

Company Participants

Lynne Maxeiner – Vice President-Investor Relations

Dave Cote – Executive Chairman

Giordano Albertazzi – Chief Executive Officer

David Fallon – Chief Financial Officer

Conference Call Participants

Nigel Coe – Wolfe Research

Andy Kaplowitz – from Citi Group

Amit Daryanani – Evercore

Lance Vitanza – TD Cowen

Jeff Sprague – Vertical Research

Nicole DeBlase – Deutsche Bank

Steve Tusa – JP Morgan

Andrew Obin – Bank of America

Mark Delaney – Goldman Sachs

Operator

Good morning. My name is Lauren, and I will be your conference operator today. At this time, I would like to welcome everyone to Vertiv's Second Quarter 2023 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. Please note that this call is being recorded.

I would now like to turn the program over to your host for today's conference call, Lynne Maxeiner, Vice President of Investor Relations.

Lynne Maxeiner

Great. Thank you, Lauren. Good morning, and welcome to Vertiv's second quarter 2023 earnings conference call. Joining me today are Vertiv's Executive Chairman, Dave Cote; Chief Executive Officer; Giordano Albertazzi; and Chief Financial Officer, David Fallon.

Before we begin, I would like to point out that during the course of this call, we will make forward-looking statements regarding future events, including the future financial and operating performance of Vertiv. These forward-looking statements are subject to material risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. We refer you to the cautionary language included in today's earnings release and you can learn more about these risks in our annual and quarterly reports and other filings made with the SEC.

Any forward-looking statements that we make today are based on assumptions that we believe to be reasonable as of this date. We undertake no obligation to update these statements as a result of new information or future events.

During this call, we will also present both GAAP and non-GAAP financial measures. Our GAAP results and GAAP to non-GAAP reconciliations can be found in our earnings press release and in the investor slide deck found on our website at investors.vertiv.com.

With that, I'll turn the call over to Executive Chairman, Dave Cote.

Dave Cote

Well, these last few quarters have been a lot more enjoyable to report. We had another strong quarter of performance at Vertiv, which positions us very well to achieve our significantly increased 2023 outlook. Adjusted free cash flow, adjusted operating profit, sales and margins all performed very well and operational execution continues to improve. We've raised our full year guidance because of our strong first half performance. We also have the very pleasant effect of a strengthening balance sheet. The data center end market continues to look very healthy, and there is an incremental tailwind from AI coming. And that tailwind should provide additional opportunities over many years for Vertiv because our technology will matter.

A great market position, a great industry where we can differentiate with technology, these attributes are what attracted me to Vertiv over four years ago, and they are truer today than ever. We're obviously pleased with the results, but there is so much more to come. There's a lot of upside, not just in the market and our technology, but also just continuing to fix legacy process issues and building a high performance culture which didn't exist.

Gio and his team are off to a great start, and there is a lot of work left to be done, but it is also [Audio Dip] supports more consistent execution over the long-term.

So with that, I'll turn the call over to Gio.

Giordano Albertazzi

Well, thank you very much, Dave. We saw the positive momentum continuing into second quarter across all key financial metrics. Second quarter sales were up 25% organically, led again by a 48% increase in Americas. We continue to see supply chain improvements and increased resiliency. We saw healthy market demand, which supported the shipment of substantial volume in the Americas region. Orders excluding FX were down just 3% from last year's second quarter better than anticipated, and book-to-bill remained at one.

Despite ongoing order normalization as well as difficult comparison, the market remains healthy. We have also seen an encouraging AI-related activity, and I'll elaborate on this when we cover Slide 6. Our adjusted operating profit was \$251 million, and we saw benefits from our increased volume as well as price cost.

Our adjusted operating profit margin improved 860 basis points to 14.5% as we continue to strengthen operational execution. I am particularly pleased to report the strong adjusted free cash flow of \$227 million in second quarter. We also continue to see the leverage profile of the business improve at 3.1x at the end of Q2 as the balance sheet continues to strengthen. These are early successes and still much more opportunity ahead.

We are raising fairly significantly our full year guidance. And are now expecting sales for the full year to be up 20% organically, AOP at \$950 million at the midpoint and adjusted free cash flow of \$550 million at the midpoint. We are executing our plan to deliver the full year one quarter at a time, and our transformation continues.

We are making meaningful steps forward in our operational execution. We are demonstrating clear traction and there is tremendous value creation ahead. We're not relenting our focus on operational execution, that is what we intend to continue to demonstrate each and every quarter.

