Lennox International: We Don’t Like The Accumulation Of Inventory

We don’t believe that Lennox International Inc. (LII) is the best stock among those in the growing HVAC industry. The company’s EV/EBITDA is overvalued as compared to other competitors. It trades at 15x, while competitors trade at a median of 11.89. Besides, the company reports much more leverage than most of its peers. Finally, the current accumulation of inventory and accounts receivables may alarm most conservative investors. We will be looking at the stock from the sidelines.

Lennox International

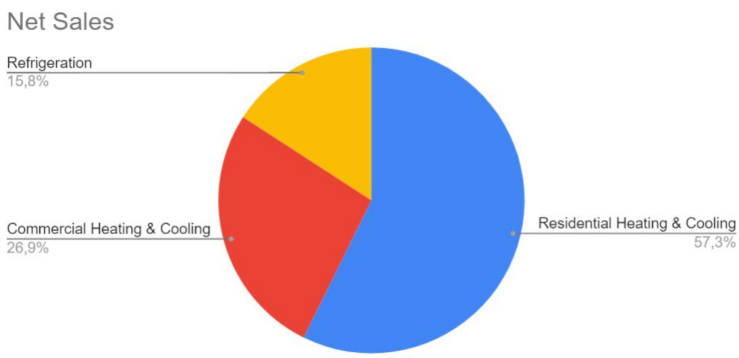
Lennox designs, manufactures and sells solutions for the heating, ventilation, air conditioning, and refrigeration markets.

The company sells under many different brand names, which is useful while penetrating multiple distribution channels. See below some of the company’s brands:

	Brand Names
Residential Heating & Cooling	Lennox, Dave Lennox Signature, Armstrong Air, Ducane, Aire-Flo, Air-Ease, Concord, Magic-Pak, ADP Advanced Distributor Products, iComfort and Lennox PartsPlus
Commercial Heating & Cooling	Lennox, Allied Commercial, Magic-Pak, Raider, Landmark, Prodigy, Strategos, Energence, Lennox VRF and Lennox National Account Services
Refrigeration	*Heatcraft Worldwide Refrigeration, Bohn, Larkin, Climate Control, Chandler Refrigeration, Kysor/Warren, Friga-Bohn, HK Refrigeration, Hyfra, Kirby and Interlink*

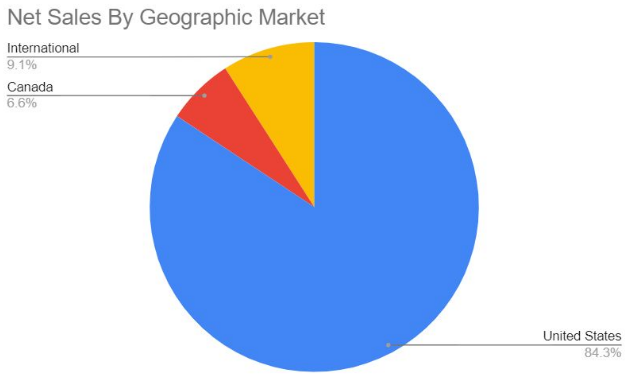
Source: 10-k

Also, notice that the company is quite strong in selling its solutions to the Residential Heating & Cooling and Commercial Heating & Cooling segments, which grow at a larger pace than the refrigeration segment:

