistic about share repurchase. I don't want to take that completely off the table, but if I set our preference up, it is going to be to build longer-term value through investments in the business and acquisitions.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, I agree with Sue's comments completely, obviously. But I would tell you that the competitive dividend's a given and the fact that we are controlling dilution in the share count is a given. We don't want to dilute shareholders through that, so that's a given.

The optionality beyond that, we want to be really smart allocators of capital and we want to have our eyes wide open on how we do that. When you get big dislocations in the share price, we want to be opportunistic and we were in the first quarter between $48 and $51 a share. Clearly, that was a good idea.

And we have been opportunistic when we saw value in long-term creation through acquisitions. And so, we will continue to do that.

Now all that being said, I think we have less than $1 billion in cash, so that's not a whole lot of cash we are talking about for a company our size to be walking around with.

Jeffrey Sprague - ***Vertical Research Partners - Analyst***

Thank you very much, guys. Appreciate it.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - ***Goldman Sachs - Analyst***

Welcome, Zac.

Zac Nagle - ***Ingersoll-Rand PLC - VP IR***

Thank you.

Joe Ritchie - ***Goldman Sachs - Analyst***

So my first question, maybe following up on Jeff's point there on maybe just the investment that you're making in industrial, Mike. I am just wondering how much of it is playing catch-up versus really investing for future growth. And then, how do you balance that with the idea that we're seven to eight years into this economic recovery and could be in this lower growth environment for some time?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, Joe, actually the efficiencies of the product launch, the 40% of the portfolio I told you about, are in the range of 9% to 13% more efficient than anything out in the marketplace. That is how we're going to market, around value, around total cost of ownership, and that's why that business is up in the high teens and bookings are closer to 30.

We know there is no purpose in us playing catch-up to a me-too. So every single thing we have done has been to leapfrog the efficiencies and reliability of what is out there. And if you just look to the Trane portfolio, you would see that. In every launch we have made, not only is it more efficient than anything in the marketplace, but it is using refrigerants that go way past the HFC phaseout.

So, we are not meeting anybody where they are; we are leapfrogging. And this whole strategic analytics piece of our business operating system of really figuring out where to go attack, specifically, and then having those strategic growth programs outlined with the resources, the talent, the investments outlined and making sure that no matter what we do, we are committing to that, is why you get 80%-plus of the growth happening through the areas we are focusing on. And that doesn't come from me-too catch-up.

Joe Ritchie - ***Goldman Sachs - Analyst***

Got it. That makes sense. How do the investments, then, maybe thinking about it through the lens of industrial, perhaps you can provide some color there.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Well, I'll make the judgment of what the investments are specifically in industrial, Joe (multiple speakers)

Joe Ritchie - ***Goldman Sachs - Analyst***

No, just I guess specifically around the investments that you're making in industrial. We have been in this really -- just this weaker growth environment, probably expected to persist for quite some time. I am just trying to get a sense for whether there is some catch-up to do on the industrial side, whether your portfolio is better positioned than your peers. Just any colors on the competitive dynamics in the investments that you're making.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, the investments we are making are obviously in the areas that we are not leading, so any place we are not leading is a right spot for it. So if we are leading in 250 horse to 400 horse in the world, we will keep that competitive and we will make sure that we are not losing that position, but we are attacking in the other areas that we think are going to grow. That's the general view.

And you can understand why I'm not going to be more specific than that, because we would rather book it and have margin improvement versus just talking about it and really signaling where we are going competitively around this stuff. That's not been our style at all.

But I will tell you that it starts with the strategic analytics being right and the investments being very specific, and the product growth teams -- so engineering, operations, and product management -- agreeing and working toward the one or two most critically important things to grow share and margin in a very specific product line or service line has been the formula for us that has been successful. We're going to continue to do that.

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

And so, the other thing that I would add, Mike, just as a practical matter, Joe, for what you are talking about is the investments that are ongoing in industrial are going to be in the same general areas as you would expect. They are going to be in new products. They're going to be in operational excellence, so improving our operating results, and they also include some channel investments, particularly in the compression technologies business. So, all the areas you might expect.