So let's now turn to Page 4. A few changes on the market environment slide. First, we moved cloud hyperscale to green in EMEA. Globally, we have seen an acceleration in the cloud hyperscale and colocation market segment in the last 90 days, substantiated by the large amount of incremental capacity that is being planned as well as by the amount of leasing capacity that was signed in this past quarter gigabytes of new capacity.

Our pipelines have clearly strengthened. It is hard to delineate what is AI and what is not. But we know the industry is certainly getting ready for AI, and we have orders in our books and opportunities in our pipeline that are unequivocally for AI infrastructure.

Conversations with cloud and colo players are now around making sure there is available capacity to support a healthy outlook, and we are in discussions with several large and relevant customers on what this commercial arrangement can look like, very encouraging.

As we move to telecom, this area has further weakened in the last 90 days, with some further carving of spent by the major telco carriers. We anticipate the teleco markets remain quiet for the balance of 2023, not particularly worrisome. These patterns are not atypical for this market. We have left the APAC market yellow across the segments. The China market specifically, experienced a slower-than-expected start to the year, not just for us but for most companies. In our current view, we are not anticipating much recovery in China market in 2023, but there are some encouraging signs as we see orders turned positive in Q2 and pipelines are healthy.

No changes in view on enterprise SMB or commercial and industrial. Overall, I'm more encouraged today than 90 days ago, given clear demand signals from the cloud hyperscale colocation markets that support our view for second half 2023 and shape our thinking around 2024.

Let's move to Slide 5. Orders performed better than anticipated, although down 3%, they are coming together stronger than expected, and they were 13% sequentially up from Q1. Book-to-bill ratio of one preserves a healthy backlog. We anticipate orders flat more or less in Q3 and turning positive in Q4.

I know everyone is interested in what AI orders looks like—looked like in the quarter. And candidly, that would be almost impossible to answer with precision. We have seen AI-related orders, I would say, in the tens of millions of dollars. Our customers are focused on AI retrofit rate infrastructure, and we see evidence of this in our pipelines. Many of our products today can be used for either regular density or high density applications, and we won't be able to report out a discrete AI number.

For example, most AI viewed today are still being air cooled, perfectly served by the traditional Vertiv portfolio. Over time, a part of these loads will transition to liquid. And here too, we are uniquely positioned, liquid to remove heat from the server and the rack, but removal of the heat doesn't stop outside the rack. You need to remove the heat from the data hall, and we have a portfolio of solutions to do just that.

As I say, we are seeing clear demand acceleration signals from the market, and we are having conversations with very relevant market players, around securing capacity and not just over the next few quarters, but well into 2024 and beyond.

Let us transition to supply chain. We see improving the environment but there are two parts to this story. First, supply chain continues to incrementally improve. No doubt, lead times are gradually reducing, and there is more certainty in supply. The second part is the self-health part. We have been vocal about our multisourcing programs. One of the most important architects of this ongoing supply chain resilience program, Paul Ryan, is now our leader of global procurement. He is not new to me or Vertiv. He has been with us over a decade and has more than 25 years of experience and a strong track record operational execution combined with very clear strategic vision. Supply chain resilience is key considering the demand waves that may be ahead.

Let's now talk capacity. We have been investing in capacity for a few years in a balanced approach across the globe. [Audio Dip] the focus is on utilizing and coordinating capacity globally. We have recently announced a new role in the organization, Executive Vice President, Manufacturing, Logistics and operational excellence with Anders Karlborg leading the effort. Over the last five years, Anders led Vertiv's operations in Asia, EMEA and finally, Americas. In the Americas operations over the past year, specifically, we have seen significant improvements. He's the right person to take the organization to the next level on process and operations improvement as well as company-wide deployment of all Vertiv operating system. Our ability to navigate strong periods of growth in a complex environment continues to improve.

Let's talk about inflation. While inflation is trending a bit more favorably than anticipated, a couple of dynamics influence the second half of 2023. First, metal prices were at lower levels in Q3 and Q4 over the last year. So as we lap that comparison, we're experiencing year-on-year inflation, a bit higher— a bit higher in the second half. We also anticipate when the Chinese economy accelerates, that increased demand could cause additional inflationary pressure on commodities. We have seen a favorable tailwind from price cost with good processes in place that better prepare us for volatility related to our input costs.