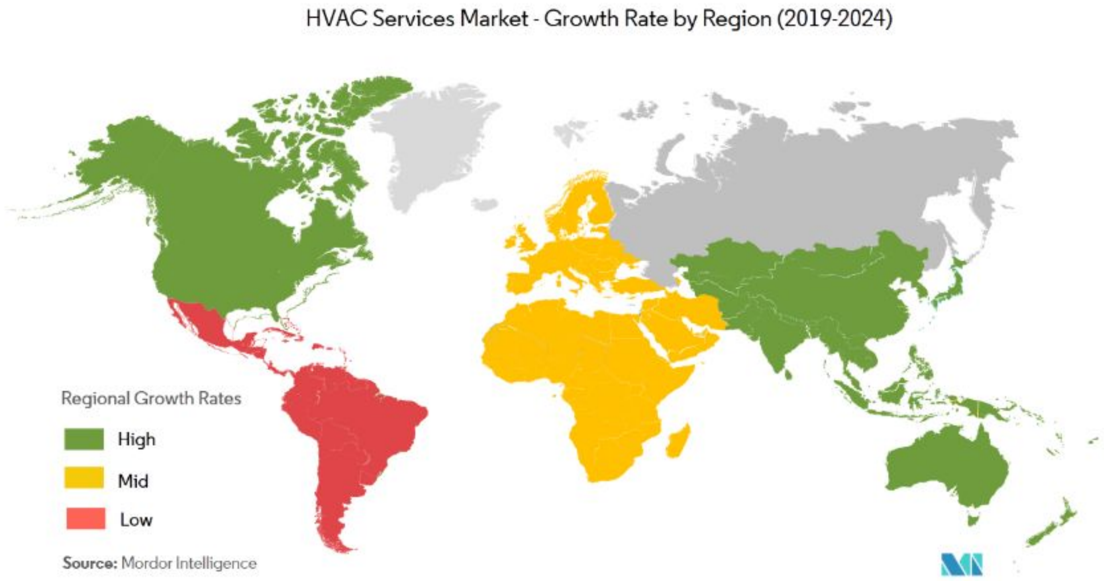


Source: 10-k And Author

On top of it, the company’s sales are generated in the United States, where Mordor Intelligence expects the HVAC market to grow at a high rate:



Source: 10-k And Author



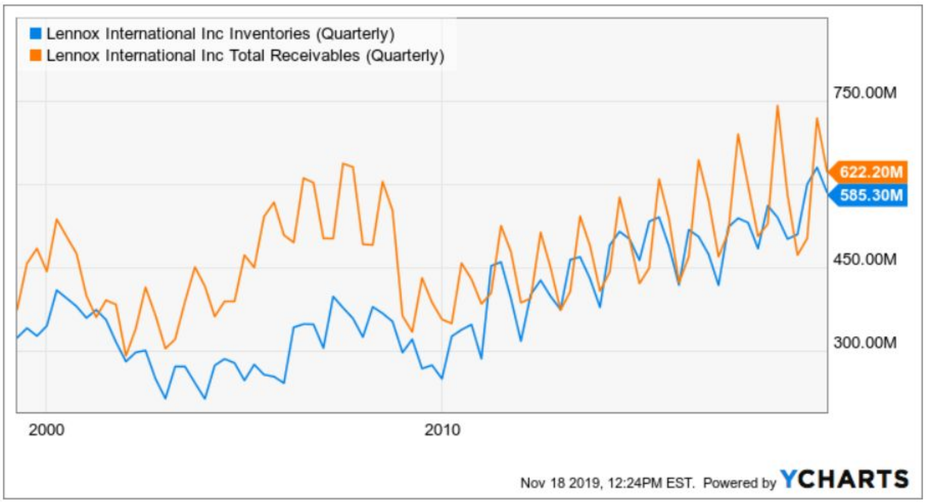
Source: Mordor Intelligence

Before assessing the most recent quarterly report, let's point out the seasonality of Lennox's business model. The company's sales are higher in Q2 and Q3 as summer is the peak season for air conditioning equipment in the United States. As a result, Lennox reports larger CFO in Q3 and Q4 and larger working capital in Q1 and Q2.

Most Recent Quarterly Report: A Comment About Inventory And Receivables

Like other manufacturing businesses, Lennox does not need a lot of cash to operate. In September 2019, the company reported only $46 million in cash. Lennox International works with many distributors and company-owned parts and supplies stores. As a consequence, the most significant assets are accounts receivables, which, in September, comprised of 28% of the total amount of assets. The amount of inventory is also very significant. In the last 10-Q, it represented $585 million, 26% of the total amount of assets.