Joe Ritchie - ***Goldman Sachs - Analyst***

Got you. That makes sense. And just one real quick one for you, Sue, on just the price/cost breakdown this quarter. How much did material deflation versus price contribute?

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

So, it was -- so let me take you back to Q1 where it was about 50-50 price and direct material deflation. In the second quarter, it was a little more direct material deflation, but really a 60/40 kind of look with deflation and price and we were price positive in both segments. And so, if you remember when we gave guidance and talked about the second quarter, we had originally called that at 110 basis points and it came in at 120. So, again, it performed exactly as we expected it to in the quarter, and I will repeat the Q1 comment of we didn't have breakage, so it was a good result.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, Joe, I actually want to take you back to the industrial question just for a second. I just had one more comment here was I made a comment about the strength of the management team, which ultimately I think is what really investors need to believe in and buy.

And I look at our industrial segment management team, and I can tell you that the top five to 10 executives running that part of the business co-architected the entire business operating system with me since it began. I couldn't have higher confidence in our ability to win as the markets recover.

So, I want to make sure that point is really clear. It is a very strong management team, paying attention to the details in that business.

Joe Ritchie - ***Goldman Sachs - Analyst***

That's helpful. Thanks, guys.

Operator

Steven Winoker, Bernstein.

Steven Winoker - ***Bernstein - Analyst***

It looks like you are certainly taking profitable share gain on the climate side, but what is going on in VRF there?

And then on the industrial side, Atlas Copco Compressor Technique orders were up 1% in the quarter. I know they have got a different mix. I know they have got vacuum and also a slightly smaller North American presence. Would that explain it all or is there something else going on as well that we should be aware of?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Look, in no particular order, Steve, if you look at Atlas Copco's business, they are going to be strong in oil-free rotary and certainly at a smaller range than our large centrifugal machines. We have got a great oil-free product and are growing that business, too, but obviously that's the bulk of what you see with Atlas Copco's business.

Vacuum and blowers you called out, and that's actually still been a market growing. When you think about oil free or vacuums and blowers, you have to think about the industries that they go into, and those industries happen to be growing as well, as opposed to some of the heavier industries that would use some of the larger centrifugal machines, for the most part.

So, we do a very thorough compare with all public information that we can pick up from all of our various competitors, not just a single competitor, have a good understanding of how that mix looks, and then we're realists about where the opportunity is for us to self-help where we can. Right now, the self-help comes into growing the service businesses and they're doing a great job with that. It also comes into refreshing and developing the portfolio in the smaller range machines. And that's where we're going to play going forward.

Steven Winoker - ***Bernstein - Analyst***

Okay, and on the VRF side?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

VRF, we're -- very well. That is growing faster than the underlying unitary business. We continue to have a very high share, no slowdown there from us at all.

Steven Winoker - ***Bernstein - Analyst***

Okay, and then just following up on your earlier comments around the balance sheet and whatnot, Mike, in the past you have talked about there being opportunity for consolidation within the overall HVAC market. Do you still -- how are you thinking about that, given the dynamics of the industry going forward? Do you think there is still room in that?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

I do. I think they are big moves and I think that you look at what we did with acquiring Cameron's compressor business, and we had synergies in the first year of 15% and we will drive it higher this year. So, look, I think great synergies exist and I think that these opportunities are happening, but I think they are bigger, more complex deals.

Steven Winoker - ***Bernstein - Analyst***

Okay, all right, great. Thanks.

Operator

Steve Tusa, JPMorgan.

Steve Tusa - ***JPMorgan - Analyst***

So, what exactly is going on here in industrial? This just seems like relative to where you were it was viewed as a high-quality business with pretty solid margins, and it just seems like every single quarter we are just getting deeper and deeper into a hole here. I guess -- you mentioned the end markets. How much -- just remind us, including Cameron, how much is oil and gas? And then, how much would be in and around oil and gas? And maybe we are just mislabeling some of these end markets, perhaps, and you guys, like everybody else, do have more exposure there than we would have thought initially.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, Steve, so I will save the oil and gas math for somebody at the end here, but if you look at the biggest market we are in on big machines, and I use 250 to 400 horsepower as being a big machine, down 20%, actually as you go up between 250 and 400 and past 400, those growth rates start to look like minus 50%, okay, from where they were.