Let's go to Slide 6. We believe AI will increase our overall TAM. AI is a reinforcement of demand trend and AI workloads are incremental to new applications. They aren't in general, replacing other applications in our digital economy. We expect growth in both high density and general compute. This benefits all Vertiv technologies. We believe liquid cooling is not a displacement risk and in fact, is additive to growth for Vertiv. Before liquid cooling, we would take the heat from it outside the rack to outside the data center building. With liquid cooling,

it's additive. We reach out into the rack and get one step closer to the heat generation point while still controlling all parts of the heat rejection.

The infrastructure transition to AI, high density environment will be complicated and likely involve hybrid approaches to technology deployment. It is very likely a data center will need both liquid and air cooling orchestrated tightly together to optimize the data center environment. We do very well with that approach with the widest portfolio of thermal technology available, deepest domain expertise on how to orchestrate these technologies using our advanced control systems.

Hence over 3,500 field service engineers across the world to support the deployment and maintenance of the infrastructure. We have the scale and the ability to increase capacity. And I hope – and I believe you can sense my excitement. Much more to come on high density AI at our Investor conference in November, but feel very well positioned for this opportunity.

With that, over to David.

David Fallon

Perfect. Thanks, Gio. Turning to Page 7. This slide summarizes our second quarter financial results. As you can see strong financial performance across the board, starting with [Audio Dip] from last year. 9% of that was from pricing and 16% from volume with most of that volume benefit in the Americas, highlighting the continued supply chain and operational improvements in that region, which has been a pillar of our turnaround over the last 18 months or so.

Adjusted operating profit of [Audio Dip] quarter and adjusted operating margin of 14.5% improved 860 basis points of which 610 basis points was from higher variable contribution margin and 250 basis points was from fixed cost leverage. Adjusted operating profit was \$61 million higher than our prior guidance. \$45 million from higher pricing, \$25 million from incremental volume and \$15 million from lower than expected inflation with these tailwinds partially offset by headwinds from foreign exchange and investment in fixed costs primarily from restructuring and incentive compensation.

Higher than expected pricing was driven by higher volume, favorable regional mix and some conservatism for potential pricing headwinds that did not materialize. Inflation was not as bad as we expected as commodity costs, including metals that declined from the end of the first quarter, likely influenced by a slower than expected rebound in the Chinese economy.

Next on this slide and very proudly, we generated \$227 million of adjusted free cash flow in the quarter, an impressive \$460 million higher than last year's second quarter. While there's still a lot of work to do to optimize working capital, our second quarter is reflective of our focus on cash and indicative of the cash generation potential of this business when we do control working capital, which increased just \$5 million in the second quarter, despite a \$213 million increase in sales from the first quarter.

Now, the second quarter number was aided by some favorable timing tailwinds, and we should not expect free cash flow to be 130% of adjusted net income each quarter, but it shows we have made significant strides towards unlocking the cash generation potential of this business, while funding organic growth.

Last on this slide, net leverage decline to 3.1x at the end of the quarter and is expected to be approximately 2.3x by year end. Well within our previously communicated target leverage range of 2x to 3x times. It was only a few months ago that we were being labeled by some and likely discounted from a multiple perspective as highly levered. We argued at the time that it was pursuant to a mechanical calculation in just a matter of timing. Well, I think we were proven correct as our year-to-date performance has now driven that mechanical calculation towards what we believe to be the practical reality.

Turning to Page 8. This slide summarizes our second quarter segment results. The Americas region continues to show strong year-over-year performance with organic net sales growth of 48%, including 35% from volume and 13% from pricing. Adjusted operating margin improved 12.3 percentage points on the strength of price cost, fixed cost leverage and notably improved operating results from E&I.

APAC top line continues to be influenced by slower than expected recovery in China, volume was relatively flat, our organic growth was driven by incremental pricing. Adjusted operating margin declined 100 – about

100 basis points from last year. And that was primarily driven by approximately \$6 million of restructuring costs in the quarter. We do anticipate sequential quarterly sales growth in APAC in the third quarter, but we have reduced our full year projection from our prior guidance now expecting a full year low single digit growth.

EMEA grew organically 9% in the second quarter, almost entirely driven by pricing. We expect third quarter sales in EMEA to be down slightly from the second quarter with a significant increase in the fourth quarter and full year growth expected to be in the upper single digits. EMEA continues to impress from an adjusted operating margin perspective, hosting 26.6% for the second quarter, 870 basis points higher than last year with this increase primarily driven by price cost and fixed cost leverage.

Finally, on this page, corporate costs were \$21 million higher than last year, driven by higher restructuring and incentive compensation costs and an incremental \$5 million loss on foreign exchange. Based on the current guidance, we anticipate these incremental costs at our corporate entity to flow through for the full year and we expect second half corporate costs to be consistent with the first half.