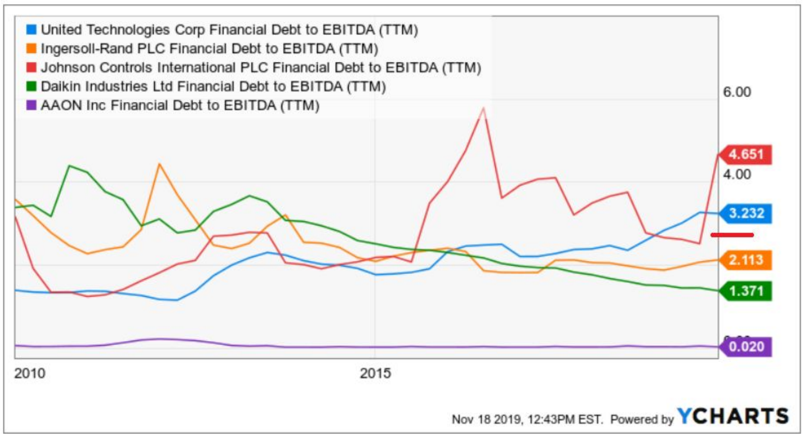
As shown in the chart below, the total amount of accounts receivables and inventories increased to almost the level of the years 2008 and 2009. We don't see this level as a very worrying factor as sales continue to increase. However, conservative investors may not like seeing further growth of these assets. They may believe that the company cannot sell its products anymore.



Source: Ycharts

Financial Leverage May Push The Share Price Down

With an EBITDA of $535 million, current long-term debt of $394 million and long-term debt of $1.056 billion, the debt/EBITDA level is at ~2.7x. The debt level appears to be under control. However, most competitors report less financial risk than Lennox, which may push the company's valuation down. As shown in the chart below, peers have a ratio of 0.02x-4.6x:



Source: Ycharts

Given the company's Debt/EBITDA level, investors will want to know when Lennox may negotiate its debt. As shown in the chart below, $409 million are payable in 2019, and $491 million are payable from 2020 to 2022:

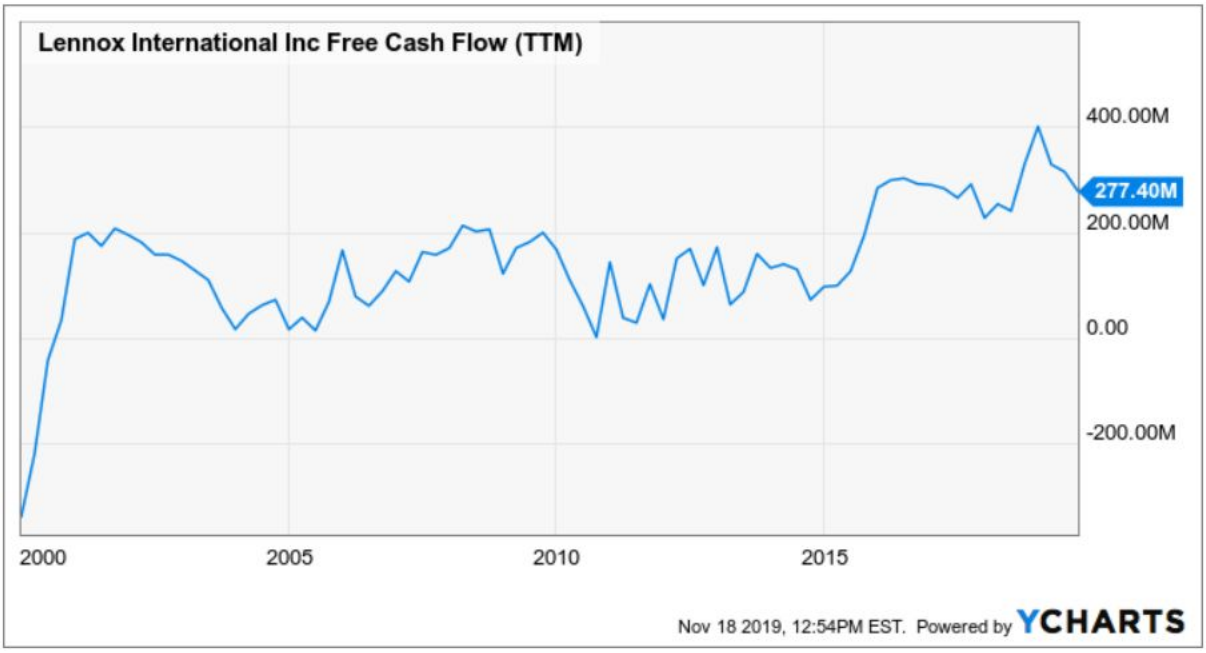
Contractual Obligations

Summarized below are our contractual obligations as of December 31, 2018 and their expected impact on our liquidity and cash flows in future periods (in millions):