These are the most capital-intensive factories we have, and that certainly when we have those kinds of volume drops really adversely affects our mix. And so, you look at volume alone contributing 3 points of negativity on the bridge, you can see what volume does. And as a proof point, again go back and look at 2009 through 2011, look what happened when volume came in after we had been effectively restructuring the footprint there, and that's where that 7 points came from. So we are heavily leveraged toward that any way you slice it and that's the main reason for it. Now on the oil and gas side?

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

Yes, so oil and gas is really going to be a low single-digit percentage, Steve. That's not -- that's part of the issue because you don't have large projects, but it is really the derivative, so all the other projects just aren't happening and so it gets labeled with oil and gas.

So let me step back and also add to what Mike was talking about. When I started talking about industrial early in 2016 and I was breaking it down into pieces for you, what I said was that Club Car was about 20% of the business and it was going to be up low to mid single digits, that the aftermarket was about 30% of the industrial segment and that it was going to be up low single digits.

Then I talked about the big machines being down in excess of 20% and some of the small rotary and small air being up slightly for the year, and then some of the other businesses, like the material handling business and the tools businesses, being down mid-single digits for the year.

If I take that and transform that now into what we're seeing in 2016 after two quarters, Club Car, same spot. They are growing in the mid single-digits range and that's on track. The aftermarket piece of industrial is continuing to grow. So you have got solid footing with about 50% of the business. However, when you get over into the other side where I talked about large machines being down 20, as Mike said they are now down 50, so they are down way larger than what we thought.

And even some of the smaller equipment is really much more pressured than I thought it was going to be and instead of being up low single digits, it is going to be down.

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So you really just have a lot of dynamics that are going on there with the industrial business, and to bring it back and wrap it around your question about oil and gas and projects, again it is really the derivative effects for us in most of our industrial businesses, where the large projects just aren't happening and the ones that are happening are much more competitive.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Yes, it is a bit of a Yogi Berra euphemism, but the business will turn when our customers start spending money on these larger plants, and so that needs to happen.

Steve Tusa - ***JPMorgan - Analyst***

Yes, I just don't know of anything like in my sector. I'm not blaming you guys at all. It is what it is. But just outside of -- if you said, hey, it is down 50%, we can look at oil and gas CapEx and that's like, oh, that's obvious. In fact in the market right now, everybody is getting credit for a 50% increase in oil and gas related spending next year, in some instances.

So, I am just -- I don't know what in the economy, other than oil and gas, is seeing 50% year-on-year declines. Even things like big gas turbines out there, big-ticket items, they are seeing -- are certainly not seeing 50 -- maybe 20% declines, not 50% declines. So, I just -- that's the source of my question, you know what I mean?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

There is a spot between small plants and energy production that is a large plant, steel would be great example of that, marine, these are heavy industries that use large machines for air and that's really where we are suffering on that.

Steve Tusa - ***JPMorgan - Analyst***

That makes a ton of sense, then. If it is that derivative type of stuff, that makes a ton of sense. One last question, Middle East you said was down. How much was the Middle East down in commercial HVAC in the quarter?

Sue Carter - ***Ingersoll-Rand PLC - SVP, CFO***

It was down about 14%.

Steve Tusa - ***JPMorgan - Analyst***

Okay, great. Thanks a lot, guys.

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

And Steve, I'm going to add one point. Material handling, if you go back and bridge over a multiyear period, it was 2, 2.5 points of op margin that went away as that business went down 90% or so for us, okay? So, you don't want to look at industrial and hang it all back on a comparison to Atlas Copco on compressors. You want to make sure you understand there is a couple of points of margin there, about 1 point in tools. Currency is a hit, and then you got the volume impact that we talked about on the bridge.