Next, turning to Page 9. This slide summarizes our third quarter guidance. As a reminder, we have anticipated a more stable quarterly sequential sales cadence as we perceive through 2023. For this reason, our third quarter guidance looks largely consistent with our second quarter in absolute terms. We have included provision for sequential increases in both pricing and inflation in the third quarter and sequential headwinds from foreign exchange, including \$15 million on sales and \$5 million on adjusted operating profit.

Moving to Slide 10 our full year guidance. We are raising our projected top line by \$285 million, primarily driven by higher expected sales in the Americas, partially offset by lower expected sales in APAC with EMEA consistent with prior guidance. We are raising our 2023 adjusted operating profit guidance by \$150 million, \$60 million from the second quarter beat and \$90 million in the second half. This increase translates into 170 basis point increase in our expected adjusted operating margin to 14%. And while we have not explicitly provided fourth quarter guidance, math suggests we exit the year at 15% edging closer to our intermediate term target of 16%, which should provide good momentum transitioning into 2024.

And finally on this page, we are increasing our full year adjusted free cash flow guidance by \$200 million at the midpoint to \$550 million. This is an \$810 million improvement over last year and demonstrates momentum not only with our drive for profitability, but also with our management of working capital.

Before I hand it back over to Gio let me front run some potential questions on our adjusted free cash flow guidance, which implies approximately \$300 million of free cash flow in the second half, which is \$150 million lower than our second quarter number multiplied by two.

The primary driver of this variance is timing. Timing for both CapEx and cash taxes, which are normally back half loaded, and this year is no exception. These two items explain approximately \$130 million of the \$150 million variance. The remainder is driven by higher use of cash from trade working capital as we prepare for strong anticipated demand in 2024 and that being partially offset by higher projected EBITDA and lower cash interest.

So with that said, I turn it back over to Gio.

Giordano Albertazzi

Well, thanks a lot. As Dave said earlier, great quarter, there's still a lot to do. In February – in our February call, I went through the focus areas for 2023, creating a high performance culture where ownership is clear and we hold ourselves accountable for the results, constant focus on things that matter and executing, relentless focus on execution. At the halfway mark of 2023, we have made progress. Innovation and technology continue to be a key differentiator for Vertiv. And with our ongoing investment in this area, I'm very encouraged by our roadmaps for R&D and technology development. I believe you will see this momentum building and differentiation further distinguished Vertiv as the partner of choice in critical infrastructure.

I continue to travel around the globe visiting customers, Vertiv locations and key industry players. I'm more excited today than I have been in the last 25 years with this great organization. I can feel the energy, the momentum building in our business, in our industry. It is tangible. This traction is not easy to translate in words, but you are starting to see the transformation taking hold, deepening and becoming Vertiv's DNA.

So the takeaways. Strong first half supported by continuing improvement in operational execution, a healthy market, momentum continuing, in fact, increasing with AI tailwinds. We are raising our guidance across all financial metrics and especially pleased to be raising our adjusted operating profit guidance to \$950 million at the midpoint. This indicates a healthy second half and a great foundation for 2024.

An important reminder, Vertiv Investors Conference on November 29th at the New York Stock Exchange, so I truly hope you can join us and make sure you mark that in your calendars.

With that over to the operator.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question comes from Nigel Coe from Wolfe Research. Nigel, please go ahead.

Nigel Coe

Thanks. Good morning, everyone. So November 29th is in the calendar, no problem with that. Great. So obviously a lot to go through. One thing you mentioned Gio was the AI stroke GPU retrofit opportunity. And we don't often think of retrofit activity in a data center. So just maybe just run through sort of what you're seeing today and sort of how impactful do you think this could be at Vertiv. And maybe just talk about how important your service organization can be if we do start seeing material retrofits?

Giordano Albertazzi

Yes. Two aspects to this Nigel, thank you for the question. There is certainly kind of a non-retrofit, new market, new data center, and it's a place this one where our service organization becomes absolutely critical in our ability to partner with customers everywhere in the world. Not all the players, specifically the liquid part of the thermal spectrum have this ability to reach out everywhere as we are. And we have demonstrated that. And our numbers prove that as I was saying, 3,500 service engineers globally.

But the other is, we see it today and we talk with customers today and they say, not only do we have to think about liquid cooling, but the thing that we have to think about is a hybrid environment to probably in the initial build that has more traditional server cooling. So there needs to be an ability to retrofit over time because sites will hybridize and be enable that and then being there with our customers to execute on that retrofit is, again, fundamental. And that retrofit is not just the rack itself or the row, but is the ability to interconnect and balance it with the rest of the existing thermal system.