	Payments Due by Period				
	Total	1 Year or Less	1 - 3 Years	3 - 5 Years	More than 5 Years
Total long-term debt obligations [1]	$ 1,045.2	$ 301.5	$ 381.9	$ 350.1	$ 11.7
Estimated interest payments on debt obligations [2]	$ 98.3	33.5	43.9	20.0	0.9
Operating leases	159.7	47.4	65.6	30.6	16.1
Purchase obligations [3]	27.2	27.2	—	—	—
Total contractual obligations	$ 1,330.4	$ 409.6	$ 491.4	$ 400.7	$ 28.7

Source: 10-k

With information from the last quarterly report, the company's TTM free cash flow is ~$277 million. In our view, the generation of free cash flow is sufficient to pay the company's contractual obligations. If the FCF continues at the same level, we don't expect shareholders to worry a lot. Also, notice that the company's FCF has been very stable in the last 10 years:



Source: Ycharts

The Company Appears Overvalued As Compared To Peers

With 38.5 million shares at $252, Lennox International Inc. reports a market capitalization of $9.8 billion. As of September 30, 2019, the company reported cash and investments of $48.5 million and debt of $1.45 billion. Thus, the enterprise value is $11.2 billion. Using the company's expected 2020 EBITDA of $703 million, the EV/EBITDA ratio is equal to 15.9x.

Other peers operating in the same sector are United Technologies Corp (UTX), Ingersoll-Rand PLC (IR), Johnson Controls International PLC (JCI), and Daikin Industries Ltd (DKILY). As compared to their EV/EBITDA ratio and Debt/EBITDA ratio, Lennox International does look expensive at 15.93x EBITDA. Peers report a median ratio of 11.89 and average of 11.96. Besides, the company's debt/EBITDA ratio is 2.7x, which is way above that of most competitors:

	EV/EBITDA	EBITDA	Debt/EBITDA
United Technologies Corp	11.89	$13.65 billion	3
Ingersoll-Rand PLC	13.52	$2.37 billion	1.8
Johnson Controls International PLC	10.49	$2.14 billion	4
Daikin Industries Ltd	11.66	$3.69 billion	1.47
Average	11.96666667		
Median	11.89		

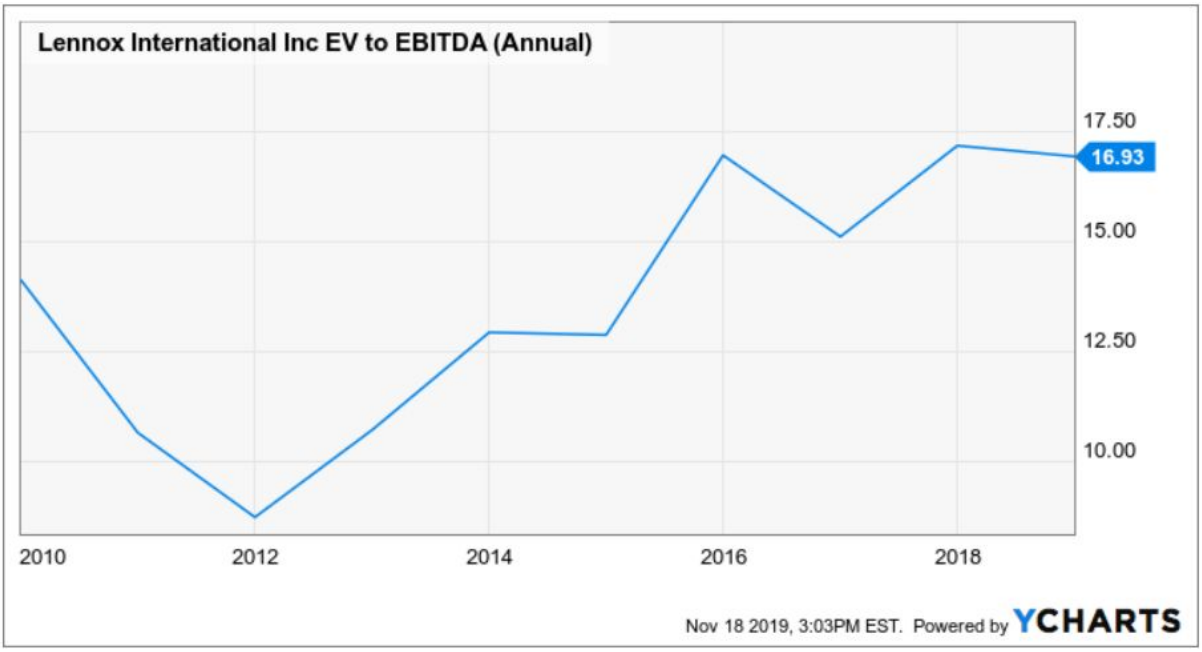
Source: [Ycharts](#) and Author

Why Did The Share Price Go To That Price Mark?