Operator

Andrew Obin, Bank of America Merrill Lynch.

Andrew Obin - ***BofA Merrill Lynch - Analyst***

I guess I won't belabor the industrial business. On transportation, could you just talk as to what you saw in the quarter that your view has changed, because before you were saying how the North American truck cycle was decoupled from the reefer market and it seems like you have changed your view?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Andrew, there's subtleties moving inside that, but the view has always been you're going to see a pullback in North American trailer, as much as 15% in flat TK, and the mix is changing slightly within that, but that is really what's happening for the full year.

Andrew Obin - ***BofA Merrill Lynch - Analyst***

And can we talk about cadence of transportation weakening into the second half, third quarter versus fourth quarter decline, and any preliminary thoughts on 2017?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Q3 will look weak, because the compare was so strong last year that it is the highest of high compares for us there, and then moderates a little bit in terms of the comparisons for the fourth quarter.

But, again, you take the first half of the year and balance it out to flat with no change and marine container being weak and really all the change coming with North American truck and trailer, and a little bit coming, obviously, from APUs with just Class 8 sleeper production being down.

Andrew Obin - ***BofA Merrill Lynch - Analyst***

All right, thank you.

Operator

Thank you. And as we have reached the time allotted for our call, our final question will come from the line of Andrew Kaplowitz, Citigroup.

Andrew Kaplowitz - ***Citigroup - Analyst***

So Mike, you changed your guidance in climate from [4 to 6] to [4 to 5], but just following up on Andrew's question, is the difference really APUs or is it marine or is it Middle East or is it a combination of the three?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

Middle East is much weaker than we anticipated at the beginning of the year, and as you can imagine, it is a large HVAC business, and so the drag on the Middle East is fairly material.

We are seeing some growth in China. That growth was really round shipping product that was booked, but we really haven't seen the pickup in China, per se. If you look at China nonresidential construction, it is still negative, but for the past six or seven months it has been trending up. I think it has gone from negative 17% up to negative 2%, but it hasn't crossed over. We really would have thought at this point we would have seen more a pickup.

The nice thing in China, buildings are built in about half the speed that we see in other parts of the world and our cycle times for delivery can be half of what they are in other parts of the world as well. So if we did see a China recovery on the HVAC side, you need to see that, say, within a six-month period, not a 12-month period, but as you get into July and you're not really seeing the bookings here, it is just a way of really derisking the forecast.

And really, that derisking is the theme coming into the industrial portfolio, too. At this point, if we haven't seen bookings on large machines or bookings on midsized even rotary machines to this point in time, the reality is you just call it lower and it is what we have done. And so, we hope we have got to the bottom of this thing.

Andrew Kaplowitz - ***Citigroup - Analyst***

Mike, that's helpful. And if you look at European transport and refrigeration in general, and FRIGOBLOCK in particular, it seems like it has hung in there quite well. I am sure -- have you seen any changes post the Brexit announcement? What is the outlook for that particular business?

Mike Lamach - ***Ingersoll-Rand PLC - Chairman, CEO***

We haven't had a lot of change relative to Brexit. I think, like a lot of companies, there is a lot of discussion going on, but not a lot of change, and our business really -- UK business is not that big in general. It is more the knockdown effect about what might happen in the region with GDP being shaved in general.

But the business has continued to develop well. It is holding in there and we don't see things turning there as a result of Brexit or other market factors here at least over the next couple of quarters.

Andrew Kaplowitz - ***Citigroup - Analyst***

Thank you, guys.

Operator

Thank you, and that does conclude our Q&A portion of the call. I would like to turn the call back over to Zac Nagle for any closing remarks.

Zac Nagle - ***Ingersoll-Rand PLC - VP IR***

I'd like to just thank everyone for joining today's call. We truly appreciate your participation, and I look forward to meeting all of you in the future and reconnecting with many of you that I have worked with before. Thank you very much and we will be in touch soon.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day.