But think about the stock of data center that exists in the industry today. It's really hard to believe that that part will not be hybrid in and of itself. And that's what we hear, that's what we hear today. Today we hear people saying, hey, we are already today sometimes having AI enabling high density racks and we air cool them, but that sounds easier said than done. Then you have to balance, of course, the cooling in the hole, but at the same time that very same retrofit can be a liquid retrofit eventually. And again, the same problem exists even more complicated, if you will, than with an infrastructure that was thought for future retrofit. Hopefully I answered. Could be very long, I will avoid.

Nigel Coe

Yes, yes, a lot there. I mean, it sounds like it could be quite a mature opportunity.

Giordano Albertazzi

It's an opportunity. We don't have exactly a figure on that.

Nigel Coe

Okay. No, we'll come back to that. On the pricing, so I think it's 9% in the quarter, I think, 7% in the third quarter. Maybe, David, what's in your fourth quarter for pricing? And then what would be a reasonable

outlook for pricing in 2024? Iâ€™m assuming weâ€™re going to be down to a more sort of normal range. But Iâ€™m just curious if you still continuing to push price real time.

Dave Cote

Yes. From a quarterly cadence perspective, pricing, 9% first quarter, 9% second quarter, 7% in the third quarter and 5% in the fourth. So full year \$420 million [ph]. Itâ€™s up about \$120 million from our prior guidance, and itâ€™s probably too early at this point to comment on 2024 pricing. But we should have a nice tailwind heading into next year.

Nigel Coe

Great. Thanks very much.

Operator

Thank you. Our next question comes from Andy Kaplowitz with from Citi Group. Andy, please go ahead.

Andy Kaplowitz

Hey good morning, everyone.

Dave Cote

Good morning.

Andy Kaplowitz

Gio, you said itâ€™s difficult to discern AI versus not AI in your markets. But as you said, your pipeline of opportunities seems to have increased in the last 90 days, and you turned EMEA cloud hyperscale to green. So is there a way to quantify how much bigger your pipeline is that is feeding into the expectation of flat bookings in Q3 and not modestly in Q4? And then just stepping back, would you say AI contribution and orders is coming earlier than you expected in 2023?

Giordano Albertazzi

Well, the acceleration of pipeline that I referred to in my â– when we were going through the slide is a specific to industry â– sorry, to region and customer really. So it varies, but acceleration it is. How big? It is, again, part of a wave of demand, as I explained, this is additional demand, and it is additional demand that will probably drive also the more traditional type of loads and compute further up. Specifically the comment about EMEA is that we start to see this effect hit EMEA as well. And anyway, we wanted to send the message that we see acceleration on colo/cloud across the board because of AI.

How big, exactly? Again, itâ€™s premature to say. The market is moving. I would say itâ€™s hard to distinguish what is AI and what is not, but we know that some technologies, specifically for high-density, specifically for GPU. And that is a little bit earlier to track. But we know that there are a lot of traditional technologies, a lot of traditional technologies that are there to enable AI as well. And thatâ€™s true for the power part of our portfolio and for the thermal part of our portfolio.

Andy Kaplowitz

Thanks guys.

Giordano Albertazzi

Thanks.

Dave Cote

Thanks, Andy.

Operator

Thank you. Our next question comes from Amit Daryanani from Evercore. Amit, please go ahead.

Amit Daryanani

Thanks for taking my question and congrats on a nice print. Gio, I was hoping you could just talk a little bit more about when it comes to cooling AI clusters, liquid cooling clearly becomes a more important thing, especially in higher densities. But there seems to be multiple ways that you can use liquid cooling, direct-to-chip is something you folks do, but I think there's immersion and other forms of it. So from your perspective, do you think Vertiv strategy would be to have a broader liquid cooling solution across different formats? Or would you want to focus more on direct-to-chip? And then as it comes to— as it relates to these air clusters, can you just touch on what do you think your economics look like versus the corporate average?

Giordano Albertazzi

So— I want to reiterate the message that I had when I was going through the slides is that when we talk about liquid cooling here, we really talk about how we extract heat from the heat generation point, i.e. the chip to outside the server outside the rack and into the data hall either way or not [ph]. This is the novelty. This is the new part. As I was saying, actually, there are three ways to make that extraction. A, continue to do it through air. And we have seen air cooled racks going all the way to north of 40 kilowatts per rack density. But clearly, at a certain stage, as one of our slides was explaining, at a certain stage, liquid kicks in. Liquid kicks in form of immersion or direct-to-chip. We have both in our portfolio. And also we're partnering with people that handle both. But the fact is we think— we believe that the main technology going forward when it comes to liquid is really direct-to-chip. But again, it is certainly a portfolio approach that we're taking.