In my view, the company's recent stock buybacks are behind the upward trend in the company's valuation. See below how the total amount of shares went down from more than 64 million to less than 40 million. The share price increase took place after 2010, when the company reduced its share count:

Source: [Ycharts](#)

In line with the previous results, from 2011 to 2012, the company's EV/EBITDA increased from 10x to more than 15x. Changes in corporate valuation are never due to only one reason. With that, it appears very clear that the increase in valuation took place when the company was buying shares in the market:



Source: Ycharts

Insiders Are Selling Shares

In the last 12 months, the number of shares sold by insiders is 1.7x more significant than the amount of shares bought. In the last three months, the ratio is equal to 1.55x. Most investors will see these figures as quite bearish. Note that insiders have many times a lot more information than the market.

Number of Insider Shares Traded

INSIDER TRADE	3 MONTHS	12 MONTHS
Number of Shares Bought	44,795	133,889
Number of Shares Sold	69,896	230,363
Total Shares Traded	114,691	364,252
Net Activity	25,101	96,474

Source: NASDAQ

Market Growth, Company Growth And Risks

According to Grand View Research, the global HVAC systems market is expected to grow at a CAGR of 5.7% from 2018 to 2025. The market expects that Lennox will grow at less than this rate. The sales increase in 2020 and 2021 is expected to be around 2.54-4.99%. The company's EBITDA is also expected to increase to $682-$740 million, which will permit the company to pay its contractual obligations from 2020 to 2021. As a result, we would not expect the company to be in need of a lot of new debt.

	2016	2017	2018	2019 E	2020 E	2021 E
Sales	3642	3840	3813	3784	3973	4074
Growth %		5.44%	-0.70%	-0.76%	4.99%	2.54%
EBITDA	528	579	606	682	703	740
EBITDA Margin	14.50%	15.08%	15.89%	18.02%	17.69%	18.16%
Debt	818	936	995	1 141	1 125	1 115
FCF	270	227	400	319	427	451

Source: Marketscreener

With that, investors should understand that the risk is not low. In 2020 or 2021, if sales and EBITDA decline, the company will require a significant amount of debt. As a consequence, the company's Debt/EBITDA ratio would increase above 2.7x, which could push Lennox's valuation down.

Among different risks for shareholders, we need to highlight changes in environmental regulations. If the government in the United States changes the legislation, the company may have to develop new products or stop the production of certain devices:

"The sales, gross margins and profitability for each of our segments could be directly impacted by changes in legislation, trade agreements or government regulations, such as the changes to taxes, tariffs and trade agreements. Changes in environmental and energy efficiency standards and regulations, such as the recent amendments to the Montreal Protocol to phase down the use of hydrofluorocarbons, may particularly have a significant impact on the types of products that we are allowed to develop and sell, and the types of products that are developed and sold by our competitors." Source: 10-k

Besides, the company's sales depend on the weather. Cooler summers usually push down the company's ability to sell products. Lennox explains the risk with the following words:

"Demand for our products and for our services is seasonal and strongly affected by the weather. Cooler than normal summers depress our sales of replacement air conditioning and refrigeration products and services.

Similarly, warmer than normal winters have the same effect on our heating products and services.” Source: 10-k

Our Takeaway

In the last 10-Q, Lennox International reported a significant accumulation in the amount of inventory and accounts receivables. We don’t believe that the current level is alarming. However, we understand that some investors don’t like these figures. Besides, we believe that the company is overvalued at more than 15x EBITDA . Other competitors report less debt/EBITDA ratio and trade at a median ratio of 11.89x EBITDA. Finally, we saw that the number of shares sold by insiders is larger than the amount bought. To sum up, we don’t think that it is the right moment to buy Lennox International.