Amit Daryanani

Got it. And then, I guess, how do you think about the economics with these clusters versus corporate average? I imagine it's more complex with higher ASPs. But I would love to know if you think that a, that's fair and then how does it flat or operating margins and so on as well?

Giordano Albertazzi

Well, it's a bit a lot of detail and also premature for those details. But I go back to the point I made at the beginning, we see this as additive. So it is another technology. We did not participate in the heat sync or extraction of the heat from the server. Now we started to participate also in that part of the equation. So a bit premature, but I want to make sure we understand that is something an addition for us. But that absolutely dovetails in what...

Operator

Thank you. Our next question comes from Lance Vitanza with TD Cowen. Lance, please go ahead.

Lance Vitanza

Thanks guys for taking the question. My question is with leverage down to around two times at the end of the year, you're about a year ahead of where we thought you'd be. And it seems to me that two times is low enough and that free cash flow in 2024 should be directed back to shareholders. Can you discuss your thoughts on that idea and would you favor increasing the recurring dividend or a share buyback or perhaps other vehicles? How are you thinking about the return on capital? Thanks.

David Fallon

Yes. First, let me say, it's very nice to have this conversation, because we couldn't have asked this a year ago. So at this point, we're going to get through this year. And we will share in our investor conference our further thoughts on capital allocation. We certainly are participating in industry where there should be plenty of growth, and there's probably plenty of opportunity to continue to reinvest in the business, but we do recognize that we will have to make some strategic decisions with what to do with some excess cash. I think as we said

previously, we do believe there are some accretive strategic acquisitions out there. That is probably something we would look at first, but we'll be able to give a lot more detail in November.

Lance Vitanza

Thanks very much.

Operator

Thank you. Our next question comes from Jeff Sprague from Vertical Research. Jeff, please go ahead.

Jeff Sprague

Thank you. Good morning everyone.

Giordano Albertazzi

Good morning, Jeff.

Jeff Sprague

Nice quarter. Good to see. I wanted to pick up on sort of the exit rate there on the margin and David, thanks for doing that math for us. We had done it, but I'm glad you pointed it out. And really, the – I guess the question is if we go back to that original algorithm before kind of the missteps to 18.5 months ago – 18 months ago or so, we were thinking about operational improvement, being better on price execution, the internal execution and the like. I just wonder if you could update us on all of those levers really, particularly kind of the internal operational opportunities that you see. And I would suspect we're in a strong enough demand environment that you would expect to be able to remain price cost positive for the foreseeable future, but I wonder if you would agree with that or how are you thinking about kind of the price cost lever inside the margin trajectory from here?

Giordano Albertazzi

Maybe I can start with a little bit of the three points we were talking and we're asking about Jeff, price, cost and execution. I mean this is something we've been absolutely vocal about in the last three calls, as a matter of fact, this included. Certainly, a lot of price efforts and successful execution, as David explained also our outlook. But what is most important is our price cost. When we were talking about price, I was vocal about the fact that we have now a muscle that we did not have before, and that has helped a lot to rebalance back to position, let's say, pretty big inflation position.

When it comes to the cost side of the equation, we have a lot of focus on efficiency, be that in manufacturing execution, be that in procurement. And there is still potential – there's still potential in general. Execution in particular, is true across the organization, across the organization. But I can point particularly to the execution that we have started to drive in the procurement and manufacturing and ability to ship, that has certainly characterized and accelerated our ability to deliver on a strong backlog, we enter 2023 with. So we will have time in November to go to more details of exactly what are the access of this acceleration. But I was vocal about our eternal promotion of Paul and Anders as a further step in the direction that is testament to the fact that we are not done yet. And that's very good news. I don't know if you got.

Jeff Sprague

Yes. No, it is. I wonder if you could maybe give us some perspective on incremental margins. So trying to kind of pull all that together. So we kind of say we're not done in 2023, but we've kind of pulled out of the big hole and or something maybe approaching normal, not quite there. But as we look into 2024 and beyond, what would be kind of a reasonable kind of incremental margin construct for us to have in our head?

Dave Cote

Yes. I think the easy answer is higher. But if you look at where we were last year – and we've disclosed this in the past. We were probably in the low 30s from a variable contribution margin perspective. We're in the upper 30s at this point in time, let's call it, the mid- to upper 30s. So if you look at the projected 600-plus basis

point increase in operating margin this year versus last year, about \$400 million of that is related to the variable contribution margin; and \$200 million is related to fixed cost leverage. And I definitely don't want to discount the power of the fixed cost constant methodology and culture, that should continue to provide upward momentum on the operating profit.

So as we've consistently said, 16% has been our intermediate term goal. We have high confidence of getting there for sure, but we're not celebrating. Our long-term goal is 20% and higher. But to get to that level, Jeff, to your question, we're going to have to continue to improve with the contribution margin while also incorporating that fixed cost leverage philosophy.

Jeff Sprague

Great. Thanks for the insight. Appreciated.

Operator

Thank you. Our next question comes from Nicole DeBlase from Deutsche Bank. Nicole, please go ahead.

Nicole DeBlase

Yes, thanks. Good morning guys.

Giordano Albertazzi

Good morning.

Nicole DeBlase

Can we just start with enterprise demand? I know you didn't change the bubbles in the market outlook, but what are you seeing on that front? I know this has been kind of like a watch item year-to-date.

Giordano Albertazzi

Nicole, not much really to add to what we were saying. We continue to see that demand fairly, fairly stable. The technology continues to be evolving for everyone in the industry, and that's not just a colo, hyperscale. But again, not a lot to elaborate upon here. We see – we've seen some stability in that space.

Nicole DeBlase

Okay. Thank you. And then the EMEA margins, obviously, pretty big step-up this quarter. How are you guys thinking about the sustainability of that level of margins into the second half of the year? Thank you.

Giordano Albertazzi

I would say that we have done a very, very good job operationally in terms of positioning ourselves in the market with our technology and with our total cost of ownership story. So we are strongly positioned in EMEA altogether.

Operator

Thank you. Our next question comes from Steve Tusa from JP Morgan. Steve, please go ahead.

Steve Tusa

Hi, congrats on the free cash flow.

Giordano Albertazzi

Thank you.

David Fallon

Thank you, Steve.

Steve Tusa

Why— just pick one, then I have a follow-up. But why do you guys have the inflation, the material, freight and labor inflation ticking up quarter-to-quarter from 2Q to 3Q? Is that something to do with the comp from last year or something?

Dave Cote

Yes. So there's three components to the inflation story. You have the material inflation, which is a \$110 million headwind for the full year. Yes, you have actually a benefit in freight of about \$40 million and labor is about \$100 million. The benefit from freight is definitely front-end loaded. So of that \$40 million, probably \$30 million of it is in the first half, which provides an actual tailwind as you look at the second half versus the first half. In addition, we do see an uptick in labor inflation, partly because of the timing of pay raises, but also related to a foreign exchange dynamic in Mexico where we have some of our labor. So I would say those are probably the two most significant dynamics. It's pretty much just front half, back half dynamics in both freight and then also labor.

Steve Tusa

And then can you just help reconcile it? It just seems like the other guys, the other peers you compete against their orders are trending better than you guys on a year-over-year basis? I know there's some difference in portfolio, there's some lumpiness. Do you guys feel like you're being selective? Or you're kind of holding your own in these bids for now?

Giordano Albertazzi

So there are two elements here. One is the normalization that we've been vocal about in the last two calls and this will continue. So that's a very normal, very healthy situation we're in. We certainly have very strong comparisons. This is certainly true. And we see pipelines growing. So— I am positive about the trajectory we're on. I can't speak for other players.

Dave Cote

Base period of comparison.

Giordano Albertazzi

There is an element, exactly. Exactly. So if we go back to the beginning of the year, we were saying, Hey, we are at \$4.8 billion backlog, and we are likely going to shrink that, and we're going to probably consume this backlog. So here we are halfway through the year, that has not been the case. So we positively surprised by that. We have a book-to-bill one. But and if we look at our book-to-bill on the 12 trailing months, then we are at 1.1. So there are multiple ways to look at this. And I recommend we don't just take things to their face value, but we double-click on what's really behind.

Steve Tusa

Yes, great. And then just one last one. On this new technology around cooling and just the proliferation of these AI related data centers. Do you feel like you're going to need to at some point go and do invest more, whether it's through acquisitions or through technology at some stage to kind of bring more in-house? Or it's more steady as she goes as far as partnerships and developing internally? Is there a certain— is there some sort of acquisition that you feel like you'll end up doing when you get better visibility on what the format is?

Giordano Albertazzi

This technology is still at a very early stage. And as every technology at an early stage— you're looking at the opportunities through multiple lenses. One is the organic lenses, and we're certainly investing a lot, but we have partnerships as well. So there are multiple opportunities out there. We'll really see and the— with a stronger

balance sheet as well – will be focused on understanding exactly what's the best path going forward as the market matures.

Steve Tusa

Great. Thanks a lot.

Operator

Thank you. Our next question comes from Andrew Obin from Bank of America. Andrew, please go ahead.

Andrew Obin

Hey guys. Good morning

Giordano Albertazzi

Hey Andrew.

David Fallon

Hey Andrew.

Andrew Obin

Hey hi. Just a question. What are typical lead times for thermal management products at this point, i.e., if data center owners are planning to buy these GPU chips, what lead times are you quoting for the related thermal products?

Giordano Albertazzi

Well, that really depends on the customer request, of course, but in this moment, we have changed a lot from a situation in – from the situation in which we were in 2022. As we explained during the last earnings call, where we were out of the 50, 60 weeks lead time to much lower levels to the 30, 40 weeks and down from there further. So really what requested lead times we get depends on the strategy of the various players. And do not think necessarily, if I may suggest that it's the exact concatenation of when do I get the chip or the GPU, and when I need the infrastructure because the two things go in parallel and very often, the infrastructure comes first.

So you will see probably some earlier infrastructure demand. And when the book or the chips will be available for AI. But it's customer specific. For what we are concerned, we have moved down the path of shortening our lead times and now we're able to serve the market with much shorter lead times than we did a year ago, and indeed three months ago. That's exactly good.

Andrew Obin

And maybe just a follow-up, and I'll echo Steve's comment on cash. Could you give us some update, just more color on internal changes that you're making to improve cash – changes on how you bill payment terms, down payments? Just any color about sort of nuts and bolts of moving the needle there. Thank you.

David Fallon

Yes. I think your words, nuts and bolts probably is a pretty good description. We are similar to what we did from an operational perspective, notably in the Americas is we are really getting into the basics and focusing on day-to-day execution. And we have a lot stronger visibility, transparency with where we are with particular payment turns with every customer. We get daily updates as it relates to inventory. And probably most importantly, we have a plan that we are executing against.

So I would say there's been some early successes but there still is a ton of opportunity out there. And this is – was a focus as we exited last year, probably started in force mid last year, but it's also a huge cultural aspect. So

when we talk about drumbeat and when we talk about financial metrics, we generally start with cash at this point in time. So we're encouraged with where we are, but not satisfied. There's still a lot of work to do.

Andrew Obin

Great. Thanks so much.

David Fallon

Thank you.

Operator

Thank you. Our final question comes from Mark Delaney from Goldman Sachs. Mark, please go ahead.

Mark Delaney

Yes. Congratulations on the strong results and thank you very much for taking my question. The company had been expecting backlog to get worked down a bit this year as lead times normalize. But book-to-bill, as you mentioned, has come in at 1.0, approximately for both 1Q and 2Q. So given the upside in orders you've seen in the first half of the year, can you share your latest views on how you expect backlog to trend? Do you still think that comes down a bit this year? And then on a related topic, given the better than expected demand, do you think you need to put any more manufacturing capacity in place to support that?

Giordano Albertazzi

Yes. Well, thanks a lot for the question. So when it comes to the backlog, we have — it planned for orders that sees our orders in Q3 and Q4 sequentially increase. And we'll see what the backlog does exactly. We still are in an unusually big backlog situation, given our historical trends and the historical trends in the industry. We were north of 70% coverage. We believe that anything above 50% is a good place to be. But yes, let's see how things unfold in that respect. Certainly, the pipeline strength is something that is encouraging in that respect.

Mark Delaney

And just operationally in order to support the backlog, do you need to put any more capacity — that you've got to see the facilities you need?

Giordano Albertazzi

Well, we do have capacity. As I explained, we have increased — invested in capacity in the last 12, 18 months. We are certainly extracting more capacity from what we have. We've been vocal many times about our vertical operating system, and that certainly is a big enabler for more capacity out of our current footprint. But we are very focused and very keen on building scenarios as to what exactly will happen. So we will move early if needed when we see that — there is an imbalance between the potential demand and our available capacity.

Mark Delaney

Understood. Thank you.

Giordano Albertazzi

Thank you.

Operator

Thank you. This concludes our question-and-answer session. I would like to turn the conference back over to Giordano Albertazzi for closing remarks.

Giordano Albertazzi

Well, thanks a lot. Again, a good first half and looking forward to our second half and looking forward to meeting you all in November.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.